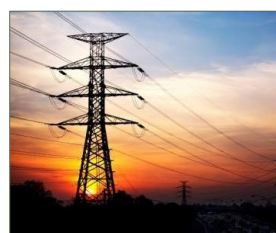


THE UTILITY REGULATOR'S PROPOSALS FOR THE 2014 POWER NI SUPPLY PRICE CONTROL

Consultation Paper
23 July 2013



About the Utility Regulator

The Utility Regulator is the independent non-ministerial government department responsible for regulating Northern Ireland's electricity, gas, water and sewerage industries, to promote the short and long-term interests of consumers.

We are not a policy-making department of government, but we make sure that the energy and water utility industries in Northern Ireland are regulated and developed within ministerial policy as set out in our statutory duties.

We are governed by a Board of Directors and are accountable to the Northern Ireland Assembly through financial and annual reporting obligations.

We are based at Queens House in the centre of Belfast. The Chief Executive leads a management team of directors representing each of the key functional areas in the organisation: Corporate Affairs; Electricity; Gas; Retail and Social; and Water. The staff team includes economists, engineers, accountants, utility specialists, legal advisors and administration professionals.

Our Mission

Value and sustainability in energy and water.

Our Vision

We will make a difference for consumers by listening, innovating and leading.

Our Values

Be a best practice regulator: transparent, consistent, proportional, accountable, and targeted.

Be a united team.

Be collaborative and co-operative.

Be professional.

Listen and explain.

Make a difference.

Act with integrity.

Abstract

This paper sets out for consultation the Utility Regulator's (UR) proposals for the next Power NI Supply Price Control (which begins 1st April 2014). It follows on from the UR's Approach paper published in February. The paper outlines the analysis and rationale for the UR's proposed decisions in relation to the main issues within the Control: customer coverage (scope) of regulated tariffs; duration of Control; operating costs (OPEX) levels and allocations; and allowed margin for Power NI.

Following responses to this consultation, final decisions will be taken in autumn/winter this year.

Audience

Electricity industry; electricity consumers and consumer groups

Consumer impact

This paper sets out the UR proposals for the Power NI Supply Price Control. Once the Price Control process is complete, the framework will be agreed for Power NI's permitted costs and margin for the duration of the Control period, and subsequent tariffs will have to operate within these limits. This will therefore impact on the bills of price regulated customers. Potentially, the number of Non-Domestic customers who may avail of a regulated tariff may also reduce as a result of this Control.

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Annex	Author	Title
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2	Power NI	UR's Consultation – Approach to the 2014 Power NI Supply Price Control – Power NI's Response
3	System Operator for Northern Ireland	Utility Regulator's Consultation on Approach to the 2014 Power NI Supply Price Control – SONI response
4	Northern Ireland Electricity	Methodology for production of Supplier Market Share Report
5	BDO (appointed by the UR)	Review of Power NI BEQ
6	Cambridge Economic Policy Associates (appointed by Power NI)	Power NI 2014 Price Review: Financeability and its Implications for a Required Profit Margin
7	Economic Consulting Associates (appointed by the UR)	Power NI Retail Price Review – The Retail Margin

Executive Summary

Feedback to the Approach Consultation

The UR published an Approach consultation for this Control in February 2013 and invited respondents' views, at an early stage, on the key areas of this Power NI supply price control. These are: Scope & Coverage, Duration, Operating Expenditure and Margin. The UR received responses from 3 stakeholders: the Consumer Council for Northern Ireland; Power NI; and the System Operator for Northern Ireland.

The UR has published each respondent's full submission as Annexes to this document.

Scope & Coverage

At present, Power NI is subject to a price control in the entire Domestic market and the Non-Domestic market for customers consuming up to 150MWh per annum.

Power NI has made submissions to the UR for the whole Non-Domestic market to be removed from price control regulation and a roadmap to price de-regulation to be provided for the Domestic market.

As regards Non-Domestic customers, following market analysis, the **UR proposes to retain the price control in the 0-50MWh pa Non-Domestic sector**; but remove coverage in the 50-100 and 100-150 MWh pa sectors.

Power NI (combined with their sister affiliate, Energia) retain a clearly demonstrable position of market dominance with a 57% market share in the 0-

50MWh pa market. However, their dominance is less clear in the 50-100 and 100-150MWh pa sectors.

Following on from the analysis and proposed reduction to the price regulated threshold, the UR also proposes a roadmap that will automatically trigger a further consultation on the reduction or removal of the Power NI price control in the 0-50MWh Non-Domestic market. The criteria to be satisfied are:

1. *Power NI/Energia must have a combined market share (by consumed units) of less than 50% for two consecutive quarters; and*
2. *There is a minimum of 3 independent suppliers, each of which has at least 10% share of consumed units in the relevant market. For clarity, what this means in practice is Power NI/Energia plus two other independent suppliers.*

As regards Domestic customers, the work regarding a roadmap to the removal of price controls for the Domestic market is more complicated and other concerns, e.g. the impact of competition for vulnerable customers, need to be assessed. Power NI has indicated that they understand they still retain significant market power in this sector. However, clarity for the market will still need to be provided.

The UR has already indicated the need for a strategic exercise to be undertaken to review the effectiveness of competition (in protecting both Domestic and Non-Domestic customers) and the implications for the regulatory policy framework and the regulatory tools to be adopted by the UR in that context. This Review has been scheduled in the UR's published Forward Work Programme to commence later this year/early next year, as the current control project comes to an end.

Duration

In line with our initial thoughts in the Approach consultation, the **UR proposes to set a control for a period of 3 years**. The control would run from April 2014 until March 2017.

Operating Expenditure

The UR carries out an analysis of Power NI operating costs at each price control review. Operating costs include items such as salaries, IT costs, bad debt and corporate overhead charges. The UR engaged expert consultants to carry out a review of the cost submissions made by Power NI. There were detailed iterations with Power NI to understand the basis for their submissions. Following this engagement there were a number of areas where the consultants recommended that Power NI's cost submission requests be reduced.

The following table shows the Power NI forecast for 2014/15; final consultant proposals; and the final UR proposals for consultation (all in 12/13 prices).

Cost Category	Forecast 2014/2015 PNI Proposal £m's	BDO & Gemserv Final Proposals £m's	UR Consultation Proposals £m's	Difference £m's
Salaries	6.215	5.964	5.964	- £0.251
MBIS	3.243	3.083	3.083	-£0.160
Agency Costs	3.686	3.686	3.686	-
Outsourced	3.826	3.790	3.790	-£0.036
Corporate Costs	1.484	1.351	1.351	-£0.133
Bad Debt	3.263	2.960	2.960	-£0.303
Total (£m)	21.72	20.83	20.83	-£0.883

The table above highlights that the consultants have proposed to reduce Power NI's forecast OPEX by circa £880,000.

Operating Expenditure Allocation

Power NI currently operates two supply businesses. One offers the supply of electricity on a regulated basis and is subject to the price control. The other is a non-price-controlled business through which Power NI offer unregulated price offerings to non domestic customers on the same basis as any other supplier. However, the two businesses share the same staff and assets. Hence these costs need to be allocated between the two separate businesses. The UR asked BDO to carry out an exercise to ensure the appropriate allocation of operating costs between the regulated and unregulated businesses within Power NI. The following table shows the Power NI proposals for allocation and the UR proposals.

	2014/15 BEQ Costs £m's	Power NI proposed Allocation %	Power NI Allocation Amount £m's	BDO Proposed Allocation %	BDO Proposed Allocation Amount £m's
Salaries	£6.193	6.88%	£0.426	10.55%	£0.653
MBIS	£3.966	12.99%	£0.515	13.06%	£0.518
Agency Costs	£2.985	0.62%	£0.018	0.62%	£0.018
Outsourced Costs	£3.826	6.67%	£0.255	14.49%	£0.555
Corporate Charges	£1.484	15.34%	£0.227	17.92%	£0.266
Passthrough	£1.829	4.36%	£0.080	10.52%	£0.192
Depreciation	£2.737	1.52%	£0.042	1.78%	£0.049
Total	23.020	6.8%	£1.564	9.78%	£2.252

Source: BDO¹

¹ Passthrough and depreciation costs are not included in the total business opex forecast table on page 3 as they do not fall within the St term. Bad debts are included in the forecast but not the above as these are calculated separately for the regulated and unregulated business. The cost split between the categories in this table is different from those in the table on page 3 but the aggregate total is the same (for salaries, MBIS, Agency Costs, Outsourced Costs and Corporate Charges) – also slight rounding difference.

Margin

Power NI has historically accepted, at recent price control reviews, an implied margin allowance of 1.7% of forecast turnover, including the last price control which is currently in operation until 31 March 2014. However, Power NI argued at the last Control, and again in this current Control process, that this level of margin is now insufficient to compensate the business for the increased risk it faces in a competitive market.

Because of the significant focus on the margin issue at the last Control, from the outset of this Control project, the UR committed to look at this area afresh in order to determine an appropriate margin that is based on robust, transparent and theoretically-sound foundations. The calibration of margin was to be reviewed from both a theoretical and evidence-based perspective. We have done that with the aid of expert advisors (ECA) and have also engaged extensively with Power NI and their own advisors (CEPA).

Following lengthy interactions and a detailed review of the evidence, the **UR proposes a margin of 2.2%**. This is a proposed increase of 0.5 percentage points on the current allowed margin of 1.7%. The analysis underpinning the estimate clearly indicates this is a reasonable estimate of the appropriate margin for Power NI based on the risks they face, which balances the UR's statutory duties to protect customers while ensuring that regulated companies can finance their licensed activities.

The UR is cognisant of the impact this will have on customer bills which we wish to ensure is kept to a minimum. As a guide, should the proposed increase in allowed margin take effect, this will raise the average customer bill by approximately 25 pence per month (or £3.00 per annum).

Structure and Form

Respondents to the Approach broadly feel that the existing structure and form of the control remains appropriate, as does the UR. Therefore, the **UR proposes to continue with the existing structure** notwithstanding the fact that the E_t term will require some drafting modifications to reflect the up to date position.

Next Steps

This consultation is due to close on 01 October 2013. The UR is keen to hear feedback on our proposals from interested stakeholders as these will influence our final decisions paper which we plan to publish during the autumn/winter. The Decisions paper will include details of respondents' feedback to this consultation and include the UR's final decisions with regards to Power NI's operating costs, profit margin, duration and scope of control.

In order to encourage engagement during the consultation period, the UR will host a stakeholder seminar on 23 August 2013 from 10.00 to 12.00. This is to help ensure that stakeholders have an opportunity to engage in the price control process. The seminar will allow stakeholders the opportunity to engage directly with the UR and other interested stakeholders to gain clarification/raise any issues arising from this paper.

Please contact Robert Stewart (robert.stewart@uregni.gov.uk) by 16 August 2013 if you would like to register your interest in attending this event.

Introduction

Background

In Electricity, the primary statutory duty of the Utility Regulator (UR) is “*to protect the interests of consumers of electricity supplied by authorised suppliers, wherever appropriate by promoting effective competition*”².

Where competition is not sufficiently developed or effective, the UR protects consumers by regulation and this applies to the relevant areas of the electricity supply market as much as to other sectors of the energy industry. The UR proposals for the 2014 Power NI (formerly NIE Supply and then NIE Energy Supply) price control must be undertaken against this statutory duty backdrop. We consulted extensively and issued decisions on these matters during 2011 and early 2012.³

Although supply price controls have been removed in the regulated energy sector in Great Britain (GB) and recently in the Republic of Ireland (RoI), this was in the context of significantly more mature markets and competition levels, as well as much greater market size and potential for truly effective competition to protect customers. This has not been the case in the Northern Ireland (NI) regulated energy supply markets, as well as other parts of the European Union (EU). Indeed, regulated end-user prices continue to operate in more than half of the Member States of the EU.⁴ Up to now, due to Power NI’s dominant position, all

² Article 12 of the *Energy (Northern Ireland) Order 2003*.

³ The Utility Regulator, *Regulatory Approach to Energy Supply Competition in Northern Ireland – a Utility Regulator Decision Paper*, published 11th May 2012. A copy of this document is available at http://www.uregni.gov.uk/publications/regulatory_approach_to_energy_supply_competition_in_ni_decision_paper.

⁴ A joint publication of the Agency for the Cooperation of Energy Regulators and the Council of European Energy Regulators, *ACER/CEER Annual Report on the Results of Monitoring the Internal Electricity and Natural Gas Markets in 2011*, published 29th November 2012.

Domestic customers of Power NI and their Non-Domestic industrial and commercial (I&C) customers using up to 150MWh per annum are protected by a regulated tariff control, as set out in Power NI's Supply Licence. I&C customers using above this threshold, and customers of other electricity suppliers in Northern Ireland, are not covered by the UR's supply price control regime.

However, we do accept that the issue of the "scope" of the Power NI control needs to be looked at and have made evolutionary proposals to reduce the coverage of the 2014 price control which are set out later in this document.

About this document

The purpose of this document is to consult on the UR's proposals in relation to setting the next price control for Power NI. The next price control period is due to commence in April 2014. We have committed to undertaking the work to develop the new Control during the remainder of 2013 and early 2014 in a transparent and robust manner. The UR has already released an information note⁵ setting out the planned timelines and various phases of the project leading up to April 2014; and an 'Approach'⁶ consultation which helped us to arrive at our proposals.

This current UR consultation builds on that transparent approach, in that it sets out for consultation our price control proposals for commencement in 2014. The UR is seeking feedback from interested stakeholders so that this may help to shape our final "Decisions" paper which is planned for December. That future paper will include details of respondents' feedback to this consultation and our

⁵ The Utility Regulator, *Power NI Price Control Review 2014 – information paper*, published 9th November 2012. A copy of this paper is available at http://www.uregni.gov.uk/publications/power_ni_price_control_information_paper.

⁶ The Utility Regulator, *Approach to the 2014 Power NI Supply Price Control – consultation paper*, published 8th February 2013. A copy of this paper is available at http://www.uregni.gov.uk/publications/consultation_on_approach_to_the_2014_power_ni_supply_price_control

final decisions in relation to Power NI operating costs, profit margin, duration and the scope of the control.

This document sets out the UR's proposals for the 2014 Power NI supply price control based on the best evidence available. The UR welcomes feedback from respondents on whether our proposals are appropriate, or how they could be altered or improved, and the reasons why.

- Section 1 reviews the **stakeholder feedback to the Approach consultation**;
- Section 2 provides detail of a proposed amendment to the **scope of the control** for the Non-Domestic market and highlights triggers that will prompt a consultation on further price deregulation in the Non-Domestic market;
- Section 3 discusses the proposed **duration** of price control;
- Section 4 sets out the UR **assessment of operating expenditure (OPEX)**;
- Section 5 sets out the proposed **allocation of the allowed OPEX** between the regulated and deregulated businesses in Power NI.
- Section 6 advances the discussion surrounding the **setting of the allowed margin** for the price controlled part of Power NI's business;
- Section 7 outlines the proposed **structure and form** of the 2014 Power NI price control;
- Section 8 revisits the **key consultation questions** on which we are seeking feedback from interested stakeholders; and
- Section 9 reviews the **timeframe and how we intend to engage** with stakeholders as we move through the price control process.

Equality considerations

As a public authority, the UR has a number of obligations arising from Section 75 of the Northern Ireland Act 1998. These obligations concern the promotion of equality of opportunity between:

- i. persons of different religious belief, political opinion, racial group, age, marital status or sexual orientation;
- ii. men and women generally;
- iii. persons with disability and persons without; and
- iv. persons with dependants and persons without.

The UR must also have regard to the promotion of good relations between persons of different religious belief, political opinion or racial groups.

In the development of its policies the UR also has a statutory duty to have due regard to the needs of vulnerable customers i.e. individuals who are disabled or chronically sick, individuals of pensionable age, individuals with low incomes and individuals residing in rural areas. Some of the above equality categories will therefore overlap with these vulnerable groupings.

In order to assist with equality screening of the proposals contained within this consultation paper, the UR requests that respondents provide any information or evidence in relation to the needs, experiences, issues and priorities for different groups which they feel is relevant to the implementation of any of the proposals. Furthermore, the UR welcomes any comments which respondents might have in relation to the overall equality impact of the proposals.

Q1. Do respondents agree that where this consultation has an impact on the groups listed, those impacts are likely to be positive in relation to equality of opportunity for energy consumers?

Q2. Do respondents consider that the approach needs to be refined in any way to meet the equality provisions? If so, why and how? Please provide supporting information and evidence.

Responding to this consultation

Representations regarding this paper should be forwarded to reach the UR on or before the Closing Date of 4.00pm on 01 October 2013 to:

Robert Stewart
Utility Regulator
Queens House
14 Queen Street
Belfast
BT1 6ED
Tel: 02890 316654
Email: robert.stewart@uregni.gov.uk

Our preference is for responses to be submitted in an electronic format.

The UR recently published our 'publication standard'.⁷ This document sets out that price control consultations, such as this, will last at least 8 weeks. The UR previously indicated this proposals consultation would possibly be for a period of 12 weeks; however this was prior to the 'publication standard' being finalised. Therefore, to strike a balance the UR has set a period of 10 weeks for this consultation. This is also in direct response to a request from CCNI to extend the period from the recently implemented 'publication standard'.

The UR will duly consider all representations received on or before the Closing Date. Please note the UR may be unable to consider any representations received after this date.

⁷ The Utility Regulator, *Our consultation standard*, published 24th May 2013. A copy of this document is available at http://www.uregni.gov.uk/uploads/publications/Our_consultation_standard.pdf

Your response to this consultation may be made public by the UR. If you do not wish your response or name made public, please state this clearly by marking the response as confidential. Any confidentiality disclaimer that is automatically produced by an organisation's IT system or is included as a general statement in your fax or coversheet will be taken to apply only to information in your response for which confidentiality has been specifically requested.

Information provided in response to this consultation, including personal information, may be subject to publication or disclosure in accordance with the access to information regimes; these are primarily the Freedom of Information Act 2000 (FOIA) and the Data Protection Act 1998 (DPA). If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory code of practice with which public authorities must comply and which deals, amongst other things with obligations of confidence.

In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Authority.

This document is available in accessible formats. Please contact Robert Stewart on 02890 316654 or robert.stewart@uregni.gov.uk to request this.

1. Stakeholder Feedback to the Approach Consultation

- 1.1. The UR has been considering the 2014 price control for Power NI for some time. We have been keen to engage with stakeholders throughout to help maintain a transparent process and allow stakeholders the opportunity to shape our thinking for the next price control. To that end, we commenced the project with a public information⁸ note in late 2012 setting out timelines and key aspects of the Control.
- 1.2. We then published a first consultation paper entitled “*Approach to the 2014 Power NI Supply Price Control*”⁹ in February 2013 (the Approach). The Approach set out for consultation a number of questions on the main issues likely to affect the Control; our initial thoughts on how those issues may be addressed or looked at further; and welcomed stakeholder feedback on various questions and issues. The purpose of that document was to consult on the approach the UR should take in relation to setting the next price control for Power NI. The first consultation feeds directly into this second consultation that now includes our findings and proposals.
- 1.3. The UR received three responses to the Approach paper. Non-confidential submissions were received from the following organisations:
- The Consumer Council for Northern Ireland (CCNI)¹⁰;
 - Power NI¹¹; and

⁸ The Utility Regulator, *Power NI Price Control Review 2014 – information paper*, published 9th November 2012. A copy of this paper is available at http://www.uregni.gov.uk/publications/power_ni_price_control_information_paper

⁹ The Utility Regulator, *Approach to the 2014 Power NI Supply Price Control – consultation paper*, published 8th February 2013. A copy of this paper is available at http://www.uregni.gov.uk/publications/consultation_on_approach_to_the_2014_power_ni_supply_price_control

¹⁰ Annex 1. CCNI, *Re: Approach to the 2014 Power NI Supply Price Control*, submitted on 22nd March 2013.

¹¹ Annex 2. Power NI, *UR’s Consultation – Approach to the 2014 Power NI Supply Price Control – Power NI’s Response*, submitted on 22nd March 2013.

- System Operator for Northern Ireland (SONI)¹².

1.4. In addition, Power NI also engaged Cambridge Economic Policy Associates (CEPA) to provide the UR with a report on *“Financeability and its implications for a required margin”*. The CEPA analysis did not answer the specific questions posed in the Approach consultation per se; however it has helped to move forward the debate surrounding the allowed margin. It is addressed fully in the section on Margin (section 6).

1.5. The Approach requested respondents to provide feedback on ten questions which are reproduced below. This chapter sets out the targeted questions we asked stakeholders and provides a brief summary to those responses. We then provide a short “UR comment” and reference where the issue has been fully addressed in the subsequent chapters of this paper. These have been given due consideration by the UR as can be seen throughout the rest of this document. Where respondents have made submissions that were not in response to a specific question in the Approach consultation, these have also been considered and are addressed later in this document if deemed appropriate.

1.6. CCNI and SONI did not respond directly to each question but provided a response that covered the whole Approach document. The UR has attempted to allocate responses to the relevant question where appropriate. Aggregate views have been used in the applicable ‘respondents feedback’ sections where they are similar.

1.7. A copy of each respondent’s full submission can be found on our website – www.uregni.gov.uk.

¹² Annex 3. SONI, *Utility Regulator’s Consultation on the Approach to the 2014 Power NI Supply Price Control – A response by SONI*, submitted on 22nd March 2013.

APPROACH CONSULTATION QUESTIONS

Q1. *Do respondents agree that where this consultation has an impact on the groups listed, those impacts are likely to be positive in relation to equality of opportunity for energy consumers?*

Q2. *Do respondents consider that the approach needs to be refined in any way to meet the equality provisions? If yes how and why? Please provide supporting information and evidence.*

Respondents' feedback

1.8. No adverse equality considerations were highlighted by any respondent.

1.9. **UR comment.** We will proceed with the Control process on that basis.

Q3. *Do respondents feel the existing structure and form remains appropriate for the next price control? If not, please explain what you believe the structure and form should be.*

Respondents' feedback

1.10. Power NI agreed that it was generally appropriate.

1.11. **UR comment.** We propose to maintain the existing general structure and form of the Control.

Q4. *In the Non-Domestic sector that is currently subject to price control regulation, do respondents agree that it is reasonable to assess Power NI supplier dominance in the 3 sections the UR has detailed: 0-50 MWh; 50-100 MWh and; 100-150 MWh per annum? If not, please explain your rationale.*

Respondents' feedback

- 1.12. No respondent provided a specific commentary on the proposed analysis of the 3 sections.
- 1.13. CCNI state the *“aim of the Regulator in the current scenario in NI, must be to protect consumers in the transition from a monopoly to a competitive market”*. Power NI asserted there should be full price deregulation of the Non-Domestic market as they have a 16.7% market share of overall commercial consumption and that any retention of a control would infringe the UR's obligation not to discriminate between suppliers.
- 1.14. **UR comment.** Section 2 of this paper covers the scope issue fully and our proposals for a change to the existing scope and coverage.
-

Q5. *How long do respondents feel the next price control should last?*

Respondents' feedback

- 1.15. Power NI did not state a preferred duration but highlighted there have been a number of controls in a relatively short period of time which increases regulatory burden and removes efficiency incentives. Both CCNI and Power NI suggest the UR should provide a road map which would indicate milestones that could be achieved to trigger further price deregulation of a market segment.
- 1.16. **UR comment.** Section 3 of this paper covers this issue and our proposals for a 3-year duration for the coming Control period.
-

Q6. *Do respondents feel the 67:33 fixed:variable apportionment of Power NI's own allowed revenue (operating costs plus margin) is an appropriate method for reducing the OPEX and margin allowance in line with customer losses?*

Respondents' feedback

- 1.17. CCNI recognise the benefit of the 67:33 apportionments but believe that a further incentive scheme based on clearly defined customer service targets may be appropriate eg the number of complaints to CCNI. Power NI advised they believe the apportionments operate effectively but that the fixed element may need to increase if customer numbers significantly decrease due to the changing customer environment.
- 1.18. **UR comment:** Section 6 of the paper considers the fixed apportionment issue and proposes a small change as a result of detailed analysis.
-

Q7. *Do respondents believe the approach outlined to assessing OPEX is appropriate at this price review following the 'line by line' approach at the last review? If not, please explain what approach you believe the UR should take to assessing OPEX and the reasons why.*

Respondents' feedback

- 1.19. CCNI highlight they believe marketing costs are an issue. They do not believe that there should be an allowance in order to win new customers. This adds shareholder value and is not of benefit to customers. However, they do believe that costs associated with improving customer awareness should be allowed provided it is carefully monitored and is appropriate.
- 1.20. SONI support the roll-over approach with Real Price Effect and ongoing efficiency / productivity adjustments.

- 1.21. Power NI is generally supportive of the transparent approach outlined by the UR, given the line by line approach taken at the last review. However, they do not support the frontier shift as they are an asset light business. They contend the original methodology was developed for an asset intensive business (NI Water), therefore the methodology is fundamentally flawed.
- 1.22. Power NI also cites the report prepared for them at the last control by NERA which contended they were already 50% lower cost to serve than key comparators and benchmarks should be against a notional new entrant company. Finally, Power NI also believes the assessment must recognise the 'unavoidable' cost of competition and subsequent impact on customer service costs.
- 1.23. **UR comment.** All OPEX issues are covered in some detail in sections 4 and 5 of this paper and its Annexes.
-

Q8. *What are respondents' views on the three methods of calculating margin that are discussed?*

Respondents' feedback

- 1.24. CCNI did not specifically respond to the question. They made the general observation that the margin should be set to ensure that the company is worth running. Shareholders receive a sufficient return to ensure that they invest 'just' as much as is required to provide an efficient and high quality service.
- 1.25. SONI agree with the UR statement to '*pay particular attention to the risks that a business such as Power NI faces and the fair and reasonable reward that investors should expect for bearing that risk*'. However, they believe the calculation of margin should include 'brand value' so as not to distort the pricing for other market participants and undervalue the service provided. They also believe that, while shareholders should not expect to make

supernormal profits or sub normal returns, it should be more than a 'fair bet' regarding the equally balanced chances of making or losing money.

1.26. Power NI see merit in the "triangulation" approach to determining the margin. However, they state there needs to be agreement on which evidence is given most weight due to the difficulties of finding perfect comparisons with other benchmarks. They contend the 'regulatory precedents' stated in the Approach are outdated but draw on examples from suppliers in GB (Ofgem RMR analysis) and evidence from Australia. Power NI also reiterates previous submissions surrounding the increased risk they now face in a competitive market as opposed to risks which an incumbent monopoly business faces. Power NI argues that 'k' no longer fully guarantees they will be able to correct under recoveries in future years. In the context of already diminishing customer numbers, attempting to recover a large 'k' under-recovery would make this position worse.

1.27. **UR comment.** The margin issues have been the subject of much UR analysis and discussion with Power NI and their consultants. The UR has engaged expert external help in calibrating the appropriate margin after a fundamental consideration of the appropriate issues. These are fully discussed in detail in section 6 of this paper and the associated Annexes.

Q9. *As detailed in Section 5, do respondents believe the UR should look across the range of methods or choose one method over the others when assessing margin? Please explain your reasons why.*

Respondents' feedback

1.28. Power NI acknowledge there is merit in looking across the range of approaches but suggest the UR also considers the approaches used by the

credit rating agencies. SONI suggest a holistic approach is required of that which is needed to make the company financeable.

- 1.29. **UR comment.** The margin issues are fully discussed in detail in section 6 of this paper and the associated Annexes.
-

Q10. *Do respondents agree that the appropriate financeability test is ensuring that Power NI can finance their price controlled licence activities by the UR demonstrating that it has a robust evidence-based methodology for calculating OPEX and margins? If not, please explain your reasons and advise what form of financeability test the UR should undertake.*

Respondents' feedback

- 1.30. Power NI welcomed the UR's robust approach and submitted a further report from their appointed economic consultants to supplement their responses submission document. SONI agrees with the UR that the traditional financeability tests used by regulators for network utilities are not necessarily appropriate but it is vital that the UR's assessment of financeability is supported by robust evidence for calculation OPEX and margin.

- 1.31. **UR comment.** The margin issues are fully discussed in detail in section 6 of this paper and the associated Annexes.
-

- 1.32. The engagement and submissions from interested stakeholders have helped to shape the sections of this consultation document that follow. The UR would like to thank respondents for their feedback.

2. Scope and Coverage of the Control

Background

2.1 Power NI is currently subject to price control regulation in the whole of the Domestic market and for customers up to 150MWh per annum consumption (or 100 kVA Maximum Import Capacity (MIC) connection if consumption data is unavailable) in the Non-Domestic market. “Regulated premises” are defined in Annex 2 of the Power NI licence.

2.2 Power NI retains a dominant position in the Domestic sector in the Northern Ireland market with a market share of c.76% both by consumption and connection for the supply of electricity. In their response to the Approach, Power NI recognises they “*currently retain a significant market share in the domestic sector*” but called for a roadmap for price de-regulation in the Domestic sector.

2.3 Market share is deemed to be an important factor in the assessment of dominance but as indicated in the Approach consultation, a range of other factors and indicators are also assessed by the UR. The UR envisages that price control regulation i.e. the setting of regulated tariffs offered by Power NI will continue to apply to the whole Domestic market whilst Power NI remain in a uniquely dominant position. The UR has previously committed to, and will continue to, monitor the situation as further competition emerges and in light of our statutory duties.

2.4 The situation for the Non-Domestic market in Northern Ireland for the supply of electricity is less clear. Power NI (when taken with their affiliate company, Energia) has been the dominant supplier in the Non-Domestic market that is still subject to price control and regulated tariffs. However, the market shares have been changing since the last price review and now require further consideration.

2.5 Please note that undertakings within the same corporate group are considered to be one undertaking for the purposes of European competition legislation, as

generally are principals and their agents. This is standard practice, which is endorsed by the Office of Fair Trading (OFT)¹³ the principal competition authority in the UK. Therefore, we are following the well established custom and practice by aggregating the market shares of Power NI and their sister affiliate Energia for the purposes of the analysis.

2.6 While there may be business separation obligations in the licences of Power NI and Energia, it is recognised that these will only ever be effective to a certain degree. The common ownership, shareholder control and joint market power of Power NI and Energia is the salient point when considering market share and potential dominance.

2.7 It is also important to note that Energia are not subject to end-user price regulation in Northern Ireland. Their regulatory framework is the same as all other suppliers in the Northern Ireland retail market that are also not subject to a price control and compete with other retailers on this basis.

Overview of Market Dominance

2.8 Establishing whether a supplier is in a uniquely dominant position in a market is important in identifying whether there is a justification for treating that supplier differently from other suppliers, by applying to it a price control to restrain its potential ability to take advantage of its significant market power. Indicative of a supplier's market position is the market share that the supplier enjoys in that market (although it is important to note that market share does not, in itself, establish dominance as will be seen from our later analysis). The prevention of the potential ability of Power NI to abuse their dominant position, to the detriment of consumers and competition, is the overriding and clearly articulated reason why the UR price control Power NI in the markets where they remain uniquely dominant.

¹³ The Office of Fair Trading guidance note OFT 415 – “Assessment of market power”.

2.9 With a market share of 50% or more, there is a legal presumption of dominance. Clearly any presumption is capable of being rebutted. However, the higher the market share, the less likely it is that the presumption will be rebutted. Within a market share range of 40-50%, there is no legal presumption of dominance either way. The analysis of other factors, such as the relative market share of their competitors, market entry barriers, etc, will require even more scrutiny to help determine whether dominance exists in the market. Clearly the lower the market share, the less likely that dominance will be established. There have rarely been findings of dominance below a 40% market share.

Analysis of the price regulated Non-Domestic market

2.10 Following a probe of energy Retail markets in GB in 2008, Ofgem identified that the smallest businesses struggle to engage in the energy market and introduced new rules to give them better protection in 2009¹⁴ In GB, statute sets out the threshold for *micro-enterprise*¹⁵ which is consumption of 55MWh per annum. In addition, Ofgem recently released their final consultation proposals to increase the protections afforded to micro-enterprises to cover customers consuming up to 100MWh pa.¹⁶

2.11 The Approach consultation set out that the UR views there to be three sections within the Non-Domestic sector that is still subject to price control regulation: 0-50MWh; 50-100MWh; 100-150MWh pa. We maintain that view. We believe that customer characteristics, buying power, know-how, energy

¹⁴ Ofgem publication dated 30th November 2009 titled "*Helping small businesses get the most out of the energy market – factsheet*"

¹⁵ Section 2(1) of "*The Gas and Electricity Regulated Providers (Redress Scheme) Order 2008*" defines the relevant consumer (micro-enterprise) as a non-domestic customer whose annual consumption is not more than 55MWh; **or** fewer than 10 employees **and** an annual turnover or balance sheet not exceeding €2million. The UR will only be able to monitor consumption in 10MWh bands, therefore an equivalent of 0-50MWh will be used.

¹⁶ Ofgem publication dated 22nd March 2013 titled "*The Retail Market Review – Final non-domestic proposals*"

retail market knowledge and awareness, etc will decline with the size of non-household customer. This fact has been recognised in other energy markets elsewhere (we reference GB experience below). We also sought views from respondents on whether it was appropriate to assess Power NI's market dominance in these three sectors to assess whether the price regulated threshold should be reduced.

2.12 In their response to the Approach, CCNI asserted that the "aim of the Regulator in the current scenario in NI, must be to protect consumers in the transition from a monopoly to a competitive market". The UR acknowledges the importance of the caution raised as this is consistent with our primary statutory duty to protect the interests of consumers of electricity, wherever appropriate by promoting effective competition. It is not simply a duty of the UR to promote competition for competition's sake in order to protect consumers. The promotion of competition must be both appropriate and the competition itself must be effective.

2.13 Power NI stated that end-user price regulation should be removed from the entire Non-Domestic market as they (when viewed in isolation from their sister affiliate Energia) have a market share of 16.7% of the entire Non-Domestic market. Power NI also calls for a regulatory roadmap for the development of price control removal from the entire retail electricity market after 2014. In this chapter, the UR sets out proposals that will automatically trigger a consultation on the regulatory threshold within the Non-Domestic market. In addition to this, the UR has already indicated in our Forward Work Programme for 2013/14 that we will commence a review of the effectiveness of competition in electricity retail markets and the resulting implications for the NI regulatory framework¹⁷ This work is due to begin in late 2013 / early 2014.

¹⁷ The Utility Regulator, *Forward Work Programme 1 April 2013 – 31 March 2014*, published 28th March 2013. A copy of this document is available at http://www.uregni.gov.uk/uploads/publications/FWP_2013-14.pdf.

2.14 There are currently 8 active electricity suppliers in the entire Non-Domestic market (or 7 if you combine companies that are members of the same corporate group) though several operate on a very small basis. They are:

- Airtricity
- Budget Energy
- Electric Ireland
- Energia (*a member of the Viridian group of companies*)
- Firmus
- LCC Power
- Power NI (*a member of the Viridian group of companies*)
- Vayu

2.15 The UR has undertaken analysis of the part of the I&C market that is still subject to price control regulation. We have obtained new supplier market share data, which provides details of supplier market shares, by both customer and consumption, split into 10MWh usage bands¹⁸ The first report was received in November 2012 but going forward, this report showing each suppliers' rolling annual consumption is due to be received on a quarterly basis from April 2013. The UR has received an additional report for June 13, to which NIE have confirmed the accuracy of the data at the time of production, and this is the basis for much of the analysis that follows. Some trend analysis has been completed but it must be noted that this only covers a limited period of 7 months so must be treated with caution.

2.16 Electricity (electric energy) is a homogeneous commodity and, in principle, the nature of the good consumed by a large industry is the same product that is used by small consumers in other parts of the system, since in all cases it is electromagnetic energy guided by the networks. The product is the electric

¹⁸ Annex 4. NIE have provided the UR with the "*Methodology for production of Supplier Market Share Report*". This is available to view as an annex to this consultation document.

energy and there is extremely limited (if any) ability to substitute the product for something else. This reinforces the potential for dominance and market power issues to be of material concern.

2.17 Dealing with electricity as a commodity is not a straightforward task.

Electric energy in each hour is produced from different plants, which are characterised by variable costs in the short and long term. Therefore, the cost of supplying a megawatt hour can vary significantly depending on the characteristics of each consumer and the particular moment in time when the consumption happens. In other words, it is about the same physical product, but delivered at different times and places, and therefore incurring different costs. This leads to different prices and different markets within the whole Non-Domestic sector.

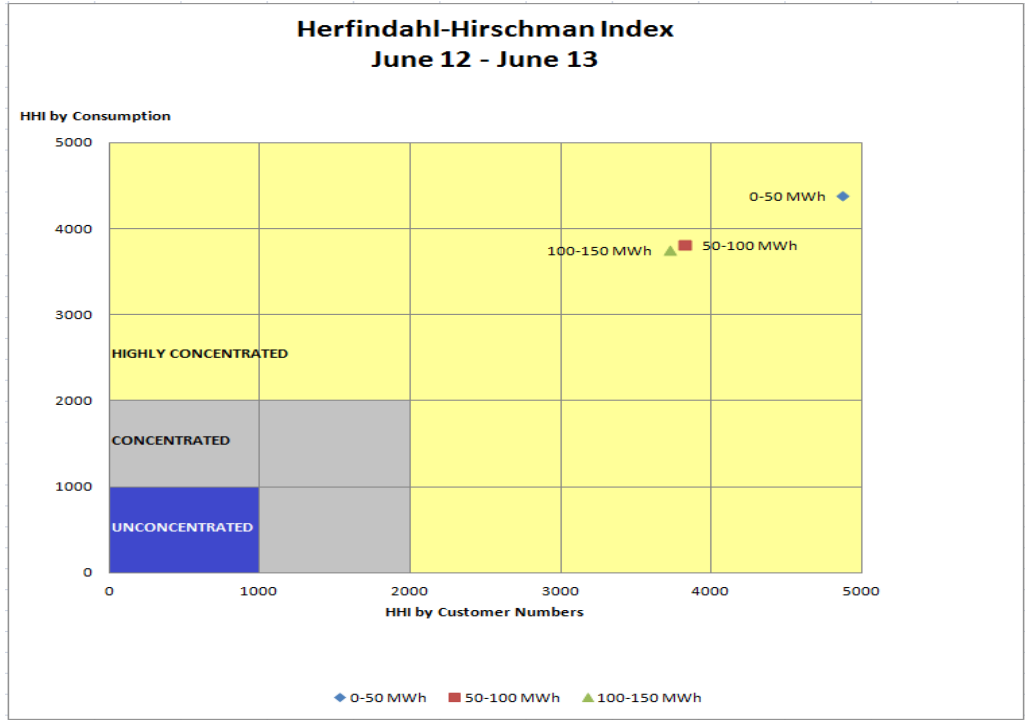
2.18 Although it does not form part of the discussion in this chapter due to the demonstrable dominance of Power NI in the Domestic market, the UR must clarify that it views the Domestic market as one market, irrespective of the way that customers decide to pay for the electricity they consume. However, within the market there are certain consumers that now or in the future may require additional protections, (eg vulnerable customers; “sticky” non-switchers).

2.19 The I&C electricity supply markets in NI do not benefit from a wide number of active suppliers – and the markets are quite “concentrated” – especially at the smaller end of the I&C market. Figure 2.1 below is a Herfindahl-Hirschman Index (HHI). The HHI is a measure of concentration that takes account of the differences in size of market participants, as well as their number. OFT/Competition Commission merger guidelines consider an HHI below 1,000 represents a market that is unconcentrated, between 1,000 and 2,000 as concentrated and above 2,000 as highly concentrated.¹⁹ The figure clearly illustrates the 3 sectors of the Non-Domestic market that we set out in the

¹⁹ A joint publication of the Competition Commission and the Office of Fair Trading, *Merger Assessment Guidelines*, published September 2010.

Approach are highly concentrated with a relatively low number of market participants, irrespective of whether we use a metric of consumption or number of customers.

Figure 2.1



2.20 In addition to being highly concentrated, the combined market share of Power NI and Energia is materially significant in the smaller I&C sectors. To aid the discussion which follows, Table 2.1 below sets out the I&C market share by customer number of Power NI in isolation, the combined Power NI/Energia market share (following established EU precedent) and the next largest competitor in the 3 sectors, Airtricity. This information is for the period June 12 to June 13. Table 2.2 sets out the same market share data but measured by the number of units consumed instead. By way of context, a Domestic premises consumes c4MWh per annum.

Table 2.1: June 12 to June 13

Annual consumption band	Total number of customers	Power NI customers		Combined Power NI/ Energia customers		Airtricity customers	
0-50 MWh	48,966	26,415	54.0%	31,288	63.9%	13,059	26.7%
50-100 MWh	4,875	1,433	29.4%	2,371	48.6%	1,715	35.2%
100-150 MWh	1,701	494	29.0%	814	47.9%	571	33.6%
Total Non-Dom Market	59,461	29,178	49.1%	36,156	60.8%	16,494	27.7%

Table 2.2: June 12 to June 13

Annual consumption band	Total units consumed	Power NI consumption		Combined Power NI/ Energia consumption		Airtricity consumption	
0-50 MWh	607,221	259,535	42.7%	346,367	57.0%	193,527	31.9%
50-100 MWh	338,386	98,272	29.0%	162,729	48.1%	120,054	35.5%
100-150 MWh	209,799	62,856	30.0%	101,786	48.5%	69,668	33.2%
Total Non-Dom Market	4,627,692	768,895	16.6%	1,846,551	39.9%	1,347,175	29.1%

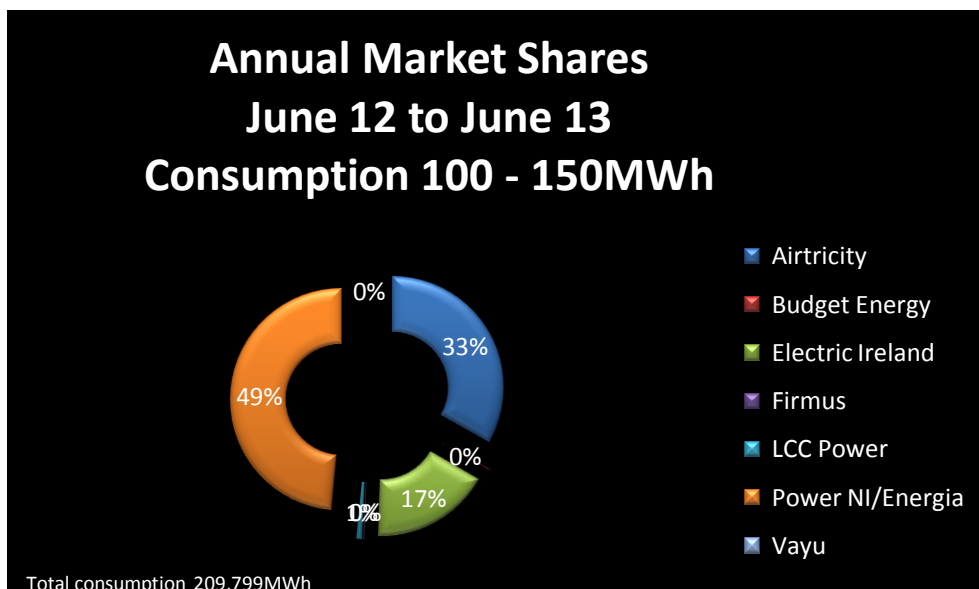
100-150MWh consumption per annum

2.21 Figure 2.2 (below) demonstrates the market shares in the 100-150MWh sector. It highlights that Power NI/Energia possess a market share of 48.5% by consumption. Power NI/Energia has a market share which is 15.3% larger than that of their nearest competitor, Airtricity.

2.22 This section of the Non-Domestic market is within a market share range of 40-50%, therefore there is no legal presumption of dominance either way.

2.23 The average level of consumption in the 100-150MWh sector is 123MWh per annum.

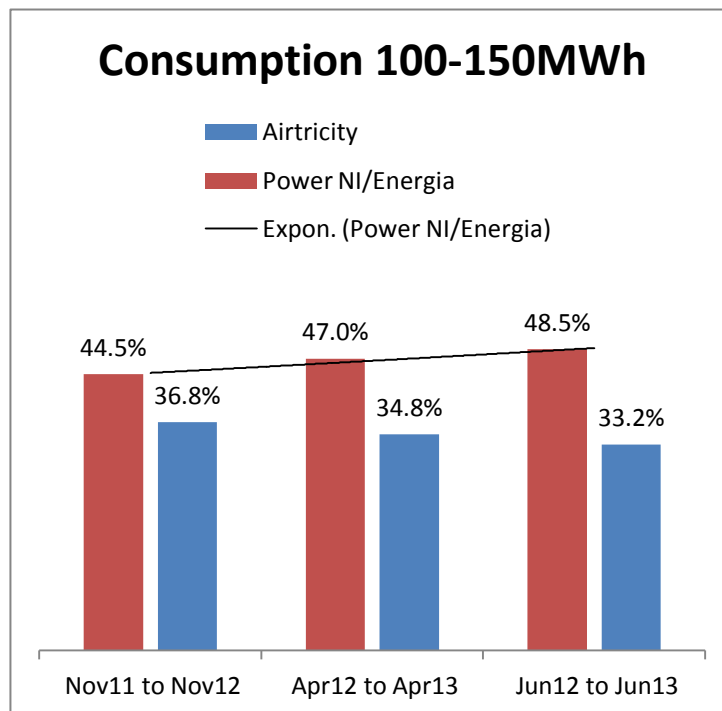
Figure 2.2



2.24 Although the following figure only highlights a limited trend (based on annual consumption) over a 7 month period, it must be noted that Power NI/Energia have actually increased their market share during the period in question by c4.0% points.

2.25 This would indicate there is limited evidence of substantial customer churn or constant attrition of the Power NI/Energia's market share in the 100-150MWh sector. In fact their market share has actually grown. However, the UR must again stress that there is currently only data to permit a trend analysis over a 7 month period so this must be viewed with caution.

Figure 2.3



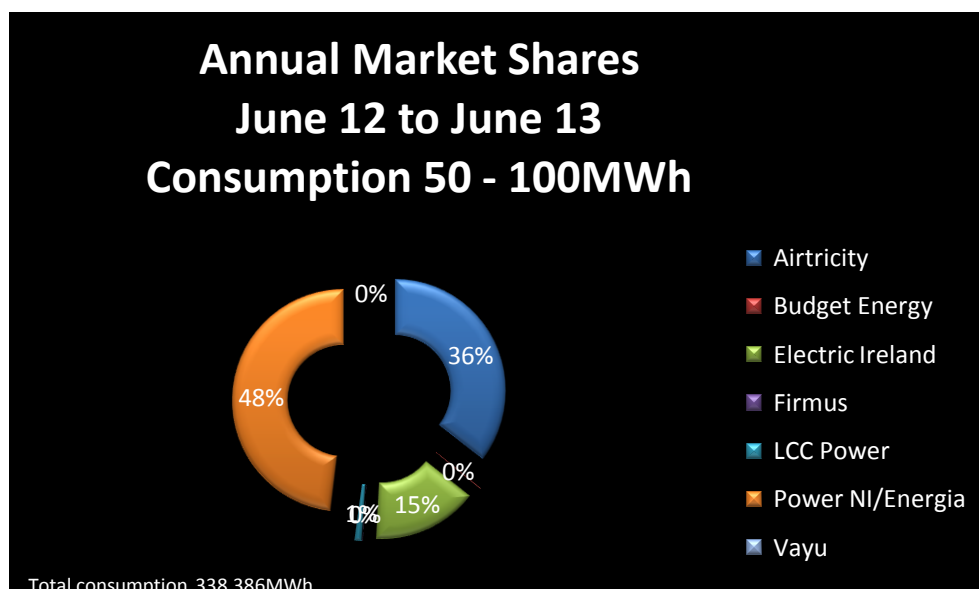
50-100MWh consumption per annum

2.26 Figure 2.4 (below) demonstrates the market shares in the 50-100MWh sector. It highlights that Power NI/Energia possess a market share 48.1% by consumption. Power NI/Energia has a market share which is 12.6 percentage points larger than that of their nearest competitor, Airtricity.

2.27 This section of the Non-Domestic market is within a market share range of 40-50%, therefore there is no legal presumption of dominance either way.

2.28 The average level of consumption in the 50-100MWh sector is 69MWh per annum.

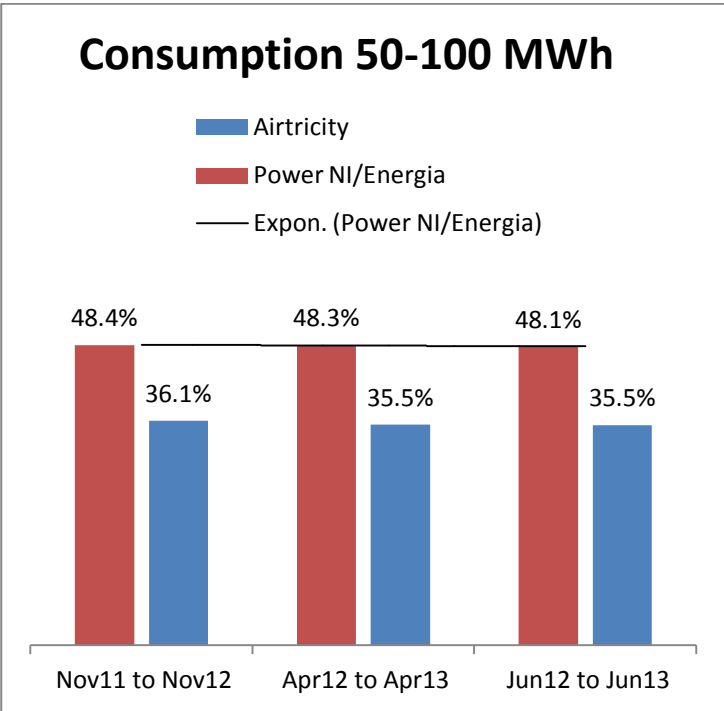
Figure 2.4



2.29 The following figure again highlights a limited trend over a 7 month period but it should be noted that Power NI/Energia have seen a marginal decrease in their market share over the period in question by c0.3%.

2.30 The very limited movement in market shares would indicate that the 50-100MWh sector may not be subject to dynamic competition. No evidence of substantial customer churn, nor constant attrition of the former incumbent's market share, can be derived from the 7 month data that is available to the UR.

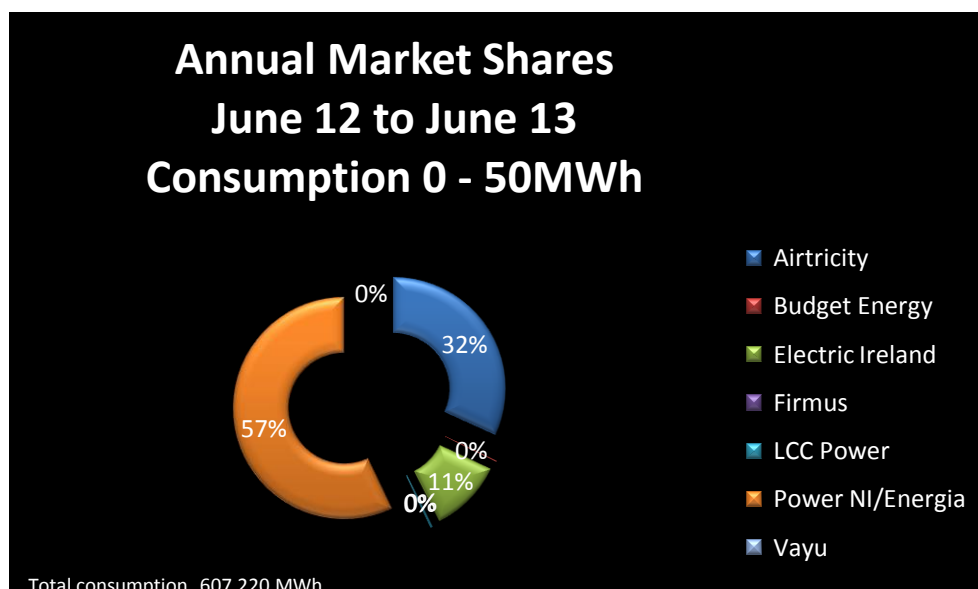
Figure 2.5



0-50MWh consumption per annum

- 2.31 Figure 2.6 (below) demonstrates the market shares in the 0-50MWh sector. It highlights that Power NI/Energia retain a clearly demonstrable position of market dominance of 57.0% market share. Power NI/Energia has a market share which is 25.1 percentage points larger than that of their nearest competitor, Airtricity.
- 2.32 The average level of consumption in the 0-50MWh sector is 12MWh per annum. This is only something in the region of 3 times larger than that of an average Domestic premise. As noted earlier, precedent from GB indicates that these smaller Non-Domestic users require extra regulatory protection in the marketplace.
- 2.33 This section of the Non-Domestic market remains significantly above the rebuttable presumption of dominance threshold which is 50%.
-

Figure 2.6

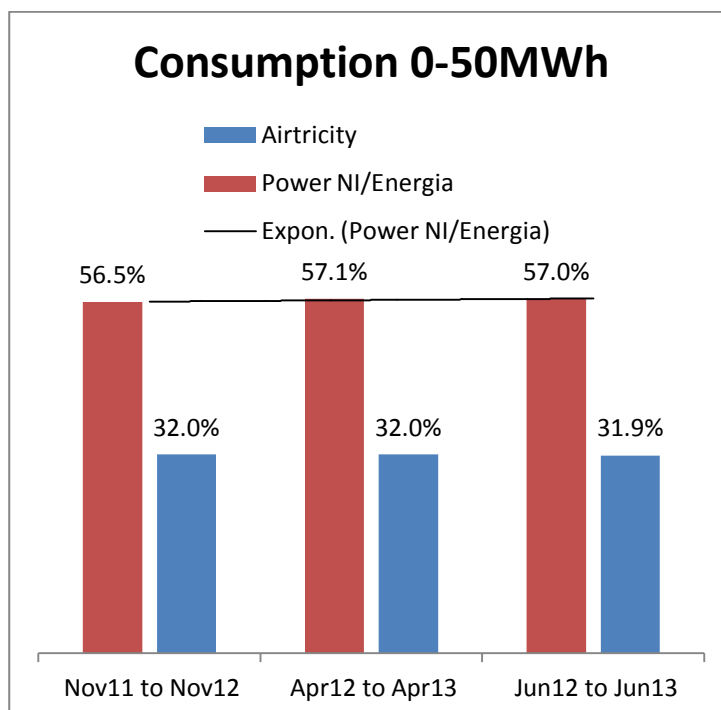


2.34 This section of the Non-Domestic market also remains significantly above the rebuttable presumption of dominance threshold.

2.35 Although the following figure only highlights a limited trend over a 7 month period, it must be noted that Power NI/Energia have grown their market share over the period in question by c0.5percentage points.

2.36 When combined with the very limited movement in market shares, this would indicate that the 0-50MWh sector is not subject to dynamic competition (with no evidence of substantial customer churn nor constant attrition of the former incumbent's market share).

Figure 2.7



2.37 As regards GB experience and considerations of market power/customer protection issues, a class of customers, ‘micro-businesses’, has been established by statute in GB as a business that consumes up to 55MWh per annum. As mentioned previously, the closest metric that the UR could monitor this at is 50MWh. In GB, these “micro-businesses” enjoy additional protections to other I&C customers, such as transparency requirements with billing and a range of other protections: they are recognised as a separate customer sector in regulatory terms²⁰

2.38 We are of the clear view that if the price control were removed from the entire Non-Domestic market, Power NI (when viewed with their sister affiliate Energia) will still retain a dominant position in the 0-50MWh market and have

²⁰ Ofgem have recently announced, as part of their Retail Market Review, final proposals to extend the protections above the consumption bands set out in statute to those consuming up to 100MWh pa. The UR is aware of the Ofgem work and thinking in relation to enhanced protection for micro businesses.

the potential to abuse their dominant position. This is of potential detriment to consumers and competition.

UR proposals for consultation

2.39 The UR therefore proposes to **retain the price control in the 0-50MWh sector**; but remove coverage in the 50-100 and 100-150 MWh sectors. It is also proposed that the threshold of 50MWh will apply to Non-Domestic customers with multiple premises - all other criteria set out in the UR's decision paper²¹ on this area (published January 2013) would remain unchanged.

2.40 The proposed new threshold of 50MWh would be implemented in April 2014 at the beginning of the new control period. The UR will monitor the 50-150MWh sector closely to ensure that competition is functioning effectively. This will include specific reports in relation to profits and pricing to be submitted by Power NI to the UR to facilitate that monitoring – the details of this will be discussed further with Power NI prior to issuing the final Decisions on this Control in the autumn. This is in addition to two important work strands in the UR's 13/14 Forward Work Plan:

- (1) the UR's plan to develop an electricity retail market monitoring system for all suppliers that will use key indicators relevant to consumers – CCNI has agreed to work with the UR in this area;
- (2) a review of the effectiveness of competition in the electricity supply markets and the required regulatory policy response.

²¹ The Utility Regulator, *Electricity customers with multiple premises in the Non-Domestic market – Decision paper*, published 29th January 2013. A copy of this document is available at http://www.uregni.gov.uk/uploads/publications/Non-Dom_Groups_decision_v10.pdf.

Roadmap to further price de-regulation in the Non-Domestic sector

2.41 In light of the above analysis and the proposal that the scope of the price control should continue to cover the smaller Non-Domestic sector of 0-50MWh, the UR proposes to set out the criteria that will trigger a consultation on further end-user price control de-regulation of the Non-Domestic sector. The criteria proposed are:

- 1. Power NI/Energia must have a combined market share (by consumed units) of less than 50% for two consecutive quarters; and*
- 2. There is a minimum of 3 independent suppliers, each of which has at least 10% share of consumed units in the relevant market. For clarity, what this means in practice is Power NI/Energia plus two other independent suppliers. (As it stands today, this second condition would be satisfied.)*

For the avoidance of doubt, by independent we mean no common parent company shared with other suppliers in the Northern Ireland market.

2.42 If the above criteria should be met and a consultation on further price de-regulation is triggered, the consultation will then be used as a vehicle to provide genuine options. It is envisaged that the options will not only be on lowering the threshold further but also regarding the issue of what should happen if the market share of Power NI/Energia (or another supplier) moves back above 50%.

Roadmap to price de-regulation in the Domestic sector

2.43 The work regarding a roadmap to the removal of price controls for the Domestic market is more complicated and other concerns, such as the impact of competition for vulnerable customers, need to be assessed. As noted earlier, Power NI has indicated that they understand they still retain significant market share in this sector. However, clarity for the market will still need to be provided.

2.44 Although it has already been highlighted in the Approach consultation, it is important to emphasise once again that alongside any removal of the price control on Power NI specifically, the UR has already indicated the need for a strategic exercise to be undertaken reviewing the effectiveness of competition (in protecting both I&C and Domestic customers) and the implications for the regulatory policy framework and the regulatory tools to be adopted by the UR in that context. This Review has been scheduled in the UR's published Forward Work Programme for that project to commence later this year/early next year, as the current control project comes to an end.

2.45 Conclusions are not expected to be completed until well after the current price control setting process has ended. The UR does not envisage that Power NI will have a market share of below 50% before the end of the next price control period. If they did, e.g. due to new supplier entry between now and 2014, the UR will revisit this issue.

2.46 The UR will be seeking to engage with a wide range of parties as we complete the Review. In addition to engaging with the parties we regulate, it is envisaged we will seek to utilise the knowledge and expertise of parties such as CCNI (as the statutory consumer representative body for Northern Ireland) and possibly also the OFT/Competition and Markets Authority²² as the UK's primary competition authority.

²² In March 2012, the UK Government's Department for Business, Innovation and Skills announced proposals for improving and strengthening the competition regime in the UK by merging the Office of Fair Trading and the Competition Commission to create a new single Competition and Markets Authority (CMA). The Enterprise and Regulatory Reform Act 2013 received royal assent in April 2013 and the CMA is scheduled to commence fully functional operation as a non-ministerial government department on 1 April 2014.

Q3. The UR proposes to retain the Power NI price control for Non-Domestic customers consuming 0-50MWh or less per annum and remove coverage for those consuming 50-100 and 100-150MWh pa. Do respondents' agree with this proposal and if not, please explain your rationale?

3. Duration of the Control

- 3.1. In Gas retail markets, the UR sets a 5 year control for the dominant supplier Airtricity Gas Supply (formerly Phoenix Supply Limited). The UR has the ability to 're-open' the price control after 3 years but is not compelled to do so.
- 3.2. The UR also typically sets a price control for NIE Transmission & Distribution (and other large utility networks) for a period of 5 years. It must be noted that this is a network price control with different characteristics to a retail control. The expenditure profile is materially different as there is generally a significant amount of capital expenditure within any network control; and the external environment in which the business operates is inherently stable. Therefore a longer period may be more appropriate given the different economic characteristics of the activities carried out by the business which is inherently a 'natural monopoly'.
- 3.3. In GB, The Water Services Regulation Authority (Ofwat) has confirmed their intention to set two types of control – wholesale (networks) and retail.²³ Ofwat have stated they will set both for a 5 year duration from April 2015. Ofwat have consulted on amendments to the various water company licences as they believe that it may be appropriate to set different durations for the different controls. Following an iterative process, the final proposals from Ofwat were unanimously accepted by the water companies.
- 3.4. The last time Power NI had a supply price control that lasted a period of 5 years was April 2000 to March 2005. This control has been followed by a number of shorter term controls, the latest of which is the current two-year control from April 2012 to March 2014. The series of shorter term controls over the past number of years has been due to the changing external environment for Power NI in terms of emerging retail competition and the impacts on their business and costs.

²³ Ofwat's "Future price limits – statement of principles" published 15th May 2012

- 3.5. In the Approach consultation, the UR sought feedback on how long respondents thought the next Power NI supply price control should last. The UR stated that our initial thoughts were towards a 3 year duration due to the ongoing context created by developing competition.
- 3.6. Although respondents did not state a preferred duration, Power NI stated the question of duration was inextricably linked to the UR's strategic roadmap, which is addressed in the Scope and Coverage chapter of this consultation. The decision about the duration of the next price control has to take account of likely developments in competition.
- 3.7. Our view is that some issues point to a shorter duration (uncertainty; developing competition), whilst others point to a longer duration (incentives on the regulated company; reducing the regulatory burden placed on Power NI and UR). At the last price control review, the UR stated its desire to move away from short-duration controls, but was mindful that there is uncertainty about the rate at which competition will develop and the impact this will have on Power NI's costs. Power NI's response indicates they also wish to move from controls of shorter one or two year duration as well.
- 3.8. On balance, and in line with our initial thoughts in the Approach consultation, **the UR proposes to set a control for a period of 3 years.** The control would run from April 2014 until March 2017. However, we are very keen to receive feedback from interested stakeholders on whether the 3 year duration of the control is appropriate, if it should be increased or indeed decreased and the reasons why.

Q4. Do respondents believe a control period of 3 years is appropriate? Please explain your rationale if you do not.

4. Operating Expenditure (OPEX)

- 4.1. One of the principal areas of analysis in formulating the proposals for this control has been to determine the appropriate level of OPEX which should be allowed for Power NI for the next control period. This section of the consultation will outline the UR proposals for OPEX.
- 4.2. In the February Approach paper, stakeholders were asked for their views on the proposed approach for assessing the OPEX allowance. This has already been discussed in Section 1 of this report.
- 4.3. As stated in our Approach document, we carried out a 'top-down' analysis of the OPEX expenditure (with the exception of outsourced costs) as a detailed review was carried out in the last control. Outsourced costs were analysed separately and specifically as there has been material changes (due to the installation of a new IT/billing system) to the relevant cost areas within Power NI's business since the last control.
- 4.4. The UR engaged experts in this area of price controls BDO (formerly PKF) to examine these cost submissions made by Power NI. They examined all the cost areas set out below, except for outsourced costs. The detailed BDO report is contained in Annex 5.²⁴
- 4.5. The outsourced costs OPEX items were reviewed in detail by Gemserv (discussed further under the outsourced heading). Outsourced costs were analysed on a detailed bottom up basis to verify the new running costs associated with the new IT/billing system that has been put in place since the last control was set.
- 4.6. Power NI has six main categories of operating expenditure/cost provision. These are:
- Salaries;
 - Managed & Bought in Services (MBIS);

²⁴ Annex 5. BDO – Review of Power NI BEQ.

- Agency costs;
- Outsourced costs;
- Corporate costs: and
- Bad Debt.

4.7. In their response to our approach consultation Power NI cited the report prepared for them at the last control by NERA which contended they were already 50% lower “cost to serve” than key comparators and benchmarks should be against a notional new entrant company. Finally, Power NI also believes the assessment must recognise the ‘unavoidable’ cost of competition and subsequent impact on customer service costs. These have been considered in the context of the submissions made by Power NI.

4.8. Power NI provided the UR and their consultants with a detailed breakdown of each of the cost categories (the Business Efficiency Questionnaire BEQ), setting out the projected operating costs for the years ending 31 March 2014 and 2015. They also provided the actual outturn of costs for the financial year 2009/10 - 2011/12 and a latest best estimate (LBE) of the likely out turn of costs for 2012/13. This LBE was later substantiated when the actual figures for 2012/13 were finalised.

4.9. The costs submitted by Power NI are shown in the table below. The table shows the Power NI Actual OPEX for 2011/12; the LBE for 2012/13; and the forecast for 2014/15 it being the first year of the new control period i.e. the “base” year.

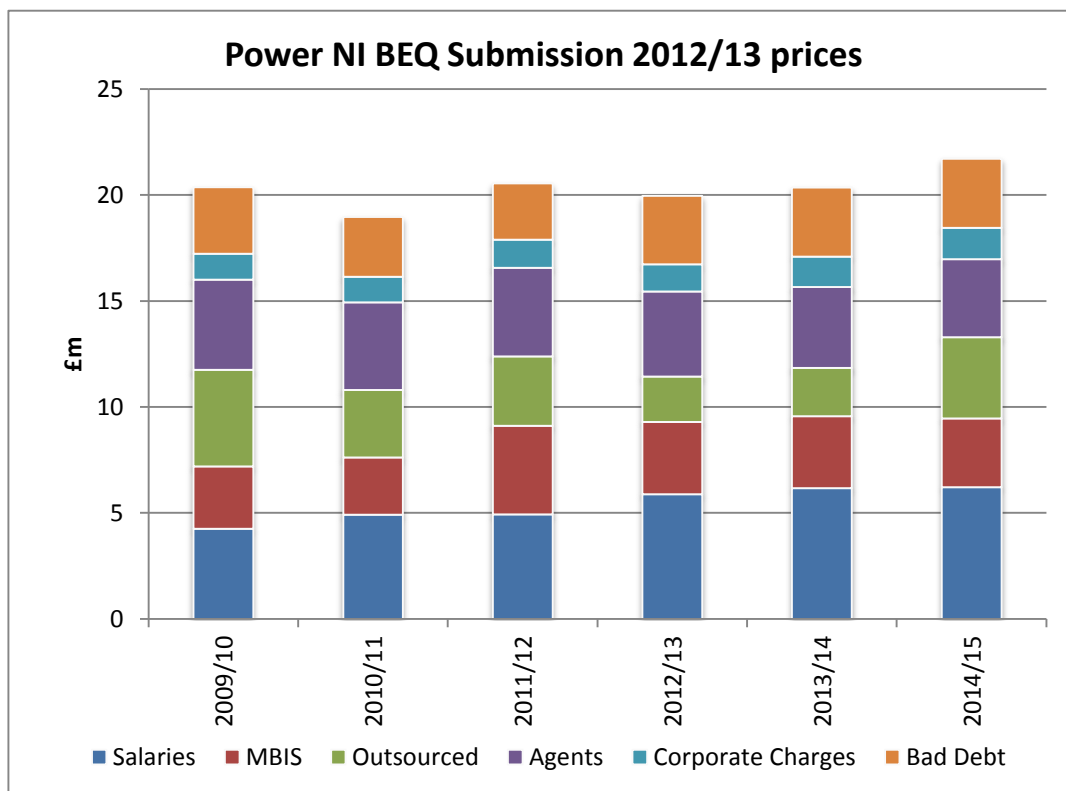
Table 4.1

Cost Category	Actual 2011/2012 £m's	LBE 2012/13 £m's	Forecast 2014/2015 PNI Proposal £m's
Salaries	4.929	5.888	6.215
MBIS	4.181	3.409	3.243
Agency Costs	4.181	4.013	3.686
Outsourced	3.280	2.141	3.826 ²⁵
Corporate Costs	1.325	1.283	1.484
Bad Debt	2.653	3.228	3.263
Total (£m)	20.55	19.96	21.72

4.10. The graph below shows the actual outturn for Power NI OPEX for the years 2009/10 to 2011/12, the LBE for 2012/13 and the forecasts made by Power NI for 2013/14 and 2014/15.

²⁵ This significant increase is primarily due to increased IT running costs with the installation of a new IT/billing system.

Figure 4.1



4.11. The graph highlights that Power NI are forecasting that their OPEX expenditure will increase from the current level. This significant increase is primarily due to increased IT running costs with the installation of a new IT/billing system.

4.12. As previously stated above the actual costs for the 12/13 year are not materially different to the 12/13 LBE. Therefore the UR consultants reviewed the projected costs for 14/15 in the context of the 2012/13 LBE costs.

4.13. BDO also adjusted the LBE figures (excluding outsourced costs) to take into account any items which were non-recurring to arrive at an underlying base cost for 2012/13, which then formed the basis for gauging base OPEX requirements for 14/15 (year one of the new Control).

Proposals

4.14. The table below shows the UR proposals for consultation which our consultants have recommended following detailed iterations with both Power NI and the UR.

Table 4.2

Cost Category	Forecast 2014/2015 PNI Proposal £m's	BDO & Gemserv Final Proposals £m's	UR Consultatio n Proposals £m's	Difference £m's
Salaries	6.215	5.964	5.964	- £0.251
MBIS	3.243	3.083	3.083	-£0.160
Agency Costs	3.686	3.686	3.686	-
Outsourced	3.826	3.790	3.790	-£0.036
Corporate Costs	1.484	1.351	1.351	-£0.133
Bad Debt	3.263	2.960	2.960	-£0.303
Total (£m)	21.72	20.83	20.83	-£0.883

4.15. The table above shows there are a number of areas where BDO have recommended a reduction in the level of allowed cost compared with that forecast by Power NI.

Salaries

4.16. Salaries have been forecast by Power NI to increase from the LBE level of £5.888m to £6.215m.

4.17. This increase is due to the fact that Power NI has forecast an increase in staff of circa seven FTE's for the year 2014/15. This is in the context that Power NI has already increased staffing levels in existing business areas between FY12 and FY13 by 12 staff, in addition to the in-sourcing of 29 staff from the Northgate billing contract.

4.18. Power NI stated that there was a need to increase staffing levels:

“Power NI believes that the additional headcount included in the BEQ will be reasonably required over the price control horizon. The additional 7 people fall into three main functional areas – Front Office including Call Handling and Debt Recovery (5), Trading (1), Strategic Development (1)”

4.19. Power NI cited reasons such as an increase in the number of customer calls and an increase in the length of calls meaning that additional call centre staff would be required. They also stated that they expect an increase in debt recovery activity.

4.20. In relation to the resource forecast for the trading area of the business Power NI stated:

“Increasing requirements in the area of hedging and the imminent beginning of interconnector trading has required an additional person in Power NI’s Commercial Office.”

4.21. In relation to Strategic Development Power NI have told the UR that this is to replace a staff member who left in 2012 and was not replaced.

4.22. Within the Power NI forecast there is also an overall rise in the average cost per staff member which has increased and this relates to auto enrolment in the pension scheme (which will be required by law) and some pay progression. BDO have accepted this slight increase in average cost.

4.23. In terms of Power NI forecast for increasing staff numbers BDO stated:

“In relation to staffing requirements, we consider that we have been provided with insufficient evidence that Power NI will require an additional 7.32 FTEs between the base year and 2014/15, given declining customer numbers, the increase in staff numbers in FY12 and what appears to be a mature / stable business model.”

4.24. The BDO proposed allowance of £5.964m represents a reduction of £251k from the staff costs figure included in Power NI’s forecast. This figure is

derived by taking the average cost of an employee per Power NI's forecast and multiplying it by 7.32 (the proposed increase to headcount).

MBIS

4.25. Whilst MBIS appear to be falling from the LBE of £3.409m to a forecast level of £3.243m, there were a number of 'one-off' costs in the financial year 2012/13 which when removed actually show that the MBIS costs are set to increase. These 'one-off' costs include the cost of the agency staff employed for the Enduring Solution implementation and the post optimal running period between go-live and business as usual operations and the cost of the triennial review for the pension scheme occurring in the 12/13 year.

4.26. There are a number of cost lines within the MBIS category where BDO recommended that there should be a decrease from the cost forecast by Power NI. These include:

- Printing and stationary (disallowance of £0.02m);
- Marketing (disallowance of £0.1m; and
- Journals/broking fees (disallowance of £0.04m).

4.27. With regard to printing and stationary BDO stated:

"We consider that we have been presented with insufficient evidence to justify any increase in Marketing and Other Printing & Stationery costs from FY13 levels."

Power NI themselves stated:

"While we are unable to source anything official from the printing and paper trade, Power NI was informed that there are threatened price increase letters to be issued from some of the main producers"

4.28. In relation to marketing, Power NI have made the argument that the term "marketing" is misleading for this category within MBIS, as it relates to communicating with existing customers as opposed to acquiring new

customers. They have stated that this takes into account the most up to date and customer friendly ways in which to communicate and includes more communication through tools such as social media and enhanced website & mobile capability.

BDO have recommended that the cost level of marketing should remain at the 2013 level and also state:

“We further note that FY13 levels are above-trend in both of these cost categories, adjusting for the impact of the FY12 rebranding exercise on marketing costs.”

In their response to our approach paper CCNI stated that marketing costs should not be allowed in order to win new customers, but that increasing customer awareness is appropriate. In this context the UR believe that the BDO proposal for not allowing an increase on the 2013 allowance (which is higher than what has previously been allowed) but remaining at this level strikes the appropriate balance.

4.29. In the relation to journals and broking, BDO stated:

“Power NI has accepted that the disallowance of broking costs is reasonable, however they have argued for the retention of the Journals increase on the basis that trading on the interconnector will reduce their wholesale energy costs, resulting in savings to the consumer.”

Therefore, the BDO proposal is to reduce the total MBIS forecast of £3.243m to an allowed level of £3.083m.

Outsourced

4.30. Power NI forecast an increase in outsourced costs from the LBE figure of £2.141m to £3.826m.

4.31. As stated above, Gemserv carried out a detailed review/audit of the forecast outsourced costs and engaged in detailed discussions with Power NI. Gemserv requested that evidence be provided for each of the elements within

this category which had shown a material increase from LBE levels. The evidence included proof of the cost level and a description and rationale of the cost itself and the need for the regulated business. Following this review, Gemserv submitted a report to the UR in which they indicated they were satisfied that the level of outsourced costs forecast by Power NI was reasonable, with only a small reduction to the initial submission made by Power NI. This results in a proposed allowance of £3.790m for outsourced costs.

- 4.32. The UR has reviewed the report and analysis provided by Gemserv and is content that Gemserv have carried out a robust audit of the individual cost lines and received evidence for each. However due to the commercial nature of the costs and contracts under the outsourced category the detailed Gemserv report will not be published as an Annex to this consultation paper.

Corporate Costs

- 4.33. Corporate charges are forecast to increase to £1.484 from the LBE figure of £1.283m.

- 4.34. BDO analysed this cost category and determined that the forecast corporate charges include proposed increases both in the overall level of charges and in Power NI's share of the overall costs.

- 4.35. BDO stated:

"In the context of a falling customer base and turnover, we do not see a justification for Power NI taking an increased share of group charges. Similarly, other than the increase attributable to the shift of HR from Power NI to Group we do not consider that the increase in underlying corporate costs over and above RPI is justifiable"

On this basis BDO went on to conclude:

“We therefore recommend that £133,000 (being the whole of the increase associated with the increase in allocation plus 50% of the increase in underlying costs) should be disallowed.”

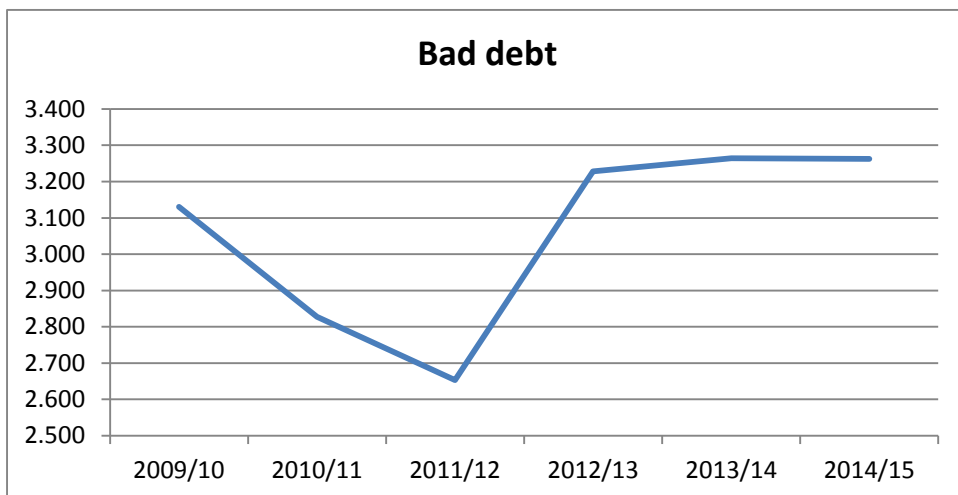
This would take into account the HR shift from Power NI to Group. Therefore, the proposal is to allow a cost level of £1.351m for corporate charges.

Bad Debt

4.36. As can be seen from the table, the level of bad debt has increased substantially from £2.653m in 2011/12 to £3.228m in the 12/13 LBE. Power NI has forecast a further increase for 2014/15 to £3.263m despite forecast turnover for that year being 10% lower than in 12/13.

4.37. BDO carried out a historical analysis of the level of bad debt since 2009. The graph below demonstrates that the level of bad debt does fluctuate quite significantly over time.

Figure 4.2



Given this analysis, BDO observed that 2013/14 and 2014/15 represent a peak in the levels of bad debt and that historically levels of bad debt have been low in the business.

4.38. Power NI have stated:

“In broad terms, the drivers of debt fall into two main categories, economic outlook and to a lesser extent market conditions. While these issues drive underlying debt, the materialisation of bad debt is subject to a time lag.”

4.39. Power NI have cited overall economic conditions as pointing to an increase in the level of bad debt:

“In assessing the economic outlook Power NI has considered the general UK economy trends, insolvency rates, corporate finance stress, unemployment, the housing market, key business sectors and the farming sector. All indications are that the recession is likely to continue with no real optimistic indicators.”

4.40. BDO stated:

“We consider that it is reasonable to assume that the cost of bad debt as a percentage of overall turnover will rise as more regulated customers switch to other providers. However insufficient evidence has been provided by Power NI to justify an increase to the overall cost of bad debt from the 2012/13 levels which represent the peak cost over the period 2009 – 2013 and an increase of £576,000 from 2011/12 levels.”

4.41. On this basis, BDO have proposed that the level of bad debt allowance which should be set as an average of the bad debt levels from FY2010 to FY2013. They highlighted that this was also in a period where Power NI had more customers.

4.42. This would represent an allowance of £2.96m for the whole business translating to 0.672% of forecast turnover - which is higher than the bad debt to turnover ratio in any year from 2009 to 2013.

4.43. Therefore, whilst this is a reduction on the level forecast by Power NI it does give a higher bad debt ratio than in previous price controls (and equal to the LBE % associated with bad debt) and therefore gives acknowledgment to

the arguments Power NI have made. However, we do not think there is sufficient substantive evidence to accept the level of Power NI's forecast.

4.44. This proposes an allowance of £2.53m for the regulated business or an allowance of 0.672% of **regulated turnover**.

“One-off” OPEX items in years 2 & 3 of the control

4.45. Power NI has raised the issue that there are likely to be a number of areas where costs will arise that have not been included in the baseline year of 2014/15 for determining OPEX requirements. They have specified certain cost lines (some of which are already dealt with within E_t) where they are anticipating they will incur costs in years 2 or 3 of the control.

4.46. They have indicated where they believe these costs are known but “non-forecastable” and should be treated as ‘pass-through’ (and therefore dealt within the E_t term of the licence); or instead treated as an OPEX item and therefore included in the baseline. The team has examined these costs and has identified three new costs categories for which we feel recovery is appropriate and new drafting will be included in the licence modification within the E_t term. These categories are:

- European Target Model costs;
- CC&B Upgrade and hardware replacement; and
- Supplier Obligation Costs.

4.47. The proposed licence modification will include drafting in the E_t section that specifies that only costs which have prior approval from the UR (after appropriate scrutiny to ensure there is robust evidence to support the spend in the first instance and the level of spend in the second) will be recoverable.

- 4.48. Furthermore any allowance approved under E_t will need to be assessed to ensure that it has been properly allocated between the regulated and unregulated businesses of Power NI with only that amount allocated to the regulated business being included in the Power NI regulated tariff revenue.
- 4.49. Finally apart from the three main new one off cost items there are several other small items that Power NI are forecasting will occur once during the second and third years of the control. The UR intends to include for these items in the OPEX allowance. Therefore we are proposing that an allowance of £100k per annum for the three years of the control be included as part of the OPEX allowance for these items which haven't been included in the BEQ baseline forecast i.e. year 14/15. This is not included in the tables shown in Section 4 as those tables relate to the BEQ which is a forecast of 14/15 only.
- 4.50. In the context of the proposals above, where we have stated that we will consider and include drafting to allow for submissions for cost recovery under the three new areas identified as E_t items, as well as our proposal to give an allowance for the smaller items which were not included in the BEQ base year, we believe this fully deals with the issue of the BEQ being for 2014/15 only and the UR decision, communicated in the Approach document, that we proposed to take a base year and roll it forward as an appropriate methodology. We are of the opinion that the opportunity to identify any additional 'one-off' items has been provided to Power NI as part of this process. In this context, we are of the view that the S_t allowance coupled with the E_t pass through items is the equivalent of an S_t allowance based on a 3 year forecast. Hence, for clarity and the avoidance of future doubt, we consider the treatment of all forecast operating costs for years two and three to have been dealt with.

Frontier shift and RPI –X

- 4.51. In the UR Approach paper of February 2013 we asked for stakeholder views on the use of the 'Frontier Shift' methodology for setting the OPEX levels for years 2 and 3 of the control. SONI in their response were supportive of this approach. However, Power NI stated this approach was fundamentally flawed on the basis that they are 'asset light' and that the original methodology was developed for asset intensive water companies. Although the UR would have calibrated the Frontier Shift to reflect Power NI's 'asset light' business, we have taken Power NI's concerns on board and no longer propose to use this methodology.
- 4.52. As an alternative, the UR is now proposing the application of an efficiency factor i.e. $RPI - X$ to the OPEX proposals, with X being set at 1%. This is consistent with the approach taken for other controls in the UR, such as the Airtricity Gas Supply control (formerly Phoenix Supply).
- 4.53. In addition to this, the proposal is for this control to be set for a period of three years compared to the previous one and two year controls set for Power NI in the past. It is appropriate to assume that within this new longer time frame the impact of competition and changes in the market will lead to Power NI being in a position to make small extra efficiencies.
- 4.54. It is also worthy of note that Power NI have sought to increase the allowed net margin under the Control. This is due they argue to the increasing risks faced by Power NI as a result of the early stages of competition in the domestic arena. However effective competition should also serve as an extra incentive to make efficiencies and reduce costs. Thus the application of an efficiency factor to drive this natural incentive is appropriate for a business which is transitioning from a monopoly position to one of beginning to compete in a more open and competitive market.

Q5. Do respondents agree with the UR's proposals for the allowed level of Operating Expenditure for Power NI? If respondents disagree they should provide clear evidence and rationale as to their reasons.

5. Operating Expenditure Allocation

- 5.1. As discussed in the scope and coverage section Power NI has customers which are price deregulated. This consultation paper has proposed that the threshold for price deregulated customers is moved to 50MWh annual consumption.
- 5.2. As in previous controls, once the level of allowed OPEX for the entire business has been determined it is then allocated between those customers that are price regulated and those who are not.
- 5.3. As the price deregulated element of the business grows it becomes increasingly important that the costs are allocated in a fair and equitable manner.
- 5.4. The UR asked BDO to examine the current methodology for allocating costs between the price regulated and de-regulated customer bases. BDO analysed the allocations in the context of the proposal in this consultation paper that the threshold for de-regulation will be moved to 50MWh pa.
- 5.5. Power NI submitted its proposed allocation of costs between the regulated and unregulated businesses for the price control commencing 1 April 2014.
- 5.6. BDO prepared a report for the UR showing detailed analysis of the proposals submitted by Power NI and their alternative proposals (being consulted on in this paper) for the allocation of costs between the regulated and de-regulated customer base. This report has not been published as an Annex to this consultation as we consider that the level of detail contained in relation to individual cost lines may be commercially sensitive. However, the BDO report has been shared with Power NI.
- 5.7. Power NI has, broadly, proposed that costs be allocated between price regulated and unregulated businesses using the same principles as applied in the current price control, i.e. by selecting a driver, dependent on the cost, from one of:
 - Revenues;

- Units;
- Customer numbers; or
- Number of bills.

5.8. Power NI's estimate of the split of the above drivers between regulated and unregulated business for 2014/15 is as follows:

Table 5.1

	Total 2014-2015	Unregulated 2014-2015	Unregulated %
Units	2,949,327	528,595	17.92%
Revenues	460,504,426	70,652,814	15.34%
Avg. Customers	588,313	3,622	0.62%
Bills	1,602,053	23,312	1.46%

Source: Power NI

5.9. These drivers are applied to individual lines within each of the cost categories.

This may mean that a cost category has a number of different drivers used in allocating the individual cost lines within it.

5.10. Applying the above drivers and Power NI's proposed allocation of costs results in an allocation of costs (excluding bad debt costs which are allocated to each business separately) to the unregulated business for 2014/15 as follows:

Table 5.2

	Allocation %	2014/15 BEQ Costs	Allocation £m's
Salaries	6.88%	£6.193	0.426
MBIS	12.99%	£3.966	0.515
Agency Costs	0.62%	£2.985	0.018
Outsourced Costs	6.67%	£3.826	0.255
Corporate Charges	15.34%	£1.484	0.227
Passthrough	4.36%	£1.829	0.080
Depreciation	1.52%	£2.737	0.042
Total	6.8%	23.020	1.564

Source: Power NI

5.11. The costs allocated to the unregulated business in 2014/15 reflect the changed assumption on the reduction in the threshold for regulation to 50 MWh pa. The proposed allocation of costs put forward by Power NI results in an overall total of 6.8% of the costs for the entire business (excluding bad debt) being allocated to the unregulated business in 2014/15.

5.12. BDO reviewed the allocation methodology used by Power NI. There were three main areas where they felt changes should be made. Firstly, where revenues were used as a driver for allocation BDO felt that units should be used. This gives a more appropriate allocation as revenues per unit will be lower for larger customers as the pay lower use of system charges. Therefore

allocating by units allocates a cost line to the unregulated business based on the volume of business being carried out by it.

- 5.13. Secondly, in relation to billing and ICT costs (which are under the outsourced cost category) which Power NI originally proposed should be allocated by number of bills. BDO felt that this was incorrect. They state in their report:

“This results in a very small allocation of these costs to the unregulated business. Based on information provided by Power NI and information supplied by the Regulator’s other consultants we understand that both these categories of costs have high fixed elements which do not significantly vary with volume of number of customers/bills. We also understand that there are additional complexities involved in billing unregulated customers which are likely to increase these costs. In this context we consider that these costs would be more fairly allocated on the basis of 80% by units supplied and 20% on bill volumes. Whilst we accept that this is subjective we consider that using an allocation rate of 1.46% materially under allocates cost to a business that represents 17.92% of units.”

- 5.14. Power NI disagreed with this proposal to allocate billing and ICT 80:20 by units and bills. Power NI prepared a paper which examined the likely cost of running a billing system for a standalone business with approximately 4,000 customers (with the capability of serving up to 25,000). This paper (prepared in conjunction with a consultant) estimated that the annual running costs for such a system would be in the region of £90,000 (which is higher than the amount of £33,000 Power NI included in their original allocation proposal).

- 5.15. BDO stated in their paper that they noted:

“the allocation of costs seeks to allocate Power NI’s cost base rather than arrive at a standalone cost for operating two businesses and it is likely that the standalone cost of operating a business with a turnover of £67.6m (being the projected revenue for the unregulated business in 2014/15) is likely to be

considerably higher than the £1,564,311 proposed to be allocated to it by Power NI.”

5.16. In subsequent correspondence with the UR, Power NI proposed that the billing and ICT costs should be allocated by numbers of bills but with a minimum allocation equal to the likely cost of running a standalone system i.e. £90,000. The UR recognises the movement away from the original proposal and Power NI acceptance that an allocation of £33,000 is inequitable. However the UR is uncomfortable with using a different methodology for allocation for these two costs and our view is that the allocation methodology should be consistent across all cost categories. There is also an issue regarding the capital cost that would be required to build a standalone system which Power NI have not included in the £90,000 estimate. The UR will continue to welcome evidence regarding the allocation of billing and ICT from Power NI. As no allocation proposal has been finalised yet, for the purposes of this consultation in the table above, we show Power NI original proposal of allocation based on number of bills.

5.17. Thirdly, in relation to salary costs, Power NI proposed the use of revenues as the allocation driver for the majority of the elements included in this category. As stated in 5.11, BDO have recommended that using revenue as a driver is not appropriate and have proposed that this driver is amended to units. Within the salary cost category there is the cost of running the bad debt team. This was previously under the outsourced cost category and allocated using revenue as the driver. Under the Power NI proposal this has been allocated based on customer numbers.

5.18. Power NI’s explanation for this change is that due to the implementation of the new ES systems it has been possible to track debt management effort. BDO stated in their report:

“Power NI argues that customer numbers have been selected based on observed data tracking of debt management effort and activity, however no details have been provided in relation to this data. We consider that debt

costs should be allocated based on a measure of overall business volume, consistent with the previous treatment. We have proposed that units are used rather than revenues, consistent with our overall assessment of the suitability of revenues as a cost driver.”

- 5.19. Power NI has argued strongly against this proposal on the basis that it allocates a disproportionate level of cost to the price unregulated customer cost base. Following the initial proposal to allocate on customer numbers Power NI subsequently proposed allocation based on bills which increases slightly the amount allocated to the unregulated business. However, the UR believe that this alternative suggested by Power NI which allocates only 1.46% of the considerable cost of the bad debt team to the unregulated customer base is not acceptable. In monetary terms this amounts to circa £13,500 of a total cost of £928,000. This equates to less than 0.5% of a bad debt team FTE. The UR does not agree that allocating only 0.5 of an FTE is an equitable apportionment. We would assume that more employee effort would be required to recover circa 16% (based on the revenue from the unregulated business making up 16% of turnover – bad debt allowance is calculated as a percentage of turnover) of Power NI’s total bad debt.
- 5.20. The UR is cognisant of the fact that there is always some subjectivity around the allocation of costs and this can be especially material when the allocation of large cost lines is undertaken. The UR is willing to accept further representations from Power NI regarding the allocations of billing/ICT costs and bad debt team salary costs. However the UR does not agree to the current proposals from Power NI.
- 5.21. The UR has amended another two small elements within the pass through category. One (NI 2007 costs) to reflect the basis used, and agreed by Power NI, in the previous control. The other a new proposal in relation to SEM development costs to be allocated on the basis of units as opposed to customers.

5.22. As stated previously in Section 4, any future allowance approved under E_t will need to be assessed to ensure that it has been properly allocated between the regulated and unregulated businesses of Power NI with only that amount allocated to the regulated business being included in the Power NI regulated tariff revenue.

5.23. Depreciation relates to the depreciation of the capital cost of the new systems (the Enduring Solution). These new system costs were incurred for the Domestic customer base as there was no need to replace Power NI Non-Domestic billing system. Up until that point the Domestic billing system being used was an older infrastructure shared with NIE.

5.24. The UR proposals outlined above would result in an allocation of costs to the price unregulated business for 2014/15 as follows:

Table 5.3

	2014/15 BEQ Costs £m's	Power NI proposed Allocation %	Power NI Allocation Amount £m's	BDO Proposed Allocation %	BDO Proposed Allocation Amount £m's
Salaries	£6.193	6.88%	£0.426	10.55%	£0.653
MBIS	£3.966	12.99%	£0.515	13.06%	£0.518
Agency Costs	£2.985	0.62%	£0.018	0.62%	£0.018
Outsourced Costs	£3.826	6.67%	£0.255	14.49%	£0.555
Corporate Charges	£1.484	15.34%	£0.227	17.92%	£0.266
Passthrough	£1.829	4.36%	£0.080	10.52%	£0.192
Depreciation	£2.737	1.52%	£0.042	1.78%	£0.049
Total	23.020	6.8%	£1.564	9.78%	£2.252

Source: BDO²⁶

²⁶ Passthrough and depreciation costs are not included in the total business opex forecast (table 4.1) as they do not fall within the St term. Bad debts are included in table 4.1 but not the above as these are calculated separately for the regulated and unregulated business. The cost split between the categories in this table are different from those in table 4.1 but the aggregate total is the same (for salaries, MBIS, Agency Costs, Outsourced Costs and Corporate Charges) – also slight rounding difference.

5.25. The table above outlines the UR's proposals for consultation on the allocation of costs between Power NI's regulated and unregulated business.

These proposals result in 9.78% of the cost base being allocated to the unregulated business as opposed to 6.8% proposed by Power NI.

5.26. BDO also examined an alternative method of allocating costs which was based on the premise that Power NI have stated that a large proportion of their cost base is fixed.

5.27. BDO stated:

"In this context it could be argued that allocating this fixed element on customer numbers or bills results in an unfair allocation of costs to smaller customers and that the allocation of Power NI's costs should be allocated more consistently with the wider customer bill, i.e. units consumed. We have prepared an illustrative calculation of the impact of allocating 70% of Power NI's costs based on units supplied and 30% on customer numbers. This results in £2,616,961 of costs being allocated to the unregulated compared to £1,564,447 by Power NI."

5.28. However, the UR deemed that using the existing methodology but changing the drivers where appropriate was more appropriate in this control.

5.29. Another alternative, which the UR may consider in the future, or if agreement cannot be reached with Power NI in this price control via a vis allocation to the unregulated business, is to carry out a fully robust and detailed 'Activity Based Cost' review. This methodology could then be used to allocate costs on the basis of activity associated with each of the cost categories.

Q6. Do respondents agree with the UR proposals for the allocation of the proposed allowed level of OPEX for Power NI? If not, respondents are asked to provide clear evidence and rationale as to their reasons.

6. Margin

- 6.1 The other material input to the S_t term, in Power NI's current price control, is an allowance for profit or "margin". The implied margin within the 2012-14 control was set equal to 1.7% of Power NI's forecast turnover, consistent with the UR approach in previous reviews. Power NI accepted the previous Control with this level of margin.
- 6.2 The calibration of regulated returns as a "% of turnover" has been the accepted regulatory approach across previous retail price control reviews in GB, RoI and NI. It has been used and accepted by Regulators and regulated supply companies (electricity and gas) in NI energy sector for many years. While network price controls have tended to provide a WACC-based return on assets/historical investment, this conventional approach is more difficult to apply to price controls for businesses with relatively small physical asset bases. As a consequence, regulators setting price controls for retail businesses have placed greater reliance on historical precedent and benchmarking to the margins earned by comparable businesses.
- 6.3 Power NI has historically accepted, at recent price control reviews, an implied margin allowance of 1.7% including the last price control which is currently in operation. However, Power NI strongly argued at the last Control, and again in this current Control process has made representations to the UR, that this level of margin is now insufficient to compensate the business for the increased risk it faces in an emerging competitive retail market. We noted this issue in our Approach consultation: in brief, they argue that in a competitive market they may not always be able to re-coup revenue under recoveries, if to do so would make their tariff too uncompetitive - leading to further customer losses. Hence they have an increased wholesale cost risk that was not present in the past.
- 6.4 Given the previous controversy surrounding the calibration of an appropriate level of margin, in the Approach consultation the UR committed to look afresh

at the appropriate level of Power NI's allowed margin, paying particular attention to the risks that the business faces and the fair and reasonable reward that investors should expect for bearing that risk.

6.5 The UR decided at the beginning of this Control project that in order to be robust and transparent, we would look at the calibration of margin from both a theoretical and evidence-based perspective. We have done that with the aid of expert advisors and have also engaged extensively with Power NI and their own advisors.

6.6 A number of ways of approaching this task were initially highlighted in the UR Approach consultation, which included:

- Regulatory precedent
- Margins earned in other sectors
- Capital base x Cost of capital

6.7 Subsequently, the UR engaged external expert economic consultants, Economic Consulting Associates (ECA), to provide a robust analysis which would draw on a range of evidence before reaching a proposal about the appropriate level of profit to include in the Power NI control. As there is no broadly accepted methodology for calculating what the allowed energy retail margin should be, this necessitates a requirement for some proprietary thinking. As an extra layer of certainty therefore, the UR also arranged for the margin issues and ECA's work and thinking to be the subject of peer review from regulatory economics/finance experts (First Economics).

6.8 Power NI also engaged expert economic consultants, Cambridge Economic Policy Associates (CEPA), to advance the debate surrounding an appropriate level of margin. Interactions with CEPA have also helped develop the thinking and proposals below.

6.9 CEPA and ECA have both argued that the risk faced by Power NI is an integral part of the assessment of allowed margin. Logically, in order to develop and progress the analysis of risk a robust analysis is required and simply

benchmarking margins earned in other sectors becomes of very limited value. This is due to the different risk characteristics of similar and dissimilar retail markets, the associated regulatory framework, cost exposures, etc. Both ECA and Power NI's own consultants have thus debated methodologies around building up the required margin in an analytical and 'Power NI-specific' manner.

6.10 The respective consultants have had numerous iterations (in order to provide clarification) to allow the respective analysis of work to be driven forward. These have been done in a constructive manner throughout and the UR would like to thank all parties involved for their assistance in moving the debate forward.

6.11 Attached to this consultation document are the initial margin proposals from CEPA.²⁷ These were presented to the UR as part of Power NI's response to the Approach consultation. CEPA advance arguments for an allowed margin requirement of 3.0% to 3.7% with their recommendation towards the lower end of the range. Subsequent to follow up iterations with ECA, CEPA have now provided a (commercially sensitive) report to the UR that has a reduced total margin requirement for Power NI of 2.8% to 3.0%.²⁸

6.12 CEPA's own financeability and regulatory cross-checks consider 3% to be a broadly appropriate margin requirement. In the aforementioned commercially sensitive paper, CEPA state "*We believe the evidence continues to indicate that the total required margin by the regulated business is 3% and above...*" This is re-affirmed in CEPA's further assertion "*that a required margin of 3% would be a relatively conservative estimate for PNI given the risks that investors would seem to face*"

²⁷ Annex 6. CEPA "Power NI 2014 Price Review: Financeability and its implications for a required margin", submitted to the UR in March 2013.

²⁸ CEPA "Power NI 2014 Price Review: Retail Margin", submitted to the UR in June 2013. This document contains commercially sensitive information and is not for publication.

6.13 Also attached to this document is a report from ECA²⁹ for the UR that analyses the margin requirements for Power NI. In order to ensure a robust approach, ECA have attempted to estimate the appropriate margin based on two separate methodologies: one taken from that advocated by Power NI's own consultants CEPA; and the other an ECA-developed methodology around return-volatility based partly on thinking adopted from regulated electricity suppliers in Australia.

6.14 As a first approach, the ECA report includes a review of the CEPA methodology and associated amendments to the margin requirement. These result in a margin requirement in the range of 2.1% to 2.5% of turnover, based on amendments ECA have made to the CEPA methodology. Whilst the reports are quite technical, essentially the difference arises from a key difference in their assumptions:

- CEPA assumes that the business will use its banking facilities in full throughout the year, notwithstanding the availability of surplus equity when capital requirements are not at their peak; while
- ECA assume that the business will use its banking facilities only when they are actually required.

6.15 ECA then introduce as a second approach, an assessment of the margin via an appropriate reward for evidenced return volatility. This results in a proposed margin of 1.4% for return volatility risk, plus 0.3% to 1.0% for wholesale cost risk as described in paragraph 5.3 of the ECA report. This second approach produces a recommended range of 1.7% to 2.4%.

6.16 For ease of reference, Table 6.1 below shows the summary of figures from the ECA report:

²⁹ Annex 7. ECA "Power NI retail price review – the retail margin", submitted to the UR in July 2013.

Table 6.1

Table 1: Summary of required margin estimates				
Section	CEPA report	CEPA adjusted		ECA
	Minimum	Peak	Average	Risk-based
	scenario	gearing	gearing	
	3.2	3.3	3.3	5
S_t requirement	2.8%	2.5%	2.1%	1.7% - 2.4%

Source: ECA

6.17 The UR notes that much work, analysis and thinking has now gone into the theoretical and practical development of an evidence-based margin estimation for Power NI. We further note that separate methodologies have been employed, and both come up with broadly similar ranges for the required margin. We note finally at this point that the lower end of the required range i.e. 1.7%, is the current allowance for the margin entitlement, and the ranges imply possibly some extra margin for extra risk issues identified in the reports attached.

6.18 The UR does not give superior weight to either the CEPA (capital base x cost of capital) approach or the alternative approach adopted by ECA of “returns-volatility”. The UR believes each provides a valuable sense check for the other. Using the methodologies and calculations highlighted in the ECA report:

- The required margin using the ECA methodology is 1.7% to 2.4%;
- The margin requirement using the (ECA amended) CEPA methodology is 2.1% to 2.5%; and
- The margin requirement stated in the latest CEPA analysis is 2.8% to 3.0%. Our consultants have set out where they have agreed and disagreed with the CEPA basis for calculating the required margin.

6.19 Therefore, given all of the above (and the technical content included in the Annexes), and in order to be prudent, **the UR proposes a margin of 2.2%** as the appropriate level for Power NI for the coming Control. This is in the mid-upper end of the ECA / (ECA amended) CEPA methodology range of 1.7% to 2.5%. It is also just below the mid-point of the minimum margin requirement using the ECA methodology and CEPA's own margin calculation i.e. 1.7% to 3.0%. Given the previous controversy around the margin estimation and the lack of a definite methodology to help calibrate the appropriate level, the UR welcomes the fact that we have developed approaches and thinking to calibrate the required margin, and that there are many commonalities between the opinions of respective consultants.

6.20 This margin proposal of 2.2% is a proposed increase of 0.5percentage points on the current margin of 1.7%. The analysis underpinning the estimate indicates this is a reasonable estimate of the appropriate margin for Power NI and balances the UR's statutory duties to protect customers, and also ensure that regulated companies can finance their licensed activities. In saying that, the UR is cognisant of the impact this will have on customer bills which we wish to ensure is kept to a minimum. As a guide, should the proposed increase in allowed margin take effect, this will raise the average customer bill by approximately 25 pence per month (or £3.00 per annum).

Collection of the S_t allowance

6.21 Power NI's present arrangements have a mechanism that calculates the total S_t Allowed Revenue (aggregate of operating costs and profit margin) for each year. This is currently collected on a ratio of a 67% fixed amount plus a variable amount collected on a per customer basis which is calculated as 33% of the total S_t divided by customer numbers. The UR sought a review of this apportionment to ascertain whether it was broadly correct and this was also undertaken by our consultants ECA. In their report on margin, they have recommended a **slight amendment to the apportionment so that it should**

be 70% fixed and 30% variable with customer numbers taken at the mid-point of the relevant year. As this is not a material change, the UR is minded to accept this recommendation but would welcome respondents' views on whether they believe that to be appropriate.

6.22 For illustrative purposes, what this means in practice is that 30% of the Power NI total allowed revenue will fluctuate with numbers of customers. For example, if Power NI loses 10% of its customers in a year then the following year its total allowed revenue will fall by 10% of 30% or 3.0% overall. Conversely, if Power NI gains a further 10% of customers in a year then the following year their total allowed revenue will increase by 10% of 30% or 3.0% overall.

6.23 Therefore 70% of the total S_t Allowed Revenue is set at the control and does not change with customer numbers throughout its duration. The variable portion of 30% will increase or decrease depending on the number of customers that Power NI gain or lose respectively. The benefits of the variable portion are twofold:

- It better reflects the actual costs incurred by Power NI as customer numbers increase or decrease; and
- It acts as an incentive to ensure that Power NI maintain high standards of customer service as there is a financial detriment for each customer that transfers to another energy supply retailer. It also removes the incentive for Power NI to divert its resources to retaining higher consumption customers as each customer within the scope of the control has the same financial value (although there may always be a natural incentive to retain higher consumption customers in anticipation of future price de-regulation). The UR also notes that units sold is a Key Performance Indicator (KPI) for Power NI as published in the Viridian Annual report

6.24 The UR believes this remains an appropriate method for setting the S_t allowance but the apportionment should be amended to a 70% fixed: 30% variable basis. The UR is keen to hear the views of stakeholders on this issue.

Q7. Do respondents agree with the proposed margin of 2.2%? If not, the UR would be grateful if you could explain your reasons why and provide supporting evidence.

Q8. Do respondents view the apportionment of the S_t allowance on a 70% fixed: 30% variable basis to be an appropriate calibration for amending the allowed OPEX and Margin as customer numbers increase or decrease?

7. Structure and Form

7.1 The details of the operation of Power NI's supply price control are set out in its Licence. At present, Power NI's maximum allowed unit price of electricity (M_t) for customers subject to price control 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 any given year t ,

7.2 G_t refers to the cost of the "wholesale" electricity which Power NI purchases.

Provided Power NI complies with its Economic Purchasing Obligation, this will be passed directly through to customers.

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

7.4 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).

7.5 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 Power NI achieves.

7.6 E_t is associated with costs which are uncontrollable and are passed through to customers on a 100% basis. These costs include licence fees; IT projects required in order to put in place the systems and processes to open Domestic markets and allow customers to switch supplier (such as NI2007 and stages of the Enduring Solution project); and past pensions deficit. The UR considers that the drafting in E_t must be reviewed as part of this price control as the Enduring Solution project Stage III is now complete and other 'tidy-ups' are required to the E_t drafting.

7.7 Furthermore there are certain "one off" items, discussed in the Operating Expenditure section, which will be included in the proposed E_t licence modification early next year. In terms of pensions it will be necessary, following

the divestment of NIE and the formation of a new Viridian Group Pension Scheme, to split the recovery of past service deficit costs between the old Viridian scheme and the new. The new scheme deficit costs will be subject to allocation between the price regulated and unregulated businesses within Power NI. We will make the appropriate proposals to amend the Power NI licence accordingly as part of the suite of changes for the supply price control once we have made our final decisions later this year. All proposed licence modifications will be subject to a full consultation.

7.8 Therefore, most of Power NI's costs are straight pass-through costs which are subject to other price controls or regulations; and thus this price control review deals with the S_t term of the tariff formula, which is in effect Power NI's own operating costs and margin allowed by the regulator. This amount must be sufficient to finance an efficient business and should comprise the following elements:

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

7.9 Respondents to the Approach broadly feel that the existing structure and form of the control remains appropriate, as does the UR. Therefore, the **UR proposes to continue with the existing structure** notwithstanding the fact that the E_t term will require some drafting modifications to reflect the up to date position.

7.10 The Allowed Revenue of S_t is currently collected on a ratio of 67% fixed amount plus a variable charge on a per customer basis of 33%. The UR is minded to accept our consultant recommendation to make a minor amendment to the apportionment so that 70% are fixed and 30% are variable. This is discussed in the earlier chapter on Margin.

7.11 Since June 2012, Power NI has had a regulated asset base (RAB) in relation to the Enduring Solution IT system. The original RAB was c.£12million

and has a pre-agreed return of 6.59% real with a straight line depreciation period of 5 years. Therefore, the Power NI RAB and return for the Enduring Solution remains a pre-determined element of this consultation.

Q9. Do respondents continue to believe the existing structure and form remains appropriate for the next price control? If not, please explain what you believe the structure and form should be.

8. Consultation Questions

8.1 The UR is keen to hear the views of interested stakeholders on the proposals set out in this consultation document. Therefore, we would like to invite representations on the following questions:

Q1. Do respondents agree that where this consultation has an impact on the groups listed, those impacts are likely to be positive in relation to equality of opportunity for energy consumers?

Q2. Do respondents consider that the approach needs to be refined in any way to meet the equality provisions? If so, why and how? Please provide supporting information and evidence.

Q3. The UR proposes to retain the Power NI price control for Non-Domestic customers consuming 0-50MWh or less per annum and remove coverage for those consuming 50-100 and 100-150MWh pa. Do respondents agree with this proposal and if not, please explain your rationale?

Q4. Do respondents believe a control period of 3 years is appropriate? Please explain your rationale if you do not.

Q5. Do respondents agree with the UR's proposals for the allowed level of Operating Expenditure for Power NI? If respondents disagree they should provide clear evidence and rationale as to their reasons.

Q6. Do respondents agree with the UR proposals for the allocation of the proposed allowed level of OPEX for Power NI? If not, respondents are asked to provide clear evidence and rationale as to their reasons.

Q7. Do respondents agree with the proposed margin of 2.2%? If not, the UR would be grateful if you could explain your reasons why and provide supporting evidence.

Q8. Do respondents view the apportionment of the S_t allowance on a 70% fixed: 30% variable basis to be an appropriate calibration for amending the allowed OPEX and Margin as customer numbers increase or decrease?

Q9. Do respondents continue to believe the existing structure and form remains appropriate for the next price control? If not, please explain what you believe the structure and form should be.

9. Timeframe and Next Steps

9.1 The following timetable is an updated version of that which was originally set out in the UR Information Note, published in November. It highlights the various stages of the price control review process and (approximately) when the UR expects each milestone to be achieved.

Table 9.1: Price Control Review timetable

Date	Milestone
November 2012	Utility Regulator information paper published
Early February 2013	Utility Regulator to send business efficiency questionnaire (BEQ) to Power NI
Early February 2013	Utility Regulator consultation paper on price control Approach to be published
26 February 2013	Stakeholder workshop
22 March 2013	Deadline for Power NI response to BEQ
22 March 2013	End of consultation period
April/May 2013	Follow-up with Power NI and other parties as necessary
23 July 2013	Utility Regulator to publish consultation paper
23 August 2013	Stakeholder seminar
August/September 2013	Follow-up with Power NI and other parties as necessary
01 October 2013	End of consultation period
December 2013	Utility Regulator to publish final decisions
January 2014	Utility Regulator to consult on licence modifications
February 2014	End of consultation period Deadline for Power NI to accept or reject licence modifications

- 9.2 In addition to Power NI, the UR hopes that a wide range of interested parties will actively participate in the review process, including customers/customer representatives and rival retailers.
- 9.3 During the consultation period, the UR will host a stakeholder seminar on 23 August 2013 from 10.00 to 12.00. This is to help ensure that stakeholders have an opportunity to engage in the price control process. The workshop will allow stakeholders the opportunity to engage directly with the UR and other interested stakeholders to gain clarification/raise any issues arising from this paper.
- 9.4 Please contact Robert Stewart (robert.stewart@uregni.gov.uk) by 16 August 2013 if you would like to register your interest in attending this event.
- 9.5 The UR is keen to hear feedback on our proposals from stakeholders as these will influence our final decisions paper which we plan to publish during the winter. That paper will include details of respondents' feedback to this consultation and include the UR's final decisions with regards to Power NI's operating costs, profit margin, duration and scope of control.