Northern Ireland Electricity Limited

Transmission and Distribution Price Controls

2013-2017

Final Determination

23 October 2012

Appendix E - Consultation Response From NIE T&D

1.1 Our consultation on the Draft Determination for the fifth price control for Northern Ireland Electricity Ltd closed on 19 July 2012. We received non confidential responses from 32 organisations.

1.2 Appendix F covers those responses received from all organisations other than NIE T&D.

1.3 In the pages overleaf we have summarised the principal points made in NIE T&D's response, and our response in turn to each of these.

The response from NIE T&D was 221 pages long, and divided into 16 sections. Included with their main response document was a 204 page Appendices document. Their response also included a confidential paper entitled "NIE Labour Costs: Real Price Effects in RP5" in which NIE T&D provided additional evidence in support of the need for an allowance for RPEs. For ease of reference, in the table below we have set out where in the NIE T&D document each comment has been made.

Chapter 1	Page	Paragraph	Comment	Our response
Introduction and Executive summary	2	1.2	The DD would disallow NIE T&D from recovering much of the revenue which it judges to be necessary to enable it to provide T&D services to the standard required by statutory and licence obligations and to satisfy the reasonable demands of customers, in terms of safety, security and quality of service.	We have considered all responses and new information carefully. We consider our final determination will allow NIE T&D to meet all its obligations.
	7	5.5	Despite the Utility Regulator's claims to the contrary, the draft determination does not observe these essential principles of the RPI-X approach to price control regulation. In particular: The Utility Regulator proposes to re-open elements of the previous price control (RP4), with the possibility that it will disallow NIE T&D's entitlement to recover a return on amounts added to its RAB during RP4. The Utility Regulator appears to have in mind to apply, ex post, new rules as to what expenditure NIE T&D should be entitled to capitalise.	This is not an ex ante approach. Rather, the basis of the capitalisation practice investigation was to ensure that the rules that the RP4 Price Control was based on continued to be applied during RP4, as would be expected by stakeholders.
	7	5.5	Utility Regulator seeks to require NIE to re-organise the way in which it runs its T&D Business, by requiring NIE to bring to an end arrangements under which its affiliate, NIE Powerteam, undertakes activities of the T&D Business and by requiring NIE to put large amounts of its activities out to competitive tender, instead of conducting them itself. This attempt to micro-manage NIE's business is inconsistent with the principles of incentive-based regulation.	We do not wish to micro-manage NIE T&D's business but wish to ensure the arrangements are in the best interest of consumers.
	8	5.7	UR proposes to disallow capex and fails to take account of cost of NIE meeting new safety legislation.	We have considered all responses and new information carefully. We consider our final determination will allow NIE T&D to meet all its obligations. Financial implications arising from changes in law can be

				addressed in accordance with the Charge Restriction Conditions of Annex 2.
	10	5.12	...The Utility Regulator's present attempts to impose ex post rules on NIE T&D as to how it should have capitalised expenditure during RP4 illustrate the difficulties for NIE T&D of operating under regulatory arrangements which are inadequately defined in formal licence conditions.	This is not an ex ante approach. Rather, the basis of the capitalisation practice investigation was to ensure that the rules that the RP4 Price Control was based on continued to be applied during RP4, as would be expected by stakeholders. The rolling opex mechanism in place for RP4 meant that it was a fundamental requirement that we understood the basis upon which cost items were classified, and how this corresponded to the RP4 agreement.
	10	5.11, 5.12	UR proposes three Funds, which will require UR to deal promptly with applications by NIE. Rules governing funds will need to be very clear.	The final determination clearly sets out the rules governing the three funds. A separate consultation was carried out in respect of Fund 3 approach.
	13	6.1	UR proposals depart from incentive-based regulation to a system of regulation by micro-management	The Utility Regulator is continuing with an incentive based regulatory approach. Incentives are applied to the RP5 price control where appropriate. The system establishes what can be expected by consumers in exchange for the revenue collected from them in RP5, and the framework within which NIE T&D can exercise its discretion in order to achieve the required outputs for consumers. This is not micro-management but ensures a clear set of defined rules for NIE T&D.
Chapter 2	**Page**	**Paragraph**	**Comment**	**Our response**
Regulatory Principles to Underpin RP5	14 & 15	Summary	The Utility Regulator will breach its statutory duties if it adopts its 'minded to' position. Incentive based regulation is based on application of clear rules. Threat of ex post write off will motivate NIE to seek comfort	The Draft Determination took into account our statutory duties and was a consultation. We agree that incentive based regulation needs clear rules that NIE T&D can operate within and reduce the need for NIE T&D to draw the regulator into operational decisions.

			in advance from the Utility Regulator and draw the Utility Regulator into operational decisions.	
	16	2.2 -2.3	UR must have regard to existing consumers and future consumers.	We agree that we must have regard to existing and future consumers. The analysis carried out in the RP5 price control process to date has been aimed at protecting the interests of both existing and future consumers. We agree that consumers, existing or future should enjoy an electricity network that is fit for purpose while paying only what is reasonable and necessary.
	16	2.4 and 2.9	The proposals for opex, pensions, capex and WACC in the draft determination would be in breach of the URs statutory duty to ensure NIE T&D can finance its regulated activities. Also the UR would be in breach of its statutory general duties because of the proposals.	We have considered all responses and new information carefully. We consider our final determination will allow NIE T&D to meet all its obligations. We have completed financeability testing as detailed in the final determination. Consequently we consider our final determination allows NIE T&D to finance its activities in line with our statutory duties.
	20	4.7	Departure from incentive-based regulation implies regulator increasingly involving itself in management of the business, which risks compromising balance of interest and consumer interest	We are not departing from incentive based regulation. Incentives are applied to the RP5 price control where appropriate. The system establishes clear rules identifying what can be expected by consumers in exchange for the revenue collected from them in RP5. It also provides the framework within which NIE T&D can exercise its discretion in order to achieve the required outputs for consumers. There is no intention of the regulator involving itself in the management of the business. It is up to NIE T&D to manage its business within the regulatory framework.
	21	4.11	<u>**Capex regulation and the introduction of a Reporter**</u> The introduction of a set of arrangements for capex that involve either a high level of ex post scrutiny of any departure from a detailed database of specified investments or the risk of significant delay in the event regulatory approval is requested ex ante. The Utility Regulator also wishes to introduce a Reporter to	We do not accept that the arrangements we are proposing will add any delay. We accept that NIE T&D will depart from the detailed proposals within the database as new information presents itself to them. The proposals will require NIE T&D to clearly identify the investment that takes place and efficiencies it creates and will significantly reduce the amount of risk associated with any review carried out for the next price control process.

			provide assistance in validating and assessing the data to be reported annually. As explained in Chapter 11 (Annual Reporting) of this response, NIE T&D is concerned that this would be a further step towards a regulatory model in NI that tends towards micro-management. This would run counter to the trend in best practice regulation.	The added value from introducing a Reporter who reviews and comments on aspects of submissions (as guided by the Utility Regulator) is deemed necessary by us. This requirement is based on experience in recent years and is believed to be an effective approach to address the inherent issue of information asymmetry. We do not accept that this is counter to the trend in best practice regulation. OFWAT are no longer requiring a Reporter on the basis that a Reporter has been in place for a number of years and reasons for introducing the Reporter have been addressed over the years, including the establishment of a sustainable working relationship together with appropriate and complete information being received from the regulated company. The benefits of a Reporter have been realized over the years to the point now that the function is no longer necessary. It is our objective to get to a similar position with the regulated company in the medium to long term. The Reporter function will add value to analysing specific technical aspects of the regulated company submissions. The reporter function will have the appropriate skills and expertise to analyse the information required from NIE T&D. The quality and completeness of information received directly impacts on whether there is a need to provide further analysis. It is hoped the information obtained from NIE T&D will be appropriate and complete, thereby eliminating any perception of micro-management. We are not interested in pursuing a micro-management regulatory model but alternatively this function is motivated to improve the quality of submissions received in order to facilitate a more robust decision making process and ensure RP6 is conducted in a more effective and efficient manner.
	21 to	4.11	The proposal that the current arrangements for NIE Powerteam should be brought to an end, and that NIE	We continue to believe that the current arrangements regarding Powerteam unacceptably complicate the regulatory process for

	22		Powerteam's activities should be subject to competitive procurement, would not be in customers' best interests. There is no need for the Utility Regulator to specify how NIE T&D management should meet its overall efficiency targets. This should be the responsibility of NIE T&D management. As noted in Chapter 3 (RP4 Overview), the use of the NIE Powerteam model has assisted NIE T&D to drive efficiency and introduce modern work practices. NIE Powerteam has brought a commercially focused culture where managers understand the importance of cost control and cost reduction, and their remuneration is partly dependent on delivery. The current model has no adverse consequences for customers of NIE T&D as only NIE T&D's efficiently-incurred costs (including costs efficiently incurred in the activities undertaken by NIE Powerteam) are passed on to customers. The Utility Regulator's role should go no further than identifying efficiency targets and incentive mechanisms: this proposal draws the Utility Regulator directly into the management of NIE T&D.	the Utility Regulator with insufficient evidence of benefits for the consumer. Under the NIE T&D licence, Powerteam provide exclusive services to NIE T&D. We accept that by setting allowances for RP5, the onus is on NIE T&D to deliver within those allowances. However as Powerteam is not subject to competition, we expect NIE T&D to demonstrate that consumers are getting the best value for money from the Powerteam arrangements. This will then be considered in our assessment for RP6. The final determination addresses the treatment of Powerteam, as informed through the consultation responses.
	21	4.11	Revisiting of asset value of company	The possibility of RAB adjustments is proposed on the basis of ensuring the current price control rules have been followed. A thorough investigation has been conducted before arriving at a conclusion.
	21	4.11	Revisiting of pensions through retrospective adjustments	As with asset value adjustment considerations, changes are proposed on the basis of ensuring costs have been incurred in accordance with the current price control. The pensions section of the final determination sets out the final treatment of pensions.
	24	5.7, 5.8, 5.9	Ofgem decisions scrutinized by regulated companies, investment community and media	We do not agree that the regulatory process for RP5 has lacked transparency. Indeed, we have sought greater stakeholder engagement in RP5 than for any previous electricity transmission and distribution price control review that we have undertaken. This has included several stages of public consultations (including draft determinations and strategy papers on the form and process of

				the price control review), stakeholder workshops and bilateral meetings with NIE T&D. We have provided multiple opportunities for NIE T&D to engage with and present its business plan and requirements for RP5 both to us and other interested stakeholders. Feedback from this engagement has been reflected in our draft and our final determination. The level of detail of analysis and information that was requested from NIE T&D was clearly signalled by us through bilateral meetings with the company and through the public strategy document consultation. Having initially reviewed NIE T&D's business plan submission, it was apparent to us that more detailed information was required on aspects of the plan, for example, on business cost allocations and capital expenditure. The volume of information requested demonstrates our regulatory objective to engage with and understand NIE T&D's business plan for the RP5 period. Price control work-plans and timetables were also developed and shared with stakeholders including NIE T&D over the course of the review.
	54, 55	6.2, 6.3	The Utility Regulator announced 6 month delay to implementation of RP5 price. The Utility Regulator attributes this to delays by NIE T&D, which NIE T&D refutes, plus BPQ was 5 months late vs. original timetable in issuing BPQ.	It must be recognised that NIE T&D chose not to respond to the BPQ in the format requested. For example it did not split out T&D in its early responses. In addition to this the information did not provide the clarity required for the Utility Regulator to come to a draft determination leading to a substantial number of additional queries.
	55	6.5, 6.9	Licence modifications are required to formalise the RP4 extension and should be consulted upon and agreed with NIE T&D.	We do not accept that licence modifications are essential to extend RP4 however we do accept that best practice is to consult on any significant decisions. At the time, a six month only extension was envisaged, and we did not deem a consultation necessary, given the coming consultation through the draft determination.
Chapter 3	**Page**	**Paragraph**	**Comment**	**Our response**

RP4 Overview	25	Summary	Outperformance of the RP4 opex allowance has been driven by a range of cost saving initiatives which resulted in reductions in the cost of salaries, corporate, R&M, IT & telecoms, managed services, insurance and other costs.	A number of changes have resulted in efficiencies in the early part of RP3. By its own admission, the scope for further efficiency savings in RP4 was constrained by the changes NIE T&D made in its controllable Opex in RP3.
	25 to 26	Summary	NIE Powerteam is an integral part of the NIE T&D organisation and its only function is to undertake activities forming part of NIE's T&D Business. The NIE Powerteam model has facilitated the driving of efficiencies and introduction of modern work practices and there is no justification for the Utility Regulator's proposal to bring the current arrangements to an end. The Utility Regulator should confine itself to identifying efficiency targets and mechanisms, leaving NIE T&D management to determine how best to deliver those outputs.	Under the NIE T&D licence, Powerteam provide exclusive services to NIE T&D. We believe that the current arrangements regarding NIE Powerteam Ltd unacceptably complicates the regulatory process for us with insufficient evidence of benefits for the consumer. We accept that by setting allowances for RP5, the onus is on NIE T&D to deliver with those allowances. However as Powerteam is not subject to competition, we expect NIE T&D to demonstrate that consumers are getting the best value for money from the Powerteam arrangements. This will then be considered in our assessment for RP6. The final determination addresses the treatment of Powerteam, as informed through the consultation period responses.
	36	2.30 and 2.31	The Utility Regulator states in its Draft Determination that NIE T&D’s salaries are higher than the NI average. NIE T&D strongly disagrees with this assertion. There are errors in the Utility Regulator’s analysis and NIE T&D has provided evidence which shows that within NIE T&D’s specialist job categories, the salaries for electrical engineers, technicians, and lines repairers and jointers who make up 52% of our workforce are a minimum of approximately 12%, 23% and 16% less than the NI average for each category respectively. Specialist labour also includes managers and specialist professional administration staff and represents 83% of NIE T&D staff in total. Further details are provided in the separate paper entitled “NIE T&D Labour Costs – Real Price Effects in RP5” that has been submitted to the Utility Regulator.	Our analysis of a large number of job adverts has allowed comparisons to be drawn between NIE T&D’s salary scales and those of the wider market in Northern Ireland. In most cases that we reviewed, NIE T&D’s rates are broadly similar to, or above, those offered by competitors and can therefore be classed as competitive. Evidence from job adverts also suggests that there is a vibrant labour market in many of the skilled staff categories that NIE T&D employs. However to date this has not had a large impact on NIE T&D’s business. This was illustrated by the low labour turnover rates in comparison with the wider market. It is also shown by the fact that there is significant interest in the vacancies that NIE T&D offers. Our draft determination included salaries in the benchmarking exercise and we have not been convinced by new information that any uplift should be applied; the allowance proposed in the draft determination is unchanged.

	39	3.7	In this context, it is of concern that the Utility Regulator has considered it appropriate to conduct a detailed review of NIE T&D's capex in RP4 and to assess it against NIE T&D's RP4 capex plan. The nature and extent of that review goes well beyond what is necessary to assess the level at which the next price control should be set or to check that NIE T&D has complied with its past obligations. Such a review is inconsistent with the principles of RPI-X incentive-based regulation and is erroneous.	Our review of RP4 capex covered the following areas: • Cost efficiency • Processes and procedures • Project selection / project governance • Cost allocation • Review of a sample of projects All of these contributed to our understanding of NIE T&D's approach to capex and the levels of efficiency within the organisation. The fact that we identified areas of concern with respect to the efficiency of indirect costs, cost allocation and the planning standards shows that this review was necessary for us to discharge our statutory duty to protect consumers.
	42	3.25	Table 3.1 below summarises the cost per storm event in RP3 and RP4 and demonstrates that NIE T&D has managed the total cost per storm event down by 46% between periods.	We acknowledge that NIE T&D has reduced the costs of individual storm events; however we note that this is in the context of significant additional investment in the 11kV network during RP3 and RP4, with the purpose of increasing the resilience of the network to storm events. We would have been concerned about the effectiveness of this investment had it not had this outcome for consumers. The further investment in asset replacement during RP5 and the implementation of the ESQCR legislation should result in additional improvements.
	43	3.28	However, having accepted the reality of RPEs, the Utility Regulator has not made any specific allowance for RPEs in RP5 thereby exacerbating the extent of underfunding of RP5 capex. The GB DNOs received RPE allowances from Ofgem.	We have considered the impact of RPEs in our final determination and have made the appropriate allowances for Opex and Capex. We closely followed the approach used by Ofgem.
	43	3.33	All departures from the RP4 capex plan were necessary and justified by reference to the need for NIE T&D to maintain a safe and reliable network. In these circumstances, investing to the budget set by the Utility Regulator should not be a reason for criticism. It has not led to an increase in the RAB beyond that envisaged at the start of RP4. It reflects the	We observe that NIE T&D capital investment during RP4 is only 1% less than the budget agreed (after the removal of the contingency for ESQCR legislation). The variance has been attributed to the phasing of projects scheduled for the end of RP4.

			effective operation of the RP4 capex regime rather than any misuse of it.	The correlation between the budget set at the start of the price control and the need for spend on the network is note worthy.
	44	3.38 & 3.39	NIE T&D accepted that achieving a 10% reduction in order to limit expenditure to the capex budget would present a challenge. However, the reluctance of the Utility Regulator to adjust the budget to reflect the increase in material costs and the cost of the March 2010 storm has meant that NIE T&D has had to absorb these additional costs within the overall programme to remain within the budget. Furthermore, it has been necessary to accommodate additional 11kV overhead line costs which NIE T&D had not taken account of in its RP4 submission. Taken together, these factors have doubled the initial efficiency challenge for RP4. Once these factors are taken into account, NIE T&D has more than met its own efficiency target.	Our benchmarking of NIE T&D's direct costs shows that they are efficient when compared with the average cost of similar work in GB, however we believe that the indirect costs are higher than the GB average. Without clearly defined outputs associated with the agreed budget, it is not possible to confirm whether NIE T&D have met the efficiency target or not.
	44	3.41 and 3.42	We accept that if the Utility Regulator had prescribed an allocation methodology for capex and opex it would have been incumbent on NIE T&D to ensure that its capitalisation practices were in accordance with that methodology. In fact, no such allocation methodology was prescribed. In these circumstances, it is reasonable for NIE T&D to allocate capex and opex on the basis of normal accounting standards. That is the approach which NIE T&D has taken. NIE T&D s accounts have been approved by the auditors and submitted to the Utility Regulator without challenge. NIE T&D has reported regularly to the Utility Regulator.	As detailed in the capitalisation practice section of the final determination we consider that the composite proposal was adopted for RP4 and therefore the principles for RP4 were understood. However NIE T&D have licence conditions, under condition 2 "Preparation of accounts" which state that; "3. The Licensee shall, in respect of each Separate Business: (b) prepare on a consistent basis from such accounting records in respect of the financial year commencing on 1 April 1992" And also; "4 (a) The Licensee shall not, in relation to the accounting statements in respect of a financial year, change the bases of charge, apportionment or allocation referred to in sub-paragraph (b) of paragraph 3 from those applied in respect of the previous financial year, unless the Authority shall previously have issued directions for the purposes of this Condition directing the Licensee to change such bases in a manner set out in the directions or the Authority gives its prior written approval to the change in such bases."
	44	3.43	It is open to the Utility Regulator to prescribe an allocation methodology that will apply to NIE T&D going forward. Indeed, NIE T&D would welcome such a methodology as a	We will carry this item forward and consider regulatory accounting guidelines on a cross utility basis.

			means of reducing the risk of ex post assessment of its capex. But it would be wrong for the Utility Regulator to introduce at this stage an allocation methodology that is to apply retrospectively to RP4. Such a step would have effect to re-open elements of the RP4 price control and lead to the Utility Regulator disallowing NIE T&D's entitlement to recover a return on amounts added to its RAB during RP4. That would be contrary to the essential principles of RPI-X regulation.	
	47	Table 3.2	NIE T&D's response indicates that the full out-performance in RP4 Opex is the result of cost reductions as shown in the table.	We acknowledge that there was an outperformance in RP4 Opex. However as discussed in the capitalisation practice section of the final determination, some of this was due to reallocation to Capex and therefore not an outperformance.
	47	4.3	Savings of £9.6 million were achieved mainly through the introduction of the "customer aligned" business model during the course of 2004/05. This was designed to seek greater clarity and absolute simplicity of approach by removing any process duplication and unnecessary organisation levels and identifying individual accountability in all business areas.	On review of the capitalisation practices a proportion of these savings are the result of changes in the capitalisation of overheads and not the result of efficiency gains.
	47	4.5	Savings of £8.5 million were achieved in respect of corporate costs reflecting both a reduction in the total level of corporate costs and a lower percentage allocation to NIE T&D.	This saving is accepted. We welcome the savings in respect of corporate costs and encourage NIE T&D to continue to obtain savings in this area.
	47	4.6	Savings of £15.6 million reflect cost reductions in fault & emergency, defect management, cyclic based maintenance, vegetation management, miscellaneous distribution costs, non-recoverable alterations and ancillaries' maintenance & testing.	On review of the capitalisation practices a proportion of these savings are the result of changes in the capitalisation of overheads and not the result of efficiency gains.
	48	4.8	Savings of £8.4 million are mainly due to savings in supply chain costs and the rationalisation of the services supplied by NIE Powerteam. The reduction in supply chain costs was due to the closure of the central stores unit at Culcavy as well as general operating efficiencies. The closure of Culcavy and the transfer from a centralised function to a distribution function was intended to remove double handling of materials issued from the Ballymena and	On review of the capitalisation practices a proportion of these savings are the result of changes in the capitalisation of overheads and not the result of efficiency gains.

			Craigavon stores. The move resulted in savings in rent, facilities management and security costs as the exit strategy entailed the relocation to existing sites. Insourcing the TNT logistics contract generated further savings.	
	48	4.9	There were a number of factors which contributed to the £4.2 million reduction in insurance costs. The insurance market entered a "soft" rating cycle which created competition between insurers and ultimately had a positive effect on premiums. A number of incentives were developed with insurers on the main employer and public liability and material damage insurances. These incentives rewarded our loyalty to insurers over a three year period and coupled with positive claims statistics, produced premium rebates. Claims performance has had a positive effect on premiums with the number of employer's liability, public liability and motor insurance claims steadily reducing from the end of RP1.	We welcome the savings contributed to the insurance costs and encourage NIE T&D to continue to obtain the most efficient premiums for its services.
	49 to 54	5.6 to 5.25	NIE T&D's response restates the original objectives, claimed benefits and commercial justification for the operation of Powerteam as a separate in-sourced provider of electrical engineering services. At the time of the RP5 price control NIE T&D emphasised the independent "arms-length" nature of the relationship but following the draft determination NIE T&D is also emphasising the close integration of the two companies and the shared pension's scheme. NIE T&D continues to maintain that there are clear benefits for the consumer and the Powerteam has been a key enabler of efficiency savings. NIE T&D states "There is no need for the Utility Regulator to specify how NIE T&D management should meet its overall efficiency targets. This should be the responsibility of NIE T&D management."	We continue to believe that the current arrangements regarding Powerteam unacceptably complicate the regulatory process for the Utility Regulator with insufficient evidence of benefits for the consumer. Under the NIE T&D licence, Powerteam provide exclusive services to NIE T&D. We accept that by setting allowances for RP5, the onus is on NIE T&D to deliver with those allowances. However as Powerteam is not subject to competition, we expect NIE T&D to demonstrate that consumers are getting the best value for money from the Powerteam arrangements. This will then be considered in our assessment for RP6. The final determination addresses the treatment of Powerteam, as informed through the consultation period responses.
	51	5.11	Given that the Utility Regulator is able effectively to regulate the costs incurred by NIE Powerteam there is no justification for its proposal to bring the current arrangements between NIE and NIE Powerteam to an end. The Utility Regulator should confine itself to setting the price control at a level that enables NIE to recover its	The Utility Regulator is not specifying how NIE management should meet its overall efficiency targets, but how the adoption of the NIE Powerteam model has benefited the consumers and if it can continue to over the price control period. In the draft determination we were minded to bring the current arrangements between NIE T&D and NIE Powerteam Ltd to an

			efficiently incurred costs and to drive further efficiencies. It should leave to NIE management the task of how best to structure NIE's business so as to deliver on the revenue and output targets set by the Utility Regulator. The Utility Regulator's proposal to unwind the arrangements with NIE Powerteam is a further illustration of the Utility Regulator's unhealthy desire to micro-manage NIE's business.	end and remove any references to NIE Powerteam Ltd from NIE T&D's licence; however this is no longer practical or possible, due to the pension arrangements. The final determination addresses the treatment of Powerteam, as informed through the consultation period responses.
	52	5.21	NIE Powerteam has played an extremely valuable role in ensuring the implementation of efficient market tested and effective terms and conditions that have facilitated significant productivity improvement that could not otherwise have been achieved. The performance of NIE Powerteam is one of the key reasons why NIE is a leading performer among the GB DNOs,	While we recognise that NIE Powerteam has played an extremely valuable role within NIE T&D, it function needs to demonstrate that its services delivered are competitive. Therefore monitoring of market testing and procurement arrangements should occur on a regular basis (annually) to ensure the arrangements are in the best interest of consumers.
	53	5.23	NIE cannot accept that these proposals are in the interests of customers for the reasons set out below: • The NIE business as a whole is efficient, and NIE Powerteam is an integral part of this efficient model. • The model enables the maintenance and development of a skilled workforce within NIE's organisation including the apprentice training programme. If NIE were required to contract out its requirement, third party contractors would have little incentive in the short to medium term to invest in the future workforce. Apprentice training programmes would be cut. This would have serious implications for future customers as NI would soon lack the skilled workforce necessary to enable the T&D network to be operated safely, efficiently and economically. • There would be a risk that current NIE Powerteam staff could be TUPE'd into a winning bidder, resulting in that carefully built up resource base being lost to NIE permanently. • The existing model allows for the most effective and cost efficient response to emergency	We continue to believe that the current arrangements regarding Powerteam unacceptably complicate the regulatory process for the Utility Regulator with insufficient evidence of benefits for the consumer. Under the NIE T&D licence, Powerteam provide exclusive services to NIE T&D. We accept that by setting allowances for RP5, the onus is on NIE T&D to deliver with those allowances. However as Powerteam is not subject to competition, we expect NIE T&D to demonstrate that consumers are getting the best value for money from the Powerteam arrangements. This will then be considered in our assessment for RP6. The final determination addresses the treatment of Powerteam, as informed through the consultation period responses. We accept that the current arrangements between NIE T&D and NIE Powerteam Ltd means that to remove any references to NIE Powerteam Ltd from NIE T&D's licence is not practical or possible, due to the pension arrangements.

			situations, including major storms. • There is a very valuable loyalty to NIE and the customer from core staff that is not achievable from external contractors. This is particularly evident during storm and emergency situations, where staff "do what needs done" to restore supplies. • The model gives flexibilities in delivery that are difficult to achieve from contractors	
	54	5.24	The NIE Powerteam model has no adverse consequences for customers. Contrary to the impression created by the Utility Regulator, NIE Powerteam's activities are subject to effective price control regulation as part of NIE's activities. There is therefore no justification for its proposal to bring the current arrangements between NIE and NIE Powerteam to an end. The Utility Regulator's reluctance to recognise that NIE Powerteam's efficiently incurred costs form an essential part of NIE's funding requirement has resulted in a number of confused and inconsistent proposals for cost allowances throughout the Draft Determination.	We continue to believe that the current arrangements regarding Powerteam unacceptably complicate the regulatory process for the Utility Regulator with insufficient evidence of benefits for the consumer. Under the NIE T&D licence, Powerteam provide exclusive services to NIE T&D. We accept that by setting allowances for RP5, the onus is on NIE T&D to deliver with those allowances. However as Powerteam is not subject to competition, we expect NIE T&D to demonstrate that consumers are getting the best value for money from the Powerteam arrangements. This will then be considered in our assessment for RP6. The final determination addresses the treatment of Powerteam, as informed through the consultation period responses.
	54	5.25	The adoption of the NIE Powerteam model has facilitated NIE to drive efficiency and introduce modern work practices. NIE Powerteam has brought a commercially focussed culture where managers understand the importance of cost control and cost reduction. There is no need for the Utility Regulator to specify how NIE management should meet its overall efficiency targets. This should be the responsibility of NIE management.	The Utility Regulator is not specifying how NIE management should meet its overall efficiency targets, but how the adoption of the NIE Powerteam model has benefited the consumers and if it can continue to over the price control period.
Chapter 4	**Page**	**Paragraph**	**Comment**	**Our response**
RP5 Capex – Quantum	75	5.3, 5.4, 5.5	The Utility Regulator's process for assessing the NIE T&D capex submission was characterized by a lack of transparency and meaningful two-way engagement… this runs contrary to regulatory best practice	We do not agree that the regulatory process for RP5 has lacked transparency. Rather, to the contrary, we have sought greater stakeholder

				engagement in RP5 than for any previous electricity transmission and distribution price control review that we have undertaken. This has included public consultations (including draft determinations and strategy papers on the form and process of the price control review), stakeholder workshops and bilateral meetings with NIE T&D. We have provided multiple opportunities for NIE T&D to engage with and present its business plan and requirements for RP5 both to us and other interested stakeholders. Feedback from this engagement has been reflected in our draft and final determination.
	75	5.5	The Utility Regulator has not [to date] accepted any of NIE's offers to arrange visits so that the UR and its consultants could see the condition of network assets	Assets are typically reviewed by reviewing KPIs and taking a sample and desk top exercise, as well as reviewing the rationale for and cost benefit of replacement
	90 to 92	6.34 to 6.41	NIE T&D's response restates the nature of the indirect costs associated with the electrical engineering work carried out by T&D and how these should be capitalised in proportion to the associated direct Capex and Opex activities. NIE T&D believes that the Utility Regulator has "fundamentally not grasped the nature of the direct and indirect cost base" and referred to the benchmarking results that it commissioned in relation to its direct costs as further justification for the scale of capitalisation of overheads.	NIE T&D commissioned different consultants to carry out its Capex unit cost benchmarking, indirect cost benchmarking and direct cost benchmarking. The CEPA consortium's review of Capex and Opex is the first co-ordinated review of NIE T&D's Capex and Opex for over 10 years. They reviewed in detail all information provided by NIE T&D including benchmarking relating to direct and indirect cost base. We do not consider this a difficult area to grasp. sults.
Chapter 5	**Page**	**Paragraph**	**Comment**	**Our response**
Rp5 Capex - Structure	95	1.3	NIE's views on the proposed 5% capex efficiency discount (in the form of a 1% year-on-year reduction in annual capital allowances) are dealt with in Section 2 of Chapter 3 (RP4 Overview). Extract from Section 2 of Chapter 3 "We do not accept SKM's limited analysis of indirects and continue to believe Frontier's far more comprehensive work is manifestly more robust. Given this, we see no reasonable basis for the Utility Regulator to apply a 5%	This comment is included here are it directly relates to the RP5 mechanism. In preparing our final determination we have asked CEPA and SKM to review our approach to the application of the capex efficiency benchmarking. CEPA highlighted that their benchmarking identified a 10% efficiency gap between NIE T&D and the GB DNOs. SKM have reviewed each item in the capex submission to identify the portion of the allowed cost that relates to indirect costs. This portion has then been reduced by 10% to remove the inefficiency. Therefore X of -1 will no longer

			discount (1% year on-year) to our capital costs.”	be applied.
	95	1.5	The proposed arrangements would be costly and inefficient to administer and could lead to substantial delays in the implementation of important projects;	Given the material uncertainty related to the projects in fund three, we do not see an alternative to individual approvals that would allow us to comply with our statutory duty to protect customers. We will work with NIE T&D to agree timescale and work programmes that will minimize the impact on the utilization of renewable electricity. Please note: between submission and summer 2012, NIE have reduced the amount that they expect to spend on these projects by £111 million.
	95	1.5	The proposed arrangements entail a large degree of regulatory micromanagement of decisions which should properly be left to NIE's management;	We have minimized the regulatory input where possible; however the absence of specified deliverables for RP4 has resulted in excessive ambiguity about the capex programme that was intended to be delivered for that amount of money. The asymmetry of information has also increased. Our aim through RP5 is to ensure that customer’s money is spent efficiently and transparently. It is not intended to micro-manage the NIE T&D business.
	95	1.5	The proposed arrangements entail substantial regulatory risk to NIE, with little prospect of NIE being able to benefit from its own efficiency;	NIE T&D will be able to benefit from cost efficiencies for five years. This is standard regulatory practice. As NIE T&D’s internal approvals process does not yet consider the full cost of their decisions on customers, we do not consider it appropriate that NIE T&D benefit from deferring capex.
	95	1.5	The proposed arrangements do not allow or incentivise NIE to innovate and respond efficiently to changing network conditions;	We have expanded fund three to include smart grids and smart metering costs. The proposals contained n NIE T&D’s business plan were not sufficiently developed and did not consider the issues that have arisen due to small scale renewables. We note the progress that NIE T&D have made over the last 18 months in developing schemes that are appropriate to our circumstances here in NI and will be open to requests for funding under fund three.

	95	1.5	The Utility Regulator has not adopted sensible proposals put forward by NIE for superior arrangements to incentivise NIE to manage its capex investment efficiently.	We do not believe that NIE T&Ds proposals provided the transparency required under the current economic circumstances. Under our proposals, NIE T&D is incentivized to focus on cost efficiencies as this is the only method to achieve additional rewards.
	96	2.1	The Utility Regulator proposes that the three funds should cover Fund 1: all asset replacement. Fund 2: load growth, incremental costs of change of law, metering, IT & communications. Fund 3: large projects for renewable generation or interconnection.	A reporter will add value to the quality of information by assessing and verifying key areas of submissions to Regulatory Authorities, thus improving the efficiency of the 3 Funds identified.
	96	3.2	The principles governing Fund 3 projects do not allow NIE T&D to best decide how to discharge its statutory and licence obligations – instead the UR scrutinises and approves ex ante on individual projects.	The proposed treatment of Fund 3 projects is taken from the NIE T&D BPQ submission (Cap19 BPQ12 Managing Uncertainty). This was aimed at providing an efficient structure to manage the risks attached to projects with inherently unpredictable costs and timing. A consultation specifically on Fund 3 was carried out and responses have been considered in relation to the Final Determination..
	97	3.4	NIE is concerned that there may well be delays and difficulties in securing a timely regulatory approval for individual projects, with the result that the introduction of additional renewable energy, and the development of a wider energy market through the use of enhanced interconnection with other systems, may be delayed to such an extent as to lead to inefficiency and consequential detriments to customers. NIE therefore invites the Utility Regulator to consider ways in which such inefficiencies might be mitigated, including the following: • The grant of an up-front approval for NIE to undertake projects within Fund 3 up to a given expenditure limit (potentially linked to NIE's existing, well developed plans for the reinforcement of parts of its core transmission network for the purposes of Renewables Integration); and • A firm agreement as to the documentation to be provided by NIE to enable the Utility Regulator to deal	When we requested an update on the amount of capex required under fund three (renewable and interconnection), the amount reduced from £291m to £180 m. This is a variance of over £100m in eighteen months. Based on the level of uncertainty and the magnitude of the costs involved, we could not grant an upfront allowance to be spent without obligation to deliver specific functionality. It is not known what projects will obtain planning permission during RP5, and the RIDP has still not been published. Therefore the functionality cannot be defined at present. We agree that clear timelines for assessing projects are required (along with the standard of information and analysis required to be provided by NIE T&D to support delivery within those timescales). We will work with NIE T&D to agree this process and will publish

			definitively with any application for approval for further projects, and a timetable for the grant of such approvals. We outline below what NIE considers to be an appropriate process.	the final timetable and list of documents in the coming months.
	98	3.7 & 3.8	On receipt of such documentation, the Utility Regulator should provide a formal response within an agreed standard period, either approving the project, or providing detailed and specific guidance as to what further steps NIE will need to take to secure approval (and the timetable for deciding NIE's further application), or detailed reasons as to why the Utility Regulator does not intend to grant approval. Alternatively, if the Utility Regulator considers that some form of public consultation is necessary to inform its decision in respect of the project, the Utility Regulator should use NIE's application as a basis for consultation, and should set a strict timetable for the conclusion of such consultation and for the making of its final decision. The Utility Regulator should provide sufficient reasons for any decision which it makes to enable NIE to satisfy itself as to whether such decision is well-founded. NIE agrees that the capital investment proposal described at (b) above should include a firm quotation for the internal and external costs associated with construction and commissioning of the proposed asset, and should define the functionality and deliverables proposed, together with a proposed mechanism for cost adjustments / risk sharing in the event of circumstances beyond the reasonable control of NIE.	We welcome NIE T&D's confirmation of the scope of each capital investment proposal. We will work with NIE T&D to agree a realistic timetable that has as little impact on the utilization of renewable sources of electricity. We will comply with our statutory duties, including the requirement to consult where appropriate. As our duties are different from those of NIE T&D, any consultation paper will use information from NIE T&D's submission, but supplemented by information relevant to our duties.
	99	3.15	NIE's Pot 1 mechanism is somewhat prescriptive, and is only suitable to be applied to a small number of asset types which meet all the requirements of predictability outlined above. The Utility Regulator now proposes that this prescriptive mechanism be extended significantly to cover all network asset replacement activity. Such a proposal is unworkable and inappropriate because:	Our updated Fund 1 contains sufficient asset replacement programmes to allow NIE T&D to prioritise and substitute investment between them. Further detail is provided in the Final Determination.

			• Neither NIE nor the Utility Regulator can predict with sufficient confidence as of now, in respect of all asset types, which assets should be replaced, in what volumes, and at what unit cost, over the RP5 period. As a result, NIE will bear the risk of the residual uncertainty of this prediction and the ability of the Utility Regulator to assess subsequently the reasons for the inevitable variations that will occur. • It is, in any event, neither sensible nor efficient to hold NIE to a plan which effectively requires it to replace specific assets, in a manner prescribed by the Utility Regulator at the outset of RP5, when the implementation of that plan may prevent NIE from developing more innovative means of achieving the same or better result for customers (e.g. by use of an improved design, or other more efficient means of achieving similar or greater outputs). • The Fund 1 mechanism does not allow NIE to replace more asset units during RP5 (even if it can do so within the proposed revenue allowances for Fund 1 and Fund 2 in aggregate). Thus, NIE is constrained from accelerating the pace of replacement of its aged network assets, even though that would be beneficial to customers or otherwise necessary to discharge its statutory or licence obligations. On the Utility Regulator's proposals, customers will face the prospect of it taking many years to replace aged assets, which ought, if it is necessary and affordable, to be replaced earlier.	
	101	3.21 & 3.22	Furthermore, the Utility Regulator's assessment of efficiency of Fund 2 investments relies on the ability to define a "target cost" in much the same way as is proposed for Fund 1 investments. Such a proposal is impractical and inappropriate for many of the same reasons set out in paragraph 3.15 in respect of the wider scope of asset replacement activity proposed by the Utility Regulator under Fund 1. In particular, neither NIE nor the Utility Regulator can predict with sufficient confidence as of now,	We believe that by approving the planning standards, associated assumptions and investment strategy for Fund 2 we are removing a significant amount of risk from NIE T&D. The reduction in consumption since NIE T&D made its submission to us, has further reduced both the amount of spend required and the magnitude of any residual risk that NIE T&D is exposed to.

			the scope, design and cost of individual Fund 2 investments that will be required over the RP5 period. As a result, NIE will bear the risk of the residual uncertainty of this prediction and the ability of the Utility Regulator to assess subsequently the reasons for the inevitable variations that will occur. As a consequence of these uncertainties, NIE had proposed that a conventional RPI-X approach be applied for "Pot 2". Having carved out "Pot 1" and "Pot 3" to cater for specifically identified investments, NIE proposed that an *ex ante* allowance be set for "Pot 2" to allow it to cater for remaining obligations, allied with strong incentives to encourage efficiencies through innovative approaches and productivity gains. Under this proposal, NIE would bear a set proportion of under spend or over spend relative to the *ex ante* allowance.	We believe that NIE T&D should only benefit from productivity gains in this area as the need for expenditure is driven by external factors.
	101	3.23	3.23 In combination, Funds 1, 2 and 3 effectively cover all of NIE's capex and leave limited scope for the operation of normal RPI-X incentive mechanisms. This is in contrast to the proposal made by NIE, and can be expected to have serious detrimental effects for customers: • As already discussed, this system of micro-management severely weakens incentives to innovate and improve efficiency; • This system draws the Utility Regulator ever closer into the management of the business, which weakens accountability; • The Utility Regulator will need substantial expertise and resources to operate the system effectively, and to produce appropriately-reasoned decisions to allow NIE to be satisfied that they are soundly based (and to challenge them if they are not); • The boundaries between the different funds are unclear, and considerable resources will have to be devoted to clarifying the boundaries in order to avoid disputes as to the rules which govern particular projects	It was our intension that all of NIE T&D's capex should be covered by the three funds. We consider our updated fund 1 to be equivalent to a standard RPI-X settlement, with the added protection for customers that a volume of work equivalent to that agreed should be completed in exchange for their money. This is consistent with our duty to protect consumers. The introduction of the reporter will reduce the regulatory input into NIE T&D's activities, and strengthens the expertise available to us to ensure an equitable outcome to RP5. The independent nature of that role should provide reassurance and protection for NIE T&D also. While we appreciate that some assets could be accounted for under both funds, we would expect NIE T&D to choose the most appropriate Fund and to ensure that it is only accounted for once. NIE T&D have not provided any evidence thataccelerating asset replacement will provide addition value for customers. It would however increase tariffs within RP5.

			or expenditure, and to ensure that the RAB is marked up appropriately over time. There is ample scope for disputes as to the boundaries between Funds 1 and 2 (where NIE may wish to build new assets to meet additional demand, and thereby address, and obviate, the need for asset replacement contemplated by Fund 1); and • The distinction between Funds 1 and 2 precludes NIE from accelerating the rate of asset replacement activity of the kind covered by Fund 1 if load growth falls short of the levels predicted for the purposes of Fund 2.	
Chapter 6	**Page**	**Paragraph**	**Comment**	**Our response**
RP5 Opex	106	Table 6.2	NIE T&D has summarised a series of adjustments to its RP5 submission which result in a reduction of £12.4m but include further increases in areas such as the Enduring Solution IT programme. NIE T&D has restated its Opex requirement in the light of the adjustments in Table 6.2	We have fully considered all information in setting the Opex allowance for RP5.
	107	2.7	NIE T&D comment "Reducing baseline meter reading costs to £1.5 million a year. This compares with a current annual allowance of £3.1 million plus an additional agreed allowance of £0.4 million for reading keypad meters."	We have revisited our analysis for meter reading and increased the allowance based on the additional information provided by NIE T&D.
	107 to 108	2.7	NIE T&D restates the case for the RP5 claims that were disallowed in the draft determination on the basis that they are driven by government policy on competition and renewables but then also refers to real price effects and workforce renewal claims.	We have fully considered all information in setting the Opex allowance for RP5.
	110	Table 6.5	NIE T&D restates its baseline Opex adjusting for the changes referred to above and refers to the shortfall of £9.7m against the allowance proposed in the draft determination with the bulk of the shortfall relating to meter reading, keypads and Rathlin. NIE T&D points out that the base year allowance proposed by the Utility Regulator has incorrectly included £1.1m of current service pension provision which is subject to a separate allowance.	We note the error regarding the current service pension provision and have corrected this in our final determination.
	111	3.8 to 3.25	NIE T&D states that agency staff costs have risen by £1.3m	We have revisited our analysis for meter reading and increased

	to 114		since the RP5 price control and require an increase in the RP5 claim. NIE T&D states “The Utility Regulator’s proposed allowance for RP5 is based on the RP4 allowance for reading keypad meters. This allowance does not reflect the current cost of agency staff, excludes management costs and makes inadequate provision for overheads. The proposed allowance is based on an average agency salary cost of £16,750 per annum. NIE T&D currently has 95 meter readers of which 53 are employed as agency staff. The average cost of the agency staff is £29,000 per annum. Agency costs have increased significantly due to the new European Union agency workers directive (AWD). This was introduced in Great Britain in October 2011 and in NI on 5 December 2011. The AWD states that agency workers are entitled to the same terms and conditions of employment as permanent workers after a period of 12 weeks.”	the allowance based on the additional information provided by NIE T&D.
	114 to 115 115 to 148	4.1 to 4.5 115 to 4.162	NIE T&D adjusts its earlier BPQ request and restates the case for costs associated with the Enduring Solution, the Renewables Programme, Real Price Effects, Workforce Renewal and storm costs. The main increase relates to the Enduring Solution with a further 30% increase in the projected costs from £22.5m to 29.4m. Other costs have generally fallen in NIE T&D’s latest estimates. Restatement of the case for the Enduring Solution costs (and the 30% increase), renewables baseline, real price effects, legislative and regulatory, storm costs, price review costs, and other costs (including injurious affection)	We have fully considered all information in setting the Opex allowance for RP5.
	115	4.6	The proposed allowance of £16.4 million is £13.0 million short of the forecast costs within the NIE adjusted BPQ.	The difference shown relates to NIE T&D’s unexpected updated submission dated 6 July 2012 updating the November 2011 submission. This update was not considered in the UR’s draft determination.
	116	4.9	Due to the complexity of the new arrangements and the	We note that NIE still seems to have a low level of confidence in

			relatively limited experience of this suite of applications in the production environment, NIE plans to adopt an iterative approach in determining the most cost effective on-going resource needs through the use of an agreed 'activity based' model. An initial review of activity in September 2012 will be followed by a further checkpoint after 12 months of live operation. This exercise may identify changes to the operating costs presented here.	the latest cost projections. We do not understand why the new arrangements are more complex than NIE T&D envisaged mainly being cloned from an ESBN production system.
	116	4.10	Within the draft determination, the Utility Regulator is proposing to allow £16.4 million for the period, a shortfall of £13.0 million.	We commissioned further work for the final determination to understand the various NIE submission formats and the many NIE changes to forecast costs.
	116	4.11	The allowance proposed falls well short of the funding required to operate the new solution effectively. NIE has provided detailed analysis of the projected costs; however, neither the detailed rationale used by the Utility Regulator to identify potential reductions nor the benchmarking information underpinning the proposals has been shared with NIE.	The main difference identified by NIE T&D relates to the SAP application support costs. The advice we received correlated well with the initial manpower requirements in the NIE November 2011 submission. The advice differed with respect to the contracting model and year on year savings. We note the later points have now been recognized in the NIE 6 July 2012 submission. Because of the time lines we could not have considered the additional costs with any supporting evidence put forward in the NIE T&D 6 July 2012 submission in the draft determination but has taken them into account in the final determination.
	116	Table 6.11 ES IT transitional costs	Shows a variance of £0.2m that is potentially misleading.	NIE T&D submitted a paper on the Enduring Solution transitional costs dated 31 May 2012. Because of the timing the forecasts and supporting evidence were not considered as part of the draft determination.
	117	4.12	Given the complexity of the ES project and the timing of the regulatory review process it was not possible to arrive at a fully informed position with respect to operating costs at the time of the original BPQ submission in February 2011. This was advised to the Utility Regulator when the initial estimate of £22.5 million for support costs for the RP5 period was provided when the BPQ was submitted. It was highlighted at that stage that the submission would be updated when the project reached a more advanced stage.	We had a strong expectation that the submissions provided up to November 2011, nine months later than the BPQ, were well considered and refined. The complex, repetitive and sometimes incomplete submissions have made assessment by us unduly difficult.

	117	4.13	Since then, NIE has developed a progressively more informed view of the ES operating costs, with revised material being provided to the Utility Regulator in October and November 2011 and a final submission being provided in July 2012 following go-live. The July submission identified costs of £29.4 million, an increase of £6.9 million from the original BPQ projections. For each submission, a detailed, bottom-up analysis was prepared which was based upon the best information then available and which could be substantiated against the assumptions which accompanied the forecasts.	Our draft determination only considered submissions up to November 2011. We do not understand how such large variances can occur when NIE T&D have indicated the Enduring Solution Project was taken into account during the managed services re-procurement in 2009. From reviewing the NIE response it would seem that although the Enduring Solution Project was being developed during 2009 there was inadequate consideration of the need to ensure a competitive operational cost baseline could be achieved without further competitive activity.
	117	4.15	The forecast view of ES support requirements in November 2011 was largely informed by visibility of the earlier stages of system testing and the associated assumptions around the amount of functionality which needed to be supported. These early test phases had been planned and undertaken by the ES Systems Integrator. It was only at the point of user acceptance testing that NIE and its outsourced IT service providers were able to review the totality of the functionality being delivered and assess in more detail the degree of testing required to provide full coverage.	The SAP ISU system is a modified ESBN system that has been in production since 2005. With an ESBN task force working as part of the project it is most surprising that so little was known about the existing and new functionality, especially as the user requirements were so well defined.
	118	4.19	In addition, the volume of information moving within the retail market is expected to increase significantly in the new competitive market. This increase in data volume and related data management requirements is driven by the needs of a competitive market and harmonisation of messaging arrangements between NI and the Republic of Ireland, as requested by both regulators. As a result, the previous 15,000 messages per day will increase potentially up to a peak of 115,000 messages per day, depending upon market activity. In the first few weeks of ES operation, with	The number of types of market message has increased but the base market information is similar. The new schema uses more market messages that are smaller in content. This has been known about for over 2 years and does not provide objective evidence for more resources than were originally required. The link between actual volumes of market messages and support costs has not been proven; see our response to 4.20.

			lower than normal market activity, peak message volumes doubled from the pre-ES position and this is expected to rise as suppliers begin to engage more fully with the new processes. In addition to the increases in volumes, the 36 pre-ES message types have been replaced by 84 message types (in line with the harmonisation of message arrangements in NI and RoI as requested by the regulators), all driving additional system functionality and potential levels of exceptions.	
	118	4.20	All of these changes drive the increased IT support costs, including infrastructure costs, software licence costs and IT support resource costs. There is a direct relationship between the numbers of market messages, the amount of functionality required to automate the outcomes from these messages and therefore the amount of support effort required to ensure the solutions can operate effectively, maintaining the required quality and service levels.	It is accepted that some of these factors change IT support costs.
	118	4.21	NIE provide reasons why they are confident that the proposed ES operating costs are appropriate.	We feel that the reasons put forward by NIE T&D are somewhat subjective. The only way to confirm the costs are 'appropriate' is to test the market through a competitive tender process. Gemserv agree the daily rates proposed for onshore staff are competitive, however the structure of the support resources may not be.
	119	4.22	The Utility Regulator's proposed allowance of £16.4 million does not represent a level of funding which would enable the ES solution to be operated and supported effectively.	We have taken further technical advice which has been taken into consideration in our final determination.
	120	4.26	In November 2011, NIE provided supplementary information to the Utility Regulator in relation to the ES operating costs. At this point, the market processes and system requirements had been finalised and the project	It is our view that with all the resources deployed and information available to NIE T&D in November 2011 it is surprising that the submission is classified as 'heavily caveated', especially since NIE must have been aware that this submission was being used in the draft determination.

			was in the early stages of testing, therefore more information was available to inform the operating cost projections. At that point, NIE projected RP5 costs of £29.5 million, an increase of £7.0 million from the February estimate. Once again, the information was heavily caveated.	
	121	4.28	Since December 2011, NIE has actively engaged with the Managed Service Provider (Northgate) and the ES Systems Integrator (Wipro) to determine and implement the most robust and cost effective arrangements for on-going support of the applications enabling NIE to commit to meeting the service expectations of both the retail market and the Single Electricity Market (SEM). In addition, NIE has continued to review the resource levels required to support the new processes in light of the information emerging from the acceptance testing phases of the project.	This is inconsistent with the NIE T&D July submission which states that: *NIE plans to contract the steady state support for the ES systems via a change control to the existing Northgate Managed Service agreement. This approach was envisaged when the Managed Service agreement was awarded in 2009.* Until December 2011 NIE T&D had always informed us that the managed services agent (NMS) had the expertise and resources to support the Enduring Solutions systems and that this was anticipated in the Managed services contract. We questioned this assumption on several occasions when suggesting a competitive tender process should be held. This request was not implemented and very late in the day NIE T&D found themselves in a situation where they needed the services of Wipro the Systems Integrator, presumably because the MSC did not have the expertise. This is despite the project contract including substantive training costs for NMS from Wipro. This lack of strategy seemed to have placed both Northgate and Wipro in a predatory position when negotiating support costs. The UR reiterates the need for a full competitive test of the market. In the absence of competitive pressure We have taken advice on what the outcome could have been.
	123	4.34	The benchmarking information used by the Utility Regulator to arrive at these proposed reductions has not been provided to NIE.	Not all information available to the Utility Regulator can be shared due to confidentiality reasons.

	124	4.37	"*…NIE T&D's implied increase in managed services contract costs needs to be considered in the light of the modern (more efficient) technology now being employed, along with economies of scale driven from the adoption of harmonised systems and processes with the new sister company, ESB.*" The meaning behind this observation is not entirely clear to NIE.	NIE T&D have an obligation to ensure that all their investments are cost effective and can be efficiently maintained. One of our original prime requirements for the Enduring Solution project was for NIE to pick a solution with the lowest life cycle costs. It is reasonable to expect the new systems to operate more efficiently and cost effectively than old systems, thereby generating substantive resource economies.
	124	4.37 first bullet point	The change from a single-structure legacy mainframe system build which aligned to a vertically integrated business to one which has numerous disparate components and numerous interfaces required to support a competitive de-regulated market and which require complex management of inter-application data flow. Information for 870,000 sites is now being managed within this architecture and approximately 100 new interfaces have been generated	The interim solution that includes the legacy mainframe systems has been supporting the market requirements since 2007. We accept that the cessation of shared costs with Power NI for the Legacy mainframe system will bring some diseconomies of scale. However, these should be ameliorated by the new modern IT systems now employed that should provide richer more automated functionality with commensurate economies. We are not inclined to reward NIE if they have produced over complex systems that will not provide customer benefits commensurate with such a large capital investment.
	124	4.37 fifth bullet point	The structure of the application set itself which must be flexible and capable of facilitating future change as dictated by market requirements – for example in the area of smart metering.	Compatibility with Smart metering was a requirement for the Enduring Solution. We do not see this having a bearing on present operating costs.
	125	4.38	*Economies of Scale* The extract from paragraph 10.75 of the draft determination cited above also infers that NIE can benefit from potential savings arising from economies of scale within the wider ESB Group. The NIE ring-fencing arrangements required by the Utility Regulator constrain the ability to achieve savings and currently preclude the exploration of any initiatives which might result in joint synergies.	Subject to regulatory clearance there are many opportunities for NIE T&D to enjoy economies of scales with ESBN.
	125	4.42	NIE outsources all its IT support services and the existing managed service contract was competitively tendered in	It is unclear to us how NIE T&D expected to achieve a competitive procurement process for an undefined ITC

			2009, to run for a minimum 5-year term.	managed service that represent its biggest ITC cost.
	126	4.44	It is envisaged that all of the NIE IT services, including those related to ES, will be re-tendered at the end of the current managed service agreement, with a new contract commencing potentially in October 2014. Inclusion of the ES services within a bigger NIE contract will potentially deliver lower cost services for the market, compared to having two separate contracts.	Last summer we requested NIE to start a competitive tender process. NIE T&D refused on the basis that the managed services contract was, defacto, a competitive process and the successful bidder had all the necessary skills to support the Enduring solution systems. This seems to have been an optimistic assessment as Northgate Information Systems seem reliant on Wipro to support the SAP applications. This is the area where there is a biggest financial difference between our draft determination and NIE T&D serial submissions. We can only conclude that the support arrangements and contract changes were negotiated under duress in an inefficient manner.
	126	4.45	Notwithstanding the above, the Utility Regulator has raised the issue of tendering of the ES support services in the Draft Determination. The Utility Regulator states at paragraph 10.75 that in July 2011 it indicated to NIE that it was required to tender the Enduring Solution managed service contract. NIE wrote to the Utility Regulator in August 2011, explaining that this would be a fundamental change to a strategy which had underpinned the project since its initiation. Due to the need to deliver the ES solutions by May 2012, it was believed, even at a very early stage of the project, that the diversion of key project resources to run an OJEU procurement for managed services in parallel would put the ES project delivery at risk.	We agree that NIE T&D were reminded of their obligation to competitively procure all major services. We have therefore taken advice about the level of costs that would have resulted from such procurement process. Of course no assessment can prejudge the outcome of such a competitive exercise but in the interests of protecting the customer an equivalent estimated allowance was made in the draft determination.
	126	4.46	Furthermore, NIE explained that the approach being adopted (i.e. a change control to the existing managed service provider contract) was the most cost effective and low risk way to achieve the go-live date and support the market during the bedding-in period. The managed service re-procurement in 2009 established a competitive resource	We do not understand how a historic competitive procurement can provide a cost effective solution for an unknown and unspecified service with a Service Provider who potentially does not possess the internal experience and skills to provide such a service.

			cost base for use in future change control throughout the life of the agreement.	
	126	4.47	Due to the integrated nature of the ES and NIE legacy applications it is considered manifestly appropriate that one organisation would continue to provide an end-to end service across the applications estate, including interfaces, and that the service desk arrangements would best be delivered by one organisation. The introduction of a second major outsourced IT provider would give rise to additional costs and greater risk for the market as ownership of specific system issues could become blurred and restoration processes extended. NIE is not currently resourced to manage two IT outsourced providers.	We understand that it is common for organizations such as NIE T&D to have more than one IT outsourcing providers. It is not for the UR to comment on NIE internal resources and their capabilities to manage two IT outsourced providers. However, we expect NIE to make judgments that are cost effective and contain costs. Negotiating a contract with both Wipro and NMS would suggest that NIE T&D do have the resources to manage more than one IT outsourced providers.
	127	4.50/5.51	*Manpower Costs* In relation to salary costs, the Utility Regulator's draft proposals for RP5 include an allowance of £2.0 million. This compares with the most recent NIE projection of £4.9 million over the period.	As previously mentioned the submission dated the 6 July was too late to be considered in our draft determination. This submission will be considered in the final determination.
	127	4.51	The proposals make no allowance for existing market-opening related staff whose costs are currently covered within separate allowances which cease at ES go-live. Also, there is no allowance for transitional resources which may be required to support the new processes going forward past the end of September 2012.	Since the draft determination we have reviewed the DT Terms for the Interim market systems and domestic market opening.
	128	4.54	In October 2011, NIE sought regulatory approval for cost recovery of additional resources required to support the ES market processes and systems. This analysis was based on	This formed part of a NIE submission for an additional 60 permanent staff most of which have not been agreed or incorporated in the draft determination.

			NIE's best view at that time and was supported by a detailed analytical model developed using an updated version of a staffing model which had been used successfully in previous market opening projects. Senior business managers were engaged to challenge the outcomes and working assumptions. As a result of this approach, NIE sought recovery for 14 permanent and 17 transitional resources.	We approved a temporary allowance under a DT Term for 9 additional permanent and up to 17 transitional staff for the period up to the of September 2012. Appropriate allowances for these permanent staff have been included in the draft determination.
	128	4.56	*Changes in manpower costs since October 2011* In light of the experience gained from the later stages of user testing and the early days of live operation, NIE has reviewed the additional business roles required to support the market following the implementation of ES. This review has identified the need for twelve new permanent resources instead of 14 i.e. a reduction of 2 from that anticipated in October 2011.	We have noted the proposed reduction.
	128	4.57	The information now available to us demonstrates that a higher level of problem solving and analytical skills is required for some roles. Therefore, the cost reduction delivered by the change from 14 to 12 permanent resources is offset somewhat by higher average salary costs for these individuals.	We note the point but are surprised this was not apparent in November 2011.
	129	4.61	The ES implementation was completed on 21 May 2012 and NIE will be incurring increased operating costs during the RP4 extension period.	We will provide temporary funding to support any reasonable additional costs over the interim period.
	140	4.115	<u>Regulatory Reporting Requirements</u> The Utility Regulator's estimate of the cost of the Reporter of £1.5 million over RP5 does not represent the full cost of that proposal. We would expect NIE T&D to incur at least a similar level of cost in servicing the needs of the Reporter, providing analysis, responding to queries etc.	As the reporter will be used for specific areas as directed by us this reduces the need for additional resources and costs. This is seen to be the most effective use of limited resources in order to achieve the objective. We would expect the reporter to be

			This response also relates to: - Page 155 6.26 – 6.28 Reporter - Page 190 Summary - Page 191 3.3 Reporter	reviewingdocuments/analysis that NIE T&D require for internal approval. We therefore do not consider there are additional costs in this area.
	151 - 152	Rates 6.2; 6.5 - 6.9	Utility Regulator's proposed allowance for uncontrollable costs falls short of that required by NIE by £6.5 million. (£3.4m rates, £3.1m wayleaves). The Utility Regulator has proposed that rates are “semi-controllable”, stating that an element of negotiation can be applied by NIE to agree their amount, and has proposed a risk sharing allocation of 80:20 between customers and NIE. NIE disagrees with this treatment of rates, for the reasons set out below. The calculation of NIE's rates liability is set out in the Valuation (Electricity) Order (Northern Ireland) 2003 (**2003 Order**). The Net Annual Valuation (NAV) is calculated in accordance with a formula based on the growth in transmission circuit length and distribution MVA transformer capacity. The Utility Regulator has suggested that rates are semi-controllable because NIE has a choice over the location of its buildings/offices. However this reasoning is wrong. NIE’s rates are based on the formula set out in the 2003 Order. Land and Property Services calculate the NAV based on circuit length and transformer capacity. This NAV is then apportioned over various district councils in NI and regional and district rates are then applied to determine the overall rating liability. The NI Finance Minister has announced that a NI ratings revaluation will take place in April 2015. This timing would align with the next revaluation of nondomestic properties in the rest of the UK. The effect which this revaluation will	We accept the Valuation (Electricity) Order (NI) 2003 sets NIE T&D’s rates bill, and as such accept the argument for allowing these costs. For clarity, any recovered amount will not include an amount for Powerteam’s rates bill, which is a separate company. We acknowledge the uncertainty around a review, and note the Finance Minister’s announcement and his comments in regards the outcome that he expects “Many will find their rate bills not changing much.” This is acceptable in relation to the regulated business while the legislation sets the rates liability.

			have on NIE is unknown. NIE should make no gain or loss in respect of rates which are fixed by formula over which NIE has no control. The appropriate regulatory treatment is passthrough. This would be consistent with the regulatory treatment adopted by Ofgem.	
	152 - 153	Wayleaves 6.10-6.17	The proposed allowance is £3.1m less than the requested amount. NIE do not agree wayleaves are "semi-controllable". NIE doesn't negotiate wayleaves case by case, but uses Scottish Power's wayleave rates which are in line with the Electricity Networks Association (ENA) recommended rates. ENA rates are reviewed in accordance with studies carried out by the Agricultural Development Advisory Service. This approach assures landowners that rates are fair and non-discriminatory. Any disparity in rates could result in challenge via the Lands Tribunal of NI and result in case by case negotiation being required. This would place additional administrative and resources burdens on NIE. NIE disagrees with the proposed 80:20 risk allocation, as the current process is efficient. Proposal that NIE may lower wayleave payments would increase administration costs and is unlikely to lower rates. Cost increase of wayleaves due to network growth is ignored. NIE should not gain or lose in respect of wayleaves and so wayleaves are not amenable to negotiation.	The further information provided on NIE's methodology is welcomed. NIE's chosen process to arrive at wayleave amounts does result in fixed amounts that are not negotiable. It is noted there are other methods that could be chosen, which would allow control over the amounts paid by NIE. However we recognise the merits of adopting a method that is used by another UK DNO, and is in line with the ENA recommended rates.We also note with interest, the GB Department of Energy and Climate Change have recently announced they intend to update legislation related to compulsory wayleaves (the Electricity (Compulsory Wayleaves) (Hearings Procedure) Rules 1967) in order "to ensure the rights and interests of both sides are appropriately balanced whilst reducing the costs and other burdens on parties."
	153 - 154	Licence fees 6.18-6.20	NIE agrees with UR this should be a pass through item.	We note the agreement of treatment.
	154	Injurious affection 6.21-6.25	UR minded to treat claims for injurious affection as uncertain and will await outcome of Lands Tribunal cases. NIE proposes that its costs and expenses associated with the Lands Tribunal process should be fully recoverable on a pass-through basis.	We note the proposal for cost recovery treatment. With no definite indication of ruling outcome or associated costs treatment as uncertain is appropriate. We will therefore await the results of the Lands Tribunal before considering how to treat these costs.

			The licence modifications for the RP5 price control should make specific provision for the recovery of such costs on this basis.	
	155	Reporter 6.26-6.28	UR proposal for £1.5m over RP5 does not represent full cost of the proposal. We would expect to incur at least a similar level of cost in servicing the needs of the Reporter, providing analysis, responding to queries etc. Such allowance will form part of our controllable opex.	NIE T&D's opinion on costs is noted, the amount for uncontrollable opex has not changed from the draft determination.
Chapter 7	**Pag e**	**Paragraph**	**Comment**	**Our response**
Pensions	156	2.1	NIE comment that 'The UR has proposed an allowance for pension costs in RP5 of £22.0 million. This is £77.6 million less than NIE's projected costs of £99.6 million'.	We stated that NIE had submitted an amount of £77.2 million, made up of £10.5 million ongoing costs, and £66.7 million deficit costs. The difference between the totals quoted by us and NIE is due to extra payments made by NIE during RP4 in addition to their regulated allowance. This extra amount was recognized by us in paragraph 11.60 of the draft determination.
	159	Table 7.2	Table summarises the UR's proposals regarding the pension scheme deficit	The amounts are in inconsistent terms. For example, the first two terms (£150m - £62.4m = £87.6m) give the pension scheme deficit at 31 March 2011, not in 2009/10 prices terms. The last 4 items, however, are in 2009/10 prices terms (according to Table 11.8 of our draft determination).
	159 - 162	3.1-3.11	The baseline funding deficit should allow for post-March 2011 market movements for consistency with the schedule of contributions agreed following the valuation, with the rationale for this being explained in detail. Paragraph 3.11 argues that NIE should not need to seek the UR's approval to the funding plan. NIE refer to the Pensions Regulator statement, issued on 27 April 2012. NIE says it is willing to carry out valuations more frequently than 3 year intervals.	We now have some information which we did not have when we published the draft determination, being the extent to which the adverse economic conditions since March 2011 have continued. We have considered this effect on our view on whether there has been a fundamental, potentially permanent change in the long-term economic outlook. This is dealt with in the final determination. Our chapter on Annual Reporting deals with the pension's information required from NIE. This statement was released after the publication of the draft determination.

				We agree that the cost of this would outweigh the benefits. Our pension principles indicate the approach we will apply to actuarial valuation results.
	162 - 164	3.12-3.17	Ofgem precedent suggests that: (i) interim funding updates can be used for price controls; and (ii) subsequent movements in the deficit will be reflected at the following price control review (paragraph 3.14). NIE also refer to the use of an interim funding update by the Competition Commission in the Bristol Water case.	The UR is under no obligation to follow Ofgem precedent. However, we were aware of Ofgem's approach and had a clear rationale for differing from it in our draft determination. Ofgem's price control covered a number of regulated companies with some differences in pension scheme funding valuation dates. Using the most recent full valuation for each scheme would have lead to inconsistencies in measurement dates across different companies in the same price control. That issue does not apply with NIE T&D. Our final determination applies a different approach – this is described in detail in the main paper.
	164 - 165	4.1-4.6	Disagreement with the UR's proposal to disallow NIE Powerteam's proportion of the deficit because: (i) all of NIE Powerteam's activities form part of NIE's regulated activities; (ii) the establishment of NIE Powerteam was not intended to avoid deficit-related pension costs; (iii) Ofgem/GB precedent is to reflect which employees are engaged on regulated activities; (iv) as this has not been done at previous price control reviews, the proposal is retrospective.	As stated in paragraphs 11.28-11.29 and 11.37 of the draft determination, NIE T&D and NIE Powerteam are separate legal entities. We recognized that an internal arrangement exists, but made clear in the draft determination that we expect competitive procurement processes to be undertaken regarding the electrical engineering services provided to NIE T&D. Our final determination applies a different approach and this is described in the main paper.
	165 - 166	4.7-4.10	The "last employer" / Option 2 calculation of NIE Powerteam's share of the deficit is inappropriate because: (i) NIE T&D was responsible for an NIE Powerteam employee's pension benefits accrued while NIE T&D was the employer; and (ii) Because the Protected Persons Regulations required NIE Powerteam to provide certain pension benefits to protected employees, such rights were not "legally avoidable".	In our draft determination proposals, we were aware of the Protected Persons Regulations. Our final determination applies a different approach and this is discussed in the main paper.
	167 -	5.4-5.11	Adjustments for differences between past pension contributions and pensions allowances – RP2 and RP3: this	Our final determination applies a different approach and this is discussed in the main paper.

	168		is inappropriate because it is: (i) retrospective; and (ii) inconsistent with RP4. Adjustments for differences between past pension contributions and pensions allowances – RP4: (i) NIE supports this proposal provided it is done through a truing-up mechanism; and (ii) the adjustment excludes the last 18 months of RP4 (including the 6 month extension).	
	168	6.1-6.4	Early retirement costs: 30%, not 50%, of the cost should be borne by the shareholder for consistency with RP4.	Paragraph 11.68 of the draft determination referred to analysis supporting a 50:50 split on the basis of the benefits received by consumers and the company. Our final determination applies a different approach – this is discussed in the main paper.
	168 - 169	7.1-7.2	Special contributions: (i) NIE did not seek to recover the value of special contributions; and (ii) the amount submitted by NIE was £51.3m, not £65.5m.	Our final determination applies a different approach and this is discussed in the main paper.
	169	8.1-8.2	Disagreement with the adjustment for benefit improvements funded out of past pension scheme surplus because: (i) such action was necessary under the Inland Revenue Surplus Regulations; (ii) the UR's rationale for not adjusting for benefit improvements during RP1 applies equally to RP2 and RP3; (iii) such benefit improvements were common within the UK electricity industry at the time; and (iv) this adjustment is retrospective and inconsistent with RP4.	NIE's argument is clear. Our final determination applies a different approach and this is discussed in the main paper.
	170	8.3-8.8	None of the current deficit is attributable to past benefit improvements. Ofgem accepts that such benefit improvements are	The current funding position of the NIEPS is a consequence of the entire past experience of the scheme together with the assumptions made for future experience. Benefit improvements (which *must* increase ultimate pension costs) are

			efficiently incurred costs.	fundamentally different to decisions such as the choice of valuation date or valuation assumptions (which affect the *timing* of contributions but not ultimate pension scheme costs). However, our final determination applies a different approach – andthis is discussed in the main paper.
	171	9.1-9.4	Agreement to the 15 year recovery period proposed by the UR, subject to timing differences attracting the regulatory rate of return, and a request to fix the 15-year period.	Our calculation of pension allowances for deficit reduction was on a net present value basis, using the NIEPS's 2011 funding valuation discount rate (rather than the regulatory rate of return). We discuss the application of a 15-year deficit recovery period in the main paper.
Chapter 8	**Pag e**	**Paragraph**	**Comment**	**Our response**
Connections	173	3.1	NIE T&D forecasts that, during the run off period of the old connection charging system, the amounts shown in Table 8.1 below will be added to the RAB**:** Table 8.1: Forecast net connections additions to the RAB for RP5	We have examined the table provided in light of other comments given by NIE T&D. We can confirm that the figures given represent a fair reflection of what can be expected in terms of connections during the run off period proposed by NIE T&D.
	174	3.2	Connection offers that have been accepted by connectees are not time-limited and it is not uncommon for connection works associated with housing developments to be completed some four or five years after the date on which the offer was accepted.	The Utility Regulator is in agreement with this statement however the fall off rate given by NIE T&D over the 5 years is subjective and may be greater or less depending on a number of external factors outside the control of NIE T&D.
	174	3.4	NIE T&D's forecast includes £1.6 million of additional costs associated with RASW legislation which applies to all construction work. The Utility Regulator is proposing to allow the additional costs incurred for two years only. However the quantum of the allowance should be proportional to the connections expenditure incurred, whether within the first two years of the transition period or over a longer period if necessary.	The Utility Regulator is in agreement with this statement.
	174	3.6	There is a range of practical issues associated with the implementation of the new charging policy which are being addressed under a separate workstream with the Utility	We approved a new Statement of Charges on 24 September 2012 and this was published by NIE T&D on 1 October 2012[1].

[1] http://www.nie.co.uk/documents/Connections/NIE-Connection-Charges-Statement-October-2012.aspx

			Regulator. These include the practicalities of what we understand to be the Utility Regulator's preference to maintain standard charging for larger housing developments.	
	174	3.7	To address these legacy agreements and the RASW liability issues, NIE T&D requests that the ring-fenced allowance to be included in Fund 2 should be based on NIE T&D's higher estimate and, following the agreement reached in relation to the charging of larger housing developments, 'trued up' to the outturn costs in due course.	The costs given by NIE T&D are indicative only and will need to reflect the actual outturn costs of providing new connection. We agree with NIE T&D that a truing up of the actual figures will be required. Only actual verifiable and efficiently incurred costs would be allowed to be added to the RAB. The use of the Reporter will be essential in this area.
Chapter 9	**Pag e**	**Paragraph**	**Comment**	**Our response**
Incentives and Innovation	178	3.1	*Flexibility*: the incentive mechanism should not restrict NIE T&D's ability to manage its statutory and licence obligations flexibly.	The principles for incentives were stated in the draft determination, and the final determination lays out incentives that we are of the opinion they are appropriate.
	179	3.1	*Accurate submissions*: there are already ample incentives for NIE T&D to provide full and accurate information to the Utility Regulator, since the governing legislation, taken together with the conditions of NIE T&D's licence, means that NIE T&D is potentially subject to financial penalties if it fails to provide accurate information. Moreover, any concern as to the level of information required by the Utility Regulator to fulfil its duties can be adequately managed by laying down clear rules and guidance on regulatory reporting requirements, as other regulators have done (e.g. Ofgem). This would provide a structured and consistent basis for providing the Utility Regulator with meaningful information in a manner that preserves the principles of RPI-X regulation, while avoiding a system of micromanagement of NIE T&D's activities as well as the additional costs that a Reporter would impose on customers;	The principles for incentives were stated in the draft determination, and the final determination lays out incentives that we are of the opinion they are appropriate for the aims and principles stated. The reporters function will not be that of a micromanager, rather to help facilitate the regulatory reporting requirements and verify the outputs of the requirements.
Chapter 10	**Pag e**	**Paragraph**	**Comment**	**Our response**
Safety and the Environment	187	3.1	It is important that the substantive reporting requirements (including the extent of any environmental benchmarking to be undertaken) and the form in which reports are to be	We are in agreement with NIE T&D that requirements are agreed as soon as practicable.

			delivered should be specified and agreed as soon as practicable (including the development of appropriate templates for reporting). It is also important that the additional costs to NIE T&D of complying with such requirements be fairly reflected in the RP5 revenue allowance.	Environmental benchmarking is already carried out by NIE T&D in the form of their Arena survey. For safety we expect NIE T&D to provide reports similar to what is provided under their director's reports. As safety is a critical part of NIE T&D's business we would expect that NIE T&D already implements internal reporting requirements so that the state of their network can be assessed. NIE T&D is also monitored by the Health and Safety Executive for Northern Ireland. We are expecting that any reports provided to it will follow a similar format to those already provided both to the HSE and for internal reporting purposes. Additional allowance in the RP5 revenue should therefore not be required.
	188	3.4	NIE T&D is seriously concerned that if it spent only the capex which the Utility Regulator proposes for RP5 then this would result in an increase in the number of safety related incidents. Since NIE T&D would need to continue to invest to avoid these outcomes, the Utility Regulator's proposals amount to underfunding the investment required to maintain a safe system.	We consider the rules and allowances for Capex allow NIE T&D to maintain a safe system in line with their statutory duties.
	189	3.6	If NIE T&D were to spend only the amount allowed by the Utility Regulator the environmental risk profile associated with leakages from oil-filled cables would be significantly higher than NIE T&D considers prudent. Since NIE T&D will need to invest to ensure that it continues to meet its environmental obligations, the Utility Regulator's proposals amount to underfunding the investment required to do so.	We consider the rules and allowances for Capex allow NIE T&D to maintain a safe system in line with their statutory duties.
Chapter 11	**Page**	**Paragraph**	**Comment**	**Our response**
Annual Reporting	191	3.1	The Utility Regulator's reporting requirements should be specified at the outset of RP5	We intend to be as specific as possible about reporting requirements, but also to respond to new reporting needs as they arise.
	191	3.4	<u>Reporter</u> NIE T&D has other concerns over the proposal to introduce a Reporter. OFWAT has recently decided to dispense with	OFWAT introduced a Reporter function a number of years ago and have benefited over the years to the point that they have now chosen to withdraw the Reporter function. We hope to get

			Reporters and Ofgem does not use Reporters. We do not agree there is a need for a Reporter here. Its introduction would be a further step towards a regulatory model in NI that tends towards micromanagement. As noted in Chapter 5 (RP5 Capex - Structure) of this Response, this tendency is particularly evident in the Utility Regulator's proposals for the 'three fund' structure of the capex element of the RP5 price control in which the Reporter would play a key role. A regulatory model based on micro-management runs counter to the trend in best practice regulation, weakens accountability and gives us little confidence that the Utility Regulator is embracing the principles of incentive-based regulation.	similar benefits reflected in the quality of information submitted together with building sustainable working relationships. The Reporter function will add value to analysing specific technical aspects of the regulated company submissions. A reporter will add value to the quality of information by assessing and verifying key areas of submissions to us, thus improving the efficiency of the 3 Funds identified. We are not interested in pursuing a micro-management regulatory model but alternatively is motivated to improve the quality of submissions received to facilitate a more robust decision making process.
Chapter 12	**Page**	**Paragraph**	**Comment**	**Our response**
WACC	193	3.1	It is essential that the Utility Regulator sets a cost of capital that is sufficient to allow NIE T&D to finance its regulated activities. As set out in Chapter 2 (Regulatory Principles to Underpin RP5), if the Utility Regulator were to do otherwise, it would fail to discharge its statutory duties.	The proposals for WACC are based on detailed analysis of market and company information by professional finance practitioners, in comparison with similar UK. We have fully considered the WACC and financeability of NIE T&D in our final Determination in line with our statutory duties.
	194	3.3	NIE T&D's considered position is that the Utility Regulator should set allowed returns based on the cost of capital approach adopted by Ofgem at DPCR5, in its intent and effect. The Utility Regulator should depart from this approach only where there is compelling evidence to suggest this is necessary.	We do not accept that Ofgem's cost of capital assessment should effectively be 'out-sourced' to another public body. We agree that it is important to understand Ofgem's analysis and to explain any differences between our proposed rate of return and Ofgem's allowed returns, but we consider that our statutory duties require us to undertake our own bottom-up assessment of NIE T&D's cost of capital.
	194	3.7	NIE T&D believes that the Utility Regulator's approach to calculating the cost of debt is not consistent with GB precedent. Ofgem's approach, which uses a trailing average of debt cost, is preferable to the embedded debt cost approach used by the Utility Regulator.	The Utility Regulator, in setting the cost of capital for a single T&D business, is in a fundamentally different position from Ofgem, which opts to set a uniform cost of debt allowance for multiple companies. NIE T&D's proposed approach would see customers pay NIE T&D more than NIE T&D pays to its lenders. We can think of no reason why NIE T&D deserves to make a profit on its interest payments.

	195	3.8	Moreover, there is evidence that NIE T&D's debt financing costs are higher than those of the GB DNOs. This has also been acknowledged by the Utility Regulator's advisers, First Economics. The Utility Regulator should take this into account when determining an appropriate debt allowance.	This premium has been factored into our cost of debt calculation. Because we calibrated our allowance to match NIE T&D's actual interest payments – rather than some wider sector or corporate benchmarks – we have automatically provided for the NIE T&D premium over the GB cost of debt.
	195	3.12	the Utility Regulator's estimate of the equity risk premium (**ERP**) is unreasonably low. It ignores important sources of market evidence that suggest that a more appropriate estimate is consistent with the value determined by Ofgem at DPCR5 (i.e. 5.25%).	We accept that there is evidence to support an ERP of more than 5.25%. There is also considerable evidence to support an ERP of much less than our chosen figure of 5.0%. In light of the difficulties that there are in estimating an ERP with precision, we think that our point estimate should be consistent with regulatory precedent generally, including recent CC determinations. We have not given undue weight to Ofgem's preferred figure.
	195	3.13	In addition, the Utility Regulator has ignored the fact that the incentive regime to which the GB DNOs are subject provides an uplift to the baseline cost of equity simply for meeting attainable efficiency targets. It is feasible for even an underperforming GB DNO to achieve the headline returns allowed at DPCR5. At DPCR5 this uplift was approximately 100 bps for the average DNO.	The 100 bps that NIE T&D refers to is a payout from incentive regimes that Ofgem put in place for the 2005 and 2010 control period. It is perverse for NIE T&D to argue that it should be handed comparable financial reward when it was not subject to the same incentive regimes and did not carry the risk of receiving penalties in the event of under-performance.
	196	3.17	Finally, NIE T&D disagrees with the Utility Regulator's assessment that renewables driven investment is less risky than existing transmission and distribution assets. If anything, renewables-driven investments are riskier than investments in the existing network. The Utility Regulator should follow GB precedent on the financing of renewables-driven investments and remunerate these investments at the same rate of return as transmission and distribution assets. The proposed reduction in asset beta, and consequent reduction in returns allowed to Fund 3 investments, is arbitrary and unjustified.	In our draft determination we said that we considered Fund 3 capex investment to be lower risk as capex allowances will be set on a rolling basis throughout RP5 once the full scope and timing of the work is known. For the final determination, however, we have decided to apply a uniform WACC across all investment. Following GB precedent, renewables driven investments will be remunerated using the same rate of return as transmission and distribution assets. Our view is that we have structured Fund 3 projects in such a way as to reduce the systematic risk in comparison with Fund 1 or Fund 2 investments. We accept that this is a novel approach and it may be more appropriate to experience the process for Fund 3 in practice before implementing a specific WACC for these investments. We have therefore decided to allow the same rate of return on renewables-driven investments and NIE

				T&D's transmission and distribution assets.
	196	3.18	For the reasons set out above, NIE T&D does not accept that the baseline cost of equity proposed by the Utility Regulator is reasonable. The proposed low levels of return are reduced further by the Utility Regulator's other "minded to" positions. When NIE T&D takes account of the inadequate allowances proposed for opex and pensions, NIE T&D's expected equity returns fall below 2%. NIE T&D's effective return would be lowered further taking into consideration the Utility Regulator's proposed underfunding in respect of capex.	NIE T&D is drawing attention here to an arithmetical consequence of the arguments it has made elsewhere in its submission. These arguments are considered under their respective chapter headings.
	196	3.21	However, at paragraph 16.38 of the Draft Determination, the Utility Regulator states that it expects NIE T&D "*to remain below a 60% gearing level*" (emphasis added). It is in principle wrong for the Utility Regulator to set the WACC by reference to an assumed level of gearing that NIE T&D is not permitted to achieve.	We agree that there were inconsistencies in our treatment of gearing. We have amended the gearing in our cost of capital calculation to 50% to remove these inconsistencies.
Chapter 13	**Pag e**	**Paragraph**	**Comment**	**Our response**
RAB & Depreciation	198	3.1	NIE T&D is content with the Utility Regulator's proposals in respect of: • the separation of the transmission and distribution RABs; • the acceleration of depreciation in respect of legacy IT systems; and • the proposal to treat network IT and telecoms investments (except SCADA) as opex.	We welcome NIE T&D's comments.
	198	3.2	NIE T&D does not however agree with the proposed adjustment in respect of proceeds received from the sale of redundant equipment. The adjustment would be contrary to the December 2006 Direction from the Utility Regulator which treated the proceeds from such sales as a deduction from the RP4 rolling opex allowance. The proceeds were included in the excluded service income line in Appendix 1 to the Direction. It would therefore be a	We accept the mechanism detailed in the 2006 Directive and do not plan to make any adjustment in our final determination. We have stated the treatment of disposals for RP5 in our final determination.

			double count if the proceeds were deducted from the RAB as well as being deducted from the RP4 opex allowance.	
	199	3.3	NIE T&D would have no objections if the Utility Regulator were to treat the proceeds from these sales differently in RP5.	We have stated the treatment of disposals for RP5 in our final determination.
Chapter 14	**Page**	**Paragraph**	**Comment**	**Our response**
Allowed Revenue	202	2.1	Table 14.2 below compares the revenue that NIE would be entitled to receive based on the Utility Regulator's proposals as set out in the Draft Determination and NIE's proposals as described in paragraph 1.2 above.	Factual Statement – no comment necessary
Chapter 15	**Page**	**Paragraph**	**Comment**	**Our response**
Impact on Tariffs	202	1.1 – 1.2	Introduction	No comment
	202	2.2	The figures in Table 15.1 are different from the figures presented in Table 20.2 of the Draft Determination which overstated the savings to customers. There were errors in the Utility Regulator's calculation which we have corrected in relation to: • presenting the figures on a consistent price base • the apportionment of costs across the customer groups.	Following a review of the backup information provided by NIE T&D, we accept there was an error in the tables in our draft determination. We have used the NIE T&D information for the final determination tariff calculations.
	202	3.1	Table 15.2 below shows the impact of NIE's proposals (excluding renewables and interconnection) on network charges on a p/kWh basis for the main customer groups;	We note that NIE T&D have assumes a unit growth of 1.35% per annum in their calculations
	203	3.2	NIE's proposals (excluding renewables integration and interconnection) would result in an increase in network charges (p/kWh) of approximately 4% per annum over RP5. This level of increase compares favourably with the average annual increase in network charges of 5.6% for the GB DNOs following Ofgem's most recent price control review (DPCR5) as shown in Table 15.3 below.	It is worth noting that the depreciation rate used by Ofgem is DPCR5 is 20 years rather than the 40 years that applies to the majority of NIE T&D assets. This may be one of a number of reasons for why the costs are different from GB.

	205	4.1	NIE's network charges comprise approximately 20% of the retail electricity tariff. As noted in paragraph 3.2 above, NIE's core capital expenditure proposals would result in an increase in network charges (p/kWh) of approximately 4% per annum. This increase in network charges would entail annual price increases of approximately 0.8% in overall electricity bills for customers.	It should be noted that the increase discussed excludes the impact of inflation. We agree that network charges comprise of approximately 20% of the retail electricity tariff.
	205	4.2	NIE's investment plans also include expenditure associated with the proposed new North South interconnector and the connection of renewable generation in pursuit of DETI's target for NI of 40% of electricity consumption from renewable sources by 2020. This investment could add a further 2% to the overall electricity bill by the end of RP5 (assuming £200 million of expenditure).	We note that the amount proposed by NIE T&D for renewables and interconnection has reduced since their original RP5 submission. As detailed in our final determination, we accept that tariffs will increase due to this investment.
	205	4.3	The increased network charges associated with the proposed new North South interconnector and the connection of renewable generation should not be considered in isolation from the customer benefits from the beneficial effects on the wholesale price of electricity. For example, the new interconnector will bring estimated savings in all-island wholesale energy costs of between £18 million and £25 million per annum. NIE agrees with the Utility Regulator's proposal that these investments should be subject to specific regulatory approval.	We note this comment and will continue to work with NIE T&D to develop this investment
Chapter 16	**Pag e**	**Paragraph**	**Comment**	**Our response**
Financeability	208	3.2	Further, NIE has to compete in the debt markets with 14 strongly rated GB DNOs. In order to compete for efficient funding in an increasingly competitive market, NIE must retain a strong investment credit rating at BBB+ or above.	We reported in our draft determination its consultants' view that there was a strong consensus that an optimal credit rating would be BBB+/A-. It does not accept though that it would be impossible for NIE T&D to fund itself at a lower ratingRothschild's analysis for NIE suggested that at least two GB DNOs/owner groups finance themselves at a credit rating of BBB.
	209	3.3	This commercial imperative is reinforced by the obligation	We agree that its price control should not, in itself, cause NIE

			in Condition 9A of NIE's licence which requires NIE to maintain an investment grade credit rating. In its recent (August 2010) report on Bristol Water's price control, the Competition Commission accepted that it could not reach a price control determination that would cause the regulated company to breach such a licence condition.	T&D to be in breach of this, or any other, licence obligation. Our analysis suggests that it will not do so.
	209 - 210	3.5-3.6	There is clear evidence that NIE's debt financing costs are higher than those of the GB DNOs. This has also been acknowledged by the Utility Regulator's advisers, First Economics. The bond market evidence suggests a perceived higher NI specific risk. Over the past year NIE's 2026 bond has traded at a spread to benchmark on average 123bps over bonds of selected UK peers that have debt of comparable maturity. This is illustrated by Chart 16.2 below. Given that NIE debt is already trading at a 123bp premium with NIE operating at BBB+ credit rating, there is a very real risk that a lowering of the rating would further increase this premium and correspondingly the cost of debt (and equity) for NIE.	The current premium has been factored into our cost of debt calculation and therefore the proposed WACC. We recognize the relationship between the cost of debt and a company's credit rating and are clear that our assessment of the cost of capital and of the financeability of our price control determination must be made on a consistent assumption for NIE T&D's credit rating. Our assessment of the financeability of our price control has therefore been conducted on the basis of NIE T&D targeting a credit rating in the range BBB+ to A-. Current market analysis suggests that the allowances made in the WACC comfortably support the real cost of debt at such credit ratings.
	210	3.7	It is essential that the Utility Regulator fully assesses the impact of the price determination on the credit rating of NIE to avoid increased financing costs arising for the company.	We agree with this statement as far as it goes. But it needs to be recognized that the Utility Regulator's interpretations of its duties leads it to assess the impact of its price control determination on the basis of an efficient company that incurs costs and is financed in line with the Utility Regulator's determination. This may differ from NIE T&D's own projections or those of credit ratings agencies.
	211	4.4	The analysis by Rothschild indicates that the Draft Determination would, if it formed the basis of the RP5 price control, result in a financial profile that puts NIE at very weak investment grade rating (BBB-) and potentially a speculative grade rating (BB).	We note that the NIE T&D modelling assumptions differ from our own and in doing so does not reflect our view of the efficient performance and financing of a company in NIE T&D's position. We do not therefore recognize its results or understand them as relevant to our assessment.
	212	4.6	While the Utility Regulator acknowledges that credit rating agency methodologies consider factors which are not directly quantifiable, including the quality of the regulatory environment, its financeability assessment is focused solely	We have considered qualitative aspects alongside a quantitative assessment and have discussed these with credit rating agencies. Whilst we accept that the financeability assessment appears to be most concerned with financial metrics, we

			on financial metrics. Under Moody's rating methodology, non financial factors including stability and predictability of the regulatory regime, revenue risk and cost and investment recovery make up 40% of the weighting in the rating of regulated network utilities.	consider that this is generally the case with the description of such tests. We consider that the non-financial aspects are also in part reflected in the threshold levels for the financial metrics. As such, an assessment of financeability against such financial metric thresholds takes account of the necessary financial headroom for a given appreciation of other credit rating factors.
	212	4.10	The rating agencies are concerned that the Utility Regulator is unpredictable and that the Draft Determination exhibits anomalous and worrying elements including: • an intention to look back as far as RP2 with a view to disallowing pensions costs which NIE is obliged to meet under a deficit repair plan agreed with its pension fund trustee; • an intention to re-open elements of the RP4 price control, with the possibility that it will disallow NIE's entitlement to recover a return on amounts added to its RAB during RP4; • the introduction of a set of arrangements for capex that involve either a high level of *ex post* scrutiny of any departure from a detailed database of specified investments or the risk of significant delay in the event regulatory sign off is required *ex ante*; and • a failure to follow Ofgem precedent without good reason, despite the superior methodology adopted by the GB regulator.	We have not seen evidence to support such a strong statement as made here. We have also not seen the credit ratings agencies identify the issues listed here, which we understand are NIE T&D's own concerns.
	213	4.12	The financeability assessment undertaken by the Utility Regulator focused solely on financial metrics. As evidenced in the published credit rating methodologies, a stable Regulatory framework is significant in determining credit ratings. Stability cannot be assumed in the NI regulatory market given the views expressed by the rating agencies in addition to the issues listed in 4.10 above. NIE considers the Utility Regulator's financeability assessment to be incomplete and as a consequence does not have confidence in the financeability assessment undertaken.	We have considered qualitative aspects alongside a quantitative assessment and have discussed these with credit rating agencies. Whilst we accept that the financeability assessment appears to be most concerned with financial metrics, we consider that this is generally the case with the description of such tests. We consider that the non-financial aspects are also in part reflected in the threshold levels for the financial metrics. As such, an assessment of financeability against such financial metric thresholds takes account of the necessary financial headroom for a given appreciation of other credit rating factors.
	213	4.14	We believe that the Utility Regulator's assessment of RP5	Our financeability assessment for the draft determination

			on NIE's credit metrics is fundamentally flawed and its calculation of NIE's PMICR over the regulatory period is materially overstated due to the following factors: • *Pension costs*: In calculating key financial metrics, particularly PMICR, the Utility Regulator has not fully considered the pension repair payments that NIE is obliged to make as contained in the deficit repair plan agreed between the company and the pension trustees. Rating agencies deduct full pension costs which NIE is legally obliged to pay because these are actual costs for the NIE group, regardless of whether they are allowed for in RP5. • *Excluded capital expenditure*: The Utility Regulator has excluded the funding requirements associated with Renewables Integration and Interconnection from the base case notwithstanding that the Draft Determination indicates funding of over £300 million may be required during RP5. While it is accepted that the quantum and timing of renewables capex is difficult to determine, the financial implications of the investments are material and have to be considered in assessing NIE's ability to efficiently finance its activities. • *Start date for RP5*: The base case incorrectly assumes that RP5 commenced on 1 April 2012, effectively ignoring the RP4 extension period. As a consequence, capital investments and funding implications for the RP4 extension period to 30 Sept 2012 have been ignored and as a result the RAB and related revenue entitlement for RP5 are inaccurate.	excludes the effect of unfunded pension deficit repair payments. This is less of an issue for the final determination as the funding for pension deficit has materially changed. We have assessed the impact of renewable capital expenditure (Fund 3 Capex) separately. This is an area of considerable uncertainty which is reflected in updated estimates for spend by NIE T&D being almost £100m less than those at the time of the draft determination. We have updated our modelling to take into account the second extension period. It is necessary to forecast the actual RAB additions and hence there will always be an estimation required in using this approach.
	214	4.16	The following assumptions underpin NIE's modelling of the Draft Determination: • Regulated entitlement in line with the Utility Regulator's Draft Determination and the RP4 extension period, other than entitlement for uncontrollable costs which are assumed to be fully recoverable;	As stated above, we have assessed financeabilty on the basis of the company living within the allowances set in the price control determination. NIE T&D is understood to have made different assumptions in its analysis.

			• Operating costs in line with NIE's projections; • Core capital expenditure in line with the Utility Regulator's Draft Determination; • Non-core capital expenditure of £180 million for Renewables and North South Interconnector; • Dividends reflect full entitlement (i.e. RAB*Cost of Equity*RAB Value financed by Equity).	
	215	4.19	Any adverse implications that could arise from the Utility Regulator's investigation into NIE's capitalisation practices would cause further deterioration in PMICR.	As detailed in the relevant sections of the final determination the impact of this adjustment is not material.
	215	5.1	Under the Utility Regulator's proposals for RP5, NIE's return on equity would be less than 2%. This is due to the Utility Regulator proposing a lower baseline return on equity and lower allowances in respect of operating costs and pensions.	NIE T&D is drawing attention here to an arithmetical consequence of the arguments it has made elsewhere in its submission. These arguments are considered under their respective chapter headings.
	215	5.2	ESB, as an equity investor, is willing to support investment in NIE but this investment needs to be fairly remunerated. The Utility Regulator fails to recognise that ESB, like any other investor, has free choice over where it invests its funds. If there are other investment opportunities that offer a comparable level of risk, but a higher expected rate of return, the case for ESB continuing to invest in NIE becomes extremely challenging.	We consider that if it provides a rate of return consistent with NIE T&D's cost of capital, this should be sufficient to attract equity to be invested in the business.