Utility Regulator
ELECTRICITY GAS WATER

NIE Supply Price Control 2007

Proposals for Consultation

24 August 2007

Executive Summary

The current NIE Supply price control is a two year extension of the 2000 price control which incentivised NIE Supply to, amongst other things, install Keypad meters and promote energy efficiency and renewable energy. The new price control is being introduced at the beginning of a period of change in the Northern Ireland electricity industry with the introduction of full market opening and the Single Electricity Market (SEM).

This price control deals with one element of the final tariff formula (S term) and essentially sets the total revenue NIE Supply can recover from customers for the duration of the control. As NIE Supply has no assets, the Allowed Revenue will consist of operating costs and a margin.

The Utility Regulator requested data and information from NIE Supply at the end of March 2007; NIE put forward its final submission on 31 July 2007. It is on the basis of information and data submitted that we have formed our proposals outlined below.

- Form and Scope will remain as they are currently;
- Duration is set from April 2007 until March 2009;
- Operating costs have been adjusted to take account of proposed disallowances on salary costs and bad debt provision; treatment of pensions will be examined separately and the proposed costs have been allowed at this stage;
- The X factor has been set at -3 for the current and next financial years;
- The allowed margin is 1.8% of total revenues;
- NIE Supply's proposed total Allowed Revenue is reduced by £0.4million in the current year and by £0.8million next year;
- The proportion of Gross Profit apportioned to fixed costs changes from 62% to 67%.

Price Control to Date

NIE Supply's current price control was a two year extension of that set to run from April 2000 to March 2005. The original price control included an incentive to roll-out keypad meters to 100,000 customers, to ensure £10m lifetime savings in energy efficiency measures, increasing sales of renewable energy and a reduction in allowed revenue of 3% in real terms per annum. The extension to this control included a further 75,000 keypad meters, an additional £4m lifetime savings in energy efficiency measures, development of the eco-tariff and a 3% reduction in operating costs in real terms for a further two years.

The current price control has been successful in meeting these objectives; the target of 175,000 keypads has been surpassed, the energy efficiency levy has produced almost 390,000 tonnes of carbon savings, almost £90million in customer savings and earned NIE an incentive of £1.95 million since 2000[1].

Changing Environment

A primary reason for the extension to the 2000 price control to cover the period 2005-2007 was the European Directive requirement to open the market to all customers, including domestic customers, by July 2007. With the development of the Single Electricity Market, it was decided to delay market opening until 1 November 2007 when the all-island market will Go-Live.

The changes to the market will also bring change for NIE's supply business; Supply is required to purchase electricity from the pool and is able to hedge the price/quantity risk by purchasing Contracts for Differences (CfDs). (These hedging arrangements have been agreed for the first year of operation of the Single Electricity market). Also, from 1st November the business faces the potential of domestic customers switching to other suppliers. This additional function brings with it a requirement for additional resources, primarily salaries and, potentially, some degree of additional risk. 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. Similarly, any increased risk from competition in the domestic sector will be largely mitigated (as experience in GB suggests) by the low risk in the short-term of competing suppliers entering the market and hence customer-switching.

Other changes include the transfer of metering from Supply to T&D to facilitate market opening from April 2007, reducing Supply costs by around £2.95 million each year; Keypad assets will also be transferred to T&D as part of common services unbundling, reducing the Supply asset base on which customers pay a return to investors to zero thereby reducing Supply's revenue requirement by £0.9 million each year. (These costs will now be recovered by T&D and be paid for by customers through the Use of System Tariffs (U term)).

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 NIE Supply purchases and so long as NIE 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 NIE 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.

Therefore, most of NIE Supply's costs are straight pass-through costs which are subject to other price controls or regulations and thus, this price control deals with the S_t term of the tariff formula which is in effect the revenue NIE Supply is allowed by the regulator to collect from customers. 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 Allowed Revenue minus the cost of electricity purchases (recovered through the G_t term) is currently collected on a ratio of 62% for fixed costs plus a variable charge on a per customer basis (38%). These amounts are currently:

Fixed: £16.697m Variable: £13.3623 per customer

The supply business, having given over responsibility for metering and the associated assets (Keypad meters) to the Transmission and Distribution business to facilitate full market opening, currently has no assets and therefore depreciation is not a consideration within the Allowed Revenue, neither is a return on assets for investors. There are no current plans for capital expenditure and thus the Allowed

Revenue minus the cost of electricity purchases will consist only of operating costs plus a margin.

Approach

The Utility Regulator requested data from NIE Supply on 30 March 2009. The first partial response to the Business Efficiency Questionnaire was returned to us on 2 May 2007 with a request for missing data sent by the Utility Regulator on 22 June 2007. Additional data was supplied by NIE Supply on Friday 29 June 2007. We analysed the data provided, formulating supplementary questions which were discussed at a meeting between the Utility Regulator and NIE Supply on 24 July 2007. On 31 July 2007 NIE Supply re-submitted data and answers to the supplementary questions and those arising from the meeting. The Utility Regulator has used the data and information supplied by NIE Supply to evaluate NIE Supply's proposals and formulate the price control.

Proposals

Form and Scope

NIE proposed that the current form and scope of the price control should continue i.e. revenue is subject to RPI-X and the control will cover all NIE Supply customers.

Utility Regulator Proposal

As the new market arrangements bring with them uncertainty it would be prudent to allow the present approach to continue until the impact of these becomes clearer. With the establishment of market opening the majority of large users have migrated to other suppliers and the Utility Regulator takes the view that NIE Supply's remaining customers still require the safeguard of regulated tariffs while competition has yet to develop. We also take the view that there is enough clarity on tariffs for larger users to ensure no cross-subsidy is being applied and consider the costs associated with further separation of financial information are too high when balanced with the potential benefits to be gained by doing so. Therefore it is proposed that the current form (RPI-X) and scope (all customer classes) of the price control shall remain the same for the period.

Duration

NIE Supply considers that the period of the price control should be relatively short so it can be revised in light of developments in the SEM and after market opening. NIE proposes a three year price control running from April 2007 until March 2010 including activation of its Economic Purchasing Obligation from 1 November 2007.

Utility Regulator Proposal

There are a number of options with regard to the period of the price control; a five year control may be desirable for many reasons, not least stability for tariffs, the opportunity for incentive regulation to work effectively, as well as certainty for shareholders. However, the new market arrangements bring uncertainty and whilst we are more sure of the likely pace of market opening, we are not yet sure how best to regulate NIE Supply under the new wholesale market arrangements. Since the all-island market will Go-Live from November, a one year price control to April 2008 would add little additional information, experience, nor certainty to new arrangements from then. Therefore it is proposed that the price control period run from April 2007 to April 2009 which will include 17 months operation within the new market environment.

Operating Costs

The Utility Regulator intends to adjust NIE Supply's proposed operating costs with regard to 2 areas of expenditure – salary costs and bad debt.

Salaries

NIE has included additional costs for:

2007/08	3	New trading and settlement functions within the business in the new market framework
	2	Field Service personnel for customer-facing field work
	2	Support Services personnel
2008/09	2	salaries relating to NFFO
	1	IT function

Utility Regulator Proposal

Whilst we are satisfied of the requirement for some additional staff, we are not convinced that all the additional posts are necessary. We accept the requirement for 3 additional staff for the new trading and settlement function.

NIE Supply has stated the two Field Service Staff currently work for T&D and have been since the transfer of the metering function from April 2007. NIE has said these staff will have a more supply-oriented customer service role that many customers require as opposed to a more technical role of other T&D staff. The Utility Regulator proposes to allow these staff to transfer to Supply but will adjust the T&D price control to reflect the transfer.

The 2 Support Service personnel (1 debt and 1 cashier) will, according to NIE Supply, will reduce dependence on agency staff. The Utility Regulator is proposing to allow these salaries on the basis that the bill for agency staff is reduced accordingly over the next 2 years.

The Utility Regulator came to an agreement with NIE Supply regarding the management of NFFO contracts during the course of this process; accordingly, only 1 additional member of staff should be retained for management of NFFO contracts.

The Utility Regulator agrees that 1 additional salary for the IT function within the business is appropriate.

Bad Debt

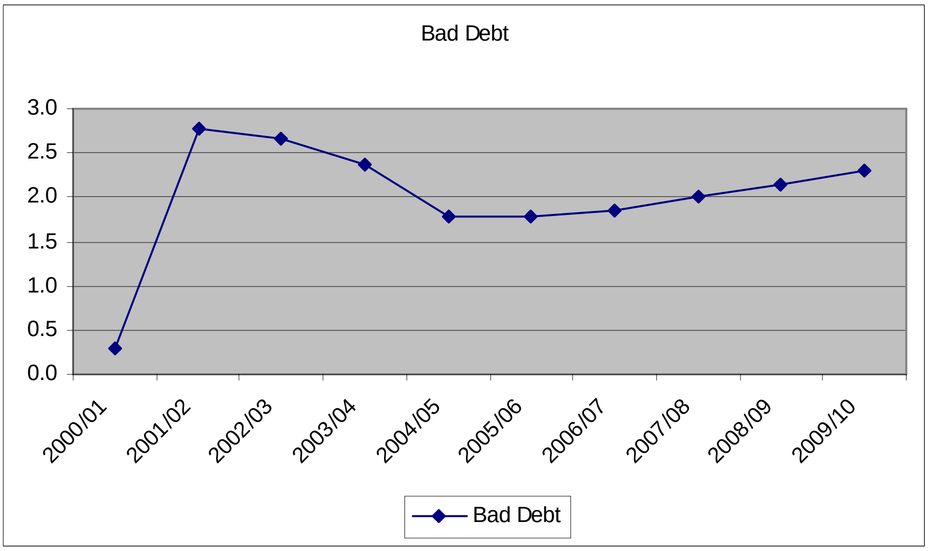
NIE Supply states that the Utility Regulator's decision not to prevent domestic customer switching on the grounds of debt will increase Supply's exposure to bad debt and therefore it will incur additional debt management costs.

Utility Regulator Proposal

Whilst we recognise exposure to bad debt may be expected to increase in a fully open market, we remain to be convinced that there is a requirement for increasing bad debt provision for two primary reasons;

Firstly, around half of NIE Supply's domestic customer base pay by Direct Debit or Pay As You Go thus, exposure to bad debt is limited to half the customer base. We also believe the competitive market will take some time, beyond the duration of this price control, to reach the stage where large numbers of customers will be switching supplier.

NIE Supply customer forecasts suggest an expectation that most customers switching in the current financial year will be SMEs. SMEs can currently be blocked from switching on the basis of debt and therefore exposure to bad debt in this sector will be a function of NIE Supply's policy.



We also note that bad debt provision had been reducing until 2004/5 with increases during the last two financial years and are therefore not convinced of the need for increasing provision for the reasons NIE Supply have given. In light of this we propose that bad debt provision be capped at 2006/7 level (£1.85 million) for the current and next financial years.

Pensions

The Utility Regulator will address the pensions issue separately in an exercise looking at PPB, SONI and NIE Supply together; there has therefore been no adjustment made at this time.

Total Operating Costs

The adjustments the Utility regulator is proposing will reduce NIE Supply's proposed operating costs by £298,000 during 2007/08 and by £636,000 during 2008/09.

	2007/08 Proposed £m	2007/08 Allowed £m	2008/09 Proposed £m	2008/09 Allowed £m
Salaries	2.161	2.096	2.441	2.188
Bad Debt	2.000	1.855	2.150	1.855
Depreciation	0.114	0.114	0.018	0.018
Reorganisation	0.000	0.000	0.000	0.000
MBIS Total	5.800	5.712	6.026	5.939
Interbusiness Total	0.885	0.885	0.897	0.897
Northgate Total	7.823	7.823	8.028	8.028
Total Operating Costs	**18.783**	**18.485**	**19.560**	**18.924**

X Factor

The X factor is a figure by which the inflationary increases in operating costs is reduced to reflect internal efficiencies that can be made to reduce these costs. Efficiency gains are usually achieved by either reducing costs and/or increasing productivity. To date NIE has had an X factor of 2 or 3 applied, reducing operating costs of the business by at least 14% in real terms since April 2000. NIE has proposed an X factor of zero which would give it an inflationary increase on operating costs of the business stating: 'There is therefore no reason to expect Supply's unit costs to fall relative to the RPI. Indeed a rise may be more likely and so X would be zero or negative…On balance, therefore, we might expect trend electricity supply Total Factor Productivity growth to be rather lower than that in the economy as a whole.'

Utility Regulator Proposal

Whilst the Utility Regulator accepts that there will come a time when the business is so efficient that further gains will be difficult, if not impossible to achieve, our analysis suggests that the company has not yet reached this stage. After stripping out non-typical costs, such as reorganisation and costs affected by additional variables such as core staff numbers or transfer of functions such as metering, we believe NIE has outperformed the X factor of -3 applied since 2002/03, by an average 28% each year.

Immediately prior to full market opening in Britain Ofgem set an X of -3 for most of the PES's for two years from April 1998; the Northern Ireland market is at a similar stage of development.

In light of additional savings made by NIE over the previous period and the extent to which we believe costs are still controllable, we propose to keep X at -3 for the next two years.

Margin

Since 2000/01 NIE Supply's net margin has averaged 1.7%, ranging from 1.3% to 2.3%. NIE Supply has suggested the margin be 1.8% of total revenue.

Utility Regulator Proposal

Since the supply business has no assets on which a return could be earned and whilst we understand that in the long-term margins are likely to increase in a competitive market, in their decision paper *Regulation of ESB and NIE in SEM: A Decision Paper*[2] the Regulatory Authorities (RAs) decided to continue with prevailing margins for PES businesses. The decision will be reviewed after one year of new market arrangements, in November 2008. We therefore propose to set the margin at 1.8% for the duration of the price control however, this will be subject to the outcome of the aforementioned review.

Allowed Revenue

Total Allowed Revenue

With the adjustments outlined, the Utility Regulator is allowing NIE Supply to collect a total of £486.0 million from customers over the course of 2007/08 and £503.5 million in 2008/09.

	2007/08 Proposed £m	2007/08 Allowed £m	2008/09 Proposed £m	2008/09 Allowed £m
Turnover	**488.2**	**487.8**	**506.1**	**505.3**
Cost Of Sales	458.9	458.9	475.7	475.7
Gross Profit	**29.3**	**28.9**	**30.4**	**29.6**
Operating Costs	18.8	18.5	19.6	18.9
Operating Profit	**10.5**	**10.4**	**10.8**	**10.7**
Other Items - Pension Adjustment	1.6	1.6	1.6	1.6
Net Profit	**8.9**	**8.8**	**9.2**	**9.1**
Net Profit Margin	1.8%	1.8%	1.8%	1.8%

Fixed: Variable Ratio

The ratio of fixed to customer variable proportions of the Allowed Revenue minus the cost of electricity purchases is currently 62:38. NIE proposes to change this to 67:33 on the basis of a larger proportion of their costs being fixed and not varying with customer numbers.

Utility Regulator Proposal

On the basis of information and data supplied by NIE Supply, the Utility Regulator proposes to change the fixed proportion of total Allowed Revenue minus cost of electricity purchases from 62% to 67%. The next price control process from April 2009 will include a thorough analysis of the nature of NIE Supply's costs and set an appropriate ratio at that time.

How to Respond

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

- The principle of extending the current price control for two years;
- The proposed adjustments to operating costs;
- The X factor;
- The margin;

And

- Allowed Revenue.

Please also suggest any alternative relevant measures/actions.

Responses to this consultation paper should be sent to:

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By Friday 21st September 2007.

Unless marked as confidential all responses will be published.

[1] Taken from 'The Northern Ireland Energy Efficiency Levy – A Review'; the Utility Regulator; March 2006 available at http://ofreg.nics.gov.uk/pdf%20files/The%20Energy%20Efficiency%20Levy%20Programme%20-Review.doc

[2] *Regulation of ESB and NIE in SEM: A Decision Paper* (AIP/SEM/304/07) published by the Regulatory Authorities 20 June 2007 http://www.allislandproject.org/en/generation.aspx?article=4ad994c7-e273-485d-a30f-c658a34e90f7