# Northern Ireland Electricity Limited

# Transmission and Distribution Price Controls

# 2013-2017

# Final Determination for changes to capitalisation practice investigation

## 23 October 2012

## CONSULTATION RESPONSES

1.1 Our consultation on the draft determination regarding NIE T&D's capitalisation practice closed on 27 September 2012. We received non confidential responses from the following organisations:

- NIE T&D
- CCNI

1.2 In the pages overleaf we have summarised the principal points made in each of the responses, and our response in turn to each of these.

**Comments from respondents other than NIE**

In the section below we address the non confidential responses excluding NIE T&D's. The NIE T&D response is dealt with in the section that follows after.

| Ref | Organisation | Chapter | Page | Comment | Our response |
|---|---|---|---|---|---|
| | **Consumer Council** | Summary | | The CC state:<br><br>*"Perhaps less shocking but of equal concern is that over a period of seven years the Regulators office failed to detect this practice by NIE"* | It is standard regulatory practice, at each five-year price control review, to examine the reasons for any 'outperformance' in the previous control period. In this case we examined the RP4 period (which lasted from 2007 to 2012). By definition, such an examination can only be conducted retrospectively. We typically wait until the end of the price control period before conducting any examination. This also allows the company some flexibility in its expenditure between years within a control period.<br><br>It is also standard practice for us to then make adjustments for any outperformance that was not in accordance with the ex-ante rules for the price control period. In the case of RP4, we are proposing to make an adjustment in order to follow the principle that a cost item cannot be recovered through both the opex allowance and the RAB. Doing so would be double counting and not an efficiency gain. |
| | **Consumer Council** | Quantifying the Loss | | The CC state:<br><br>*"It has been at times difficult to compare information in the consultation with corresponding information in the earlier 'Northern Ireland Electricity Transmission and Distribution Price Controls 2012- 2017 Draft Determination' (the 'Draft Determination'), on the same issue."* | We appreciate that this investigation has been complex and has involved a lot of accounting and mathematical analysis. |
| | **Consumer Council** | Culpability and Sanctions | | The CC state:<br><br>*"The Regulator has powers to impose financial penalties under Article 45 of the Energy (Northern Ireland) Order 2003, and having considered the culpability of NIE and considered regulatory precedent, must publicly state whether a fine or an alternative sanction should be imposed. If no sanction is deemed appropriate, the Regulator must explain why, as giving consumers back their money is not a penalty to the company. A deterrent is required if regulation is to protect consumers going forward"* | As we are not stating that NIE T&D have broken any accounting rules or regulations we are not of the opinion that any further sanctions should be placed upon NIE T&D. Rather we consider that the RAB should be adjusted, as NIE T&D should not gain from double counting which arises due to a change in capitalisation practice. Changes in capitalisation practice include changes to the extent of capitalisation for any cost item.<br><br>We also intend to introduce a reporter into future price controls. The main benefits of a reporter include independent verification of performance and improved quality and completeness of a wide range of information to improve efficiency of the approval process. |

| Ref | Organisation | Chapter | Page | Comment | Our response |
|---|---|---|---|---|---|
| | **Consumer Council** | Regulatory Scrutiny | | The CC state:<br><br>*"consumers also expect the Regulator to have in place a framework that ensures that this type of practice does not occur in the first place and where it does exist is able to detect and deal with it as quickly as possible. The issue of capitalisation appears to expose a weakness in the past practices of the Regulators office"* | Please refer back to our response to the summary chapter.<br><br>We also intend to introduce a reporter into future price controls. The main benefits of a reporter include independent verification of performance and improved quality and completeness of a wide range of information to improve efficiency of the approval process. |

**NIE response**

The response from NIE was 2 pages long, and divided into 2 sections. For ease of reference, in the table below we have set out where in the NIE document each comment has been made.

| Chapter | Page | Paragraph | Comment | Our response |
|---|---|---|---|---|
| | | | | |
| 1 Introduction and Executive Summary | 2 | 1.2 | NIE have stated<br>"Its accounts have been properly prepared in accordance with relevant accounting standards and relevant licence obligations. These conclusions are supported by an independent review undertaken by KPMG for NIE. KPMG's review did not identify any changes in NIE's capitalisation practices as defined by IAS 8 (Accounting policies, changes in accounting estimates and errors), or any inappropriate capitalisation of expenditure resulting from breaches of applicable accounting standards." | It is important to note that we have never concluded that NIE T&D had changed its policy in the sense meant by the accounting standards. The point was rather that NIE T&D has changed the way in which the policy has been applied in practice. |
| 1 Introduction and Executive Summary | 3 | 1.4 | This section briefly outlines the key elements of NIEs critique. Among the points made are the following:<br>1. "Contrary to the view expressed by the Utility Regulator in the Draft Determination, there were no additional implied "rules" in the RP4 price control (and there was no need for such rules), beyond the provisions of licence condition 2, as to how NIE should estimate the amounts of expenditure to be capitalised." | We consider that it is NIE T&D's licence and the adoption of the composite proposal that govern the rules on which the RP4 price control were based.<br><br>The opex section of our RP4 final determination refers to a December composite proposals paper. Page 3 of the December paper clearly refers to the composite proposal, stating that:<br>*"NIE has presented to NIAER its 'Composite Proposal' which would form the basis of a five year T&D price control for RP4."*<br><br>The paper goes on to state:<br>*"The principles behind the Composite Proposal include:*<br>*• A rule-based approach to the Opex allowance that strengthens efficiency incentives and shares the savings with customers*<br>*• A Capex allowance based on actual rather than forecast expenditure, together with strengthened Capex efficiency incentives*<br>*• An allowed rate of return on assets consistent with established precedent".* |

| Chapter | Page | Paragraph | Comment | Our response |
|---|---|---|---|---|
| | | | | It is important to realise that the composite proposal, and indeed the price control, are based on principles and not specific rules. One of these underlying principles was that actual expenditure cannot be recovered through both opex and capex. It is also important to note that point three talks about consistency with established precedent. In our view, by changing its capitalisation practice NIE T&D is not consistent on this point.<br><br>Page 1 of the composite proposal document made explicit reference to the measurement of opex and capex expenditure stating:<br><br>*"The use of actual expenditure to determine future revenue entitlement removes ambiguity around the allocation of costs as between opex and capex. For regulatory purposes actual expenditure is recovered either via the RAB over 40 years or via the opex allowance but not through both."*<br><br>The explanation given in the composite proposal above is clear and states that expenditure cannot be counted twice. The composite proposal also makes clear, consistent references to encouraging efficiency savings at various points throughout the paper. |
| 1 Introduction and Executive Summary | 3 | 1.4 | 2. "NIE has not changed its capitalisation practices. Most of the changes in opex and capex which the Utility Regulator has identified arise from changes in the underlying nature of NIE's activities" | It is important to note that NIE T&D has not denied that a change in capitalisation practice has taken place. This change in practice if not addressed will result in Northern Ireland customers paying twice for certain costs. |
| 1 Introduction and Executive Summary | 3 | 1.4 | 3. "The Draft Determination represents an attempt to re-open the RP3 and RP4 price controls, without any compelling reason." | RP3 is not being re-opened and no adjustment is being made in relation to RP3. A review of RP4 is a standard requirement of the price control process and having completed and consulted on the findings of this review we are not intending to make any adjustments in relation to money collected in RP4. We have concluded that an adjustment to the RAB will be applied from the beginning of RP5. |
| 1 Introduction and Executive Summary | 3 | 1.4 | 4. The Utility Regulator's proposed adjustments to deal with asset disposals are incorrect, and do not reflect the terms of NIE's licence. | Following a review of NIE T&Ds response to Asset Disposals we have amended our final determination that no adjustment to be made for asset disposals. |

| Chapter | Page | Paragraph | Comment | Our response |
|---|---|---|---|---|
| | | | | Our draft determination calculation was based on an adjustment in the year of the disposal occurring, rather than five years later. On further consideration of both NIE T&D's response and the 2006 Direction we accept that a five year incentive for NIE T&D is appropriate. By adjusting the figure in this manner an adjustment of £0.045 million is required for asset disposal and is deemed immaterial. Therefore we now propose no adjustment to be made for asset disposals. |
| 1 Introduction and Executive Summary | 3 | 1.4 | 5. The Utility Regulator fails to recognise that the RP4 price control has worked effectively and to the benefit of consumers. | The utility regulator accepts that RP4 has delivered outperformance. This adjustment will mean that NIE T&D will keep the outperformance element. However, it will also mean that consumers will not pay twice through a return on the RAB in the future. |
| 1 Introduction and Executive Summary | 3/4 | 1.5 – 1.6 | NIE T&D state:<br>"In practice, many of the deficiencies of the Utility Regulator's reasoning and conclusions appear to be attributable to the way in which the Utility Regulator instructed its consultants to undertake detailed analysis of NIE's accounting data"<br><br>and that their consultants KPMG<br><br>"conclude that the Utility Regulator's consultants provide no evidence of changes in capitalisation practice, as defined in IAS 8, nor of any inappropriate capitalisation of expenditure, contrary to relevant accounting standards, and that the methodologies which the Utility Regulator's consultants used were simplistic and were not apt to identify changes in capitalisation practice." | We have never concluded that NIE T&D had changed its policy in the sense meant by the accounting standards. The point was rather that NIE T&D has changed the way in which the policy has been applied in practice. At no point did we state that any accountancy standard had been broken.<br><br>NIE T&D has been very careful to define its terms when describing whether there was a change in its capitalisation policy. NIE T&D says it has not made a change to capitalisation as defined by a particular accounting standard, IAS8. Our draft determination did not state an accounting standard had been broken. |
| 1 Introduction and Executive Summary | 4/5 | 1.7 – 1.9 | NIE T&D have stated that we have attempted to bring in rules into the RP3 & RP4 price control when in fact:<br>*"there were no such rules, and the Utility Regulator's attempt to introduce them now has no foundation in fact or principle"*<br>NIE T&D further state that:<br>*"The RP4 opex and capex arrangements, in combination, were designed to ensure that, in the long run, it should not matter whether particular expenditure was treated as capex or opex, since it would be recovered one way or the other"* | Please revert to our response to paragraph 1.4. This covers both NIE assumption that there were no "rules" around the price control and also quotes the composite proposal that states:<br><br>*"expenditure is recovered either via the RAB over 40 years or via the opex allowance but not through both."*<br><br>As a result of the change in capitalisation of certain items, reported operational expenditure on these items fell significantly while the reported capitalised spend (capex) increased. This created a situation whereby consumers in Northern Ireland could effectively be paying twice for certain costs: |

| Chapter | Page | Paragraph | Comment | Our response |
|---|---|---|---|---|
| | | | | • first through the opex allowance;<br>and<br>• secondly through the return and depreciation that NIE T&D receives from its RAB.<br><br>It is due to this double payment that it does matter how items of expenditure are recovered.<br><br>Paragraph 4(a) of condition 2 of NIE T&D license states:<br>*"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. The Licensee shall comply with any directions issued for the purposes of this Condition".*<br><br>We consider that this goes considerably further than simply requiring NIE T&D to apply the same accounting policies. In our view it also requires the company to apply consistent detailed application bases to the apportionment and allocation of charges. We further note that neither NIE T&D nor KPMG refer to paragraph 4(a) of licence condition 2 in their response. |
| 1 Introduction and Executive Summary | 6 | 1.10 | *"Condition 2 of NIE's licence does not preclude NIE from modifying the methods by which it estimates the amounts to be capitalised in respect of particular heads of expenditure from time to time (or the resulting estimates)"* | Please revert to response to paragraph 1.7 – 1.9 |
| 1 Introduction and Executive Summary | 6/7 | 1.11 - 1.12 | NIE T&D state:<br>*"NIE has not changed its capitalisation practices, a view supported by the independent review undertaken by KPMG which did not identify any changes in NIE's capitalisation practices as defined by IAS 8"*<br><br>And further comment that: | Our draft determination did not state an accounting standard had been broken.<br><br>One of the main principles of the RP4 price control, as laid out in the composite proposal, was that<br><br>*"expenditure is recovered either via the RAB over 40 years or via the opex allowance but not through both."* |

| Chapter | Page | Paragraph | Comment | Our response |
|---|---|---|---|---|
| | | | *"Instead, much of what the Utility Regulator condemns as wrongful capitalisation relates, in fact, to changes in the underlying activities which NIE has undertaken to improve its stewardship of its transmission and distribution network."* | The changes in capitalization practice if not addressed will result in the Northern Ireland consumer effectively paying twice for certain costs, first through the opex allowance and secondly through the return and depreciation that NIE T&D receives from its RAB. |
| 1 Introduction and Executive Summary | 7 | 1.14 | NIE T&D state *"The work undertaken by the Utility Regulator's consultants embodies important errors, which render their conclusions unreliable"* | In conjunction with our consultant auditors, we have evaluated and reviewed the calculations and conclusions and we are confident that it is accurate. |
| 1 Introduction and Executive Summary | 8 | 1.16 | *"In reality, the Utility Regulator's proposals to reduce NIE's opening RAB for RP5 by £32.67 million, and to claw back revenues representing depreciation and returns in respect of RP3 and RP4 capex, are no more than discretionary ex post adjustments to the previous price controls."* | The adjustment will be applied from the beginning of RP5. The RP4 and RP3 price controls will not be re opened. |
| 1 Introduction and Executive Summary | 8 | 1.17 | *"The Utility Regulator's proposed adjustments to deal with asset disposals are incorrect, and do not reflect the terms of NIE's licence"* | Our draft determination calculation was based on an adjustment in the year of the disposal occurring, rather than five years later. On further consideration of both NIE T&D's response and the 2006 Direction we accept that a five year incentive for NIE T&D is appropriate. By adjusting the figure in this manner an adjustment of £0.045 million is required for asset disposal and is deemed immaterial. Therefore we now propose no adjustment to be made for asset disposals. |
| 2 The RP4 Price Control: Rationale, "Rules" and NIE'S Regulatory Accounts | 9 - 15 | 2.1 – 2.14 | In section 2.1 – 2.4 NIE T&D outline our position around the rules of the price control.<br><br>Section 2.5 – 2.14 sets out NIE T&Ds response. | Please revert to our response to paragraph 1.4 |
| 3 The Utility Regulators Consultants report: Errors of Approach and Execution | 15-16 | 3.1-3.8 | In section 3.1 – 3.5 NIE T&D outline a summary of the views of our consultants.<br><br>Section 3.6 – 3.12 NE T&D outline their response to the Terms of Reference and overall approach of our consultants<br><br>In section 3.8 NIE T&D state that *"the Utility Regulator instructed the consultants to the effect* | Please revert to our response to paragraph 1.4 |

| Chapter | Page | Paragraph | Comment | Our response |
|---|---|---|---|---|
| | | | *that NIE should have obtained the Utility Regulator's consent before changing any element of its capitalisation practices. But, for the reasons given in paragraph 2.12 above, this is incorrect. It is unfortunate that the consultants should have embarked on their work on this erroneous basis"* | |
| 3 The Utility Regulators Consultants report: Errors of Approach and Execution | 18 | 3.13-3.17 | In sections 3.13 – 3.20 NIE T&D discuss the history of NIE T&Ds capitalization practices.<br>In paragraph 3.16 – 3.17 NIE state:<br><br>*"The Draft Determination further suggests that the Utility Regulator did not know about the "change" to NIE's capitalisation practice when it settled on the RP4 price control. Paragraph 2.6 of the Draft Determination states that the NIE Executive approval of 21 December 2005 "occurred after we had written to the company that we were minded to accept its 'composite proposal'."*<br><br>*We have already pointed out that there was, in fact, no "change" to NIE's capitalisation practice in December 2005. But, quite apart from whether any changes to the CEPM were substantive or not, it is misleading for the Utility Regulator to suggest that it did not know about them before settling the terms of the RP4 price control."* | We were not aware at the time of the changes made by NIE T&D that lead to an increasing proportion of certain cost items being capitalized.<br><br>No approval was given for NIE T&D to change the portion of certain costs to be capitalized in line with condition 2 paragraph 4 (a) of its licence. |
| 3 The Utility Regulators Consultants report: Errors of Approach and Execution | 18 | 3.18 | NIE T&D state:<br><br>*"In fact, NIE provided the Utility Regulator with a copy of the 2005 revision of the CEPM on 22 December 2005. This was part of the first tranche of information provided by NIE to the Utility Regulator and its consultants, Mott MacDonald, in their review of NIE's capital investment programme for RP3 and RP4, which review was undertaken in the period from December 2005 to June 2006. The Utility Regulator did not publish its Final Proposals for RP4 until September 2006"* | NIE did not highlight or state that any change in the capitalization of certain items changed when submitting the CEPM. |
| 3 The Utility Regulators Consultants report: Errors of Approach and Execution | 19 | 3.23 | NIE T&D state:<br><br>*"KPMG identify various important deficiencies in the data extracted and used by the Utility Regulator's consultants and in the manipulation of that data to address the issues discussed in the consultants' report21. We summarise those* | The KPMG response has been critiqued by our consultants. All the comments made by KPMG have been addressed. |

| Chapter | Page | Paragraph | Comment | Our response |
|---|---|---|---|---|
| | | | *criticisms in paragraphs 3.25 to 3.37 below*, *but we would refer the Utility Regulator to KPMG's full report for a fuller account of them"* | |
| 4 Asset Disposals | 24 - 25 | 4.1 – 4.6 | NIE T&D state they *"NIE disagrees with the Utility Regulator's proposed adjustment regarding the regulatory treatment of these proceeds: proceeds from the sale of plant and equipment have been consistently treated as a reduction in operating costs since NIE was privatised. The Utility Regulator expressly endorsed this approach in its 2006 Direction regarding the calculation of the controllable operating cost allowance, albeit that proceeds from the sale of plant and equipment were 'misclassified' under the heading "Excluded Service Income". By virtue of paragraph 2.3 of Annex 2, the 2006 Direction is to govern the calculation of individual terms of the RP4 price control formula."* | Our draft determination calculation was based on an adjustment in the year of the disposal occurring, rather than five years later. On further consideration of both NIE T&D's response and the 2006 Direction we accept that a five year incentive for NIE T&D is appropriate. By adjusting the figure in this manner an adjustment of £0.045 million is required for asset disposal and is deemed immaterial. Therefore we propose no adjustment to be made for asset disposals. |
| 5 The Utility Regulators Computation of the Required Revenue Adjustment | 26 | 5.1 – 5.2 | NIE T&D state that our computation of the adjustment is correct. NE further state: *"Annex 2 to NIE's licence prescribes that RP4 revenues should be calculated using a vanilla WACC approach (pre-tax cost of debt and post-tax cost of equity) and adding a separate allowance for tax. The use of a vanilla WACC approach plus tax would have the effect of increasing the allowed RP4 revenues by £0.3 million, compared with the Utility Regulator's proposed reduction of £2.65 million. This difference arises because the Utility Regulator's use of a pre-tax approach does not take into account the fact that the proposed capitalisation adjustments would affect the tax capital allowance pools with the effect that more tax would be payable."* | We have accepted that using a vanilla WACC and tax allowance is in keeping with the formula defined in NIE T&D's licence for the period when this money was recovered from customers. We therefore propose that no adjustment is to be made with respect to revenue adjustment. |
| 6 The Utility Regulators Regulatory Task: The Problem of Ex Post Adjustments | 27 | 6.4 | *"Although the Utility Regulator seeks, in the present Draft Determination, to portray its proposed intervention as an implementation of "rules" which were always intended to govern the RP4 price control, it is clear that there were no such "rules" as it now tries to find"* | Please see previous response to the issue of rules which governed the RP4 price control. |
| 6 The Utility Regulators Regulatory Task: The Problem of Ex Post | 28 | 6.8 | NIE state: *"It is damaging to confidence in the regulatory regime (and hence to investors' willingness to invest in NIE) for the Utility Regulator to re-open matters which have been satisfactorily settled in previous price control decisions: the Utility Regulator* | We are not proposing opening the RP3 and RP4 price controls. We wish to make an adjustment to the RAB that will be applied from the beginning of RP5. This adjustment will result in consumers not paying twice through a return on the RAB. |

| Chapter | Page | Paragraph | Comment | Our response |
|---|---|---|---|---|
| Adjustments | | | *adopted fair and reasonable decisions as to the price controls to be applied for RP3 and RP4, and they have served their purpose well. An ex post intervention, going back into two previous price control periods, without an exceptionally compelling justification, will merely serve to reduce investors' confidence in the NI regulatory system, to the ultimate detriment of consumers"* | |
| 6 The Utility Regulators Regulatory Task: The Problem of Ex Post Adjustments | 29 | 6.10 | NIE T&D state:<br>*"Instead of making a soundly-based judgment as to whether there should be ex post adjustments, the Utility Regulator's Draft Determination fails to consider how such adjustments sit with its statutory objectives and duties. In short, if implemented, the Draft Determination would be unfair to NIE, damaging to investor confidence, inequitable as among different generations of consumers, and ultimately to the detriment of all consumers"* | The proposed adjustment will result in NIE T&D will keeping the outperformance element. However, it will also mean that consumers will not pay twice through a return on the RAB in the future. Ensuring that consumers do not pay twice and protecting their interests is an objective of the Utility Regulator |