

The Utility Regulator's proposals for the 2014 Power NI Supply Price Control

Consultation Paper

Power NI's Response

V1.0
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1 Introduction

Power NI welcomes the opportunity to respond to the Utility Regulator's (UR) recent consultation paper entitled 'Proposals for the 2014 Power NI Supply Price Control'.

Power NI and its consultants CEPA have engaged with the UR and its consultants over the assessment period. Whilst Power NI acknowledges that significant process improvements have been implemented by the UR in their conduct of this review, Power NI is disappointed by a number of the outcomes and proposed decisions. Within this paper Power NI describes the areas of disagreement and presents its arguments.

Power NI trusts that the UR will revisit the areas and arguments highlighted in this paper and Power NI will engage constructively with the UR on these issues through the next phase of the price control process.

2 Executive Summary

Power NI welcomes the process improvements made by the UR in undertaking the price control. The degree of engagement and the opportunity for the teams at both organisations and their respective consultancy support, to directly interact improved the process. Across a number of issues such as some opex elements, duration and structure, Power NI and the UR found consensus. Power NI however disagrees with the UR's position on a number of important points. The main issues of disagreement are; scope, opex, opex allocation methodology, margin and financeability. Power NI has sought, through this paper, to describe the areas of disagreement and present its arguments.

Scope

Power NI does not concur with UR's proposal regarding scope, and believes that the prolonged application of a price control in sectors where there is demonstrably effective competition will compromise the proper operation of the market. Power NI believes that price controls should be completely removed from the non-domestic market. Such a decision would be consistent with the European Commission's intention to see the progressive removal of price controls and thus facilitate full and effective competition.

By retaining a price control for circa 4 per cent of the Northern Ireland non-domestic electricity market, the UR will not be acting in the best interests of customers. The price controlled tariff associated with this unrepresentative and higher cost sub-sector has the effect of distorting pricing in the rest of the non-domestic sector.

Power NI would also strongly contend that the non-domestic market in Northern Ireland is demonstrably competitive, with four suppliers all with market shares in excess of 15 per cent, and a fifth supplier growing their market share very rapidly.

Opex

The UR has proposed disallowances in the areas of; salaries, MBIS, outsourced services, corporate costs and bad debt. In total these disallowances amount to £833,000.

Power NI believes that it has provided substantial, reasoned justification for the cost proposals submitted through the Business Efficiency Questionnaire (BEQ) process. By contrast, the information provided by BDO both in the published papers and at the Opex workshop, appear to target disallowances rather than attempt to assess what a reasonable level should be via the analysis of industry benchmarks and market conditions.

The BDO approach if followed would set Power NI's opex allowance at below industry best practice.

In addition, the proposed 1 per cent efficiency factor should not be implemented as it is inappropriate given that Power NI is a demonstrably efficient supply business comparable with other supply businesses in the UK and Ireland.

Opex Allocation Methodology

The UR proposals represent a 44 per cent increase in the allocation of costs to deregulated customers¹ and are based upon changes to previously established regulatory precedent and cost drivers, which arbitrarily push costs from the domestic to the commercial sector and which are unjustifiable on the basis of regulatory precedent, underlying cost drivers or sound economic principles.

Power NI provided a considered and reasonable cost allocation solution especially with regard to dealing with the difficult issue of billing system costs and therefore urges the UR to revisit the billing cost reallocation and base it upon this methodology.

Margin

While a net margin allowance of 2.2 per cent represents progress towards recognising the risks which Power NI face and the capital requirements of its regulated business, Power NI believes that the UR's proposals, and ECA's supporting analysis, give limited weight to the impact that the changing retail landscape in Northern Ireland has for the basis on which investors are expected to commit their capital to Power NI in the forthcoming control period.

Power NI believes that too much weight is placed by the UR on ECA's risk-based methodology particularly ECA's quantification of K risk and how investment/cost recovery risk is therefore accounted for in the UR's margin proposal. Power NI believes the CEPA method of calculating the margin, based on the forecast capital requirements of the business, cross-checked to practical evidence of financeability constraints retail electricity

¹ over and above what would be warranted by changes in Power NI's customer base

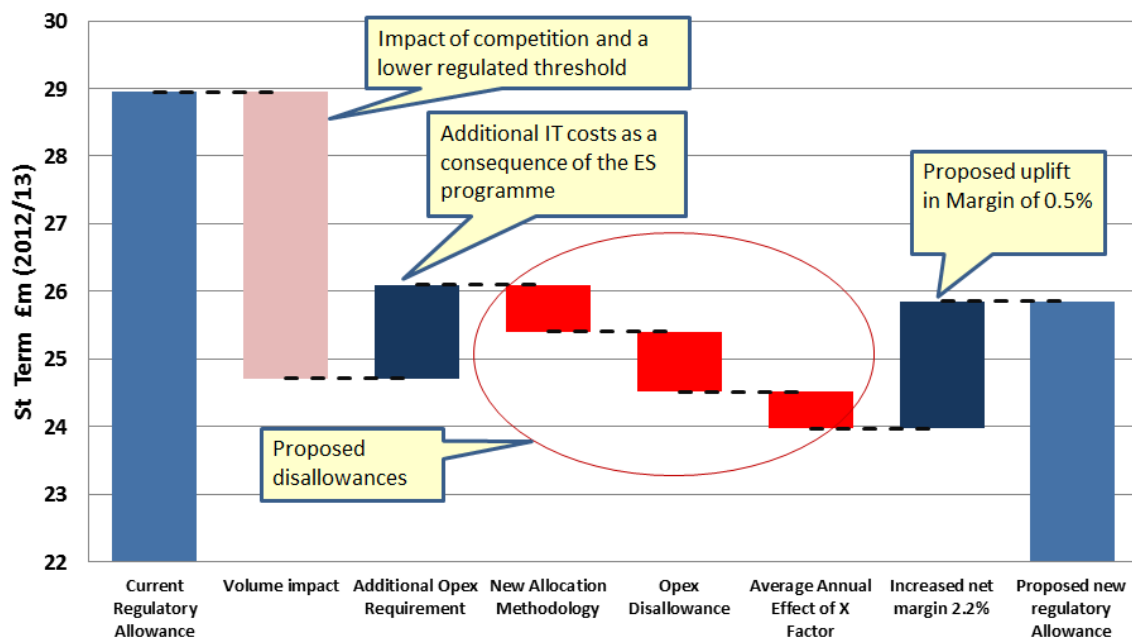
trading businesses face, provides a more established and reliable estimate of the required margin.

Power NI believes the riskiness of the business therefore continues to be underestimated by ECA's analysis, particularly as a result of how key financeability issues, such as capital commitment, are treated within a largely theoretical analysis of the risks.

Power NI therefore believes that the UR's proposals provide a low estimate of what is required in the forthcoming control period, given the risks that Power NI face. An ex ante supply margin (St) entitlement closer to 3 per cent (as supported by previous submissions) would be a more realistic estimate.

Financeability

Having recognised the appropriateness of an increase to Power NI's net margin; this is then counteracted in the UR's proposals by adjustments to the allowed gross margin through arbitrary costs disallowances and the unwarranted application of an efficiency factor. When comparisons are made, as demonstrated in the chart below, between the current price control and the new proposal, it clearly illustrates that there is effectively no recognition of increased risks faced by Power NI.



Power NI therefore believes that the proposal currently represents a flawed outcome and does not appear to meet the fundamental financeability objectives which should be delivered by an effective and fair price control process.

Furthermore, by setting regulatory allowances below an efficient and fair level, UR are effectively acting against the best interests of customers by creating a retail market reference that is unattractive to potential new energy retail investors.

3 Scope and Coverage of the Control

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

While Power NI welcomes the further reduction in scope and coverage of the price control; the retention of any form of price controlled regulation in the non-domestic sector is fundamentally wrong, inequitable and inconsistent with central government /EU policy.

For some considerable time, Power NI has argued that if a market is demonstrably competitive, the prolonged application of a price control will compromise the proper operation of that market and is counterproductive. A regulated tariff that acts as a market reference price but is based on an unrepresentative set of cost drivers will distort the market and lead to poor customer outcomes. These outcomes are clearly not in the best interests of customers generally, or those customers who are taking supply from a competing supplier whose price offer is distorted upwards in line with the unrepresentative reference.

The non-domestic market is demonstrably competitive with four active suppliers all with market shares in excess of 15 per cent and a fifth supplier growing their market share very rapidly. The arbitrary sub-division of the non-domestic sector only serves to maintain an unrepresentative reference price and does not support effective competition or deliver consumer protection.

Regulatory Approach

Power NI welcomes the UR's commitment to "*commence a review of the effectiveness of competition in electricity retail markets and the resulting implications for the NI regulatory framework*". It is unclear, however, if this will encompass a roadmap and a forward looking view or simply be a report on the current market position. Power NI strongly believes that this work must provide a clear forward view with defined trigger points for the removal of price control regulation.

As highlighted in Power NI's response to the price control approach consultation, Power NI believes that the UR's monitoring and decision making in relation to coverage has not kept

pace with the Northern Ireland electricity supply market. While Power NI does currently retain a significant market share in the entire domestic sector (i.e. 75 per cent) Power NI in the Keypad sector for example, has witnessed a 34 per cent reduction in market share in approximately 2 years; if this trend were to continue Power NI's share of the Keypad market would drop to less than 50 per cent in mid to late 2014. This price control will potentially extend to 2017. By not adequately describing the regulatory view to 2017, the UR fails to provide transparency of expected market developments, does not support the further development of competition, is unable to move to longer term price controls, prevents Power NI undertaking normal business planning activities and is wholly unprepared to deal with the rapidly changing market dynamics.

The UR should develop and articulate to stakeholders a clear regulatory roadmap for the development of the retail electricity market after April 2014 which will protect the interests of consumers in the medium to long-term.

The key element to address in developing this clear regulatory roadmap is how the plan promotes a competitive supply market in Northern Ireland. The regulator, in carrying out its statutory duties, is required to promote competition unless the UR considers that it is inconsistent with the primary duty to protect consumers. While the statutory duties do afford the UR with some discretion it is also bound by EU law, and in particular Internal Energy Market legislation. Here the primacy of competition as the methodology to protect consumers is reflected in the European Commission's insistence on timetables for phasing-out regulated energy prices. It is worthwhile to note that the European Commission clearly view regulated retail prices as a barrier to effective competition.

The removal of the retail price control will allow consumers to engage with suppliers who are able to tailor products, participate in tendering processes, provide quotations and compete for their business on a level playing field. This is a requirement which has been clearly communicated by consumer associations and customers alike as it provides increased 'real' competition whilst having the comfort of consumer protection through normal regulatory arrangements.

The non-domestic retail electricity market in Northern Ireland already has more active competition than at the time those markets were deregulated in the Republic of Ireland and Great Britain. Contestability is a goal of the ideal market and Power NI believes it not to be in the best interests of customers that it continues to be effectively excluded from areas of the business market due to the current regulatory regime.

The regulatory review of the market should provide a transparent basis for a scope and coverage assessment. Regulatory market monitoring is essential to ensure the effective operation of the market. Market shares, switching rates and the number of competing suppliers are inputs of standard reporting. Power NI considers that in a rapidly evolving market, such as in Northern Ireland; quarterly reporting is insufficient and potentially hampers the UR's responsiveness. Pricing and tariffs will require the UR to be more active in monitoring and accurately reflect differentials between introductory and standard offers as well as aspects such as terms and conditions.

It is in this context that Power NI is particularly disappointed with the UR's approach. The UR seemingly is suggesting that should market shares reach a trigger point in the non domestic market only then will a consultation be issued to discuss options. This increases the level of risk to which Power NI is exposed. The UR also appears silent in relation to the domestic market and has not indicated any potential trigger points or timetable for consultation. This provides no real clarity of approach or certainty of action to Power NI, investors or the wider supplier market. It is also inconsistent with the EU's desire to see the active phasing out of price controls. Furthermore, such an approach does not allow for a transformational glide path and would ultimately only serve to add more delay and uncertainty to a regulatory decision making process.

Within the consultation paper the UR also makes extensive reference to the concepts of dominance, market power and the potential for abuse. Any framework for the assessment of market power and dominance must include consideration of the lack of competitive constraints. The Northern Ireland electricity market already has price competition between suppliers, low barriers to entry, unrestricted switching, consumer service level protection and a commonly accessible wholesale market.

In addition, Power NI unlike many of its competitors does not have supply chain power and would question the assertion that *"it is recognised that these [the separation licence conditions] will only be effective to a certain degree"*. This statement does not reflect the absolute separation between the Power NI and Energia business both managerially and operationally.

Given the explicit nature of the licence separation requirements on Power NI and Energia it is unclear as to why the UR is aggregating the market shares in its analysis. It is clearly inconsistent to mandate managerial and operational separation in one context then aggregate market shares in another.

Regulatory Analysis

The UR has consistently published information in its Quarterly Transparency Report which shows the non-domestic market split by connection voltage. Within the Consultation Paper the UR has sub divided its assessment into 0-50 MWh, 50-100 MWh and 100-150MWh consumption bands. As stated in our previous response, while Power NI believes these bandings may provide greater levels of monitoring detail, as stated above the entire non-domestic sector should be deregulated without further delay.

Annex 4 of the UR's paper provides the methodology used for reporting supplier market shares. Power NI believes that the criteria are fundamentally flawed. Annex 4 states that the data extracted will exclude unmetered sites and transmission connected sites. These 2 categories represent some of the largest consuming non domestic customers; any report which does not include these groups misrepresents the non domestic market. Power NI also believes that the report should include customers connected within the reporting period and not exclude them because of a part period issue.

Using the UR's published figures to assess the percentage of customers who will be subject to a regulated tariff² the UR is proposing to retain a price regulated non-domestic tariff for 4 per cent of the total non-domestic market and 33 per cent of the 0-50MWh band. Power NI believes that the assessment when used to determine if price controlled regulation should remain in effect clearly illustrates that the non domestic market should be removed from the coverage of this control.

The UR has positioned the assessment as a method of protecting customers from a potential higher non-price controlled tariff by insisting on a regulated price to act as a public reference. While this method is appropriate when competition is in its infancy, retaining the reference when competition is well established results in the controlled price being based on a smaller unrepresentative base. The price therefore becomes distorted as it is no longer reflective or appropriate for the non domestic sector. Non price regulated customers are thus put at risk of or actually will pay more as a result of such an inappropriate benchmark.

The retention of price controls in the non-domestic market is therefore no longer appropriate. Power NI believes any retention of a control would infringe the UR's obligation not to discriminate between suppliers and importantly does not act as a customer protection tool.

As price regulation no longer acts as a consumer protection measure and is no longer justifiable due to the levels of competition in the market, the UR should focus on the non price related process or consumer service protection measures such as is referenced in the recent Ofgem work.

Ofgem have introduced a new mandated process for “micro-enterprises”. This process involves new rules on provision of the contract terms and conditions, and on contract roll-over. At a high level, before entering into a contract a supplier must explain the key terms and conditions to the customer, and make it clear that the contract is binding. Before the end of the fixed-term period, suppliers must send customers a statement of renewal terms and details of the key terms and conditions which apply.

This protective measure is designed to protect all consumers in the “micro-enterprise” sector and have nothing whatsoever to do with price controls. Power NI has experienced instances in the current non price regulated sector of customers being unable to switch due to notice period requirements contained with terms and conditions. It is important not to confuse process protection measures with price control regulation; one is not a substitute for the other and it is incorrect to use the lack of one as a justification for the retention of the other.

Such process protection measures, as implemented by Ofgem, provide clarity for customers and suppliers as well as support for competitive pressure in the market. The measures are consistent with the IME3 licence changes recently implemented by the UR and set the competitive framework for suppliers to actively compete for customers. Given therefore the respective market shares of suppliers in the non domestic sector, the lack of competitive constraints and the distortion caused by price regulation; Power NI continues to believe that the full non-domestic market sector should be removed from the coverage of this control.

The full non domestic sector should be removed from the scope of the Power NI price control.

The retention of price regulation does not provide any qualitative protection and creates an unrepresentative, distorting reference price for the entire market which is not in the best interests of consumers.

The arbitrary sub division of the non domestic sector does not represent the competitive nature of the market and is inconsistent with stated policy objectives.

² Excluding group customers who are able to avail of a non price controlled tariff

4 Duration of the Control

Q4. Do respondents believe a control period of 3 years is appropriate?

As Power NI stated in its response to the approach consultation, the question of duration is inextricably linked to the development of the UR's strategic roadmap. Short term controls create a significant burden of regulation and remove efficiency incentives while long term controls do not adequately reflect the changing market. A 3 year proposal is a reasonable mid point however should not be considered as a long term control. Longer term controls typically last between 5-7 years.

Power NI is concerned that a 3 year control may be interpreted as the timeframe for the production of UR's market review. There is clear evidence that the Northern Ireland retail market is developing at a much faster rate than the UR acknowledges and that the regulatory framework lags significantly behind.

Power NI believes that there is a clear need for a process that leads to a progressive removal of price controls and a properly functioning domestic retail market. A feature of this model would be clear trigger points or undemanding re-openers which align the price control process with the roadmap. This would provide clarity for the market, reduce the regulatory burden, facilitate appropriate business planning and restore the basic premise of incentive regulation.

Such a framework should be completed as a matter of urgency and ideally in parallel to the price control process.

A 3 year control is a reasonable position to adopt given the changing nature of the retail electricity market.

It should not be taken to represent a long term control.

Duration is inextricably linked to the development of the UR's strategic roadmap to deregulation which should be completed as a matter of urgency.

5 Operating Expenditure (OPEX)

Q5. Do respondents agree with the UR's proposals for the allowed level of Operating Expenditure for Power NI?

Power NI is disappointed with the approach and proposals presented by the UR and its consultants BDO in respect to the opex assessment and subsequent disallowances. In total these disallowances amount to £833,000.

This opex review follows the 2010/11 and 2012/14 decisions which implemented severe reductions in opex entitlement; including disallowances due to what Power NI believes was the erroneous treatment of efficiency gains. Early harvesting of efficiency gains are a function of short price control terms (1-3 year versus 5-7 year). The disallowed efficiency gains from earlier reviews resulted in Power NI's share of gains being capped at an estimated circa 4 per cent to 8 per cent. Under a 5 year price control an expected share would have been in the region of 30 per cent. This compromises the basic premise of incentive regulation i.e. providing a reasonable return for risks taken in securing savings.

As communicated during the previous price control process and throughout this assessment, a 'line by line' approach while representing a reasonably transparent methodology is subject to significant error. While the UR did state an intention to conduct a 'top-down' review, BDO reviewed the Power NI BEQ submission on a line by line basis.

Such an approach does not take a holistic view using cost to serve benchmarks, but rather subjectively disallows certain opex lines based upon a consultancy view.

Assessing individual opex categories by taking the lower of Power NI's own cost forecast or a line item specific view of historic spend is fundamentally flawed. It gives no macro assessment to the overall efficiency levels of the business, fails to recognise that there is a likelihood of variation in reported individual cost categories and cost allocation methods; and implies a need for Power NI average efficiency to exceed best practice in order to achieve the baseline target. This places an unrealistic burden on the business and drives the opex allowance below comparable market levels.

While Power NI welcomes the assertion that it is an efficient business and believes this is a reasonable starting point for an opex review; to presume that everything will remain in a steady state is an oversimplification and reflects the general position taken by UR in recent reviews, that the business is exposed to little external cost pressure and the operating

context is stable and largely risk free. Power NI has consistently argued to the contrary. This most recently manifested itself following the introduction of the “Enduring Solution” billing system to facilitate market opening.

To base the assessment on the presumption that Power NI’s operating cost context is largely constant fails to forecast the changing market and places the entire risk on Power NI. Should there be any changes in how things are done in the market generally (e.g. changes to CfD auction platforms etc.), issues with the billing system, IT, the market, NIE’s meter readings, or movements in fuel prices covered in the press will each drive increased customer communications whether written or via the contact centre. Dependent upon the issue, project teams and IT development may also be required. None of these issues were given any consideration by the UR’s consultants despite being raised by Power NI.

The methodology employed therefore gives no consideration to the comparative overall efficiency levels or inherent allocation differences and if no adequate forward view is built into an opex allowance changes when they materialise can only result in an adverse opex outcome. For these reasons, Power NI believes opex should be assessed at a macro as well as if not rather than a micro level.

Power NI also highlighted that it is important that the UR recognises the impact the Enduring Solution Project had on Power NI. During 2011/12 and 2012/13 Power NI was engaged in successfully delivering the Enduring Solution Project. This project received precedence over all other activities and the business was entirely focussed on its success.

An effective moratorium therefore was placed on other activities until after the project went live and a substantial period of stabilisation was completed. This focus meant that a number of important business activities were deferred while Power NI was in project mode. This impacted the incurred opex spend in areas such as consultancy, communication, payroll and other individual line items. It is therefore inappropriate to selectively rely on a base year which was distorted by such a major undertaking. BDO gave no recognition of this in its assessment.

The UR has proposed disallowances in the areas of salaries, MBIS, Outsourced, Corporate Costs and Bad Debt. Power NI believes that it has provided substantial, reasoned justification for the cost proposals submitted through the Business Efficiency Questionnaire (BEQ) process. By contrast, the information provided by BDO both in the published papers and at the opex workshop, appear to target disallowances rather than attempt to assess what a reasonable level should be. In summary therefore, Power NI believes that the opex assessment has not been subject to objective macro assessment by BDO.

Salaries

While BDO and the UR have accepted the underlying staff costs as detailed in the Power NI BEQ submission; the UR is proposing to disallow the additional 7 people that Power NI sought to deploy in the functional areas of Front Office which include Call Handling and Debt Recovery (5 people), Trading (1 person) and Strategic Development (1 person).

The justification for the disallowance is unclear. While Section 4.22 of the BDO paper states that BDO were provided with “insufficient information” Section 4.25 states that “Power NI provided further information and explanations”.

The call handling statistics provided by Power NI clearly illustrates an increase in front line service activity. Total call hours are up in 2012/13 compared with 2009/10 by 28 per cent (despite fewer customers), calls per customer are up by 12 per cent, call duration has increased by 14 per cent and the trend continues into 2013. In Q3 2012/13 compared with Q3 2011/12 email traffic has increased by 48 per cent and online queries by 110 per cent.

The drivers of this activity are largely competitive activity (including calls from customers of other suppliers), change of supplier calls, general competitive activity i.e. customers shopping around and registration activity through customer churn. This is compounded by longer calls caused by new market processes.

In this area is the issue of debt management; increased debt management activity arising from higher levels of underlying debt, the drivers for which are described elsewhere, is a drain on Power NI’s resources.

The UR and BDO do not appear to acknowledge the significant increase in service effort required of Power NI as illustrated by the contact statistics and the projected debt levels. To deliver against the increased service effort and manage the projected debt levels, both of which are ultimately to the benefit of the generality of consumers, Power NI considers an increase in front line staffing as absolutely necessary and it is unclear why the UR/BDO have disallowed the additional staffing levels.

Power NI believes it necessary that the UR revisit the front line staffing issue.

Within the salaries submission Power NI also highlighted that 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. The active trading with GB and associated risk management activity is complex. Power NI believes it is entirely warranted to increase numbers in this area and hopes the work undertaken will be reflected in improved hedging

outcomes which will ultimately be reflected through the Gt term. Improved hedging will reduce end user tariff volatility, an issue which is of particular importance to customers and has been highlighted recently through ETI Committee and DETI investigations. Power NI believes this is an important area of work, is clearly in the customer's interest and due to the complex nature of the activity requires adequate resourcing.

The UR is aware of Power NI's intention in this area and is actively considering a proposition paper. It is therefore disappointing that there has been disallowance of the supporting headcount.

The additional person in Strategic Development is in fact a replacement for a member of staff lost in 2012. Due to the Enduring Solution requiring the business focus there was no replacement immediately sought. Following the implementation and stabilisation period Power NI has sought to replace this person in our analysis team. The UR's disallowance is an acknowledgment that the UR has not recognised the effect of the Enduring Solution and particularly its implementation phase has had on the Power NI business.

Power NI believes the submissions made for additional headcount are entirely reasonable, justified and prudent. Power NI is unclear as to why the UR has reached the conclusions proposed.

MBIS

The main area of MBIS disallowance is under the heading of 'Marketing'. As has been acknowledged by the UR, Power NI has consistently stated that Marketing is a term which is unhelpful in accurately describing the cost elements included in this section. These costs relate to communication with our existing customers not 'marketing' to prospective customers.

Power NI has provided historic, LBE and forecast figures in this area. Power NI has also provided an explanation of the drivers, justifications, proposed target areas and benchmarking information. BDO by contrast have recommended a disallowance based upon historic levels and has given insufficient consideration to market developments, context, benchmarks or Power NI's submissions.

Power NI argued that as a price control is in essence a proxy for competition, as Power NI has special licence conditions covering non-discrimination, Power NI therefore focuses on product and service innovation. This is an area that Power NI has a very strong track record of success.

Energy efficiency, consistent with our licence obligations and corporate social responsibility feature highly in our communication channels. Additionally, new products require explanation and marketing e.g. Keypad Reward. When considering this type of communication it is important to recognise that products such as Keypad Reward can benefit consumers through encouraging a relatively small change in average behaviour which delivers a cost saving to the customer. Uptake and delivery of such a customer benefit cannot be delivered without communication.

In forecasting marketing (communication) costs, Power NI not only considered the 'what to communicate' but the 'how to communicate'. Technology opportunities are driven by technological advancement and consumers driving need and increased expectations. Expectations are often driven by progressive competition and the need to provide similar channels e.g. competitors with mobile ready websites. If Power NI's communication methods do not evolve they risk becoming stale and losing customer interest.

Examples of increased technological based communication costs forecast are:

- Mobile ready website
- Changes to website design and embedded functionality³
- Automated email systems
- Email communication preferences
- Apps
- Social media presence set up and on-going costs
- Online advertising re how to save energy and money

Power NI believes that it is important that the UR recognises what is a reasonable amount of spend in the communication area. As the price control is a proxy for the costs incurred in running a competitive supply company Power NI has also considered benchmarking data -

- In 2008, the Big 6 spent £2.32 on average per customer on marketing. As confirmed by Mintel 2009. This translates to £2.59 per customer in 2012/13 prices.
- CER approved circa £2.25 per customer in respect of Electric Ireland's last Price Control before deregulation. This translates to £2.55 in 2012/13 prices and is line with the GB marketing costs.

The above references do not include sales and acquisition costs and therefore Power NI believes provide a valid communication cost benchmark. To apply a direct correlation, allowed by a peer regulator and in a deregulated market, to Power NI, would equate to a

³ Power NI has witnessed significant increased web traffic over the past few years

£1.4m allowance, a figure more than double the modest levels contained in the BEQ which equated to £1.12 per customer. Power NI therefore can see no justification in the UR proposing only £0.95 per customer, a figure in excess of 50 per cent less than comparable benchmarked references.

Furthermore, given that this control is likely to run until a time period almost four years from now, additional communication expenditure is warranted as the requirements for communications increases as competition continues and the market moves towards the removal of all retail price control regulation. As this transition takes place the level of marketing spend allowed must trend towards other relevant benchmarked market levels if Power NI are to be treated equitably in the marketplace.

Power NI believes that the BDO assessment in this area is flawed and has not given adequate consideration to the details provided. Power NI believes the UR should revisit this area.

Printing and Journal costs are areas which are more difficult to accurately forecast however the proposed disallowance is a further example of where lack of a forward looking assessment places Opex risk on Power NI.

Outsourced

Power NI notes the UR's conclusion that the BEQ submission in respect of outsourced costs is reasonable and expects that constructive progress will continue to be made in respect to some transitional IT costs.

Corporate Costs

In the area of Corporate Costs, the characterisation of an increased share is misleading. As included in the BEQ and clarified during the consultancy assessment phase, the Power NI apportionment methodology is consistent across the timeline. Allocating the corporate overhead on a revenue basis results in a lower cost allocation to Power NI than for example headcount, which would result in a 41 per cent allocation.

The question therefore is not one of allocation but rather if the cost increases are real and justified. Power NI has provided details on the activities undertaken at a corporate level. As stated in previous interactions areas such as Group Technology, Group Tax, Group Legal, Group HR & Payroll and SAP administration are undertaken by Viridian. The completion of such activities would require substantial additional resource and cost if Power NI were to operate on a standalone basis. Undertaking such functions at a group level provides a degree

of efficiency and economy of scale which could not be replicated within the business in isolation.

The increases forecast within the BEQ submission are directly related to an unavoidable upgrade of SAP, the implementation of Cognos which is required due to the increasing financial reporting complexity, an IT refresh which is also unavoidable, a necessary focus on IT security, a telephony support project to provide upgrades and enhancements to the underlying platform and HR requirements.

It would appear from the BDO report that no assessment of the activities completed or the activities planned was undertaken.

Bad Debt

During the price control discussions BDO presented an assessment of bad debt based upon averaging. Power NI expressed its concern with this approach and it is disappointing that due regard has not been given to the concerns raised.

The assessment is based on averaging the bad debt figures over the previous three years. Accordingly, the allowance for bad debt is based on the assumption that the next three years will be exactly the same as the last three. This approach is demonstrably incorrect and fails to recognise the drivers of debt.

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.

The time lag tends to occur as economic hardship drives consumers to run down personal savings and seek efficiencies by 'turning things off' in the first instance. Prolonged periods of economic difficulty, such as Northern Ireland is currently experiencing, result in the degradation of personal savings and efficiencies will only offer a partial solution. An intense prolonged recession therefore will eventually manifest itself in increased debt. This debt has an accumulating effect over time, further compounded the lag effect.

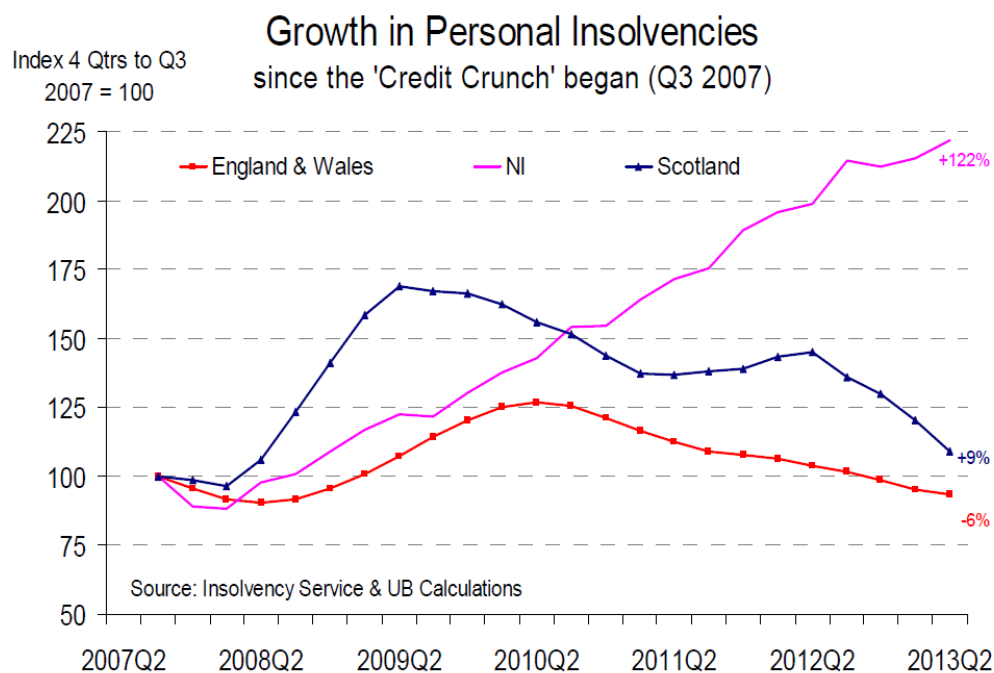
Difficult Economic Conditions

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. Indications are that recovery will be slow to materialise in increased standards of living of the general population.

The general UK economy continues to show only modest improvement, with growth expected to remain low, c. 1.8 per cent for 2013; with Northern Ireland lower at 1.2 per cent, the lowest growth of all UK regions still remaining in recession⁴.

Insolvency trends, corporate and individual, in Northern Ireland continue to increase compared to the GB average. Since Q3 2007, corporate insolvencies have grown by 30 per cent in England & Wales, 125 per cent in Scotland and 175 per cent in Northern Ireland. Individual insolvencies, over the same period have grown; 1.7 per cent in England & Wales, 36 per cent in Scotland and 115 per cent Northern Ireland⁵. Personal insolvencies in Northern Ireland hit a record high of 3,189 in 2012. This trend has continued in Q1 2013 with 3,231 insolvencies recorded over the last four quarters.

Indeed the most recent data demonstrates that the trend is worsening (see below⁶)



Corporate financial stress, or 'zombie companies', estimated at c. 30,600 in Northern Ireland and Scotland, where bank debt can be serviced but no growth continues to be of concern as

⁴Source – PWC UK Economic Outlook

⁵Source - Ulster Bank NI Individual and Corporate Insolvencies Q3 update 07 Nov 2012

⁶ Abstract from Ulster Bank NI Individual and Corporate Insolvencies update

banks, trying to rebuild their balance sheets, may cause insolvency by calling in debt, or placing too onerous conditions on ongoing debt⁷.

Unemployment in Northern Ireland is expected to continue to rise in 2013, estimated to be circa 3 per cent higher than 2012 at 66,500, which supports the view of growth in corporate insolvencies and corporate stress forcing staff redundancies⁸. Increasing unemployment will place additional stress on household budgets.

The housing market continues to stagnate, combined with demographic trends, this is driving demand in the private rental sector, and includes HMOs (where the use of Keypads is prohibited).

The recession continues to hit certain sectors e.g. high street retail and hospitality. These sectors account for circa 19 per cent of Power NI's business customer base.

Provisional figures indicate that the 'Total Income from Farming' (TIFF) in Northern Ireland decreased by 50.6 per cent (52.2 per cent in real terms) from £290m in 2011 to £143m in 2012⁹. Most farms continue to run at a loss with little prospect of improvement in farm gate prices. They were further hit when the EU CAP payments were cut by 8 per cent due to exchange rates. Impact of recent meat scares impacting on customer confidence in Northern Ireland meat products may lead to job losses and further problems in agri-food sector. Farms account for circa 2.0 per cent of Power NI business customers and high percentage of domestic customer base

Market Conditions

Three electricity market related issues have also caused underlying debt issues – competition, RPU changes and tariffs.

Power NI has experienced competitor 'cherry picking' of high usage debt free customers while student properties (HMOs) for example are not being targeted. As the UR is aware legislation prevents a Keypad Meter being fitted in HMOs. These activities in combination are increasing the proportion of high risk customers served by Power NI which tend to be high cost to serve and likely to incur debt.

The increasing levels of competition are also increasing the numbers of final accounts generated, creating opportunity risk of customer default as the leverage of disconnection or pre-payment debt recovery options are no longer available.

⁷ Source – PWC NI Economic Outlook Dec 12

⁸ Source – PWC NI Economic Outlook Dec 12

⁹Source: DARD

In addition to competitor activity; NIE introduced in May 2012 more stringent RPU practices. The implementation of the Enduring Solution in NIE has provided better information to their RPU unit with which to pursue illegal abstraction and tampering, as well as to their metering services assessing meter reading frequencies and potential metering faults. This activity tends to push fraudulent debt to the registered supplier to attempt to recover. Households where illegal abstraction activities are taking place clearly do not have any motivation to switch supplier (i.e. draw attention to themselves) and therefore almost all RPU debt risks fall to Power NI.

Fraudulent debt is among the most difficult to recover and the most likely to be eventually written off.

Additionally, as has been expressed by a number of stakeholders following the recent tariff announcement, electricity tariffs have an impact on debt levels. The retail tariff has recently increased by 17.8 per cent, world fuel prices do not show any indication of a downward trend, the NIE RP5 determination may prompt a significant upward network cost increase and substantial investment is required in both the electricity network and market. All these factors suggest that tariffs are likely to increase over the timeline of this review.

Power NI has attempted to take both of the major drivers of debt and the lag effect into consideration when forecasting future debt levels and it is disappointing that the UR or BDO did not attempt to complete a similar assessment when determining the bad debt provision.

BDO and the UR's conclusion therefore, that Power NI's bad debt levels should fall back to a level of a 3 year average completely ignores the reality of the current market conditions. Power NI has experienced a current debt level in line with the BEQ submission forecast and therefore strongly disagrees with UR's proposal to disallow £300k of bad debt.

One-Off Opex Items in years 2 & 3 of the control

Power NI welcomes the acknowledgment that there will be additional one-off items in years 2 and 3 of the control. Power NI further agrees that a number of those items are better suited to an Et term.

One of the items discussed was the implementation of the Supplier Obligation. Power NI expects that the energy efficiency aspects of Annex 2 of the Power NI licence will be removed when the Supplier Obligation is implemented.

Frontier shift and RPI-X

Power NI fundamentally disagrees with the UR's proposed introduction of an efficiency factor and the consultation paper does not provide adequate justification for it.

Power NI notes that the UR has not attempted to provide any reason or justification as to the inconsistency with previous Power NI price control determinations which included no X factor. The UR had previously stated that due to the short term nature of earlier controls (typically 2 years) an X factor was inappropriate. A 3 year control does not represent a long term control (which would typically be 5-7 years in duration).

Within the consultation paper the UR has not sought to adequately describe how efficiency factors are typically derived, has not completed any analysis as to the efficiency levels of Power NI to justify the proposal nor sought to ensure the appropriateness of quoted regulatory precedent.

- Catch-up and frontier shift

In the consultation document, the UR notes that the proposed one per cent efficiency factor 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. It believes that it is *"appropriate to assume that within [the time period of the three year price control] the impact of competition and changes in the market will lead to Power NI being in a position to make small extra efficiencies."*

Power NI considers that this is inconsistent with the evidence that Power NI is already efficient, does not recognise the 7 years between 2000 and 2007 when the UR applied an RPI-X efficiency factor which equated to a 17.5 per cent cost reduction. Neither could the requirement to attain incremental efficiency based upon outperforming the general economy by 1 per cent per annum be regarded as reflective of small extra efficiencies.

Conceptually there are two types of efficiency improvements that can be considered in an RPI-X framework: "catch-up" and "frontier shift:"

- Catch-up efficiency is defined as efficiency improvements which are made by adopting current technology or working practices, thus it relates to the extent to which firms should be able to catch-up to current best practice. An organisation which is considered to be inefficient in the present is deemed to fall short of the level of efficiency that is feasible (or achievable) with current technology and working practices (also known as the frontier of performance). In order to become more efficient based on current technology, the organisation would need to update its systems / working practices in order to catch-up to this frontier of performance.

- Frontier shift represents the movement over time that is achieved by the firms that are at the frontier of performance. For example, frontier shift efficiency in electricity supply could be the development of new billing software which was more efficient than the current technology, whereas catch-up efficiency would involve ensuring that all departments had the most efficient software based on currently available technology. It is a concept used by private companies, consultancy firms and regulators to help understand and compare businesses' performance.

Bearing these two types of efficiency in mind, it is clear that if a company is already on the frontier, there will be no need for "catch-up." The efficiency rate need only reflect expected changes in the frontier. Furthermore, because RPI is concerned with output prices, it incorporates both price inflation on inputs and the greater efficiency with which the economy uses them. This implies that the whole economy frontier shift is already reflected in RPI. Therefore, any sector-specific productivity adjustment in an RPI-X framework should be made on a net basis to avoid double counting economy-wide productivity growth.

Within the UR's Approach consultation was a proposal to use a frontier shift methodology developed for the NI Water price control to adjust Power NI's opex levels. The UR summarised Power NI's response to this proposal as stating that it was fundamentally flawed. The UR's summation does not accurately reflect Power NI's response to the proposal¹⁰.

The response reflects Power NI's belief that because of its position at the efficiency frontier a productivity growth assessment was not required. As the UR is aware, productivity growth is only one aspect of a frontier shift assessment. Should the UR have applied the full methodology Power NI believes a figure of between RPI + 1.5 per cent to RPI +1.8 per cent would have been concluded.

Power NI's assessment uses the methodology developed by First Economics for the UR and published as part of the UR's NI Water determination¹¹. As described by this report three elements are required to reach a final figure - input price inflation, productivity growth and RPI – measured inflation. The calculation is –

¹⁰ Power NI stated *"The reference to NI Water is illustrative of the dangers of using flawed benchmarks. NI Water is a monopoly network company making the first steps towards a semi-private state. It is widely recognised that NI Water has scope to make significant efficiencies over the next five years. Power NI by contrast is an asset light retail company which has, over the preceding 15 years, made significant efficiency strides and is considered to be at the efficiency frontier. To suggest applying the methodology developed to determine productivity growth assessments for NI Water to Power NI is fundamentally flawed."*

¹¹ http://www.uregni.gov.uk/uploads/publications/ANNEX_D_-_Rate_of_Frontier_Shift_-_PC13_FD.pdf

Frontier Shift = input price inflation minus productivity growth minus RPI – measured inflation.

First Economics state that 2014/15 general wage inflation is +4.4 per cent . Given Power NI's headcount levels this figure would be the major element of the input price inflation assessment. As stated above Power NI believes that the productivity growth would be zero although First Economics do quote a figure of (0.3) per cent for the business service sector which Power NI operates¹². First Economics also quote a figure of (2.6) per cent for the RPI-measures inflation element.

Power NI therefore concludes that the frontier shift methodology if applied would have determined a figure of between RPI+1.5 per cent and RPI+1.8 per cent.

- Power NI opex efficiency

The UR appears to be claiming through the assumption that Power NI can make further efficiency savings; that Power NI is currently inefficient on a relative basis compared to other electricity retailers in the Northern Ireland supply market. This contradicts earlier assertions that Power NI is an efficient business and is not supported by any evidence presented.

Despite Power NI's position as the main retailer in NI, its supply opex has been shown to benchmark well against comparator businesses in the UK and the Republic of Ireland. As explained above, this indicates that there is no need to account for catch-up efficiency.

Opex benchmarking, presented below, and performed by NERA in 2011 indicated that Power NI is at the frontier.

NERA benchmarking of Power NI opex:

Supplier	£/Cust/Annum	per cent vs Power NI
ESBCS ¹³	64	+137 per cent
Average GB	50	+57 per cent
Phoenix Supply	39	+44 per cent
Power NI	27	

¹² This was the figure used for the SEMO control

¹³ ESB Customer Supply

The table above shows that Power NI's supply opex per customer per year is well below comparable companies. It is even reasonable to argue that the disallowances of the previous price control pushed Power NI's opex to below an efficient level.

The UR has not presented any evidence to suggest that Power NI has not maintained its position at or below the frontier. In fact, the recent BDO review of the Power NI BEQ for the UR noted that they understood that "NIAUR considers that Power NI has a reasonably efficient cost base."¹⁴

This statement is at odds with the UR's proposing the application of an efficiency factor to opex, under an RPI-X methodology.

If Power NI is already at the productive frontier and the UR requires the implementation of an efficiency rate above the predicted level of frontier shift (as reflected in the RPI), the UR is building in a form of disallowance which places opex at a level further below that which would be available in a competitive industry. Setting such a contrived low level of opex may pass on a price reduction to consumers, but it may also reduce quality of service, delay market entry from potential competitors and represents an unnecessary regulatory interference in the market.

The UR also appears to justify this inclusion by reference to regulatory precedent.

- Regulatory precedent and the basis for one per cent

In the consultation document, the UR notes that the proposed one per cent *"is consistent with the approach taken for other controls in the UR, such as the Airtricity Gas Supply Control (formerly Phoenix Supply)."*¹⁵ Power NI considers this to be insufficient justification because:

- the approach taken for Airtricity was not based on a suitable evidence base
- the approach proposed by the UR is inconsistent with the approach taken for Airtricity as the Airtricity efficiency factor applies to opex only while the UR appears to be proposing to apply it to opex and margin for Power NI; and
- it is not consistent with the 0.3 per cent recently selected for SEMO.

¹⁴ BDO (July 2013) "Northern Ireland Authority for Utility Regulation: Review of Power NI BEQ" Available on the UR [website](#).

¹⁵ UR (2013): 'Proposals for the 2014 Power NI Supply Price Control'

The Airtricity Gas Supply efficiency factor of one per cent, cited by the UR, is an artefact of the 2011 Phoenix Supply Price control determination.¹⁶ This value should in theory represent a comparator for Power NI given its similar role. However, the determination document reveals that the basis for this value was evidence drawn from distribution network companies.¹⁷ Power NI considers that network companies are sufficiently different to provide only weak comparators for a supply business, such as Power NI.

Power NI is an asset-light company and as such is not able to drive future efficiencies from operating and building its asset base in the same way that an asset-backed network might. The supply business is fundamentally too different to networks to make direct comparison robust.

In the past, the relative size of supply opex when included within NIE's integrated structure may not have merited estimation of a separate opex efficiency factor. However, on a standalone basis, the efficiency factor requires attention in its own right. The precedent for one per cent as being a network-based efficiency rate is cemented in UR's adoption as the frontier shift assumption for the recent NIE T&D decision.¹⁸ The UR has not made any adjustment in its proposals to take account of the nature of Power NI's business.

Power NI does not accept that consistency with Airtricity is a strong enough argument for application of the proposed efficiency factor. This is all the more the case given the different implementation methodologies. Power NI considers that there is another efficiency rate that the UR would need to account for on these grounds. A 0.3 per cent efficiency rate was selected by the UR and the CER in the SEMO decision published on 8th August 2013.¹⁹

While SEMO is not a perfect comparator either, SEMO (a similarly asset-light, IT and staff based business) is more relevant for Power NI than the value for Airtricity founded on a network company evidence base.

In conclusion therefore, Power NI considers the arbitrary 1 per cent disallowance i.e. RPI-1 per cent is fundamentally flawed. The UR has not provided any supporting information as to how it reached this position, what analysis was completed and why the UR has sought to re-introduce an efficiency factor as a 3 year control does not represent a movement from a short to long term control. Should however the UR believe that a 3 year control merits an

¹⁶ NIAUR (November 2011) "Utility Regulator Determination on Phoenix Supply Price Control, 2012 – 2016"

¹⁷ Ofgem's DPCR5 and the Phoenix Natural Gas Distribution price controls.

¹⁸ http://www.uregni.gov.uk/uploads/publications/RP5_Executive_Summary_22-10-12.pdf, p. 16

¹⁹ "Opex will be subject to a revenue-cap regime adjusted by RPI-X with an X of 0.3." <http://www.allislandproject.org/GetAttachment.aspx?id=0a8ed021-338c-41b0-8a2b-135decb97039> p. 1

efficiency assessment Power NI believes a figure of between RPI+1.5 per cent and RPI+1.8 per cent represents an evidence based assessment.

The UR has proposed disallowances in the areas of salaries, MBIS, Outsourced, Corporate Costs and Bad Debt.

Power NI believes that it has provided substantial, reasoned justification for the cost proposals submitted through the Business Efficiency Questionnaire (BEQ) process and other supporting information.

The information provided by BDO both in the published papers and at the opex workshop, appear to solely target disallowances rather than attempt to assess what a reasonable level should be via the analysis of industry benchmarks and market conditions.

The BDO approach has focussed on specific line items and has not benchmarked Power NI's efficiency level against market levels. The approach taken therefore will drive Power NI's opex allowance to below industry best practice.

The proposed RPI-X factor should not be implemented as it is inappropriate, inconsistent, not justified and not required.

6 Operating Expenditure Allocation

Q6. Do respondents agree with the UR proposals for the allocation of the proposed allowed OPEX for Power NI?

Power NI fundamentally disagrees with the UR's proposals for the allocation of Opex between its price regulated and non-price regulated businesses. The UR proposals represent a 44 per cent increase in cost allocation unsupported by the cost drivers, which arbitrarily push the burden of costs from the domestic to the commercial sector and are not based on sound economic principles.

The current methodology was based on regulatory precedent in respect of what was agreed in 2008 for Phoenix Supply, and then reinforced in its application within the Phoenix (AGS) current price control 2012 – 2016. Power NI's BEQ submission was made in line with the previous UR price control decisions and there appears little justification in radically changing the allocation methodology.

The changes proposed by BDO centre on 3 main areas –

- Replacing revenue as a basis of allocation with units.
- Allocating the debt chase costs by units rather than customer numbers.
- Allocating billing system costs 80 per cent based on units and 20 per cent on bills rather than solely bills issued.

Power NI disagrees with each of these proposed changes.

Revenue or Units driver

BDO points to 2 main reasons why a change from revenue to units should be made; the effect of K and the lower price per unit charged to higher consuming commercial customers.

While it is correct to state that K will have an effect it can have either a positive or negative impact dependent upon the prevailing conditions.

Unit rates do tend to be lower for larger commercial customers as the application of Distribution Loss Adjustment Factors (DLAFs) and Distribution Use of System charges (DUoS tariff elements) are lower for customers who are connected to the higher voltage elements

of the electricity network. There are therefore, naturally lower revenues associated with larger customers on a per unit basis. This does not justify changing to units, Power NI believes that allocating costs on the basis of revenues better reflects the incurrence of costs than units which are not a driver of costs.

Debt Chase

BDO are contending that as the cost of debt chasing activity had historically been allocated on the basis of revenue, the allocation should be changed to units in line with their view on cost allocation generally.

In the analysis submitted through the price control process, Power NI was asked to break salaries down into more detailed categories, along with proposing the most appropriate cost driver. One of the advantages of the new Enduring Solution systems is that debt management effort is tracked through the automated record of debt chase letters, contact logging and detailed user level activity logs. Observed data tracking debt management effort and activity illustrates that customer numbers is the most appropriate metric.

Power NI believes that BDO have not adequately considered the type of customer which Power NI serves in the non-price controlled sector. Power NI's portfolio of customers in this sector, are overwhelmingly either governmental, local authority or blue chip commercial sites. All customers are credit checked and a significant proportion pay by direct debit or provide security deposits. This type of customer base ensures that the actual debt chase activity required is kept to a minimum and this is supported by the analytical information available.

Power NI therefore would strongly argue that there is no objective justification to change Power NI's proposed allocation from customers to units.

Billing ICT costs

Power NI currently utilises bills as the primary driver for Billing Applications and ICT. Should the current price control allocate Power NI costs using the precise Phoenix methodology of customers for billing and IT related costs the reallocation amount would be smaller than the Power NI submission.

During discussions with the UR, Power NI accepted that £33k was instinctively not the correct amount to allocate to non price regulated in relation to billing system costs. The BDO proposal of £332k however is manifestly inequitable, unreasonable and not supported by any substantive analysis.

BDO simply have applied a general “rule of thumb”, allocated costs based on an 80:20 split and derived a ten fold increase in cost allocation. Power NI fundamentally disagrees with this approach.

In an attempt to properly quantify what a reasonable cost allocation would be, Power NI commissioned an independent report which was provided to the UR. The report was written by an expert in the provision of IT solutions for retail billing. The conclusion reached was that even with a small number of customers such as Power NI are supplying in the non-price controlled sector, there would be an unavoidable cost of £90k incurred to set up and run an IT billing solution. This system would be useable up to a base of 25,000 customers, a figure well below the Power NI non price controlled portfolio.

In recognition of this conclusion therefore Power NI proposed that the bills issued metric should be used with a £90k floor i.e. a £90k minimum reallocation if the bills metric calculated a lower amount. Power NI believes this represents a reasonable methodology to base the reallocation calculation as it is based upon expert analysis.

Power NI therefore urges the UR to revisit the billing cost reallocation and base it upon substantive analysis.

The UR proposals represent a 44 per cent increase in cost allocation and are based upon unsupported changes to cost drivers which arbitrarily push costs from the domestic to the commercial sector rather than sound economic principles.

Power NI provided a considered and reasonable cost allocation solution especially with regard to dealing with the difficult issue of billing system costs.

7 Margin

Q7. Do respondents agree with the proposed margin of 2.2 per cent ?

The UR has proposed an allowance of 2.2 per cent of turnover as the appropriate level for Power NI's supply margin for the forthcoming price control period.

Referencing previous analysis by CEPA and the UR's own economic consultants, Economic Consulting Associates (ECA), the UR concludes that: *"this is a reasonable estimate of the appropriate margin for Power NI and balances the UR's statutory duties to protect consumers, and also ensure that regulated companies can finance their activities."*²⁰

While a margin allowance of 2.2 per cent represents progress towards recognising the risks which Power NI face and the capital requirements of its regulated business, Power NI believes that the UR's proposals, and ECA's supporting analysis, give limited weight to the impact that the changing retail landscape in Northern Ireland has for the ability of Power NI to finance its regulated activities. Power NI is clearly significantly less dominant than when a monopoly supplier and has transitioned to a position close to when comparable suppliers had price controls removed²¹ and were deemed to be no longer dominant. The relatively modest increase in margin from 1.7 per cent when Power NI supplied 100 per cent of the domestic market, to 2.2 per cent when supplying 74 per cent, does not equate to a transition towards market margins at 60 per cent. As the Northern Ireland market becomes increasingly competitive Power NI's margin must transition to competitive levels.

Power NI believes that too much weight is placed by the UR on ECA's risk-based methodology particularly ECA's quantification of K risk and how investment/cost recovery risk is therefore accounted for in the UR's margin proposal. Power NI believes the CEPA method of calculating the margin, based on the forecast capital requirements of the business, cross-checked to practical evidence of financeability constraints retail electricity trading businesses face, provides a more reliable estimate of the required margin.

²⁰ UR (2013): 'Proposals for the 2014 Power NI Supply Price Control'

²¹ Power NI's current domestic market share is circa 74 per cent . CER removed price controls at 60 per cent

Capital and regulatory commitment

As CEPA explained in previous reports, the K term in Power NI's pricing restriction is intended to provide an allowed revenue cap for Power NI, protecting the company from volume and cost recovery risk. In theory it ensures that if allowed revenues are not recovered today they can and will be recovered by the business tomorrow.

K is therefore based on an assumption that Power NI has a sufficient retail customer base, the regulatory approval and sufficient pricing power (from which it can sustain any required level of retail prices) to enforce its revenue cap. Historically it has been against this retail market context, regulatory regime (with associated incentive properties and risks) and, importantly, form of regulatory commitment, that investors in Power NI have been expected to commit their capital.

The UR's own analysis illustrates how significantly the retail environment is changing. With increasing competition, the dynamics of the market and the inherent timing mismatch between the incurrence of costs and their recovery (with associated risks) is changing. The dynamic process of the market, combined with declining regulated customer numbers and Power NI market share, mean that the previous protections and regulatory commitments to investment recovery that we outlined above, no longer provide the same quality of risk mitigation for the business.

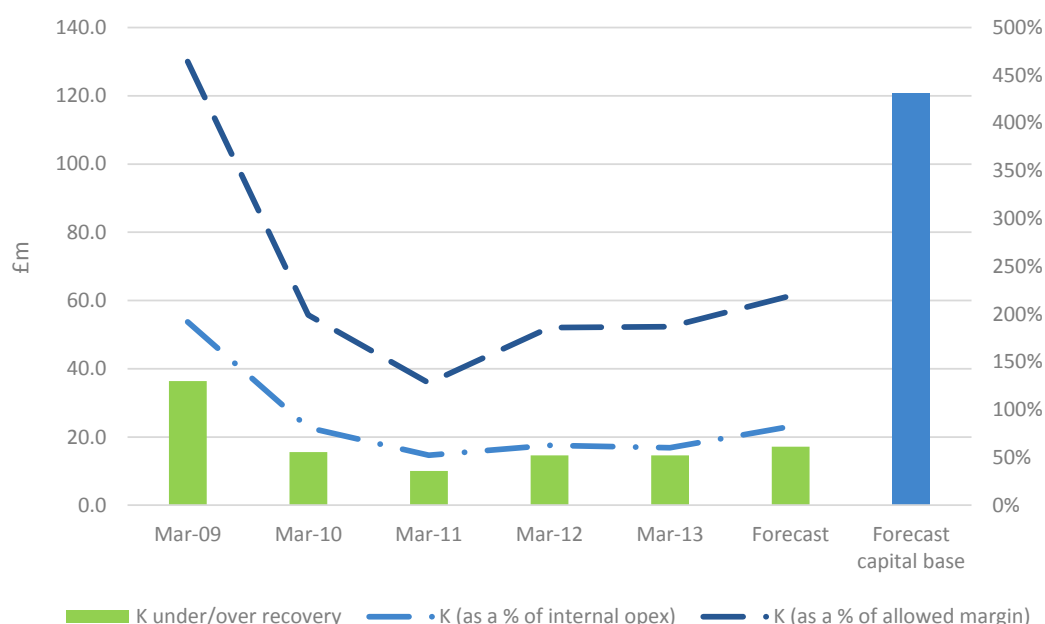
Power NI believes ECA's report underestimates the impact of this fundamental shift in capital and regulatory commitment as a result of the changing retail landscape in NI:

- Firstly, accepted ex ante principles of regulatory commitment to Power NI capital may not be perceived as reliable. As highlighted previously, the UR cannot ensure that Power NI will always retain a sufficient size of customer base, regulatory approval to recover costs and sufficient pricing power to always facilitate the full recovery of K. As the previous protections and regulatory commitment to the retail businesses capital can no longer be so strongly relied upon in the increasingly competitive market, this fundamentally alters the basis of investor risk and return in the context of the forthcoming price control period.
- Secondly, commercial protections against the risks of accumulating under-recoveries are based on theoretical inferences, not the practical circumstances of the market. The examples that ECA provide of how Power NI could manage K risk illustrate again how the state of world has changed. While fixed term supply contracts and hedging policies may

provide a market based means, in certain circumstances, to manage aspects of risk, no evidence is provided by ECA that the practical circumstances exist to implement such strategies. As highlighted previously, there are significant practical constraints on the contract hedging market which may prevent Power NI from efficiently managing certain risks in a context where it is still subject to price controls.

Capital at risk

Given the conclusions on capital commitment, the size of the required capital base and level of return risk in Power NI's business is underplayed by ECA's analysis.



Source: CEPA analysis of Power N data

As shown above, on a peak seasonal (annual) basis, Power NI's business is forecast to require over £120m in capital in the forthcoming control period, including nearly £20m to finance forecast K under-recovery. This is a significant capital requirement that must be in place (100 per cent available) for the full course of the trading year.

On a historical basis, there have also been examples of an accumulated K greater than £35m. Previous submissions illustrated how the business can typically need to cover an under

recovery of allowed revenues of as much as 50 per cent of its internal operating cost base and even greater. A 2.2 per cent allowed margin on a turnover of £356m equates to just under £8m. To place this in context, the forecast (2014/15) peak seasonal K under-recovery is 219 per cent of the proposed allowed margin.

Historical and forecast analysis illustrates the real possibility of significant under recovery of wholesale purchasing costs. Thus the value at risk is high relative to Power NI's "thin" margin allowed in price controls.

Power NI also questions the basis on which ECA suggests it has quantified the additional margin requirement for asymmetric K risks (0.3 to 1.0 per cent) through its return volatility approach. There is no reference point to establish whether ECA's quantification of K/investment recovery risk for the forthcoming control is reasonable or not. ECA have stated that they assume a relatively low propensity for customers to switch, which is not supported by the market information and switching levels seen since domestic competition began. A fundamental shift in the risk profile of the business is only captured within ECA's risk-based approach by a representative ball-park figure based on illustrative expected loss assumptions.

There are numerous plausible scenarios for how K could be an imperfect mechanism in an increasingly competitive market, and investors are fully aware of that risk, and would require a commensurate risk premium and margin to invest in the business. But attempting to directly quantify a theoretical return requirement for individual risks that the business faces, removes the focus of the analysis and overall judgement of the required margin from the practical financing requirements of the business.

For these reasons Power NI believe that the CEPA approach to 'triangulate' a required supply margin from a proposed cost of capital and forecast capital requirement, has a far stronger and more practical analytical basis than ECA's risk-based volatility method. It takes a relatively conservative starting assumption of the asset beta²² and debt facility costs of Power NI's business, and provides a clear basis for establishing what type of return requirement (accounting for various types of risk) could be needed to support the business in its financing.

²² Compared to observed beta's for retail companies and that allowed for other regulated physical 'asset-light' companies in the UK.

In conclusion therefore, Power NI believes the riskiness of the business continues to be underestimated by ECA's analysis, particularly as a result of how key financeability issues, such as capital commitment, are treated within a largely theoretical analysis of the risks.

On that basis, Power NI believes that the UR's proposals provide a low estimate of what is required in the forthcoming control period, given the risks that Power NI face. An ex ante supply margin (St) entitlement closer to 3 per cent (as supported by previous submissions) would be a more realistic estimate.

Power NI believes that should the UR set the margin at the proposed levels i.e. below a fair and reasonable level, the UR will hamper competition.

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

Power NI agrees with the UR's analysis that a 70:30 split is more representative of the underlying fixed: variable drivers.

As discussed with the UR, a mid year customer number figure should be used in the calculation to reflect the effect of customer attrition in the calculation.

The riskiness of the business continues to be underestimated by ECA's analysis, particularly as a result of how key financeability issues, such as capital commitment, are treated within a largely theoretical analysis of the risks.

Power NI believes that the UR's proposals provide a low estimate of what is required in the forthcoming control period.

A supply margin closer to 3 per cent (as supported by the detailed analysis) would be a more realistic estimate.

A 70:30 split is more representative of the underlying fixed: variable drivers.

8 Structure and Form

Q9. Do respondents continue to believe the existing structure and form remains appropriate for the next control?

Power NI considers the current structure and form of the price control as generally appropriate.

As the UR has characterised, a number of one-off costs were raised during the price control interactions. Power NI believes that all the submissions made are entirely justified and due to the uncertain nature belong in an Et 'pass through' term. Power NI will engage directly with the UR on these items through the modification drafting phase.

The UR has stated a new intention to allocate new pension scheme deficit costs between the price regulated and non-price regulated businesses within Power NI. Power NI believes that the current methodology and allowance for pension recovery is correct. It would be wholly inappropriate and inequitable to reallocate a legacy issue which relates to past service prior to the concept of price or non-price regulation to the non-price regulated business within Power NI.

Current service obligations are allocated, legacy obligations should not be. Power NI will engage directly with the UR on this issue.

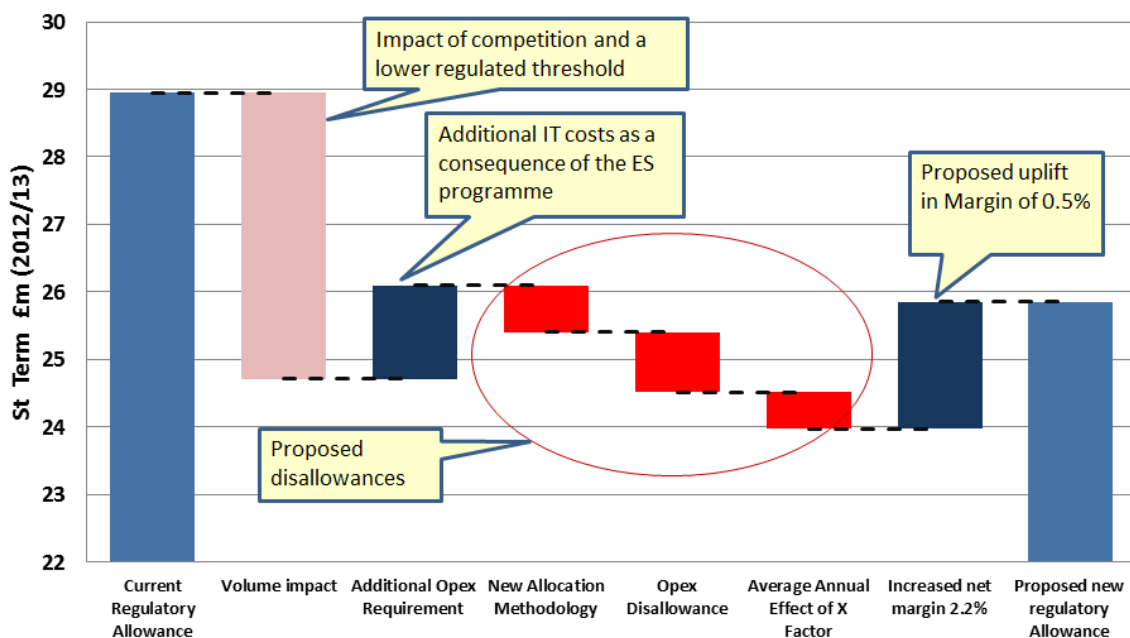
Power NI considers the current structure and form of the price control as generally appropriate.

9 Financeability

The UR has a duty under Power NI's operating licence to ensure that where price controls are applied to its licensed activities, the company is able to finance those price controlled activities. In its original Approach consultation, the UR has suggested that it can best discharge this duty by demonstrating that it has a robust, evidence based methodology for calculating allowed opex and margins. Power NI welcomed the UR's commitment in the Approach consultation to adopt such a robust evidence based approach to determining opex and margin.

Power NI has consistently argued that the allowances associated with this proposed new price control should be properly reflective of the new operating landscape and risks that the business is now exposed to relative to the period under consideration when the current price control was proposed.

It is therefore highly concerning, that overall, when comparisons are made between the last price control and the new proposal, that there is effectively no recognition of increased risks. In essence, the increased margin proposed by the UR is displaced by arbitrary costs disallowances and an erroneous application of an efficiency factor (see diagram below).



Power NI therefore urges the UR to revisit the issues highlighted in this response, as the proposal currently represents a flawed outcome and does not appear to meet the fundamental financeability objectives which should be delivered by an effective and fair price control process.

The increased margin proposed by the UR is displaced by arbitrary costs disallowances and a flawed application of an efficiency factor.

The proposal currently represents a flawed outcome and does not appear to meet the fundamental financeability objectives which should be delivered by an effective and fair price control process.

10 Next Steps

Power NI trusts the UR will revisit the areas highlighted in this response. Further engagement may be required specifically on areas of scope, opex, allocation methodology and margin to ensure that an effective and reasonable final determination is reached. Power NI is committed to constructively engaging with the UR on these issues through the next phase of the price control process.

In parallel with finalising its decision it will be important that the UR also reaches a conclusion on the treatment of collateral costs. Power NI notes that both CEPA and ECA acknowledged that collateral costs are an issue which can be dealt with via the Gt term. This is an important element of the financeability question. Power NI will therefore seek to engage with the UR on this issue and will consider the outcome alongside the final margin determination.

Finally, Power NI notes that the Et term has not been a focus for this consultation and therefore does not expect major change to the Et structure, with the exception of the new one-off cost items that have been highlighted in Section 5.

Power NI urges the UR to revisit the areas highlighted in this response.

Further engagement may be required to reach a reasonable outcome.

Collateral cost issues must be resolved in parallel to ensure the financeability test is met.