Utility Regulator
ELECTRICITY GAS WATER

NIE Energy Supply Price Control 2009/2010

Decision Paper

19th May 2009

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Executive Summary

This document forms a further continuation of NIE Energy Supply's current price control (2000-2005, extended 2005-2007 and extended further for the period 2007-2009); this extension covers 1st April 2009 until 31st March 2010. The new price control is being introduced at a time of advancement in energy retail competition which will bring about a period of change for the Northern Ireland electricity industry.

This price control deals with one element of the final tariff formula (S_t term) and in the main sets the total revenue NIEES can recover from customers for the duration of the control. As NIEES has minimal assets, the Allowed Revenue will consist of operating costs and a margin. The price control will be applicable to all customers except for non-domestic customers with an annual consumption greater than 150MWh, as these customers will become de-regulated and be removed from the price control.

This paper outlines the Utility regulator's decisions with regard to the supply business entitlement. The decisions have been made on the basis of information, data submitted and meetings held with NIEES, and also with regard to the public consultation (five responses).

Form:	RPI-X
Scope:	All customer classes except for the 'new deregulated category' - non domestic customers with annual consumption of more than 150MWh
Duration:	1st April 2009 until 31st March 2010 with a possible extension of a further one year to March 2011 (this is to be reviewed by Utility Regulator in October 2009)
Operating costs:	Increase in agency costs driven by increased volumes of keypad transactions; a reallocation of costs associated with the deregulated tariffs; bad debts 0.4% of regulated turnover
X factor:	Set at zero
Margin:	£10.491m which is 1.68% of total revenue
Allowed Revenue:	£29.81m
Energy Efficiency:	Target based on 'energy savings' of 42.64GWh per year

NIEES Price Control to Date

The original NIEES price control ran from April 2000 to March 2005, this was extended to cover the period 2005-07 and the current price control extended this once more to cover the period 2007-09. References in this document to NIEES, NIE Supply or the Supply business, should be taken to refer to NIE Energy Supply.

Changing Environment

A primary reason for the extension to the current 2007-2009 price control to cover the period 2009-2010, a duration of only one year, is so that it can be revised in light of any developments that have been identified due to any decisions taken with regard to the current ongoing review of supply margins and K-factors. This workstream could have an impact on the NIEES price control. There is therefore the possibility that the new price control could be extended for a further year (2010-2011) dependent on the progress of this workstream. The Utility Regulator will review the price control in October 2009 and make the decision at that point if a further extension would be appropriate in light of any decision taken; and any such extension would include a review of the S_t term.

The Price Control and Tariffs

The allowed unit price of electricity (M) is made up of a number of components:

$$M_t=G_t+U_t+S_t+K_t+(J_t-D_t)+E_t$$

In year $_{t,}$

G_t refers to the cost of the electricity which NIEES purchases and so long as NIEES complies with its Economic Purchasing Obligation, this will be passed directly through to customers.

U_t covers the costs of using the electricity network; these costs are regulated through the NIE Transmission and Distribution (T&D) price control.

K_t is a correction facility whereby under or over-recoveries in the previous year can be collected by the business (under-recovery) or given back to consumers (over-recovery).

J_t encompasses costs associated with buy-out from the Northern Ireland Renewables Obligation with the D_t term representing any savings on the buy-out NIEES achieves.

E_t is associated with costs arising from implementation of the Single Electricity Market (SEM) and European Directive concerning the internal market for electricity including retail market opening, along with uncontrollable costs which are passed through to customers on a 100% basis. These latter costs include licence fees, NI2007 establishment costs and past pensions deficit.

Therefore, most of NIE Energy Supply's costs are straight pass-through costs which are subject to other price controls or regulations and thus, this price control review deals with the S_t term of the tariff formula which is in effect NIEES' own operating costs and margin allowed by the regulator . This amount must be sufficient to finance an efficient business and would normally comprise:

Operating costs
Capital expenditure
Depreciation
Return on assets/ Profit margin

The Allowed Revenue, minus the cost of all electricity wholesale purchases (ie Ut, Gt, Et, Kt and (Jt-Dt) terms), is currently collected on a ratio of 67% for fixed costs plus a variable charge on a per customer basis (33%).

NIEES currently has minimal assets and therefore a return on assets for investors is not a consideration within the Allowed Revenue. There are no current plans for the price control duration for capital expenditure and thus the Allowed Revenue minus the cost of electricity purchases will consist only of operating costs plus a margin.

Approach

The Utility Regulator requested data from NIE Energy Supply on 12 November 2008 via a Business Efficiency Questionnaire (BEQ). The first response to the BEQ was returned to us on 26 November 2008 with a request for additional information sent by the Utility Regulator on 3 December 2008. Additional data was supplied by NIEES on 8 December 2008. We analysed the data provided, formulating supplementary questions which were discussed at progress meetings between the Utility Regulator and NIEES on 17 December 2008 and 20 January 2009. On 28 January 2009 NIEES re-submitted the Business Efficiency Questionnaire and answers to the supplementary questions arising from the meetings. Further meetings were held on 3 February 2009, 11 February 2009 and 24 February 2009 to discuss the proposals. The Utility Regulator used the data and information supplied by NIEES to evaluate NIE Energy Supply's proposals and formulate the modifications to the price control. A consultation document [i] outlining the Utility Regulator's proposals was published on Wednesday 25th March 2009 and the consultation period ended on Friday 24th April 2009. Five responses were received from NIE Supply, ESBIE, VP&E, Airtricity and CCNI. These responses have been considered in making the decisions outlined in this paper.

Proposals

Form and Scope

It is the Utility Regulator's view that the form and scope of the current price control should continue, that is revenue is subject to RPI – X and the control should cover the majority of NIEES customers. However NIEES suggested certain refinements to the current scope and proposed to deregulate tariffs for a current customer category, that is non-domestic customers with annual consumption greater than 150 MWh (and hence remove these customers and their subsequent costs from the price control). Respondents comments on the proposed deregulation follow later in this paper.

Utility Regulator Decision

As the new workstreams that have been identified following on from the recent consultation exercise on the development of energy retail competition in NI, it would be judicious to allow the present approach to continue until the impact of these becomes clearer. This is because some of these workstreams, such as the review of K factors and supply margins are likely to have a direct impact on the NIEES price control formulae. Thus the decision is that the current form (RPI-X) of the price control shall remain the same for the period and scope (all customer classes), except for the non-domestic customers with annual consumption greater than 150MWh.

Duration

In light of developments in retail competition it is our view that the period of the price control should be relatively short and should be a one year price control running from April 2009 until March 2010 including a possibility for further extension until March 2011.

One respondent stated opposition to the proposed extension on the basis that there has been no due consideration to the materiality of future uncertainties, and they felt that it was difficult to see if efficiencies awarded to NIEES in previous price controls were still being retained, hence they proposed that the pricing baseline should be re-set and a new price control started.

Another response also opposed this extension and requested a full review of the NIEES price control, stating that without a fundamental and thorough review of the elements that impact on the cost of electricity that they cannot be assured that customers are getting a fair deal, and the opportunity to make changes that benefit customers may be lost.

However two other respondents stated that an extension is entirely appropriate due to the current ongoing workstreams.

Utility Regulator Decision

The Utility Regulator considered a number of options with regard to the period of the price control; a five year control may be desirable for many reasons, not least stability for tariffs, the opportunity for incentive regulation to work effectively, as well as certainty for shareholders. However, due to the current workstreams which will have an impact on the NIEES price control, and due to the fact these workstreams are currently ongoing, the timing of the findings of these reviews is unclear at this point, as is the implementation of these findings. Hence the decision is for a one year price control from 1st April 2009 until 31st March 2010, with the possibility that this proposed price control extension will be extended further by another year (2010-11) if the workstreams in retail competition that potentially impact the price control have not been sufficiently progressed. This will be reviewed by the Utility Regulator in October 2009 where it will be considered if an extension is a more favourable option, and if this is the case there may be a full review of the S_t for the further year extension.

The Utility Regulator takes the view that a duration of a year is prudent under these circumstances, with the flexibility of a further extension of another year if need be, depending on the timing of the progress of these workstreams and any resulting decisions.

Operating Costs

The Utility Regulator proposed adjustments to NIE Supply's proposed operating costs with regard to agency costs and also a reallocation of costs:

i. an increase in agency costs, driven by increased volumes of keypad transactions; and

ii. a reallocation of costs associated with the phased deregulation of tariffs.

Agency Costs

MBIS costs are currently estimated for 2009/10 to be £5.812m. This is attributable to, in light of the increased tariffs, an increase in the volume of keypad transactions by c15%. NIEES proposed that the keypad related transaction costs element of MBIS allowed costs should increase by 6% to reflect this additional cost. In relation to this cost category, one respondent requested that in further reviews this cost category should be further broken down to allow for a more informed view.

Reallocation of costs associated with the deregulation of tariffs

A phased deregulation of tariffs for NIEES' large non-domestic customers (with annual consumption of more than 150MWh) was proposed by NIEES. This would result in a reallocation of costs associated with these customers (both NIEES's internal costs and the pass-through costs) as they are removed from the price control. These costs are estimated at £0.605m in 2009/10 and would remove 1,440 customers from the control (0.2% of the number of customers and 8.7% of the value of supply). The offerings to these customers would include the option of a tariff, which could be compared with tariffs to groups within the price control. It has been proposed by NIEES that the initial allocation and any reallocation would be notified to the regulator by NIEES at the end of the year, or if tariffs were altered. The NIEES methodology for the reallocation of costs was published with the consultation paper.

One respondent to the consultation stated that this proposal to deregulate this category of customers was recognised as a positive step towards a lighter regulatory approach, where markets can support it and customers would benefit, and another respondent also agreed with the deregulated proposals. Another respondent supported the move towards greater competition, so long as none of the costs of serving the newly deregulated customers will fall on customers who remain regulated.

One respondent opposed this proposal to deregulate this category, on the grounds that the removal of a further group of customers from the price control regime is not justified.

Utility Regulator Decision

We have reviewed the agency costs and accept the increase as reasonable in light of the increase in volume of keypad transactions, and therefore the Utility Regulator will allow the costs as outlined above.

The proposal to deregulate the >150MWh category has been well received and is consistent with the policy in the previous price controls on deregulation. The Utility Regulator has reviewed the allocation of costs to the deregulated category, both on a high level basis and also using a bottom up approach, and accept that these are reasonably allocated and should be removed from the price control. As a result NIAUR will allow the reallocation of costs associated with the deregulated customers as outlined above.

Bad Debt

The present price control has a Bad debt provision of 0.4% of regulated turnover and NIAUR proposed to retain the provision at this level. NIEES forecasts higher prices and the increasing recession to increase these costs, and maintain that bad debt levels may 'well exceed the current best practice bad debt to turnover target' however is prepared to accept, for nominally a one year extension period, the application of this ratio with the new levels of forecast tariff revenues, giving a bad debt provision of £2.489m. Due to the application of this ratio to the new levels of forecast tariff revenues, the value of the bad debt provision has increased (from £1.941m in 06/07 prices) which is a reflection of the higher forecast prices.

One respondent stated that this bad debt provision was inadequate and unrealistic set against the present economic downturn.

Utility Regulator Decision

Whilst we recognise exposure to bad debt may be expected to increase due to the current climate, we remain unconvinced of the requirement to increase the bad debt provision. The Utility Regulator has accepted the policy of keeping bad debt provision at 0.4% of turnover for the duration of this price control.

X Factor

The X factor is a figure by which the inflationary increases in operating costs is reduced to reflect internal efficiencies that can be made to reduce these costs. Efficiency gains are usually achieved by either reducing costs and/or increasing productivity. The current price control has an X factor of zero and the Utility Regulator proposed an X factor of zero for the new price control, which NIEES agreed to, stating that there is 'no reason to expect productivity in an industry such as supply to increase faster than in the economy as a whole'.

One respondent stated agreement with the proposed X factor. One respondent opposed this proposal, stating that setting the X factor at zero, NIEES is not being stretched sufficiently to make efficiency savings as there is no penalty if NIEES fails to achieve any efficiencies.

Utility Regulator Decision

Whilst the Utility Regulator accepts that there will come a time when the business is so efficient that further gains will be difficult, if not impossible to achieve, our analysis suggests that the company has not reached this stage however, in the light of this extension to the price control being a duration of only one year and in the context of current retail workstreams affecting the Supply business we have decided to set X at zero for the next financial year. The X Factor has been set to zero to reflect the price control extension but the Utility Regulator expects any further efficiencies made to be reflected in a lower operating costs submission in any future review, allowing customers to benefit from efficiencies made.

Net Margin

During the discussion process NIEES proposed for the new price control a net margin of £11.22m, which is 1.80% of revenue. NIEES understood that a net margin of “1.8% is an explicit guiding principle associated with the current price control, and therefore should be a central consideration in setting a one year extension”. They stated that a 1.8% margin would compensate them for the increased risk of the value of supply (that is higher tariffs resulting from higher wholesale costs) with a c45% rise in working capital requirements between 2007-08 and 2009-10. “The consistent net margin principle efficiently captures movement in working capital and thus reasonably compensates the business for the related additional cost.”

Utility Regulator Decision

The margin agreed in the current price control was based on a decision paper *Regulation of ESB and NIE in SEM: A Decision Paper*[ii] which set a margin at 1.8% of total revenue, giving the following absolute values for net margin for the current price control (in 06/07 prices):

2006/07 Prices	**2007/08**	**2008/09**
	£m	**£m**
Net Margin	6.911	6.997

In 09/10 prices this margin would be £7.921m (1.27% of total revenue), however this amount would not take into consideration the increased working capital commitment that has been brought about by the higher tariffs due to the higher wholesale costs. In order to understand the additional working capital going forward for 09/10 a large amount of analysis was performed in order to calculate a reasonable amount to alleviate the additional stress of working capital in the year 09/10 for NIEES. This analysis included:

- Review of forecast and historic trade debtors over trade creditors to capture the net working capital position (split by the K element and non K element due to NIEES being able to recoup the K element at Bank of England base);
- Review of both monthly balance sheet data and year end data to obtain averages for net working capital position going forward. These amounts were also compared to the historic position for the previous 5 years to the forecast 09/10 amounts to ascertain the quantum of change for the new price control period;
- A reasonable level of return on these figures was calculated using various rates of return, with a lower rate of return on the K element to reflect the Bank of England base.

The Utility Regulator was not convinced that there was any one conclusive way to calculate the additional working capital commitment and as a result all of the analysis was taken into consideration and a mid-point was established as a reasonable amount to reflect the additional working capital commitment for 09/10. This acknowledgement of working capital increases the real margin from the current price control (£7.921m) by £2.57m to a total margin of £10.491m. This represents 1.68% of total revenue.

	2009/10	2009/10
	Proposed	**Allowed**
	£m	**£m**
Turnover	**623.6**	**623.6**
Cost of Sales	593.1	593.85
Gross Profit	**30.5**	**29.75**
Operating Costs	19.259	19.259
Net Profit	**11.224**	**10.491**
Net Profit margin %	**1.8%**	**1.68%**

Three respondents stated that a margin of 1.68% was not adequate based on the following arguments:

- Due to the increased risk of wholesale energy costs and the effect on tariffs;
- The 1.80% agreed in the previous price control was a central principle that should be endured for the proposals; and
- Not fully consistent with a competitive market.

The Utility Regulator is of the view that a 1.80% margin, which is an increase in net margin, in a year with high and not typical increases in tariffs is therefore difficult to justify considering also that NIEES have publicly explained that they would not make additional profits from the increased tariffs. Note also that if the reverse had occurred we would not propose that NIEES should then make less of a return. The increased risk of wholesale energy costs has been included in the quantification of the increased working capital exposure within the 1.68%. A new unit has been established within the Utility regulator and workstreams are ongoing which are consistent with a competitive market.

Allowed Revenue (S_t)

The allowed revenue figure is the total of operating costs and the allowed margin:

2009/10 Prices	**2009/10**	**2009/10**
	Proposed	**Allowed**
	£m	**£m**
Total Operating Costs	19.198	19.198
Depreciation	0.060	0.060
Net Margin	11.224	10.491
Total S_t	**£30.482m**	**£29.749m**

Fixed:Variable Ratio

The ratio of fixed to customer variable proportions of the Allowed Revenue minus the cost of electricity purchases is currently proposed at 67:33 which remains unchanged from the current price control.

Utility Regulator Decision The Utility Regulator is content to accept this proposal and continue with the current fixed:variable ratio of 67:33. There were no respondents comments on these proportions.

Energy Efficiency

Over the period of the price control NIEES's allowed operating costs have included costs for delivering energy efficiency and sustainable energy obligations within the framework of the price control. A target of £2million customer lifetime savings per annum was originally set in 2000; this was subsequently increased to £3million customer lifetime savings per annum for the initial two year extension 2005 to 2007, and also for the current price control term of 2007 to 2009. NIEES have proposed that with a budget of £202,000 and in the light of very high commodity prices, they would be prepared to consider increasing this commitment to £4.5m customer lifetime savings per annum for this further one year extension 2009-2010.

Utility Regulator Decision

In the current price control, it was agreed that the energy efficiency and sustainable energy obligations of the Supply business would remain the same for the duration of the price control i.e. £3 million customer lifetime savings each year until 2009. The Utility Regulator has sought advice from the Energy Saving Trust on the appropriateness of this obligation going forward. On the recommendation of the Energy Saving Trust, the Utility Regulator has decided that a more appropriate target measure would be 'energy savings' instead of 'customer financial savings'. Based on the average cost effectiveness of schemes over the last two years and a budget of £202,000, the revised energy efficiency and sustainable energy obligations for this price control will be 42.64GWh energy savings per year. In the event that this target is not met, the licensee's allowed revenue for the period commencing 1 April 2010 will be reduced by an amount equal to £7k for each GWh of difference between the 42.64GWh target savings and the savings actually achieved for this period. In addition, due to the incoming legislation phasing out incandescent and halogen bulbs between 2009 and 2012, schemes which focus on CFL bulb giveaways will no longer be approved unless a good argument for additionality can be demonstrated.

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[i] *NIE Energy Supply Price Control 2009/10 Proposals for Consultation* published by the Regulatory Authorities 25th March 2009 http://www.niaur.gov.uk/uploads/publications/2009-03-25_Electricity_NIEE_Supply_Price_Control_Consultation.pdf

[ii] *Regulation of ESB and NIE in SEM: A Decision Paper* (AIP/SEM/304/07) published by the Regulatory Authorities 20 June 2007 http://www.allislandproject.org/en/generation.aspx?article=4ad994c7-e273-485d-a30f-c658a34e90f7

[ii] Total operating costs of £19.259m as per proposed amount for allowed revenue, adding back reallocated costs and pass-through costs, and excluding bad debt costs equals £20.219m