



**Forward Work Plan
1st April 2007 – 31st March 2008
and Corporate Strategy**

**An Ofreg consultation paper
22nd December 2006**

Responses by 5.00pm on 1st February 2007

Summary

This document sets out for consultation:

- Ofreg's draft forward work plan for 2007-8;
- Ofreg's corporate strategy for the coming year, and a proposed approach to developing a 3-year strategy;
- Key drivers of such work plans and strategy, notably our statutory duties, key risks and contextual information; and
- Ofreg's proposed approach to demonstrating value for money and effective management of our work.

NOTE:

Ofreg's Forward Work Plan (entitled "Forward Work Programme") for the period 1st April 2006 – 31st March 2007 can be viewed by accessing our website - <http://ofreg.nics.gov.uk/> - then clicking on "Publications" at the top of the page and it can be found under 1st July 2006.

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Purpose of this consultation

Forward work plan

1. Ofreg¹ has a statutory duty “before each financial year, [to] publish a document (the “forward work programme”) containing a general description of the projects, other than those comprising routine activities in the exercise of its functions, which it plans to undertake during the year. That description shall include the objectives of each project. The forward work programme ... shall also include an estimate of the overall expenditure which the Authority expects to incur... Before publishing the forward work programme for any year, the Authority shall give notice containing a draft of the forward work programme, and...shall consider any representations or objections...”²
2. The first purpose of this document is to provide a draft forward work plan for consultation as required by the statute. We expect to publish the final forward work plan in April 2007.

Corporate strategy

3. Ofreg sees consultation on our approach to our duties as a major plank of the framework of accountability within which we work. Viewed as a vehicle for accountability, we see significant drawbacks in consulting on only a single year’s work programme. Without setting out longer-term objectives, it is hard to clarify the underlying direction of travel for a number of projects, and the inter-relationships between different projects. This will become a growing problem as Ofreg regulates three industries and seeks to identify and exploit multi-utility synergies. Moreover, there is inevitably some “overhang” from one year to the next and so a single-year presentation can present as unavoidable some projects which are in truth discretionary.
4. For these reasons, a second purpose of this paper is to begin work on developing a longer-term corporate strategy. Such a strategy will underpin the single-year forward work plan, illuminating its strategic rationale. For convenience we will include both strategy and plan in a single document.
5. This is a particularly good time to begin work to set out Ofreg’s strategy more formally. The membership of Ofreg’s board has substantially changed in the last year, as has its executive leadership. Ofreg itself is changing fast, taking on new responsibilities, expanding and bringing in

¹ Ofreg is the day-to-day name for the Northern Ireland Authority for Energy Regulation.

² Energy (Northern Ireland) Order 2003, section 5, 1-4.

staff with a wider range of professional skills and backgrounds. The context for our work is also changing fast, for instance as the SEM project will move from development into live operation during 2007.

6. At the same time, these factors suggest it may be wiser not to attempt to develop a long-term strategy in a single bite. Instead, this document takes a two-track approach:
 - It sets out a draft one-year strategy for 2007-8, for consultation;
 - It also lays out a process for strategy development over the coming year, with a view to creating a multi-year strategy. Notably, it consults on the broad themes around which strategy should be built. We expect a further publication in April 2007 to confirm the key themes, while a series of publications and consultations during 2007-8 will lead to a fully fledged strategy being published in March 2008.

Accountability

7. The third objective of this paper is to set out Ofreg's proposed approach to provide visibility and accountability for our use of resources.
8. Ofreg is expanding to address a growing range of challenges and an accelerating pace of change. This growth is important to ensure consumers' interests continue to be protected and the utility industries shielded from the risks that could arise from slow or erratic regulation. Nevertheless, the growing resource requirement of NI regulation makes it imperative that we manage resources effectively, and demonstrate that this is the case.

Context of Ofreg's work

9. We see two main drivers that should determine Ofreg's strategy and work-plan for any given year: our statutory duties, and the range of risks that face the parties to whose interests we have regard (broadly, customers and regulated companies).

Statutory duties

10. Ofreg's statutory duties are set out at length in Annex I. We present the full set of duties so as to illustrate the complexity of strategy formation for Ofreg. Our goals are multi-dimensional, and include objectives that are in tension. While customers are at the heart of our duties, an important way that we protect customers is by ensuring that utility companies are financially viable (subject to their being efficient). In particular, we have a role to promote the (economic and efficient) development of the gas industry. Ofreg's duties and way of working are primarily economic, but our goals incorporate other objectives whose rationale does not arise from economic principles: such as ensuring prices are the same across the whole jurisdiction, or protection of vulnerable people.
11. It is also important to note that Ofreg is tasked to determine for itself the best balance between these many duties. Ofreg tries to work with the grain of wider government policy. For instance, Ofreg has been happy to collaborate in delivery of the 2004 Ministerial Framework agreement on energy markets, and works in a number of areas to bear down on fuel poverty and promote renewable generation. Nevertheless, these initiatives have only been possible because they have been consistent with, and in Ofreg's view an appropriate means to deliver, our primary objective and duties.

Risks

12. It also seems important to ground our strategy and work-plan development in an analysis of risk for the parties to whom we owe statutory duties.
13. Annex II sets out a range of risks that Ofreg considers to be material. They appear to be of at least medium impact on regulated companies or customers. Moreover, the likelihood of their crystallizing (unless we take steps to avoid them) appears to be at least medium.
14. Ofreg invites comments on whether there are important risks not covered in Annex II, and on potential approaches to mitigate these risks.

Economic and industrial background

15. In order to assist the general reader, we have briefly set out in Annex III some key facts about the context for Ofreg's work.

Rapid change

16. Ofreg's work – and the organisation itself – is currently subject to rapid change, across a number of fronts:

- Becoming a water regulator;
- Learning to “co-regulate” with CER, which raises organizational and also legal (cross-jurisdictional) issues;
- Developing our competition-economics expertise;
- Working through the implications of new statutory duties towards sustainability;
- Completing implementation of the 2003 EU directives, and engaging in discussions (expected to begin in January 2007) on a new round of legislation;
- Expanding resources to meet all these challenges, recognizing that many of the individuals with relevant skills are found outside the Northern Ireland Civil Service.

17. Ofreg must change not only its policies, but also its own structures and processes. We will do more, and meet existing priorities differently. This change process will be reflected in several elements of our forward work plan, setting up a water regulator, for instance. More generally, however, the plan will recognise that the change process itself makes a call on management time: it requires extra communication with stakeholders, more time spent ensuring staff understand what they have to do, and the manner of work expected of them, more thought about basic office processes. In particular, the recruitment activity planned for the first half of next year will be time-consuming. Our forward work plan will tailor activity to available resource, and needs to recognize this short-term “management overhead”.

Corporate Strategy

Strategy for 2007-8

18. The following paragraphs set out for consultation our strategic intent for the coming year. The purpose of this strategy is to indicate the broad direction of travel that informs individual projects selected for the forward work plan.
19. Ofreg's strategy flows from our statutory duties. These are complex, but ultimately are driven by the interests of utility consumers. We have direct duties to current consumers. We also have duties to secure the financial, environmental and social sustainability of the utility companies, because this is in the longer-term interests of consumers. Our duties are to future consumers as well as today's, and we should ensure that today's utility industries are not undermining the well-being of society in the future.
20. Competition is one main method of securing consumer benefit, and is often a better means to this end than regulation; although its appropriateness needs to be assessed case-by-case. Providing customer choice can be a means to strengthen customer confidence in the utility industries, and can therefore be an important element in promoting the development of the utility industries.
21. Competition is very immature in most sectors of the NI utility industries, and in this context our roles in regulating monopolies and limiting the exercise of dominance remain of great importance. This means controlling prices. It also means prompting monopolies to provide the highest possible standard of service within the appropriate cost. Ofreg will seek to prompt utility companies to be innovative, but we will in general be cautious before encouraging monopolies to take risks where costs are ultimately borne by customers, or to play roles that would be better fulfilled by the market.
22. Ofreg will work where possible through partnership. Our collaboration with CER in the Republic of Ireland is of particular importance. We also acknowledge the importance of the 2004 Ministerial Framework Agreement which indicated the importance of North-South collaboration in the overall direction of NI energy policy. Our partnership with the Consumer Council (NI) is also a key relationship, given substantial overlap between our mission and the Council's.
23. Ofreg will seek to comply with good regulatory practice. We will adopt good ideas developed elsewhere, where appropriate. We will consult on all substantial decisions, tailoring our consultation style to the topic. Stakeholders may not always like or agree with our decisions, but they should always understand our rationale for them. We will work openly, using the media to communicate with the general public on topics of wide

interest, but will not use the media as an alternative to direct dialogue with stakeholders.

24. Ofreg's HR and organizational strategies will be tailored to the requirements of our work. We will allocate resources in line with work priorities. We will ensure our recruitment and employment policies make us a good employer, attractive to a wide range of individuals with the skills we need. We will not only ensure the propriety and regularity of expenditure, but will also endeavour to deliver good value for money, and be able to demonstrate this.

3-year strategy

25. As discussed in the introduction, Ofreg sees value in building on this year's corporate strategy to develop a multi-year strategy to guide the production of one-year Forward Work Plans. Given our new management team (at board and executive levels), we intend to carry forward strategy development over the course of 2007-8, with a view to publishing a synergy document in December 2007.
26. We propose that the first multi-year strategy should cover 3 years. This will provide value-added over a single-year approach, without attempting to see into the more distant future which is difficult because of the current pace of change.
27. Ofreg intends to carry out a series of "themed" strategy consultations during the coming year. These should enable us to think more deeply about particular issues, while not losing sight of the interfaces between issues which will become important when trying to craft an integrated strategy. The themes we tackle could include some or all of the following:
- a. Regulating competitive markets at wholesale and retail level;
 - b. Regulating monopolies – price controls and service standards;
 - c. Sustainable development – Ofreg's role and options, including a look at metering;
 - d. Multi-utility regulation;
 - e. Industrial competitiveness and security of supply;
 - f. Fuel poverty and social action;
 - g. Value for money regulation: HR and organisational strategy.
28. Respondents are asked to comment on this list: are these the right themes; have we missed important topics; in what order do you suggest we address these themes (recognizing the limits on Ofreg's resources)?

Forward work plan

29. As noted in the introduction, we have a statutory duty to publish an annual forward work plan (FWP). This chapter sets forward a draft forward work plan (FWP). At this stage it consists simply of a set of tasks. Our aspiration is that the final FWP will also include KPIs/milestones of some kind, as discussed in the next chapter.
30. The FWP will also indicate the planned expenditure in each area. Budget data for next year will be generated through Ofreg's detailed planning over the next few months. However, we can indicate at a high level that we expect next year's budget to be around £6.5m, of which 50% would relate to electricity, 20% gas and 30% water.

Electricity

SEM

31. SEM design along with initial work on preparation for the new market will continue to consume existing resource levels until summer 2007.
32. From summer 2007 resources will be spread across four main areas in preparation for the new market:
- a. Working towards go-live. This includes work with market participants to ensure readiness, and step-wise implementation of the various legal transitional measures;
 - b. Developing market monitoring. As system participants begin market trialling, the market monitoring unit will be developing its systems and methodologies to be ready in November 2007;
 - c. Developing a modelling capability to provide the various regulated parameters for the start of trading in November 2007;
 - d. Developing the new collaborative regulatory arrangements.
33. From November 2007 strands b-d of this work will also "go live". Resources in area (a) will be released. We expect that these precious experienced staff will be redeployed, leading to a reduction of consultancy spend but not of head-count.

Non-SEM

34. Key tasks for the non-SEM electricity team will include:
- a. Market opening. Monitoring the development of consumer switching from November 2007, and removing identified entry barriers;
 - b. Business separation, and the divestment of SONI;
 - c. Restructuring of the Power Procurement Business and the Public Service Obligation levy;

- d. Development of consumer communications programmes (with Corporate Affairs);
- e. Price controls (PES, SONI, PPB); and
- f. Influencing the EU's Electricity Regional Markets Initiative.

Gas

35. Key tasks for the gas distribution and supply teams in 2007-8 include the following:
- a. Review the Phoenix network price control and put in place a network price control on firmus and a new supply price control on Phoenix;
 - b. Finalise full business separation;
 - c. Manage market opening; and
 - d. Develop a consumer communications programme.
36. On the transmission side, the main tasks are:
- a. Adapting Irish commercial arrangements policy to new GB network exit rules;
 - b. Manage the divestment (mutualisation) of Phoenix's transmission business;
 - c. Processing code modifications to facilitate the growth of competition;
 - d. Conducting cost-benefit analysis for alternative approaches to an all-Island gas market and carrying out initial planning;
 - e. Ongoing transmission price controls; and
 - f. Influencing the EU's Gas Regional Markets Initiative.

Water

37. The water team will have four main tasks during the first two to three years in operation. The first and considerably the largest is preparation of the 2010 price control. We would expect in this to follow the Ofwat timetable which requires around two years, covering:
- a. Informal consultations on opportunities and issues;
 - b. Consultation on the framework and approach, which informs initial Ministerial guidance;
 - c. Preparation of draft business plans, informing the principal Ministerial guidance;
 - d. Development of a draft determination, on which the company makes representations;
 - e. Receipt of final Ministerial guidance, to be followed by a Final determination and Asset Management Plan monitoring plan.

38. A second task is setting in place the full legal framework of regulation. This will be “front-loaded” as all MoUs, rules of procedure etc. need to be put in place during 2007-2008.
39. A third task is defining what information we will expect NIWL to provide to Ofreg during each year, and how much we will publish.
40. Finally, Ofreg will have a much more extensive power of determination of consumer complaints under water than in energy. This is a quasi-judicial function and, depending on volumes of complaints, could consume substantial resource. We need to develop complaints processes and appropriate governance.

Corporate Affairs

41. Ofreg intends to carry out a significant set of internal reforms over 2007-2009:
 - a. Review HR procedures and policy to formulate an Ofreg staff manual consistent with recruiting from the private sector;
 - b. Introduce more streamlined financial processes, to improve quality and auditability, and in time to reduce the staff numbers required;
 - c. Review our communications approach: to develop more comprehensive communications tools (e.g., intranet; contact plan; knowledge management); and to clarify our approach to consultation and consumer communication;
 - d. Confirm and clarify our “brand” i.e., will we continue to have a formal and a day-to-day name, and what will they be?
42. Ofreg intends to create a dedicated strategy team. This team will be responsible for the strategy development outlined in the previous chapter, and also for:
 - a. Identifying cross-utility issues and driving synergy analysis;
 - b. developing Ofreg’s strategic approach to EU matters, working to co-ordinate and add value to work by Ofreg’s industry specialists;
 - c. reviewing Ofreg’s social action plan;
 - d. co-ordinating policy on the various environment-related schemes that Ofreg administers (e.g., NIROCs, LECs, etc.)
 - e. leading on other socially oriented regulation (e.g., maximum resale price).
43. Corporate Affairs will also take leadership on devising and operating our processes to demonstrate value for money and will review the allocation of fee levels between licensees.

Accountability

44. Ofreg's accountability is all the more important because we are independent of Ministers. Ofreg must show value for money for the resources we spend (taxpayers' or customers' money); and we must be able to demonstrate that the impact of our work on companies is proportionate and justified. This chapter reviews for consultation how we can best achieve these goals.

Success indicators

45. At the highest level, it would perhaps be desirable to identify some overall indicator of the impact of Ofreg's work on consumers and regulated companies: looking for instance at prices, competition indices or investment levels. Ofreg monitors this kind of broad indicator as part of the policy review process, and as an input to planning.
46. We could therefore adopt such high level indicators as a formal KPI. However, we see major practical difficulties with this approach. Many Ofreg decisions take into account the long-term development of the industry and their impacts cannot be measured in the first few years. In many cases our work is only one factor influencing the overall out-turn, and not the most important, and so assessments would need to be on an "all other things being equal" basis.
47. We are concerned that such assessment would therefore be complex and resource-intensive to carry out, and in any case the findings would be ambiguous or contestable.
48. Indicators at a finer level of granularity could be adopted. These would tend to focus not on the overall impact on customers but on next-level drivers of such outcomes. (For instance, not so much on overall security of supply as on generation margins and network reliability.) However, we see a significant risk that selecting an incomplete set of such drivers would distort our prioritisation; whereas using a complete set would be extremely cumbersome.

Process indicators

49. It seems more sensible for us to set out indicators of process that can demonstrate where our work is being managed efficiently and effectively.
50. The most important of these may be milestones. If we adopted this approach we would aim in our March publication to set out the main milestones associated with each task. Stakeholders will then be able to assess how often we stay broadly in line with our own plan, and we would expect in our Annual Report to report not only whether the objectives of the task have been met, but also whether the timetable has been observed.

51. We also propose to publish guidelines about Ofreg's approach to consultation, setting out a standard approach to:
- a. consultation timetable;
 - b. the information to be included in consultation; and
 - c. our approach to regulatory impact assessment.
52. In addition, we see value in Ofreg's setting out the resources we expect to deploy in carrying out each project, and reporting on this at the end of the year.
53. We would welcome suggestions about the best way to enhance accountability through use of such process indicators.

Consultation

Questions

54. Ofreg would welcome comments on any matter raised in this paper, but in particular the following:
55. Are there important risks to utility customers or industry not covered in Annex II, and can you suggest approaches to mitigate these risks?
56. Do you think our corporate strategy for 2007-8 (paragraphs 19-24) is correctly focused and sufficient for its purpose?
57. Paragraph 27 gives some examples of topics that could focus Ofreg's development of a 3-year strategy. Do you agree with these, are important themes missing, and how would you prioritise them?
58. Do you agree with Ofreg's choice of proposed tasks for the coming year's forward work programme? Are any missing? Comments are welcomed on the approach we should take to particular tasks.
59. How can Ofreg enhance accountability, and in particular:
 - a. do you see an effective way to use overall success indicators to measure Ofreg's impact?
 - b. do you favour publishing process indicators such as milestones and resources to be spent on each project? Can you suggest other such indicators?
 - c. do you favour publishing guidance about our approach to consultation? What topics should it cover?

Next steps

60. Ofreg asks for written responses to this paper by **5.00pm** on **1st February 2007**. Enquiries about consultation arrangements and responses to this document can be made by mail, phone, fax or e-mail to:

Kevin Shiels, Queens House, 14 Queen Street, Belfast, BT1 6ER

Tel: 028 9031 6637

Fax: 028 9031 1740

E-mail: kevin.shiels@ofregni.gov.uk

61. In January (dates to be announced) Ofreg intends to hold two open meetings where stakeholders can comment on and discuss the themes of this paper: one for the companies we regulate; and a second meeting for consumer groups and special interest groups (e.g., fuel poverty, green groups).

62. Our final FWP and corporate strategy for 2007-2008 will be published in April 2007. This will be followed by a series of strategy consultations/publications during next year, and a draft corporate strategy will be published in December 2007 (along with a draft FWP for 2008-9).

Annex I – Ofreg’s statutory duties

63. In electricity, Ofreg’s principal objective is to protect the interests of consumers of electricity, wherever appropriate by promoting effective competition. Our primary duty is to act in the manner best calculated to further the principal objective, having regard to—

- (a) the need to secure that all reasonable demands for electricity are met;
- (b) the need to secure that licensees can finance their activities; and
- (c) the need to secure (i) that prices charged to tariff customers are geographically non-discriminatory , and (ii) that public suppliers are not thereby disadvantaged in competing with other persons authorised by a licence or exemption to supply electricity to such premises.

64. In gas, our principal objective is to promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland. Our primary duty is to act in the manner best calculated to further the principal objective, having regard to—

- (a) the need to protect the interests of gas consumers;
- (b) the need to secure that licensees can finance their activities;
- (c) the need to secure that prices charged for common carriage are in accordance with a common tariff which is non-discriminatory geographically and as regards pipe-line use; and
- (d) the need to protect the interests of licensees in respect of the prices and terms on which any services are provided by one gas licence holder to another.

65. In water no principal objective is provided, but we have a primary duty which is to carry out our regulatory functions in the manner we consider best calculated³:

- (a) to protect consumers’ interests in relation to the water and sewerage services provided by undertakers, wherever appropriate by facilitating effective competition between persons engaged in, or commercial activities connected with, the water and sewerage services;
- (b) to ensure that undertakers carry out their functions properly in every part of Northern Ireland; and

³ This is drafted on the assumption that the water order will have passed intact by the time we publish.

(c) to ensure that undertakers are able (in particular by securing reasonable returns on their capital) to finance the proper carrying out of their functions.

66. Subject to these primary duties, Ofreg must also have regard to a set of secondary duties. In general they are matters to which Ofreg must have regard in exercising its primary functions, but we do not need in each case to have specific strategies or work-streams to deliver a product relating to each duty.

67. The secondary duties are summarized in Table 1:

Have regard to...	Electricity	Gas	Water
Economy & Efficiency	✓	✓ (Just efficiency)	✓
Undue Preference / Discrimination	x	x	✓
Consumer Benefits – Land Disposals	x (But we do supervise the NIE landbank in consumers' interest)	x	✓
Consumer/Public Protections	✓ From dangers of electricity	✓	✓ Non-regulated activities
Sustainability	✓	✓	✓
Diverse Long term supply	✓	✓	x
Promote R&D	✓	x	x
Health & Safety of Industry Employees	✓	x	x
Facilitating Competition	x	✓	x

Annex II – Risks

We have set out here some of the more important risks facing customers and industry players. This list is not necessarily comprehensive.

Multi-utility issues

- Fuel and water poverty
- Weak incentives lead to excessive consumption
- Network or monopoly supplier insolvency
- Abuse of market power to raise prices or prevent competitive entry
- Cross-subsidies between captive and competitive customers
- Absence of competitive entry to retail markets
- Lack of service innovation
- Service standards decline
- Increasing disconnections or heavy-handed debt management
- Weakened security of network operation
- Weakened security of supply owing to lack of commodity
- Costly or heavy-handed regulation
- Threat to competitiveness of energy intensive/high load-factor industry

Electricity

- High costs of carbon lead to higher prices
- High fuel costs lead to high power prices
- Lack of public confidence in competitive markets

Gas

- Import bottlenecks increase prices or reduce supply security
- Catastrophic failure e.g. a mains explosion
- Low load on network means high costs per-unit
- Lack of public confidence in competitive markets
- Benefits of falling wholesale costs not passed to customers

Water

- Lack of public confidence in water industry
- Inefficient capital “splurge”
- Insecure supplies
- Catastrophic failure e.g., a dam burst

- Public health problems owing to poor standard drinking water
- Supply chain bottlenecks owing to co-incidence of NI investment/regulatory cycle with GB
- High levels of debt increase prices for all consumers
- New EU obligations

Annex III – Brief Economic and industrial context to Ofreg’s work

1. In order to assist the general reader, this section sets out some context and key facts about Ofreg’s work.

Economic

2. The sectors regulated by Ofreg are an important part of the NI economy. Latest Government data indicate that they generate together employment of almost 3,000 people in Northern Ireland, a turnover of £1,354million with Net capital expenditure of close to £200m⁴.
3. Electricity and water are vital services for life in a developed country, and for customers living in homes that use natural gas for heating (given Northern Ireland’s climate), so is gas.
4. Utility services are also consumed by all businesses in NI (for example, two thirds of Phoenix gas is used by their Industrial and Commercial customers, and only one third by their domestic customers) and as such they represent an important element of the fabric of business costs and competitiveness.
5. Energy prices have historically been higher in NI than in Great Britain or many other European countries, although NI prices for domestic consumers are currently comparable to GB prices – see table 1 below. Analysis undertaken by Ofreg in September 2006 on the comparison of GB and NI domestic electricity tariffs has shown that NI customers consuming 3300kWh per annum would have been paying 3% less for their electricity than the average of those customers in GB who had chosen to remain with the former PES in their region. Domestic customers in GB who have chosen to switch to another supplier may be enjoying the benefit of reduced tariffs. However, Ofreg has compared the NI tariff with the tariffs offered by the former PES in their home region as customers in Northern Ireland cannot at present choose to move to another supplier.

⁴ Data from DETI Census of Employment and NI Annual Business Inquiry.

Table 1: NI v's GB regional electricity prices:

Region	Annual bill based on 3,300 kWh £	NIE Vs
Seeboard	362	6%
Southern	363	5%
Scottish Hydro	364	5%
London	372	3%
Eastern	390	-2%
Midlands	415	-8%
Yorkshire	418	-9%
Northern Ireland	382	0%
East Midlands	390	-2%
Swalec	383	0%
Northern	428	-11%
Norweb	401	-5%
SWEB	397	-4%
Manweb	408	-6%
Scottish Power	420	-9%
GB Average	394	-3%
GB Comparator Regions	381	0%

6. At the same time, the amounts paid for water and sewerage services by NI customers have been low. Even if a proportion of rates were regarded as covering water services, the total burden of local taxation in NI is well below the GB average.
7. The NI economy overall has fared well in recent years. In terms of unemployment for example, the seasonally adjusted unemployment rate in NI (4.6%) is lower than the UK average rate (5.5%). NI has the third lowest unemployment rate among the UK regions - only the South East (4.4%) and the South West (4.0%) regions have lower rates. The NI rate also compares to an EU25 rate of 8.0% and a Republic of Ireland rate of 4.2% for September 2006.

8. However, data indicate that Northern Ireland has still some catching up to do in terms of incomes - the Annual Survey of Hours and Earnings (ASHE) shows that median gross weekly earnings for all employees in NI at April 2006 was £324.7, and is 89% of overall UK earnings (£364.1), and NI's growth in median gross weekly earnings was 1.9%, well below the UK rate of 4.3%. In addition, the NI economy is sustained by over £5bn of subsidy each year and although NI's productivity (as measured by GVA per employee) has been rising in recent years (from £26,607 in 1996 to £33,929 in 2004), the rate of increase has been slower than for the UK as a whole. As a result, NI's productivity gap relative to the UK has been widening (see Figure 6), with relative productivity levels falling from 95.8% of the UK average in 1996 to 89.0% in 2004⁵.
9. The context above makes clear why utility prices in Northern Ireland are important to the economy and people of Northern Ireland. High and volatile prices for utility services have potentially serious consequences for households and businesses.
10. Fuel poverty is a particular scourge in Northern Ireland⁶. The latest data suggest that around 153,000 households were in fuel poverty in 2004, 23.9% of the total⁷, although subsequent energy price increases are likely to have increased this somewhat. This compares to 6% of households in Great Britain. However, the incidence of fuel poverty differs from GB, with this phenomenon in NI being concentrated among rural households (33% fuel poor compared to 20% of urban households).
11. There are a number of factors underlying fuel poverty. The important link between fuel poverty and the underlying health of the NI economy is illustrated by the suggestion from the NI Fuel Poverty Action Group that roughly two-thirds of fuel-poor would remain so (although perhaps to a lesser extent) even if all the NI housing stock were brought to an acceptable level of energy efficiency. Indeed, the average SAP rating for NI housing is 57, compared to 52 in GB.
12. There is already much debate around the impact of water charges in NI and the effects on households and businesses in NI. Ofreg formally takes on it's regulatory role for water and sewerage services next April (2007) and one of our first main tasks will be to begin the process of price control to help ensure that future charges are as low as possible.

⁵ Source: DETI Quarterly Economic Review.

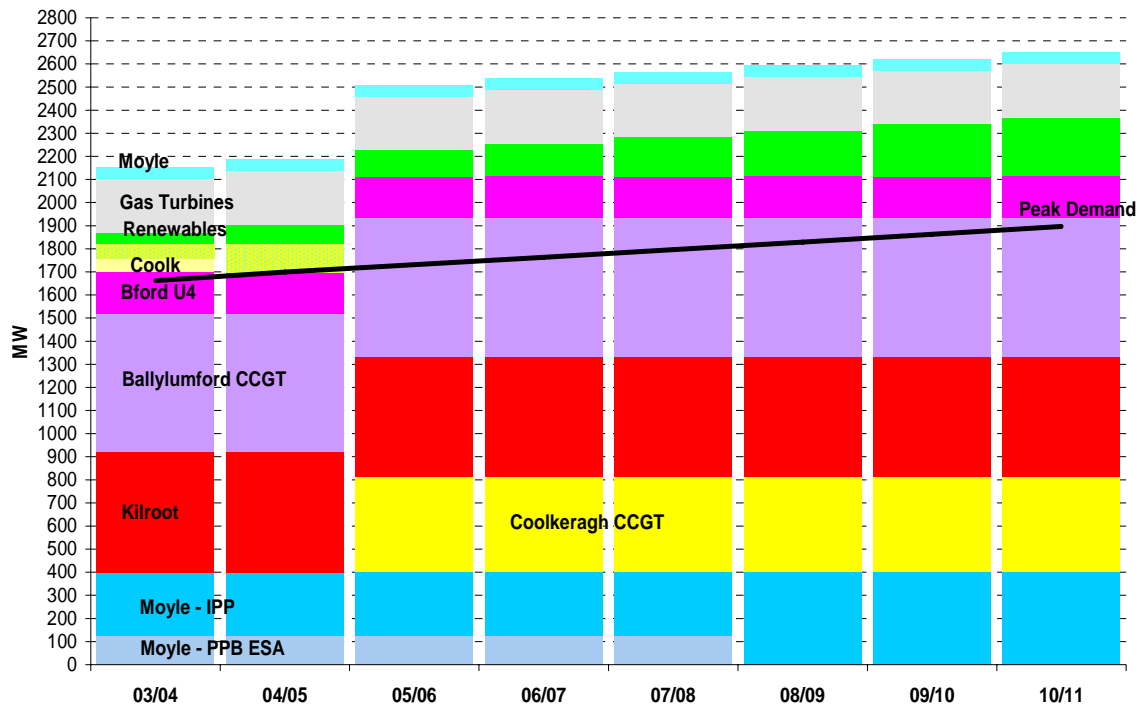
⁶ There a number of definitions of fuel poverty but the most common definition used in NI is "A household is in fuel poverty if, in order to maintain an acceptable level temperature throughout the home, the occupants would have to spend more than 10% of their income on all household fuel use".

⁷ Data sourced from the NI Fuel Poverty Advisory Group's first annual report, 2006.

Industrial

13. Northern Ireland's utility services are provided by local companies: notably Viridian, Phoenix Gas, Firmus, and from April 2007, Northern Ireland Water Limited. All of these are small companies compared to international comparisons. The largest is Viridian (recently valued at around £1.6bn), which is nevertheless several orders of magnitude smaller than the largest EU energy companies. Phoenix gas' entire regulated asset base (transmission and distribution) is around £400m, compared to £2,500m for National Grid Gas transmission alone. This might have several implications – it may mean for example that NI companies have potentially fewer human resources to manage change and development.
14. Local ownership of our utility service providers may mean that they are particularly focused on serving NI customers, but could also mean they are less exposed to international best practice.
15. NI is, overall, a small market. This means that it is extremely important to minimize the fixed costs incurred in market reform. It also means that companies operating only in the NI market are unlikely to be able to reach minimum efficient scale in some business processes: retail service operations, for instance. This underlines the importance of ensuring that systems and processes that work elsewhere can be applied here. This might be most likely to occur through competitive market entry by companies from elsewhere, through large-scale outsourcing, or through local players being taken over.
16. NI currently has a relatively satisfactory electricity generation adequacy margin above peak demand – see chart 1 below. However, around 6% of the boiler-plate capacity is wind and outages/off-trips etc. have also to be factored in. In addition, demand levels are growing fast, at around 2% p.a.. In the absence of an all-island solution, NI would be likely to require substantial new generation (e.g., a new conventional plant) within the next decade for adequate security of supply considerations.

Chart 1: NI generation of Electricity: capacity v's peak demand:



17. The small size of the NI market has important consequences for maintaining electricity balance. It means we have only a few generation stations at efficient scale, which reduces supply security. In consequence, the costs of running back-up plant are high.
18. Northern Ireland has virtually no hydro-carbon energy resources of its own. This means that NI is particularly exposed to international price trends. This may contribute to price volatility in the short-term. This tendency is reinforced by the frequent linkage on gas prices to oil prices, which removes a potential natural hedge that could exist if these two fuels were priced independently.
19. Having no hydro-carbon fuel with a price advantage owing to local factors means that the cheapest fuel on wider markets is generally the most cost-competitive in NI electricity generation. This may also make it harder to maintain fuel diversity.

20. Transportation costs are important in gas supply, which means prices will tend to be higher in markets more remote from supply sources. This has historically placed NI at a significant disadvantage to GB, because of the latter's proximity to North Sea gas; but in a relatively favorable position compared to many Continental markets since the latter import gas over thousands of kilometers. The differential to GB is unlikely to change, but the decline of North Sea production may mean that UK prices as a whole increase relative to the rest of Europe. Production off the island of Ireland could potentially alter this situation if it were in large enough volumes to be the marginal units of supply. However, it does not currently seem that current fields (including Corrib) will be price-setters, and so the UK and Ireland seem likely to remain a price-taking market for some time to come.
21. Northern Ireland's security of gas supply depends heavily on import pipelines, the Scotland-Northern Ireland Pipeline (SNIP) in the first instance. The completion of the South-North pipeline to the Republic will enable NI to use additional pipelines to back-up SNIP and so enhance security of supply.
22. The adequacy of import facilities into the UK as a whole is of great importance to NI consumers. This issue is broadly in the hands of Ofgem, the GB regulator, not the NI authorities. The GB regulatory regime has in recent years placed significant emphasis on using market signals to drive infrastructure investment. This is partly as a result of a perceived earlier failure of planning to secure adequate network capacity to bring gas into the UK from the St Fergus terminals. The UK as a whole has also seen periods of very high prices in recent years, in part because of market concerns about inadequacy of import facilities. Substantial new import capacity is expected to open this year and in the next few years.
23. Recent experience also suggests that actions by regulators astride up-stream pipelines (notably in Belgium, NL, Germany, Poland, Ukraine) are also of great importance to NI consumers. The current EU legal framework creates only very limited ability for authorities in downstream markets to require up-stream regulators to take our interests into account.
24. New storage capacity is under construction in the UK and will further augment security of supply downstream. In Ireland, Marathon currently offers a storage product using the Southwest Kinsale Gas Field. However using this would probably be uneconomic for NI users until an "all-island" gas regime – a strategic issue which is discussed in the main body of this consultation. The same issue would likely be true of any Republic of Ireland LNG plant. We understand that Shannon LNG has entered into an 'option-to-purchase' agreement on a possible site on the Shannon estuary and design and appraisal work is ongoing, with 2011 as the earliest operational date.

25. However, NI has significant wind resources and NI's strong agricultural sector may also make it a good place to develop bio-fuels, and like elsewhere it generates significant amounts of waste that are a potential energy resource. The development of renewable generation is of particular importance given growing concerns about climate change and the costs of mitigation as evidenced by recent research such as the Stern Report. At the EU level, there is much focus on climate change and the promotion of renewable energy/move away from carbon emissions e.g.(the installed capacity of wind turbines across the EU has increased by 154% since 2000. It is responsible for more than half of the new generating capacity, the other half being largely conventional thermal power stations).
26. The EU Emission Trading Scheme (EU ETS) is the cornerstone of the EU's strategy for fighting climate change. It is the first international trading system for CO₂ emissions in the world and covers over 10,000 installations in the energy and industrial sectors which are collectively responsible for close to half of Europe's emissions of CO₂. The aim of the EU ETS is to help EU Member States achieve compliance with their commitments under the Kyoto Protocol in a cost-effective way. Letting participating companies buy or sell emission allowances means that emissions cuts can be achieved at least cost. If the Emissions Trading Scheme had not been adopted, other – more costly – measures would have had to be implemented. At the heart of the ETS is the common trading 'currency' of emission allowances. One allowance gives the holder the right to emit one tonne of CO₂. For each trading period under the scheme, Member States draw up national allocation plans which determine how many emission allowances each installation receives. The 'cap,' or limit, on the total number of allowances granted is what creates scarcity in the market. Companies that keep their emissions below the level of their allowances can sell their excess allowances. Those facing difficulty in keeping their emissions in line with their allowances have a choice between taking measures to reduce their own emissions, such as investing in more efficient technology or using less carbon-intensive energy sources, or buying the extra allowances they need on the market, or a combination of the two. Such choices are likely to be determined by relative costs. In this way, emissions are reduced wherever it is most cost effective to do so.
27. The Northern Irish water industry also have significant environmental concerns including compliance with EU Regulations and possible infraction proceedings if these are not met, and the costs and investment requirements associated with fully meeting water and waste water quality standards. These are key issues which will become intrinsic aspects of future water price control assessments and debate between ofreg and the various other "water" stakeholders.