RP7 - NIE Networks Price Control 2025-2031

Draft Determination Annex

Rate of Return Adjustment Mechanism

November 2023

About the Utility Regulator

The Utility Regulator is the economic regulator for electricity, gas and water in Northern Ireland. We are the only multi-sectoral economic regulator in the UK covering both energy and water.

We are an independent non-ministerial government department and our main duty is to promote and protect the short- and long-term interests of consumers.

Our role is to 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.

We are based at Queens House in Belfast. The Chief Executive and two Executive Directors lead teams in each of the main functional areas in the organisation: CEO Office; Price Controls, Networks and Energy Futures; and Markets and Consumer Protection.

Our mission

To protect the short- and long-term interests of consumers of electricity, gas and water.

Our vision

To ensure value and sustainability in energy and water.

Our values

- Be a best practice regulator: transparent, consistent, proportionate, accountable and targeted.
- Be professional – listening, explaining and acting with integrity.
- Be a collaborative, co-operative and learning team.
- Be motivated and empowered to make a difference.

Utility Regulator
ELECTRICITY GAS WATER

Abstract

This annex provides the Utility Regulator's approach to the rate of return adjustment mechanism.

Audience

Likely to be of interest to regulated companies, consumers, other regulatory bodies, government and other statutory bodies.

Consumer impact

The overall consumer impact of RP7 is set out in the main draft determination report.

An adjusted rate of return will ultimately change the amount earned for rate of return within the price control and this will feed into tariffs during the RP7 period.

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Rate of Return Adjustment Mechanism

Overview

1.1 In Chapter 13 we explain why we think it will be appropriate for the UR to make an ex-post adjustment to the RP7 allowed rate of return.

Risk free rate

1.2 Ofgem operates a risk-free rate adjustment mechanism in its RIIO-2 framework for the GB energy networks and our understanding is that that the mechanism has been welcomed by both consumer representatives and by networks as a way of reducing exposures to exogenous, interest rate driven changes in the cost of capital. Based on this experience we included a similar mechanism in our GD23 decision for the GDNs. We now propose to introduce the same mechanism for NIEN as part of its RP7 price control arrangements.

1.3 Our calculation of the risk-free rate uses three different input indices and requires forecasts of both RPI and CPIH inflation. Rather than strive to replicate this computation on a continual basis, we propose to focus the adjustment mechanism on change in the value of index on which we place most weight - i.e., the yield on 20-year index-linked gilts. We will track the value of this index, as published on the Bank of England's website, and adjust retrospectively the calculation of the risk-free rate in each year of the RP7 period by an amount that is equal to the difference between the annual average out-turn value of the index and the value at our cutoff date for data on 30 September 2023 of 1.34%.

Debt

1.4 Our intention is that the adjustment mechanism will operate as follows. Table 1 reproduces the Chapter 13 ‘baseline’ estimates of NIEN’s cost of debt. The inputs highlighted in yellow are to be regarded as holding assumptions that apply until the business enters into new borrowing(s) either to refinance existing debts or to fund new investment. All other inputs into the calculations are fixed allowances.

Average nominal cost of debt				
			Current market rates	6.1%
Average interest costs	5.8%		Forward rate adjustment	nil
Transaction costs	0.1%		Transaction costs	0.1%
Embedded debt	5.9%		Cost of new debt	6.2%
30:70 weighted average				
Weighted average cost of debt = 6.11%				

Table 1 – RP7 cost of debt calculation.

1.5 At the time of the RP7 review, our expectation is that the UR will replace the figures highlighted in yellow with replacement figures based on estimate(s) of the prevailing market interest rates for BBB rated corporate borrowers at the point(s) in time when the company raises new debt. The replacement figure(s) will be obtained as follows:

a) data source – the UR will use information about bond market prices/yields contained within the Markit iBoxx database; and

b) index family – the UR will refer specifically to the iBoxx £ non-financials BBB index; and

c) tenor – this family of indices contains separate series for tenors of bond of 1-3, 3-5, 5-7, 7-10, 10-15 and 15+ years, as well as other more aggregated data. The UR will read off the reported yield from the series[1] that most closely matches the tenor of the debt that NIE raises. For example, if the company raises debt with a tenor of 12 years, the UR will refer to the 10-15 years series. If the company raises debt with a tenor of 6 years, the UR will refer to the 5-7 years series; and

d) averaging – the reading will be for the average reported yield on the relevant series over the whole of the calendar month in which NIE carried out its financing exercise; and

[1] using iBoxx rules

e) sharing – The Rate of Return Adjustment Mechanism for the RP6 period included a sharing of any movement in the value of the IBoxx reference index at the time of refinancing relative to our placeholder assumption. The sharing factor was 80% to consumers and 20% to the company. In our recent GD23 we decided to remove this sharing factor for the GDNs, so that the full value of any change in the iBoxx benchmark – up or down – is passed to consumers. In view of this we propose that the sharing mechanism is also removed from the RP7 adjustment mechanism and that NIEN's incentive is limited to out-performance against the iBoxx benchmark. However, we will review this sharing mechanism again during RP8.

Inflation

1.6 We made our decisions on GD23 at the peak of the inflationary spike and when the future trajectory for inflation remained uncertain. While we based our final determination on OBR forecasts, we adjusted the cost of debt mechanism to correct for the forecasting error in inflation.

1.7 We believe there is merit in extending this approach to RP7 Price Control. If it is appropriate to protect companies against forecasting errors for debt, it seems equally appropriate to protect against forecasting errors in inflation. Consumers have borne additional costs from forecasting errors in respect of inflation in RP6. It is likely that, given the current low forecasts for inflation, consumers might also bear additional costs of forecasting errors in respect of inflation in RP7 as well. Noting that the CMA has accepted medium term forecast inflation for price controls in principle, there does not appear to be any rational argument against adjusting for actuals when we adjust for actual cost of debt. We are aware that this is an issue that is also under consideration by both OFGEM and OFWAT who are considering possible remedies, and we are following their process closely.

1.8 Actual annual average inflation for October in each year will replace the forecasts set out in Table 1 used is setting RP7 Rate of Return. October is the reference point for inflation used within the NIE Networks licence.

Forecast	24/25	25/26	26/27	27/28	28/29	29/30	Average
CPIH	0.0	1.3	2.0	2.0	2.0	2.0	1.55

Table 1 – CPIH forecast

Method of true-up

1.9 Annex I sets out the computations in greater detail and includes an illustration of how updated values would impact the final rate of return for RP7.

1.10 The adjusted rate of return will be considered as part of the RP8 review and also as part of tariff setting process during the RP7 period. This is because a change to the rate of return will impact on maximum regulated revenue calculations in each of the years of RP7 which in turn drives changes in tariffs. This should avoid any significant build-up of under or over recoveries (K correction factor) due to the adjusted rate of return feeding into the RP7 period.