

Northern Ireland Electricity's  
Power Procurement Business

**Final Proposals Paper**

Price Control Final Proposals issued by  
The Director General of Electricity Supply (NI)  
for the period April 2002 – March 2005

July 2002

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## **Introduction**

Ofreg issued an initial consultation paper in February 2002 in relation to price controls for Northern Ireland Electricity's Power Procurement Business (PPB). This consultation process received a limited response. Ofreg then held a series of meetings and exchanged correspondence with NIE in order to try and reach agreement on the basic principles of the price control proposals.

In light of this the final Power Procurement price control proposals are issued in this paper. Ofreg feels that the decisions presented below effectively align the interests of customers and shareholders.

## **Background**

The EU Directive EC/96/92 concerning the Internal Market in Electricity (IME) caused changes in the operating roles and incentives of PPB. In particular there has been a movement to incentivise PPB to earn additional revenue from outside the franchise market and to reward its ability to add value for franchise customers.

It is likely that the next EU Energy Directive will call for complete market liberalisation within the next five years. The exact nature of this Directive should become clearer later this year. Therefore PPB will increasingly move from its original position of being a single buyer of wholesale power to a market participant and energy wholesaler. Further liberalisation of the market will most likely result in PPB's expected sales from BST to fall over time. However the potential still exists for PPB to maximise the possible return from its generation contracts by selling its capacity into the market at its best possible price.

The price control decisions by Ofreg aim to encourage PPB to source an increasing amount of its revenue from commercial markets. This ability will be essential to PPB in the context of market liberalisation. This new regulatory period will be an important transitional phase for the PPB. It must be allowed to recover sufficient revenues to meet its licence obligations but at the same time it should be encouraged to act in a more commercial manner.

Ofreg does not consider PPB to be an inherently risky business during the period covered by this price control. Even with the possibility of further market opening, PPB faces no more risk now than it has in the past. It has a largely captive market, with a tightening capacity margin, near guaranteed sales and scope for considerable non-BST sales. Its portfolio of contracts has recently become more competitive as old contracts expire and as a more efficient power station supplies the Ballylumford contract. Ofreg would argue that any risks which may be associated with the power purchase contracts are primarily perceived risks by potential PPB purchasers and counter parties to the contracts. Therefore they are not actually risks borne by NIE shareholders since money can be recovered from customers.

The effect of the final price control decisions is to modify the revenue profile which applies to the PPB business, with the intention of allowing PPB to earn revenue from sales into the market.

Ofreg feels that the price control decisions for the period 2002-2005 more than allow PPB to recover sufficient revenues to meet its licence obligations.

### **The Existing Power Procurement Price Control**

The existing PPB price control came into operation on 1 April 1997. However the control was modified in 2000/01 to account for the new roles placed on the System Operator Northern Ireland Ltd. (SONI Ltd). This modification allowed PPB's own costs to be recovered through an allowance per unit sold at the Bulk Supply Tariff and an allowance per unit sold at non-BST rates. The allowance for BST sales for the period to 31 March 2002 was set at 0.02p/kWh, and for non-BST sales at 0.12p/kWh. The greater allowance for non-BST sales was to encourage PPB to maximise the use of its contracted generation plant by making additional sales over and above the BST sales to the NI market, and hence make a contribution to lower electricity prices by reducing the gross level of the BST.

The Bt or "yardstick" term was established in the first price control set in 1992 and its purpose was to give PPB an incentive to control and manage BST costs over which it had significant influence, for example the purchase price of fuel and the effective management of the generation contracts. The Bt term was made up of a basket of fuel price indices, which were then used as a yardstick against which NIE's actual contracted generation (including fuel) price would be compared on an annual basis. A cap and collar mechanism was also in place which effectively allowed PPB to earn no more than £4m per annum or incur a loss no greater than £4m per annum on this term. However in 1997 it was decided that although the yardstick should be retained, the cap and collar arrangements were too wide and the maximum profit was easily attained.

The cap and collar arrangements suited a structure where PPB acted as a monopoly/monopsony and therefore had no other commercial or regulatory pressures to maximise revenues by either cost minimisation or sales maximisation. This is no longer the case. Following market opening, the price control was again modified in 2000 to specifically encourage PPB to make sales at a non-BST price. The form of encouragement was a specific monetary allowance per unit sold, set at 0.12 p/kWh (this was six times higher than the allowance for sales at BST).

### **The Next Regulatory Period**

#### Duration of the Interim Control

A duration of three years has been given for this regulatory period. However the price control may be re-opened within this period should circumstances require. The duration of this price control is relatively short due the uncertainty surrounding the development of the market. It is important that this price control does not include any elements or induce any behaviour in PPB which will be difficult to unravel when new structures are needed. This price control period will encourage PPB to seek sales opportunities now which will provide valuable experience in any new market structures.

## The Structure of the New Control

The price control for the regulatory period 1 April 2002 to 31 March 2005 is based on the same principles as but is not a simple continuation of, the existing control. The following paragraphs summarise the main elements of the new price control.

### Revenue Entitlement

#### *BST Sales to Franchise Market*

The CA<sub>t</sub> term will be set at 0.02 p/kWh (2000 prices) and revenues earned from the franchise market will be set at a minimum level of £1.08m. If this level is not met by sales to franchise market at 0.02 p/kWh then the CA<sub>t</sub> term will be adjusted to allow revenue to reach the floor amount of £1.08m.

#### *Other Sales*

PPB should demonstrate to Ofreg that a non-franchise market sale has been made and that this sale will automatically attract a 0.12 p/kWh incentive payment. Thus revenue from the CB<sub>t</sub> term will be these other sales times 0.12 p/kWh. Ofreg recognises that it is difficult for PPB to monitor the exact profitability of CB<sub>t</sub> sales. The level of profit is difficult to measure without running a full system re-dispatch analysis. This would not be a cost-effective way of calculating CB<sub>t</sub> revenue. However it is believed that the simpler method proposed above will still be in the interests of customers, as a contribution will still be made to franchise sector PPA costs. Prudent contracting by PPB will ensure customer benefit.

#### *Total Revenue Entitlement*

PPB will be required to undertake an annual calculation of sales volumes and the associated CA<sub>t</sub> and CB<sub>t</sub> revenues. This calculation will demonstrate the effectiveness of the flat 0.12p/kWh CB<sub>t</sub> incentive payment. PPB's sales levels will therefore be considered after the first year of this price control in order to assess the effectiveness of the incentive.

In order to ensure that PPB is allowed sufficient revenues to cover its licence obligations under this price control period it will be allowed a minimum revenue entitlement of £3.86m. Therefore the B<sub>t</sub> element of the formula will be set at the greater of £1.52 million and the difference between the sum of CA<sub>t</sub> sales of £1.08m and expected CB<sub>t</sub> sales of £1.26m and £3.86m. In other words it will act as a balancing mechanism to derive minimum PPB revenue of £3.86m, while not preventing non-BST sales pushing total revenue even higher.

### The Price Based "X" Factor

The continuation of the "X" factor approach is important from a regulatory perspective. However it will only apply to the CA<sub>t</sub> and B<sub>t</sub> revenues. Thus it will effectively cap the growth of the £1.08m and £3.86m floors at inflation less 0.5%. The "X" factor approach does not apply to the CB<sub>t</sub> sales revenue, hence there is scope for PPB to earn significant revenues in excess of £3.86m in any event.

## Renewable Electricity

PPB currently acts as the purchaser of energy from renewable generators under the NFFO Orders. The excess cost of NFFO is recovered in the Public Service Obligation (PSO) charge.

In 2001/02 PPB held an auction of NFFO output rights and allocated the output to market participants. This was intended to allow those suppliers who had a market for renewable electricity to obtain green energy to meet their customers' demand. It also allowed the excess cost of NFFO to be reduced, hence reducing the burden on all customers. The auction process has been continued for 2002/03. However from 2002/03, PPB will take on a further role in the encouragement of more renewable electricity development by acting as a purchase of last resort for small independent (non-NFFO) renewable output. This will add certainty to the renewable market and encourage the commercial development of renewables, hence avoiding some or all of any future government levy. It is envisaged that a bilateral renewables market will develop, such that customers and small renewable independent power producers will contract independently. Energy produced and not sold by these small renewable producers will be purchased at a fixed price by PPB (which would be based on a percentage of the market price of renewable energy and it is likely, subject to further study in the interim, that this price will be set initially at 3p). PPB could then re-package and sell this incentivised renewable energy on to suppliers, who could sell to final customers. NIE has been incentivised to take on this role as it will be allowed to retain the profit resulting from the difference in the purchase and sale price. The profit will be calculated on the basis of the revenue earned in excess of the renewable spill price (i.e. likely to be 3p/kWh) for all sales. In addition, NIE would be indemnified against making a loss by the ability to pass through any costs not met through a PSO levy. This mechanism will come into effect on 1 October 2002.

## Further Initiatives

PPB has for 2002/03 disposed of by auction the energy equivalent to the 125MW of its 70-month take or pay contract with Scottish Power (MEE auction).

This, and other PPB trading sales (e.g. sales to IPPs or sales to ESB) will attract a 0.12p/kWh incentive.

The energy equivalent, which may be auctioned, will equate to approximately 1,000 GWh over each twelve-month period. PPB may decide to hold a further MEE auction during the period 2003/04.

This mix of incentives is intended to encourage PPB to continue to seek to maximise its generation capacity's potential by seeking to maximise its portfolio of sales, and simultaneously minimise fuel and other input costs.

Should PPB seek, under its own volition, at a future date to make any potential excess generation output available to the market at a non-BST price, then it would (subject to a suitable economic purchasing case being made to the DGES) attract the 0.12 p/kWh incentive payment. Should PPB decline to make a sale of energy which is not

required for the franchise market or to honour other commitments it could be considered to be in breach of its economic purchasing obligation. Thus the efficient management of generation resources under contract to PPB is inextricably linked to PPB revenues.

### Contract Renegotiations

Any proposals, which PPB brings forward to further improve contractual or other agreements for the benefit of customers, should be rewarded. It may prove that upon initial examination there is no “deal” to be done, but PPB should be incentivised to examine possibilities. The DGES will allow initial exploratory costs to be recovered through the Dt term, subject to notification. Any further work to take proposals forward would proceed after joint examination of the potential benefits, and an appropriate incentive allowance could be determined. Proposals will be appraised on a case-by-case basis. This approach will ensure, in broad terms, that the interests of PPB and the interests of customers in terms of contract management and most efficient use of resources are aligned.

### Risk and Uncertainty

The DGES recognises that there may arise certain unforeseen costs as a result of market liberalisation which do not fit into any of the specific categories contained in the analysis outlined above. With this in mind, the Dt term should be considered to include any such cost which the DGES deems to be allowable but not covered elsewhere in the price control formula. The approval of such costs would be required before they were incurred.

### The Asset Base of PPB

This price control analysis does not derive PPB regulated income from the application of a typical RPI-X price control formula, nor does it establish a modified asset base for PPB. The nature and short duration of the proposed control dilutes the efficacy of this approach. The BST sales allowance as set in 2000 was based on the adjusted asset base for the period 1997-2002. The continuation of this allowance into 2002-05 effectively preserves that asset base implicitly. The area of PPB asset value will be re-visited as part of the next stage of the evolution of the PPB, to be implemented from April 2005.

### **Conclusion**

The proposals outlined above require PPB to become increasingly entrepreneurial in its approach. The effect of the proposals will be to modify the revenue profile that applies to the PPB business, with the intention of allowing PPB to earn revenues from sales into the market. However they also open for PPB the opportunity, through incentives which align customer and shareholder interests, of substantially increasing profits through adding value for customers as Northern Ireland moves to develop a more liberalised generation market. Ofreg has allowed PPB revenue to cover the operating costs of the business as well as providing a significant margin to reward the business.

Comments on the issues contained in this Final Proposals Paper should be sent by Friday 23 August 2002, to

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Please include a one page summary with submissions.