The Utility Regulator's Proposals
for the
2014 Power NI Supply Price Control
Consultation Paper

SONI Response

1st October 2013

Introduction

SONI welcomes the opportunity to comment on the 'Proposals for the 2014 Power NI Supply Price Control' consultation paper (the 'proposals paper') published by the Northern Ireland Authority for Utility Regulation (NIAUR) on 23rd July 2013. It does so as holder of both System and Market Operator licences as well as in the desire to ensure that network businesses in Northern Ireland and in particular the energy sector are capable of conducting their activities on a sound financial footing, ultimately providing a more economically sustainable electricity industry for electricity consumers.

As per our response to NIAUR's earlier consultation, 'Approach to the 2014 Power NI Supply Price Control' (the 'approach paper'), this paper incorporates analysis of a number of regulatory building blocks which are of specific interest to Power NI, as a retail electricity supplier, its competitors and customers, and SONI has no material comment to make on those particular areas. As an organisation with regulated electricity businesses in Northern Ireland, SONI is however inherently interested in general regulatory reviews of regulated businesses - their context, approach and decision making processes. However, as SONI is also similar to Power NI in that it is a regulated business, with a relatively low physical Regulatory Asset Base (RAB), subject to significant financial through flows and consequential working capital requirements; there are specific aspects of the Power NI Supply Price Control that are of interest to SONI and we will focus our comments in relation to these areas.

In addition to our interest in certain regulatory building block elements of this price control (PC), SONI is generally interested in the appropriate framework and regulatory treatment of an asset light regulated business operating in an industry more traditionally associated with a utility industry with significant physical assets and asset bases. Power NI's regulated charges are designed to cover the addendum of allowable costs including cost of capital, depreciation, operational expenditure and (net) profit margin. As its overall financial well-being depends heavily on such regulatory decisions, Power NI, like SONI, requires a stable regulatory framework which is fair, balanced and well structured. Over time, this formula is most likely to deliver the required outcomes for society and industry which ultimately leads to the desired and best benefits for consumers.

Consultation Issues

Essentially there are 3 main areas which SONI wishes to comment on in relation to this PC, specifically:

1. Financeability
2. (Net) Margin
3. Operational Expenditure

Financeability

The term 'financeability' could be described as being void of a universally recognised definition yet is frequently discussed, debated, determined and challenged, particularly in the regulated utility environment. Moreover, it is a requirement of the regulator to have regard for licence holders to be able to finance the activities associated with its licence obligations. As per NIAUR's consultation paper Ofwat[1] has previously referred to it as the Cost of Debt (and not the Cost of Equity) element of capital cost analysis. They have more recently described it as meaning that the price limits set are 'sufficient for efficient companies to raise the finance they need so that they can invest to deliver the services those customers expect'[2].

Whilst the term is more usually associated with traditional asset based businesses, or those with large investment requirements and/or poor cash positions, the principle of companies raising finance so it can invest to deliver the service expected can be equally applicable to retail or asset-light businesses. The reference to *sufficiency* in raising finance could also be interpreted as a move away from a Cost of Debt focus. In essence a more general interpretation of the term could be the collective arrangements in place which allow a business to service its (debt) liabilities and (equity) investors, sufficiently and efficiently.

In the approach paper published prior to the proposals paper, NIAUR questioned the relevance of financeability for retail – as opposed to network – businesses. This was attributable to three reasons, which were based around the lack of requirement for previous or new capital investments; the resulting assumption re the absence of (accumulated) balance sheet; and the real versus nominal return mismatch. While it is accepted that retail – or asset-light – businesses do not in general make large-scale capital investments, in the traditional interpretation of this, it is important to recognise - and remunerate appropriately - all assets employed in the delivery of efficient services - be they physical, financial, human or intellectual capital (or property).

If the Regulator employs capital cost methodologies solely based off physical infrastructure then additional revenue tools (e.g. transaction fees, margins, incentives etc) are required to adequately remunerate the building of non-physical assets which are equally required for a business to carry out its licensed activities. The basis of remuneration for performance in service companies outside the utility sector is based on a combination of human capital, intellectual property and the cohesion of the various factors of production within the context of the overall organisation. But as per the requirement for a sufficient (which may be different to appropriate) return to businesses with large physical asset capital, regulated businesses which are asset-light are equally entitled to a sufficient, fair and reasonable revenue income which allows the business to raise the finance it requires to invest in the delivery of services their customers expect, or in more general terms - to service its (debt) liabilities and (equity) investors, sufficiently and efficiently.

[1] The Water Services Regulation Authority in England and Wales
[2] Ofwat – Financeability and financing the asset base – a discussion paper

Is a remuneration calculation enough?

Regardless of the methodologies or tools employed there are three key concepts that are important from SONI's point of view:

1. A regulated entity heavily involved in commercial, financial and investment transactions requires a **stable remuneration framework** to operate within which will provide it with revenue streams sufficient to convince financiers and investors to provide it with the most efficient source of funds. In this regard the current framework in place is heavily associated with network owning, physical asset rich entities. It is not appropriate for asset-light regulated entities and particularly those who wish to deliver not only an efficient service, over time, but value-add features for the benefit of consumers.

2. There must be a reasonable level of **regulatory consistency** across utility price controls employing the building block methodology for determining allowable revenues. While deviations may occur from time to time, and may be justifiable, the absence of a framework and the consistent application of its basic principles lead to a perception at least of higher risk which in turn translates into higher costs. With regard to financeability SONI would have particular concerns regarding the consistency or otherwise in the treatment of contingent capital between the Power NI and the recent SEMO price control.

3. It is important to accept that despite the many advantages associated with building block methodologies it is the **overall assessment** of the cost of capital, in conjunction with other financial measures, that an organisation is concerned with, as this is where the investment markets' interests lie. And because it is the participants of the latter who ultimately determine actual capital cost (with subsequent consequences) this should be of equal concern to consumers and their representatives.

Margin

NIAUR states in its approach paper that it did not deem it necessary to apply a traditional financeability test to retail price control decisions due to its history relating specifically to Networks and that it was not obvious as to how relevant it is for retail businesses. As per our comment set out in the section above we believe the principles of financeability can apply equally for retail (or asset-light) businesses. Regulated price limits must be set at sufficient levels which allow an efficient licence holder to finance its licensed activities, presumably at fair cost to consumers over time.

In general, regulatory decisions regarding allowable revenues (tariffs) of traditional, asset-heavy, utility organisations include a large element of review and assessment of the RAB and an allowed Cost of Capital (most often by employing the WACC methodology). In traditional, asset-light, utility organisations the same methodology may be used to determine allowable costs for capital expenditure projects; however due to the low RAB this cannot translate into enough revenue value to efficiently finance activities. However once a business has a revenue stream that appropriately satisfies its operating costs (and interest payments, taxes, equity and debt liabilities) efficiently; then it should be capable of financing its activities (and hence 'financeable'). The revenue stream may comprise of the (allowable) margin or be a combination of revenue streams considered suitable and fit for purpose for the characteristics (its systematic and specific risks) of that particular business.

The Options for Determining Margin

The approach paper referred to three potential methods for 'calculating margin' that the Regulator was considering as an allowance for profit. The first two were based on a traditional 'Return on Sales' margin approach whilst the third option, based on 'Capital base * cost of capital', appears to have been discounted thereafter. The subsequent proposal to increase the (net) margin from 1.7% to 2.2% does indeed increase (by £3/annum) the average customer bill however (net) margin should not simply be thought of in terms of shareholder return as the more financially secure a business is the less financing costs it is likely to incur on an ongoing basis e.g. working capital requirements.

As part of the SONI response to the approach paper SONI commented that it did not agree with NIAUR assessment that it was inappropriate in assessing the capital base of the business to include intangibles. SONI believes the purpose of a price review in a regulated supplier context is to simulate a competitive marketplace with a fair and level playing pitch. In a competitive marketplace non-physical capital is required for successful business growth and sustainability. To not provide for this can distort the competitive market landscape required to ultimately protect consumers on a sustainable basis.

Also in SONI's aforementioned response, we stated our agreement with NIAUR that shareholders should not expect to make supernormal or subnormal profits however we did not agree that this necessarily translates into what NIAUR terms 'a fair bet in which the chances of making money or losing money are equally balanced'. SONI explained that financial markets are underpinned by standard investors, who are in general risk adverse and require compensation, over and above a 'fair bet' where the odds are somehow equal in respect of reward or loss, in order to make investment. In the NIAUR proposals paper this has been somewhat misinterpreted as SONI stating that profits must be more than a 'fair bet'. SONI would like to see this point clarified by NIAUR in its final decision paper.

Regardless of the delivery mechanism(s) selected, it is the overall value that is allowed to the (regulated) business that is of its concern, as well as it is to the lending and investor markets, and ultimately customers (who at first may believe it is in their best interests to have the lowest possible level selected). Ofwat stated the risk to customers of setting too low a cost of capital when setting price limits in 2009[3] – and the principle extends to margin.

Ascertaining an Appropriate Margin

We understand that NIAUR engaged external expert consultants (Economic Consulting Associates or ECA) to provide it with analysis and that this was subject to peer review provided by a separate consultancy (First Economics). Power NI also engaged expert consultants (Cambridge Economic Policy Associates or CEPA) as part of their preparations for the review. This resulted in a wide

[3] Ofwat 'Future water and sewerage charges 2010-15: Final Determinations'

margin range, from 1.7% to 3.7%; although the higher end is quoted as 2.8%, due to CEPA providing a subsequent unpublished report reducing their original 3.0% - 3.7% assessment to 2.8% - 3.0%.

The range of +0 to +2% over the current margin of 1.7% is not in itself surprising. Indeed in similar reviews the range has been wider e.g. a recent report for Water UK by First Economics quoted a review of *relevant* benchmarks range as being between +0.5% to +6%[4]; although the former was based on the Monopolies and Mergers Commission's conclusion in a 1995 inquiry into Scottish Hydro-Electric's price control while the latter the high end of the most recent experience of average post-2008 margins for GB energy retail businesses. The 'benchmarks' were relevant to the utility sector though still somewhat wide-ranging with regard to source.

As part of the approach paper NIAUR commented on a recent retail margin review by Ofgem (a 2011 report[5]), which was also referred to in the aforementioned First Economics report, where a 'generic' retail benchmark was reported at 5.8% margin on turnover with two key reference numbers – a 1.5% margin for a hypothetical business that faces no volume or upstream energy price risk and a 3.0% margin where there is volume risk but no upstream energy price risk. The key aspect of these risks is the ability of the business to recoup any additional costs due to volume or price risk. If there is certainty for recovery then the lower margin level may be appropriate. Where the risk to cost recovery increases, the margin must also increase, as otherwise the business is at risk of incurring extra financing costs (at a minimum).

SONI notes the approach as set out by both CEPA and ECA which examines the capital requirements, both core and contingent, and applies a notionally geared WACC arrangement to both. In general, as a proposed framework, SONI believes this approach has merit and should be adopted more widely in relation to dealing with liquidity demands. Unfortunately SONI notes that such a framework, even after adjusting for risk, has not always been applied consistently by NIAUR, including in relation to the SONI business(es). It is important that a consistent framework which is understood by investors is applied consistently, and non discriminately by NIAUR to all licensees. This is something on which SONI wishes to engage further with NIAUR as it both reaches, and following, its decision in respect of Power NI.

As a regulated utility in Northern Ireland one area of concern to SONI is that a relatively large range of appropriate supply margin formed the basis from which a point estimate has been selected. Power NI, as with all other asset-light businesses, has a number of systematic and indeed specific risks included in its own set of characteristics, the former more particular to the Northern Ireland context, the latter particular to its industry sub-set or the organisation itself.

SONI understands that selecting a relevant range requires particular expertise and experience in this area and hence NIAUR determined to procure the services of two different consultants to provide NIAUR with the relevant advice. Perhaps it is testament to this point that in the finish, despite a quite a particular set of characteristics, the eventual range of ***appropriate*** answers was quite broad, making the selection of a ***sufficient*** point all the more difficult. As the monetary value of such a decision determines the underlying financeability of the business over the long term, just like the

[4] First Economics: Setting the Allowed Margin for Retail Price Controls – A report for Water UK; March 2013; pg.2
[5] Ofgem The retail market review – findings and initial proposals

selection of a WACC point for asset-heavy organisations, the concept of 'aiming up' is just an important one. It recognises the fact that the overall cost implications of calling the point on the lower side of "right" rather than the higher side of "right" can far outweigh any benefits that might be initially associated with a persistent pursuit of cost cutting.

Operational Expenditure (Opex)

In the approach paper NIAUR proposed an alternative, frontier shift methodology for setting Opex, over the current line-by-line approach. We understand that Power NI themselves were not in favour of the former and as such recognise that their view of their own business specific characteristics supports that position. However SONI does not hold the same view and in general are supportive of a frontier shift approach as a basis which could be adapted so that it is fit for purpose as a suitable cross-utility framework.

We understand that the NIAUR proposal to opt for the 'RPI – x' methodology is based on a combination of (regulated) business choice and the (regulators) view that the benefits of the frontier shift methodology for energy utilities was unclear while the (proposed) approach allowed for the alignment of the gas and electricity sectors within the energy sphere. SONI's view of the frontier shift approach it that it would provide a very suitable framework for asset-light entities and on a cross-utility basis (in 2012 NIAUR implemented it for Northern Ireland Water)[6]; and provides a substantial amount of recent research, experience and regulatory practice factors around which such a framework could be built.

In SONI's view, the current RPI – x proposal imposes an efficiency factor on the regulated entity that is asymmetrical in nature. It is clearly demonstrable, across all industries that over time, real prices rise, and as such so do general business cost. As a result, it is more likely that an organisations cost (including wages) will increase rather than decrease (again over time). In a competitive marketplace it is in an organisation's own interests to maintain costs at efficient, yet sufficient, levels, over time and at the same time continue to deliver an efficient level of service plus value-add activity which ultimately delivers benefits for consumers. It is difficult to ascertain how the RPI - x methodology will succeed with these objectives in mind. Further it is even more difficult to understand the justification for a -1% 'x'.

One of the more successful strategies in maintaining costs at sufficient yet efficient levels, over time, is by way of incentivisation programmes which reward organisations for good performance and value-add services which provide benefit for consumers. Adopting a methodology which is deliberately set up to reduce opex rather than enhance service appears to be counter-intuitive to such strategies.

[6] Ref: Water and sewerage service Price Control 2013-2015 Northern Ireland Water; pc13 Final Determination Main Report; December 2012

Summary

1. Financeability: A regulated entity is entitled to expect to recover its required revenues in order to finance the activities associated with its licence obligations. If sufficient revenue recovery cannot be relied upon by the spectrum of regulated businesses it creates uncertainty and risk which in turn will be reflected in such regulated businesses costs, including its cost of finance, which ultimately is borne by consumers in general. There is a real requirement for not only an appropriate framework for financeability (and cost recovery) for asset-light utilities in Northern Ireland but also for a consistent approach in relation to same.

2. Margin: Traditionally regulated utility companies have been (physical) asset-heavy in nature and have been entitled, through regulation, to a revenue stream normally based on an assessment of a sufficient level of the cost of capital which is applied to a large regulated asset base. Due to their relatively low asset base(s), supply or service companies tend to rely on separate or different revenue streams including margin which will allow it to operate efficiently, over time, and to raise the finance it is required to invest to deliver the services their customers expects.

3. Operational Expenditure: It is entirely correct to ensure that a regulated business's operational costs are efficient and effectively neutral to those incurred by a similar business operator in a similarly competitive market in a similar environment and with comparable systematic and specific risks. In the event that costs are not near to neutral there is possible justification for an RPI – x methodology of operational cost control. However in the longer term this is not a sustainable approach and would not appear to provide good performance or value-add service to consumers.

Conclusion

- Financeability concerns of utilities are based on their ability, or otherwise, to deliver license obligation activities to consumers, in a financially sound, efficient, sustainable manner. Being sufficiently resourced, financially, is vital to allowing the utility to do so.

- Utilities should be encouraged, through appropriate remuneration, to invest in capital, - physical and otherwise – so that it is sufficiently resourced to deliver both standard and value-add benefits for customers, over a reasonable length of time. The allowance for operational costs should of course be based on reasonable efficiency however a continuous target of lowering costs does not necessarily deliver the best outcome for consumers.

- Margins for regulated entity service providers should be set at levels which allow for efficient financeability, appropriate remuneration and effective delivery of value-add as well as standard service.

- The financial treatment of asset-light entities in the same format and manner as asset-heavy entities is unsuitable and therefore unlikely to achieve optimum outcomes for consumers.

- A framework allowing for the incentivisation of higher service delivery and value-add activity would ultimately deliver greater returns for consumers.

- It is acknowledged that not all frameworks, or the various principles of same, can be applied equally at all times; nor do we believe they should be. However this does not diminish the requirement for such frameworks and such principles, and their transparent and consistent application in general, to support a stable regulatory environment which ultimately provides for and delivers benefits to consumers.