NORTHERN IRELAND AUTHORITY FOR ENERGY REGULATION

NORTHERN IRELAND ELECTRICITY - TRANSMISSION AND DISTRIBUTION PRICE CONTROL 2007-2012

PROPOSALS PAPER

14 December 2005

CONTENTS

INTRODUCTION

The amount of revenue which NIE's Transmission and Distribution Business (T&D) earns is subject to controls which are set by the Northern Ireland Authority for Energy Regulation (NIAER) following consultation with NIE and other interested parties.

As part of the arrangements to re-structure the electricity industry in Northern Ireland in 1992 the first regulated period for the T&D price control was set by the government to run for the five years between 1992-1997. The price control for the second five year period (RP2) was set by the Monopolies and Mergers Commission for the period 1997-2002. A third five year price control was agreed between NIE and Ofreg for the period 2002-2007.

In recent months NIE and Ofreg (working for NIAER) have initiated and carried forward work to define the principles for a price control for the period after 2007. This paper sets out the results of the work undertaken to date and highlights the areas where progress has been made. The paper also highlights those areas where additional analysis is required and sets a draft timetable for concluding the work.

Financial figures in this paper are stated in 2004/05 price base, unless otherwise indicated.

APPROACH

Following difficult negotiations between Ofreg and NIE the second price control for the T&D business was eventually settled following the 1996 referral to the Monopolies and Mergers Commission. The third price control (RP3) was agreed between the regulator and the company but not without hard negotiations and extensive and expensive work agendas for both parties.

It was felt by both parties that a satisfactory outcome could be reached for the price control for the fourth regulatory period (RP4) by adopting a collaborative approach. This paper sets out the progress made to date in developing the principles by which the various 'building blocks' of the price control would be determined.

NIE has presented to NIAER its 'Composite Proposal' which would form the basis of a five year T&D price control for RP4.

The principles behind the Composite Proposal include:

- A rule-based approach to the Opex allowance that strengthens efficiency incentives and shares the savings with customers
- A Capex allowance based on actual rather than forecast expenditure, together with strengthened Capex efficiency incentives
- An allowed rate of return on assets consistent with established precedent

PRICE CONTROL DURATION

Traditionally the T&D price control has been set for 5 years. The Authority had considered reducing the length of the price control to three years. A shorter time period would have enabled the Authority to review the price control in a shorter timeframe if any unforeseen consequences were to occur. A three year term would also bring the price review timetable in Northern Ireland into line with GB and more in line with RoI and therefore many of the components of the price control such as the cost of capital could be determined alongside Ofgem.

However, after consideration, the Authority believes that a longer duration is necessary for a T&D business to fully plan ahead its expenditure profiles. It will also lead to greater confidence by investors in the stability of the regulatory regime. A 5 year period is proposed. (Allowed rate of return may be subject to an adjustment after year 3 – see section below).

Each of the building blocks of the price control is now dealt with in turn:

OPERATIONAL EXPENDITURE (OPEX)

One of the requirements of any price control is for an assessment to be made of the level of operating costs that the company should be allowed to recover in the next price control period.

Once the Opex allowance has been set, the company is incentivised to spend less on Opex than that allowed by the regulator. The difference between allowed Opex and actual expenditure would be realised as efficiency gains by the company. At the time of the next price control review the regulator would see the reduction in Opex levels and would set a correspondingly lower entitlement for the next period. Customers would then benefit from the efficiency improvements through lower bills in the subsequent price control period.

The traditional approach

Traditionally, in determining the efficient level of Opex to be allowed, the regulator would take advice from consultants. The work typically involved an examination of the company's operating cost base, benchmarking it against the cost bases of other electricity network companies both nationally and internationally, and undertaking a very detailed item by item analysis of individual expenditure categories. This work lead to the determination of an efficient cost base upon which to set the Opex allowance for the new price control period.

Shortcomings

However, the traditional method of Opex analysis is time consuming and resource intensive and differences in the way that companies report their costs adds to the difficulty in ensuring that efficiency comparisons are made on a like-for-like basis. In addition, under the 'traditional' approach the incentive to reduce costs diminishes as the regulatory period progresses. This is because any efficiency measures implemented towards the end of the period will signal to the regulator that a reduction in allowed Opex is required for the next period. The company would therefore be incentivised to hold back from making efficiency improvements until after the next price control is negotiated.

For RP4 it is proposed that a simpler and more mechanistic approach be adopted - one that strengthens the efficiency incentive by maintaining it constant throughout the period and ensuring that savings are automatically passed to customers through lower prices. The proposal is described below.

The proposed approach

Some elements of operating costs are controllable (to some extent) while others are uncontrollable in that they are driven by factors beyond T&D's influence. The proposed new approach to setting the controllable cost element of the Opex allowance is best described as a 'rolling mechanism'.

Under the rolling mechanism it is proposed that the actual controllable Opex in each year of the current price control period (which should be less than the allowed Opex – if the company is making efficiency improvements) is rolled forward with RPI indexation to become the controllable Opex allowance for the corresponding year in the next period.

Thus, the controllable Opex allowance in year one of the new price control, RP4(1) would be set equal to the actual controllable Opex in year one of the current price control RP3(1) RPI-indexed and so on. This rolling approach simplifies the Opex calculation process and still incentivises the company to reduce costs with the savings automatically being passed back to customers in due course.

Adjustments

The rolling Opex proposal is a sensible method of incentivising the company to make cost reductions. However the Authority believes that a fair trade-off between the interests of shareholders and consumers requires the absolute levels of the allowed controllable Opex to be below those that result from the application of the 5 year rolling rule and two adjustments are proposed.

The first is a reduction to be applied in each of the first two years of RP4 as shown in the table below.

The second adjustment relates to pensions costs. NIE has argued that pensions should be allowed on the same rolling basis proposed for controllable costs. The Authority accepts that most of the company's pensions costs should be allowed on this basis. However, following precedent set in the price control for the GB Distribution Network Operators (DNOs), the Authority considers that 30% of the pension costs relating to early retirement deficiency costs should be disallowed. This is an amount of c£225k per annum and will be deducted from the rolling Opex calculation.

As a further protection for customers, it is proposed that the operating cost allowance would be constrained in the event that regulated revenues would cause a price cap to be exceeded. The price cap is explained later in the paper.

Uncontrollable Opex

Uncontrollable Opex which includes rates, wayleaves payments and licence fees will not be subject to the rolling mechanism and will be recoverable on a pass-through basis. In estimating its rates liability, NIE has forecast its Net Annual Valuation (NAV) based on the formula set out in the Valuation (Electricity) Order (Northern Ireland) 2003 assuming a 5% nominal growth in the rate/£ in line with the historical trend. NIE has also made projections of wayleave payments and licence fees. The Authority will require NIE to furnish it with an annual report on uncontrollable Opex.

Projected allowance

The following table shows the projected allowance for controllable and uncontrollable operating costs[1] taking account of the adjustments and pensions disallowances.

Table 1

Projected Opex Allowance 04/05 Prices	07/08 £m	08/09 £m	09/10 £m	10/11 £m	11/12 £m
Controllable Opex					
Rolling Opex Allowance	46.6	45.8	42.9	41.9	40.9
One-Off Opex adjustments	-2.6	-1.6	0.0	0.0	0.0
Pension Adjustment	0.0	-0.2	-0.2	-0.2	-0.2
Adjusted Controllable Opex Allowance	**44.0**	**44.0**	**42.7**	**41.7**	**40.6**
Un-Controllable Opex					
Forecast Rates	11.1	11.5	11.9	12.3	12.8
Forecast Wayleave Payments	3.2	3.5	3.4	3.4	3.3
Forecast Licence Fees	0.5	0.5	0.5	0.5	0.5
Total Forecast Un-Controllable Costs	14.8	15.4	15.8	16.2	16.5
Projected Total Opex Allowance	**58.8**	**59.4**	**58.5**	**57.8**	**57.2**

To the extent that T&D reduces its costs in the last two years of RP3 below the level assumed for the purpose of these projections, the Opex allowance in the last two years of RP4 will be correspondingly lower than shown in the table.

Ringfencing NIE Powerteam

The Authority was concerned that NIE might be able to use its Opex allowance in a manner which was unjustly beneficial to its affiliate company NIE Powerteam Ltd (Powerteam). The Authority is satisfied that NIE has now put in place a firm ring-fence around the network services which Powerteam provides to T&D. In addition Powerteam Electrical Services Ltd (PES) has been established to provide services to third parties to separate them from the services that Powerteam provides to T&D. This ringfencing is necessary to prevent any cross subsidisation by T&D customers to customers of PES.

[1] The projected controllable Opex allowance assumes that the actual controllable Opex in 2004/05 rolls forward into 2005/06 and 2006/07 on the basis of a 2.5% pa real efficiency factor. The actual controllable Opex allowance in 2010/11 and 2011/12 will depend on the actual controllable Opex in 2005/06 and 2006/07.

CAPITAL EXPENDITURE (CAPEX)

The framework

The second major area of costs faced by NIE is in relation to Capex.

Regulated revenue includes an element to cover the costs of financing (return and depreciation) of new capital expenditure over the period. Under the traditional approach regulated revenue depends on forecast Capex and once the Capex allowance was agreed there was an incentive on the company to underspend and increase profits by avoiding the financing costs associated with the underspent Capex. It is often difficult for the regulator to distinguish between an underspend due to valid efficiency gains and one due to investment being deferred into a later period.

For RP4 it is proposed that the regulated entitlement will be dependent on ***actual*** Capex rather than ***allowed*** Capex. A separate mechanism will be introduced to incentivise capital efficiency (as outlined later) and NIE will be required to continue to report annually on its investments.

With this approach the difficult issue of Capex underspend is avoided and the incentive to achieve efficiencies within the capital programme are strengthened so that customers will benefit through the savings in RAB financing costs. In addition there will be improved transparency around the investment programme by virtue of the annual reports that NIE will be required to submit.

Capex required in RP4

NIE's assessment of the overall network investment requirement for RP4 is in the region of £360m - £370m, but it has set itself the target of managing its obligations for 10% less expenditure (c£326m) through further efficiencies.

Between 1997 and 2002 (RP2) Capex investment was circa £70m per annum on average. During RP3 the Capex allowance was set much lower at £51m per annum on average. NIE has identified network investment needs which will increase the Capex expenditure to c£65m per annum. The principal driver in RP4 (accounting for over 60% of investment) is the need to replace assets that have reached the end of their useful lives.

NIE's statutory and licence obligations are a key determinant of Capex requirements. The five year capital framework should produce an outcome that makes full provision for a level of investment that is consistent with compliance with these obligations. Such mandatory obligations include:

- Replacement of aged network components that, because of their deteriorated condition, present an unacceptable risk to either the safety of the public or staff; the environment; or the quality of service provided to customers. This includes replacement of existing switchgear,

transformers, cables and overhead lines, which have typically been in service for 40 years or more.

- Increasing the capacity of the network to cater for growth in customer demand. This includes building new substations, increasing transformer capacity, as well as building new overhead lines and underground cable circuits.

- Extending the network to enable new customers to be connected to the network. This includes the connection of new houses/housing developments, as well as new commercial and industrial developments.

A key starting point for the Authority will be to be satisfied as to the base Capex required to ensure compliance with these mandatory obligations.

In light of the extent of mandatory investment required in RP4, NIE's capital plan makes minimal provision for non-mandatory investments, for example investment to improve overall network performance and the selective replacement of overhead lines by underground cables to effect environmental improvements.

NIAER has appointed consultants to examine NIE's proposals. The consultants are due to report by the end of March 2006.

Capex efficiency

A system for rewarding Capex efficiency has been under development between NIE and NIAER. It is based on identifying efficiencies in the procurement of materials and services and improvements in productivity and then sharing the savings with customers on an equitable basis. NIAER will provide details of the scheme along with its views on the appropriate level of Capex for RP4 in a further paper it will issue next Spring.

SMART

During RP3 NIE has been responding very positively to the challenge of enhancing the sustainability of the electricity supply system in a number of ways. The Sustainable Management of Assets and Renewable Technologies (Smart) programme has been developed in conjunction with the Authority to encourage environmentally-friendly approaches to the provision of electricity network infrastructure to meet customer demand in Northern Ireland and to support emerging renewable technologies. In the Smart1 category (support for emerging technologies) funding has been committed for 34 renewable programmes and projects. Technologies targeted for support include photovoltaics, solar water heating, biomass, domestic CHP, tidal power and hydro-electric power, with £1m committed. In addition over £3m of additional funding from the public and private sector has been secured. Under Smart2 (alternatives to conventional network reinforcement) £2.27m has been committed to 3 renewable generation facilities based on biomass, CHP and tidal technologies, and a study into the feasibility of an Energy from Waste facility. In April 2004 the Smart programme won the business category at Action Renewables' renewable energy awards.

NIAER will continue to work with NIE to develop the scheme further during RP4.

REGULATORY ASSET BASE AND DEPRECIATION

The Regulatory Asset Base (RAB) is a measure of the value of the capital employed in the regulated business on which the company earns revenues to provide a return and to cover depreciation.

The opening RAB at 1 April 2002 was agreed as part of the current price control for RP3. The opening RAB is rolled forward during RP3 by adding actual capital expenditure during RP3 and subtracting depreciation. Assets comprising the pre-vesting part of the RAB (ie those in existence at NIE's flotation in June 1993) will continue to be depreciated according to the profile established by the MMC during the 1996 referral and post-vesting assets will be depreciated according to the so-called 'kinked' profile (whereby the annual rate of depreciation is 3% for the first twenty years and 2% for the second twenty years). The closing RAB at the end of RP3 (31 March 2007) will become the opening RAB for RP4 as at 1 April 2007. The same method will be applied to roll forward the RAB during RP4.

COST OF CAPITAL

NIE proposed that the allowed rate of return on the T&D RAB should be set equal to the Ofgem precedent when it set the current price control for the DNOs in GB.

Ofgem allowed a 4.84% post tax real rate of return which was based on a post-tax cost of equity of 7.5% and a pre tax cost of debt of 4.1% with a gearing level of 57.5%. On a 'vanilla' basis (ie pre tax cost of debt and post tax cost of equity), the rate of return is equivalent to 5.545%.

NIAER does not believe that the cost of capital for NIE is necessarily the same as that estimated by Ofgem for the DNOs. However it was willing to agree with the Ofgem allowance if preliminary checks proved to be satisfactory.

Traditionally CAPM (Capital Asset Pricing Model) analysis has been used to establish the appropriate range for the Cost of Capital. Ofreg undertook the following analysis of the components in the CAPM model to see if there are any factors which would lead to the conclusion that NIE has a different Cost of Capital than that decided by Ofgem for the DNOs.

The weighted average cost of capital using the CAPM calculation is made up of several components some of which are market specific and will be the same for all companies whilst others are company specific:

Market specific factors

The following components of the CAPM are based on market observations / analysis and will not be affected by NIE's own circumstances. The Ofgem assumptions are detailed below. While it is the case that some of these components could have changed since the Ofgem analysis and a large volume of work could be directed towards establishing whether this is the case or not, the final decision on the 'correct' value will still necessarily warrant a degree of judgement. For this reason the Ofgem assumptions have been used.

Risk-free rate
Given the uncertainty surrounding the expected risk-free rate, Ofgem adopted a cautious approach to determining this parameter and hence it arrived at a relatively wide range of 2.25% to 3.0%. In the period since Ofgem carried out its cost of capital calculation there is evidence that the risk-free rate in the UK market has fallen.

Equity risk premium (erp)
Ofgem consulted several reports and surveys in its approach to determining the ERP. It concluded that there was not strong evidence to diverge from the range used in recent decisions by the Competition Commission which show a range from 2.5% to 4.5%.

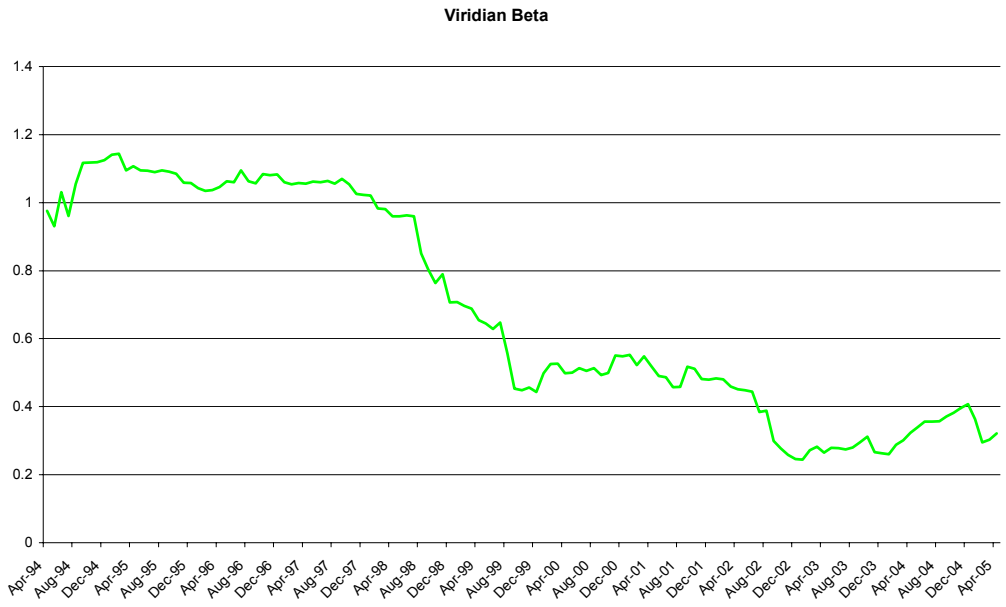
Company specific factors

Debt premium
Given that there seems to be considerable uncertainty surrounding the expected cost of debt, Ofgem adopted a relatively wide range for the debt premium of 1.0% to 1.8% in its cost of capital calculations.

Ofgem had access to a publication which is not in the public domain – the HSBC Sterling Bond Daily. Ofreg did not have access to this information. However given the wide range which Ofgem adopted it is unlikely that a calculation for NIE would lie outside this range.

Beta values.
The CAPM model assumes that beta is stable over time. However Ofgem observed that monthly electricity betas have fallen over time. This raises the question as to whether the actual risk profile of the company has changed. Another interpretation might be that because of the Technology/Media/Telecoms bubble bursting, that regulated utilities are regarded as safe haven stocks.

Evidence from London Business School (LBS) data suggests that Viridian's equity beta value has also been declining over time as the graph below illustrates.



No data are available at the T&D business level. This means that the observed betas are based on Viridian's activities. This observed beta is likely to overstate the risk of NIE T&D given that non-regulated activities are likely to be more risky.

Ofgem adopted a range of 0.6 to 1 for its cost of capital calculations.

Based on the LBS evidence it could be argued that a lower range would be appropriate for NIE. A range of 0.3 to 0.6 has been used in the cost of capital calculation below.

Cost of capital calculation

The following table shows how the different components in the WACC model are used to calculate a range for the cost of capital. Ofgem's final proposals took a figure towards the high end of the range. (4.84% post tax real).

Adjusting Ofgem's figures for the lower beta value results in a lower cost of capital than GB in the ranges shown in Table 2. A further adjustment could be made to reduce the risk-free rate based on the evidence since the Ofgem calculation.

Table 2

COST OF CAPITAL CALCULATION							
		Ofgem 2004		Ofreg		Difference	
		LOW	HIGH	LOW	HIGH	LOW	HIGH
A	Risk-free rate	2.3	3	2.3	3		
B	debt premium	1.0	1.8	1.0	1.8		
C	Pre-tax cost of debt = A+B	3.3	4.8	3.3	4.8		
D	post-tax cost of debt = C*(1-K)	2.3	3.4	2.3	3.4		
E	Gearing	0.5	0.6	0.5	0.6		
F	Equity Risk Premium	2.5	4.5	2.5	4.5		
G	Equity beta	0.6	1	0.3	0.6		
H	Pre-tax cost of equity = J/(1-K)	5.4	10.7	4.3	8.1		
J	post-tax cost of equity = A+(F*G)	3.8	7.5	3.0	5.7		
K	Corporation tax	0.3	0.3	0.3	0.3		
L	Pre-tax CoC = (C*E)+(H*[1-E])	4.3	7.2	3.8	6.1	0.5	1.0
M	post-tax CoC = (D*E)+ (J*[1-E])	3.0	5.0	2.6	4.3	0.4	0.7
N	'Vanilla' WACC = (C*E)+(J*[1-E])	3.5	5.9	3.1	5.2	0.4	0.7

The cost of capital calculations rely on judgement as to the appropriate components (marked in light blue in the table above). Once a range is established there is no hard or fast rule to suggest where within the range the appropriate final figure should be chosen. Ofgem chose the top of the range and indicated that this was due to a high degree of stock market instability although the connection between this and their decision was never made explicit. It could be argued that the post tax cost of capital for NIE should be around 0.35% lower than GB.

Because of the level of uncertainty surrounding the issue and in the light of decisions by other regulatory authorities the Authority proposes to take a pragmatic approach to setting the allowed rate of return for the T&D RAB as described below.

The proposed allowed rate of return

In the interests of avoiding a protracted cost of capital debate involving consultants and the prospect of an appeal, the Authority proposes that the allowed rate of return should be set at the GB DNO level for the distribution portion of the T&D RAB. However, for the duration of RP4 there will be a 0.35% post tax reduction in the GB DNO rate of return in relation to the 18% of the total T&D RAB that has been assumed up to now as comprising transmission assets. With the GB DNO rate at 4.84% post-tax real, that would mean a transmission rate of return of 4.49% post-tax real.

The Authority further proposes to adjust the rate of return in year 4 of RP4 in the light of the cost of capital analysis which will be undertaken by Ofgem at its next price control review for the DNOs. However, rather than NI automatically tracking an increase in the allowed rate of return at the next GB review, it is proposed that a downward only adjustment for distribution is applied, i.e. if the DNO rate goes down, such a lower rate would be applied to NIE's distribution assets. If the DNO rate goes up or remains the same, NIE's allowed rate of return for distribution assets would remain at 4.84% post-tax real. Any such downward adjustment as a result of the control applied to the GB DNOs at their next review would apply to NIE's distribution rate of return only. The 4.49% post-tax real return for NIE's transmission assets would remain fixed, in recognition of the fact that it had already been set at a lower level.

These proposals do not preclude the Authority adopting a different allowed rate of return from Ofgem at T&D's RP5 review. Ofreg will have an unprejudiced review of the prevailing precedents on allowed rate of return in other regulatory regimes as part of that review.

The following table 3 sets out the proposed 'blended rate' of return for NIE T&D business.

Table 3

	Allowed return (pre tax)	Allowed return (post tax)	RAB %	Blended return %
Transmission	6.41	4.49	18%	0.81
Distribution	6.91	4.84	82%	3.97
				4.78

TAXATION

The RP4 price control proposals would, for the first time for T&D, set a rate of return on a post-tax basis. This means that the allowance for taxation will be based on the actual tax cost rather than an assumed 'tax-wedge' in the cost of capital calculation.

NIE has forecast its capital expenditure requirements for the duration of RP4. Tax allowances will depend on the nature of this expenditure and NIE has provided a forecast of the likely categories which the expenditure will fall into for tax purposes. The level of tax allowances will follow HM Customs and Revenue rules. NIE would be required to furnish the Authority on an annual basis with a tax return against which it can compare actual taxation with NIE's forecast. Such information will also inform the Authority of how to treat taxation at the time of the next price control review.

One of the reasons other regulators have moved to a post-tax approach to the cost of capital is that it allows the incentives to increase gearing to be mitigated. Correspondingly if NIE's gearing increases above the 57.5% used in the cost of capital model and interest costs are higher than those in the financial model underpinning these proposals, NIAER intends to claw back the associated tax benefits for customers at the next review (based on the difference between actual interest and interest charges included in the financial model underpinning these proposals). This policy is the same as that adopted by Ofgem for the DNOs.

VULNERABLE CUSTOMER FUND

As a further enhancement to customer value NIE has proposed a significant new initiative for Northern Ireland that would make an important contribution to Government's strategy and NIAER's Social Action Plans for the alleviation of fuel poverty. Although the proposal is still in the embryonic stage, NIE envisages establishing a £1m Vulnerable Customer Fund that would finance projects specifically targeted at combating fuel poverty by assisting low income households to access available grants and social benefits. NIE Supply would administer the programme which would be delivered through local agencies. Experience in GB suggests significant benefits for customers are possible. Early indicators taken from EAGA data suggest that £1m would fund a three year programme capable of delivering very substantial customer benefits. NIE would finance this programme from its own funds.

The Authority was very impressed with this initiative and NIE has agreed to bring the programme forward by one year commencing in April 2006 if overall agreement on the price control package can be reached at that time.

EMBEDDED GENERATION, PEAK DEMAND AND RESEARCH CAPABILITY

NIE has indicated that it would be willing to separately fund a planning and research facility up to the value of £1m during RP4 with the aim of identifying the best long-term options for network development to accommodate Government's sustainability objectives. In general, with increasing deregulation of the retail market NIE will explore how it could adopt a more central role in the development and delivery of strategic energy objectives.

THE REVENUE FORMULA

Under the price control proposal the maximum regulated T&D revenue (MD_t) in any year t would be calculated according to a formula which would be set into the licence through an agreed modification. The proposed new revenue formula is set out below:

$$MD_t = CO_{t-5} + P_{t-5} + UO_t + (RAB_t \times CoC_t) + Tax_t + Dep_t + CoL_t + Adj_t + K_t$$

Where:

CO_{t-5} is the actual controllable Opex five years earlier (excluding pensions costs and after making the one-off adjustments in respect of 2002/03 and 2003/04), RPI indexed to the year t price base;

P_{t-5} is the amount of pensions costs paid five years earlier (less a disallowance of £225k in respect of early retirement deficiency costs), RPI indexed to the year t price base;

UO_t is the actual uncontrollable Opex in year t in nominal prices;

RAB_t is the average RAB for year t in nominal prices;

CoC_t is the allowed cost of capital;

Tax_t is the allowance for tax costs;

Dep_t is the RAB depreciation allowance;

CoL_t is revenue adjustments arising under the change of law provisions;

Adj_t is revenue adjustments arising from assessed Capex efficiency gains and revenue due under SMART programmes' etc;

K_t is the correction factor due to over/under recoveries

PRICES

Since 1992 to date, NIE's T&D prices have fallen by 40% in real terms.

Table 4 below shows the projected revenue entitlement for RP4 based on these proposals together with T&D prices (in p/kWh) projected on the basis of forecast units.

Table 4

Proposed Allowed Revenue **04/05 Prices**	**07/08** **£m**	**08/09** **£m**	**09/10** **£m**	**10/11** **£m**	**11/12** **£m**
RAB Return and Depreciation	96.8	98.9	101.4	104.1	106.2
Proposed Total Opex Allowance	58.8	59.4	58.5	57.8	57.2
Total Allowed Revenue	155.6	158.3	159.9	162.0	163.4
Forecast Units	8490	8620	8750	8881	9014
p/kWh	**1.83**	**1.84**	**1.83**	**1.82**	**1.81**

The projections show what would be a modest increase in the T&D price compared to the current T&D price which stands at 1.81p/kWh. The Authority proposes to cap T&D prices during RP4 at the current level.

The price cap would be applied as a reduction in the Opex allowance as shown in Table 5 below.

Table 5

Price Cap Adjustment **04/05 Prices**	**07/08** **£m**	**08/09** **£m**	**09/10** **£m**	**10/11** **£m**	**11/12** **£m**
Allowed Revenue	155.6	158.3	159.9	162.0	163.4
Adj to allowed opex	-2.0	-2.3	-1.5	-1.2	-0.2
Capped Revenues – See Note	153.7	156.0	158.4	160.7	163.2
Forecast Units	8490	8620	8750	8881	9014
p/kWh Entitlement	1.81	1.81	1.81	1.81	1.81

Note: The cap would operate on the basis of the forecast units which means that it is essentially a fixed cap on revenues. However, the revenue cap would be flexed to take account of actual uncontrollable costs varying from the forecasts and new costs such as those that would be incurred in the event of new or more strict obligations being placed on T&D eg as a result of change of law.

If the improved efficiency incentives result in savings in controllable costs in the last two years of RP3 being greater than those assumed, then there will be scope for Opex allowance foregone in early years of RP4 to be recovered in the later years of RP4 as long as the 1.81p/kWh price cap would not then be exceeded.

Depending on the level of controllable costs in the last two years of RP3 there may be scope for T&D prices in the last two years of RP4 to be lower than those projected in Table 4, subject to the operating cost allowance foregone in the earlier years of RP4 having been recovered.

The capped revenue in the first year of RP4 is a 2.8% real increase on the level of regulated revenue today. Increases in revenue entitlement were a feature of the last distribution review in GB (where for example, regulated revenues for Scottish Hydro, Swalec and Sweb, the three companies most comparable to NIE in terms of their scale and network characteristics, increased by over 4% in real terms on average). Ofgem explained that the increases were necessary because of 'the need for increased investment, combined with additional tax and pension costs facing companies'. NIE faces those same issues.

NEXT STEPS

In light of other significant work such as the introduction of the All Island Market scheduled for 1 April 2007, the Authority is keen to complete the work on the T&D price control as soon as possible. It expects to be in a position to issue its final proposals early in the Spring of 2006.

RESPONSES

Views are sought on the following issues arising from the proposals developed in this paper

The proposal for a five year term.

The approach to setting the operating cost allowance, the allowed rate of return, rolling forward the RAB, depreciation and the price cap.

The proposal to continue with the SMART programme.

NIE's proposal to separately fund the network planning and research facility and the Vulnerable Customer Programme.

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The closing date for responses is 31 January 2006.

Please indicate if your reply is confidential and therefore cannot be published.