

Northern Ireland Electricity Limited

**NIE's Response to
the Utility Regulator's Draft Determination
in respect of an Investigation into
NIE's Capitalisation Practice**

27 September 2012



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**NIE'S RESPONSE TO THE UTILITY REGULATOR'S DRAFT DETERMINATION
IN RESPECT OF
AN INVESTIGATION INTO NIE'S CAPITALISATION PRACTICE**

1. INTRODUCTION AND EXECUTIVE SUMMARY

- 1.1 This submission contains NIE's response to the Utility Regulator's Draft Determination of 29 August 2012 resulting from its investigation into NIE's capitalisation practices (**Draft Determination**). The Draft Determination provisionally decides that NIE's opening RAB for RP5 should be reduced by £32.67 million, and that its base allowed revenues should be reduced by £2.65 million to take account of alleged over-recoveries during RP4. The Utility Regulator has provisionally found that NIE has changed its capitalisation practices, with the result that it has capitalised excessive amounts of expenditure in respect of overheads (£9.8 million), repair and maintenance costs (£13.2 million) and tree-cutting costs (£12.6 million). The Utility Regulator has provisionally found that, in consequence, consumers have been charged twice for such expenditure – that is, through the opex allowed to NIE and through NIE's recovery of part of the same expenditure through depreciation charges and a return on the amounts that were wrongly capitalised.
- 1.2 NIE firmly rejects the Utility Regulator's provisional conclusions. NIE has not changed its capitalisation practices. 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. Nothing in the Draft Determination or the Utility Regulator's consultants' report establishes that NIE has double-charged consumers for any expenditure. NIE's regulated transmission and distribution charges have been set within the levels contemplated in the RP4 price control settlement, in line with the overall capex budget agreed for the RP4 period and the agreed opex allowance. In consequence, the Utility Regulator has no sound basis for reclassifying NIE's expenditure so as to reduce the amounts added to the RAB during RP3 and RP4, nor to make consequential adjustments to the revenue allowance for RP5 to claw back the monies recovered by way of depreciation and a return on capital in respect of those additions to the RAB. Any suggestion that NIE has acted improperly in any way is firmly rejected.
- 1.3 NIE submits that much of the Draft Determination is misconceived: it is based on assumptions which are incorrect; it addresses questions which are, in principle, irrelevant to the setting of the RP5 price control; and its findings and conclusions are therefore also irrelevant. But, quite apart from the fact that the Draft Determination is misdirected in these ways, the work undertaken by the Utility Regulator's consultants

is also unsound. For completeness, NIE elaborates on all these points in the body of this response.

1.4 In this summary section, we outline the key elements of NIE's critique of the work undertaken by the Utility Regulator's consultants and of the Draft Determination insofar as it relies on and gives effect to the consultants' conclusions. NIE's critique shows that:

- 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.
- NIE has at all times compiled its regulatory accounts in accordance with condition 2 of its licence, and condition 2 allows NIE periodically to re-assess the amounts to be capitalised in respect of particular heads of cost.
- 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.
- The Utility Regulator fails to recognise that the RP4 price control has worked effectively and to the benefit of consumers.
- The work undertaken by the Utility Regulator's consultants embodies important errors, which render their conclusions unreliable.
- The Utility Regulator has received annual updates from NIE as to its outturn capex and opex, but has not raised any objection until now.
- The Draft Determination represents an attempt to re-open the RP3 and RP4 price controls, without any compelling reason.
- The Utility Regulator's proposed adjustments to deal with asset disposals are incorrect, and do not reflect the terms of NIE's licence.
- The Utility Regulator's conversion of the adjustments proposed by its consultants into final revenue adjustments is incorrect.

1.5 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, without first discussing the consultants' terms of reference with NIE, and without encouraging the consultants to consult NIE as to how the data was to be interpreted. The consultants' work was, in consequence, conducted inefficiently due to their deficient understanding of NIE's programmes and processes, and misinterpretations of the data. And the tasks which the consultants were asked to undertake proceeded

on the basis of an erroneous set of assumptions as to how the RP4 price control was intended to operate.

- 1.6 NIE refers below to work undertaken by KPMG for NIE. KPMG has reviewed the work undertaken by the Utility Regulator's consultants. KPMG's report at Annex 2 explains many of the shortcomings of the consultants' analysis and conclusions. KPMG 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. NIE is satisfied that its regulatory accounts have been properly prepared, and NIE's auditors have not reported any breaches of applicable accounting standards or inappropriate capitalisation of expenditure.

Contrary to the view expressed by the Utility Regulator in the Draft Determination, there were no additional implied "rules" in the RP4 price control, beyond the provisions of licence condition 2, as to how NIE should estimate the amounts of expenditure to be capitalised

- 1.7 The Utility Regulator seeks to characterise the Draft Determination as being directed at ascertaining whether NIE has broken "rules" which formed part of the price control arrangements for RP3 and RP4¹. It assumes that there were "rules" which required:
- (i) that NIE should maintain precisely the same methods of estimation of the amounts of expenditure to be capitalised (or of the percentages to be capitalised) from one year to the next in RP4 (and, so far as might impinge on RP4, during RP3 too); and
 - (ii) that, prima facie, NIE should benefit from outperformance, relative to the opex allowance for each year of RP4, only if it can be shown that its outperformance was attributable to operational efficiency gains on a like for like basis compared to the costs incurred 5 years previously.
- 1.8 But, in reality, there were no such rules, and the Utility Regulator's attempt to introduce them now has no foundation in fact or principle. The Utility Regulator seeks to infer such rules from a misreading of comments made by NIE prior to the adoption of RP4. The correct construction of the RP4 price control is to be determined by reference to the Utility Regulator's Final Proposals for RP4 and the resulting licence conditions. But there is nothing in the RP4 price control conditions, nor in the Final Proposals for RP4, nor in the logic of the RP4 price control arrangements to justify the finding of such "rules".

¹ See paragraph 2.10 of the Draft Determination, where the Utility Regulator says that "These rules [i.e. the ones which are identified in chapter 3 of the Draft Determination] are very important to our approach ...". Yet these rules, which go beyond condition 2 of the licence and are inconsistent with general principles of RPI-X price control regulation were not articulated before the Draft Determination.

1.9 The underlying logic of the RP4 price control arrangements was as follows:

- There should be simple mechanisms to ensure that, so far as related to controllable opex, any savings achieved by NIE in one regulatory period should feed through to lower prices in the next period; and, so far as related to capex, the recovery of depreciation and a return on capital employed would be based on actual rather than forecast capex.
- The RP4 opex mechanism was designed to avoid the need for granular ex ante assessment of NIE's operating costs, whilst incentivising NIE to spend less on opex than was provided for in the revenue allowances, so that the lower outturn opex could be used to inform the opex allowance to apply for the next price control period (RP5)². But the present Draft Determination entirely defeats the first objective, by subjecting NIE's outturn opex to a detailed ex post comparison with opex incurred in RP3. The Draft Determination fails to recognise that the RP4 opex mechanism has been successful in incentivising NIE to reduce its opex expenditure: NIE has delivered significant real efficiencies in RP3 and RP4 which are already flowing through to customers and will continue to do so in RP5. NIE's position as a top quartile performer in terms of cost efficiency is supported by the detailed benchmarking analysis carried out by NIE's consultants.
- The RP4 capex mechanism was designed to avoid the possibility of NIE's RAB being increased by more than its actual capex spend, where actual capex fell short of what NIE had forecast at the beginning of the price control period. That has been successfully achieved, but the Utility Regulator pays no regard to the successful attainment of this objective of the RP4 arrangements.
- 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, either over the life of the asset (capex), or in the regulatory period in which it was incurred (opex). Condition 2 of NIE's licence (which regulates the way in which NIE should draw up its regulatory accounts) ensures that NIE applies appropriate principles for the treatment of expenditure as capex or opex. It thereby supports the effective operation of the RP4 price control mechanism, and also ensures equity among different generations of customers, by allowing the Utility Regulator to set price controls which allow for the fair recovery of overall costs according to the period in which opex is incurred, and the life of assets resulting from capex expenditure.

² This latter point is clear from the Utility Regulator's proposals for RP4 (December 2005), where the Utility Regulator stated that "the difference between allowed opex and actual expenditure would be realised as efficiency gains by the company. At the time of the next price control review, the Utility Regulator would see the reduction in opex levels and would set a correspondingly lower entitlement for the next period. Customers would see the benefits from efficiency improvements through lower bills in the subsequent price control period. "

NIE has compiled its regulatory accounts in accordance with condition 2 of its licence, and condition 2 allows NIE periodically to re-assess the amounts to be capitalised in respect of particular heads of cost

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)³, provided that NIE's accounts conform to appropriate accounting standards, and are otherwise consistent with the particular obligations imposed by condition 2. NIE has at all times complied with condition 2 in the preparation of its regulatory accounts. Indeed, it would be difficult for NIE to comply with condition 2 if it were not allowed to alter the methods by which it estimates the amounts to be capitalised from time to time (or the resulting estimates), since periodic re-assessment of such estimates is necessary and appropriate to ensure that its accounts continue to give a true and fair view of the matters to which they relate. NIE's auditors have expressed themselves satisfied that NIE's regulatory accounts comply with condition 2 of NIE's licence (and this entails a judgment that the accounting practices used by NIE are sound) by providing an audit opinion to that effect in respect of NIE's regulatory accounts for each relevant accounting period.

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

1.11 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 (Accounting policies, changes in accounting estimates and errors), or any inappropriate capitalisation of expenditure resulting from breaches of applicable accounting standards. The Utility Regulator and its consultants identify only very limited changes in the way in which NIE estimates the amounts to be capitalised in its accounts: NIE has changed the way in which it estimates the amounts to be capitalised in respect of certain heads of expenditure (or the resulting estimates) and it has employed new ways of estimating the amount of repairs and maintenance expenditure to be capitalised (based on better tools for capture of the underlying data and business process improvements). But these do not amount to changes in capitalisation practices, but in the estimates derived from the application of consistent practices.

1.12 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. For example,

³ And the Utility Regulator accepts that it is open to NIE to determine its capitalisation policies, within the constraints of condition 2 of the licence. See paragraph 2.5 of the Draft Determination.

since 2004/5, NIE has focused more attention on asset refurbishment on the overhead line network, which entails a substantial amount of tree-cutting activity, to address increasing safety- and performance-related risks. The costs of the tree-cutting activity undertaken as part of the asset replacement programme are properly capitalised in NIE's accounts. In consequence of this capital programme, NIE undertakes less reactive tree-cutting activity and there is therefore a lesser charge to opex for such tree-cutting activities. There is no proper basis for the Utility Regulator now to reopen the RP4 settlement so as to penalise NIE for having introduced new more efficient ways of managing its network, simply because the overall mix of work differed from what had been done in previous years. Indeed, the Utility Regulator's version of the "rules" which governed the RP4 arrangements appears to contemplate that efficiencies which consist in the undertaking of new capex projects, and thereby avoid the incurring of opex, and reduce overall costs, are not legitimate efficiency savings at all.

The Utility Regulator fails to recognise that the RP4 price control has worked effectively and to the benefit of consumers

1.13 In light of what is said above, it is clear that the RP4 price control has worked well: it has driven reductions in NIE's opex and has enabled NIE to adopt new and more effective ways of managing its assets. NIE reduced its gross operating costs (before the capitalisation of overheads) by more than £65 million between RP3 and RP4, and those reductions will be factored into the assessment of allowable costs for RP5. The Utility Regulator and its consultants have erred in failing to recognise that the RP4 price control has worked effectively to protect consumers and to incentivise efficiency on the part of NIE without any need for such adjustments as they now propose.

The work undertaken by the Utility Regulator's consultants embodies important errors, which render their conclusions unreliable

1.14 The Utility Regulator's Draft Determination relies heavily on the work undertaken by its consultants. But their work was undertaken, for much of the time, without proper engagement with NIE. Although NIE has sought to correct many of the initial errors which they made, their analytical model, and the implementation of their model, still embodies important errors and shortcomings, which render their overall conclusions erroneous and unreliable.

The Utility Regulator has received annual updates from NIE as to its outturn capex and opex, but has not raised any objection until now

1.15 The Utility Regulator implies that it has commissioned its consultants to review these matters at this juncture because it has only just discovered the alleged changes in

NIE's accounting practices, and that the setting of the RP5 price control provides, quite fortuitously, an appropriate opportunity to "correct" for any deficiencies in the implementation of the RP4 price control⁴. But this suggestion is spurious: NIE has reported annually to the Utility Regulator on its price-controlled revenues, its capex expenditure and its opex expenditure during RP4⁵, and the Utility Regulator should not have found it necessary to wait until the setting of the RP5 price control to raise questions, and to examine the matters discussed in the Draft Determination (to the extent that such matters merit examination at all).

The Draft Determination represents an attempt to re-open the RP3 and RP4 price controls, without any compelling reason

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 Utility Regulator's attempt to disguise the adjustments as corrections which are necessary to bring NIE's accounts into line with "rules" which formed part of the RP3 and RP4 arrangements is without foundation. The proposed adjustments are inconsistent with the incentive properties of RPI-X price control. The Utility Regulator has not sought to justify the proposed adjustments by reference to its statutory duties and objectives and, in NIE's submission, it could not do so. The adjustments are based on erroneous analysis and findings undertaken by the Utility Regulator's consultants; they fail to take account of relevant facts and considerations; and, in principle, the detrimental effects of this kind of ex post intervention (in terms of reduced investor confidence in the regulatory regime) outweigh any benefits to consumers (through lower prices in the short term).

The Utility Regulator's proposed adjustments to deal with asset disposals are incorrect, and do not reflect the terms of NIE's licence

1.17 The Utility Regulator's proposed adjustments to NIE's RAB and revenues to correct for alleged errors in respect of the treatment of the proceeds of asset sales are also incorrect. The Utility Regulator has failed to apply an appropriate treatment of such transactions, having regard to the provisions of NIE's licence and the accompanying 2006 Direction.

⁴ Paragraph 1.3 of the Draft Determination. But this is partially contradicted, so far as relates to RP3, by paragraph 4.3 of the Draft Determination.

⁵ Via regulatory accounts, capex reports, and tariff submissions.

The Utility Regulator's conversion of the adjustments proposed by its consultants into final adjustment figures are incorrect

- 1.18 In addition, the Utility Regulator's calculations to convert the adjustments proposed by its consultants into final adjustment figures are incorrect, owing to the incorrect treatment of the WACC element of the calculation.
- 1.19 We elaborate on these points in the remainder of this response.
- 1.20 In line with the Draft Determination, all costs referred to in this response are in 2009/10 prices unless otherwise stated.

2. THE RP4 PRICE CONTROL: RATIONALE, "RULES" AND NIE'S REGULATORY ACCOUNTS

The Utility Regulator's position

- 2.1 The Utility Regulator's Draft Determination places emphasis on what it describes as the regulatory "rules" which governed previous price controls applied to NIE's Transmission and Distribution (T&D) Business⁶, as being the benchmark by which it judges whether there should now be any ex post adjustment to the revenue allowances envisaged by the principal draft determination for RP5⁷.
- 2.2 The Utility Regulator describes the principal "rules" which applied in RP3 and RP4 in paragraphs 3.4 to 3.10 of the Draft Determination, noting that the RP3 price control specified overall revenue allowances for the RP3 regulatory period (to cover both opex and projected capex), whilst the RP4 price control provided for each year's controllable opex allowance to be derived from the outturn controllable opex for the corresponding year of the RP3 price control period, with a separate figure for recoverable capex, based on NIE's actual capital expenditure from year to year, and with the RAB being updated by reference to actual capex.
- 2.3 The Utility Regulator now seeks to infer that certain additional rules are to be understood as implicit in the RP4 price control settlement, which are adumbrated (but not specifically formulated) in paragraphs 3.12 to 3.14, as follows:

"3.12 Because of the regulatory rules that were in place for RP4, the classification of costs between opex and capex was particularly important. The Regulatory agreement at the time of setting the RP4 rules was based on an understanding that costs were, and would continue to be, classified in a consistent manner. [This paragraph is annotated with a footnote as follows: As per condition 2 of NIE T&D's licence "Preparation of Accounts" Paragraph 3(b) "The Licensee shall... prepare on a consistent basis".]

⁶ See, for example, paragraphs 2.7, 2.10 and section 3 of the Draft Determination.

⁷ i.e. the Draft Determination dated 19 April 2012.

- 3.13 It should be noted that the issue of cost allocation was specifically addressed by NIE T&D in making its proposals in relation to the RP4 price control.

*"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**" (emphasis added).*

- 3.14 It is standard regulatory practice to review the costs incurred in the most recent price control period, to ensure that any outperformance is efficient and to inform the next price control. During the review that we carried out as part of the process for RP5, it became apparent that changes had occurred in relation to capitalisation practice. These changes related to certain cost items which had been included in the opex allowance for RP4."

2.4 As the remainder of the Draft Determination (and the accompanying consultants' report) shows, the Utility Regulator infers the following from these paragraphs (without ever saying so expressly):

- the first new "rule": that it formed part of the RP4 price control settlement that NIE should not alter its "capitalisation practices" in any way that would alter the amounts treated as capex under any particular head of expenditure, and that the amounts of capex recoverable, and the amounts to be added to the RAB from one year to the next, should be calculated by reference to accounts drawn up by reference to unaltered "capitalisation practices"; and
- the second new "rule": that it formed part of the RP4 price control settlement that the Utility Regulator should review NIE's outperformance against its opex allowance ex post to determine to what extent such outperformance was attributable to efficiency, and that, prima facie, any outperformance might be clawed back at the end of RP4 if it was not the outcome of improvements in operational efficiency in the conduct of activities on a like for like basis.

NIE's response

2.5 The Utility Regulator correctly identifies that the structure of the RP3 and RP4 price controls was different in key respects. It also notes that the RP4 price control was based on a "composite proposal" advanced by NIE in its submission of 4 March 2005, as part of a dialogue with the Utility Regulator which had started shortly after the adoption of the RP3 price control, to facilitate a more collaborative, and less labour-intensive approach to the setting of future price controls. However, much of the Utility Regulator's description and analysis of the implications of the RP3 and RP4 price controls is erroneous or misleading.

2.6 So far as relates to RP3, the Utility Regulator fails to explain that the allowed revenues for RP3 were determined at the level of "total revenues"; a capex allowance and opening RAB were agreed between the Utility Regulator and NIE, and the implied opex allowance was derived as a residual amount, having regard to the

capex allowance, opening RAB and the applicable depreciation charges and allowed return⁸.

2.7 So far as related to RP4, NIE's composite proposal had specifically proposed that the RP4 price control should allow NIE to recover (so far as presently relevant):

- an annual controllable opex allowance based on the outturn controllable opex for the corresponding year of the RP3 period; and
- actual capex incurred in the relevant year of the RP4 period

and that the RAB should be updated by reference to such actual capex from one year to the next.

2.8 NIE had suggested that its composite proposal for RP4 would be simple to implement, since it would avoid the need for the Utility Regulator to forecast NIE's future opex on a bottom-up basis⁹; it would remove the risk that NIE's prices would factor in the cost of capex projects which, with hindsight, it was unable to deliver during the price control period and which led to an overall capex underspend (i.e. the "capex underspend problem") and it would ensure that any opex savings achieved in one regulatory period would be reflected in the opex element of allowed revenues in the next regulatory period. The figures would be audited (via NIE's regulatory accounts), and capex expenditure would be reported annually to the Utility Regulator. Accordingly, the composite proposal would be easy and transparent to implement in accordance with a simple mechanistic formula. In addition, the treatment of particular expenditures as capex or opex would be a matter of indifference over the life of particular assets (approximately 40 years), since the longer term operation of the formula would mean that any amounts charged to capex would reduce opex by a corresponding amount, and be factored into the next period's price controls in the form of lower allowed opex. (In addition, the system would facilitate the setting of price controls which would operate equitably as between different generations of customers, since any decision as to whether to capitalise particular costs or to recover them immediately as opex would have to be made in accordance with condition 2 of NIE's licence, which required that the regulatory accounts be prepared in accordance with best accounting practices, and provide a true and fair view of the matters to which they relate. The Utility Regulator could rely on the regulatory accounts to determine whether particular costs should be recovered immediately from the present generation of customers, or over the longer term, from customers who enjoyed the benefit of the assets resulting from capex expenditure.) The extracts from NIE's composite proposal quoted in paragraphs 3.9 and 3.13 of the Draft Determination are to be understood accordingly.

2.9 The Utility Regulator adopted a price control for RP4 which reflected NIE's composite proposal. The Utility Regulator's Final Proposals of September 2006 run to just 6

⁸ See Ofreg's letter dated 23 December 2003 to NIE.

⁹ Ofreg's letter dated 18 October 2005 acknowledges that this high level approach was intended to "provide a mechanism whereby the Opex allowance becomes mechanistic and avoids the need for detailed micro-modelling of required costs."

pages, and the resulting price control conditions (at Annex 2, paragraph 2.3 of NIE's licence) set out the formula for the application of the composite proposal in mechanistic terms. The price control formula is supplemented by a regulatory Direction dated 19 December 2006, which outlines the method by which the values of particular terms of the price control formula are to be ascertained for individual years during the RP4 period. Generally, the Direction takes it as read that the figures will be derived from NIE's regulatory accounts and that the regulatory accounts should be supplemented by the provision of additional calculations to show how the new price control values have been derived from the accounts. It is to be noted that neither the Final Proposals nor the price control condition, nor the regulatory direction provide for (or contemplate) that there should be any additional accounting or other rules to govern the operation of the RP4 price control.

- 2.10 As a further safeguard for consumers, the Utility Regulator decided that there should be no risk of any increase in transmission and distribution charges during RP4, so the price control formula provides that NIE's charges should be capped at whichever is the lesser of the charges applied during RP3 and the charges implied by the composite proposal formula¹⁰. This provided a further safeguard against any improper increase in the charges to be applied during RP4 by, for example, the re-classification of expenditure from opex to capex.
- 2.11 Within this context, it is clear that the Utility Regulator has no proper basis for finding additional "rules" to govern the operation of the RP3 and RP4 price controls, in the terms set out in paragraph 2.4 above.
- 2.12 So far as relates to the first new "rule":
- The Utility Regulator suggests that licence condition 2 requires NIE not to alter any of its "capitalisation practices" in the preparation of its regulatory accounts. The Utility Regulator does not define precisely (by reference to condition 2 of the licence) what it means by "capitalisation practices" nor what particular practices it considers NIE to have changed.
 - In reality, as explained below, NIE has not altered the basis on which it draws up its accounts¹¹, nor its accounting policies.
 - NIE has, however, in some cases, re-assessed the estimates of the amounts to be capitalised under particular heads of expenditure (notably overheads), or it has used more sophisticated methods to identify amounts to be capitalised, through business process improvements and improved data collection tools which provide better visibility as to the purpose for which costs are incurred (notably in respect of some elements of repairs and maintenance expenditure). But these new methods of estimation, or new estimates, do not amount to changes in the basis on which the accounts are prepared, or the accounting policies used.

¹⁰ Described in a letter dated 18 October 2005 from the Utility Regulator to NIE.

¹¹ Except that it changed from a current cost basis to a historic cost basis in 2005/6, with the consent of the UR.

- The part of licence condition 2 which the Utility Regulator quotes requires only that the accounts be prepared each year on a consistent basis. But condition 2 also requires that NIE prepare its accounts in accordance with relevant accounting standards (imported via the Companies (Northern Ireland) Order 1986), and procure an audit opinion as to whether the accounts provide a true and fair view, in accordance with such standards. In this context, the requirement for consistency may require NIE to adopt consistent accounting policies from one year to the next (which NIE has done), but it does not preclude NIE from re-assessing from time to time the methods by which it estimates the amounts to be capitalised under particular heads of expenditure (or the resulting estimates), where a modified method or a different estimate is consistent with the presentation of a true and fair view, in compliance with applicable accounting standards. Indeed, it may be necessary for NIE to adopt modified methods of estimation, or estimates, from time to time in order to provide a true and fair view and to secure continued compliance with such standards¹². Moreover, the provisions of condition 2.4 which restrict NIE's freedom to alter the bases of charges, apportionments etc. as between Separate Businesses would be otiose if condition 2.3 bore the meaning for which the Utility Regulator contends.
- Nor do the terms of the RP4 settlement preclude NIE from adopting modified accounting methodologies and practices, provided that they comply with licence condition 2. The rationale for RP4 does not require the application of such a "rule", for the reasons outlined in paragraphs 2.8 to 2.10 above, and the Utility Regulator has misunderstood NIE's submissions as to its composite proposal to the extent that it concludes otherwise.
- Licence condition 2, and the supplementary cap applied to NIE's charges during RP4 (as described in paragraph 2.10 above) were, in combination, amply protective of the interests of consumers, and there was no need for (and no proposal for) the application of additional accounting rules such as the Utility Regulator now seeks to apply.
- NIE has complied with licence condition 2, as described above¹³.
- It is not open to the Utility Regulator to argue (as it appears to do) that some implicit or potential obligation in condition 2 not to alter "capitalisation practices" became more stringent during RP4 because of the nature of the RP4 price control arrangements¹⁴. Such an argument is not consistent with the terms and logic of condition 2.

¹² See also the KPMG report at pages 16 to 17.

¹³ It is telling that, notwithstanding the fact that their terms of reference required them to report on NIE's internal audit function and on the external audit of NIE's accounts (section 2, page 18), the Regulator's consultants make no finding that NIE has failed to comply with condition 2 in the preparation of its regulatory accounts, and find no fault with the auditors' audit report.

¹⁴ See paragraph 3.12 of the Draft Determination.

- Moreover, it is notable that the Utility Regulator intends to adjust the RAB to reverse certain additions made to the RAB during RP3, to the extent that they derived from alleged changes in NIE's capitalisation practices in the later years of RP3. This suggests that the Utility Regulator does not consider that any "rule" precluding the making of such changes derives from the terms of, or underlying rationale for, the RP4 settlement. If the "rule" were part of the RP4 settlement, then it would be wrong to apply it retrospectively into RP3.
- Indeed, the fact that the annual opex allowance in RP3 was derived as a residual amount from a total revenue allowance precludes any useful consideration of how NIE was expected to spend the RP3 opex allowance and, in particular, whether particular expenditure in RP3 was expected to be treated as opex or capex. The Utility Regulator's only objective was to constrain the total revenue allowance within specified levels, and the way in which that total allowance was split as between capex and opex was a matter of only lesser concern.

2.13 So far as relates to the second new "rule":

- the Utility Regulator wishes now to apply a "rule" that NIE's outturn opex should be reviewed ex post and any outperformance clawed back, to the extent that it is not attributable to simple operational efficiency gains. However, the RP4 settlement provided no basis for the application of such a "rule";
- the adoption of the "rolling opex" mechanism is designed to obviate the need to conduct a detailed examination of the source of particular savings in controllable opex. It formed no part of the RP4 settlement that there should be detailed assessments of how NIE has spent its opex allowance, or how the composition of its opex expenditure in one period compares with the composition of its opex expenditure in the corresponding year of a previous regulatory period;
- the Utility Regulator (and its consultants) appear, at times, to have fallen into the error of assuming that NIE should carry on "opex elements" of its business, from one price control period to the next, by repeating the same kinds of maintenance activities as it conducted in previous price control periods, and should be rewarded (by retaining the benefits of outperformance) only to the extent that it conducts such similar activities more efficiently. The Utility Regulator (and its consultants) appear to consider that NIE has enjoyed an undeserved windfall to the extent that NIE has found new ways of attaining appropriate outputs which avoid incurring repeat opex at all, or which entail more efficient capital work instead of maintenance work, or to the extent that opex is incurred in one period on items which simply do not recur in future periods. But such an approach is wholly alien to the rationale for the RP4 settlement, as outlined in paragraphs 2.8 to 2.10 above; and

- since the annual opex allowance in RP3 was determined as a residual amount, and since the annual opex allowance in RP4 was determined mechanistically by reference to the outturn opex expenditure in the corresponding year of RP3, there can have been no firm expectation as to how (or how much of) the opex allowance would be spent, and there can therefore be no proper basis for holding now that any particular saving is illegitimate¹⁵.

2.14 Thus, the "rules" which the Utility Regulator claims to be applying in the Draft Determination have no basis in the reality of the RP4 settlement (nor the RP3 settlement). Even if the factual conclusions reached by the Utility Regulator's consultants were sound, the Utility Regulator's application of such "rules" to those factual conclusions to justify adjustments to the base revenue allowances for RP5 would be unsound. But, in fact, much of the consultants' analysis of the facts is unsound, so that the Utility Regulator has erred in relying on the consultants' findings as a basis for the Draft Determination. We discuss the consultants' analysis and conclusions in section 3 below.

3. THE UTILITY REGULATOR'S CONSULTANTS' REPORT: ERRORS OF APPROACH AND EXECUTION

The Consultants' Report

- 3.1 The particular adjustments which the Utility Regulator proposes to make to the RP5 opening RAB and allowed revenues are based on its acceptance of the key analysis and findings in the Utility Regulator's consultants' report¹⁶. It is therefore important to examine that report to ascertain whether it provides a sound basis for such adjustments.
- 3.2 The Utility Regulator's consultants explain that their report examines whether the nature of the RP4 price control determination coupled with "evident" changes in NIE's capitalisation practice has benefited NIE to the detriment of consumers¹⁷. The consultants outline certain elements of the terms of reference under which they prepared their report. They then examine in detail NIE's capitalisation practices in respect of the treatment of:
- Capitalisation of overheads;
 - Capitalisation of repair and maintenance costs;
 - Capitalisation of tree-cutting costs.

¹⁵ Unless it results in a breach of an output obligation, which is not alleged.

¹⁶ NIAUR – Northern Ireland Electricity (NIE) Transmission and Distribution (T&D) Price Control RP5. Confirmation of Capitalisation Practice Materiality, prepared by Cambridge Economic Policy Associates Ltd, in association with PKF (UK) LLP and Sinclair Knight Merz.

¹⁷ Section 1.1 of the report.

- 3.3 In the course of their examination, they examine the treatment of costs incurred within NIE Powerteam.
- 3.4 In their conclusions, the consultants propose that, by virtue of changes in capitalisation practice, NIE's additions to the RAB should be reduced by £35.6 million (comprising £9.8 million in respect of capitalised overheads; £13.2 million in respect of repairs and maintenance; and £12.6 million in respect of tree-cutting).
- 3.5 The consultants also identify other potential adjustments which the Utility Regulator might wish to make to the allowable revenues for RP5 (e.g. so-called "negative Dt counterclaims" – that is, cases of opex items occurring in RP3, but not recurring in RP4, which might be said to have generated a "windfall" for NIE). Since the Utility Regulator has chosen not to propose any adjustment in respect of such matters, NIE does not deal with them in the present response.

NIE's response

Terms of reference and overall approach

- 3.6 It is to be noted at the outset that the consultants' report does not disclose their full terms of reference.
- 3.7 However, their account of the RP5 price control and the background to the RP4 price control (sections 1.1 and 1.2) suggests that the Utility Regulator's instructions to them are likely to have pre-judged issues which have not been aired with NIE, and that the instructions are likely to have been designed to draw out potential adjustments to NIE's detriment, whilst paying insufficient regard to the basic principles of RPI-X price control regulation. We would, for example, draw attention to the following.
- 3.8 Section 1.1 of the report records that the report focuses on "changes in capitalisation practice that, had they been discussed and agreed with the Utility Regulator, would not have been acceptable or would have required a different accounting treatment and would not therefore have been so beneficial to NIE." This wording suggests that the Utility Regulator instructed the consultants to the effect 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.
- 3.9 It is also unclear on what basis the consultants expected to know what the Utility Regulator would or would not have agreed with NIE if NIE had made a reasoned case in support of a change to its capitalisation practice. If the Utility Regulator instructed the consultants that it would not have agreed to particular changes, then that is a decision which the Utility Regulator has made without consultation and without giving any reasons for it.

- 3.10 Moreover, the consultants' comments make clear that they have focused only on changes which they consider would have operated to NIE's benefit, not to those which might have operated to NIE's detriment¹⁸. The report is therefore likely to present a somewhat partial picture of the issues to which it relates. It is clear that, if the consultants had sought to approach the matter even-handedly, they should also have recognised, and factored into their proposed adjustments, heads of expenditure in which NIE has incurred more opex in RP4 than in RP3 (amounting to some £3.6 million)¹⁹.
- 3.11 Section 1.1 of the report further explains that the consultants' work was prompted by the Utility Regulator's alleged discovery, as part of the RP5 review process, that NIE's outturn controllable opex costs were "significantly lower than their agreed allowance for RP4". This is presented as if it were, in itself, a cause for concern. Yet the consultants also acknowledge, at the end of section 1.1, that the Utility Regulator had intended that the rolling opex mechanism in RP4 should provide NIE with an incentive to further reduce controllable operating costs. These comments suggest a very incomplete understanding of the RPI-X system of price control regulation, and, in particular, of the incentive properties of the RP4 price control mechanism. RPI-X price control regulation generally incentivises regulated companies to reduce their overall costs, by allowing them to retain the benefit of any outperformance for a specified period, after which any new price controls will be reset so as to pass on to consumers the recurring benefit of the company's efficiency savings. The RP4 opex mechanism set NIE's controllable opex allowance without direct regard to NIE's likely opex requirements, but by reference to historic outturn figures. There was therefore no reason to view a reduction in outturn opex with concern or suspicion. The mechanism had worked, insofar as it passed on to consumers the benefit of efficiencies achieved during RP3, and provided a lower baseline figure by reference to which to set the opex allowance for RP5.
- 3.12 In introducing the summary of their findings in section 1.3, the Utility Regulator's consultants explain that, where NIE has outperformed by reference to its opex allowance, they have focused on confirming "that this was caused by efficiency savings and not by other means". It turns out, from a reading of the full report, that the consultants appear to have been under the impression that NIE should be entitled to retain the benefit of outperformance only to the extent that it was attributable to the achievement of efficiency savings in the undertaking of like for like activities (e.g. lower unit procurement costs, or higher productivity per employee), and that any other source of outperformance (e.g. the installation of new types of asset, or the undertaking of new kinds of capital work, which avoid opex costs) should be reviewed with a view to a discretionary clawback of any "undeserved" or "windfall" benefits. For the reasons given in paragraph 2.13 above, NIE submits that this is entirely inappropriate, and that the consultants misdirected themselves in applying such a test.

¹⁸ See for example page 49 of the consultants' report.

¹⁹ Page 28 of the accompanying KPMG report.

The history of NIE's capitalisation practices

- 3.13 The consultants' report proceeds on the assumption that NIE made changes to its capitalisation practices late in 2005, after the terms of the RP4 price control had been settled, at which point – by implication – it would have been apparent to NIE that there might be short term benefits to NIE in capitalising more of its expenditure. This is also reflected in the Utility Regulator's Draft Determination. In paragraph 2.5, the Utility Regulator states: *“On 21 December 2005 the NIE T&D executive approved changes to their capitalisation practices”*.
- 3.14 In fact, this is incorrect. As NIE has already explained to the Utility Regulator²⁰, the Executive approval in December 2005 was to bring documentation into line with practice rather than to approve a change in practice. At its meeting on 21 December 2005, the NIE Executive Committee approved an update to NIE's Capital Expenditure Procedures Manual (CEPM). The primary purpose of the CEPM is to describe the procedures relating to the appraisal, approval and monitoring of network related capital expenditure.
- 3.15 Appendix 1 of the 2000 version of the CEPM set out a “Capital vs Revenue Classification”. However, this classification was not applied in practice. On 21 December 2005, the NIE Executive approved a number of revisions to the CEPM, one of which updated Appendix 1 to bring it into line with the capitalisation policy set out in the paper entitled “Northern Ireland Electricity, Accounting for Fixed Assets and Depreciation, Implications of FRS15” which dates from 2001, (the 2001 Paper). The 2001 paper sets out the criteria applied when deciding whether expenditure is either capital or revenue in nature. Those criteria have been applied since 2001.
- 3.16 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’.”
- 3.17 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.
- 3.18 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.

²⁰ 30 September 2011.

- 3.19 Thus, in reality, when the Utility Regulator settled the RP4 price control, the Utility Regulator and its consultants (Mott MacDonald) were in possession of both the 2005 and 2000 versions of the CEPM.
- 3.20 It is a matter of serious concern to NIE that, in conducting the present investigation, the Utility Regulator's consultants should have been under the misapprehension that the RP4 price control was settled in circumstances where NIE had, in effect, withheld information from the Utility Regulator as to the principles by reference to which expenditure was being, and was to be, capitalised during RP3 and RP4.

Source data and co-operation with NIE

- 3.21 The Utility Regulator's consultants proceeded with the tasks entrusted to them by taking a large volume of accounting records and supporting information from NIE, analysing it in the manner described in their report, and drawing conclusions as to the extent to which NIE had modified its "accounting practices" in a way which had the effect (relative to its previous accounting practices) of increasing the extent to which costs were capitalised, and reducing the amounts charged to opex.
- 3.22 It was clearly critical to the soundness of the consultants' conclusions that they should have extracted data accurately from NIE's accounting records and manipulated and interpreted that data appropriately. NIE has commissioned KPMG to review the consultants' report, and a copy of KPMG's critique of the consultants' report is provided at Annex 2.
- 3.23 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 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.
- 3.24 NIE considers that many of the deficiencies in the Utility Regulator's consultants' work are likely to be attributable to the way in which the Utility Regulator framed their terms of reference (without consultation with NIE, and in disregard of the underlying rationale of the RP4 price control), and to the way in which the consultants sought to analyse and manipulate NIE's data without reference to NIE. In consequence, for much of the period of their engagement, the consultants' work proceeded on the basis of misunderstandings of the data and the underlying work and activities reflected in the accounts. NIE elaborates on the deficiencies in the consultants' processes in Annex 1 to this response.

²¹ It is to be noted that the Utility Regulator provided NIE with sight of an earlier draft of the consultants' report and with the proposed final draft of the report. NIE drew attention to material deficiencies and errors in the earlier draft and more minor deficiencies and errors in the close-to-final draft, but these stages in the proceedings are not mentioned in paragraph 5.10 of the Draft Determination nor in the consultants' report.

Shortcomings in the consultants' work

- 3.25 In light of these considerations, NIE considers that the consultants' report should be viewed with caution, and that any judgments which the consultants make as to the propriety of NIE's conduct should be carefully scrutinised to determine whether the consultants have misdirected themselves as to NIE's underlying obligations and as to the functioning of the RP4 price control.

Capitalisation of overheads

- 3.26 The Utility Regulator's consultants note²² that, during the final 2 years of RP3 and the whole of RP4, NIE has capitalised a larger proportion of overheads than in previous accounting periods. They find that, as a result, NIE has capitalised £9.8 million²³ more in overheads than it would have done if it had not changed the proportion of overheads to be capitalised. They therefore consider that NIE's RAB should be reduced by £9.8 million, with consequential adjustments to the amounts recoverable by way of depreciation and return on the RAB.
- 3.27 KPMG's review of the consultants' report (pages 19 to 23, summarised at page 7) notes that:
- During the period under review, NIE adopted new percentage rates in respect of the proportion of overheads to be capitalised. (In fact, the new percentage rates reflected an updated assessment of the proportion of capex to opex in recent years, before any capitalisation of overheads).
 - The £9.8 million adjustment which the Utility Regulator's consultants recommend is based on a simple calculation of the difference between the amount of overheads which would have been capitalised at the "old" percentage rates and the higher amounts capitalised at the "new" rates. The consultants make no attempt to assess or recognise the legitimacy of NIE's re-assessment of the proportion of overheads attributable to capital projects.
 - The changes made by NIE to capitalisation rates reflect the normal on-going review and updating of overhead capitalisation rates; such changes are appropriate and are made in accordance with IAS 8 (Accounting policies, changes in accounting estimates and errors).
 - In short, the changes do not represent a change in accounting policy or "capitalisation practice", but in the estimate of the amounts to be capitalised, in the light of new evidence. Throughout the whole period, NIE has adopted the same overall approach – that is, to capitalise such amounts of overheads expenditure as are properly referable to capex projects, and its assessment of the amounts so referable have been updated to render them more accurate.

²² See in particular section 6.6 of the consultants' report.

²³ i.e. £8.3 million plus an additional £1.5 million referable to 2011/12.

- 3.28 Indeed, it is notable that the overheads capitalised in RP4 (£45.1 million, representing 10.2% of its gross capex of £444.4 million) were lower than those capitalised in RP3 (£48.0 million, representing 12.5% of its gross capex of £385 million), and lower than those included in the RP4 capex budget (£48.1 million).

Repairs and maintenance

- 3.29 The Utility Regulator's consultants note²⁴ that the amounts appearing in NIE's accounts for the final two years of RP3 and the first 4 years of RP4 as opex incurred by NIE on repairs and maintenance (**R&M**) are less than the amounts appearing in earlier corresponding base years. Since they suspect that this reduction is attributable at least in part to a change by NIE in its practice as to the capitalisation of expenditure on R&M, the consultants have calculated an outperformance difference of £20.5 million for the six years of their analysis (2 years of RP3 and 4 years of RP4) by reference to an equivalent base year's cost (average of years 1 to 3 of RP3 for years 4 and 5 of RP3 and the equivalent base year of RP3 for the first 4 years of RP4). Having identified this "outperformance difference", by way of this simplistic data and comparison analysis, the consultants then set out to attribute their own reasons for the outperformance. As a starting point, the consultants examined the extent to which amounts initially entered as R&M opex in NIE's accounts have been transferred to capex (so-called "direct R&M capitalisation", with an attributable amount of £7.0 million) and, where that does not fully account for any fall off in R&M opex in a particular year in question relative to its base year, the extent to which any reduction in R&M opex is matched by an increase in capex in an accounting category which they deem covers broadly the same kind of work (so called "capital programme substitution" with an attributable amount of £6.2 million). The consultants claim that the direct R&M capitalisation amount of £7.0 million and the capital programme substitution amount of £6.2 million represent inappropriate capitalisation of opex. Overall, the consultants propose that the additions to the RAB be reduced by £13.2 million.
- 3.30 KPMG's review of the consultants' work (pages 24 to 37, summarised at pages 8 to 9) notes that:
- The Utility Regulator's consultants have erred in that they have assumed that any amount initially entered in NIE's accounts as opex and then transferred to capex has been wrongly re-categorised as capex (so-called direct R&M capitalisation). In fact, NIE enters amounts as opex, and then transfers such amounts to capex when they are properly to be treated as capex, as part of its normal methods of accounting entry. It cannot simply be inferred that any such transfer is inappropriate and the consultants have not provided any evidence of changes in capitalisation practices or inappropriate capitalisation of opex in this regard. The consultants have assumed a simple cause-and-effect relationship between reductions in opex and increases in capex: they assume that, where there is a reduction in opex in excess of the direct R&M

²⁴ See in particular section 6.5 of the consultants' report.

capitalisation amount and an increase in a loosely-related category of capex, the reduction and increase result from capitalisation of expenditure in respect of a single underlying activity which would, in a previous accounting period, have been treated as opex (so-called capital programme substitution). The consultants have not provided any actual evidence of changes in capitalisation practices or inappropriate capitalisation of opex to the extent proposed by their data analysis.

- Thus, the consultants have not examined at all the extent to which the reductions in opex and the increases in capex in NIE's accounts reflect changes in the nature of the underlying activity (so that the application to such new activities of exactly the same accounting policies and methods of estimation as were used in previous periods would still lead to such reductions and increases).
- The consultants' starting point (the base year expenditures) is flawed: the "normalised" opex figures for years 4 and 5 of RP3 (which form the base amounts for the equivalent years of RP4) assume that outturn opex in years 4 and 5 of RP3 should have been equivalent to the average outturn expenditure for years 1 to 3 of RP3. But this takes no account of increasing efficiency savings realised throughout RP3 (and which the consultants themselves acknowledge elsewhere in their report) and results in an overstatement of the purported adjustment of £2.7 million.
- The consultants' approach is not even-handed: they look only at reductions in opex, not increases in opex, and their adjustments are not amended to take account of offsetting increases in opex (amounting, on their own analysis, to some £3.6 million) and, in KPMG's view, representing an overstatement of the purported adjustment of this amount.
- The consultants' calculations embody numerous errors, which cast doubt on the reliability of their work and their conclusions.

Tree-cutting

- 3.31 The Utility Regulator's consultants have noted²⁵ that NIE's capex expenditure includes more tree-cutting costs during the final two years of RP3 and during RP4, relative to earlier years. The consultants conclude that the increase in capex costs for tree-cutting is attributable to excessive unit costs for tree-cutting and to NIE's having decided to capitalise a higher proportion of tree-cutting costs. The consultants propose a reclassification of £12.6 million²⁶ (after eliminating double counting with the R&M adjustment), designed to reverse the effect of the capitalisation of amounts in excess of one third of tree-cutting costs.

²⁵ See in particular section 7 of the consultants' report.

²⁶ i.e. £8.6 million plus an additional amount of £4 million for 2011/12.

3.32 KPMG's review of the consultants' work (pages 38 to 42, summarised at page 10) notes that:

- The adjustment proposed by the Utility Regulator's consultants is based on the difference between the amount of tree-cutting costs capitalised and the amount expected to be capitalised, assuming capitalisation of one third of tree-cutting costs. But the consultants have no sound basis for expecting only one third of tree-cutting costs to be capitalised, other than by reference to historic information in the first three years of RP3. NIE's RP4 capex submissions provided no basis for such an estimate and KPMG do not consider that a policy of capitalising one third of tree-cutting costs would be appropriate.
- During the RP4 process, NIE advised the Utility Regulator of its plans for programmes of asset replacement and asset refurbishment on overhead lines, which would entail substantial tree-cutting activities. It was therefore to be expected that more tree-cutting costs would be capitalised.
- The consultants have not provided any evidence of a change in capitalisation practice as defined in IAS 8, nor any evidence of inappropriate capitalisation of expenditure on tree-cutting, entailing breach of applicable accounting standards.
- The consultants have no convincing basis for concluding that the costs of tree-cutting per kilometre are excessive. They take no account of the greater density of vegetation, compared with the vegetation which had been cut in previous periods.

3.33 In NIE's submission, it is particularly telling that, during the RP4 process, in May 2006, the Utility Regulator's own consultants, Mott McDonald, stated that "With respect to NIE's strategy for management of overhead lines, these are generally in line with other utilities" and went on to say in respect of the management of the LV network that: *"However, from the numbers above not all tree trimming is covered by TAR or re-engineering suggesting that some expenditure may need transferring to maintenance expenditure. This will require confirmation between Ofreg and NIE."* (Italics in original). Thus, Mott McDonald was satisfied that NIE's strategy for management of overhead lines (which it knew to include substantial elements of tree-cutting) was appropriate, and drew this strategy to the Utility Regulator's attention.

3.34 In setting the final capex budgets for RP4 (i.e. the amounts which NIE was expected to spend on capex projects, and to add to the RAB) pursuant to Mott McDonald's report, the Utility Regulator applied a discount to NIE's proposed capex programme but did not apply any discount specifically in respect of the amount of tree-cutting expenditure that was expected to be undertaken, and capitalised, as part of the asset replacement and refurbishment programmes.

- 3.35 In short, the Utility Regulator's consultants, and the Utility Regulator, have misunderstood and misrepresented the evolution of NIE's strategy in dealing with the risks posed to its overhead network by trees and other vegetation, the way in which that strategy was reflected in NIE's capex proposals for RP4, the extent to which those proposals were accepted in the Utility Regulator's capex budgets for RP4, and the resulting capex and opex expenditures appearing in NIE's regulatory accounts. A summary of the evolution of NIE's approach to these matters is set out in Annex 3, together with a short commentary on the factual errors contained in the consultants' report.

Other issues

- 3.36 We have focused above on a critique of the three areas in respect of which the Utility Regulator's consultants recommended an adjustment to the opening RAB for RP5, and consequential adjustments to the revenue allowance for RP5.
- 3.37 However, the Utility Regulator's consultants also examined a number of other issues, and identified areas in which, in their opinion, NIE had enjoyed "windfall" -type benefits from the rolling opex mechanism of RP4. But they did not propose adjustments in respect of them, and/or, having considered their report, the Utility Regulator has provisionally decided not to make any adjustment for them. NIE takes issue with much of what the consultants and/or the Utility Regulator say in respect of these matters, and the attitude which they disclose to the underlying rationale for RPI-X price control regulation (and, in particular, the RP4 price control settlement). However, in the interests of brevity, NIE does not address these matters in detail in this response. The most important deficiencies in the consultants' work are addressed in KPMG's review.

4. ASSET DISPOSALS

The Utility Regulator's position

- 4.1 The Utility Regulator has proposed an increase of £0.07 million in NIE's allowed RP4 revenues and a reduction in the opening RAB for RP5 of £0.95 million on the basis that NIE has incorrectly classified proceeds from the sale of redundant equipment (scrap) as 'excluded services income'.
- 4.2 In the principal draft determination of 19 April 2012, the Utility Regulator stated that:
- it did not consider it appropriate to treat the proceeds from the sale of plant and equipment as "excluded services";
 - sales of plant and equipment cannot be deemed to be excluded services, as the original costs of plant and equipment are included in the RAB;
 - NIE was non-compliant with its licence, by virtue of the provisions of paragraph 5.2 of Annex 2 to NIE's licence; and

- NIE had misinterpreted or misunderstood the 2006 Direction in relation to Asset Disposals.

NIE's response

4.3 NIE agrees that proceeds from the sale of plant and equipment are not excluded services under the terms of its licence. However, 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.

4.4 The table below analyses the items classified under the Excluded Service Income line in appendix 1 to the 2006 Direction.

Nominal Prices	02/03	03/04	04/05
	£m	£m	£m
Metering	0.429	0.023	0.022
T&D Recharge	0.478	0.406	0.470
Rechargeable Income	3.002	2.722	4.053
Rental Income (SX3)	0.114	0.102	0.105
Rental Income (AssetCo)	0.011	0.018	0.067
3rd part Income (Tort - damage to network)	0.840	0.836	0.772
Scrap Sales	0.006	0.088	0.100
Other	0.196	0.170	0.151
Total	5.076	4.365	5.740
CBO Fee	-1.722	-1.602	-1.413
	3.354	2.763	4.327

Thus, the 2006 Direction clearly recognises that the proceeds of sale of scrap should be applied as a reduction in operating costs, rather than a reduction in the RAB.

4.5 In short, therefore, NIE's calculation of the RP4 controllable cost allowance has been consistent with its licence, by reference to the 2006 Direction, and the Utility Regulator's proposed adjustments in respect of asset disposals are not justified.

4.6 In contrast, the agreed regulatory treatment in respect of land and property disposals is that the RAB should be reduced by the amount of the disposal price less any reasonably incurred costs, such reduction to take effect five years after the disposal. This treatment has been followed since RP3 and the proceeds from the sale of land and property are shown as a separate line deduction in the annual RAB reconciliation which is included in NIE's regulatory accounts. The same treatment was followed in the RAB calculations in Appendix 2 to the 2006 Direction.

5. THE UTILITY REGULATOR'S COMPUTATION OF THE REQUIRED REVENUE ADJUSTMENT

- 5.1 Quite apart from what is said in sections 2 to 4 above, and assuming (contrary to NIE's primary submissions) that it would be appropriate for the Utility Regulator to adjust NIE's opening RAB for RP5, and the allowable revenues for RP5, to reflect the matters discussed in the Draft Determination, the Utility Regulator's computation of the relevant adjustment is incorrect²⁷.
- 5.2 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.

6. THE UTILITY REGULATOR'S REGULATORY TASK: THE PROBLEM OF EX POST ADJUSTMENTS

- 6.1 In deciding whether to adjust NIE's opening RAB for RP5, and the base allowable revenues for RP5, by reference to the matters discussed in its Draft Determination, the Utility Regulator should consider and decide whether such adjustments are the best means of fulfilling its regulatory objectives, by reference to its regulatory duties. The duties imposed upon the Utility Regulator by Article 12 of the Energy (Northern Ireland) Order 2003 (as amended) reflect (among other considerations) the importance of protecting consumers as to the price at which electricity is available for supply, the quality of supply, and the need to ensure that NIE can finance its regulated activities.
- 6.2 It is clear from the materials which NIE has submitted to the Utility Regulator as part of the RP5 process that NIE needs to be able to continue to invest in its network to maintain the quality of transmission and distribution services, and to enable new sources of generation to be connected to the network. In these circumstances, it is particularly important that the Utility Regulator's decisions should be soundly and robustly based on evidence, and soundly reasoned, so as to maintain the confidence of investors in the fairness and soundness of the regulatory regime under which NIE operates. NIE needs to raise finance from investors to fund its further capex projects, and the availability and cost of such finance will be adversely affected by what

²⁷ There are also minor errors in the Utility Regulator's computations. E.g. a depreciation figure in Table 5 of the Draft Determination is wrongly stated as £3.59 million, when the correct figure is £3.89 million. We do not comment exhaustively on such errors in this response.

investors will regard as an unjustified intervention, and by the fear that there will be similarly unjustified interventions in future.

- 6.3 In this regard, NIE has emphasised, in its response to the Utility Regulator's principal draft determination of 19 April 2012, the benefits associated with the observance of good regulatory practice, in terms of transparency, predictability and consistency of approach. These considerations serve to emphasise that the Utility Regulator would need very compelling reasons to go back to the RP4 (and, a fortiori, the RP3) price control arrangements, with a view to reopening the assessments made then as to the way in which NIE's RAB should be updated to reflect the addition of new assets, and the way in which NIE should recover depreciation and a return on the RAB from time to time.
- 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.
- 6.5 Although the Competition Commission (**CC**) has not yet completed its review of the price control to be applied to Phoenix Natural Gas Limited (**PNGL**), the CC's provisional determination of 3 August 2012 is useful in its recognition that the Utility Regulator will require very compelling reasons to justify an ex post intervention to alter a firm regulatory arrangement reached during a previous price control period, where the effect of the intervention will be to reduce returns to the company on investments made under the previous arrangements. The CC has therefore focused on considering whether, for example, the previous arrangements were so manifestly wrong as to have made it obvious that they would need to be revisited, or whether there are exceptional circumstances justifying a new intervention.
- 6.6 For the reasons outlined in sections above, there are no such grounds for intervention in the present case.
- 6.7 So far as relates to capitalisation adjustments, details of NIE's capitalisation practices were available to the Utility Regulator and its consultants in setting the RP4 price control. NIE's capex plans disclosed what it intended to do, in terms of its overhead line and tree-cutting strategy. NIE's accounting treatment of overheads and repair and maintenance costs (including the capitalisation of some of those costs) is perfectly reasonable, is in line with accounting standards, is informed by data available from its SAP and JMS information systems, and is satisfactory to its auditors. The overall amounts of capitalised expenditure are not excessive. Genuine operational efficiencies achieved during RP3 and RP4 have led to real benefits for consumers.²⁸ Conversely, the Utility Regulator's proposed intervention flies in the face of the underlying logic of the RP3 and RP4 price controls, which contained their own safeguards of consumers' interests, were soundly based and have served

²⁸ And the fact, if such it is, that the Regulator was particularly busy in the run up to the setting of the RP4 price control (section 1.2 of the Regulator's consultants' report) cannot conceivably amount to an exceptional circumstance.

consumers well. The reasons provided by the Utility Regulator for its proposed intervention provide no sensible justification for adjusting NIE's opening RAB for RP5 and its allowable revenues for RP5.

6.8 Moreover, so far as relates to the proposed capitalisation adjustments, the Utility Regulator has entirely failed to take account of important considerations which would be highly relevant if it were to consider adjustments designed to hold NIE to particular methods of estimating the amounts to be capitalised, and particular percentage estimates, just because they were used in past years. In particular:

- It is important that NIE's regulatory accounts should contain as robust as possible a classification of costs into opex and capex, and that the updating of the RAB should be based on the best possible accounting records, since the proper classification of costs between capex and opex is essential to the attainment of equity between present and future customers. It would be wrong for today's customers to pay (through a higher opex allowance) amounts which have been invested in assets which will endure for the benefit of future generations (and should be reflected in the RAB), just as it would be wrong for future customers to have to contribute, via depreciation charges and a return on the RAB, to costs which have produced no lasting benefit. The Utility Regulator's approach pays no regard to this important principle;
- The inclusion in the RAB of costs which might, in previous years, have been treated as opex, and the "benefit" to NIE of being able to recover such costs via future years' revenues, instead of out of RP4 opex allowances, does not in itself justify the "clawing back" of such benefit for consumers during RP5. There are other countervailing factors to consider: any "benefit" to NIE is offset by the fact that opex allowances in RP5 will be reduced, to reflect the reduced outturn opex in RP4; and there is no logic in looking for a precise match in the heads of cost borne out of opex as between RP3 and RP4, since the opex allowances in RP3 and RP4 were not set by reference to forecast costs (nor, a fortiori, by reference to any particular assumptions as to how much of particular heads of expenditure would be classified as capex or opex), but were a residual amount (in RP3) or were impliedly capped by a safeguard "total charges" cap (in RP4);
- 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 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.

- 6.9 So far as relates to asset disposals, NIE has complied with its licence obligations as to the accounting treatment of disposals, and there is no good reason to intervene now to adjust NIE's opening RAB or allowable revenues for RP5 to its detriment.
- 6.10 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.

7. CONCLUSIONS

- 7.1 NIE firmly rejects any suggestion that it has changed its capitalisation practices. 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 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. Nothing in the Draft Determination or the Utility Regulator's consultants' report establishes that NIE has double charged consumers for any expenditure. NIE has not acted improperly in any way in respect of any of the matters considered in the Draft Determination or the consultants' report.
- 7.2 The Utility Regulator's Draft Determination is misconceived and the work undertaken by the Utility Regulator's consultants is unsound. In the foregoing sections we have demonstrated that:
- Despite the Utility Regulator's assertions to the contrary, there were no additional implied "rules" in the RP4 price control, beyond the provisions of licence condition 2, as to how NIE should estimate the amounts of expenditure to be capitalised. The Utility Regulator's attempt to introduce them now has no foundation in fact or principle.
 - NIE has at all times compiled its regulatory accounts in accordance with condition 2 of its licence. Indeed, it would be difficult for NIE to comply with that licence condition if it were not allowed to alter the methods by which it estimates the amounts to be capitalised from time to time, since periodic re-assessment of such estimates is necessary and appropriate to ensure that its accounts continue to give a true and fair view of the matters to which they relate. NIE's auditors have expressed themselves satisfied that NIE's regulatory accounts comply with condition 2 of its licence.
 - NIE has not changed its capitalisation practices. Most of the changes in opex and capex which the Utility Regulator has identified are not related to

changes in capitalisation practices, but to changes in the underlying nature of NIE's activities. There is no proper basis for the Utility Regulator now to reopen the RP4 settlement so as to penalise NIE for having introduced new more efficient ways of managing its network, simply because the overall mix of work differed from what had been done in previous years.

- The Utility Regulator fails to recognise that the RP4 price control has worked effectively and to the benefit of consumers. NIE reduced its gross operating costs (before the capitalisation of overheads) by more than £65 million between RP3 and RP4, and those reductions will be factored into the assessment of allowable costs for RP5.
- The work undertaken by the Utility Regulator's consultants embodies important errors, which render their conclusions unreliable. KPMG's review of this work has concluded that the consultants provided no evidence of changes in capitalisation practice or of inappropriate capitalisation and that the methodologies which the consultants used were simplistic and were not apt to identify changes in capitalisation practice.
- The Utility Regulator has received annual updates from NIE as to its outturn capex and opex, but has not raised any objection until now.
- The Draft Determination represents an attempt to re-open the RP3 and RP4 price controls, without any compelling reason. The proposed adjustments are inconsistent with the incentive properties of RPI-X price control. The Utility Regulator has not sought to justify the proposed adjustments by reference to its statutory duties and objectives and, in NIE's submission, it could not do so.
- The Utility Regulator's proposed adjustments to deal with asset disposals are incorrect, and do not reflect the terms of NIE's licence.
- The Utility Regulator's conversion of the adjustments proposed by its consultants into final revenue adjustments is incorrect.

7.3 The Utility Regulator requires very compelling reasons to justify an ex post intervention to alter a firm regulatory arrangement reached during a previous price control period. There are no such grounds for intervention in the present case. 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.

ANNEX 1

SOURCES OF DATA AND INTERPRETATION OF DATA

The Utility Regulator's consultants imply that their task was rendered more difficult by shortcomings in the data supplied by NIE, or by NIE's failure to assist them in understanding such data. However, on examination, any such implication is unjustified. We comment in particular on the following parts of the Utility Regulator's Draft Determination:

"5.7 Because of the complex nature of the reporting systems and the substantial number of changes that NIE T&D had introduced into its financial management arrangements the investigation took longer than the consultant auditors had initially anticipated. Further, due to NIE T&D submitting updated reports the consultant auditors had to undertake reworking of data in order to ensure that their report remained robust and accurate."

NIE's financial reporting systems are necessarily complex, as is the case in all large organisations. NIE's work activities are numerous and the primary challenge for any external auditor is to understand the business processes, how they are captured in the accounting records, and how costs are collected and reports generated within the key financial systems. NIE undergoes both internal and external audits each year on a proportion of its key processes and the auditors build time into their timetable to engage with NIE's staff and fully to understand the processes prior to commencing analysis of the data.

In the case of this investigation, the consultants did spend time at the beginning of the process to discuss the work programmes and financial treatment. This resulted in the very substantial data request reproduced in Annex C to the final report.

The basis of the initial request was to ask for all conceivable data without due consideration as to how this data was intended to be used. (This entailed production of historic data back to 2000 extracted from financial systems, software records and also hard copy records in archived stores and was a substantial undertaking).

However, the consultants did not engage further with NIE to discuss either their proposed methodology, which sets of data they were intending to use for their analysis, nor any other aspects of NIE's underlying processes, cost collection or cost allocation.

It was only when NIE received the consultants' initial draft report and supporting data analysis on 20th June 2012, that it became aware how the consultants had designed and performed their analysis.

At that stage, NIE was required to perform a forensic study of their analysis, as no explanatory guidance was provided into the methodology adopted. NIE was allowed only one week to comment on the factual accuracy of this assessment. But it became apparent

that NIE had not been supplied with all the necessary information to make this assessment, and it did not obtain all the necessary information until 5th July 2012 .

In reality, only a small number of the data files submitted by NIE as part of the original request formed the basis of the consultants' initial analysis. Throughout the period of analysis, NIE had regularly to provide additional information in order to enable their analysis to be completed (see Annex C to the report).

Once NIE had understood the methodology applied, it was concerned that the Utility Regulator's consultants had been referencing an incorrect data set, a point which NIE had clarified with the consultants earlier in the investigation as part of a response to one of their many queries. This fundamental error, together with a number of other significant concerns, rendered their initial analysis flawed, and necessitated a re-working of the analysis. This re-work was thus required entirely as result of the deficiencies in the consultants' independent treatment of the information supplied. NIE is firmly of the opinion that these errors, delays and the resulting need to re-work the analysis could have been avoided had NIE been engaged in the process.

NIE does not recognise the charge that it introduced a 'substantial number of changes' into 'its financial management arrangements'.

"5.8 It should be noted that within its composite proposal NIE T&D had stated that it anticipated an 'open book approach'. The consultant auditors' investigation revealed difficulties when trying to understand the company's reporting systems. We intend to discuss this area further with NIE T&D to allow effective reporting for RP5 and future price controls."

The difficulties experienced by the Utility Regulator's consultant auditors in understanding the reporting systems stems from the distinct lack of direct engagement that NIE would historically have expected from auditors in order to aid a practical understanding of the business processes, cost collection and reporting systems prior to any analysis. It is difficult to gain a sufficient understanding from analysis of data alone and without engagement with the process owners within NIE. This difficulty with the consultants' understanding has subsequently resulted in the over-simplistic and flawed analysis which forms the basis of the Draft Determination.

"5.9 During the course of the investigation NIE T&D highlighted to us the impacts the investigation was having on the company's own internal resources. Some information was delayed as a result of the company's resource constraints."

The data intensive nature of this capital investigation was coincident with NIE's work with the Utility Regulator on its RP5 submission and in particular with its response to the Utility Regulator's Draft Determination for RP5. As such, the small number of staff involved in this investigation were responding to data requests, attending meetings and preparing the response to the principal Draft Determination in respect of the RP5 price control at the same time.

The quantity of data requested for both the RP5 capex review and the capitalisation investigation far exceeds any previous price control applied to NIE. In addition to the information requests, there have been numerous questions which have been accompanied by tight response times. The timescales for return of information have often been very short. NIE has stated to the Utility Regulator that often, these deadlines have been unreasonable, having regard to other requests from the Utility Regulator, and the limited resources available to NIE. NIE has always strived to respond to requests within the requested timescales, no matter how unrealistic. This has entailed much evening/weekend working and cancelled annual leave.

The Utility Regulator has also failed to recognise that NIE is hampered, in the conduct of its T&D Business, by delays arising from Utility Regulator's failure adequately to resource the RP5 assessment. This has necessitated interim arrangements to be put in place for an RP4 extension period (and a subsequent second extension), leaving NIE uncertain as to how much revenue will ultimately be available to it for the RP5 period, and placing an additional burden on NIE's internal resources to define interim plans.

ANNEX 2
KPMG REPORT



cutting through complexity

Northern Ireland Electricity Limited

Report on the Utility Regulator's proposed
adjustments in respect of Northern Ireland Electricity's
capitalisation policies and practices

26 September 2012





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Private and confidential

26 September 2012

The Directors
Northern Ireland Electricity Limited
120 Malone Road
Belfast
BT9 5HT

Dear Sirs

Report on the Utility Regulator's ("UR") proposed adjustments in respect of Northern Ireland Electricity's ("NIE") capitalisation policies and practices

In accordance with our engagement letter and its attachments dated 25 July 2012 ('our Engagement Letter'), we enclose our report on the UR's proposed adjustments in respect of NIE's capitalisation policies and practices. The scope of work is set out in our Engagement Letter and is directed at those issues which you determined to be critical to your review. You should note that our findings do not constitute recommendations to you. The Important notice on page 2 should be read in conjunction with this letter.

Our report is for the benefit and information of the addressees only and should not be copied, referred to or disclosed, in whole or in part, without our prior written consent, except as specifically permitted in our Engagement Letter. The scope of work for this report has been agreed by the addressees and to the fullest extent permitted by law we will not accept responsibility or liability to any other party (including the addressees' legal and other professional advisers) in respect of our work or the report.

Yours faithfully

KPMG

Our work commenced on 18 July 2012 and our fieldwork was completed on 20 September 2012. We have not undertaken to update our report for events or circumstances arising after that date.

In preparing our report, our primary sources have been NIE's internal management information, representations made to us by management of NIE and interim and final reports prepared by Consultants. We do not accept responsibility for such information which remains the responsibility of management. Our principal information source has been discussions with NIE management and we have satisfied ourselves, so far as possible, that the information presented in our report is consistent with other information which was made available to us in the course of our work in accordance with the terms of our Engagement Letter. We have not, however, sought to establish the reliability of the sources by reference to other evidence.

This engagement is not an assurance engagement conducted in accordance with any generally accepted assurance standards and consequently no assurance opinion is expressed.

Our report makes reference to 'KPMG Analysis'; this indicates only that we have (where specified) undertaken certain analytical activities on the underlying data to arrive at the information presented; we do not accept responsibility for the underlying data.

**The contacts at KPMG
in connection with this
report are:**

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Accounts	Regulatory accounts	R&M	Repairs and Maintenance
Capex	Capital expenditure	RP3 and RP4	Regulated Price Control Period
Cat	Category	SKM	Sinclair Knight Merz
CEPA	Cambridge Economic and Policy Associates Limited	The Company	Northern Ireland Electricity Limited
Consultants	UR's consultants: Cambridge Economic and Policy Associates Limited (CEPA), PKF (UK) LLP (PKF) and Sinclair Knight Merz (SKM).	Totex	Total operating and capital expenditure
IAS	International Accounting Standards	UK GAAP	United Kingdom Generally Accepted Accounting Practice
IFRS	International Financial Reporting Standards	UR	Utility Regulator
IO	Internal Order Number		
NIE or the Company	Northern Ireland Electricity		
Opex	Operating expenditure		
PKF	PKF (UK) LLP		
PG	Processing Group		

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Section 1 – Executive Summary

Area	Key findings
	<ul style="list-style-type: none"> • The Consultants have recommended an adjustment of £35.6 million arising from changes in capitalisation practices, analysed as follows: <ul style="list-style-type: none"> - £9.8 million – Capitalised overheads - £13.2 million – R&M costs - £12.6 million – increases in tree cutting expenditure • We do not consider that the Consultants have provided any evidence to support their conclusion that there have been changes in capitalisation practices. • The Consultants appear to have derived methodologies for adjustments but without linking these to any rationale or evidence relating to a change in capitalisation practice. The adjustment methodology is simplistic and highly questionable and may be summarised as follows: <ul style="list-style-type: none"> - Capitalised overheads - the adjustment is based on the assumption that the overhead capitalisation rate should not change from one period to the next. This is not an appropriate accounting policy and hence any adjustment calculated on this basis can not be correct. - R&M – the adjustment is based on a data analysis considering reductions in R&M Opex and attributing most of the reductions to inappropriate capitalisation. Whilst the analysis does not actually prove anything (it is just a data analysis), and hence should not be used as the basis for any adjustment, we have concerns regarding the accuracy and the logic of the analysis. We identified a significant number of inaccuracies in the workings supporting the analysis and also what we believe to be errors totalling £6.3 million in the application of Consultants' own logic. - Tree cutting – the adjustment is based on the premise that only one third of tree cutting costs should be capitalised irrespective of the nature of the expenditure. This is not an appropriate accounting policy and hence any adjustment calculated on this basis can not be correct. • The Consultants highlight that this review is investigating changes in capitalisation practices rather than assessing the legitimacy of expenditure that NIE considers as Capex. We consider that an assessment of the legitimacy of the expenditure that NIE consider as Capex is a key consideration of purported changes in capitalisation practices. We have not identified any evidence put forward by the Consultants to suggest that expenditure has been inappropriately capitalised by NIE. • Based upon our review of the information made available to the Consultants and on other information provided by NIE in relation to the Consultants' proposed adjustments: <ul style="list-style-type: none"> - we did not identify any changes in capitalisation practice as defined by IAS8: Accounting policies, changes in accounting estimates and errors. - we did not note any inappropriate capitalisation of expenditure resulting from breaches of applicable accounting standards • NIE's statutory financial statements and Regulatory Accounts have been subject to audit for each of the years spanning RP3 and RP4. As the related audit reports for these years were unqualified, it would be reasonable to conclude that the Auditors did not consider that there had been any material breaches of applicable accounting standards or inappropriate capitalisation of operating expenditure.

Area	Key findings
Capitalisation of overheads	<ul style="list-style-type: none"> • With regard to overheads, the Consultants have recommended an adjustment of £9.8 million on the basis of a change in capitalisation practice by NIE. • The overhead capitalisation rates used by the Consultants in calculating their proposed adjustments are historic rates used by NIE. • Whilst the capitalisation overhead rates have changed over the period, resulting in a higher proportion of total costs being capitalised, the absolute level of capitalised overheads in RP4 were lower than those capitalised in RP3 and lower than the capitalised overheads included in the RP4 Capex budget. • The consultants note that NIE did not discuss these changes in the capitalisation rates with the UR. Whilst consideration of this matter is outside the scope of our work, we are not aware of any requirement for NIE to discuss such changes with the UR. • The capitalisation rates were updated during the period to reflect the underlying mix of work carried out based on management's review. This review identified that the amount of overheads attributable to capital works was in excess of the capitalisation overhead rates being applied, and accordingly resulted in an increase in the capitalisation overhead rates. The changes made to the capitalisation rates reflect the normal ongoing review and updating of overhead capitalisation rates; such changes are appropriate, and are in accordance with IAS8: Accounting policies, changes in accounting estimates and errors. We do not consider that these changes represent evidence of a change in capitalisation practice and as such have not identified a supportable rationale for the proposed adjustment. • The Consultants highlight that this review is investigating changes in capitalisation practices rather than assessing the legitimacy of expenditure that NIE considers as Capex. We consider that an assessment of the legitimacy of the expenditure that NIE consider as Capex is a key consideration of purported changes in capitalisation practices. We have not identified any evidence put forward by the Consultants regarding the changes in overhead capitalisation rates to suggest that expenditure has been inappropriately capitalised by NIE. • Based upon our review of the information made available to the Consultants and on other information provided by NIE in relation to the Consultants' proposed adjustments regarding changes in overhead capitalisation rates: <ul style="list-style-type: none"> - we did not identify any changes in capitalisation practice as defined by IAS8: Accounting policies, changes in accounting estimates and errors. - we did not note any inappropriate capitalisation of expenditure resulting from breaches of applicable accounting standards • NIE's statutory financial statements and Regulatory Accounts have been subject to audit for each of the years spanning RP3 and RP4. As the related audit reports for these years were unqualified, it would be reasonable to conclude that the Auditors did not consider that there had been any material breaches of applicable accounting standards or inappropriate capitalisation of operating expenditure.

Area	Key findings
Repairs and maintenance	<ul style="list-style-type: none"> With regard to repairs and maintenance, the Consultants have calculated an out performance “difference” of £20.5 million between base costs and actual costs over the six year period of their analysis (2 years of RP3 and 4 years of RP4). Out of the “difference” identified by the Consultants’ six year analysis of £20.5 million, the Consultants have allocated £13.2 million of the Opex reduction to inappropriate capitalisation of Opex expenditure arising from changes in capitalisation practice and are proposing an adjustment of this amount. The Consultants have assumed a cause-effect relationship between reducing Opex and increasing Capex and that operating costs in RP4 should be identical to costs in RP3. This is a fundamental aspect of their analysis and drives the “difference” figure of £20.5 million. The assumption is inappropriately simplistic and unsupported and ignores reductions in Opex due to efficiencies, changes in the underlying work and cyclical issues. The assumption also ignores the planned increases in Capex together with the effect of capital programmes on Opex levels. The conclusion drawn by the Consultants implies that there are only two reasons for reduced Opex: (1) incorrect capitalisation of R&M expenditure; and (2) efficiency gains. This assumption ignores the impact of the actual mix and volume of underlying work carried out. R&M can legitimately decline in a situation where the volume of work decreases. At the same time Capex can increase, the two are not mutually dependent. The Consultants have also adopted an unsupported cause-effect approach to their categorisation of the analysis difference of £20.5 million into the particular “adjustment” categories, with the adjustment of £13.2 million arising there from. The Consultants’ analysis, and the proposed adjustment is based on a simple review of decreasing Opex, coupled with increased transfers from Opex to Capex (Direct R&M capitalisation) and increased charges to Capex in excess of Opex (Capital programme substitution). This analysis is just that, i.e. a data analysis. It assumes a causal relationship but does not provide any supportable evidence as to a change in capitalisation practice. The assumptions adopted by the Consultants in respect of their “Direct R&M capitalisation” category (representing £7.0 million of the £13.2 million purported adjustment), in addition to being highly simplistic, effectively implies that NIE have engaged in retrospective manipulation of their accounting records by way of making inappropriate transfers from Opex to Capex – a claim that is not supported with any evidence whatsoever. The assumptions adopted by the Consultants in respect of their “Capital programme substitution” category (representing £6.2 million of the £13.2 million purported adjustment) are highly simplistic and questionable. With regard to the logic of the Consultants’ starting point (being the base costs versus actual costs comparison), we consider that the use of the average actual Opex in years 1 to 3 of RP3 as a base for years 4 to 5 of RP3 has given rise to a larger difference between base costs and actual costs than would have arisen had the actual Opex for year 3 been used as a base for year 4 and the actual Opex for year 4 been used as a base for year 5. The impact of this has been to inflate the “difference” by approximately £2.7 million (with a resultant knock on overstatement effect on the purported adjustment of £13.2 million). The Consultants have adopted an assumption within their analysis such that R&M increases between periods are ignored with the “difference” figure only taking into account R&M decreases. This non-symmetrical approach has resulted in an overstatement of £3.6 million of their purported adjustment of £13.2 million.

Area	Key findings
Repairs and maintenance	<ul style="list-style-type: none"> • A significant number of inaccuracies were identified in the repairs and maintenance analysis workings and in the capital analysis workings supporting the Consultants' final report. These inaccuracies are set out later in this report. • Whilst significant commentary in respect of Powerteam is included in the Consultants' report, no specific conclusions have been drawn from this, other than that the analysis identifies increasing levels of capitalisation over the analysis period. We would also note that the increased level of capitalisation is not unexpected given the increase in capital programmes over this period. • In essence, the Consultants' proposed adjustment of £13.2 million relates to this amount of reduced Opex and increased Capex over their analysis period. We do not consider that this reducing/increasing trend in Opex/Capex is evidence of a change in capitalisation practice and as such have not identified a supportable rationale for the proposed adjustment. With regard to certain R&M categories including defects, fault and emergency, non-recoverable alterations and plant workshop costs we have identified changes made to the way in which costs have been capitalised over the period. These changes were as a result of the evolution of systems for recording costs, changes in operational structures and improvements in business processes. These changes, do not represent changes in capitalisation practice. • The Consultants highlight that this review is investigating changes in capitalisation practices rather than assessing the legitimacy of expenditure that NIE considers as Capex. We consider that an assessment of the legitimacy of the expenditure that NIE consider as Capex is a key consideration of purported changes in capitalisation practices. We have not identified any evidence put forward by the Consultants regarding the reducing/increasing trend in Opex/Capex to suggest that the items of expenditure have been inappropriately capitalised by NIE. • Based upon our review of the information made available to the Consultants and on other information provided by NIE in relation to the Consultants' proposed adjustments regarding the reducing/increasing trend in Opex/Capex: <ul style="list-style-type: none"> - we did not identify any changes in capitalisation practice as defined by IAS8: Accounting policies, changes in accounting estimates and errors. - we did not note any inappropriate capitalisation of expenditure resulting from breaches of applicable accounting standards • NIE's statutory financial statements and Regulatory Accounts have been subject to audit for each of the years spanning RP3 and RP4. As the related audit reports for these years were unqualified, it would be reasonable to conclude that the Auditors did not consider that there had been any material breaches of applicable accounting standards or inappropriate capitalisation of operating expenditure. • As part of our review we discussed with management the reasons giving rise to the Opex reductions as identified by the Consultants. The reasons included: (i) efficiencies in processes (ii) the effects of changes in systems, processes and structures (iii) the effects of changes in the nature and allocation of work activities; (iv) the adoption of best practice in asset strategies, procurement and cost allocation; and (v) the benefits of capital programmes and the reducing effect on Opex. In our discussions with NIE management we did not identify any instances of inappropriate capitalisation of R&M costs as being the reason for Opex reductions.

Area	Key findings
Tree cutting	<ul style="list-style-type: none"> • With regard to tree cutting, the Consultants have recommended an adjustment of £12.6 million on the basis of a change in capitalisation practice by NIE. The adjustment has been calculated as the difference between actual amounts capitalised and expected amounts capitalised. The expected capitalised amount is based on an assumption that only one third of total tree cutting costs should be capitalised. The Consultants' rationale for suggesting that a policy of capitalising one third of tree cutting costs is that; "in its RP4 submission showing historic costs in RP3 and earlier years, NIE had typically capitalised one third of tree cutting". The figure of one third was not in the RP4 submission. The use of a capitalisation policy of one thirds Capex and two thirds Opex is not an appropriate capitalisation policy. In our view, NIE have correctly capitalised tree cutting costs in accordance with the requirements of IAS 16: Property, plant and equipment. • NIE advised the UR in the RP4 capital submission of it's HV overhead line strategy comprising re-engineering, refurbishment and targeted asset replacement (TAR) all of which incorporated vegetation management as part of their specification of work and hence an increase in capitalised amounts would have been expected. • We do not consider that the increase in tree cutting associated with capital overhead line programmes to be evidence of a change in capitalisation practice and as such have not identified a supportable rationale for the proposed adjustment. • The Consultants highlight that this review is investigating changes in capitalisation practices rather than assessing the legitimacy of expenditure that NI considers as Capex. We consider that an assessment of the legitimacy of the expenditure that NIE consider as Capex is a key consideration of purported changes in capitalisation practices. We have not identified any evidence put forward by the Consultants regarding the increasing trend in tree cutting costs being capitalised to suggest that the items of expenditure have been inappropriately capitalised by NIE. • Based upon our review of the information made available to the Consultants and on other information provided by NIE in relation to the Consultants' proposed adjustments regarding the increase in capitalised costs in respect of tree cutting associated with capital overhead line programmes : <ul style="list-style-type: none"> - we did not identify any changes in capitalisation practice as defined by IAS8: Accounting policies, changes in accounting estimates and errors. - we did not note any inappropriate capitalisation of expenditure resulting from breaches of applicable accounting standards • NIE's statutory financial statements and Regulatory Accounts have been subject to audit for each of the years spanning RP3 and RP4. As the related audit reports for these years were unqualified, it would be reasonable to conclude that the Auditors did not consider that there had been any material breaches of applicable accounting standards or inappropriate capitalisation of operating expenditure.

Area	Key findings
<p>One off costs included in RP3 that did not recur in RP4 and “Negative” Dt claims</p>	<ul style="list-style-type: none"> • The Consultants have drawn to the UR’s attention claims for “one off costs” and “Dt costs” made by NIE during RP4 and have indicated that NIE may have benefitted in certain areas where it has reduced Opex in RP4 as a result of exceptional non-recurring RP3 costs and also carrying out less work in certain areas or deferring activities. • We do not consider that the claim for these costs represents evidence of a change in capitalisation practice and as such have not identified a supportable rationale for any future proposed adjustment. Our review has not identified any changes in capitalisation practice in this regard. • We have not identified any evidence put forward by the Consultants regarding the “one off costs” and the “negative Dt costs” to suggest that the items of expenditure have been inappropriately capitalised by NIE.

Section 2 – Background

Background

As part of the RP5 price control review, the UR engaged Consultants to undertake a review of the consistency of NIE's capitalisation practices across RP3 and RP4.

The Consultants issued their draft status report and initial findings on 20 June 2012. The report summarised the initial findings in respect of the review addressing the question of whether the nature of the determination for the fourth price control (RP4) coupled with purported changes to NIE's capitalisation practice has benefited NIE to the detriment of the consumer. In particular, the report focused on changes in practice that, had they been discussed and agreed with the Utility Regulator, would not have been acceptable or would have required a different accounting treatment and would not therefore have been so beneficial to NIE. The report concluded that certain capitalisation adjustments were required.

The Consultants issued their draft final report entitled 'Confirmation of Capitalisation Practice Materiality' on 13 August 2012. This report concluded that £30.1 million of costs charged to Capex arose from inconsistent application of capitalisation practices and not as a result of efficiency gains. The Consultants subsequently updated their draft final report, this time concluding that £35.6 million of costs charged to Capex arose from inconsistent application of capitalisation practices and not as a result of efficiency gains. The draft determination issued by UR refers directly to the £35.6m and notes that the figures included in respect of 2011-12 are provisional and that UR will request the information required to update the 2011-12 figures with the actual outturn costs.

KPMG have been engaged by Northern Ireland Electricity Limited ("NIE" or "the Company") to provide an independent review of the UR's proposed adjustments in respect of NIE's capitalisation policies and practices.

The Consultants' final report sets out a number of assertions which we will consider as part of our review. These are set out below:

Consultants' assertions	KPMG considerations
<p>Report on the extent of any Opex out-performance (e.g. surplus against agreed Opex allowance) that can be attributed to a change in capitalisation practices.</p>	<p>With regard to this assertion we will consider:</p> <ul style="list-style-type: none"> ■ Firstly, whether the report provides evidence that the “purported changes” suggested by the Consultants do actually represent changes to NIE’s capitalisation practice; and ■ Secondly, whether the report provides evidence that there has been any inappropriate capitalisation of Opex expenditure for whatever reason. <p>With regard to what is considered to be a change in capitalisation practice we will assess any “purported changes” against appropriate accounting standards.</p>
<p>Whether the nature of the determination for the fourth price control (RP4) coupled with evident changes to NIE’s capitalisation practice has benefited NIE to the detriment of the consumer.</p>	<p>There are two assessments to consider here:</p> <ul style="list-style-type: none"> ■ Firstly, whether the nature of the determination for the fourth price control (RP4) has benefited NIE to the detriment of the consumer; and ■ Secondly, whether the “purported changes” to NIE’s capitalisation practices as suggested by the Consultants has benefited NIE to the detriment of the consumer. <p>The first assessment, i.e. with regard to the nature of the determination for the fourth price control (RP4), is outside the scope of this report.</p> <p>The second assessment, i.e. with regard to “purported changes” to NIE’s capitalisation practices benefiting NIE, is covered by our assessment of whether the “purported changes” suggested by the Consultants are actually changes to NIE’s capitalisation practices.</p>

Consultants assertions	KPMG considerations
<p>The report focuses on changes in capitalisation practice that, had they been discussed and agreed with the Utility Regulator, would not have been acceptable or would have required a different accounting treatment</p>	<p>There are four assessments to consider here:</p> <ul style="list-style-type: none"> ■ Firstly, whether the “purported changes” suggested by the Consultants are actually changes to NIE’s capitalisation practices; ■ Secondly, whether the “purported changes” (irrespective of whether or not they represent changes in capitalisation practices) were discussed and agreed with the Utility Regulator; ■ Thirdly, whether there was any obligation on NIE to discuss or advise the UR of the “purported changes”; ■ Fourthly, whether the UR would have agreed with the purported changes or would have required a different accounting treatment, <p>The first and second assessments are covered as part of our assessment of whether the “purported changes” suggested by the Consultants are actually changes to NIE’s capitalisation practices.</p> <p>The third assessment is not considered further as it is outside the scope of this report.</p> <p>The fourth assessment appears to be considering what might or might not have happened and hence cannot be reasonably assessed and is not therefore considered further in this report.</p>

Addressing the Consultants’ assertions
<p>Based on our review of the assertions included in the Consultants’ report as noted above, our analysis will consider:</p> <ul style="list-style-type: none"> ■ Whether the Consultants’ report provides evidence that the “purported changes” suggested by the Consultants do actually represent changes to NIE’s capitalisation practice; and ■ Whether the Consultants’ report provides evidence that there has been any inappropriate capitalisation of Opex expenditure for whatever reason. <p>In respect of each the categories of adjustments suggested by the Consultants, our analysis will specifically consider (i) the Accuracy of the analysis of the data used by the Consultants and (ii) the Interpretation applied by the Consultants.</p>

Consultants assertions	KPMG considerations
<p>Consistency of capitalisation practices and required communication with the UR</p>	<p>The Consultants' approach</p> <p>Throughout the report, the Consultants seek to determine whether, and to what extent, NIE has changed its capitalisation practices from one accounting period to the next. They also note that NIE appears not to have discussed such changes with the UR.</p> <p>It is notable that the Consultants do not define "capitalisation practices", but, in the accompanying draft determination, the UR makes clear that it refers to "the process of classifying expenditure between Capex and Opex as being NIE's capitalisation practices" (paragraph 2.5 of the draft determination).</p> <p>In essence, the Consultants appear to be suggesting that changes to the way in which NIE capitalised expenditures in the final two years of RP3 and RP4, relative to the earlier periods, needed the UR's consent, and amounted to a breach of some relevant obligation to maintain consistent capitalisation practices from one accounting period to the next.</p> <p>NIE's obligations in respect of its regulatory accounts</p> <p>It does not form part of our terms of reference to opine as to whether NIE has breached some regulatory obligation in respect of its capitalisation practices, nor whether NIE should have discussed particular accounting practices with the UR.</p> <p>We have, however, examined condition 2 of NIE's licence, which regulates the way in which it should prepare its regulatory accounts. In this regard, we note the following:</p> <ul style="list-style-type: none"> ■ NIE is required to prepare its accounting statements (i.e. its regulatory accounts) on a consistent basis from one accounting period to the next. ■ NIE is also required to procure, under joint obligation with the UR, a report by its auditors stating whether, in their opinion, the accounting statements have been properly prepared in accordance with condition 2 and give a true and fair view of the revenues, costs, assets, liabilities, reserves and provisions of, or reasonably attributable to, the Separate Business to which the statements relate (paragraph 3(c) of condition 2). <p>For this purpose, accounting statements will have been properly prepared on a consistent basis if they have been prepared in accordance with paragraphs 3(a) and 3(b) of condition 2.</p> <p>Whilst no definition of consistency is included in condition 2, the references in Paragraph 3(a) to the Companies (Northern Ireland) Order 1986 ("the Companies Order") and the references in Paragraph 3(c) to the Accounts being "properly prepared" and giving a "true and fair view", mean that the word consistency should be interpreted in the context of the Companies Order and the accounting standards that apply to the preparation of NIE's statutory accounts (i.e. International Financial Reporting Standards).</p>

Consultants assertions	KPMG considerations
<p>Consistency of capitalisation practices and required communication with the UR (continued)</p>	<p>So far as presently relevant, the 1986 Order and the relevant Standards impose the following requirements:</p> <ul style="list-style-type: none"> ■ Paragraph 11 of Schedule 4 Part 1 of the 1986 Order states that: "accounting policies should be applied consistently from one financial year to the next"; and ■ Paragraph 15 of IAS 8 (Accounting policies, changes in accounting estimates and errors) requires that: "the same accounting policies are applied within each period and from one period to the next unless a change in accounting policy meets one of the criteria in paragraph 14". <p>IAS 8 makes a very clear distinction between changes in accounting policies and changes in accounting estimates. IAS 8 Paragraph 33 states that "the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability". Paragraph 34 notes that "an estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience" and Paragraph 35 clarifies that "when it is difficult to distinguish a change in an accounting estimate from a change in accounting policy, the change is treated as a change in accounting estimate".</p> <p>Conclusions</p> <p>Whilst the Consultants conclude that the full amount of their proposed adjustment of £35.6 million is attributable to changes in "capitalisation practices", they do not explain to what extent they consider the adjustment to be justified by reference to changes in accounting policies, rather merely than changes in the methods of estimation, or the resulting estimates, by reference to which particular accounting entries are made.</p> <p>As part of our review, we examined this question. We consider that no part of the adjustments proposed by the Consultants arises from any change in accounting policy. Where NIE has changed the method of estimation, or the resulting estimate, of the amount to be capitalised under any particular heading, such changes are not changes in accounting policies or practices.</p>

**Section 3 – Accuracy
of the analysis of the
data and Interpretation
by the Consultants**

A blue trapezoidal graphic on the left side of the slide, containing white text. The graphic is a parallelogram with a slanted right edge.

Section 3a – Capitalisation of overheads

Key messages:

- **The overhead capitalisation rates increased during the period under review.**
- **The overhead capitalisation rates used by the Consultants in calculating their proposed adjustments are based on the historic rates used by NIE.**

Capitalisation of overheads relating to services areas

- The Consultants were provided with details of capitalised overheads in the form of spreadsheets representing SAP Report 55 for each year from 2002-03 to 2010-11. The data provided agreed to NIE's underlying nominal ledger analysis. Whilst the Consultants have referred in their report to SAP Report 50, the correct reference is SAP Report 55.
- NIE confirmed to the UR that over RP3 and RP4 it had increased the percentages that it applied to determine the capitalised overhead adjustment (amount to be reclassified from Opex to Capex). The table below sets out the overhead capitalisation rates used by the Consultants in determining the adjustment to Opex as set out in their report.

Percentage of Opex indirect costs that has been capitalised						
	Price control period	Yr 1 RP3 RP4	Yr 2 RP3 RP4	Yr 3 RP3 RP4	Yr 4 RP3 RP4	Yr 5 RP3 RP4
Powerteam managed service/supply chain						
Actual capitalisation rate applied	RP3	65.0%	65.0%	65.0%	72.5%	80.0%
Actual capitalisation rate applied	RP4	80.0%	80.0%	80.0%	80.0%	80.0%
Connections department						
Actual capitalisation rate applied	RP3	65.0%	65.0%	65.0%	77.5%	77.5%
Actual capitalisation rate applied	RP4	77.5%	77.5%	77.5%	77.5%	77.5%
Networks department						
Actual capitalisation rate applied	RP3	65.0%	65.0%	65.0%	72.5%	72.5%
Actual capitalisation rate applied	RP4	72.5%	72.5%	72.5%	72.5%	72.5%
Technology department						
Actual capitalisation rate applied	RP3	40.0%	40.0%	40.0%	45.0%	45.0%
Actual capitalisation rate applied	RP4	45.0%	45.0%	45.0%	45.0%	45.0%

Source: Consultants' Final Report

- The overhead capitalisation rates used by the Consultants in calculating their proposed adjustments are those used by NIE and agree to the data provided to them by NIE.

Key messages:

- **The adjustment proposed by the Consultants has been calculated correctly based on the underlying data and historic overhead capitalisation rates.**
- **The proposed adjustment amounts to £9.8 million (covering a seven year period).**
- In their interim report, the Consultants proposed an adjustment of £8.3 million over the six years to 2010-11 by taking the percentages applied by NIE for 2002-03 to 2004-05 (the first three years of RP3) and applying them to each year to 2010-11. In their final report the Consultants added an adjustment of £1.5 million to cover 2011-12 bringing the total proposed adjustment to £9.8 million.
- The proposed adjustment in respect of overhead capitalisation was calculated by reference to the financial impact arising as a result of changing from the previous overhead capitalisation rates to the new capitalisation rates in place.
- The change in the overhead capitalisation rate has led to an additional £9.8 million of overheads being capitalised over RP3 and RP4.

Key messages:

- **The ongoing review and updating of overhead capitalisation rates is appropriate, and is in accordance with IAS8: Accounting policies, changes in accounting estimates and errors.**
- **No requirement to discuss any changes in rates with the UR has been identified.**
- **The refinement of overhead capitalisation rates does not represent a change in capitalisation practice.**

Consultants' specific comments	KPMG commentary
<ul style="list-style-type: none"> ■ "Our review has confirmed that capitalisation practices have not been consistent across RP3 and RP4 and have resulted in a higher proportion of total costs being capitalised" (Page 14). 	<ul style="list-style-type: none"> ■ Whilst the capitalisation overhead rates have changed over the period, resulting in a higher proportion of total costs being capitalised, the absolute level of capitalised overheads in RP4 were lower than those capitalised in RP3 and lower than the capitalised overheads included in the RP4 Capex budget.
<ul style="list-style-type: none"> ■ "This increase of Capex over Opex is the subject of this review and has reduced Opex and increased Capex without an associated efficiency gain. This change has resulted in a windfall gain under the Rolling Opex mechanism and was not discussed with the Utility Regulator before being made" (Page 14). 	<ul style="list-style-type: none"> ■ The Consultants do not explain why they formed the view they did other than indicating that a resultant windfall gain to NIE should have triggered discussions and agreement with the UR. ■ Whilst consideration of whether NIE was required to discuss the changes made to the capitalisation rates with the UR is outside the scope of our work, we are not aware of any requirement for NIE to discuss such changes with the UR. ■ The capitalisation overhead rates used to allocate indirect costs are set to reflect the underlying mix of work (i.e. Opex or Capex) carried out by the organisation. Ongoing review, and updating, of overhead rates is appropriate, and is required by generally accepted accounting standards. ■ The capitalisation rates were updated during the period to reflect the underlying mix of work carried out based on management's review. This review identified that the amount of overheads attributable to capital works was in excess of the capitalisation overhead rates being applied, and accordingly resulted in an increase in the capitalisation overhead rates. ■ The resultant increases in the capitalisation overhead rates were therefore in accordance with IAS8: Accounting policies, changes in accounting estimates and errors.

Key messages:

- **The ongoing review and updating of overhead capitalisation rates is appropriate, and is in accordance with IAS8: Accounting policies, changes in accounting estimates and errors.**
- **No requirement to discuss any changes in rates with the UR has been identified.**
- **The refinement of overhead capitalisation rates does not represent a change in capitalisation practice.**

Consultants' specific comments

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KPMG commentary

- The Consultants highlight that this review is investigating changes in capitalisation practices rather than assessing the legitimacy of expenditure that NIE considers as Capex. We consider that an assessment of the legitimacy of the expenditure that NIE consider as Capex is a key consideration of purported changes in capitalisation practices. We have not identified any evidence put forward by the Consultants regarding the changes in overhead capitalisation rates to suggest that expenditure has been inappropriately capitalised by NIE.
- Based upon our review of the information made available to the Consultants and on other information provided by NIE in relation to the Consultants' proposed adjustments regarding changes in overhead capitalisation rates:
 - we did not identify any changes in capitalisation practice as defined by IAS8: Accounting policies, changes in accounting estimates and errors.
 - we did not note any inappropriate capitalisation of expenditure resulting from breaches of applicable accounting standards
- NIE's statutory financial statements and Regulatory Accounts have been subject to audit for each of the years spanning RP3 and RP4. As the related audit reports for these years were unqualified, it would be reasonable to conclude that the Auditors did not consider that there had been any material breaches of applicable accounting standards or inappropriate capitalisation of operating expenditure.

Section 3b – Repairs and maintenance

With regards to repairs and maintenance, the Consultants have calculated a difference of £20.5 million between base costs and actual costs over the six year period of their analysis (2 years of RP3 and 4 years of RP4)

Source of data used by the Consultants

- The table below sets out a summary of the Consultant’s analysis of repairs and maintenance expenditure for the last two years of RP3 (2005/06 and 2006/07) and the final four years of RP4 (2007/08 to 2010/11) and then aggregated for RP3 and RP4. The same information, disaggregated into individual years, has been provided to NIE by the Consultants. The analysis is split into Processing Groups (PGs) as employed internally by NIE. This analysis has been prepared based on a number of assumptions made by the Consultants. We make reference to these assumptions later in this section.

Summary of Consultant’s analysis			
£'000	Base line	Actual expenditure	Difference
RP3			
Routine maintenance (PG0 & PG1)	11,395	8,317	(3,077)
Non recoverable alterations (PG3)	1,439	1,005	(434)
Faults & emergency (PG4)	12,161	11,100	(1,061)
Customer driven (PG5 & PG7)	2,168	1,889	(280)
Metering (PG6)	602	391	(211)
Total for RP3 (2 years)	27,764	22,702	(5,063)
RP4			
Routine maintenance (PG0 & PG1)	24,137	14,942	(9,195)
Non recoverable alterations (PG3)	2,782	1,221	(1,561)
Faults & emergency (PG4)	23,651	20,401	(3,249)
Customer driven (PG5 & PG7)	4,266	3,002	(1,264)
Metering (PG6)	1,060	914	(146)
Total for RP4 (4 years)	55,896	40,480	(15,416)
Aggregate RP3 and RP4			
Routine maintenance (PG0 & PG1)	35,532	23,259	(12,272)
Non recoverable alterations (PG3)	4,221	2,226	(1,995)
Faults & emergency (PG4)	35,812	31,501	(4,310)
Customer driven (PG5 & PG7)	6,434	4,891	(1,543)
Metering (PG6)	1,662	1,305	(358)
Total for RP3 and RP4	83,661	63,182	(20,478)

Source: Consultants’ Final Report

- The Consultants state that “The Rolling Opex regulatory model that applied in RP4 was being discussed in mid RP3 and significantly the final two years of RP3 show a marked reduction in Opex expenditure”. The Consultants’ analysis starts in year 4 of RP3 with the implication being that this is when they consider changes in capitalisation practices started.
- The “Base line” column in the analysis opposite sets out the base cost of repairs and maintenance for each Regulated Period. The base line has been calculated based on historic actuals adjusted for increases in RPI. The base line for RP3 (2005/06 – 2006/07) has been calculated based on the average actual costs during 2002/03 to 2004/05 (the first 3 years of RP3). The base line for RP4 (years 2007/08 to 2010/11) has been calculated based on the actual costs for the corresponding year in RP3, for example 2007/08 is calculated based on 2002/03 actuals uplifted for RPI.
- The “Actual expenditure” column is based on the actual expenditure uplifted by RPI in each of the Regulatory Periods.
- The “Difference” column is the actual difference between the base line (column 1) and the actual expenditure (column 2). This difference, amounting to £20.5 million, is the subject of the Consultants’ investigation into changes in capitalisation practices.

The use of the average actual Opex in years 1 to 3 of RP3 as a base for years 4 to 5 of RP3 has given rise to a larger difference between base costs and actual costs than would have arisen had the actual Opex for year 3 been used as a base for year 4 and the actual Opex for year 4 been used as a base for year 5. The impact of this has been to inflate the difference by approximately £2.7 million.

The categorisations by Processing Groups are based on clarification provided by NIE. Errors in the interim report initially issued by the Consultants have been resolved.

- The “Base Line” for the first 4 years of RP4 has been set based on the rolling Opex mechanism that is in place throughout RP4. The base line for the 2 years of RP3 is set on an arbitrary basis as there was no equivalent mechanism operating throughout the period. The Consultants have stated that their comparison assumes that the expenditure trend for the first 3 years should be comparable with the final two years. This assumption contradicts other areas of the report where the Consultants indicate that the material savings in controllable Opex achieved in the first 3 years of RP3 appear to have resulted from operational efficiency changes. As such, using the average of the first 3 years ignores the ongoing trend of reduced costs. Had the base line for the last two years of RP3 been set by reference to the actual Opex in the preceding year (i.e. 2005/06 base line based on 2004/05 actual) then the total base line for RP3 would be £25.08 million and the difference that would be subject to the Consultants investigations would be £17.75 million (i.e. a reduction of £2.7 million).
- The table opposite sets out the aggregated RP3 and RP4 repairs and maintenance analysis prepared by the Consultants which is collated and analysed into five Processing Groups (PGs), which are Routine maintenance, Non-recoverable alterations, Faults & Emergency, Customer driven and Metering. The Consultants have analysed the Routine maintenance processing group into sixteen further cost classifications. In order to allocate the costs between the Consultants’ classifications, NIE’s internal categorisations have been used to ensure comparability of information.
- These categorisations differ to those included in the interim report provided by Consultants which were based on a simple word search function. NIE advised that this was not an accurate basis for categorising expenditure and the Consultants subsequently revised their categorisations.
- The categorisations initially used in the interim report gave rise to a balancing figure of £11 million (base line) and £9.9 million (actual expenditure) which was classified as “Remainder” and amounted to 33% of the total routine maintenance cost. This anomaly has been resolved in the Consultants’ final report.

Detailed UR analysis			
£'000	Base line	Actual expenditure	Difference
Aggregated RP3 and RP4	83,658	63,181	(20,477)
Routine maintenance (PG0 & PG1)	35,529	23,258	(12,271)
Cyclic plant maintenance	8,722	6,523	(2,199)
Inspections	2,519	3,138	619
Patrol	900	670	(230)
Plant miscellaneous	2,999	2,685	(314)
Defects	4,062	3,416	(646)
Tree cutting	3,012	1,147	(1,865)
Ground maintenance	1,523	873	(650)
AOR	2,519	1,317	(1,202)
Project Opex	1,770	1	(1,769)
Fault and Emergency	95	3	(92)
Overhead	451	324	(127)
Cable	371	338	(33)
Plant workshop	3,352	2,141	(1,211)
Excavation and reinstatement contract monitor	497	127	(370)
Control room services / Buildings and grounds	2,375	427	(1,948)
Miscellaneous	362	128	(234)
Non recoverable alterations (PG3)	4,221	2,226	(1,995)
Faults & Emergency (PG4)	35,812	31,502	(4,310)
Customer Driven (PG5 & PG7)	6,434	4,891	(1,544)
Tree cutting	2,341	2,378	36
PG5 minus tree cutting	4,093	2,513	(1,580)
Metering (PG60)	1,662	1,304	(358)

Source: Consultants Final Report

Out of the “difference” identified by the Consultants’ six year analysis of £20.5 million, the Consultants have allocated £13.2 million of the Opex reduction to inappropriate capitalisation of Opex expenditure and are proposing an adjustment of this amount. This adjustment however is provisional and is subject to review following the review of the actual outturn for 2011/12.

Summary of UR's analysis									
£'000	Reduction due to direct R&M capitalisation (identified)	Reduction due to direct R&M capitalisation (probable)	Reduction due to capital programme substitution (identified)	Reduction due to capital programme substitution (probable)	Reduction due to one-off expenditure in RP3	Remaining reductions	* Increased expenditure	Total	
RP3									
Routine maintenance (PG0 & PG1)	447	121	678	401	-	2,638	1,207	3,078	
Non recoverable alterations (PG3)	434	-	-	-	-	-	-	434	
Faults & emergency (PG4)	1,038	-	22	-	-	-	-	1,060	
Customer driven (PG5 & PG7)	70	-	-	-	-	335	126	279	
Metering (PG6)	-	-	-	-	-	211	-	211	
Total for RP3	1,989	121	700	401	-	3,184	1,333	5,062	
RP4									
Routine maintenance (PG0 & PG1)	957	73	2,828	639	2,521	4,320	2,144	9,194	
Non recoverable alterations (PG3)	1,561	-	-	-	-	-	-	1,561	
Faults & emergency (PG4)	2,138	-	129	982	-	-	-	3,249	
Customer driven (PG5 & PG7)	201	-	459	-	-	604	-	1,264	
Metering (PG6)	-	-	-	-	-	223	76	147	
Total for RP4	4,857	73	3,416	1,621	2,521	5,147	2,220	15,415	
Aggregate RP3 and RP4									
Routine maintenance (PG0 & PG1)	1,404	194	3,506	1,040	2,521	6,958	3,351	12,272	
Non recoverable alterations (PG3)	1,995	-	-	-	-	-	-	1,995	
Faults & emergency (PG4)	3,176	-	151	982	-	-	-	4,309	
Customer driven (PG5 & PG7)	271	-	459	-	-	939	126	1,543	
Metering (PG6)	-	-	-	-	-	434	76	358	
Total for RP3 and RP4	6,846	194	4,116	2,022	2,521	8,331	3,553	20,477	

KPMG Note: * figures are negative

Balance indicated to have been inappropriately capitalised £13.2 million

- The table on the previous page sets out the analysis prepared by the Consultants to classify and explain the difference of £20.5 million identified as the reduction in repairs and maintenance expenditure against the base line over the six year analysis period. The Consultants have attributed the difference (i.e. the Opex reduction) to seven categories:
 - (i) Reduction due to direct R&M capitalisation (identified);
 - (ii) Reduction due to direct R&M capitalisation (probable);
 - (iii) Reduction due to capital programme substitution (identified);
 - (iv) Reduction due to capital programme substitution (probable);
 - (v) Reduction due to one-off expenditure
 - (vi) Remaining reductions; and
 - (vii) Increased expenditure.
- The “Reduction due to direct R&M capitalisation (identified)” relates to expenditure that was originally charged to Opex but then transferred to Capex, as identified by negative accounting adjustments in the Opex data (transfers out of Opex).
- The “Reduction due to direct R&M capitalisation (probable)” also relates to transfers out of Opex, but where capitalisation is infrequent rather than a continuing trend.
- The “Reduction due to capital programme substitution (identified)” relates to where the R&M reduction cannot be wholly accommodated by direct capitalisation and where the Consultants have assessed that there is a relative increase in a relevant capital programme to cover the difference.
- The “Reduction due to capital programme substitution (probable)” relates to reductions in Opex in processing groups (in excess of the amount of “Direct R&M capitalisation” for that processing group), where the Consultants consider that there is clear evidence that the Opex reduction is due to capitalisation, based on the overall trend and policy change commentary from NIE, but where reductions cannot be accounted for based on the corresponding increases in capital programmes.
- The “Reduction due to one-off expenditure” refers to expenditure incurred in RP3 that did not recur in RP4.
- The “Remaining reductions” refer to the movement within the £20.5 million which the Consultants have not attributed to capitalisation.
- The “Increased expenditure” represents increases in repairs and maintenance expenditure and no further analysis was performed by the Consultants. Effectively this is a balancing figure (negative amount of £3.6 million) and in our view represents an error in the Consultants’ analysis arising from a non-symmetrical approach adopted (see below).
- The Consultants’ analysis of the Opex reduction may be summarised as follows:

Consultants’ analysis	
£’m	
Inappropriate capitalisation	
Direct R&M capitalisation	7.0
Capital programme substitution	6.2
Total inappropriate capitalisation	13.2
Efficiencies and one-offs	10.9
	24.1
Increased expenditure	(3.6)
	20.5

The Consultants have collated and presented the underlying data based on their initial assumptions and methodology as explained by the Consultants to NIE.

A significant number of inaccuracies were identified in the analysis workings supporting the Consultants' final report.

Accuracy of data used by the Consultants in preparing their report

- In their interim report the Consultants, in calculating the “reduction through direct R&M capitalisation” balances, effectively took any credit items identified within the analysis and assumed that the credit items were being debited (i.e. added) to capital. This assumption was incorrect as the data included other items such as those returned to stock. This has been resolved in the final report following discussions with NIE.
 - We note that there is an inconsistency in the Consultants' report in respect of the categorisation of identified movements. For example with regard to the “Trans F&E Cat J” 2006/07, difference classified within “Reduction due to direct R&M capitalisation (identified) (column H), the source of this data is the same as that for the 2005/06 difference which has been classified as “Reduction due to capital programme substitution (Probable)” (column K). There is no support or explanation as to the reasons behind the different classifications adopted.
 - The sources of data used by the Consultants in the preparation of their analysis was: (i) for the repairs and maintenance expenditure, the ‘R&M by PG AML IO.xls’ provided by NIE to the Consultants on 29 March 2012, which contained a data set of R&M costs over the periods under review. This data was then grouped in accordance with the NIE follow up document ‘2 – timeline R&M.xls’ which was submitted on 22 June 2012; (ii) for the capitalised R&M analysis, the ‘Cap R&M by IO.xls’ provided on 16 June 2012. A revision to the Capex data set was provided on 23 July 2012; and (iii) for the capital programme substitution analysis the ‘Capex by Cat AML ORD.xlsx’ provided to Consultants on 5 March 2012. This was followed up with file ‘capex programmes .xlsx’ following meeting of 18th July.
 - KPMG have reconciled the Consultants workings analysis to the underlying supporting R&M data set provided by NIE, and, while noting adjustments for RPI and the removal of certain one-off costs (Project Opex) and the reclassification of certain items (mini-pillars), no material issues were noted.
- KPMG have checked the mathematical accuracy of the data within the supporting workings prepared by the Consultants, including the calculation of average expenditure for the base periods, 2005/06 and 2006/07, RPI uplift calculations and movement reconciliations.
 - KPMG have performed a high level review of the mathematical accuracy of the calculations within the analysis summary spreadsheet supporting the Consultants' report and note that there are a number of mathematical errors included in the formulas and calculations, including the following:
 - With regard to the base year costs, the “Misc Cat. P” figure in years 2005/06 and 2006/07 is excluded, amounting to £177k in each year. If amended this would increase the total base cost by £0.35 million to £84.0 million.
 - In a number of years the sub-total of the “Customer driven (PG5 & PG7)” cost classification does not agree to the supporting analysis. For example while the sub-total for the Customer Driven category in the “Reduction due to direct R&M capitalisation (identified)” is £70k, the analysis indicates that the PG5 & PG7 categorisation excluding tree cutting is £145k and tree cutting is nil (therefore there is an understatement in column H of the analysis).
 - In addition, the £70k noted in this column as the sub-total is linked to the sub-total difference, which is inconsistent with the approach and is deemed an error.
 - In a number of cells within the analysis there are hard coded figures or adjustments (possible balancing items) made to arrive at the figure reported for inclusion within the adjustment columns. This is deemed an error and misstatement of the data as they would appear to be unsupported.

A significant number of inaccuracies were identified within the Consultants' capital analysis workings.

Accuracy of data used by the Consultants in preparing their report (*cont'd*)

- While we note that there are various mathematical errors in the summing and calculation of difference columns, the overall analysis at the top reconciles to the £20.5 million difference. We note that if the errors in formulas were corrected, then the difference would still reconcile to the £20.5million, however the amounts per each classification would differ. Therefore the analysis is inaccurate and there is a risk of misinterpretation between classifications, especially given the vague definitions provided for each column.
- For plant workshop, it would appear that the summary sheet is picking up the wrong cell within the Consultants' analysis. The cell only presents the difference in expenditure and does not support the assumption that the difference is actually capitalised.
- KPMG note the following, in addition to the above:
 - From a review of 31 cost categories within the Consultants' analysis for "reduction due to direct R&M capitalisation (identified)", we note that there were 19 inconsistencies or inaccuracies identified.
 - From a review of 31 cost categories within the Consultants' analysis for "reduction due to capital programme substitution (identified)", we note that there were 12 inconsistencies or inaccuracies identified.
 - From a review of 17 cost categories within the Consultants' analysis for "reduction due to capital programme substitution (probable), we note that there were 5 inconsistencies or inaccuracies identified.
- As already noted, the Consultants have used a number of source workings analysis within their the overall summary. Two of these source working analysis files do not agree. The R&M expenditure for Category E in Consultants' "Cap sub_AH" file does not agree to "AH category analysis v0.2" file (£688k v £703k). Both files are using the same source data, however are calculating a different figure. This will result in inaccurate analysis and interpretation of the data.
- KPMG have reconciled the Consultants' Capex workings and analysis to the underlying source data. We note the following inaccuracies within the analysis:
 - Category E Defects - the Consultants were advised by NIE that of the reclassification of defects costs, 25% was in relation to general enhancements. However, the Consultants have applied an assumption that 75% of the defects was general enhancements and therefore the like for like analysis is inaccurate and may result in incorrect interpretations.
 - Category E Defects - while overall the Consultants' analysis could be reconciled to the underlying source data, there appears to be inaccuracies within the capital analysis from 2007/08 onwards, which we have been unable to reconcile to NIE's source data.
 - Category M Plant Workshop – the Consultants have excluded all capital costs in RP3, while also understating the Capex in years 1 and 2 of RP4. The exclusion of these costs within the analysis will result in incorrect conclusions being formed.

The Consultants non-symmetrical approach has resulted in a £3.6 million overstatement in calculating the £13.2 million purported adjustment.

Accuracy of data used by the Consultants in preparing their report (cont'd)

- Category P Misc – within the R&M analysis the Consultants have reclassified “Mini pillar defects” to Category E, however they have not performed a similar reclassification of the capitalised R&M analysis which remains within Category P. This will result in an inaccurate analysis of the underlying data and interpretations formed.
 - PG3 Non-recoverable alterations – the Consultants have excluded the Capex programmes from their analysis and instead have used the total absolute difference in R&M expenditure as the basis for their adjustment. This is not consistent with the rest of the Consultants’ analysis.
 - PG4 Faults and emergency – the capital expenditure analysis does not reconcile to the underlying source data.
 - PG5 Customer driven (excl trees) – the Consultants have used an AMI “District” which was used for various Capex programmes in earlier years, this will have resulted in an increased capital figure. This was an oversight in the provision of information by NIE.
- In addition to the significant inaccuracies and inconsistencies identified in the workings supporting the Consultants’ final report, the actual method of analysis used by the Consultants has given rise to a significant overstatement of the purported adjustment amount of £13.2 million. The Consultants have compared individual years between periods (focusing on Opex reductions) and at the same time excluded increases in Opex from their analysis (i.e. a non symmetrical approach). This has led to the “Increased expenditure” column (totalling £3.6 million) of the Consultants’ analysis and represents the amount of overstatement (applying their own analysis) that is included in the purported adjustment of £13.2 million. The overstatement arises from the fact that the Consultants’ analysis includes claimed adjustments in cases where Opex has increased over the six year period and also claimed adjustments in excess of the overall Opex reduction over the six year period.

The Consultants have assumed a cause-effect relationship between reducing Opex and increasing Capex. This is a fundamental aspect of their analysis and drives the “difference” figure of £20.5 million. The assumption is inappropriately simplistic and ignores reductions in Opex due to efficiencies, changes in the underlying work and cyclical issues.

The Consultants have also adopted an unsupported cause-effect and highly subjective approach to their categorisation of the analysis difference of £20.5 million into the particular “adjustment” categories”.

Assessment of the analysis applied by the Consultants in preparing their report

In terms of assessing the analysis carried out by the Consultants we would note the following:

- The Consultants have made a general assumption that if Opex has reduced and Capex has increased, the increase in Capex has driven the reduction in Opex (“a cause-effect relationship”). This assumption is inappropriate and the view is too simplistic for any meaningful conclusions to be drawn. Reductions in Opex are also driven by efficiency savings, changes in underlying work or reduction in required levels and not necessarily attributed to the capitalisation of costs.
- The Consultants’ assumptions in relation to Opex reductions do not consider efficiency or cost savings achieved from the actual additional Capex spend in the periods. While Capex has increased, this can result in reduced Opex due to lower requirements for maintenance spend due to newer equipment being installed or improved equipment which may require less maintenance/defects or result in less wear and tear.
- The Consultants have calculated a difference (the Opex expenditure reduction of £20.5 million) using their own analysis criteria and a specific set of parameters. They have then considered what could have given rise to this ‘difference’ and have attributed the ‘difference’ to seven categories. They have established definitions for the categories used and have analysed the ‘difference’ using these definitions. However, the Consultants have not provided evidence to support their view that the treatment of expenditure within these categories has any relationship whatsoever to the difference (i.e. to the Opex reduction). For example, the Consultants have determined that any transfers from Opex to Capex as reflected in the accounting records is evidence of inappropriate capitalisation (i.e. Direct R&M capitalisation) and similarly, that any increase in Capex in excess of this amount is evidence of further capitalisation (i.e. Capital Programme Substitution).
- In our view the Consultant’s analysis is effectively a “data analysis” and does not actually present any evidence regarding changes in capitalisation practice.
- A fundamental matter to note is that the first step of the Consultants’ analysis is their allocation of the £7.0 million to the category heading “Reduction due to direct R&M capitalisation” arising from transfers from Opex to Capex as reflected by negative adjustments in the accounting records. The implication of this is that this amount represents retrospective and inappropriate adjustments made by NIE within its accounting records – a claim that is not supported with any evidence whatsoever.
- With regard to the Consultants’ allocation of the £6.2 million to the category heading “Reduction due to capital programme substitution” it is noted that this is subject to a high degree of subjectivity in that it is assumed that all Opex categories have a directly associated Capex programme. This is not the case in practice. In general there is no equivalence and this is a loose connection. Also, the analysis takes no account of the increased capital programme in RP4 over RP3. NIE’s Capex submission for RP4 and the UR’s subsequent final determination was significantly in excess of that determined in RP3 and as such there has been a significant increase in the number of Capex projects since the beginning of RP3 which has driven an increase in Capital expenditure over the period. There was a planned and agreed 20% increase in Capex programmes in RP4 compared with RP3. This has not been reflected within the analysis prepared by the Consultants which incorrectly assumes that capital spend should remain flat.
- Further to the above, the Consultants’ adjustment of £2.0 million defined as “Reduction due to capital programme substitution (Probable)”, would appear to be unsupported by the Consultants’ underlying analysis and also would appear to be inconsistent across the individual cost categories.
- A significant amount of expenditure is cyclical in nature, in particular maintenance Opex. Further detailed investigation would be required to determine and appropriately assess the impact of cyclical expenditure both within the base line and the actual expenditure.

Whilst significant commentary in respect of Powerteam is included in the Consultants’ report, no specific conclusions have been drawn from this.

We have identified changes in the methodology in respect of fault and emergency, non-recoverable alterations and plant workshop costs as a result of the evolution of systems for recording costs and changes in operational structures. These changes, do not represent changes in capitalisation practice.

- The Consultants’ report contains significant commentary in respect of the total number of Powerteam hours and the level of capitalisation and draws the conclusion that there is a clear trend of increasing Capex within Powerteam over the review period. The Consultants also conclude that their analysis has focused on time recording rather than financial accounting but is consistent with their findings in the rest of the report. No further conclusions have been drawn and no adjustments suggested. Our assessment is that the increase observed in the number of Powerteam hours capitalised as a percentage of total hours would inevitably be consistent with the findings elsewhere in the report given the fact that Powerteam costs are charged into other cost categories (e.g. R&M) and as such are directly correlated. We would also note that the increased levels of capitalisation would be expected given the increase in capital programmes over this period. In addition, we note that such increased levels of capitalisation in no way indicates any change in capitalisation practice.
- The Consultants in their report have suggested an adjustment of £6.8 million under the classification of “Reduction due to direct R&M capitalisation (identified)”. Of this adjustment, a significant amount is attributable to three cost groupings:
 - Fault and emergency - £3.2 million
 - Non-recoverable alterations - £2.0 million
 - Plant workshop - £1.1 million
- The Consultants in their report have not undertaken any detailed assessment to understand the key drivers behind movements between Opex and Capex in calculating their £6.8 million “Reduction due to direct R&M capitalisation (identified)” and rather assumed that the movements over the period are directly caused by capitalisation with no consideration given to improvements /changes in reporting structures, business processes or systems in place.

For example:

- Within Fault and Emergency there has been ongoing review and development in reporting systems and structures. Prior to 2006/07 Troubleman faults were managed through a series of 6 digit event numbers. There were limitations with this as Troubleman did not align with SAP which collects costs against 7 digit internal order (IO) numbers. In 2007/08 an upgrade of Troubleman resulted in 7 digit event numbers being generated. This aligned with SAP system and resulted in greater visibility of costs per event. This was further enhanced by the creation of F&E resource engineers and dedicated 2 man teams. Both of these have accounted for an increase in capitalisation of F&E costs. This is not a change in accounting policy or capitalisation practice but is a result of improved systems, structures and business processes.
- In Non-recoverable alterations there was the introduction of the JMS system. JMS was introduced in 2001/02 and fully implemented for all general Connections activities across all areas in 2002/03, while for “unclip/reclip” jobs a job type was not set up on JMS until 2005/06. Prior to 2005/06 “unclip/reclip” was managed through a central database and costed against a series of general IO numbers. Implementation, and ongoing development of JMS, coupled with restructuring within Customer operations has provided greater visibility and control of costs. This is not a change in accounting policy or capitalisation practice but is a result of improved systems, structures and business processes.

- The Consultants' have calculated an adjustment of £1.1 million for Plant Workshop within the "Reduction due to direct R&M capitalisation (identified)", however their analysis and assumptions do not take into consideration the following events over the period reviewed:
 - In 2007/08 there was a change in internal costing procedures in relation to re-calibration of OH testing equipment. As a result of the change the cost of re-calibrations was charged to cost centres as opposed to a Plant Workshop Internal Order Number. This change in procedure results in circa.£100k reduction in R&M costs. This was not a change in accounting practice or policy.
 - Plant workshop prior to 2003/04 would have undertaken all steel work fabrication, with these costs being charged to Plant workshop internal order numbers, however after 2003/04 the fabrication work was outsourced to a third party contractor. This reduced costs incurred by the Plant workshop as a result of efficiency savings. This was not a change in accounting practice or policy.
 - Subsequent to the above, in 2009/10 the procurement department changed their procurement and sourcing policy and went direct to the contractor to provide the fabricated steel work, effectively cutting the Plant workshop out of the process. This resulted in further efficiency savings in procurement and eliminated some of the costs incurred by the Plant workshop. This was not a change in accounting practice or policy.

Key messages:

- **The Consultants’ evidence of changes in capitalisation practice is based on a simple review of decreasing Opex, coupled with increased transfers from Opex to Capex (Direct Capitalisation) and increased charges to Capex in excess of Opex (Capital Substitution).**
- **This review assumes a causal relationship and does not provide any supportable evidence as to a change in capitalisation practice.**

Consultants’ specific comments	KPMG commentary
<ul style="list-style-type: none"> ■ “Our detailed analysis shows that a prime driver of this reduction is an increase in capitalisation of costs that in the first part of RP3 were treated as Opex” (Page 45). 	<ul style="list-style-type: none"> ■ There has been a significant out-performance during the period under review. The out-performance of £20.5 million has occurred at the same time as Opex has reduced and Capex has increased.
<ul style="list-style-type: none"> ■ “This proportional reducing/increasing relationship between Opex/Capex suggests that the difference in Opex each year is being predominantly capitalised rather than arising through improved operating efficiencies” (Page 50). 	<ul style="list-style-type: none"> ■ We have not identified any evidence to support the assertion that an inappropriate increase in the capitalisation of costs previously treated as Opex has been a prime driver for the reduction in R&M Opex.
<ul style="list-style-type: none"> ■ “A comparison of any reduction in R&M expenditure against a corresponding increase in the relevant capital programmes demonstrates where expenditure has been substituted into Capex” (Page 6 & 47). 	<ul style="list-style-type: none"> ■ The Consultants do not provide any explanation as to the rationale for assuming that there is a causal relationship between movements in Opex and Capex and the resultant assumption that a reduction in Opex is as a result of inappropriate capitalisation rather than efficiencies.
<ul style="list-style-type: none"> ■ “Continuing trends of significant changes in capitalisation are taken as evidence of changes in policy or practice” (Page 7 & 47). 	<ul style="list-style-type: none"> ■ We do not consider that identifying an increase in a capital programme in association with a reduction in Opex in any way demonstrates inappropriate capitalisation (Capital Substitution).
<ul style="list-style-type: none"> ■ “Finally, it should be highlighted that this review is investigating changes in capitalisation practices rather than assessing the legitimacy of expenditure that NIE considers as Capex” (Page 8). 	<ul style="list-style-type: none"> ■ Continuing trends of significant changes in capitalisation does not provide any evidence of changes in policy or practice. This assertion is simplistic in nature and does not take into consideration the nature or quantum of the work carried out.
<ul style="list-style-type: none"> ■ “The review specifically compares the Opex reduction against Capex increases. Thus, increased capitalisation identified that is greater than the Opex reduction is omitted from the figures” (Page 7). 	<ul style="list-style-type: none"> ■ Failure to assess the underlying work and legitimacy of expenditure classified as Capex does not give a balanced assessment.
<ul style="list-style-type: none"> ■ “The review specifically compares the Opex reduction against Capex increases. Thus, increased capitalisation identified that is greater than the Opex reduction is omitted from the figures” (Page 7). 	<ul style="list-style-type: none"> ■ The logic applied in this situation is that Opex in RP4 should be identical to the equivalent year in RP3. This is inappropriate and unrealistic. The omission of capitalisation greater than the Opex reduction fails to recognise the true nature of the underlying work.

Consultants' specific comments	KPMG commentary
<ul style="list-style-type: none"> ■ "In summary we have identified £13.2 million of costs charged to Capex that arise from changes in the application of capitalisation practices and are not the result of efficiency gains" (Page 8). 	<ul style="list-style-type: none"> ■ The approach assumes that operating costs in RP4 should be identical to costs in RP3 with the conclusion drawn by the Consultants being that there are only two reasons for reduced Opex: (1) incorrect capitalisation of R&M expenditure; and (2) efficiency gains. This assumption ignores the impact of the actual mix and volume of underlying work carried out. R&M can legitimately decline in a situation where the volume of work decreases. At the same time Capex can increase, the two are not mutually dependent. ■ We do not consider that this reducing/increasing trend in Opex/Capex is evidence of a change in capitalisation practice and as such have not identified a supportable rationale for the proposed adjustment. With regard to certain R&M categories including defects, fault and emergency, non-recoverable alterations and plant workshop costs we have identified changes made to the way in which costs have been capitalised over the period. These changes were as a result of the evolution of systems for recording costs, changes in operational structures and improvements in business processes. These changes, do not represent changes in capitalisation practice. ■ The Consultants highlight that this review is investigating changes in capitalisation practices rather than assessing the legitimacy of expenditure that NIE considers as Capex. We consider that an assessment of the legitimacy of the expenditure that NIE consider as Capex is a key consideration of purported changes in capitalisation practices. We have not identified any evidence put forward by the Consultants regarding the reducing/increasing trend in Opex/Capex to suggest that the items of expenditure have been inappropriately capitalised by NIE. ■ Based upon our review of the information made available to the Consultants and on other information provided by NIE in relation to the Consultants' proposed adjustments regarding the reducing/increasing trend in Opex/Capex: <ul style="list-style-type: none"> ▪ we did not identify any changes in capitalisation practice as defined by IAS8: Accounting policies, changes in accounting estimates and errors. ▪ we did not note any inappropriate capitalisation of expenditure resulting from breaches of applicable accounting standards

Consultants' specific comments	KPMG commentary
	<ul style="list-style-type: none"> <li data-bbox="907 354 1991 496">■ NIE's statutory financial statements and Regulatory Accounts have been subject to audit for each of the years spanning RP3 and RP4. As the related audit reports for these years were unqualified, it would be reasonable to conclude that the Auditors did not consider that there had been any material breaches of applicable accounting standards or inappropriate capitalisation of operating expenditure. <li data-bbox="907 518 1991 718">■ In addition to the systems, structures and process developments identified above, management have identified a number of further reasons that have given rise to the Opex reductions. These reasons included: (i) efficiencies in processes (ii) the effects of changes in the nature and allocation of work activities; (iii) the adoption of best practice in asset strategies, procurement and cost allocation; and (iv) the benefits of capital programmes and the reducing effect on Opex. In our discussions with NIE management we did not identify any instances of inappropriate capitalisation of R&M costs as being the reason for Opex reductions.

Section 3c – Tree Cutting

The Consultants have calculated a difference of £12.6 million between actual amounts capitalised and expected amounts capitalised.

The difference is based on an assumption that only one third of total tree cutting costs should be capitalised. The Consultants have not identified any evidence to support this assertion.

Summary of Consultants' analysis							
£'m	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	Total
RP3							
Total costs	2.60	2.20	2.80	4.00	4.50	5.80	21.90
Assumed opex	1.70	1.50	1.80	2.70	3.00	3.80	14.50
Assumed capex	0.90	0.70	0.90	1.30	1.50	1.90	7.30
Actual capex	1.70	1.50	2.40	3.50	3.90	5.20	18.20
Excess capex	0.80	0.70	1.50	2.20	2.40	3.30	10.90
Tree cutting included in R&M adjustment	0.20	0.30	0.70	0.70	0.10	0.30	2.30
Tree cutting capex adjustment	0.60	0.40	0.80	1.50	2.30	3.00	8.60

Source of data used by Utility Regulator

- The table above sets out a summary of the Consultants' analysis of tree cutting expenditure for RP3, RP4 and aggregated for RP3 and RP4 and identifies an adjustment of £8.6 million. In their final report, the Consultants added an additional £4 million to cover 2011-12 bringing the total proposed adjustment to £12.6 million.
- The assumed Opex is based on an assumption that typically one third of total costs relate to capital items. The Consultant's rationale for suggesting that a policy of capitalisation of one third of tree cutting is that "in its RP4 submission showing historic costs in RP3 and earlier years, NIE had typically capitalised one third of tree cutting".
- The actual Capex is based on data provided to UR as part of the RP5 process. No issues have been noted regarding its accuracy.
- The tree cutting noted as included in R&M adjustments relates to the element of tree cutting included in the £13.2 million adjustment set out on page 27.
- The underlying data in relation to total tree cutting costs and actual amounts capitalised have been agreed to source data provided by NIE.

The use of a capitalisation policy of one thirds Capex and two thirds Opex is not an appropriate capitalisation policy.

NIE advised the UR in the RP4 capital submission of it's new dedicated programme to address vegetation management issues.

Consultants' specific comments	KPMG commentary
<ul style="list-style-type: none"> ■ "The remaining adjustment of £8.6 million* relates to the step up in the level of vegetation management costs that occurred over the period 2005-06 to 2010-11 and is the proportion historically that would have been charged to Opex" (Page 13). <p>*(subsequently increased by £4m to include 2011-12)</p>	<ul style="list-style-type: none"> ■ The Consultants are incorrect to assume that this is the proportion that would have been charged to Opex. There is no evidence to support the assumption of one third Capex, two thirds Opex which has been used by the Consultants in their calculation of the suggested adjustment. In prior years, NIE have always capitalised tree cutting costs associated with capital programmes. The increase in capitalised tree cutting in the current period is due to the increase in the overhead line programmes.
<ul style="list-style-type: none"> ■ "We have not considered whether the historic trend is reasonable based on the overhead lines work undertaken but have focused on ensuring consistency through the Rolling Opex period. We believe that this cost should be transferred out of Capex and treated as Opex" (Page 13 & 66). 	<ul style="list-style-type: none"> ■ The use of a capitalisation policy of one thirds Capex and two thirds Opex is not an appropriate capitalisation policy. In our view, NIE have correctly capitalised tree cutting costs in accordance with the requirements of IAS 16: Property, Plant and Equipment. Costs are capitalised under IAS 16 if it is probable that future economic benefits associated with the item will flow to the entity. Such costs include costs incurred initially to acquire or construct the item of property, plant and equipment and costs incurred subsequently to add to, replace part of or service it, together with all costs directly attributable to bring the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. ■ The focus on the consistency of the application, with no consideration of the reasonableness of the historic trend, ignores the nature of the underlying work undertaken. ■ The failure to consider the underlying overhead lines work undertaken throughout the period has led to inappropriate conclusions being drawn. Consistency of treatment can only be assumed when the underlying works undertaken is consistent. ■ Tree cutting costs (both Opex and Capex) are included in the statutory and regulatory financial statements which are subject to audit and no issues have been noted in this regard.

Consultants' specific comments	KPMG commentary
<ul style="list-style-type: none"> ■ “In our opinion, routine tree cutting is an operational activity and should not be capitalised. The increasing scale and unit cost per km of tree-cutting is also an issue and we have made an adjustment for the excess capitalisation that has occurred” (Page 23). 	<ul style="list-style-type: none"> ■ The Consultants do not explain the basis of the assumption that routine tree cutting is an operational activity that should not be capitalised. ■ NIE advised the UR in the RP4 capital submission of its overhead line strategy comprising re-engineering, refurbishment and targeted and replacement (TAR), all of which incorporates vegetation management as part of their specification of work. Hence an increased level of capitalised tree cutting costs would have been expected. ■ We also consider that an adjustment in respect of excess cost per km of tree cutting is inappropriate. The underlying density of the vegetation changed significantly from RP3 to RP4 and thus comparisons between the 2 periods, and adjustments thereon, are inappropriate.
<ul style="list-style-type: none"> ■ “Our conclusion is that there has been an excessive level of capitalised tree cutting and that an adjustment is required covering 2005-06 to 2010-11” (Page 66). 	<ul style="list-style-type: none"> ■ As noted, we do not consider that the increase in tree cutting associated with capital overhead line programmes to be evidence of a change in capitalisation practice and as such have not identified a supportable rationale for the proposed adjustment. ■ The Consultants highlight that this review is investigating changes in capitalisation practices rather than assessing the legitimacy of expenditure that NI considers as Capex. We consider that an assessment of the legitimacy of the expenditure that NIE consider as Capex is a key consideration of purported changes in capitalisation practices. We have not identified any evidence put forward by the Consultants regarding the increasing trend in tree cutting costs being capitalised to suggest that the items of expenditure have been inappropriately capitalised by NIE.

Consultants' specific comments	KPMG commentary
	<ul style="list-style-type: none"> ■ Based upon our review of the information made available to the Consultants and on other information provided by NIE in relation to the Consultants' proposed adjustments regarding the increase in capitalised costs in respect of tree cutting associated with capital overhead line programmes : <ul style="list-style-type: none"> ▪ we did not identify any changes in capitalisation practice as defined by IAS8: Accounting policies, changes in accounting estimates and errors. ▪ we did not note any inappropriate capitalisation of expenditure resulting from breaches of applicable accounting standards ■ NIE's statutory financial statements and Regulatory Accounts have been subject to audit for each of the years spanning RP3 and RP4. As the related audit reports for these years were unqualified, it would be reasonable to conclude that the Auditors did not consider that there had been any material breaches of applicable accounting standards or inappropriate capitalisation of operating expenditure.

Section 3d – Other

- In addition to the capitalisation adjustments set out in the preceding pages, the Consultants have also identified a number of other areas which have had a beneficial impact on NIE’s outperformance which may not have been as a result of efficiency gains and have brought these to the attention of the UR. These are considered below:

Consultants’ specific comments	KPMG commentary
<p>One off costs included in RP3 that did not recur in RP4</p> <ul style="list-style-type: none"> ■ The Consultants have identified a category of costs that they consider to be exceptional non-recurring items of expenditure which are not excluded from the RP3 controllable Opex annual outturns that were used as the basis for the controllable Opex allowance in the corresponding year in RP4. The Consultants have stated that where such costs did not recur in RP4, NIE experienced a windfall gain and the Consultants believe that an adjustment to the Rolling Opex allowance is appropriate (Page 23). ■ With the exception of one significant such cost relating to earthing mats in the amount of £633k, the Consultants have not identified any additional adjustments of this nature (Page 14 & 67). 	<ul style="list-style-type: none"> ■ This does not represent a change in capitalisation practice and has not been considered further.
<p>“Negative” Dt items</p> <ul style="list-style-type: none"> ■ “Our review has indicated that NIE may have benefitted in certain areas where it has reduced Opex as a result of carrying out less work in certain areas or deferring activities” (Page 15). 	<ul style="list-style-type: none"> ■ This does not represent a change in capitalisation practice and has not been considered further.
<p>One off costs and “Negative” Dt items</p> <ul style="list-style-type: none"> ■ The Consultants have drawn to the UR’s attention claims for “one off costs” and “negative Dt costs” made by NIE during RP4 and have indicated that NIE may have benefitted in certain areas where it has reduced Opex in RP4 as a result of exceptional non-recurring RP3 costs and also carrying out less work in certain areas or deferring activities. 	<ul style="list-style-type: none"> ■ We do not consider that the claim for these costs represents a change in capitalisation practice and as such have not identified a supportable rationale for any future proposed adjustment. Our review has not identified any changes in capitalisation practice. ■ We have not identified any evidence put forward by the Consultants regarding the “one off costs” and the “negative Dt costs” to suggest that the items of expenditure have been inappropriately capitalised by NIE.



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ANNEX 3

TREE-CUTTING

This Annex provides a summary of the evolution of NIE's approach to tree-cutting and a short commentary on how these matters were made known to the Utility Regulator. It also identifies the factual errors contained in the consultants' report so far as relates to these matters, and draws conclusions as to the absence of any basis for the Utility Regulator to determine that NIE has, in any sense, charged customers twice for any of its tree-cutting activities.

A. Introduction

All utilities who manage an overhead electricity network carry out programmes of cyclic asset replacement. Although the terminology used may vary, the principles are generally the same: companies aim to replace worn or deteriorated components to address the performance- and safety-related risks associated with failure of this equipment.

LV Strategy

During RP1 and early RP2, investment on the low voltage (**LV**) overhead network was managed at local level, with different districts applying different specifications and management practices.

In 2001, NIE undertook a centralised programme of LV network condition monitoring based on ground level patrols. This in turn led to a programme of limited refurbishment and, during RP3, NIE carried out a programme of replacement of decayed poles and limited tree-cutting on approximately 1,750 km of the LV network.

In RP4, a programme of re-engineering, refurbishment, undergrounding and tree-cutting was commenced on the remaining 3,650km of network

HV Strategy

The development of NIE's high voltage (**HV**) wood pole overhead line asset management strategy is summarised in Table 1 and the notes below.

Prior to the Boxing Day Storm of 1998, refurbishment was carried out against a single policy-based specification (Programme 1 in the attached Table).

One of the important lessons learned from the 1998 Boxing Day storm was the recognition that, although this work programme was improving both the day-to-day performance and the

storm resilience of the circuits refurbished, it was not refurbishing enough of the network as quickly as was required.

It was clear that there was a need to initiate an additional programme that would seek to ensure that the complete network was made “storm resilient” by addressing decayed poles and tree interference in a more timely manner than was possible under the existing single programme. As a result, a programme of “lighter” refurbishment was introduced in parallel with full refurbishment (Programme 2 in the attached table). Tree-cutting was integral in each of these programmes of work and the associated costs were included in the unit rate.

The UK storms in October 2002, which resulted in circa 2 million domestic consumers losing supplies for up to 10 days, highlighted the need to improve electricity network resilience in adverse weather conditions. Soon after these storms, the then Energy Minister commissioned an investigation into electricity company performance. The subsequent British Power International (BPI) report²⁹ highlighted, amongst other things, that some companies were not as effective as others at mitigating the risk of faults caused by trees. The Network Resilience Working Group³⁰ was also set up to take forward the recommendations from the original investigation. It agreed that one of the factors needing to be addressed to improve the network performance in storms is the management of trees and branches in proximity to overhead lines.

During 2004/05, NIE acted on these recommendations and, in conjunction with the introduction of the HV re-engineering programme (Programme 3 which addressed underlying design issues), reviewed the HV refurbishment and TAR specifications. The refurbishment specification became no longer policy-based and focussed on the replacement of assets that were not expected to be serviceable for a further period of 15 years (Programme 1a). This specification incorporates the majority of the decayed poles replacements which were previously undertaken in the light refurbishment programme (Programme 2). The TAR specification (Programme 2a) focuses on urgent defects and severely decayed poles. All three strategies include associated tree-cutting. Taken together, these strategies sought to ensure that the entire network had tree-cutting performed within a 5 year Regulatory period through one of the three strategies.

By 2005, the HV wood pole overhead line strategy had developed to its present level as presented to the Utility Regulator in the RP4 submission with the 3 programmes of work aligned in terms of cycles and volumes; 45 years for re-engineering, 15 years for refurbishment/reengineering and 5 years for TAR.

²⁹ DTI October 2002 Power System Emergency Post Event Investigation

³⁰ Network Resilience Working Group is a joint DTI, Ofgem, Energywatch and DNO group, which was established in April 2003 to propose initiatives to improve the resilience of electricity distribution networks during severe weather events.

	RP1					RP2					RP3					RP4				
Year ended 31 March	93	94	95	96	97	98	99	00	01	02	03	04	05	06	07	08	09	10	11	12
Capex programmes:																				
Full refurbishment	1	1	1	1	1	1	1	1	1	1	1	1	1a	1a	1a	1a	1a	1a	1a	1a
Light Refurbishment/TAR							2	2	2	2	2	2	2a	2a	2a	2a	2a	2a	2a	2a
Re-engineering													3	3	3	3	3	3	3	3
Opex programmes:-																				
Reactive/hot spot tree cutting	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4

1	Intensive Policy Based Refurbishment - 15 year cycle
	This specification includes the replacement of decayed poles, insulators over 35 years old, certain types of stays and earthing and any associated tree cutting.
1a	Refurbishment – 15 year cycle
	This specification includes the replacement of decayed poles, defective insulators, defective stays and earthing and any associated tree cutting. Addresses components that won't remain serviceable for 15 years until next refurbishment cycle.
2	Lighter refurbishment
	This specification includes the replacement of decayed poles, defective stays and earthing and associated tree cutting.
2a	Targeted asset replacement (TAR) - 5 year cycle
	This specification includes the replacement of severely decayed poles and other urgent defects and any associated tree cutting. Other major component replacement is referred to the refurbishment programme.
3	Reengineering including Redesign and Reconductoring - 45 year cycle
	This specification includes addressing the underlying design issues associated with a circuit including conductor replacement. This specification therefore includes replacement of conductor, decayed poles, defective insulators, defective stays and earthing and any associated tree cutting.
4	Reactive
	Reactive tree cutting or hot-spot tree cutting identified by NIE or customers and required to address safety / performance issues on circuits not included in the TAR refurbishment, or reengineering programmes.

HV Overhead Line Strategy development

B. RP4 Submission

LV Overhead Lines

As detailed in Sections 6 & 7 of Document RP4_1D_4 “LV Overhead Mains Network Investment Strategy RP4” provided with the RP4 Capital Submission, the strategy outlined was:-

Starting in RP4 it is proposed to initiate a strategic ten-year programme of investment on the remaining 3,650km of network. It is proposed that the RP4 programme will be much broader than that which was carried out in RP3 and will encompass a number of constituent elements aligned to the three types of network (Urban, Suburban and Rural).

Based upon an estimation of the makeup of the network the strategy proposed for RP4 is:-

- *A programme of Refurbishment on 1,125km of rural network.*
- *A programme of re-engineering on 620km of suburban network.*
- *A programme of undergrounding on 80km of network.*
- *A programme of cyclic tree cutting in conjunction with and aligned to the above programmes (Totalling 2,620 km).*

HV Overhead Lines

As detailed in Section 4 of Document RP4_1D_3 ‘Asset Management Strategy for Distribution HV Overhead Lines’ provided with the RP4 Capital Submission, the strategy outlined was:-

- *Continue with the current cyclic TAR programme.*
 - *The programme involves proactively targeting decayed poles, addressing identified defects and any necessary tree cutting on circuits that have not yet been prioritised for refurbishment*
- *Continue with the current cyclic refurbishment programme.*
 - *The objective of the refurbishment programme is that each overhead line circuit would be refurbished every 15 years, with the replacement of those components identified as being defective carried out during each refurbishment visit. In theory all individual components that make up the overhead line section would eventually be replaced over the normal asset life of 45 years during one of three 15-year refurbishment visits.*
 - *Work carried out as part of refurbishment includes:-*

- *Replacement of decayed poles*
 - *Replacement of faulty and worn insulators*
 - *Replacement of faulty and worn stays*
 - *Replacement of faulty and worn connectors*
 - *Replacement of faulty and worn earthing installations*
 - *Tree cutting*
- *Apply a re-engineering solution to those circuits that are not amenable to either refurbishment or TAR.*
 - *re-engineering will include a range of work elements ranging from intensive refurbishment to complete rebuild.*

It was clear from these submissions that such solutions would include tree-cutting and that the tree-cutting elements of the various programmes were to be treated as capex.

UR's Final Proposals

The Utility Regulator's Final Proposals for RP4 capex did not make any disallowance with respect to tree-cutting and NIE regards this as endorsement of its proposals for tree cutting within the capex programmes.

C. RP4 Actual

The table below outlines the tree cutting requirements as per the RP4 submission and also presents the RP4 outturn delivery.

Network	RP4 submission			RP4 outturn			Variance	
	Km ³¹	£/km	Cost £M	Km	£/km	Cost £M	km	Cost £M
11kV	20400	515	10.5	21348	827	17.7	-948	-7.1
33kV	4935	474	2.3	5037	288	1.5	-102	0.8
LV	2620	568	1.5	4030	928	3.7	-1410	-2.2
Total	27955		14.3	30415		22.9	-2460	-8.5

RP4 Tree Cutting summary (costs at 2009/10 prices)

³¹ 11kV: The target of 20,400km of tree cutting comprises 13,595km of TAR, 4,535 of cyclic refurbishment and 2,270km of Reengineering.

33kV : The target of 4,935km of tree cutting comprises 3,945km TAR, 660km of cyclic refurbishment and 330km of Reengineering.

LV : The submission target was 2620km (50% of the LV overhead network).

Km of tree-cutting

The strategy on tree-cutting was consistent with the RP4 submission.

In overall terms there has been an additional 2,460 km of tree-cutting delivered in RP4 over submission and, of this total, 1,410 km is attributable to the LV network. This reflects the high number of tree interference risks associated with this customer-facing asset, resulting from the limited tree cutting on LV in RP3 and earlier periods. The marginal increases in the 33kV and 11kV km reflect alignment with circuit outages.

Cost/km

NIE surveys each km of circuit in the overhead line programme and records the quantity of tree-cutting required on each span of line required to achieve a 5 year cut³². The cost of tree-cutting is directly related to the volume of timber required to be cut.

There was an increased cost to the programme of £8.5 million over submission as a result of a substantial increase in unit costs reflecting (a) increased growth rates that increased the density of tree-cutting required; and (b) discussions with DTI/HSE which provided NIE with more clarity as to their view of the clearances required. These increases were partly offset by a reduction in the 33kV unit cost, reflecting efficiencies achieved through incentive programmes which were able to be implemented because much of this work was not outage dependent, and could be undertaken via out-of-hours working.

D. Hot spot/reactive tree cutting

Throughout RP3 and RP4, NIE has continually performed reactive and 'hot-spot' tree cutting within the R&M programme. Since 2004/05 the introduction of the re-engineering, refurbishment and TAR programmes has had the effect of reducing the requirement for reactive or hot spot tree cutting as the benefits of the overhead line programme were realised. From RP3 to RP4 the benefit to R&M from the capital investment was £3m. A reduction in R&M costs is not an uncommon benefit from capital investment and has been seen in other areas of the investment plan for example; the transmission circuit breaker replacement programmes where the maintenance requirement associated with maintaining pneumatic operating systems has been eliminated and the maintenance burden reduced from intrusive strip downs of the units to an inspection and monitoring regime.

E. Conclusions

- The TAR, Cyclic Refurbishment and Re-engineering programmes and the implied volumes of tree cutting were included in the RP4 capex plan which was approved by the Utility Regulator;

³² 5 years at 11kV, 3 years at 33kV

- NIE’s strategy in RP4 was the same as that outlined in the submission albeit the costs of these programmes increased for the reasons stated above;
- The only opex/R&M activity that includes tree cutting is hot spot/reactive tree cutting;
- The cost of the TAR, Cyclic Refurbishment and Reengineering capital programmes is therefore not included in RP3 opex costs and it is wrong for the Utility Regulator to assert that customers have been charged twice in respect of these costs.

F. Factual Inaccuracies in Draft Determination

TAR specification

The Utility Regulator's consultants' report (page 63, Section 7) refers to the NIE RP4 submission specification for TAR and makes reference that in the submission TAR has a wider specification than a definition supplied as part of this investigation.

“The specification for TAR is primarily tree cutting with some defect rectification (decayed poles). It is not possible to separate defect and tree cutting costs - the assumption is that the costs are all attributable to tree cutting”.

As part of this investigation, the Utility Regulator was attempting to isolate tree cutting costs from the 3 defined overhead line strategies. NIE proposed that as a proxy for the tree cutting costs associated with the Reengineering and Refurbishment programmes, the unit cost for TAR would be an appropriate cost to use and NIE submitted an analysis on this basis. However, as stated in the RP4 submission and confirmed in the Mott MacDonald report³³ (page 5-44), TAR covers a wider specification that includes defect clearance. The costs associated with defect repairs are not collected or reported on separately but are included in the TAR costs.

Historic tree cutting ratios

The Utility Regulator’s consultants’ report states (page 64, Section 7): *‘In its RP4 submission showing historic costs in RP3 and earlier years, NIE had typically capitalised one third of tree-cutting.’*

In the RP4 submission, NIE did not present analysis of historic costs of tree cutting as stated. During this investigation, NIE supplied historic costs and in the first 3 years of RP3 the amount of tree cutting associated with the capital programmes was one third. If earlier years are considered for instance the previous 2 years (last 2 years of RP2), the amount associated with the capital programmes is 45%.

Use of historic tree cutting costs in the early years of RP3 is not a reasonable or logical basis to assess current or future costs as this approach does not take account of the associated

³³ Ofreg Review of NIE Capital Investment – NIE Capital Investment for RP3 and RP4 May 2006

asset management strategy for overhead lines which was indicated in NIE's RP4 submission.

Change in capitalisation practice

The Utility Regulator's consultants' report states (page 65, Section 7): *'This acknowledges that the capitalisation practices changed in mid RP3 but this description in September 2011 differs from how the programmes were described in the RP4 Capex submission.'*

Capitalisation practice did not change mid RP3. NIE has consistently cut trees as part of the overhead line capital programmes of work. In 2004/05, the overhead line asset strategy evolved to the 45 year reengineering , 15 year refurbishment and 5 year TAR strategies – strategies which Mott Macdonald in their report referred to as follows:

"Overall, the approach is representative of strategies being implemented by other utilities in the UK"

These strategies continued with the practice of including tree cutting as part of the work specification and are fully documented in the RP4 submission strategy papers³⁴.

The description provided in September 2011 does not differ from the RP4 submission rather it supports it.

Tree cutting is a secondary element of the overhead line specifications.

The Utility Regulator's consultants' report states (page 65, Section 7): *'For example, NIE emphasised the cost of pole replacement and pole pinning under its LV TAR programme and across the three Rolling Programmes, tree cutting was referred to as secondary to asset replacement, refurbishment and re-engineering'.*

The 3 overhead line strategies are re-engineering, refurbishment and TAR.

Nowhere in NIE's RP4 capex submission is tree cutting referred to as 'secondary' to any strategy. This is the Utility Regulator's interpretation and is factually incorrect. The NIE overhead line specifications clearly outline tree cutting as an integral element of the specifications of work as they have been throughout RP3 and RP4.

Tree cutting classification

The Utility Regulator's consultants' report states (page 23, Section 4): *'In our opinion, routine tree cutting is an operational activity and should not be capitalised.'*

This issue was raised by Mott MacDonald during RP4 and the Utility Regulator specifically allowed tree cutting costs as Capex. In their Draft Determination for RP5, the Utility Regulator has specifically made an allowance for 33kV TAR within the capex programme and is implied in the 11kV allowance. This is contradictory to this statement.

³⁴ Strategy Papers RP4 1D3 and 1D4

RP4 anticipated increase in tree cutting over RP3

The Utility Regulator's consultants' report states (page 65, Section 7) *'The Overhead Lines Capital Programmes reviewed by the engineering consultants give no indication that capitalised tree cutting would increase from £4.5m in RP3 (after a steep increase in the final two years of RP3) to over £20m in RP4'*.

The RP4 submission outlined the 3 HV overhead line strategies together with the circuits km associated with each strategy and also the LV overhead line strategy, therefore it would have been apparent that this represented an increased tree cutting requirement over RP3. In outturn terms, tree-cutting has realised an increased unit cost due to a higher volume of timber required to be cut. However, through reappraisal of the dynamic network risks and investment needs, the increased cost has been accommodated within the RP4 capital programme and Regulatory allowance.