NIE Energy Supply Price Control 2011 - 2013

Proposals for Consultation

20th May 2011

Introduction

NIEES Price Control to Date

The original NIE Supply price control ran from April 2000 to March 2005. This has been followed by a number of shorter term controls the latest of which ran from April 2010 to March 2011. The Utility Regulator is proposing the new control has a duration of 24 months. The UR is proposing the control should be retrospective and be effective from April 2011 to March 2013.

Changing Environment

As highlighted above, there has been a series of shorter term controls over the past number of years. This has been due to the changing environment in terms of retail competition. In June 2010 another supplier entered the domestic market, which has resulted in competition being active for 10 months.

At the beginning of 2011 NIE plc was purchased by ESB and divested from the Viridian group (which NIEES is part of). Therefore, NIEES is now part of smaller group, when compared with the previous Price Control. This has impacted on the NIEES submission in relation to cost lines such as Corporate charges and salary costs.

Duration

The most recent price controls for NIEES have been set for a single year. Whilst the Utility Regulator (UR) wishes to move away from one year controls, it is mindful that there is uncertainty about the rate at which competition will develop and the impact this will have on NIEES' costs. We are therefore proposing that the control will cover a two year period from 2011 to 2013 as described above.

The Price Control and Tariffs

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

$$\mathbf{M_t = G_t + U_t + S_t + K_t + (J_t - D_t) + E_t}$$

In year t,

Gt 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.

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

Kt 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).

Jt encompasses costs associated with buy-out from the Northern Ireland Renewables Obligation with the **Dt** term representing any savings on the buy-out NIEES achieves.

Et is associated with costs which are uncontrollable and are passed through to customers on a 100% basis. These costs include licence fees; IT projects required in order to put in place the systems and processes to open domestic markets and allow customers to switch supplier such as NI2007 and Enduring Solution Stages 1 and 2; and past pensions deficit.

Therefore, most of 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 with the **St** 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 should comprise the following elements:

- Operating costs
- Capital expenditure / depreciation
- Return on assets / profit margin

The Allowed Revenue, minus the cost of all electricity wholesale purchases (ie Ut, Gt, Et, Kt and (Jt-Dt) terms), is currently collected on a ratio of 67% for fixed costs plus a variable charge on a per customer basis (33%).
The UR is proposing that this should change (resulting in a change to Annex 2 of the licence). This means that there will be an allowed level of operating expenditure plus a margin. The margin will be calculated based on actual allowable (being turnover generated only through regulated sales and excluding income such as Energy Efficiency or any other unregulated income) turnover and it will out turn as an amount of money which NIEES are allowed. This is further discussed in the Margin section of this paper. Therefore the UR is proposing to set a fixed amount (given that switching assumptions have been built into our considerations) for operating costs and a margin based on actual allowable turnover. This is in line with the more traditional approach in Regulated Supply Price Controls such as Phoenix Supply.

NIEES currently has minimal assets and therefore a return on assets approach that would be applied to an asset intensive business such as a regulated network is not considered appropriate. The approach taken is therefore to allow operating costs (including depreciation on the assets NIEES do have) plus a profit margin based on a percentage of actual allowable turnover.

Approach

In the previous price control review the Utility Regulator conducted a high level 'top-down' review of overall opex. For this review the Utility Regulator decided to conduct a more detailed review of the individual components of opex. Consultants were appointed to assist the Utility Regulator in this process.

An initial request for data was sent to NIEES in December 2010 and returned to the UR in January 2011. Since then the UR and its appointed consultants have reviewed that information and held a number of meetings with NIEES to understand their projections of costs for 2011/12 and 2012/13. NIEES have also provided further information when requested by the UR or its consultants.

The following pages set out our initial thoughts for consultation. We will take account of the responses received on the matters discussed in this document and set out our final proposals in the subsequent decision paper.

All amounts set out in this document are in 2010 prices unless otherwise stated.

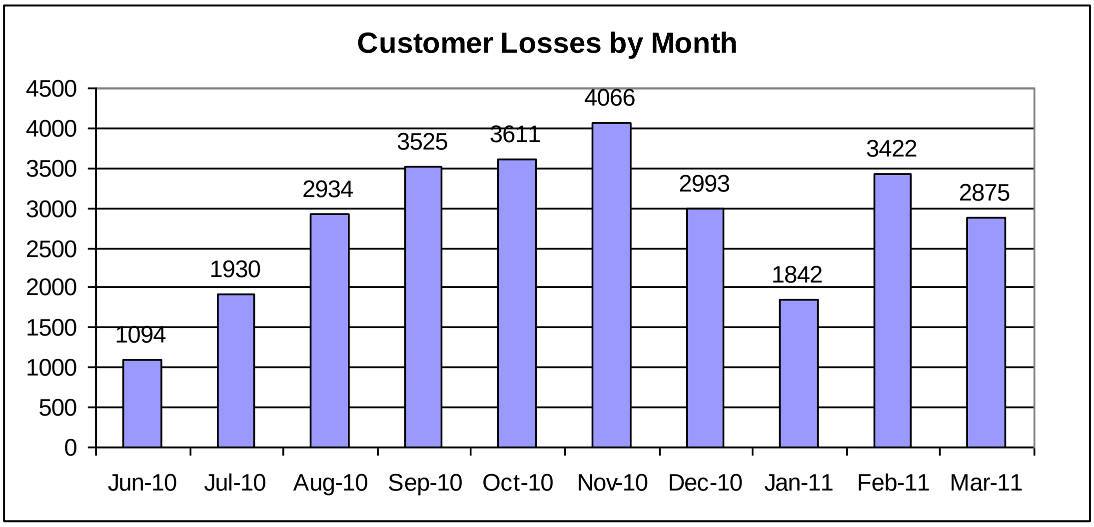
Opex Analysis

Customer Switching Rates

A significant factor in assessing future costs will be the rate at which NIEES' customer numbers reduce as a result of loss to other suppliers as competition develops. If there is a significant reduction in customer numbers then the number of customers raising queries, the number of meter readings and bills, the number of customers being pursued for outstanding amounts, etc will all be expected to reduce accordingly. To some degree then this will potentially lead to downward pressure on operating cost requirements which we detail later.

NIEES' submission to the UR contains a switching forecast which represents a reduction in NIEES' customer numbers of 5.75% over the two years. With an assumption of 1% per annum growth in connected customers this equates to actual switching losses of 59,783 or an average of 2,490 per month.

The following chart based on data supplied by NIEES, illustrates the number of domestic customers that have switched away from NIEES since domestic customers were given the ability to change supplier in June 2010



NB June and March incomplete months at the time above data provided

The average number of customers switching away from NIEES between July 2010 and February 2011 (based on data from NIE Plc) was 3,253 per month.

NIEES have argued that switching rates can be expected to slow down going forward, since those customers that were most inclined to switch will have done so, leaving those customers that are less inclined to switch.

However, the UR believes that there are a number of factors that may actually increase the switching rate going forward, including:

- The number of keypad customers that can switch is currently constrained but keypad switching commenced in May of this year. This constraint will be removed in May 2012 and this will result in an increase in the pool of potential switchers;
- Currently there is only one other supplier competing in the domestic electricity supply market. The UR believes that a number of other suppliers are also considering competing for domestic electricity supply. The majority of switching to date has been as a result of doorstep selling from just one competitor to NIEES. This would suggest that when more suppliers enter the market this will increase the level of such selling;
- Current restrictions limit the number of customer switches that can be handled in any month to May 2012. After 'go-live' of the Enduring Solution (May 2012) this restriction will be removed, providing unlimited switching; and
- Currently supplies to new premises are by default supplied by NIEES. From May 2012 new customers will have to choose a supplier rather than defaulting to NIEES.

The UR believes that these factors will lead to an increase in switching for the next two years from the actual rates seen since competition in domestic supply began in June 2010 and is therefore, for the purposes of relevant operating cost calculations (for example bad debt), we are assuming switching rates will average 3,500 per month during 2011/12 and 3,750 per month during 2012/13. These switching rates represent 5-6% of domestic customers switching each year compared to switching rates in GB of 17% in 2010 and as high as 22% in 2006[1].

Headcount and Staff costs (inc. agency staff)

During 2010/11, excluding staff that were backfilling for those involved in the Enduring Solution work, NIEES employed an average of 146.5 FTEs including both permanent and agency staff. It is useful to note that the number of staff increased during the 2010/11 year as competition developed, as a result of increased debt workload and higher call volumes so that at 31 March 2011 the number of FTEs (excluding staff backfilling for Enduring Solutions) was 152.6.

NIEES have proposed further increases in staffing levels of 7 FTEs in 2011/12 and a further 11 FTEs in 2012, mainly additional call centre and debt team staff as well as staff to deal with the 'cutover' to the new Enduring Solution system. The Utility Regulator does not accept the need for such further large increases in staffing levels. Staffing levels have already increased during 2010/11 to deal with higher call volumes and increased debt workload; since NIEES have operated with customer switching since June 2010. As mentioned before, we also view that some NIEES staff resource/time should be freed up as customers migrate away from NIEES during the coming two years. We believe therefore that the staffing levels at the end of

[1] Ofgem Retail Market Findings, March 2011

2010/11(152.6 FTEs), together with gains that should be made from reductions in the number of customers existing staff are dealing with, should be sufficient to deal with the debt and call centre volumes that arise from customer switching and the crossover to the new Enduring Solution system.

NIEES argue that the further increases in staffing levels are necessary to maintain customer service levels because of the increased call centre and bad debt workload. Customer service has not fallen with the increased staffing levels that have existed since domestic competition was introduced in June 2010 and for the reasons given above we do not agree that any further increases are required to maintain customer service levels. NIEES also identified a number of other specific roles they wish to increase their 2011 year end staffing levels for. The UR believes that NIEES should be able to run the business using the staffing levels which were in place at 31 March 2011.

This results in allowed staffing levels which are 152.6 FTEs for 2011/12 and 152.6 FTEs for 2012/13.

NIEES forecasts also showed a real (i.e. above inflation) increase in the average cost per FTE from 2010/11 to 2011/12 and 2012/13. The UR does not accept that there is any justification for above inflation increases in the level of staff costs. We have therefore taken the average cost per FTE in 2010/11 (excluding both the FTEs and costs associated with Enduring Solution backfill) and applied it to the above FTE figures to determine a staffing cost of £4.945m in 2011/12 and £4.945m in 2012/13. Please note that the Latest Best Estimate (LBE) of outturn costs for 2010/11 are used in the table below.

Staff costs	**NIEES Forecast** (inc Enduring Solution backfill)			**UR Proposal** (excl Enduring Solution Backfill)	
	2010/11 LBE	**2011/12**	**2012/13**	**2011/12**	**2012/13**
FTEs	151.5	165.7	176.8	152.6	152.6
Cost (£m)	4.827	5.344	5.559	4.945	4.945
Cost/FTE (£)	31,861	32,251	31,442	32,405	32,405

MBIS (excluding agency staff)

NIEES' forecasts for MBIS (Materials and Bought In Services) costs comprise the following items. Please note that the Latest Best Estimate (LBE) of outturn costs for 2010/11 are used in the table below.

MBIS costs (£'m)	**Forecast (2010 prices)**		
	2010/11 LBE	**2011/12**	**2012/13**
Agency costs	3.057	2.988	3.078
Postage	0.876	0.896	0.896
Other	2.355	2.679	2.854
MBIS (excl. Agency staff)	**6.288**	**6.563**	**6.829**

Agency costs represent the costs of collecting money from customers through third parties such as Post Offices or Paypoint outlets. NIEES are forecasting these costs to remain broadly the same as incurred during 2010/11. We believe that this is an appropriate assumption for these costs.

For postage costs we would expect a decline in costs as NIEES market share decreases and also as more customers move to Keypad meters and the potential for electronic billing in the future. However, NIEES have argued that the potential for mid-year tariff reviews will lead to an increase in postage costs to inform customers of the revised tariffs. We accept that this is a valid argument, and therefore believe that the above forecast of a slight increase compared to 2010/11 LBE figures is appropriate for postage costs. Furthermore, NIEES will need to cover the cost of any additional unforeseen postage costs from this allowed amount.

The "other" category in MBIS contains a mix of about 20 different items. The most significant items in this category are:

- Marketing expenses which have increased from £0.227m in 2009/10 to £0.487m in 2010/11, and drop to around £0.4m in each of 2011/12 and 1202/13. The UR has not received sufficient justification from NIEES to support this increase in marketing costs from 2009/10 levels. The UR believes that some degree of marketing spend is necessary to maintain customer awareness. However, efforts to win or retain customers are about increasing or maintaining the value of the business for shareholders, and should therefore be funded by shareholders rather than customers. We are therefore proposing to freeze marketing expenses at 2009/10 levels;
- Also included in the 'other' category, in both years 11/12 and 12/13 is £0.36m relating to "loss of synergies". These are additional outsourced IT costs of £200k, accommodation of £50k, relocation costs of £30k and consultancy of £75k. This accounts for the majority of the increase in "other" within MBIS. NIEES has not provided any explanation of the

'loss of synergies' and in particular has not indicated the degree to which they relate to the divestment of NIE. The UR therefore considers that these amounts should be disallowed unless NIEES can provide further justification which demonstrates that these costs do not arise from the divestment;

- Energy Efficiency is included within in this category also. This relates to money invested by NIEES to generate energy savings from customers. In the past this has included schemes such as distributing energy saving light bulbs. For 2011/2012 the amount for investment has been forecast at £213k with the amount forecast for 2012/2013 increasing to £291k which is a significant increase. The UR has asked the Energy Savings Trust to provide guidance whether these forecasts appear reasonable. The £213k for 2011/12 and £291k for 2012/2013 are currently included with the URs proposal for the 'other' category. However, this may be subsequently reduced pending the guidance from the Energy Savings Trust;
- The largest single item in the 10/11 "other" figure is professional services spend of £552k. Professional services expenditure reduces in NIEES' forecasts to £393k in 11/12 and £340k in 12/13. Given that the level in 09/10 was £498 this appears to be reasonable.

With the exception of the marketing expenditure and "loss of synergies" described above, the Utility Regulator proposes to accept NIEES' forecasts of MBIS expenditure. However, as noted above, this may further change pending guidance from the Energy Savings Trust.

MBIS (£'m)	NIEES Forecast			UR Proposal	
	2010/11 LBE	2011/12	2012/13	2011/12	2012/13
Agency Costs	3.057	2.988	3.078	2.988	3.078
Postage	0.876	0.896	0.896	0.896	0.896
Other	2.355	2.679	2.854	2.153	2.305
Total MBIS	**6.288**	**6.563**	**6.829**	**6.037**	**6.280**

Bad Debts

NIEES' bad debt costs have previously been approximately 0.45% of total revenues in both 2009/10 (actual) and 2010/11 (LBE). NIEES are forecasting this figure to rise to 0.56% for 2011/12 and 2012/13. NIEES have explained that this increase is due to customers switching suppliers and leaving unpaid final accounts with NIEES. In addition to this, NIEES have indicated that when Keypad customer switching occurs there are likely to be increased levels of stranded debt as customers that were paying outstanding debts to NIEES through their Keypad account switch to other suppliers.

The UR accepts NIEES' arguments that there will be an increase in bad debts with more competition. However, we are proposing to increase the bad debt level to 0.5% rather than 0.56% given that competition has been in place for 10 months and bad debt has not risen above 0.45%.

Since the Utility Regulator is assuming a slightly greater level of switching, this will lead to slightly lower revenues.

Bad Debts	Outturn		Forecast	
	2009/10	2010/11	2011/12	2012/13
NIEES Figures	Actual	LBE		
Revenues (£'m)	605.5	545.7	546.1	528.2
Bad Debt (%)	0.45%	0.45%	0.56%	0.56%
Bad Debts (£'m)	2.75	2.43	3.04	2.98
UR Proposal				
Revenues (£'m)			535.4	508.4
Bad Debt (%)			0.5%	0.5%
Bad Debts (£'m)			2.677	2.542

Outsourced

NIEES' LBE for 2010/11 and forecast for 20011/12 and 2012/13 for outsourced costs are as follows:

Outsourced costs	Forecast (2010 prices)		
	2010/11 LBE	2011/12	2012/13
	£m	£m	£m
Billing	2.046	2.123	2.083
Call Centre	0.130	0.132	0.124
IT	0.717	0.750	0.744
Other	0.081	0.012	0.012
Service Introduction (electronic billing)	0.000	0.020	0.100
Total outsourced	**2.975**	**3.036**	**3.063**

The largest single item within this category is billing. This external contract was procured under a full competitive tendering process. The UR therefore believes that it is appropriate to allow these contracted amounts for the limited coming control period (2011/12 and 2012/13). For future Controls, the UR believes that as NIEES loses market share, and as more customers move to Keypad meters, the costs of billing should reduce.

The remaining outsourced costs are mainly IT costs and a number of other smaller items. These remain relatively constant in real terms from the LBE figure for 2010/11 and the Utility Regulator accepts these as reasonable.

The Utility Regulator is therefore proposing to accept NIEES' forecast figures for Outsourced Costs.

Corporate Charges

NIEES original submission contained the following summary of corporate charges:

£'m	2009/10 Actual	2010/11 LBE	2011/12	2012/13
Corporate Charges	1.081	1.055	1.001	1.022

That submission stated that the forecast figures for 2011/12 and 2012/13 had been prepared based on estimates from previous years (prior to divestment of NIE T&D) and were subject to revision by corporate to take account of the impact of divestment on both the overall level of corporate charges and the share apportioned to NIEES. Corporate charges include such things as Human Resources, Payroll, and Corporate Services etc.

When the revised analysis was received from corporate, the corporate charges for 2011/12 had increased to £1.281m as a result of a reduction in the overall level of corporate costs following divestment (from £6.651m in 2010/11 to £3.996m in 2011/12) but a significantly larger portion of those costs (now 32%) being allocated to NIEES as a result of fewer group entities to absorb the charges.

The breakdown of the revised £1.281m charge has only very recently been submitted to the UR.

The UR is proposing that the allowable Corporate Charges should remain at the 2010/2011 LBE level. We believe that corporate charges have increased as a result of the divestment of NIE plc, and as such should be borne by the shareholder.

Depreciation

NIEES forecast depreciation charge increases from negligible levels up to 2010/11 to £55k in 2011/12 and £2.815m in 2012/13.

This increase results from a NIEES forecast capital expenditure of approximately £14m between 2010/11 and 2012/13 primarily on new systems for the Enduring Solution project which the Utility Regulator is aware of. The assets are being depreciated over 5 years which is appropriate for such IT systems. However, the agreed level of depreciation will be determined at the completion of the Enduring Solution project (once all costs are known and finalised and approved as recoverable) rather than agreeing a specific amount at this time.

The UR therefore accepts the forecast depreciation figures for 2011/2012 only at this point, with the figure for 2012/2013 to be agreed at a later stage.

£'m	NIEES Costs and Forecasts			UR Proposals	
	2010/11	2011/12	2012/13	2011/12	2012/13
Depreciation	0.014	0.055	2.815	0.055	TBC

Pass-through items

Pass through items are items that are examined separately by the UR as part of the Tariff Review Process, with a specific amount then being allowed in the determination of allowed revenues. They have therefore not been examined further as part of this price control review. They consist of:

£'m	Pass-through items		
	2010/11	2011/12	2012/13
Licence Fees	0.483	0.700	0.700
NI2007 Market Opening (Depreciation)	1.204	1.137	1.081
SEM Development	0.037	0.024	0.024
NI2010 Market Opening (Depreciation)	0.158	0.000	0.000
Enduring Solution (Expensed until Project Completion)	1.556	3.090	0.710
Total Pass-through	3.437	4.951	2.515

Opex Summary

In summary then the following table sets out our Opex proposals for the Control Period:

£'m	NIEES Costs and Forecasts			UR Proposals	
	2010/11	2011/12	2012/13	2011/12	2012/13
Staff Costs (incl Agency Staff)	4.827	5.344	5.559	4.945	4.945
MBIS (excl Agency Staff)	6.288	6.563	6.829	6.037	6.280
Bad debts	2.429	3.041	2.984	2.677	2.542
Outsourced	2.975	3.036	3.063	3.036	3.063
Corporate Charges	1.055	1.281	1.281	1.055	1.055
Sub-total	**17.574**	**19.265**	**19.716**	**17.75**	**17.885**
Depreciation	0.014	0.055	2.815	0.055	TBC
Pass-through items	3.437	4.951	2.515	TBC	TBC
Total opex	**21.025**	**24.271**	**25.046**		

It should be noted that the above operating costs relate to the whole of NIEES' activity, **both** regulated and deregulated sales. As in previous price control reviews, once we have decided on the appropriate cost level we will need to apportion them between regulated and deregulated activities. This will allow the UR to set a maximum allowed revenue for the regulated business. This apportionment will be done using the same model that was applied in the previous price control but with the cost driver units updated as appropriate.

Margin

Introduction

Regulated networks provide their returns to the owners of the business through a return on the value of assets invested in the business. A supply business is not asset focussed in the same way that a network business is, so needs an alternative approach to providing some reward to the owners of the business. The more orthodox approach (for example the approach taken for Phoenix Supply Limited) for regulated supply businesses is to allow a margin on turnover. The margin should to some degree reflect the riskiness of the activity, so that it is appropriate that a business facing full commercial and competitive risks should earn a higher margin than one that is either in a monopoly position or is not facing full competition.

A regulated supply business can achieve an actual margin higher than that allowed by the regulator if it manages to reduce its costs below what the regulator had allowed, when the Price Control is set.

Below are several precedents for determining an appropriate margin, some examples include:

- Data from Ofgem supply market report suggests typical supply margins achieved by GB suppliers, in a fully competitive market, have been in the range 3.5% to 5.0%

	Dec-10	**Dec-09**	**Dec-08**	**Dec-07**	**Dec-06**
Average Customer bill	520	505	545	420	445
Implied margin	45	25	20	15	20
	8.65%	**4.95%**	**3.67%**	**3.57%**	**4.49%**

Source:Ofgem Supply Market report Dec 2010

- A 1995 MMC Review held that 1.0% margin for Scottish hydro supply business was too high and set it at 0.5% (Supply was not open to competition in GB at that stage);
- In setting price controls in 1998, Offer and Ofgas considered a margin on sales of 1.5% to adequately reflect the increased risks from the introduction of competition;
- In 2005 CER used a 1.3% margin for ESB supply; and
- UR currently uses a 1.5% margin for gas supply.

NIEES position on level of margin

NIEES has commissioned a report from external consultants (NERA) which concludes that an amount of £14.5m (equivalent to 2.9% in year 1 and 3% in year two of NIEES' projected annual regulated sales for the two years of the control) is a reasonable estimate of NIEES' required net margin. The report argues that NIEES is fully exposed to market risk then uses a probabilistic model (Monte Carlo simulation) with various assumptions and inputs to calculate a distribution of earnings outcomes that NIEES might achieve. The probability of default (assumed to equate to negative returns) is determined and then the capital needs requirements to ensure that this probability of default is in line with various categories of other companies is determined. This risk capital requirement and a figure for working capital assumptions are assumed to earn a rate of return commensurate with the derived cost of capital for the comparator organisations to give an amount of margin that NIEES is deemed to require.

The argument that NIEES is fully exposed to market risk is based on basis that:

- NIEES "*is now fully exposed to competition across all sectors of the market … and faces the risk of rapidly losing market share in the SME and household customer segments*";
- The K factor only limits NIEES' profits by ensuring it pays back any over recovery but does not protect it from losses on under recovery since any attempt to recoup the under recovery by raising prices in the following year will lead to loss of market share which "*could be large and rapid*"; and
- The Economic Purchasing obligation ensures that NIEES can only pass through procurement costs if they have been efficiently incurred, which is no different from a retailer operating in a competitive environment.

The UR does not accept that NIEES is exposed to risks to the same extent that a supplier or similar organisation in a fully competitive environment is. There are a number of reasons why this is so:

- NIEES still maintains a very high market share in the domestic and smaller business segments and given the general stickiness of customers (which to date appears higher in NI than in the rest of GB) this is likely to remain so over the price control period. We do not therefore believe that the volume risk to NIEES over the period covered by this review is significant. NIEES' own forecasts of customer numbers in their opex submissions do not show increases in losses of customers to the extent that the loss of market share becomes significant.
- The UR believes the K factor in NIEES' licence continues to fully operate in a manner to protect NIEES from under-recoveries as well as passing back over-recoveries to customers. This is particularly the case during the limited two year horizon of this Price Control.

    - The risks that NIEES describe which may affect the ability to recoup any under recoveries are not exclusive to NIEES, for example a general increases in wholesale prices will require other suppliers to increase prices too. This will provide scope for NIEES to increase theirs without losing market share. Furthermore, there appears to be a core proportion of customers who are unwilling to switch ('sticky' customers).

Whilst these remain NIEES will have the ability to recoup any under recovery.

- In terms of passing back over recoveries NIEES argue that they cannot retain these, so the K has the effect of capping profits but not insulating NIEES from losses. The UR is firmly of the view that the K will insulate NIEES from making losses as outlined above. In addition to this, if NIEES have to pass back an over recovery then they will be pricing below prevailing market prices. This will represent a problem for NIEES competitors, and may well lead to migration back to NIEES. It is reasonable to assume that those customers who have switched away from NIEES are price sensitive. Therefore, whilst passing back an over recovery means NIEES cannot make extra profits (as they argue competitors can) those same competitors are faced with competing with tariffs that are artificially low in the subsequent year. However, the UR wishes to avoid any large over or under recoveries and will consider all submissions for in year reviews in this context.

- The UR has agreed, and confirmed with NIEES, that it will conduct 'in year' tariff reviews when it appears that a K factor adjustment may be required. By adjusting tariffs early, rather than waiting until the end of the tariff year end, it will prevent the K factor becoming too large. We have also agreed to discuss a protocol with NIEES to ensure any in-year review happens expediently.

- The UR believes that the K factor mechanism has worked well to date. It does not anticipate that changes during the coming price review period will be significant enough to change that.

- NIEES argue that a previous statement from the UR means NIEES position is no different to that of a retailer operating in a competitive market, which is only able to recover its losses if they are efficiently incurred. The UR previously stated

  "However, any increased risk on trading will be largely mitigated by the retention of a K factor allowing NIE Supply to pass through 100% of electricity purchasing costs for the first year of the new market ***so long as it complies with the Economic Purchasing Obligation outlined in its licence****"* Emphasis added.

  They argue this gives NIEES exposure to the same market risk as a retailer operating in the competitive market.

This ignores all precedent in this area. It also assumes that there is a possibility that the UR will disallow costs after approving both the generation costs submitted by NIEES for a tariff review and NIEES hedging policy statement which must be submitted for approval pursuant to the licence condition regarding economic purchasing.

Once the policy statement has been approved by the UR, NIEES have the assurance that if they purchase as per this policy costs will be allowed and passed through to customers. The UR believes it is not reasonable to suggest it would agree a purchasing strategy and subsequently disallow costs that had been incurred as per that strategy. If the UR was to be inconsistent in this regard then the licensee has recourse to appeal.

The UR therefore does not believe that it is appropriate for the current price control review to use a methodology to calculate risk margins on the basis of calculating what risk capital requirements would be for a comparable entity operating in a fully competitive environment.

The UR does not believe that the 'capital at risk' approach adopted by NERA is appropriate at the current time for the reasons stated above.

However, even if the approach proposed by NERA was to be applied to set the price control, there are a number of assumptions which have a significant impact and for which the UR believes alternative assumptions may be more appropriate. For example, the analysis is largely based on the assumption that NIEES has comparable default risk with a Baa rated merchant power producer. We believe that, given the dominant position of NIEES in the regulated supply sector, the regulated income stream it consequently receives, and the 'K' factor NIEES is more comparable to other regulated businesses. Using figures from the NERA report (without checking their derivation) the required risk margin for an organisation with a default probability similar to an A rated regulated network is £5.8m and the return on the forward looking working capital requirement for such an organisation is £3.4m, giving a total required return of £9.2m compared to £14.5m proposed by NERA. This also assumes (based on the NERA paper) a half yearly tariff reset (going forward there is an increasing likelihood that this will be the case to deal with volatility and the UR would support this). This equates to a margin of about 1.8%[2] compared to the 2.9% return proposed by NERA. However, this figure of 1.8% is based on a forecast turnover not actual.

Margin Conclusions

The UR believes that for the coming Control Period, NIEES still operate in an environment where very little competition has actually occurred in the domestic market. Although NIEES is losing some market share in these sectors, we do not believe that over the period of this price control the development of actual competition will be significant enough to change

[2] = £9.2m/£14.5m * 2.9%

NIEES' dominant position. In addition to this, we believe that consumers rather than NIEES take"market risk". We do not see that there is yet a need to change the basis on which the allowed return is determined, or that there is a need to significantly increase the return provided to NIEES. We are therefore considering using a net margin of 1.7% of allowable turnover to determine NIEES maximum allowed revenues. This was the implied previous margin and is consistent with the last control. However, the last control saw a fixed amount of money used. At the last control we clearly stated that for future controls the UR was minded to move to a methodology consistent with gas and previous supply price controls in other jurisdictions.

To be more consistent with the approach we use for gas supply, we will fix the margin at this percentage (1.7%) of ***actual*** regulated electricity sales turnover (to be agreed with the UR) rather than fixing an amount of money with an implied margin of this level.

However, given the materiality of the quantum of the NIEES turnover in comparison to Phoenix, we are minded to put in place a maximum and a minimum level which the margin can be. There is a risk that the wholesale gas prices could potentially increase significantly and as a result this could drive up electricity prices. This would result in an increased turnover and subsequent increase in margin, which the UR does not feel would be appropriate. In the same context, there is potential for the opposite to occur, where gas prices drop significantly. Therefore, the UR feels that it is prudent to protect both the customer and the company against the potential for cost shocks. These costs are outside the control of both the customer and shareholder.

As stated above, the UR is considering giving a target margin of 1.7% of allowable turnover, with a maximum and minimum level set. This will protect the shareholder as well as customers. In the absence of regulatory precedent we are proposing to set this at 20% above and below a 'midpoint'. The 'midpoint' has been derived based on the forecast turnover submissions made by NIEES. This is detailed below.

	2011/2012 £ million	**2012/2013 £million**
Forecast Turnover (based on NIEES submissions)	501.2	494.3
1.7% of Turnover	8.52	8.40
Maximum Margin	10.22	10.08
Minimum Margin	6.82	6.72

We welcome respondents' views on this proposed approach.

The UR intends to undertake analysis, through its cross-utility Price Control group, to ascertain if it is more appropriate that 'Regulated Supply Businesses' receive a margin based on other parameters than percentage of turnover in future years. Whilst we agree that working capital costs may fluctuate with turnover this makes up only a proportion of the percentage margin regulators, both in NI and other jurisdictions, have allowed in previous controls for supply companies. Therefore, that proportion not related to working capital costs perhaps should not fluctuate with turnover. The rational being that the risk of the company does not become any greater or less as turnover moves as the majority of its costs are passed through to customers.

How to Respond

Responses are invited on any of the issues raised in this paper and in particular on:

- Allowed Operating Costs; and
- The methodology for setting the margin.

Please also suggest any alternative relevant measures/actions.

Responses to this consultation paper should be sent to:

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By Friday 17th June 2011.

Unless marked as confidential all responses will be published.

Individual respondents may ask for their responses, in whole or in part, not to be published, or that their identity should be withheld from public disclosure. Where either of these is the case, we will ask respondents to also supply us with the redacted version of the response that can be published.

As a public body and non-ministerial Government department, we are bound by the Freedom of Information Act (FOIA) which came into full force and effect on 1January 2005. According to the remit of the Freedom of Information Act, 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 the Utility Regulator to treat responses as confidential. It is therefore important that respondents note these developments and in particular, when marking responses as confidential or asking the Utility Regulator to treat responses as confidential, should specify why they consider the information in question to be confidential.