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

30 August 2012

ABOUT THIS DOCUMENT

- This document represents our draft determination following an audit investigation into changes in NIE T&D's[1] capitalisation practice. We also propose a financial adjustment for the asset disposals issue, which we highlighted in Chapter 17 of our RP5 draft determination[2].

- In our RP5 draft determination we explained that we intended to investigate NIE T&D's accounts in relation to a change in capitalisation practice. The reason for doing this was to determine whether or not any of the outperformance that was claimed by NIE T&D had simply resulted from this change in the capitalisation practice, rather than from genuine efficiency savings.

- This document contains information on:

    - the regulatory rules that applied during both the RP3 and RP4 price control periods[3];

    - the results of an investigation into the change in capitalisation practice by our consultant auditors; and

    - the actions we propose to take to protect customers' interests by making sure that they do not pay twice for the services provided by NIE T&D, because of this change in capitalisation practice.

- We welcome comments from all stakeholders on this draft determination. This document does not pose specific consultation questions. Instead, we invite comment on any aspect of the document or related matter.

- Our preference is for responses to be submitted by e-mail, although hard copy responses are also acceptable.

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[1] Northern Ireland Electricity Ltd owns, maintains, plans and develops the transmission network in Northern Ireland. It also owns, maintains, plans, develops and operates the distribution network. The company is referred to as NIE T&D throughout this document.

[2] http://www.uregni.gov.uk/uploads/publications/RP5_Draft_Determination_-_Main_Paper_19-04-12.pdf

[3] The RP3 price control covers years ending March 2003 to March 2007 inclusive. The RP4 price control covers years ending March 2008 to March 2012 inclusive.

- Responses should be received by 5pm on Thursday 27 September 2012. They should be addressed to:

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- Individual respondents may ask for their responses not to be published (in whole or in part), or for their identity to be withheld from public disclosure. In either case, we will ask respondents to supply us with a redacted version of the response that we can publish.

- As a public body and non-ministerial government department, we are bound by the Freedom of Information Act (FOIA) which came into effect in January 2005. According to the remit of FOIA, it is possible that certain recorded information contained in consultation responses can be put into the public domain. Hence it is now possible that all responses made to consultations will be discoverable under FOIA – even if respondents ask us to treat responses as confidential.

- It is therefore important that respondents note these developments and when marking responses as confidential or asking responses to be treated as confidential, should specify why they consider the information in question to be confidential.

- This document is available in alternative formats on request.

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1. EXECUTIVE SUMMARY

Introduction

1.1 This document represents our draft determination following an audit investigation into changes in NIE T&D's capitalisation practice. We are also proposing to make a small financial adjustment in relation to the company's asset disposals.

1.2 For the RP4 price control, NIE T&D was given an operating cost (opex) allowance. Under the rules, if NIE T&D actually incurred less operating costs, it was entitled to keep the difference in full. This is known as outperformance. NIE T&D was also allowed full recovery of its actual capital expenditure (capex). This largely reflected the proposals that NIE T&D had made to the Utility Regulator for RP4 (referred to as the 'composite proposals') and which the Utility Regulator accepted in its final RP4 determination. This proposal contained the statement that: "*For regulatory purposes actual expenditure is recovered either via the RAB (regulatory asset base) over 40 years or via the opex allowance* ***but not through both***" (emphasis added).

1.3 During the last two years of RP3, and after the Utility Regulator had indicated its acceptance of NIE T&D's proposals for RP4, NIE T&D changed its capitalisation practice in regard to a number of cost items. NIE T&D did not make the Utility Regulator aware of this change. The change in practice meant that some cost items that were treated as opex could now be treated as capex. The Utility Regulator became aware of this during its review of the RP4 opex outperformance. The Utility Regulator decided to appoint consultant auditors to investigate this matter further, to ensure that the change did not result in consumers paying twice for the same service, once via the opex allowance and again via the full pass through of capital costs.

Findings

1.4 The consultant auditor's report indicates that a significant amount of the reported opex outperformance, for the last two years of RP3 and for all of RP4, resulted from a change in capitalisation practice.

1.5 NIE T&D has also inconsistently classified asset disposals as being 'excluded services income'. When we correct this treatment, to be consistent with the licence conditions, an additional adjustment is required.

Impact on regulatory entitlement

1.6 We are minded to adjust NIE T&D's revenues over the next two years to account for our minded to approach on capitalisation practice and asset disposals. This will total £2.65 million as shown in Table 1 below.

1.7 Similarly, we are minded to adjust NIE T&D's RAB to account for our minded to approach on capitalisation practice and asset disposals. This will reduce the RAB by £32.67 million as shown in Table 1 below.

1.8 In total we propose to make £35.32 million worth of adjustments in respect of capitalisation practice and asset disposals treatment.

1.9 We do not expect these adjustments to have any impact on NIE T&D's ability to finance its activities. However we will discuss this matter with NIE T&D in more detail and re-profile the timing of the adjustments if necessary.

Table 1: Summary of adjustments required to account for both asset disposals and capitalisation practice.

Adjustment type/reason	Asset disposals	Capitalisation Practice	Total
Revenue Adjustment	£0.07m	-£2.72m	-£2.65m
RAB adjustment	-£0.95m	-£31.72m	-£32.67m
Total	-£0.88m	-£34.44m	-£35.32m

Impacts for electricity customers

1.10 Electricity customers will benefit from a rebate for amounts already paid to NIE T&D, to account for the revenue adjustment. This will equate to approximately a 1% reduction on network charges for two years.

1.11 Customers will also avoid paying for amounts in the future that were due to be paid to NIE T&D, as a result of the RAB adjustment. This will equate to approximately a 1% reduction on network charges for 40 years.

2. INTRODUCTION

2.1 We have reviewed NIE T&D's price controls every five years since it was privatised in 1992. As part of each price control we determine appropriate amounts to cover the company's expenditure, including amounts for operating expenditure and capital expenditure. Operating expenditure (opex) refers to day to day expenses such as payroll, maintenance & repairs and rates. This differs from capital expenditure (capex) which refers to investment expenditure such as buying or creating new assets. At the RP4 price control, we adopted new approaches for treating capital expenditure and controllable operating expenditure. The approach we developed was in response to submissions we had received from NIE T&D. These submissions were referred to at the time as the 'composite proposal'.

2.2 Within this submission NIE T&D stated:

> *"The use of actual expenditure to determine future revenue entitlement removes ambiguity around the allocation of costs as between opex and capex. For regulatory purposes actual expenditure is recovered either via the RAB over 40 years or via the opex allowance but not through both."*

2.3 The RP4 price control, which NIE T&D accepted, included an allowance for opex. The allowance in RP4 was based on the actual spend which occurred five years previously in RP3. This mechanism for deriving new allowances is referred to as the 'rolling opex mechanism'.

2.4 The RP4 price control also determined an amount for capex expenditure. The capital expenditure was on a pass through actual basis. This meant that capital expenditure equated to actual spending rather than an allowance for the actual spend.

2.5 NIE T&D determine whether to classify expenditure as opex or capex. They use internal guidance documents and procedure manuals to do this, as well as other methods. We would refer to the process of classifying expenditure between capex and opex as being, their capitalisation practices. On 21 December 2005 the NIE T&D executive approved changes to their capitalisation practices.

2.6 This change occurred after we had written to the company on 18 October 2005 to confirm that we were minded to accept its 'composite proposal' as described earlier.

2.7 We explain below in detail the regulatory rules which applied for each price control and why in this particular case, a change in capitalisation practice, has resulted in a double charge to customers.

2.8 The RP5 draft determination[4] highlighted the issue of the change in capitalisation practice. We commissioned consultant auditors to:

- assess the impact of this change; and
- identify any financial gain to NIE T&D (to the detriment of electricity customers) as a result of this change.

2.9 The RP5 draft determination also highlighted an asset disposals issue.

2.10 This document describes the regulatory rules with regards to the relevant price controls. These rules are very important to our approach to resolving both the capitalisation practice and asset disposals issues.

2.11 The capitalisation practice issue is the much more significant issue but the relevant price control rules and the adjustment approach are similar for the asset disposals issue.

2.12 Both the capitalisation practice and disposals issues have arisen due to the classification of the associated costs by NIE T&D.

[4] http://www.uregni.gov.uk/uploads/publications/RP5_Draft_Determination_-_Main_Paper_19-04-12.pdf

3. REGULATORY RULES FOR THE RP3 AND RP4 PRICE CONTROLS

3.1 At price control reviews, the regulator determines how much revenue the company requires from customers to fulfil its licence obligations during the next price control period.

3.2 Under the RPI-X framework the company is incentivised to be efficient. For the RP4 price control, NIE T&D was given an opex allowance. If its actual operating costs were less that this allowance, NIE T&D was allowed to keep the difference. NIE T&D was also allowed to recover its actual capital costs.

3.3 At the end of the price control, the regulator benefits from the information the company has revealed about its efficient costs. The regulator takes this information into account when setting price or revenue limits at the next price control, with customers benefitting as a result.

The RP3 Price Control Agreement

3.4 The final proposals for the RP3 regulatory period included allowances for both capex and opex (dated June 2002, see Appendix C- RP3 final proposals). The opex allowance was updated from this final proposals paper, in a subsequent letter dated 23 December 2003.

3.5 Modifying NIE T&D's licence to implement the RP3 price control determination resulted in these values being translated into an overall entitlement for the RP3 period. This overall entitlement was based on volumes of electricity units and the number of electricity customers. NIE T&D's RAB increased by actual capex rather than the allowance indicated within the final proposal.

The RP4 Price Control Agreement

3.6 When setting the RP4 price control, the Utility Regulator adopted a different approach for the treatment of capex and controllable opex. These were based on proposals from NIE T&D.

3.7 NIE T&D submitted a 'composite proposal' to the Utility Regulator on 4 March 2005. This proposal stated that the actual controllable opex in each year of the RP3 price control period would be rolled forward with RPI indexation to become the controllable opex allowance for the corresponding year in the RP4 period. This rolling approach would simplify the opex calculation process while still incentivising the company to reduce costs, with the savings automatically being passed back to customers in due course.

3.8 In addition to the proposed treatment of opex in RP4 NIE T&D's proposal included a pass through of actual capex expenditure rather than an allowance.

3.9 In its RP4 submission, NIE T&D described the advantages of the RP4 agreement as follows:

- *"The 5 year rolling approach to setting the opex allowance provides a clear and constant incentive to reduce operating costs all through the regulatory cycle. The figures are audited. Any artificial increase in opex has a direct negative impact on profits for the year in question. The annual efficiency narrative improves transparency as to movements in costs and Ofreg (now the Utility Regulator) can be assured that savings automatically feed into price reductions. The cost of efficiency studies by consultants is avoided.*
- *Capex efficiency incentives are strengthened. The use of actual capex as opposed to allowed capex in determining revenue entitlement addresses the issue of under-spends. The improved incentives together with the introduction of annual capex reporting (with certified figures for annual investment) and the stakeholder approach to non-mandatory capex promotes confidence that capital investments within a regulatory period are made efficiently and in the interests of customers."*

3.10 The Utility Regulator's (initial) proposals for the RP4 price control were published in December 2005 (see Appendix D- RP4 (initial) proposals). They included NIE T&D's 'composite proposal'. We also made two adjustments to the rolling mechanism:

- we disallowed £225,000 a year of opex in relation to pensions early retirement deficiency costs; and
- we made a one-off absolute reduction in opex for the first two years of the new price control (of £2.6 million in year 1 and £1.6 million in year 2).

3.11 The Utility Regulator published the RP4 final determination in September 2006 (see Appendix E- RP4 final proposals). No change was proposed in relation to the treatment of opex from our initial proposal.

3.12 Because of the regulatory rules that were in place for RP4, the classification of costs between opex and capex was particularly important. The regulatory agreement at the time of setting the RP4 rules was based on an understanding that costs were, and would continue to be, classified in a consistent manner[5].

[5] As per condition 2 of NIE T&D's licence 'Preparation of Accounts' Paragraph 3(b) "The Licensee shall...prepare on a consistent basis"

3.13 It should be noted that the issue of cost allocation was specifically addressed by NIE T&D in making its proposals in relation to the RP4 price control.

> *"The use of actual expenditure to determine future revenue entitlement removes ambiguity around the allocation of costs as between opex and capex. For regulatory purposes actual expenditure is recovered either via the RAB over 40 years or via the opex allowance* ***but not through both****." (emphasis added)*

3.14 It is standard regulatory practice to review the costs incurred in the most recent price control period, to ensure that any outperformance is efficient and to inform the next price control. During the review that we carried out as part of the process for RP5, it became apparent that changes had occurred in relation to capitalisation practice. These changes related to certain cost items which had been included the opex allowance for RP4.

4. OUTPERFORMANCE CLAIMS FROM NIE T&D

4.1 It is standard practice for regulators to assess the efficiencies a company has delivered so that these can be taken into account when setting allowances for the following price control. This assessment takes place during the price control review (so allowances are in place at the start of the next period).

4.2 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.

4.3 Once RP3 was complete we had the information we needed to calculate actual outperformance during the period. Our analysis of NIE T&D's results showed that outperformance in relation to opex continued to show a significant benefit to the company (see Figure 1).

4.4 This level of outperformance continued into RP4.

4.5 As part of its 'composite proposal' for RP4 NIE T&D stated:

> "the rolling opex mechanism removes a recognised shortcoming with the conventional approach whereby the implementation of efficiency initiatives tends to take place in the first half of a regulatory period and then tail off."

4.6 As can be seen from Figure 1, the NIE T&D efficiency gains did not tail off in RP3.

4.7 After publishing our RP5 draft determination, in which we raised our concerns about NIE T&D's capitalisation practice, the company provided additional information with regards to its claimed outperformance over RP3 and RP4.

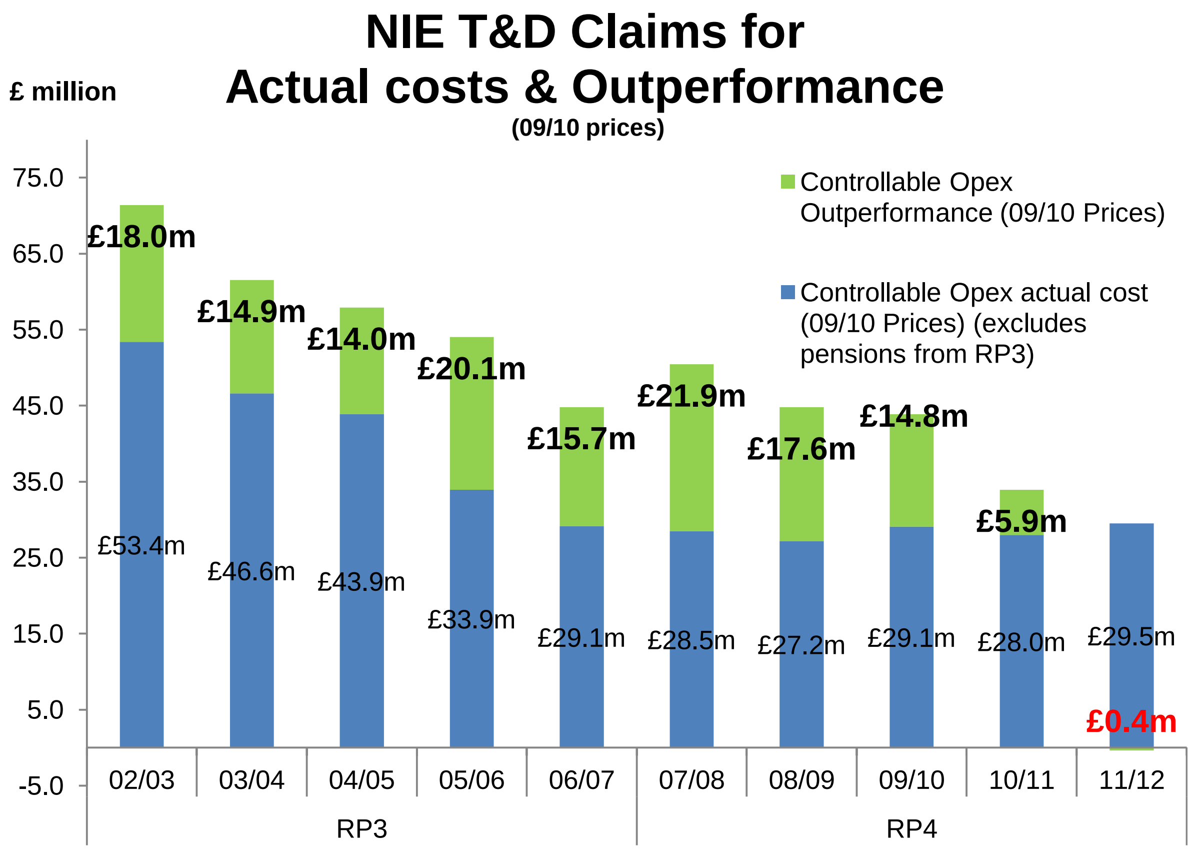

Figure 1: NIE T&D's claims for controllable actual costs & controllable opex outperformance (RP3 & RP4)

4.8 Table 2 summarises the information in Figure 1.

Table 2: Summary of claims for controllable opex actual and controllable opex outperformance for RP3 & RP4

Price control period	RP3 total	RP4 total
Claimed actual controllable opex costs	£207.01m	£142.30m
Claimed outperformance	£82.69m	£59.90m
Claimed outperformance (%)	40%	42%

4.9 The Utility Regulator considered this level of outperformance to be significant, particularly given that it has occurred 10-20 years after privatisation. The Utility Regulator considered it appropriate to evaluate the figures in more detail, to determine whether or not any outperformance has resulted from the change in capitalisation practice.

5. APPROACH TAKEN TO CAPITALISATION PRACTICE INVESTIGATION

5.1 The approach we took to the investigation was to source all data where possible, direct from the relevant IT systems at NIE T&D. This included the company's SAP accounting system and Trouble Management System.

5.2 We collected data for over ten years (mostly 2002-11 inclusive) to ensure that we fully understood the accounting treatments before and after 2005.

5.3 The purpose was to complete a bottom-up analysis to determine what the accounting figures would have been had NIE T&D's capitalisation practices not been changed.

5.4 The approach we used is set out in detail in the consultant auditor's report. Please see Appendix F.

5.5 We initiated the investigation on 20 February 2012 by issuing a detailed information notice to NIE T&D.

5.6 Our consultant auditors met NIE T&D during February and March 2012 to discuss the structure of the company's accounts and reporting systems. These meetings allowed the auditors to understand the company's reporting structures and led to the development of detailed information requests that were issued to NIE T&D on 1 March and 20 April 2012.

5.7 Because of the complex nature of the reporting systems and the substantial number of changes that NIE T&D had introduced into its financial management arrangements the investigation took longer than the consultant auditors had initially anticipated. Further, due to NIE T&D submitting updated reports the consultant auditors had to undertake reworking of data in order to ensure that their report remained robust and accurate.

5.8 It should be noted that within its composite proposal NIE T&D had stated that it anticipated an "open book approach". 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.

5.9 During the course of the investigation NIE T&D highlighted to us the impact the investigation was having on the company's own internal resources. Some information was delayed as a result of the company's resource constraints.

5.10 Further information requests were made to NIE T&D on 20 April, 16 May, 21 May and 24 June 2012.

6. THE CONSULTANT AUDITORS' FINAL REPORT ON CAPITALISATION PRACTICE

6.1 The consultant auditors have now completed their investigation. They focused on:

- identifying changes in capitalisation practice; and
- quantifying the extent of any double payment by consumers (past or future) which could result from this change.

6.2 The consultant auditors identified three areas of claimed outperformance that were attributable not to efficiency savings but to a change in capitalisation practice. These are:

- repairs and maintenance,
- tree cutting; and
- capitalised overheads.

6.3 The consultant auditors' investigation clearly identified that a change in capitalisation practice had occurred. The consultant auditors noted the following:

- Cost analysis of repairs and maintenance had shown that there was:
    - 'direct capitalisation', ie where a significantly higher proportion of the same tasks were being transferred to capital via repairs and maintenance; and
    - 'capital substitution', ie where reductions in repair and maintenance tasks were due to an increase in capital projects that delivered the same outputs.
- Cost analysis of tree cutting showed that where costs had previously been classified as one-third capex: two-thirds opex (2003-05), there had been large increases in the apportionment to capex (91% by 2011). The consultant auditors' report also shows that there was a large increase in the level of expenditure and cost per kilometre.
- Cost analysis of capitalised overheads showed that there had been a large increase in the allocation of these costs between capex and opex (up from 65% capex to 80% in some cases).

6.4 The consultant auditors identified £35.6 million[6] of costs charged to capex that arise from a change in capitalisation practices and an inconsistency in the recording of costs. There was clear evidence that these were not the result of efficiency gains. They concluded that the expenditure should be reclassified from capex back to opex. This is set out in Table 3.

Table 3: Consultant auditors' recommended reclassification of capex costs

Price control period	**RP3**	**RP3**	**RP4**	**RP4**	**RP4**	**RP4**	**RP4**	
Financial year ended 31 March	**2005/06**	**2006/07**	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12** [6]	Total
Repairs and maintenance	£1.6m	£1.6m	£3.2m	£2.4m	£2.6m	£1.8m	£TBD	>£13.2m
Tree cutting	£0.6m	£0.4m	£0.8m	£1.5m	£2.3m	£3.0m	£4m	£12.6m
Capitalised overheads	£1.0m	£1.6m	£1.5m	£1.4m	£1.4m	£1.4m	£1.5m	£9.8m
Total	£3.2m	£3.6m	£5.5m	£5.3m	£6.3m	£6.2m	£5.5m	£35.6m

Other issues that the consultant auditors identified

6.5 The consultant auditors identified two other areas where claimed outperformance may not have been a result of genuine efficiency gains:

- reduced/eliminated operational activities which the consultant auditors referred to as 'negative DT counter claims'; and
- exceptional/non-recurring items of expenditure.

6.6 Reduced/eliminated operational activities

[6] Provisional numbers are included for 2011-12. Under its licence obligation, NIE T&D will provide us with its regulatory accounts for 2011-12 by September 2012. We will ask for the information we need to update the £5.5 million figure with the actual outturn costs.

- NIE T&D has made operational changes that involve reducing or eliminating operational activities and therefore operational costs.
- Given that NIE T&D had claimed for additional costs (beyond the opex allowance) during the RP4 price control, the consultant auditors were of the opinion that any work that the company reduced or eliminated could be subject to the same treatment depending on the rules set within the price control. This may be particularly relevant to maintenance work that is classified as opex and where the level of activity was reduced. This could result in this work having to be done later (and paid for by consumers again) or it could result in a necessary acceleration of asset replacement. A counterclaim could therefore be made to NIE T&D in relation to this reduced or eliminated work.

6.7 Exceptional/non-recurring items of expenditure

- The consultant auditors highlighted that if a cost that occurred during RP3 did not re-occur during the corresponding year in RP4, then NIE T&D experienced a windfall (due to the rolling opex mechanism). A number of the costs that occurred in RP3 costs were one-off type costs (such as earthing mats). Such windfalls were not associated with efficiency gains.

6.8 The consultant auditors' report is published alongside this draft determination and is available at Appendix F.

7. OUR APPROACH TO ADJUSTING THE REGULATORY ENTITLEMENT

7.1 There are two elements that will be impacted by this investigation, a revenue adjustment to return money to customers and a RAB adjustment to prevent customers paying incorrectly in the future.

7.2 With regards to capitalisation practice we have used the findings from the consultant auditors' report on cost classification to determine the impact on NIE T&D's regulated entitlement.

7.3 With regards to asset disposals we have used information provided by NIE T&D and taken a similar approach (as we did for capitalisation practice), to determine the impact on NIE T&D's regulated entitlement.

7.4 The investigation has shown that the RAB has increased to some extent since 2005-06 simply as a result of a change in capitalisation practice. As a result, customers will have paid twice (via depreciation and return) for a proportion of the costs that were classified inconsistently in RP4.

7.5 The reclassification in RP3 will reduce the value of the closing RAB.

How we calculated the adjustments

7.6 In RP3 the regulatory agreement was different from that which was agreed for RP4. As outlined above, the consultant auditors highlighted that costs were inconsistently classified in the last two years of RP3. However, because of the nature of the RP3 rules it is not necessary for any refund of depreciation or return (in relation to the capex amounts) to be made.

7.7 Where customers have already have paid twice for a capitalisation practice change in RP4 our approach will be to refund them by adjusting the company's future revenues. We refer to this as a 'revenue adjustment'.

7.8 The revenue adjustment will account for the following amounts that have already been paid by customers:

- depreciation[7] on the inconsistently classified costs;
- rate of return[8] on the inconsistently classified costs;

[7] Depreciation is the method by which capital costs are refunded to the company.

[8] The rate of return is the WACC value that is applied to the average RAB value, and is provided to the company via their annual tariff.

- the rolling opex increases[9] for the last two years of RP4 resulting from the rolling opex mechanism.

7.9 Where the RAB value contains amounts that are still due from customers, because of the change in capitalisation practice, we will adjust the closing RAB value for 2011-12 to account for this. This adjustment will represent amounts that customers were due to pay to NIE T&D, but have not yet done so. We refer to this as the 'RAB adjustment'.

[9] Note that the rolling opex mechanism results in an increased opex allowance for NIE T&D when we reclassify its costs from capex to opex.

8. PROPOSED ADJUSTMENTS

8.1 To account for the capitalisation practice investigation, the proposed reclassification of costs from capex to opex over the two years of RP3 and the five years of RP4 totals £35.6 million (as shown in Table 3).

8.2 To account for the asset disposals issue, the proposed reclassification of costs from capex to opex over the ten years of RP3 & RP4 totals £1.05 million.

The revenue adjustment

8.3 In order to determine the revenue that customers have already paid through the annual network tariffs, we calculated the impact of the cost classification on the different elements of NIE T&D's return (depreciation, rate of return etc). We then used this to calculate the size of the revenue adjustment required.

8.4 As noted earlier, we do not propose to reclaim the return and depreciation on the RP3 reclassification of costs, as this was not part of the revenue entitlement for RP3.

8.5 The classification of costs in RP3 is important because the RP4 revenue entitlements were based on the depreciation and return of the RAB value. Hence an inflated closing RAB value did not benefit the company in RP3 but increased the depreciation and return due to the company in RP4.

8.6 The reclassification of costs for RP3 also means that the RP4 opex allowances need to be adjusted. We have accounted for this in our revenue adjustment also.

The revenue adjustment to account for capitalisation practice

8.7 We applied NIE T&D's depreciation rate[10] of 3% to the reclassified costs. This showed that customers had paid £3.59 million in depreciation allowances to the company, over the five-year (RP4) period, because of the costs being reclassified (see Table 4: Calculation of revenue adjustment).

8.8 To calculate the return that was paid to NIE T&D on these inconsistently classified costs we calculated the impact of the reclassification on the opening

[10] As noted in paragraph 17.33 in our RP5 draft determination, NIE T&D's core RAB is depreciated using a kinked method over 40 years. The first 20 years are depreciated at 3% whereas the remaining 20 years are depreciated at 2%.

and closing RAB. We then determined the return customers would have paid to NIE T&D (see Table 4). We did this using the WACC value applicable to each year.

8.9 We have used a pre-tax WACC in our calculations. The rate of return calculation over the five-year period (RP4) is £5.49million.

8.10 We have also taken account of the increased opex allowances which are required for the reclassification of costs in the last two years of RP3. This equates to £6.8 million.

8.11 The effect of these three adjustments is £2.72 million. This is shown in Table 4.

8.12 Note that we are not minded to make adjustments for the other issues identified in paragraphs 6.5 to 6.7 of this report. We explain this further in section 9 of this paper.

Table 4: Calculation of revenue adjustment in light of consultant auditors' recommendations

Price control period	**RP3**	**RP3**	**RP4**	**RP4**	**RP4**	**RP4**	**RP4**	**Total**
Financial year ended 31 March	**2005/06**	**2006/07**	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12**	
Price control year	Yr4	Yr5	Yr1	Yr2	Yr3	Yr4	Yr5	
Reclassification as per consultant auditors' recommendations								
Reclassification of capex (decrease)	-£3.20m	-£3.60m	-£5.50m	-£5.30m	-£6.30m	-£6.20m	-£5.50m	
Reclassification of opex (increase)	£3.20m	£3.60m	£5.50m	£5.30m	£6.30m	£6.20m	£5.50m	
Calculation of revenue adjustment								
Depreciation (3% of cumulative reclassified capex) (RP3 depreciation not included in total adjustment)	-£0.10m	-£0.20m	-£0.37m	-£0.53m	-£0.72m	-£0.90m	-£1.07m	-£3.59m
Amount by which the opening RAB changes	£0.00m	-£3.10m	-£6.50m	-£11.63m	-£16.40m	-£21.99m	-£27.28m	
Amount by which the closing RAB changes (reclassification plus depreciation)	-£3.10m	-£6.50m	-£11.63m	-£16.40m	-£21.99m	-£27.28m	-£31.72m	
WACC rate (using pre-tax)	6.50%	6.50%	6.82%	6.72%	6.72%	5.74%	5.67%	
Return (based on average RAB change) (RP3 return not included in total adjustment)			-£0.62m	-£0.94m	-£1.29m	-£1.41m	-£1.67m	-£5.94m
Rolling opex mechanism (reclassification from five previous years)						£3.20m	£3.60m	£6.80m
Total revenue adjustment								-£2.72m

The RAB adjustment to account for capitalisation practice

8.13 The second element of the adjustment will be the RAB adjustment. This will take into account the un-depreciated capex on the RAB. This is shown in Table 5 as £31.72 million.

Table 5: Calculation of RAB adjustment in light of consultant auditors' recommendations

Price control period	**RP3**	**RP3**	**RP4**	**RP4**	**RP4**	**RP4**	**RP4**	**Total**
Financial year ended 31 March	**2005/06**	**2006/07**	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12**	
Price control	Yr4	Yr5	Yr1	Yr2	Yr3	Yr4	Yr5	
Reclassification as per consultant auditors' recommendations								
Reclassification of capex (decrease)	-£3.20m	-£3.60m	-£5.50m	-£5.30m	-£6.30m	-£6.20m	-£5.50m	
Reclassification of opex (increase)	£3.20m	£3.60m	£5.50m	£5.30m	£6.30m	£6.20m	£5.50m	£35.60m
Calculation of RAB adjustment								
Depreciation	-£0.10m	-£0.20m	-£0.37m	-£0.53m	-£0.72m	-£0.90m	-£1.07m	-£3.59m
Amount by which opening RAB changes	£0.00m	-£3.10m	-£6.50m	-£11.63m	-£16.40m	-£21.99m	-£27.28m	
Amount by which closing RAB changes (reclassification plus depreciation)	-£3.10m	-£6.50m	-£11.63m	-£16.40m	-£21.99m	-£27.28m	-£31.72m	-£31.72m

The revenue adjustment to account for asset disposals

8.14 Using the information provided by NIE T&D on its historic asset disposals, our calculations indicate that NIE T&D should have received an additional £0.07 million in its tariffs to date. This is shown in table 6.

Table 6: Calculation of revenue adjustment to account for the asset disposals issue

Price control period	RP3	RP3	RP3	RP3	RP3	RP4	RP4	RP4	RP4	RP4	Total
Financial year ended 31 March	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	
Price control year	Yr1	Yr2	Yr3	Yr4	Yr5	Yr1	Yr2	Yr3	Yr4	Yr5	
Reclassification of asset disposals											
Reclassification of capex (decrease)	-£0.01m	-£0.10m	-£0.11m	-£0.09m	-£0.05m	-£0.07m	-£0.12m	-£0.28m	-£0.22m	£0.00m	
Reclassification of opex (increase)	£0.01m	£0.10m	£0.11m	£0.09m	£0.05m	£0.07m	£0.12m	£0.28m	£0.22m	£0.00m	
Calculation of revenue adjustment											
Depreciation (3% of cumulative reclassified capex) (RP3 depreciation not included in total adjustment)	-£0.00m	-£0.00m	-£0.00m	-£0.00m	-£0.00m	-£0.01m	-£0.01m	-£0.02m	-£0.02m	-£0.02m	-£0.08m
Amount by which the opening RAB changes		-£0.01m	-£0.11m	-£0.22m	-£0.30m	-£0.35m	-£0.41m	-£0.53m	-£0.79m	-£0.98m	
Amount by which the closing RAB changes (reclassification plus depreciation)	-£0.01m	-£0.11m	-£0.22m	-£0.30m	-£0.35m	-£0.41m	-£0.53m	-£0.79m	-£0.98m	-£0.95m	
WACC rate (using pre-tax)	6.50%	6.50%	6.50%	6.50%	6.50%	6.82%	6.72%	6.72%	5.74%	5.67%	
Return (based on average RAB change) (RP3 return not included in total adjustment)	-£0.00m	-£0.00m	-£0.01m	-£0.02m	-£0.02m	-£0.03m	-£0.03m	-£0.04m	-£0.05m	-£0.05m	-£0.21m
Rolling opex mechanism (reclassification from five previous years)						£0.01m	£0.10m	£0.11m	£0.09m	£0.05m	£0.36m
Total revenue adjustment											£0.07m

The RAB adjustment to account for asset disposals

8.15 The asset disposals issue also requires a RAB adjustment. This will take into account the un-depreciated capex on the RAB. This is shown in Table 7 as being £0.95 million.

Table 7: Calculation of RAB adjustment to account for the asset disposals issue

Price control period	RP3	RP3	RP3	RP3	RP3	RP4	RP4	RP4	RP4	RP4	Total
Financial year ended 31 March	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	
Price control	Yr1	Yr2	Yr3	Yr4	Yr5	Yr1	Yr2	Yr3	Yr4	Yr	
Reclassification of asset disposals											
Reclassification of capex (decrease)	-£0.01m	-£0.10m	-£0.11m	-£0.09m	-£0.05m	-£0.07m	-£0.12m	-£0.28m	-£0.22m	£0.00m	
Reclassification of opex (increase)	£0.01m	£0.10m	£0.11m	£0.09m	£0.05m	£0.07m	£0.12m	£0.28m	£0.22m	£0.00m	£1.05m
Calculation of RAB adjustment											
Depreciation	-£0.00m	-£0.00m	-£0.00m	-£0.00m	-£0.00m	-£0.01m	-£0.01m	-£0.02m	-£0.02m	-£0.02m	-£0.08m
Amount by which opening RAB changes		-£0.01m	-£0.11m	-£0.22m	-£0.30m	-£0.35m	-£0.41m	-£0.53m	-£0.79m	-£0.98m	
Amount by which closing RAB changes (reclassification plus depreciation)	-£0.01m	-£0.11m	-£0.22m	-£0.30m	-£0.35m	-£0.41m	-£0.53m	-£0.79m	-£0.98m	-£0.95m	-£0.95m

8.16 The capitalisation practice investigation can be summarised as follows. We were unaware of NIE T&D's change in accounting practice and so the past seven years (2006-12) included claims for outperformance that were actually a reclassification of costs (currently valued at £35.60 million). When we account for this (given the rules of the RP4 agreement) the total adjustment required is £34.44 million (£2.72 million of which is a revenue adjustment and £31.72 million of which is a RAB adjustment).

8.17 The asset disposals issue can be summarised as follows. NIE T&D has inconsistently classified asset disposals as being 'excluded services income'. When we correct this treatment to be consistent with the licence conditions a revenue adjustment (increase) of £0.07 million is required and a RAB adjustment (decrease) of £0.95 million is required. The total adjustment required in respect of the asset disposals issue is a decrease of £0.88 million.

9. OTHER ISSUES

9.1 Some of outperformance that was claimed by NIE T&D was the result of the company's capitalisation practice. However, there remains substantial outperformance that the company claimed was delivered through efficiencies. The main areas of savings identified by the company were savings in payroll, repairs and maintenance, IT and telecom, managed services and insurance.

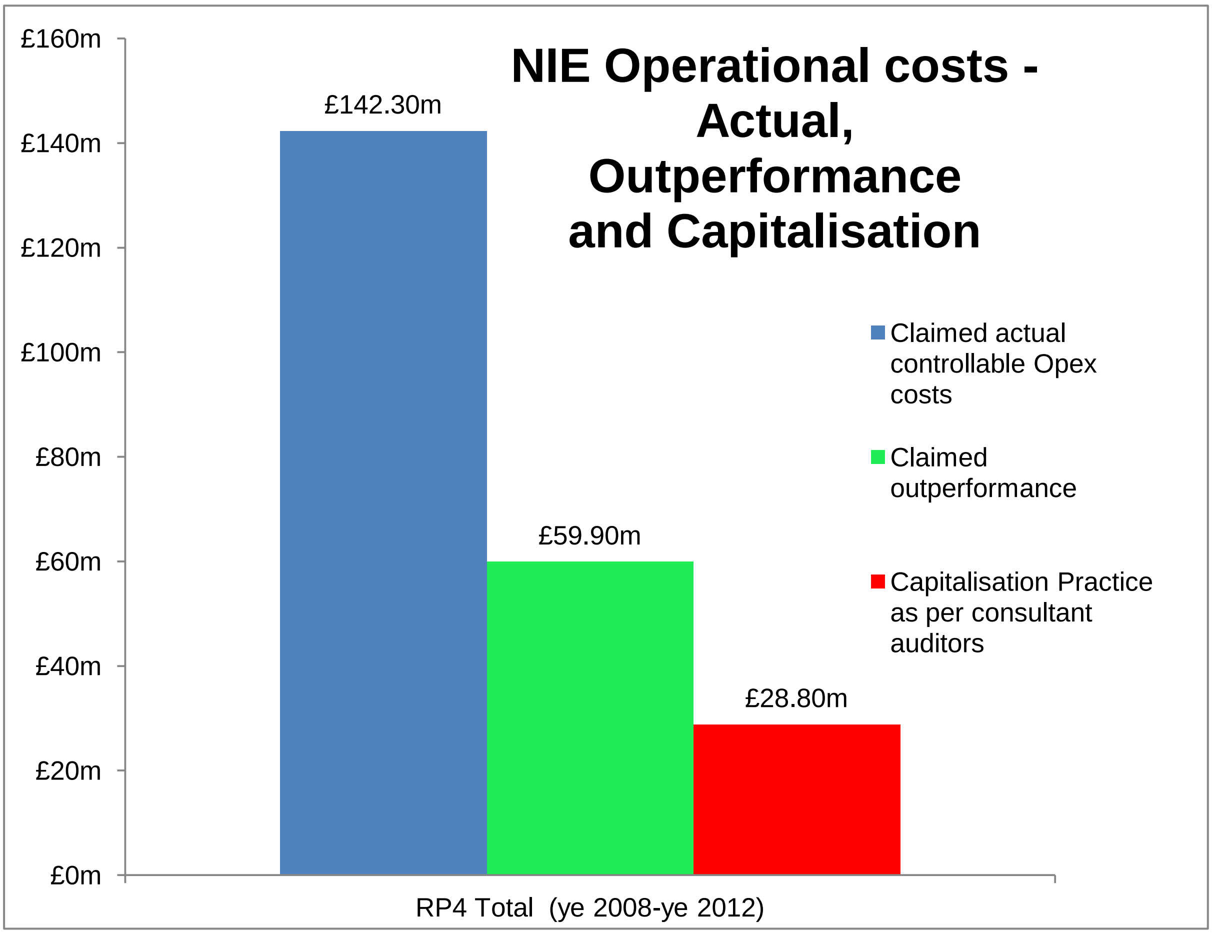

Figure 2: NIE T&D's claims for controllable actual costs & controllable opex outperformance and consultant auditors' capitalisation practice (cost reclassification) (RP4)

9.2 The consultant auditors have stated that a proportion of the claimed efficiencies are the result of reduced/eliminated operational activities.

9.3 There is a potential concern that this type of activity could lead to consumers paying for maintenance again at a later date or a need to accelerate asset replacement. The approach may not represent best asset management practice. It is our intention to explore reporting arrangements and asset management practices further with NIE T&D. NIE T&D has a licence and legal requirement to manage its assets efficiently. It is not the role of regulation to set out in detail how NIE T&D should meet with this requirement, and to decide which activities it should increase or decrease. What is important is that NIE T&D delivers the expected outputs and that capitalisation practice is applied consistently, in regard to all activities, before and after a price control determination is signalled. The Utility Regulator does not consider that it is appropriate to make any financial adjustment in relation to this finding.

9.4 The consultant auditors also stated that the rolling opex mechanism created an unforeseen benefit, with regards to one-off expenditure in RP3.

9.5 We do not feel it is appropriate to make an adjustment to the RP4 allowances to reflect one-off expenditure in RP3 because the rules for RP4 did not account for these unforeseen benefits.

9.6 We had noted in our RP5 draft determination document some other cost classification issues regarding storms and interest. We will consider these further in our final determination.

10. DRAFT DETERMINATION

10.1 We are minded to adjust NIE T&D's revenues over the next two years to account for the revenue adjustments noted above. This will total £2.65 million, as shown in Table 8 below.

10.2 Similarly, we are minded to adjust NIE T&D's RAB to account for the RAB adjustments noted above. This will reduce the year ending 2012 closing RAB by £32.67 million, as shown in Table 8 below.

10.3 In total we propose to make £35.32 million worth of adjustments in respect of capitalisation practice and asset disposals treatment.

10.4 We would like to publish a final determination on these matters along with the final determinations for RP5. This is scheduled to be on 23 October 2012.

Table 8: Summary of adjustments required to account for both asset disposals and capitalisation practice.

Adjustment type/reason	Asset disposals	Capitalisation Practice	Total
Revenue Adjustment	£0.07m	-£2.72m	-£2.65m
RAB adjustment	-£0.95m	-£31.72m	-£32.67m
Total	-£0.88m	-£34.44m	-£35.32m

Impact for electricity customers

10.5 Electricity customers will benefit from a rebate for amounts already paid to NIE T&D, as a result of the revenue adjustment. This will equate to approximately a 1% reduction on network charges for two years.

10.6 Electricity customers will avoid paying for amounts in the future that were due to be paid to NIE T&D, as a result of the RAB adjustment. This will equate to approximately a 1% reduction on network charges for 40 years.

Appendix A - Asset disposals adjustment calculation

Price control period	RP3	RP3	RP3	RP3	RP3	RP4	RP4	RP4	RP4	RP4	
Financial year ended 31st March	**2002/03**	**2003/04**	**2004/05**	**2005/06**	**2006/07**	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12**	**Total**
Price Control Year	Yr1	Yr2	Yr3	Yr4	Yr5	Yr1	Yr2	Yr3	Yr4	Yr5	
Reclassification of Capex (decrease)	-£0.01m	-£0.10m	-£0.11m	-£0.09m	-£0.05m	-£0.07m	-£0.12m	-£0.28m	-£0.22m	£0.00m	-£1.05m
Reclassification of Opex (increase)	£0.01m	£0.10m	£0.11m	£0.09m	£0.05m	£0.07m	£0.12m	£0.28m	£0.22m	£0.00m	£1.05m
Calculation of RAB adjustment											
Opening RAB Changes by		-£0.01m	-£0.11m	-£0.22m	-£0.30m	-£0.35m	-£0.41m	-£0.53m	-£0.79m	-£0.98m	
Closing RAB Changes by (reclassification plus depreciation)	-£0.01m	-£0.11m	-£0.22m	-£0.30m	-£0.35m	-£0.41m	-£0.53m	-£0.79m	-£0.98m	-£0.95m	-£0.95m
WACC Rate (use Pre tax)	6.50%	6.50%	6.50%	6.50%	6.50%	6.82%	6.72%	6.72%	5.74%	5.67%	
Calculation of Revenue Adjustment											
Depreciation (3% of cumulative reclassified capex)(RP3 depreciation not included in total adjustment)	-£0.00m	-£0.00m	-£0.00m	-£0.00m	-£0.00m	-£0.01m	-£0.01m	-£0.02m	-£0.02m	-£0.02m	-£0.08m
Return (based on average RAB change) (RP3 return not included in total adjustment)	-£0.00m	-£0.00m	-£0.01m	-£0.02m	-£0.02m	-£0.03m	-£0.03m	-£0.04m	-£0.05m	-£0.05m	-£0.21m
Rolling Opex mechanism (reclassification from 5 years previous)						£0.01m	£0.10m	£0.11m	£0.09m	£0.05m	£0.36m
											£0.07m
Total adjustments											-£0.88m

Appendix B - Capitalisation practice adjustment calculation

Price control period	RP3	RP3	RP3	RP3	RP3	RP4	RP4	RP4	RP4	RP4	
Financial year ended 31st March	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	**Total**
Price Control Year	Yr1	Yr2	Yr3	Yr4	Yr5	Yr1	Yr2	Yr3	Yr4	Yr5	
Reclassification of Capex (decrease)	-	-	-	-£3.20m	-£3.60m	-£5.50m	-£5.30m	-£6.30m	-£6.20m	-£5.50m	-£35.60m
Reclassification of Opex (increase)	-	-	-	£3.20m	£3.60m	£5.50m	£5.30m	£6.30m	£6.20m	£5.50m	£35.60m
Calculation of RAB adjustment											
Opening RAB Changes by				£0.00m	-£3.10m	-£6.50m	-£11.63m	-£16.40m	-£21.99m	-£27.28m	
Closing RAB Changes by (reclassification plus depreciation)				-£3.10m	-£6.50m	-£11.63m	-£16.40m	-£21.99m	-£27.28m	-£31.72m	-£31.72m
WACC Rate (use Pre tax)				6.50%	6.50%	6.82%	6.72%	6.72%	5.74%	5.67%	
Calculation of Revenue Adjustment											
Depreciation (3% of cumulative reclassified capex)(RP3 depreciation not included in total adjustment)				-£0.10m	-£0.20m	-£0.37m	-£0.53m	-£0.72m	-£0.90m	-£1.07m	-£3.59m
Return (based on average RAB change) (RP3 return not included in total adjustment)				-£0.10m	-£0.31m	-£0.62m	-£0.94m	-£1.29m	-£1.41m	-£1.67m	-£5.94m
Rolling Opex mechanism (reclassification from 5 years previous)									£3.20m	£3.60m	£6.80m
											-£2.72m
Total adjustments											-£34.44m

Appendix C - RP3 final proposals

Please see web link;

http://www.uregni.gov.uk/uploads/publications/Final_Proposals.pdf

Appendix D - RP4 (initial) proposals

Please see web link;

http://www.uregni.gov.uk/uploads/publications/price-control-rp4-public-paper-nie4.pdf

Appendix E - RP4 final proposals

Please see web link;

http://www.uregni.gov.uk/uploads/publications/TD_Final_proposals_Sept_06.pdf

Appendix F - Consultant auditors' report

Please see web link;

http://www.uregni.gov.uk/uploads/publications/Cap_pract_-_Confirmation_of_capitalisation_practice_materiality.pdf