NIE Energy Supply's 1 October 2009 Tariff Decrease

A Regulatory Briefing

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Summary

The Utility Regulator has verified a 5% decrease in NIE Energy (NIEES) tariff for domestic electricity customers to take effect from 1 October 2009. This paper sets out the background and reasoning behind our decision.

Background

While the electricity supply market has been fully open to competition since 1 November 2007, in practice for some classes of customers, in particular domestic customers, NIEES does not face effective competition from other suppliers. The Utility Regulator therefore takes an active role in scrutinising and approving NIE Energy Supply's retail tariffs which are the final prices customers pay.

NIEE retail tariffs for this upcoming tariff year 09/10 are made up of a number of components:

Retail Tariff	=	Generation Costs	+	SSS Charges	+	PSO Levy	+	Use of Systems	+	Supplier Charge	+	NIRO Costs	+	Correction Factors
What Customers Pay		Costs of procuring electricity including MO charges, contracting costs, cost of electricity, constraints and capacity charges		For system planning, operation and despatch		Public Service Obligation costs which must be spread across all customers		Costs of transmission and distribution of electricity		Costs to supply electricity to customers e.g. meter reading, billing		Net costs of NI Renewable Obligation - NIRO costs relate to government obligation to sell a proportion of their output as renewables		The difference between allowed revenue and actual recovered revenue (mechanism whereby differences between forecasts for tariff-setting and actuals can be recouped or returned to customers) and first year effect
Split 09/10 100%		**57%**		**2%**		**4%**		**23%**		**6%**		**1%**		**7%**
Split 08/09 100%		**72%**		**1%**		**1%**		**18%**		**5%**		**1%**		**2%**

Figure 1: Components of NIEE tariff from 1st Oct 09[1]

[1] The first year effect relates to the time lag in revenues due to the quarterly billing cycle, this is a decrease in a year when there is a tariff decrease, as it takes actual revenue received some time (approximately 3 months) to catch up with the tariff change.

Several of these components are common across all suppliers and the final customer must pay these regardless of who their supplier is; these components are all subjected to regulatory review:

Cost/Tariff	Regulatory Scrutiny
Market Operator (MO) Charges	SEMO Revenue & Tariffs 2009-2010
SSS Charges (System Support Service)	SONI Price Control 2007-2010
PSO Levy (Public Service Obligation)	Annual approval of other costs
Use of System Charges (UoS)	T&D Price Control 2007 - 2012

Table 1: Tariff Components common across all suppliers and their regulation

These costs are regulated because they represent parts of the industry which are natural monopolies. Independent suppliers are free to enter the market and purchase power, but they must add on the tariffs outlined above before setting the final price to sell to customers.

The remaining components of NIEES tariffs, because of the level of competition in the market, are also all subject to regulatory scrutiny.

Cost/Tariff	Regulatory Scrutiny
Generation Costs	Competitive and regulated wholesale market; approval of NIEES hedging methodology by NIAUR; annual approval of Gt statement
Supplier Charge	NIEES Supply Price Control 2009-2010
NIRO Costs	Audited on behalf of NIAUR by Ofgem as part of its UK-wide audit
'K' Correction Factor	Analysis by NIAUR of variances between forecasts used for setting tariffs and out-turn costs

Table 2: Remaining Components of NIEE tariffs

Annual Price Review

The 5% decrease in domestic tariffs from 1 October 2009 is on top of a 10.8% in year tariff decrease in January 2009, which cumulatively is a decrease of over 15% from the previous tariff year. Overwhelmingly the key driver for the decrease is total wholesale generation costs. The 10.8% tariff decrease in January came from the same underlying cause although it was actually

delivered through a PSO rebate mechanism. This is illustrated in the table below which analyses the required revenues of NIE Energy for all of its regulated customers[2], by key component, comparing the forecast revenue underlying tariffs for the year beginning 1 October 2009 with the equivalent last year.

Component	Oct 2008/09 (12 mths) £m [3]	Oct 2009/10 (12 mths) £m	12 months movement £m	12 months movement % Change	Cost as a % of overall tariff
Generation	399.5	244.8	(154.7)	(39%)	
Capacity	56.1	60.3	4.2	7%	
Other (MO, Imperfections, NIROC)	19	20.2	1.2	6%	
TOTAL GENERATION COSTS	**474.6**	**325.3**	**(149.3)**	**(31%)**	**59%**
UoS	121.5	130.8	9.3	7.6%	**23%**
PSO	7.3	22.9	15.6	214%	**4%**
SSS	9.9	12.2	2.3	23%	**2%**
Supply costs	31.0	35.0	4.0	13%	**6%**
Correction Factors	13.8	29.1	15.3	111%	**5%**
TOTAL ALLOWED REVENUE	**658.1**	**555.3**	**(102.8)**	**(16%)**	**100%**

Table 3: Price decrease comparison in Total Revenue terms

Overall the required revenues of NIE Energy for the year commencing 1 October 2009 are 16% down compared with the requirement (on a 12 month basis) from 1 October 2008. This decrease has been fully delivered to customers: 10.8% in January 2009, and 5% in October 2009.

The following sections analyse the above cost components in more detail.

[2] NIE Energy supplies some customers in some sections of the market that are competitive, where tariffs are not set by NIAUR.

[3] To aid comparison, the 2008/09 amounts have been restated as a result of the deregulation of non-domestic customers with annual consumption greater than 150MWh (as agreed in the 2009/10 Price Control)

Generation costs

Generation costs have been decreasing as shown in graph below.

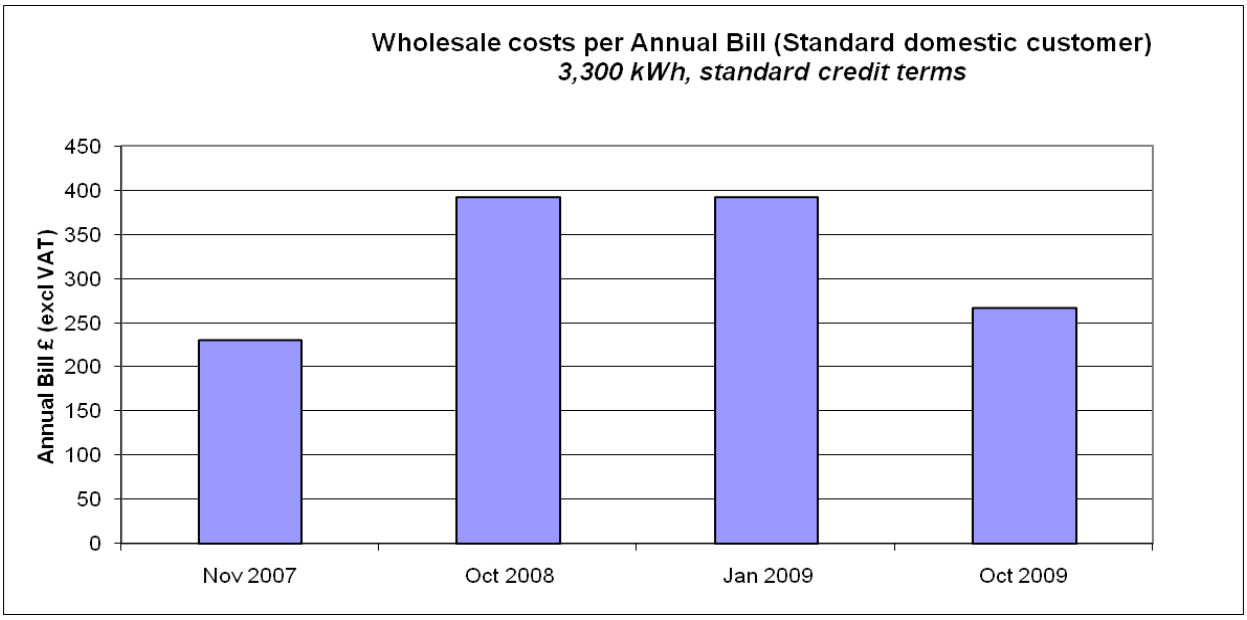

Figure 2: Wholesale costs per Annual Bill based on average annual customer usage of 3,300kWh (excluding VAT). Note as described above that the January 2009 figure does not include the downward effect on tariffs which was delivered via the PSO.

As in the previous tariff year, NIEES have now hedged a large proportion (c.80%) of their wholesale generation costs. These generation costs have decreased (from the tariff year Oct 08/09 to the coming tariff year 09/10) by 31%. Total generation costs made up around 72%[4] of the typical electricity bill in Oct 08, so the lower price of generation on its own would potentially mean a 31% * 72% = 22% reduction in the tariff:

- A proportion of this price decrease, 10.8%, has already been seen in the 1 January 2009 reductions.
- 5% of the decrease is now due to take effect 1 October as part of this normal annual review.

The remaining potential decrease (of c.6%) has not been realised due to: (1) increases in Network and Supply costs as described below; and (2) the need in the coming tariff year to recoup an under-recovery from tariff year 2008/9. These two elements are separately discussed in the sections below.

[4] Per Table 3 for 08/09 tariff year Total Generation costs £474.6/£658.1 = 72%

(1) Increases in Network and Supply Costs

Use of System

Use of System costs for NIEES have increased relative to last tariff year. This is attributable to a forecast drop in demand from 08/09 tariff year to 09/10 for NIE networks (total system demand) which has therefore pushed up unit rates and also an under recovery in the previous tariff year. (See Annex 1 for further explanation).

PSO

PSO unit charges levied on all suppliers have increased by 147% (from 0.222p/kWh to 0.549p/kWh) in 2009/10 compared to the previous year. This is due to increases in elements such as: NFFO/ROC's, excess legacy generation costs (see Annex 1 for details). In the table above it can be seen that the forecast NIEES PSO revenue for tariff year 09/10 is in fact 214% higher that the forecast PSO revenue for the 08/09 tariff year. NIEES underestimated the actual PSO revenue required for tariff year 08/09 (due to a delay in the actual PSO tariff being published at the time of the 08/09 tariffs being set). However this did not have a material effect as the PSO tariff was re-set to a p/KWh rebate in the new tariff that was announced to take effect 1 January to 30 September 2009.

SSS

SSS unit charges levied on all suppliers have increased by 23% (from 0.238p/kWh to 0.294p/kWh) in 2009/10 compared to the previous tariff year and as a result the NIEES required revenue has increased by an equal amount.

Annex 1 provides further explanation of the reasons for the increases from the 2008/9 tariff year in the above tariff components.

Supply Costs

Supply costs have increased by 13% from the previous tariff year. This is due to increased agency costs (driven by increased volumes of keypad transactions), increase in bad debt provision and increase in working capital requirements. Overall, supply costs make up 6% of the overall tariff.

(2) Reasons for under-recovery in tariff year 2008/9

Costs were under-recovered in the tariff year 2008/9 due to the following reasons:

1. NIEES carried forward £6.8m of an under-recovery from 2007/8. This was not included in the 2008/9 tariff so as to mitigate the rise last year, and is therefore included in the 2009/10 tariff.

2. Sterling weakening: An exchange rate of 1:1.16 was assumed for the NIESS' euro denominated energy hedges that represented a significant input into the January 2009 tariff review. Whilst NIEES secured hedges at the earliest opportunity following agreement to do so with the Utility Regulator, sterling weakened a further 7% from the rate assumed in early December 2008 when the 1 January 2009 Tariff reduction was announced.

3. Falling demand: A combination of the economic downturn (impacting for example on the numbers of vacant domestic properties, and reduced SME consumption) and the mild weather (average temperatures well above 20 year average), has led to NIEES sales turning out lower than expected. A reduction in demand meant that at certain times NIEES was contractually committed to hedging costs, and "difference payments" were required to buy out this obligation. Downturn in overall SEM demand also increased the capacity charge rates to suppliers. (The total capacity payments made to generators are fixed for the year ahead; with less demand there are fewer units to smear the capacity costs over and therefore suppliers are charged more per unit for capacity than was forecast).

Recent Tariff Changes - Impact

For NIEES domestic customers using 3,300 kWh per annum on standard credit, this tariff review will decrease their bill by £26 (from current 2009 tariffs) per annum to £496.

The graph below takes an average customer with average consumption of 3,300kWh per year, and compares the average bill for Oct 2009, Jan 2009, October 2008 and November 2007.

This graph shows that wholesale costs have fallen significantly but are not quite back to November 2007 levels. As described in the Annual Price Review section above, this is reflected in a decrease in tariffs since October 2008, however this decrease has been offset to some extent by other increases in network/supply/PSO and residual/correction factor costs.

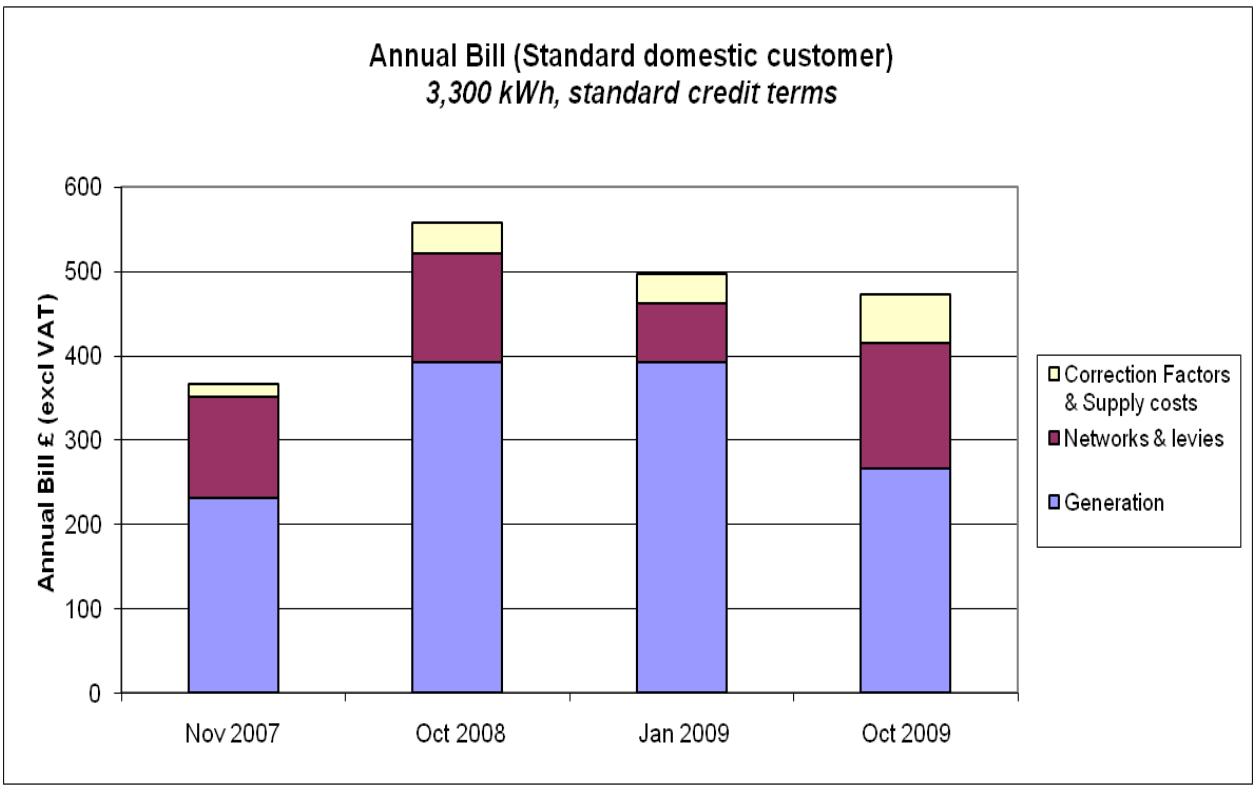

Figure 3: Recent Tariff changes based on an average annual customer usage of 3,300kWh (excl VAT). [Note: in the chart above, "Networks & Levies" includes SSS charges, PSO Levy, Use of System charges, NIRO charges and Supply costs].

Comparisons with ROI and GB Suppliers

The October 2009 NIEES tariffs compare favourably to the ESB tariffs, being on average 12.9% lower. The table below compares the previous tariff announcement in January and the current announcement to the equivalent ESB urban and rural charges. NIEES are on average lower than the comparable ESB tariffs:

	January 2009	**Higher than NIE £**	**Higher than NIE %**	**October 2009**	**Higher than NIE £**	**Higher than NIE %**
NIEES	**£522**			**£496**		
ESB – urban	£597	£75	14.4%	£545	£49	9.9%
ESB – rural	£627	£105	20.1%	£575	£79	15.9%

Table 4: Domestic Electricity costs based on average annual customer usage of 3,300kWh (including VAT and using a euro exchange rate of 1.16)

Comparison with GB and RoI

% Price Change	Effective Date	GB Comparison	RoI Comparison
10.8% increase	April 2006	NI prices 11% higher for domestic, and 28% higher for SME's than in GB	NI domestic prices will be around 7% lower than RoI prices, but SME's 10% higher in NI.
3% decrease	April 2007	NI prices same as GB average for domestic, and around 28% higher for SME's	NI prices 17% lower than RoI average.
3.6% increase (domestic) 1% increase (businesses)	November 2007	NI domestic prices just below GB comparator regions[5]; and SME prices 21% higher than GB average.	NI domestic prices around 8% lower than RoI , and SME's around 4% higher than av. RoI
14% increase	July 2008	NI domestic prices approx 2.1% higher than GB	NI prices around 9% lower than RoI.
33.3% increase	October 2008	NI domestic prices 20-24% higher than GB	NI prices comparable to RoI prices
10.8% decrease	January 2009	NI domestic prices around 10% higher than GB average and around 5% higher than comparator GB regions.	NI prices around 14.7% lower than RoI prices
5% decrease	October 2009	Following the round of price reductions in GB in spring 2009, NI domestic prices around 12% higher than GB average and 8% higher than comparator GB regions.	NI prices around c 13% lower than the RoI prices (ESBCS).

Table 5: Historical NIEES price adjustments compared to GB and RoI

[5] The three GB comparator regions are: Sweb, Swalec and Scottish Hydro Electric (these relate to the regions of the former GB electricity boards: South-Western Electricity Board (SWEB), South Wales Electricity Board (SWALEC) and North of Scotland Hydro-Electric Board (Scottish Hydro)). These are the normal comparator regions when assessing domestic electricity prices vis-à-vis Northern Ireland, due to similarities in the distribution and scarcity of the population.

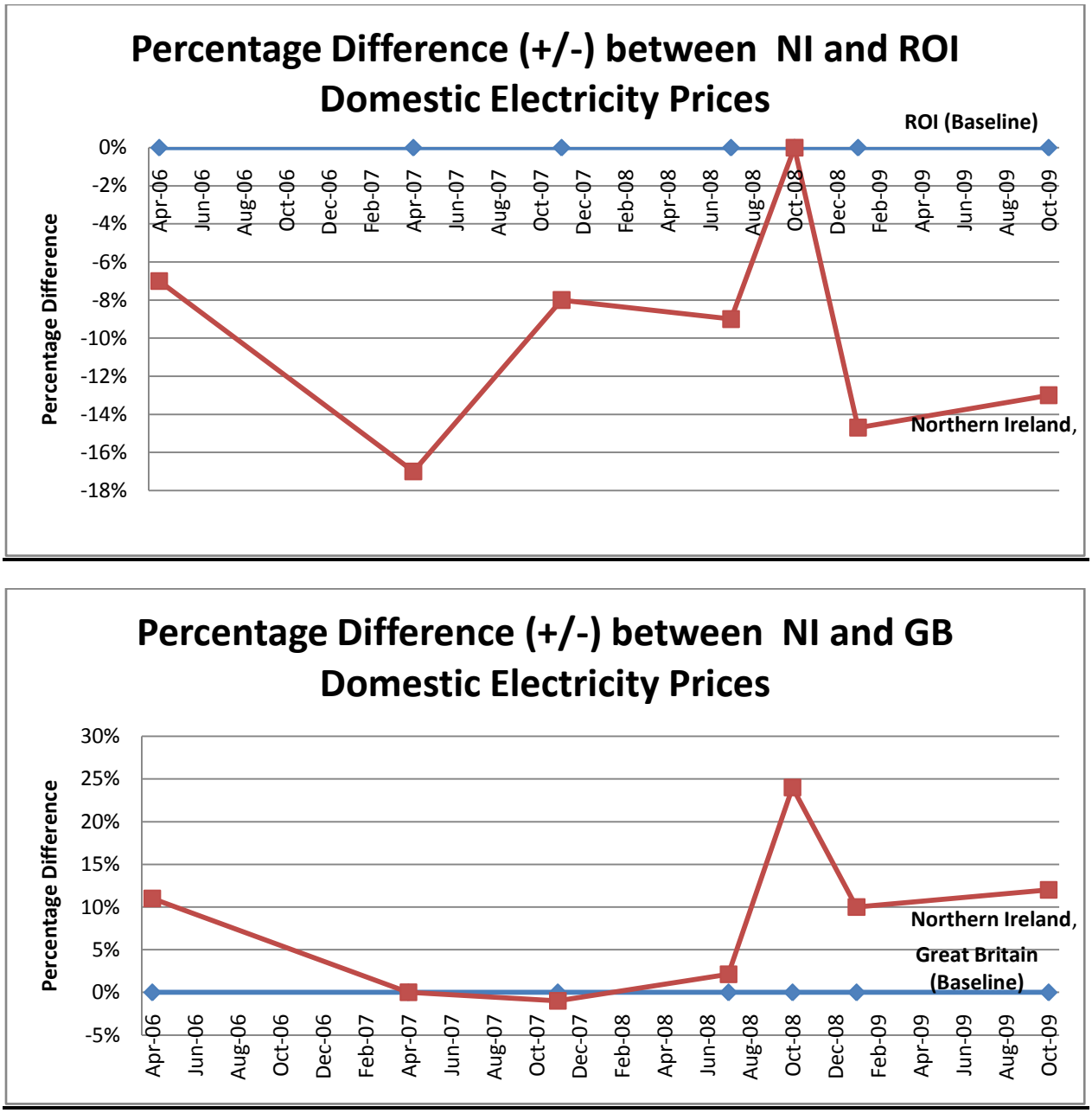

Figure 4: NI v's RoI v's GB (GB average) domestic comparisons

The long-run trend is for NIEES prices to be c.10% higher than those in GB (reasons are discussed below in Figure 5). Note that 2007 was an unusual year. The principal cause of the temporary parity between GB/RoI prices in the period April 07 to April 08 was as a result of a significant over-recovery built up by NIEES in the previous tariff year.

The following graph compares the October 2009 prices for NI and RoI to the prices from the larger suppliers in GB.

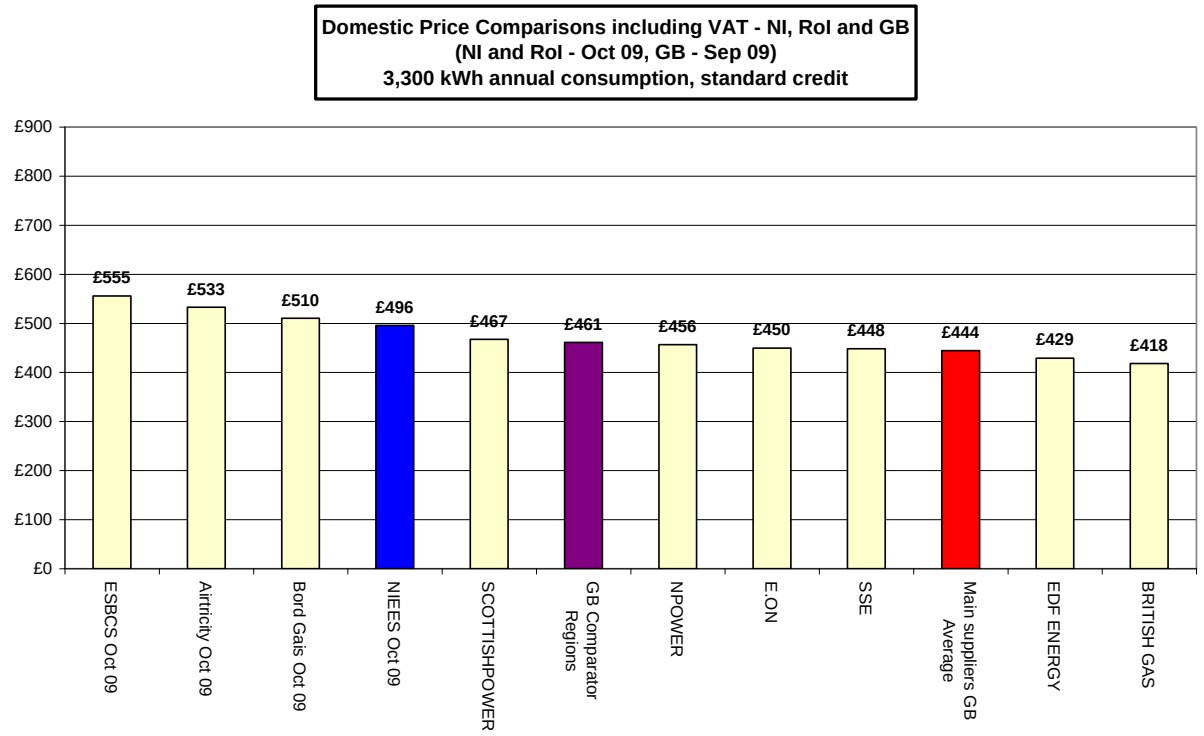

Figure 5: NIEES tariffs per average customer compared to RoI and GB

From the graph it can be seen that NIEES tariffs are c.12% higher than the main suppliers in GB (average) and 7.6% higher than the GB comparator regions.

Historically electricity prices in Northern Ireland have tended to be higher than Great Britain. Key disadvantages that have led to higher prices in Northern Ireland are:

- higher energy transport costs;
- economies of scale in Great Britain owing to the size of the market there compared to Northern Ireland;
- the additional cost of long term legacy generation and associated contracts (not present in GB markets) although this is not relevant this year; and
- the different fuel mix in Great Britain (i.e. Northern Ireland has a reliance on gas, Great Britain's generation mix is spread between nuclear, gas and coal).

Comparison with Europe

The following graph compares the October 2009 prices for NI, RoI and GB to Europe.

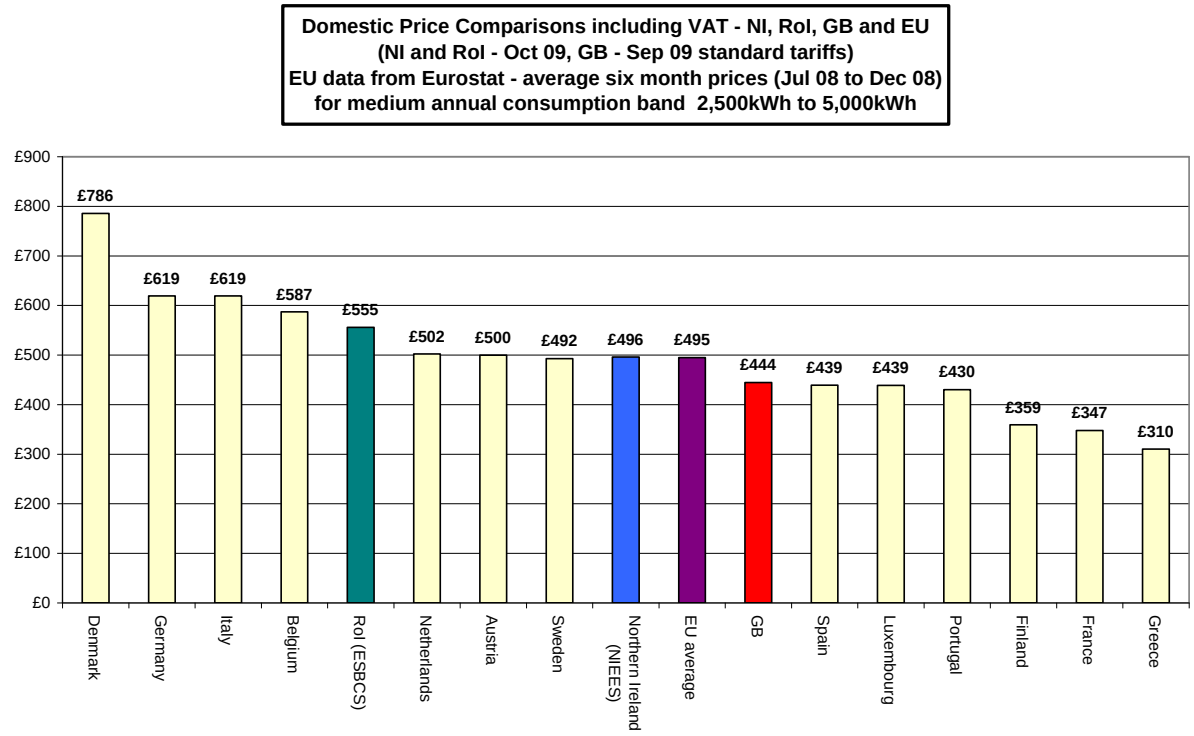

Figure 6: NIEES tariffs per average customer compared to RoI, GB and EU

We recognise the need to caveat these figures as the EU data is relatively historial due to delays in data availability; however, with that caveat, from the graph it can be seen that NI tariffs are broadly equal to the EU average.

ANNEX 1 – Briefing on PSO, SSS and UoS inputs to the Tariff model (published on 11th September 2009)

REASONS BEHIND INCREASES IN PSO, DUoS, TUoS and SSS

Information Note

September 2009

1 – Introduction

New regulated retail tariffs are due to come into effect in Northern Ireland from 1 October 2009. A number of the elements that have been used to create these tariffs have substantially varied from the previous year and to increase transparency in relation to this issue the Utility Regulator has published this note providing information on these variations and the reasons that they have occurred.

	2008/09 £m	2009/10 £m
NFFO / ROCs	-3.943	0.432
Landbank	0.095	0.093
CBO allocation	20.711	20.715
Kilroot Flue Gas Desulphurisation	22.760	23.960
Excess Legacy Generation costs	-37.540	-15.102
Market Costs	10.213	7.958
Energy Efficiency Prog. Funding	6.822	7.780
PSO Total Charges	**19.118**	**45.836**
Distribution Use of System (DUoS)	156.678	164.683
Transmission Use of System (TUoS)	35.372	35.757
SSS	20.550	24.180
Total	**£231.718**	**£270.456**

Table 1 PSO, UoS and SSS comparison to previous tariff year

Table 1 shows the comparison between individual elements within the Public Supply Obligation (PSO), Distribution Use of System (DUoS) and Transmission Use of System (TUoS) for both 2008/09 and 2009/10. An impact on all of these costs has been the reduction in electricity demand during 2009 below predicted levels leading to additional cost recovery required in the 2009/10 tariff year. These are revenue tariff requirements and the impact of these changes on individual tariffs will vary in relation to any projected demand in 2010. The PSO figure in table 1 does not reflect the PSO reduction in January 2009; it is comparing the position at start of October 2008 to the current position in October 2009.

NFFO contracts and ROCs are managed by NIE Energy Supply. Any costs associated with these processes are claimed through the PSO. The majority of NFFO contracts ended in March 2009 and the volumes of energy have significantly reduced. This has impacted on this value.

The Customer Buy Out (CBO) allocation costs relate to the customer buy out of Ballylumford contracts and these costs are due to end in March 2012. The Kilroot Flue Gas Desulphurisation costs end 1st November 2010.

Historically within the tariff setting process increases have been applied as a percentage increase across the tariff groups however EU legal requirements require this to be revised and a more cost reflective approach to be adopted. It should be noted that the cost reflective pricing model has led to larger than average changes, both positive and negative, within individual tariffs. This change is part of a two stage approach by the Utility Regulator to meet its legal obligations. The change in DUoS to cost reflective pricing is the first stage with a planned change in TUoS to cost reflective pricing next year completing this approach. The Utility Regulator plans to hold a workshop this winter in relation to this issue. This will be aimed at increasing transparency in relation to cost reflective requirements and the impact of cost reflective tariffs.

2 - Reasons Behind Increases

Excess Legacy Generation costs

The reduction in excessive legacy generation costs from 2008/09 to 2009/10 reflects the expected reduced running of Kilroot Power Station due to gas prices. In December 2008 NIE's Power Procurement Business (PPB) was in a position to return a substantial amount of money to the customer. This was due to PPB selling contracts for electricity generation to suppliers in the summer without backing off these sales with fuel "hedges". This was done with regulatory approval. As fuel prices fell in the latter half of 2008 a surplus was built up, and by December it was around £100m. This allowed a one-off reduction in the PSO charge for the remainder of the tariff year, which was deemed the best method of returning this money to all customers. This led to a negative PSO value to customers. This is not reflected in the table as this relates to the January 2009 reduction.

Market Costs

Costs attributable to the approval of Further Residential Market Opening (Enduring Solution) are within market costs. These are costs both for the initial stage and for stage 2. These include the costs of NIE scoping various options and carrying out a full procurement exercise for a suitable implementation partner for a project that will entail exiting their moribund legacy system and installing a new set of market systems. These systems will facilitate a fully competitive domestic market. This will ensure compliance with EU Directives regarding full business unbundling and competitive electricity markets.

Other items included within these costs that have led to an overall reduction in market costs are the Fuel Security Code and an adjustment for under recovery from the previous year.

Distribution Use of System (DUoS)

The increase in DUoS is due to primarily due to under recovery in the previous tariff year. The overall required review regarding DUoS has led to changes within the DUoS charging groups. In the past Use of System costs were weighted towards greater revenue recovery from those customers with higher peak demand. The cost reflective pricing that has been applied to distribution costs has higher standing and availability charges. It also produces a more constant phasing of revenue recovery throughout the year for some customers.

Transmission Use of System (TUoS)

Transmission Use of System costs have not moved to a cost reflective model this year but as there are legal obligations on regulators from EU directives to be cost reflective it is intended to apply a cost reflective approach to Transmission costs next year.

System Support Services (SSS) Charges

Under recovery and demand reduction account for 8.5% of the increase in SSS tariff. Ancillary Services has also seen an increase due to change in allocation of grid code penalty payments, increase in Moyle low frequency reserve provision and an addition of high frequency response via Moyle.

The biggest driver in the increase in the SSS tariff is the ETSO (European Transmission System Operators) scheme. The purpose of the scheme is to compensate Transmission System Operators across Europe for use of their network for transit flows. In 2007 the Utility Regulator approved SONI's signing up to the scheme. The cost was originally estimated to be relatively small, however the complex methodology proved to be impossible to predict and the out-turn is much higher. (A £200k provision was made in 2008/9 tariffs, but the outturn cost was £814k.) This methodology is currently being reviewed, with the new method due to be in place by 2011. The EU framework imposes this cost onto system operators, therefore at present it can only be collected via the SSS tariff (SONI's source of income). This current charging framework is defined in SONI's licence. There is an expectation that the SSS allowance will significantly reduce for the next tariff year.