NIE Energy Ltd - Power Procurement Business Price Control 2012 - 2015

Proposals for Consultation

21st December 2011

Contents

Introduction and Background to the Power Procurement Business (PPB)

NIE Energy Ltd Power Procurement Business (PPB) was set up following the legacy contracts being put in place on 1 April 1992 as a separate regulated business under the Northern Ireland Electricity Transmission and Public Electricity Supply Licence. The role of PPB before the creation of the Single Electricity Market (SEM) was to purchase power under the long term legacy contracts (PPAs) from independently owned generators. Prior to the commencement of EU liberalization in 1999 all of this power was sold to suppliers in the Northern Ireland market at a Bulk Supply Tariff (BST). From then, PPB sold to suppliers of Franchise customers at the BST and sold to suppliers in the competitive markets in Northern Ireland and Ireland under various bilateral arrangements as well as providing a balancing market for the competitive market segment in Northern Ireland.

Following the creation of SEM PPBs role changed significantly in some respects. The business still continues to purchase power under the long term contracts but sells that power directly to the SEM pool. Furthermore the business enters into contracts for differences (CFDs) with suppliers in both jurisdictions (Northern Ireland and Ireland). These contracts have the effect of “hedging” or “fixing” the revenue that PPB will receive for the volume of power the contract is for. Thus PPB is able to hedge a significant proportion of the revenues it will receive for the power it sells to the market.

If there is a mismatch (positive or negative) between PPB cost of sales i.e. the payments it makes to generators under the contracts and revenues (pool receipts, difference payments and PPB allowed price control amount) then that amount will be collected or rebated via the Public Service Obligation (PSO) levy. The existence of this arrangement enables PPB to recover any shortfalls between costs and revenues from Northern Ireland customers and hence, aside from some small residual risks which will be discussed later, the profit margin allowed in the price control is assured.

This consultation paper puts forward proposals for the next PPB price control which will be effective from 1 April 2012 and discusses the proposals that PPB have submitted to the Utility Regulator (UR). Although the price control in its entirety takes into account power purchase costs, change in law costs, non-PSO revenues (market revenues received) and a correction factor, it is the Et term of the price control i.e. PPB’s own allowed revenue with which this paper is concerned. PPB own costs relate to the operating costs and working capital costs of the business. The entire price control formula deals with how PPB will calculate the PSO levy amount and PPB’s own costs make up only one part of this. The detail of the price control calculation is contained in the NIE Energy Limited Licence in annex 3[1]. The Formula is shown below is shown below:

[1] A full copy of the NIE Energy Limited Licence can be found at http://www.uregni.gov.uk/uploads/publications/NIE_Energy_Ltd_-_14_September_2010_Supply_Licence_-_Consolidated_Working_Copy.pdf

$$MPPB_t = A_t + D_t + E_t - NPR_t + KB_t$$

Where:

$MPPB_t$ = the maximum regulated PPB PSO revenue in relevant year t

A_t = the actual power purchase costs incurred in the purchase of electricity in relevant year t

D_t = excluded power procurement costs, costs for change in law, 2003/54/EC directive or SEM changes and any other amounts approved by the Authority

E_t = the allowed Power Procurement Business entitlement

NPR_t = the non-PSO revenue in relevant year t

KB_t = the correction factor to be applied in relevant year t

UR invites views from interested parties on the proposals discussed below.

Structure of the Current Price Control (2009-2012)

The approach to the current price control taken by UR and accepted by PPB (albeit on a without prejudice basis highlighting disagreement with various UR conclusions) followed on from the 2007 – 2009 price control were the approach was to allow a rate of return and depreciation on PPBs regulatory asset base (RAB) and an incentive amount equal to 1% of forecast PPB turnover with PPBs own operating costs and working capital costs coming out of the incentivised amount. This is explained further below.

The following formula sets out the calculation for PPBs own allowed revenue or entitlement (Et). This is the total amount PPB is allowed in the price control to be retained by the business itself out of which it pays its internal business operating costs.

$$E_t = DEP_t + RTN_t + IC_t + PD_t$$

Where:

DEP_t = means the depreciation amount determined from the depreciation of the PPB Regulated Asset Base on a 25 year profile and the New PPB Regulated Asset Base on a 5 year profile.

RTN_t = means the allowed return on the PPB Regulated Asset Base and the New PPB Regulated Asset Base

IC_t = means the PPB incentivised amount which is dependent on the outturn performance against the targets specified in the incentive

PDt = means the allowed PPB pension deficit cost per year, such figure to be revised in accordance with the results of each triennial actuarial valuation.

The current incentives and the weightings given to them are set out below. As one of these objectives is no longer relevant the proposed changes for the price control beginning April 2012 are set out in column on right:

PPA Costs				
Description	**Objective**	**Target / Reporting method**	**Weight**	**Proposed Weight**
Availability Payments	Challenge and verify availability declarations and payments	Enforcement of the contract. Demonstrated via PPB's testing (via SONI).	5%	5%
Change in Law costs	Minimise costs passed through (FGD, SO3, Ash disposal, etc.)	Costs minimised. Demonstrated via report to UR.	10%	10%
Coal management	Ensure minimum contracted consumption is burnt	Minimum quantity consumed. Contractual compliance demonstrated ex-post.	3%	0%
Gas management	Ensure minimum contracted consumption is burnt	LTI3 minimum take consumed. Contractual compliance demonstrated ex-post.	3%	3%
Gas costs	Ensure minimum gas costs	Ensure an effective gas purchasing strategy is developed and implemented. Demonstrated ex post.	17%	17%
CO2 management	Meet surrender obligations	Ensure no penalties for non compliance Demonstrated ex-post.	5%	5%
Fuel Stocking	Ensure adequate fuel supplies	Agree strategy with UR/DETI and demonstrate compliance with the plan	7%	7%

Market Activity				
Description	**Objective**	**Target / Reporting method**	**Weight**	**Proposed Weight**
Nomination processes	Compliance with bidding principles	Market Monitor Challenges of PPB Bids should be no greater than overall market average. Demonstrated ex-post.	5%	5%
Market Revenue	Ensure revenue receipts are correct	Verify invoices and query all deviations. Demonstrated ex-post.	5%	5%
Settlement Reallocations	Effective utilisation of Settlement reallocations (e.g. with the regulated NIE Energy Supply business)	75% of PPB"s market revenue reallocated under SRAs (unless otherwise agreed with NIAUR)	7%	7%
CfD and Commodity cover position	Implement Risk Management in accordance with plans	Agree strategy/plan with UR and demonstrate implementation within the agreed framework	17%	20%
Risk Management products	Increase product portfolio to align with supplier/ Customer needs	Demonstrate product portfolio development [and customer satisfaction]	6%	6%
Manage counter-party risk	Minimise risk of bad debt through rigorous implementation of the Payment Security Policy	Full compliance with the PSP. Demonstrate ex-post.	5%	5%
Manage interfaces	Ensure new interface arrangements operate effectively or are modified where deficiencies are identified	Effective operation of the interfaces with SONI and T&D. Agreed modifications and referrals to UR for dispute resolution.	5%	5%

Under the previous two price controls PPB had to cover its own operating costs from the IC_t amount. The original value for the baseline score for the 2007-09 price control was £4M (2006 prices and based on 90% achievement) and this figure was based on an alternative benchmarks methodology whereby PPB received 1% of forecast turnover as revenue (other than depreciation and return on assets).

The benchmark approach looked at those businesses such as brokerages and other trading type businesses (e.g. a reseller of gas) and these were used as analogies as it is difficult to find a company analogous to PPB within the energy industry.

Under this incentive for Financial Year 11-12 the value of IC_t for 90% achievement was £5.823M and for 100% achievement £6.043M, 2008 prices. It should be noted that 90% achievement is seen as the baseline or expected score that PPB is likely to achieve and hence the incentive amount is based on this expected score.

Price Control Proposals

The section below looks at the data received from PPB in recent months and outlines UR proposals for a new PPB price control to run from April 2012.

PPB sent an original Business Efficiency Questionnaire (BEQ) submission to NIAUR in June 2011. A further supplementary submission was received on 24 October 2011 setting out PPB's assessment of price control allowances it should receive calculated on the basis of a bottom-up building blocks approach and including an updated assessment of the cost of PPB's Working Capital Facility (WCF). This latter submission was supported by a report from NERA Economic Consulting who PPB had engaged to provide analysis and advice to inform PPB's submission.

UR and PPB met to discuss the submissions on 30 September 2011 and again on 31 October 2011. Following the meeting of 30 September PPB sent further submissions including PPB's management accounts, the RAB models and outlining the current staff remuneration.

Duration of New Price Control

The role of PPB is very much linked to the continuing term of the long-term Generating Unit Agreements (GUA). The duration of any price control for PPB must therefore take into account the potential duration of contracts.

The GUA contracts that are currently held by PPB are listed below, as well as the contracts that have been cancelled.

Company	**Generating Unit**	**GUA Contracted Capacity (MWs)**	**Fuel Type**	**Earliest Cancellation Date (ECD)**	**Contract Expiry Date (CED)**
AES Kilroot	G1	260 (oil), 195 (coal)	Coal/Heavy Fuel Oil	1 November 2010	**Cancelled @ ECD**
AES Kilroot	G2	260 (oil), 195 (coal)	Coal/Heavy Fuel Oil	1 November 2010	**Cancelled @ ECD**
AES Kilroot	GT1	29	Distillate	1 November 2010	31 March 2024
AES Kilroot	GT2	29	Distillate	1 November 2010	31 March 2024
AES Ballylumford	CCGT 10	106	Gas	31 March 2012	31 March 2012 (with two five-year extension options exercisable by PPB with two years notice in each case)
AES Ballylumford	CCGT 20	510	Gas	31 March 2012	31 March 2012 (with two five-year extension options exercisable by PPB with two years notice in each case)
AES Ballylumford	G4	180	Gas	1 November 2010	31 March 2012
AES Ballylumford	GT1	58	Distillate	1 November 2010	31 March 2020
AES Ballylumford	GT2	58	Distillate	1 November 2010	31 March 2020
Coolkeeragh ESB	GT8	58	Distillate	1 November 2010	31 March 2020

As shown above two of the long term legacy contracts have been cancelled as of November 2010 and that effectively all contracts can be cancelled subject to a 180 day notification period, there is no certainty with respect to cancellation of the remaining contracts[2]. UR proposes that the new price control should be applicable from April 2012 until March 2015.

However, with potential further cancellation in mind UR reserves the right to re-open the price control if further contracts are cancelled during this price control as this would see a change in PPB activities and possible operating costs. It may not be appropriate for a price control set in the context of all existing contracts to continue unchanged in the event of any future cancellation.

UR regards the proposed price control for 2012-15 to be largely a further continuation of the 2009-12 control with any changes reflecting a material change in circumstances.

Form of New Price Control

UR is satisfied that the current form and structure of the price control is appropriate as it allows for a reasonable return and depreciation on assets as well as incentivising PPB to carry out the business efficiently, firstly because there is a natural focus to achieve the highest possible score (and the incentives are linked to efficient business activity) and secondly because operating costs are derived from the incentive amount. This ensures that the efficient management of operating costs (other than those associated with changes in law/directives or SEM where approved by the Authority) lies with PPB for the duration of the price control. Therefore as described above, the section of the price control associated with PPBs own costs shall be structured as follows:

$E_t = DEP_t + RTN_t + IC_t + PD_t$

Each of these elements is discussed in more detail below.

Depreciation (DEP_t)

PPB currently has a Regulatory Asset Base (RAB) and a “New” RAB. The original PPB RAB is based on an estimate of an initial RAB of £5Million for PPB/SONI. This valuation was based on the initial market value of NIE at flotation and the observed profitability of PPB/SONI. In 1999, when implementing the separation of the PPB and SONI businesses, UR split the £5Million RAB into a £4Million RAB for PPB and a £1Million RAB for SONI, with all subsequent asset acquisitions allocated to SONI. The UR method to roll forward the RAB is to add inflation and deduct an allowance for depreciation based on a 25 year straight line profile1. Using this methodology the

[2] For further information please see the recent consultation Paper on Relevant Considerations in Relation to the possible Cancellation of Generating Unit Agreements in Northern Ireland (http://www.uregni.gov.uk/uploads/publications/2011-03-10_GUA_Consultation_on_Relevant_Considerations.pdf) and the further consultation paper on the same issue(http://www.uregni.gov.uk/uploads/publications/2011-09-09_2nd_Consultation_re_GUAs.pdf)

value of the RAB at April 2012 is expected to be £1.6Million and a depreciation amount of circa £0.25Million is due. These figures are aggregated and shown below.

Initial RAB				
period ending	31-Mar-12	31-Mar-13	31-Mar-14	31-Mar-15
RAB Value (£m)	1.601	1.345	1.089	0.833
Average Value (£m)	1.473	1.217	0.961	
Annual Depreciation (£m)	**0.256**			

The new RAB is made up of assets invested in over the last six years and is mostly IT assets. This new RAB has an opening value at April 2012 of circa £0.07M and will be fully depreciated by April 2015.

New PPB RAB				
period ending	31-Mar-12	31-Mar-13	31-Mar-14	31-Mar-15
RAB Value (£m)	0.072	0.024	0.006	0.000
Average Value (£m)	0.048	0.015	0.003	
Annual Depreciation (£m)		**0.070**	**0.026**	**0.011**

UR has, after taking the views of PPB into account, agreed to both the depreciation and the present value of the initial RAB at £1.601M. This is consistent with previous price control decisions UR also accepts the value of the new RAB.

Rate of Return (RTN_t)

In the 2009-12 PPB price control UR allowed PPB the same WACC as applied in the SONI price control of 6.3%. As stated in the decision for the current price control UR believe the PPB activity bears more resemblance to the SONI activity that it does to the activities of a distribution network business. Both PPB and SONI have few assets in relation to turnover and both deal directly with generators and suppliers as opposed to end customers.

Additionally WACC should be set equal to that of SONI at 5.68% for the new price control. This takes into account the reduction in the tax rate from 28% to 26% in 2012. The amounts PPB will receive under this proposal are illustrated below.

	Annual	Annual	Annual
	Apr 2012 - Mar 2013	Apr 2013 - Mar 2014	Apr 2014 - Mar 2015
Return	0.086	0.070	0.055

Incentive Amount (IC_t)

The current incentive amount was based on 1% of PPB forecast turnover when the price control was set for 2007 – 09 and this formed the basis for the subsequent price control - November 2009 until March 2012.

Currently, under this incentive for financial year 2011-12 the value of the incentive amount for 90% achievement is £5.823M and for 100% achievement £6.043m (2008 prices). 90% achievement is seen as the baseline score i.e. an “expected” score that is both reasonably obtainable but also reasonably challenging.

As stated previously this number was derived from the original incentive amount from the 2007-09 price control which had an original 90% score value of £4M (2006/07 prices), this figure was based on an alternative benchmarks methodology whereby PPB received 1% of forecast turnover as revenue (other than depreciation and return on assets). Businesses such as brokerages and other trading type businesses (e.g. a reseller of gas) were used as analogies as it is difficult to find a company analogous to PPB within the energy industry. For the 2009-12 price control this £4m figure was adjusted for inflation and included the agreed legitimate costs of the business.

The 2009-12 price control had a core figure of £4.345M as the incentive amount but in recognition of the extra costs PPB has legitimately incurred (which are discussed later) i.e. the extra cost of procuring a Working Capital Facility (1.64M), extra operating costs (0.11M) and extra costs of commodity hedging (0.294M)[3] the incentive amount was uplifted by the aggregate of these extra costs to give a total incentive amount of £5.99M[4].

This approach was consistent with the NIE Energy Supply price control decision taken in 2007, where UR did not automatically apply the margin of the previous price control but rather calculated the new margin as the absolute figure allowed for margin in the existing control plus extra costs that were legitimate and justifiable i.e. increased cost of working capital. The sum of the two gave a new figure that will be the margin allowed in the new NIEES price control.

As operating costs are required to be covered by the incentive amount it is appropriate that we look at these. PPB operating costs (excluding past service pension deficit costs) are shown below.

[3] Commodity hedging costs were £0.294M in year one only. Subsequent years were £0.127M. The ICt amount was also reduced by £0.167M to reflect this in price control years two and three.

[4] This was the 90% baseline figure for the 2009/10 year in subsequent years this figure was reduced to £5.823m

£k	Comments	2010/11 LBE	2011/12 Forecast	2012/13 Forecast	2013/14 Forecast	2014/15 Forecast
Controllable Opex						
Payroll		850.1	938.2	968.2	975.5	983.0
Transport and Travel		13.9	17.8	17.8	17.8	17.8
Training		10.0	19.9	10.4	10.4	10.4
Share Save Scheme		0.0	0.0	0.0	0.0	0.0
Total Staff Related Costs		874.0	976.0	996.4	1,003.8	1,011.2
MBIS Consultancy		193.5	190.5	190.5	190.5	190.5
CfD Trading		0.0	0.0	0.0	0.0	0.0
MBIS		193.5	190.5	190.5	190.5	190.5
IT & Telecoms		232.0	218.9	218.9	218.9	218.9
Accommodation		31.1	29.9	29.9	29.9	29.9
Telephones		19.2	21.2	21.2	21.2	21.2
LH&P		5.9	8.8	8.8	8.8	8.8
Corporate		0.0	0.0	0.0	0.0	0.0
Cleaning		5.1	4.5	4.5	4.5	4.5
Other Office Related Costs		8.5	12.3	12.3	12.3	12.3
Total Office Related Costs		69.8	76.7	76.7	76.7	76.7
Insurance Premiums		0.0	3.9	2.0	2.0	2.0
Printing and Stationery		5.8	8.6	8.6	8.6	8.6
Subscriptions		34.3	44.0	43.7	43.7	43.7
Audit Fees		21.5	22.0	31.5	22.4	22.4
Professional services (please specify)		0.0	0.0	0.0	0.0	0.0
Severence/Redundancy/Restructuring		0.0	0.0	0.0	0.0	0.0
Other Controllable Opex		0.0	0.0	0.0	0.0	0.0
Capitalisation of overheads		0.0	0.0	0.0	0.0	0.0
Other (Agency Costs)		0.0	0.0	0.0	0.0	0.0
Total Other		61.6	78.5	85.8	76.8	76.8
Corporate Charges		487.6	395.9	395.9	395.9	395.9
Land Bank Management Income		0.0	0.0	0.0	0.0	0.0
SONI Accomodation Charge		0.0	0.0	0.0	0.0	0.0
Corporate & Other Interbusiness Charges		487.6	395.9	395.9	395.9	395.9
Pension - Past Service Costs		360.8	382.7	386.4	390.1	393.8
Uncontrollable Opex						
Rates		10.3	10.3	10.3	10.3	10.3
Licence Fee		1.0	1.2	1.2	1.2	1.2
Other		0.0	0.0	0.0	0.0	0.0
Other Opex (Exceptional Items)		(344.5)	0.0	0.0	0.0	0.0
Dt Costs		0.0	0.0	0.0	0.0	0.0
Depreciation		0.0	0.0	0.0	0.0	0.0
Total Opex		1,946.1	2,330.6	2,362.1	2,364.0	2,375.2

PPB proposal

PPB submitted a report, which provides their estimated working capital and risk capital requirements. They propose applying a WACC to this capital requirement and using this data to derive their margin requirements. They propose an ICt figure of being equal to their proposed margin plus their proposed operating costs. PPB proposed a required margin in excess of £5.5m per year. UR deemed that the proposal was not appropriate for the purposes of this price control.

It should be noted a similar approach was proposed for the recent Power NI price control, this proposal was also rejected by UR.

Utility Regulator Proposal

During the current price control two of the long-term GUAs that were managed by PPB were canceled, those relating to Kilroot Units 1 and 2. This has resulted in a reduction in revenue since the beginning of the last price control. The duties and therefore costs of PPB would be expected to reduce as a result of this reduction in revenue.

In recognition of the function carried out by PPB the Utility Regulator proposes continuing with the ICt allowance from the previous price control adjusted for inflation, however due to the reduced role of PPB the Utiilty Regulator proposes a 10% reduction in the IC_t from the last price control, the DEP_t and RTN_t elements are also included and are as defined previously:

				Ict			
		DEPt	**RTNt**	OPEX	WCF	Total Ict	Profit
Current Price Control	2010 Prices	**0.317**	**0.156**	2.526	1.701	6.040	2.286
UR Proposal	2010 prices	**0.330**	**0.090**	2.273	1.531	5.436	2.052

How to Respond

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

Responses to this consultation paper should be sent to:

Andrew McCorriston
Utility Regulator
Queens House
14 Queen Street
BELFAST
BT1 6ED

E-mail: andrew.mccorriston@uregni.gov.uk

All responses must be received **by 17.00 Tuesday 14th February 2012**.

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.