

PPB PRICE CONTROL

AN INITIAL PROPOSAL PAPER BY THE NORTHERN IRELAND
AUTHORITY FOR UTILITY REGULATION

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Section 1 Introduction and Background to the PPB Business

NIE's Power Procurement Business (PPB) was set up at privatisation in 1992 as a separate regulated business under the Northern Ireland Electricity Transmission and Public Electricity Supply Licence. The role of PPB, as defined under the Supply Competition Code, was to act as a single buyer for the purchase of wholesale electricity in Northern Ireland, and to sell this wholesale electricity to licensed suppliers (including NIE's own Supply Business) at a published and regulated tariff, the Bulk Supply Tariff (BST). NIE, via the PPB, purchases energy from independently owned generators under long term contracts (Power Purchase Agreements - PPAs) which were put in place prior to privatisation, and continue in force until expiry or cancellation (earliest cancellation for some units is 2010). These contracts are a "pass through cost" and form the largest element of cost under the BST.

The contracts are a legacy from the privatisation arrangements put in place in 1992 and they must be paid for until they expire or can be cancelled. To date PPB's primary role has been the management of these contracts and the associated cost recovery.

To date, PPB has had a significant public interest role in managing the contracts on behalf of customers. PPB will need to continue in this public interest role as long as the generation contracts put in place at privatisation remain. However it should also be borne in mind that PPB has never been in a position where it bears any risk in relation to these contracts. If at any time PPB could not make enough money from energy sales to cover the cost of the contracts the money would simply be recovered from customers via a levy. It is also important to bear in mind that PPB is an NIE company with Viridian as its parent company. It therefore belongs to a privately owned company whose main priority is the financial health of its shareholders.

The structure where PPB acted as a monopsony buyer and monopoly seller of electricity changed with the EU Directive EC/96/92 which allowed some eligible customers to buy from alternative suppliers who in turn could buy from alternative generators other than PPB's contracted generation. Under the new market structure PPB was incentivised to maximise its sales.

The form of the regulatory controls set on PPB has therefore emerged with the emergence of new market structures. The first form of price control was in an environment where all sales were at BST. The price control reflected the need to ensure contracts were run efficiently and purchased economically. The

second form of control, at the time when market opening was piecemeal, reflected the need for the PPB to make as much sales as possible in order to reduce the fixed costs of the contracts faced by an ever-decreasing customer base. With the advent of the SEM we are now moving into a third phase of regulatory control on PPB where there is no longer a need to maximise sales as all sales will now be made through the mandatory pool.

This paper examines the options for setting the allowed revenue which the PPB is allowed to earn in the SEM.

Section 2 Structure of the Current Price Control (2002-2007)

The current price control was initially set for a three year period from 1 April 2002 until 31 March 2005, and was subsequently extended for a further year until 31 March 2006, then extended with a small modification to run until the start of the SEM in November 2007.

The 2002-2007 price control incentivised PPB to act in a manner which maximised efficient use of generation capacity, allowing additional incentive based profit to be earned which also provided a benefit to franchise customers. The current price control essentially secured for PPB, at at little or no risk, all the benefits of owning generation.

During this price control PPB's behaviour was incentivised in relation to a number of roles. The transition of PPB from a single buyer of wholesale power to a market participant and energy wholesaler was facilitated by a p/Kwh incentive on non-BST sales.

Currently PPB's own costs are recovered through an allowance per unit sold under the Bulk Supply Tariff, and an allowance per unit sold at non-BST rates. Sales at the BST reflect the sales made to the non-liberalised element of the NI market, i.e. franchise sales. While the non-eligible market is technically open to competition from other suppliers, the requirement to buy at BST effectively limits the degree of non-NIE supply. Therefore BST sales are largely made to NIE's own Supply business, and are also made as "top-up" energy to those suppliers in the eligible sector which do not have sufficient independently-sourced energy to meet their customers' demand. Non-BST sales, i.e. eligible sales, are those sales which are made to other parties such as Energia - an affiliate business of PPB and ESB/ESBIE, and are not made at a set or regulated tariff price.

PPB Operating Costs and Profits.

PPB's reported operating costs for the last five financial years (since 2002/03) are displayed in the table below.

Year	2002/03	2003/04	2004/05	2005/06	2006/07
Operating Costs (Nominal prices) £m	0.8	1.1	1.2	1.2	1.3

As can be seen from the table, PPB's operating costs have been gradually increasing from 2002/03 until 2006/07.

PPB's profit since 2002/03 is shown in the table below.

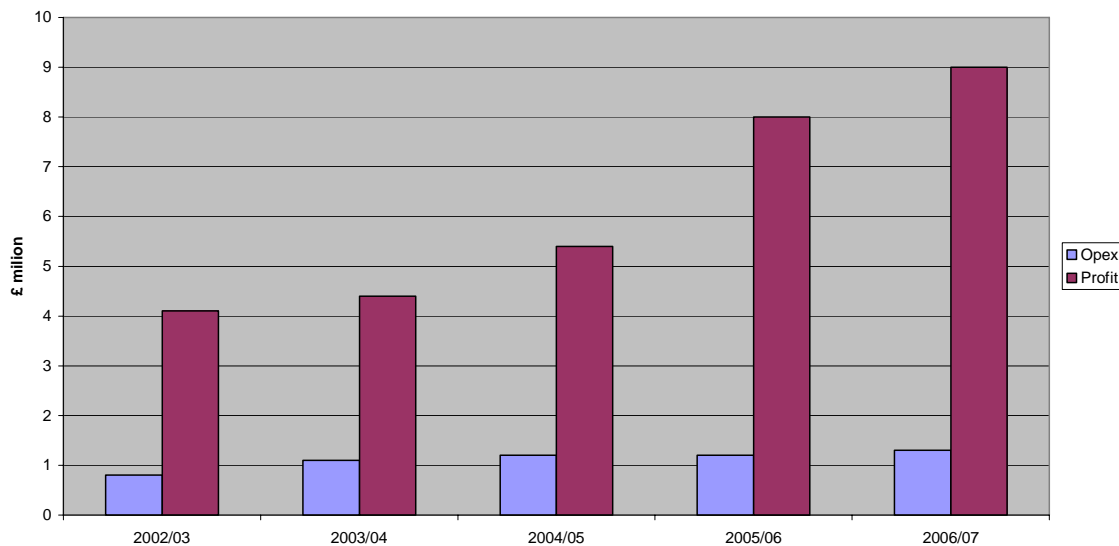
	2002/03	2003/04	2004/05	2005/06	2006/07
Total Profit (Nominal prices) £m before exceptional items	4.1	4.8	7.0	7.9	7.2
Total Profit (Nominal prices) £m after exceptional items	4.1	4.4	5.4	8.0	9.0

Exceptional items relates to provisions for costs such as Kilroot FGD, Centrica disputes etc

PPB's profit has grown in recent years, particularly in the last two years of the current price control period.

The greatest revenue stream for PPB has been from the entitlement received from the eligible (non-BST) sales. This has been the main driver behind PPB profit levels particularly in the last 2 financial years when eligible sales accounted for more than 60% of net profit. With the advent of the SEM, this sales requirement is no longer necessary.

PPB Opex vs Profit



Section 3 : proposals for the new price control

Background

Agreement was reached with NIE in 2006 to extend the existing price control which was due to expire in April 2006 until the start of the SEM. An amendment to the incentive for non- BST sales was introduced resulting in some £300k savings to customers per annum.

Following that agreement NIE wrote to the regulator in December 2006 with proposals for establishing a new price control on the PPB business. The Utility regulator sent NIE PPB a business efficiency questionnaire on 30 March 2007. This questionnaire was designed to extract information from the company which would inform the regulator of the financial position of the company - necessary to form an opinion of the suitable form of price control in the future. NIE PPB sent back a partially completed questionnaire on 3rd July 2007. Meetings between the regulator and NIE PPB were subsequently held for clarification and further analysis of the data provided by NIE. On 31 July the utility regulator received a further proposals paper from NIE.

This section outlines the arguments made by NIE in its paper and gives the utility regulator's response to those arguments. The issues to be decided in relation to the PPB price control are in 4 main categories:

1. Nature and Duration of the price control
2. Operating Costs
3. Profit allowance; and
4. Incentives

Each of these categories is dealt with in turn in this section 3. Section 4 outlines the Utility regulators proposals for the price control based on the rationale outlined in this section.

1. Nature and Duration

The Power Procurement Business is currently part of Northern Ireland Electricity plc along with the transmission and distribution business and the supply business. However, post SEM Go-Live it will be transferred as part of NIE Energy along with NIE Supply and will be a separate entity from NIE plc which will comprise of the transmission and distribution only. Both NIE plc and NI

Energy will continue to be owned as part of the Viridian group. Strong business separation arrangements will be in place within NIE Energy to ensure that the PPB activity is separated from the Supply activity of NIE Energy.

Default price controls for PPB and NIE Supply have been included in the NIE Energy licence effective from Go-Live. These default price controls are essentially continuations of the existing controls. In the event that the proposals for an enduring price control are not accepted by NIE/NIE Energy then the default price control will apply. The default price controls were formulated without prejudice to any enduring price controls that the Utility regulator may propose. The purpose of this paper is to discuss the proposal for the enduring PPB price control.

PPB presently buys power via the legacy contracts put in place following NIE privatisation and sells it through the Bulk Supply Tariff (BST). It also makes non-BST sales with power also purchased via the legacy contracts and currently has a volume based incentive in order to maximise the sales of contracted power and hence reduce the effect of the fixed cost elements of these contracts to Northern Ireland suppliers.

Post SEM Go-Live this situation will change. PPB will still purchase power under the legacy contracts but will sell it to the SEM pool. It may also offer contracts for differences on a non-directed basis to suppliers. (Arrangements for the sales of CfDs have been agreed with the regulator for the first year of the SEM - the enduring format and any price control consequences will be negotiated once the SEM is up and running).

NIE have argued that the new price control should run until April 2010. However it is the Utility regulator's view that given the uncertainty surrounding new arrangements in the SEM a shorter duration is appropriate.

The Utility Regulator therefore proposes an initial control period of 17 months until end March 2009.

2. Operating Costs

The table below sets out PPB's submission of its historical and forecast operating costs. Post-SEM, PPB envisages that the operating costs are set to double as a consequence of the introduction of the new arrangements. The majority of their envisaged increase in costs is due to PPB's proposal to employ 6 extra staff. Two of these will be transferred from SONI to carry out contract management functions that are presently carried out by SONI. They also propose to employ four extra staff to carry out new functions with respect to the SEM market.

These new staff costs are part of the “SEM related costs” set out in the table below (as submitted by NIE) and also part of “Other costs 3” which have been pro rated from their 2006/07 level to reflect six new staff joining the seven existing staff.

Financial Year	Historical 2007 Prices £'000							Forecast 2007 Prices £'000		
	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Salaries	380	340	300	520	510	455	500	490	507	520
MBIS	670	270	270	220	140	100	198	200	190	190
Other Costs 3	90	40	40	20	60	70	70	160	190	180
SEM Related Costs	0	0	0	0	0	0	0	410	730	745
Interbusiness	440	420	320	470	560	640	530	510	520	510
Reorganisation	290	0	0	0	0	0	0	0	0	0
Operating Costs	1,870	1,070	930	1,230	1,270	1,265	1,298	1,770	2,137	2,145
Adjustments										
Other Costs 3	0	0	0	0	0	0	0	(50)	(50)	(50)
SEM Related Costs	0	0	0	0	0	0	0	(125)	(189)	(202)
Total Adjustment	0	0	0	0	0	0	0	(175)	(239)	(252)
Adjusted Operating Costs	1,870	1,070	930	1,230	1,270	1,265	1,298	1,595	1,898	1,893

The Utility regulator has reviewed the operating cost submission made by PPB and proposes making the following adjustments:

The Utility regulator’s initial view is that as well as the two SONI staff, one additional employee would constitute sufficient resources for PPB to carry out its activities in the SEM. PPB’s proposal of a total of six extra staff is almost a doubling of staff numbers. There are currently seven people employed in PPB and one of these is the overall manager. Therefore six new staff would double non-management numbers to twelve. The Utility Regulator is of the opinion that this is excessive. Although it is recognized that extra functions will be required to be carried out under SEM (SRMC bidding, any CFD settlement, Pool revenue settlement) it is also true that various functions carried out by PPB today will no longer be necessary (BST formulation, bi-lateral contract sales settlement, NFFO contract settlement and land bank management).

The Utility Regulator has made adjustments to the proposed costs as can be seen in the table. These adjustments are in the extra “SEM related” and “other” costs discussed above and the operating cost line has been adjusted to reflect this change.

Hence the overall reduction in costs is £175k for 2007/08 compared to the submission by NIE. This is an operating cost saving of c.9% for Northern Ireland customers and although this is recognized as challenging it is most definitely achievable. Should PPB be required to move to a 24 hour operation or indeed some form of “out of hours” operation then these costs could be examined again and possibly revised.

Finally, with respect to operating costs the Utility Regulators initial view is that operating costs should rise by the Retail Price Index minus 3% on a yearly basis. The 3% is the figure by which the inflationary increase in operating costs we would expect to see is reduced to reflect internal efficiencies that can be made to reduce these costs.

3.Profit Allowance

Basic Profit Margin - NIE Proposal

NIE has suggested that the PPB price control should also provide for a “basic profit margin”. Essentially the Utility Regulator understands that in addition to revenues to cover its basic operating costs and any incentive/pass through mechanism for new external costs, NIE’s proposal is that PPB’s allowable revenues should include an additional margin of profit.

The reasons NIE gives for why such a profit margin should be included are as follows:

- Most regulators in other jurisdictions have applied a margin-based approach to set a reasonable profit allowance for energy trading businesses. They cite the example of Ofgem when it set up price controls for the supply businesses of the RECs in the late 1990s and by Offer before it. They go on to state that in the United States there are several examples of regulated intermediaries receiving a fixed margin and finally, they state that in Canada, the Alberta Energy and Utilities Board recognised that a rate of return approach may not provide a reasonable return for energy trading businesses.
- They further state that there are many other compelling reasons for using a margin-based approach, citing that many of the costs incurred by energy traders are driven by total revenues (e.g. meeting credit requirements), and hence a margin-based approach automatically reflects an energy trader’s cost drivers.

- NIE then state that PPB's basic margin (i.e. excluding any incentive) is warranted by (i) the risks it incurs, (ii) the expertise it deploys on behalf of Northern Ireland customers, and (iii) the implicit guarantee (which will become explicit under the NIE Energy restructuring) that NIE provides to its contract counterparties.
- They state that while the risk the business faces is mitigated by the PSO arrangements it is not negligible.

NIE go on to discuss the risks as follows:

First, they state that there are some assets employed. Their explanation of this is that the timing of payments is such that PPB's regulatory accounts have a monetary working capital adjustment (MWCA) cost of around £1m. This, they state, is a measure of the inflation-related part of the interest costs of the business. In the absence of final decisions on SEM pricing rules and reliable modeling of the SEM price profile, they indicate that it is not yet possible to determine what changes there will be to the working capital requirements for the business but that there is likely to be a material requirement.

Secondly, they state that without an ex-post pass-through to the PSO, PPB would have a substantial revenue risk which would increase as wholesale and retail competition increases, and which is subject to influence by ESB's continuing market dominance. Even with a pass-through they state that there will be fluctuations in PPB profitability from year to year as a result of the inherent variability of the PPA contract costs and market revenue under the SEM.

They also state that given the pass-through, PPB's cost risk might seem to be limited to its own costs. This is small (relative to overall turnover) but not insignificant, particularly given the uncertainty associated with the introduction of the SEM.

Moreover, they argue that there are potentially more serious cost risks. They argue that a cost may be incurred that turns out not to be allowable, for example as a result of a difference of opinion over whether PPB has satisfied its Economic Purchase Obligation (EPO) requirements. They go on to state that similarly, the ex-post PSO guarantee may be altered while there is still a k-factor deficit. They believe that this might take the form, say, of alteration of cap and collar limits, claiming that the recent discussion in both RoI and NI of the possible removal of revenue correction mechanisms illustrates the risk.

They also state that it might be argued that an efficient company should have no regulatory risk problems (e.g. EPO) but the risk of disallowance is one-sided. In their view, investors face the possibility of inefficiency and disallowance but no compensating upside for super-efficiency. Hence they believe that their expected return, which should equal the cost of capital, should be calculated after allowing for the expected value of this one-sided risk.

NIE also mention the explicit guarantee that will be necessary for T&D to give to generators on behalf of PPB after NIE is split into NIE plc (T&D) and NIE Energy (Supply and PPB). They argue that although NIE is able to give the guarantee by virtue of its possession of assets in the transmission and distribution business, it is not the case that these assets have already been rewarded in the T&D price control and that no further reward is warranted in respect of the guarantee. They believe that the T&D price control rewards the risk to the assets stemming from their use in the T&D business and that the guarantee to the generators introduces further risk that needs to be rewarded.

Finally they state that the level of risk borne by PPB will be no lower in the future than in the past. Indeed the uncertainties of the SEM, the CfD market and potentially competing regulatory objectives simultaneously in two jurisdictions mean that it is likely to be higher. Hence, they state there is a case for a higher margin.

NIE then go on to attempt to benchmark the PPB activity:

They state that the combined profit of PPB and NIE Supply, at approximately 3% of supply business turnover, is significantly lower than the profit recorded in supply in Great Britain after market opening in 1998.

They also point to the Omani Power and Water Procurement Company. In 2005, it earned a profit of £1.2 million (after deduction of £1.6 million business costs) on a turnover of £171 million from sales of purchases from 2,600 MW plant. The gross margin was 1.6% compared to PPB's gross margin in 2005-06 of 1.9%.

NIE then justify a profit margin by arguing that they have been charged with creating liquidity in an immature and illiquid contract market by offering contracts for differences to suppliers. They argue that market makers should receive a margin for this function.

Finally NIE suggest that it would be wrong to define PPB as a "not for profit" organization. They state, while the activities of the business may appear analogous to a "not-for-profit" enterprise, the business was established in 1992 as a commercial business within NIE.

Basic Profit Margin - The Utility Regulator's views

In general terms, the Utility Regulator's view is that there is no basis for an ex-ante "basic profit margin" as proposed by NIE. Whilst the Utility Regulator does believe that there may be some merit in considering performance incentives for the PPB activity, it is not the view of the Utility Regulator that PPB should be awarded a non-performance related ex-ante profit. Normal regulated utilities might expect to be allowed a rate of return not on turnover, or margin, but on the capital employed in the business and at a level which reflects a reasonable rate of return on that capital, taking into account the risks faced by the company. Such companies should not, for example, expect a rate of return on opex or on the intellectual prowess of staff (which should be expected to be reflected in salaries and training costs and hence opex). In the case of PPB, the fact that the activity is funded through the PSO arrangement means that generally there are low risks for investors and, as a starting point there does not appear to be validity in permitting an up-front "profit" of the manner suggested.

NIE's assertion that most regulators in other jurisdictions have applied a margin-based approach to set a reasonable profit allowance for energy trading business does not appear to have any relevance to the PPB activity. Setting aside performance incentives and assuming that essentially the net costs of the PPB activity will be passed back to NI suppliers through the PSO, there is no valid analogy between PPB and the supply business of RECs. Firstly PPB is not engaged in supply, secondly, it has no competitors and thirdly, other than through possible incentives and a small number of specific risks that it may face, it cannot make a loss. The analogy between PPB and US retail distributors operating in a provider-of-last resort mode appears even more remote.

NIE also argue that energy traders' costs are linked to total revenues and hence a margins-based approach reflects an energy trader's cost drivers. An energy trader's costs may be linked to its total revenues and indeed energy traders may expect to make a profit that is in some way related to turnover. Indeed if a company's revenues are linked to its costs it is true that if its costs go up its revenues will also go up, and hence such a company would certainly be compensated (in revenue terms) for unpredictable increases or decreases in costs. However the Utility Regulator does not agree PPB should be permitted a non-performance related ex-ante profit linked to the pass through of the net costs of managing the PPB contracts. The Utility Regulator expects that PPB will pass through increases or decreases in its net external costs through the PSO charges. Some inter-year adjustments may be required and consequently it will be necessary to take into account any financing costs, but it is not expected that PPB will be financially exposed to these cost fluctuations in the intermediate term and hence they do not represent a risk to the capital employed in the company.

With regards to liquidity NIE's argument is not quite clear. There is no licence obligation to enhance or create liquidity. No other market participants have been selected for this role. Whilst the Utility Regulator believes that it is appropriate that the natural hedges against pool price available from PPB generators should be made available to the market and that these will need to be made available by the conduit of PPB, PPB's role is not to manipulate the market by artificially increasing or decreasing liquidity in some way. The Utility Regulator has agreed with PPB that it should have a role in selling CfDs for its contracted generation for the first year of the SEM. Indeed the Utility Regulator commends PPB for the professional manner in which the current auction process has been delivered. However, no agreement has been reached regarding enduring arrangements with PPB backed CfDs. This will form part of the work of examining the role of PPB in the SEM and will be undertaken after the start of the SEM.

Insofar as monetary working capital is concerned, the Utility Regulator does accept that such costs need to be funded (or interest on any cash surplus repaid). However the fact that working capital is needed is not, in itself a risk in that it does not itself increase the risk to each £ of capital invested. To the extent that the cash-flow requirement is debt-funded then the actual or reasonably forecast interest costs should be remunerated. Where it is funded by capital, then an appropriate rate of return is due on the capital employed. The Utility Regulator accepts that this needs to be considered when setting the price controls for PPB, but does not accept that this is a justification for an up-front profit allowance linked to turnover or some other measure of gross or net cash-flow.

NIE also discuss what it perceives to be risks faced by PPB. They state that even with an ex-post pass-through to the PSO there will be fluctuation in PPB profitability from year to year as a result of the inherent variability of the PPA contract costs and market revenue under the SEM. Ultimately this appears to result in being an argument that an up-front profit expectation is reasonable because profits will vary from year to year and this represents a risk. The Utility Regulator does not accept this as a valid argument for enshrining an up-front incentive free profit margin for PPB.

NIE also argue that PPB faces the risk that some PPB costs may not be considered to fall within the EPO requirements and may therefore be discounted as uneconomic. Whilst the Utility Regulator accepts that this is a risk faced by PPB, it does not warrant the creation of an up-front profit payment. Such risks are implicitly rewarded in the rate of return on capital employed. Historically, where PPB has formed part of the NIE transmission business, this risk has been implicit in the rate of return on capital allowed in the price control. The Utility Regulator would prefer not to undertake a detailed review of NIE T&D's allowed rate of return on capital as a consequence of transferring out the PPB activity to NIE Energy, nor does the

Utility Regulator believe that it is necessary given that the PPB activity will be guaranteed by NIE T&D. This arrangement ensures that the majority of these risks (and associated rewards in terms of rate of return) continue to rest ultimately with the wires business of NIE. Whilst it may be appropriate to review the rate of return for T&D once the PPB contracts come to an end, as indicated above The Utility Regulator does not propose to re-open this issue at this stage.

The Utility Regulator is of the view there is insufficient detail in NIE's submission to judge whether or not the Omani Power and Water Procurement Company provides an analogous "single buyer" example. Furthermore, the disparity between European and Middle-eastern business and governance arrangements would appear to further dilute any real value of this comparison. More generally, the Utility Regulator is doubtful whether it is necessary or productive to refer to various overseas and different sector analogies in this case. Rather than looking for similar business models in other countries or business sectors, the analogies that are ubiquitous are those for how regulators should reward the capital invested in and incentivise behaviour of regulated utilities. Based on our analysis of the risks faced by PPB, there does not appear to be any case for allowing an up-front profit margin.

In summary, the Utility Regulator is not of the view that an ex-ante profit is appropriate for PPB.

4. Incentives

Incentives - NIE Proposal

In its submission to the Utility Regulator, NIE argued that PPB has a very strong record in saving costs for customers. They stated that it has been incentivised to do so by its price control, initially through comparison of costs with an external index ("the yardstick formulae"), and more recently through a volume incentive.

NIE then gave a resume of their view of PPB's achievements, stating that as a result of PPB's actions, customers have benefited substantially through lower BST and PSO charges. NIE believe that under the SEM there will be more opportunities for savings to be captured by PPB, the benefit of which will flow to customers through lower PSO charges. For example, they state that all PPB's output is now available for sale through contract, accurate bidding will maximise net SEM receipts. They state that there is a further opportunity for savings through CO₂ trading and efficient operation of the contracts. NIE states that PPB expects to continue to play a major role in the operation of the PPAs, challenging cost pass-through by the generators (including under the change in law provisions) and being closely involved in the fuelling strategies adopted and feel good performance in these areas should be rewarded.

NIE state that it would be both efficient and normal regulatory practice to incentivise PPB to minimise power purchase costs and maximise its receipts from sales thereby reducing PSO charges. However, they state that the Utility Regulator will wish to be sure that in setting such an incentive that:

- PPB is not incentivised to abuse market power; and
- NIE as a whole is not incentivised to raise prices to Supply's customers in order to increase payments to PPB and so the contribution it receives.

As regards the first point, NIE's view is that PPB's market share is low and it does not have control over availability declarations of the contracted generators. They state that it is not dominant and that PPB's bidding behaviour will be transparently auditable and its contracts are to be sold predominantly through transparent auctions.

NIE suggest in relation to the second point, not only would NIE Supply's EPO prevent it from purchasing from PPB on those terms but, with the exception of purchases through the directed and non-directed contract processes, its hedging policy statement prevents it from entering into contracts with affiliates without the prior approval of The Utility Regulator.

Whilst NIE believe that further work is needed to establish appropriate parameters governing the incentive mechanism, their initial thoughts suggest that possible parameters might be:

- A 10% incentive rate, similar to the proportion in the initial 1992 price control
- A baseline target; and
- A collar that ensures PPB does not operate at a loss.

Incentives - Utility Regulator views

The Utility Regulator agrees that there may a case for providing PPB with an incentive mechanism although there are a number of matters that need to be carefully considered in structuring any incentive.

First, it is necessary to be clear about exactly what it is appropriate for PPB to be incentivised to do. As discussed before, the Utility Regulator does not believe that under the SEM, PPB should be incentivised to improve "liquidity" or quantity of CFD sales. Also under the current arrangements, whilst PPB has a volume incentive, this does not necessarily equate to an incentive to minimise

net PSO costs. Moreover, PPB does not currently have a profitability that is linked to minimising payments under the PPB generator contracts.

All other things being equal, the Utility Regulator believes that a PPB incentive (if any) should give it an incentive to minimise the PSO. From an external cost perspective, this means that their incentive should (broadly speaking) be to minimise the value of:

PPB contract costs - [pool revenues + CfD costs]
(where CfD costs could be negative).

The exact detail of any incentive would be likely to include other calculations and would need to be formulated carefully after discussions with NIE.

There are, however, a number of difficulties associated with this. First, as some of the discussion in NIE's submission pointed out, the PSO might vary substantially from one year to the next. Furthermore, it is likely to be difficult to predict. This means that there is a danger that the inappropriate setting of target values for any performance incentive mechanism could simply result in a windfall profit or loss for PPB. Furthermore, there is a great deal of information asymmetry between the Utility Regulator and PPB on such matters (details of PPB contract costs, detailed CfD arrangements, pool bidding strategy etc.) These issues need to be overcome to the satisfaction of the Utility Regulator before any incentive scheme could be agreed.

Furthermore, given the fact that PPB is not currently incentivised to maximise the difference between sales revenues and costs (instead there currently is a volume incentive which will no longer apply) additional concerns arise. First historic payments under the PPB contracts may not necessarily represent a reasonable picture of the efficient level of payments under the PPB contracts that might reasonably be expected given a reasonable PSO minimising incentive and second, the absence of such incentives in the recent past implies that the level of influence that PPB (acting prudently) can exert on the actual level of the PSO might not be that great. Indeed PPB in their submission suggest as much when they say they have no control of plant availability and the CfDs offered are via auction. Hence, whilst the Utility Regulator accepts that in principle incentives would potentially be a good idea, there are concerns that the level of controllability PPB can exert over the PSO is not that great implying that there is no great need for an incentive.

Finally to the extent that any incentive mechanism is developed, it would be important that PPB is capable of making a loss as well as a profit. This is because a profit only incentive may have the effect of incentivising PPB to gamble in order to attempt to secure a large profit without the commensurate chance of a large loss.

Section 4 : Utility Regulator Proposals

Duration

The Utility Regulator is of the view that an initial PPB price control under the new SEM should be of one year duration but given the fact it will commence in November 2007 means it will actually last 17 months, from November 2007 until March 2009 to coincide with the end of the company financial (and licence year).

Operating Costs

The Utility Regulators initial operating cost allowance in the forthcoming price control should be the following:

PPB Operating Costs 2007 prices £'000		
	2007/08	2008/09
Opex Allowance	1,595	1,898

These costs should rise by the Retail Price Index minus 3% to reflect internal efficiencies that can be made to reduce these costs.

Monetary Working Capital Costs

It is the Utility Regulators view that working capital costs of PPB can be recovered as allowable revenue (or any interest on cash surplus repaid).

Profit Margin

The Utility Regulator's view is that it is inappropriate to enshrine an ex-ante profit margin for PPB for the reasons discussed in the previous section. The Utility Regulator is therefore not proposing any profit margin for this price control.

Incentive

The Utility Regulator is of the view that there may be some merits in giving PPB financial incentives to manage its PSO costs. However there are two principal reservations. First, there is a question over the extent to which PPB can manage the costs of the PSO (i.e. the degree of influence that they have over the costs), and consequently whether there will be any benefit from developing and applying an incentive regime; and second, there is a danger that the information asymmetry between the Utility Regulator and PPB over the likely level of PSO costs might lead to the setting of an incentive scheme that simply results in PPB being granted a windfall profit.

In relation to the first of these concerns, the Utility Regulator is of the view that it is likely that there are steps that PPB can take to minimise PSO costs. PPB will have some flexibility through which it may be able to maximise pool revenues and minimise contract costs. PPB can also influence the level of the PSO by entering into appropriate contracts for differences. On this basis, it is probably worth pursuing the development of some form of incentive for PPB. There may however be some elements of the PSO costs that PPB cannot reasonably be expected to influence, for example underlying fuel costs, or costs or savings arising from unpredicted fault outages. It may be appropriate to consider incentive designs that exclude some of these less controllable costs.

Whether the second of these two reservations concerning information asymmetry can be overcome remains to be seen. It is likely that even PPB themselves will have difficulty in forecasting PSO costs, principally because pool revenues and net CFD revenues or costs may be difficult to forecast. The Utility Regulator also faces additional uncertainties over forecasting PPB's contract costs. We propose to engage in further discussions with PPB in an attempt to gain an understanding of the likely PSO costs and the uncertainties associated with any estimate of them. It is hoped that this process will enable the Utility Regulator to develop an incentive arrangement which sets reasonable targets for PPB. Finally the use of sharing factors will enable PPB to be subject to incentives whilst reducing the financial consequences of misplaced target values. The use of a dead-band and caps and floors on maximum profits and losses that PPB can make from the incentive arrangements are also likely to assist in this regard.

Next Steps

Responses to this consultation paper should be sent to Michael Campbell

Michael.Campbell@niaur.gov.uk

not later than 21st September.

In particular responses are sought on:

- The duration of the price control of 17 months
- The proposed adjustments to operating costs
- The X Factor
- The proposed incentive

The Utility Regulator intends to publish all comments received. If any respondent wishes certain sections of their submission to remain confidential they should submit these sections as an appendix marked confidential.