Utility Regulator
ELECTRICITY GAS WATER

Power NI (Formerly NIE Energy Supply) Price Control 2011-2013 Decision Paper

October 2011

Executive Summary

This paper outlines the decisions of the Utility Regulator (UR) determination with regard to the Supply price control for Power NI (formerly NIE Energy Supply).

The paper outlines the UR decisions with regard to the supply business entitlement. The decisions have been made on the basis of information and data submitted and meetings with Power NI, and also with regard to the responses to the public consultation of which there were seven. Listed below are the main features of this control.

Form and Scope: Will remain as they are currently;

Duration: 24 months;

Margin: Will be 1.7% of the forecast turnover for each year of the two year control;

Year 1 £8.87 million

Year 2 £8.87 million

Operating Cost

(10/11 prices): Year 1 £18.17 million

Year 2 £18.301 million

Et The costs for the enduring solution in the second year of the control will not be agreed at this stage but as they out turn and will be passed through the Et at the time of Tariff setting.

The table below provides an overall summary of the Power NI submission and the corresponding UR decision on the proposals made.

The allowed revenue figure is the total of operating costs and the allowed margin minus the operating cost figure for the de-regulated section of the Power NI business (which will be calculated using the same methodology employed in the 09/10 price control determination :

	2011/12		2012/13	
	Power NI Proposal £m	**UR Decision £m**	**Power NI Proposal £m**	**UR Decision £m**
Total Operating Costs	19.364	18.17	19.872	18.301
Net Margin	17.8	8.87	17.8	8.87
Total St	**37.164**	**27.04**	**37.672**	**27.171**

Power NI/NIEES Price Control to Date

The original NIE Supply price control ran from April 2000 to March 2005. This has been followed by a number of shorter term controls the latest of which ran from April 2010 to March 2011.

This is a 24 month price control to cover the period 1 April 2011 to 31 March 2012. In the event that the control can only begin from the date the POWER NI licence is modified it shall cover a period of 24 months from that date.

References in this document to Power NI, or the Supply business, should be taken to refer to Power NI.

Changing Environment

As highlighted above, there has been a series of shorter term controls over the past number of years. This has been due to the changing environment in terms of retail competition. In June 2010 another supplier entered the domestic market, which has resulted in competition being active for 10 months from planned Control start date.

At the beginning of 2011 NIE plc was purchased by ESB and divested from the Viridian group (which POWER NI is part of). Therefore, POWER NI is now part of smaller group, when compared with the previous Price Control. This has impacted on the Power NI's submission in relation to cost lines such as corporate charges and salary costs.

The Price Control and Tariffs

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

Mt= Gt + Ut + St + Kt + (Jt-Dt) + Et

In year t,

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

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

Kt 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).

Jt encompasses costs associated with buy-out from the Northern Ireland Renewables Obligation with the **Dt** term representing any savings on the buy-out POWER NI achieves.

Et is associated with various costs which are passed through the tariff to customers as reasonably determined by the Authority. These costs include amongst other things licence fees; IT projects required in order to put in place the systems and processes to open domestic markets and allow customers to switch supplier such as NI2007 and Enduring Solution Stages 1 and 2; 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 **St** term of the tariff formula which is in effect POWER NI' own operating costs and margin. This amount must be sufficient to finance an efficient business and should comprise the following elements:

- Operating costs
- Capital expenditure / depreciation
- Return on assets / profit margin

St is currently collected on a ratio of 67% for fixed costs plus a variable charge on a per customer basis (33%).

Power NI currently has minimal assets and therefore a return on assets approach that would be applied to an asset intensive business such as a regulated network is not considered appropriate. The approach taken is therefore to allow operating costs (including depreciation on the assets Power NI do have) plus a profit margin.

Approach

The Control has been completed after a thorough and extensive process, including many meetings, exchanges of information and papers, and a full briefing session between Power NI and UR Board Advisory Group members.

In the previous price control review the Utility Regulator conducted a high level 'top-down' review of overall opex. For this review the Utility Regulator decided to conduct a more detailed review of the individual components of operating expenditure. Consultants (IPA) were appointed to assist the Utility Regulator in this process.

An initial request for data was sent to POWER NI in December 2010 and returned to the UR in January 2011. Since then the UR and its appointed consultants have reviewed that information and held a number of meetings with POWER NI to understand their projections of costs for 2011/12 and 2012/13. POWER NI also provided further information when requested by the UR or its consultants.

Power NI also engaged the help of consultants (NERA) to examine both the Margin and Opex elements of the control. NERA primarily focused on the margin element of the control and how this should be formulated. NERA submitted a detailed paper to

the UR in relation to the margin. This was addressed in the consultation paper the UR issued.

The UR published the Price Control consultation paper on the 20th May, with an original closing date of Friday 17th June, given the extensive engagement with Power NI since December 2010. However, Power NI requested an extension to the length of the consultation period and as a result the consultation was extended until Friday 15th July (totalling an eight week consultation period).

Given their strength of objection to the initial proposals laid out in the consultation paper in relation to the opex and, in particular, the level of margin being proposed and indeed the methodology by which it was derived, Power NI requested a meeting with the UR Board Advisory Group (BAG),

Power NI, along with their consultants (NERA), met with the UR BAG on the 8th June. At this meeting Power NI and NERA presented their analysis and rationale as to why they thought that the margin proposed by the UR was too low. They also expressed concern as to the level of the proposed operating expenditure.

As a result of this meeting with the BAG the UR took the decision to employ consultants (First Economics) to specifically supplement the Operating Expenditure review carried out by IPA in relation to the Power NI Price Control. This review was specifically to look at the margin analysis and proposals made by NERA in their paper and provide advice on the appropriateness of this methodology. Subsequent to the meeting with the BAG and as a result of queries/issues they had with the analysis, NERA carried out some further work and another paper was submitted to the UR on the 18th July. This has also been reviewed by First Economics. As highlighted above, further discussion on the margin is included in the margin section of this paper. There were seven responses to the consultation, including:

- Power NI;
- Viridian Power and Energy (VPE);
- Consumer Council Northern Ireland (CCNI);
- NI Envirolink (NIEL);
- Energy Savings Trust (EST);
- Bryson House; and
- National Energy Action NI (NEA NI).

All amounts set out in this document are in 2011 prices unless otherwise stated.

Form and Scope

In terms of the Form and Scope, as discussed in the consultation paper the St is currently collected on a ratio of 67% for fixed costs plus a variable charge on a per customer basis (33%).

The UR proposed that this should change (resulting in a change to the appropriate section of Annex 2 of the licence). This would mean that there would be an allowed level of operating expenditure plus a margin.

The margin would be calculated based on actual allowable turnover (being turnover generated only through regulated sales and excluding income such as Energy Efficiency or any other unregulated income) and the margin would therefore out turn as an amount of money which Power NI would be allowed.

In previous controls the margin amount was a fixed amount of money which was added to the allowed operating expenditure to derive overall allowable St. Given that the new proposal would result in the margin being based on actual turnover it was more logical that the allowance would not be split into a fixed and variable element as this would need to be based on forecasts.

A number of respondents to the consultation expressed their concerns in relation to the move away from the fixed and variable split of the allowed revenue. These concerns were predominantly voiced by organisations concerned with energy efficiency and customer service.

Bryson House Stated:

'NIE would now be incentivized, through profit, to sell more units of electricity and therefore to concentrate customer service effort on larger customers who consume or have the potential to consume greater volumes of electricity. This would cause Bryson Energy to have concerns on two counts, socially and environmentally.'

NEA NI also expressed concerns in relation to the move away from allowable revenue being made up of a fixed and variable element:

'NEA NI would not wish to see a price control established by NIAUR that would incentivise NIEES to sell more units of electricity, and consequently promote customers to use more energy consumption pattern or cherry pick high end users.'

And

'A price control that incentivises the selling of electricity units seems to also be at odds with current environmental policy in Northern Ireland; a policy that is focused on a C02 emissions reduction plan.'

Similarly, NIEL and the EST also expressed they were unhappy that the price control may incentivise Power NI to sell more electricity.

CCNI stated:

"The Consumer Council believes further consideration should be given to setting a minimum level of margin that must at least be achieved by NIEES. By setting a minimum margin there is potential for NIEES to act in an aggressive manner by reducing costs but still be guaranteed a margin regardless of their activities. This provides a risk for customers who will ultimately pay for these cost savings in the future."

In their response Power NI stated:

'The proposed form of control represents a fundamental policy change. This policy change potentially has significant implications on vulnerable customers, energy efficiency and general service delivery; while placing greater risk and uncertainty on Power NI. This has also not been sufficiently described or impact assessed within the consultation.'

And

'the consultation paper misleadingly characterises the 2010/11 price control, describing it as being determined on an absolute %, where in effect it was a carry forward of an absolute net profit of £10.5m from the previous price control.'

In terms of the form of the control, this was consulted on last year and the UR decided to keep the form the same – i.e. gave an allowed margin which was a fixed amount of money as opposed to the margin being given as a percentage of actual turnover. However, it should be highlighted that the Decision Paper for the Price Control which ran from April 2010 to March 2011 stated that it was very likely that we would move to a percentage of turnover. It should also be noted that, whilst the amount of money allocated as an allowed margin was fixed the amount was an implied percentage of the estimated turnover for 2010/11 provided by Power NI.

The 2010/11 Price Control decision paper stated:

"the UR has decided to keep the margin as proposed in the consultation. This will result in a fixed allowed margin for the price control of £10.491 million. This equates to c.1.7% margin on an assumed turnover of circa £600M as opposed to the NIEES proposal of £12M or a 2% margin. However, it is likely that in the longer term price control from 2011 onwards it will move to a floating margin i.e. calculated as a percentage of actual turnover."

However, the UR recognises the points made in relation to this issue, in the responses received by us. On further consideration of this issue and in light of the responses received, the UR takes on board that there may be an incentive for Power NI to sell more units of electricity to increase their turnover and in turn increase their margin. In addition to this, the UR would wish to ensure that there is a uniform level of good customer service for all customers and not just large users.

In terms of the Scope of the price control, this was deemed to be the same in the consultation paper given that there have been no additional proposals in terms of further deregulation. At the last Price Control the issue was discussed and consulted upon. It was clearly stated that any further deregulation would not be considered as part of the Supply Price Control and would be considered as part of a separate consultation exercise when deemed appropriate.

Power NI noted their disappointment that there was no discussion of the scope of the control in terms of consideration of further deregulation of the market.

They also stated:

"Power NI believes that if a market is demonstrably competitive, the prolonged application of a price control will compromise the proper operation of a competitive market and is in effect counterproductive. Contained within the recent forward work plan NIAUR state they will be working towards "developing energy retail competition" and acknowledge that this has been a long term vision."

The UR, produced their paper "Regulatory Approach to Energy Supply Competition in Northern Ireland, A Utility Regulator Position Paper", which superseded any commitment to work on further deregulation. In this Consultation paper we indicated that we did not envisage any further deregulation at this time. However, final decisions on the issues in that paper are still pending following the recent close of that consultation.

In addition to this, we would refute the point made by Power NI that the Price Control acts as an inhibitor to competition given that there are now a number of suppliers in the domestic market, as well as in the small business sector which Power NI refer to specifically, and competition seems to be flourishing well despite the continuance of an incumbent price control. Furthermore issues such as access to historical consumption data for all suppliers and market shares of affiliate suppliers would need fully consulted on before any further de-regulation based on consumption could even be considered. It is therefore not appropriate for the UR to annex a decision regarding further price de-regulation into a price control determination.

Utility Regulator Decision

Taking into account the views of a large number of the consultees in relation to the form of the control the UR proposal is to move away from the proposal made in the consultation. This would have resulted in the margin moving to a fixed percentage of actual outturn turnover, and allowed revenue not being collected on a fixed and variable basis.

Whilst the UR did highlight that it wished to be consistent in both electricity and gas in terms of setting Price Controls, in this instance the UR has an obligation to encourage energy efficiency in terms of electricity usage whilst in gas there is a commitment to grow the market. We would also like to encourage good customer service to all customers.

Therefore, the UR decision is to keep the form of this control consistent with that of previous controls where the allowed revenue is collected on a ratio of 67% for fixed costs plus a variable charge on a per customer basis (33%). The margin will be a fixed amount, based on a 1.7% percentage of the forecast turnover.

With regard to the Scope of the control, it will remain the same. Any potential for further deregulation would form part of a separate consultation when deemed appropriate. As highlighted above the UR policy paper on competition has recently closed for consultation and responses to this will also need to be taken into consideration.

Duration

The UR proposed a control period duration of 24 months with the view that this would run from April 2011 – March 2013. Previously there had been a series of shorter term controls.

The duration of the control was discussed with Power NI at the initial stages, and indeed through the iteration process. There was agreement that a further one year control was not acceptable in terms of resource input as well as the ability to keep any efficiency gains made. It was also agreed that, given that the market is changing and that the Enduring Solution will be completed mid 2012, a control with a duration longer than 2 years would be too long.

In their response VPE stated:

'The retrospective application of the price control as proposed and its short duration of only two years (part of which is applied retrospectively) does not appear to provide a stable and predictable regulatory framework for the institution being regulated, its (potential) competitors, and consumers.'

We note that retrospective application, whilst not ideal, has been used in a number of the previous controls. Its use for this control was always intended should the information exchanges and clarifications require delivery post planned start date.

Utility Regulator Decision

Due to the uncertainty about the rate at which competition will develop and the impact this will have on POWER NI' costs, the UR takes the view that it would not be prudent to apply a control with a duration of longer than two years. Therefore, as per the consultation the duration of the control will be two years. We propose that this should be applied retrospectively from 1st April 2011.

General points

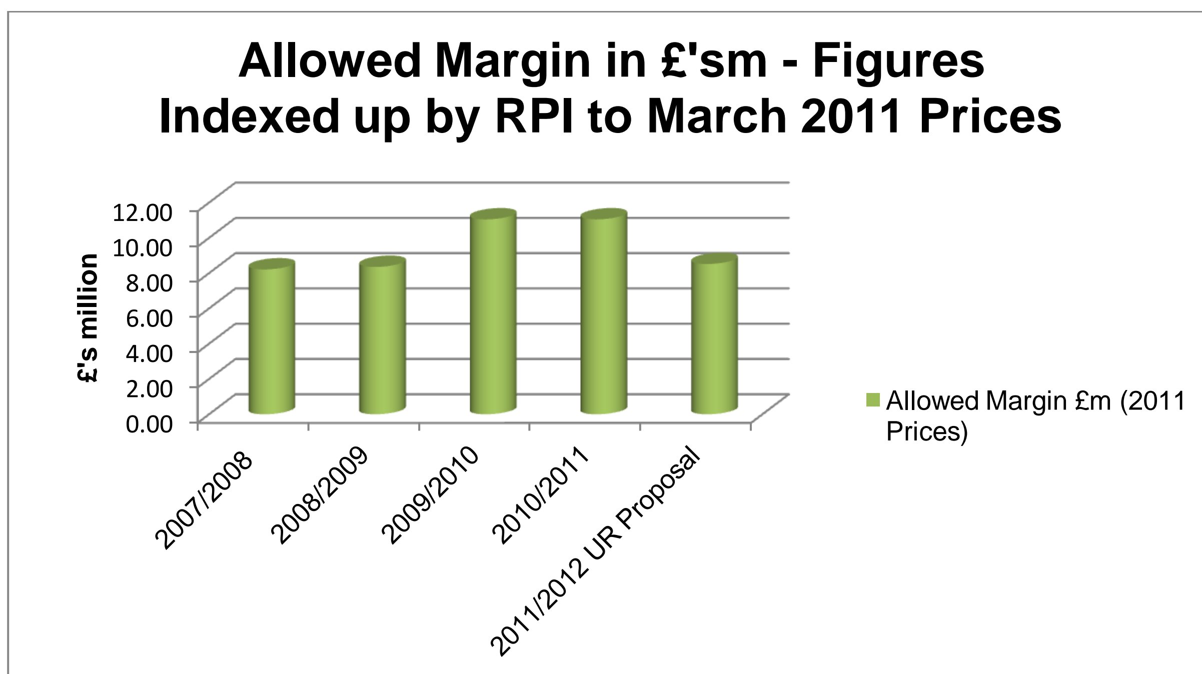
In terms of the overall core allowance Power NI state:

"At no stage is the severity of the financial impact of the proposals on Power NI set out. The quantum of the proposed cut represents a circa 18% reduction since 2009/10 to core entitlement, despite turnover being largely flat."

As stated above in the approach section, there have been numerous meetings since the start of the process, and both the level of margin and operating expenditure lines were communicated to Power NI at these meetings.

The table and graph below show the allowed margin in £'s million over the last number of the price controls (the figures have been indexed up to March 2011). ***NB The figures for 2011/2012 are those which were included in Consultation Paper. These figures have been modified by the UR in terms of reaching decisions on the allowed margin due principally to an updated forecast of turnover – these are discussed later in this paper.***

Year	**2007/2008**	**2008/2009**	**2009/2010**	**2010/2011**	**2011/2012 UR Proposal**
Allowed Margin £m (2011 Prices)	8.21	8.35	11.05	11.05	8.52

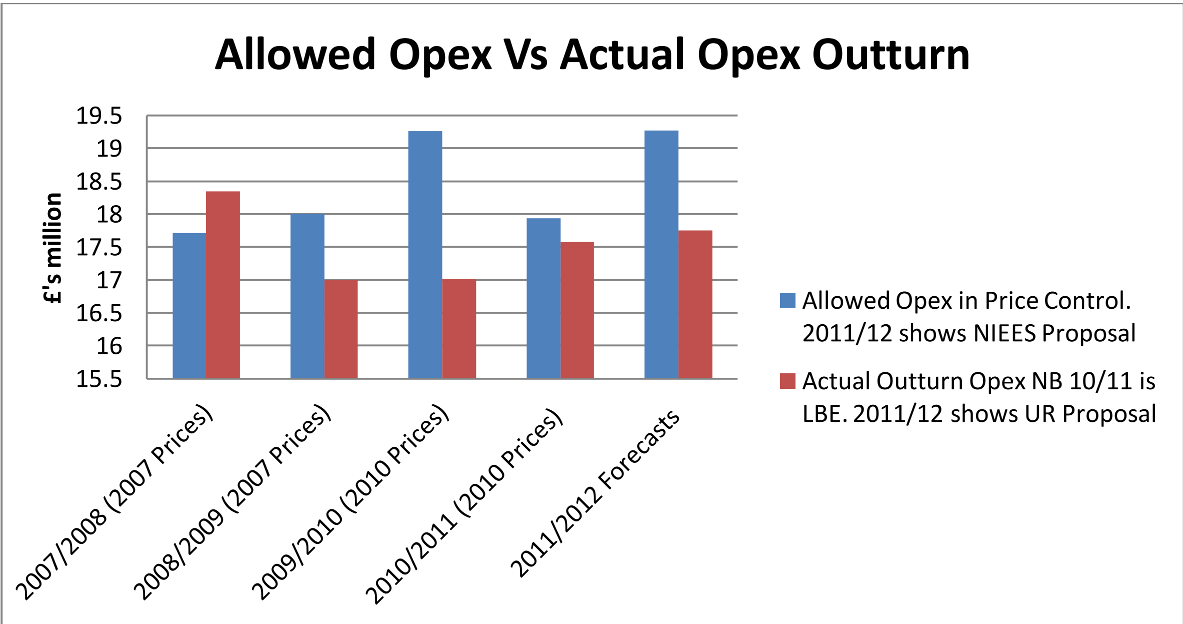


As shown above the UR proposal for 11/12 sees the margin fall in terms of £'s million. However, it is critical to note that it is the same margin allowance in terms of "percentage of turnover" as in 09/10. Last year in 10/11 it was decided to allow the

margin to remain constant from the previous year's amount in £'s million as the control was for one year only. In addition the margin allowance at that stage was directly and explicitly related to turnover, i.e. it was stated in the decision paper for the 2010/2011 control that it was an implied percentage of 1.7% based on the forecast turnover provided by Power NI for the year 10/11 i.e. £600m.

The table and graph below show the Operating Expenditure allowance given to Power NI and the correlating actual opex outturn figures for each year. ***NB** The figures for 2011/2012 are those which were included in Consultation Paper. These figures have been modified by the UR in terms of reaching decisions on the allowed operating expenditure – these are discussed later in this paper.*

Year	**2007/08 (2007 Prices)**	**2008/09 (2007 Prices)**	**2009/10 (2010 Prices)**	**2010/11 (2010 Prices)**	**2011/12 Forecasts**
Allowed Opex in Price Control. 2011/12 shows POWER NI Proposal	17.713	18.002	19.259	17.933	19.265
Actual Outturn NB 2010/11 is LBE. 2011/12 shows UR Proposal	18.349	16.998	17.013	17.574	17.75



As is demonstrated in the graph above, over the last 3 years Power NI have out-performed the Operating Expenditure allowance. In particular, 2009/10 was an exceptional case as the allowance was set much higher than the actual outturn. The 2010/11 control saw the allowance reduced to reflect the previous year's outturn but it would appear that Power NI have still out-performed against that allowance despite

hiring new staff. The graph shows that the intended 11/12 opex allowance is on a par (indeed slightly higher) than the Latest Best Estimate submitted by Power Ni for opex in 10/11.

In terms of the aggregate proposed core allowance for 2011/12 (combined allowed operating expenditure and margin) which Power NI refer to above, this has indeed fallen from the 2009/10 level of cc £30m. However, the year 2009/10 was unique for two reasons. Firstly, the efficiencies made in that year led to the operating expenditure allowance being much higher than outturn (£19.25m allowance vs £17.01m outturn) and secondly because the margin, which was set at 1.7% of forecast turnover (as is the proposal for this control), was large (£10.49m) due to forecast turnover being high (£623m). Furthermore under the proposal for this decision discussed on page 8 with margin being allowed as a fixed amount and included in the overall St, Power NI would be receiving the same margin in £m as they did in 2009/10 if the forecast turnover was £623m, as it was in 2009/10. POWER NI accepted this margin in 09/10. The appearance of a large reduction is due therefore to the operating cost allowance being reduced to reflect revealed efficiencies and come down to the real operating cost level and turnover falling.

Power NI also commented in their response to the UR consultation:

"The proposals generally lacked supporting detail"

The UR would argue that we engaged fully with Power NI during the data submission phase and when formulating proposals. The UR & their consultants endeavoured to attain as much information as possible in relation to the submissions made by Power NI. Power NI themselves in the presentation to the UR BAG mentioned that they responded on "very detailed opex queries". This indicates that the UR along with its consultants IPA carried out a thorough review.

As demonstrated above, it would appear that Power NI were able to operate within the allowed operating expenditure which was given in the last control despite increases in headcount and areas such as marketing. When considering the submissions, the UR and their consultants provided ample opportunity for Power NI to provide robust rationale (and supporting detail) for any increases in cost areas (taking into consideration risk to Power NI). Where the information was not forthcoming or not adequately detailed it was not prudent to allow an increased level of expenditure. In terms of the margin, as highlighted above the margin proposal as a percentage of forecast turnover has not changed. This reflects the UR view that whilst it retains a large majority of the regulated customer base, the K factor and price control will continue to insulate Power NI as it has done in the past and the First Economics view of the NERA methodology.

Operating Costs

In the consultation paper published the UR proposed the following figures in terms of what the allowed level of operating expenditure should be:

£'m	POWER NI Costs and Forecasts			UR Proposals	
	2010/11	**2011/12**	**2012/13**	**2011/12**	**2012/13**
Staff Costs (incl Agency Staff)	4.827	5.344	5.559	4.945	4.945
MBIS (excl Agency Staff)	6.288	6.563	6.829	6.037	6.280
Bad debts	2.429	3.041	2.984	2.677	2.542
Outsourced	2.975	3.036	3.063	3.036	3.063
Corporate Charges	1.055	1.281	1.281	1.055	1.055
Sub-total	**17.574**	**19.265**	**19.716**	**17.75**	**17.885**
Depreciation	0.014	0.055	2.815	0.055	TBC
Pass-through items	3.437	4.951	2.515	TBC	TBC
Total opex	**21.025**	**24.271**	**25.046**		

Power NI disagreed with some of the proposals detailed above. As previously highlighted, Power NI requested a meeting with the UR BAG. This meeting was requested to discuss both the level of margin proposed as well as the level of operating expenditure. In relation to the allowed level of operating expenditure the arguments which were laid out in the consultation paper were reiterated at the meeting with the BAG.

These have also been repeated in the response to the UR consultation.

In their response, Power NI have stated that:

"NIAUR have conducted a bottom-up analysis of operating costs and subjectively disallowed certain opex lines; taking the lower of Power NI's submitted figure or another benchmark"

The UR does not agree with this statement. The Power NI submissions were examined on a line by line basis looking at both the historical allowance and the Latest Best Estimate figures (provided by Power NI). These were analysed and where they had moved by a significant amount, compared with historical figures and further detail was requested. The proposals in the consultation were based on the UR's view of the supporting information provided by Power NI not benchmarks. Where the supporting information and rationale for increases in certain cost lines wasn't adequate, the UR proposed that an increase in the allowance for that cost line could not be justified. Where the supporting information was robust and the arguments for an increase reasonable, and backed by some evidence, the UR allowed the increase or in some cases allowed the cost line to remain flat but in the context of falling customer numbers which is effectively an increase.

Power NI also refer to the operating expenditure benchmarking paper submitted by their consultants (this was supplementary to the paper on margin which was submitted by NERA).

"While it is not Power NI's intention to repeat the full content of that paper, it is worth noting NERA's concluding comment and a summary of the 2010 cost to serve benchmark analysis – "our analysis strongly suggests that NIEES' [Power NI] operating costs are substantially below those of its comparators at least in part because NIEES [Power NI] is an efficiently run operation."

This paper benchmarked at a high level and given the nature of the information available it is difficult to establish if the comparisons made in terms of 'cost to serve' are comparing 'like-with-like'.

NERA, in their benchmarking paper, stated:

"Our benchmarking analysis shows that NIEES has substantially lower operating costs than its main comparators, ***albeit some caveats must be kept in mind****…*
1. Differences in the definition of "operating costs" undoubtedly explain some of the observed differences:
– the differences in accounting treatment between ESB PES and NIEES, for example of corporate overheads or the classification of "exceptional items";
– the different categorisation of costs in Ofgem's and NERA's estimates for GB suppliers; and
– the wide range of operating costs found in the GB suppliers' regulatory accounts;
2. Part of the reason that NIEES' costs appear low may because the comparators are ahead of NIEES in terms of investments in billing and marketing systems and risk management; and
3. The depreciation of Sterling tends to exaggerate ESB PES' costs relative to NIEES and the GB Suppliers."

The UR would refute the argument that if the Supply Business is operating at an efficient level, which is commendable, then that in itself gives justification for a higher level of operating costs. Power NI have many times in the past had operating costs below the price control allowance for opex and the business has retained this difference. The last control also allowed for some efficiencies to be retained to reflect the short nature of the previous control. This retention of allowance is the incentive or reward that Power NI can expect for being efficient and the business has received this reward in past years. It is not then justifiable to declare that because the business is efficient the opex should be calculated with reference to benchmarks and increased on the basis that it will still be lower than comparators. The UR is of the view that the bottom up approach that has been taken is more thorough and protects customers much more than any top down analysis.

Any additional level of operating expenditure requested should be supported by robust detail and analysis. It would not be prudent for the UR to approve additional/increasing levels of expenditure in the absence of this. The UR decision on the various operating cost items is set out below.

IME3 Cost Implications

The impact of the new European legislation package of IME3 was not considered as part of the original Price Control submission. In their response Power NI state:

"Additionally and for the avoidance of doubt, Power NI expect that all reasonable IME3 compliance costs will be treated as a pass through item, including new tariff notice conditions and any compounding impact arising from multiple tariff changes. As the IME3 details were not available at the time of data submission no cost estimation for the related changes were requested or included in the opex figures. Should NIAUR consider IME3 compliance as a St opex item, the relevant cost areas will require amendment."

UR decision

The UR agrees that efficiently incurred and unavoidable IME3 costs should be considered for cost allowance. These costs will be allowable where specifically agreed with the UR as being necessarily, reasonably and efficiently incurred and will be passed through the Et term. However, it should be noted that any costs submitted should take into account costs that would have been incurred under the UR consultation paper proposals e.g. in year tariff review communications with keypad customers.

Headcount and Staff costs (inc. agency staff)

In the consultation paper the UR proposals in terms of the headcount are laid out in the table below (note that the figures in the table relate to the business as a whole included the deregulated portion).

Staff costs	Power NI Forecast (inc Enduring Solution backfill)			UR Proposal (excl Enduring Solution Backfill)	
	2010/11 LBE	2011/12	2012/13	2011/12	2012/13
FTEs	151.5	165.7	176.8	152.6	152.6
Cost (£m)	4.827	5.344	5.559	4.945	4.945
Cost/FTE (£)	31,861	32,251	31,442	32,405	32,405

In their response, Power NI stated:

'Power NI considers correlating headcount to customer numbers as a flawed approach.'

As stated in the UR consultation paper the Power NI Staffing levels increased during 2010/11 to deal with higher call volumes and increased debt workload. Power NI have operated with customer switching since June 2010.

The UR would argue that the combination of the already increased level of staff as well as the view that some Power NI staff resource/time should be freed up as customers migrate away during the coming two years means that headcount as it stands should be sufficient for the next two years. The level of customer service has not suffered during 10/11 (with ten months of competition). Power NI have not shown that the existing staff are currently oversubscribed at present and as such that there is justification for an increase in the level of staffing.

CCNI agreed with the UR in their response to the consultation:

"With NIEES's customer numbers expected to reduce it does not seem reasonable to expect larger call volumes. Therefore current staffing levels would seem appropriate at this time. As the customer base decreases NIEES should be expected to continue to maintain its levels of customer service with its existing staff levels. Therefore, taking into account current economic conditions, it does not seem reasonable for staffing costs to be increased above inflation as this would not represent the actions of a truly competitive business within the current market conditions"

UR Decision

We therefore take the view that the staffing levels at the end of 2010/11(152.6 FTEs), bearing in mind that Power NI have operated with ten months of competition by the year end, together with gains that should be made from reductions in the number of customers, should be sufficient to deal with the debt and call centre volumes that arise from customer switching and the crossover to the new Enduring Solution system.

However, the UR may consider some pass through of Enduring solution cross-over costs if Power NI can provide solid robust evidence of the requirements at the time of 'go-live' These would have to be submitted for approval to the UR.

The decision in terms of the number of staff and the associated allowed cost for these is laid out in the table below.

Staff costs	**UR Decision (excl Enduring Solution Backfill)**	
	2011/12	**2012/13**
FTEs	152.6	152.6
Cost (£m)	4.945	4.945
Cost/FTE (£)	32,405	32,405

MBIS

In relation to the MBIS, the following proposals were made in the consultation paper:

	POWER NI Forecast (£'m)			UR Proposal (£'m)	
	2010/11 LBE	**2011/12**	**2012/13**	**2011/12**	**2012/13**
Agency Costs	3.057	2.988	3.078	2.988	3.078
Postage	0.876	0.896	0.896	0.896	0.896
Other	2.355	2.679	2.854	2.153	2.305
Total MBIS	**6.288**	**6.563**	**6.829**	**6.037**	**6.280**

In the consultation proposals the UR accepted the majority of the items contained within the MBIS Category and this was noted by Power NI in their response.

It should be highlighted that Power NI, in their response to the consultation, noted that they did not intend to have more than one tariff review in a year and as such additional costs associated with this should be allowed. However the UR, in the Consultation, highlighted that we would expect a decline in costs as Power NI market share decreases, more customers move to Keypad meters and the potential for electronic billing in the future is realised. In relation to this Power NI (during iteration) argued that the potential for mid-year tariff reviews will lead to an increase in postage costs to inform customers of the revised tariffs. We accepted this as a valid argument, and accepted the above forecast of a slight increase compared to 2010/11 LBE figures as appropriate for postage costs.

The UR was clear that Power NI would need to cover the cost of any additional unforeseen postage costs from this allowed amount (i.e. potential in-year tariff reviews). In addition to this, in their paper *Discussion note re NIE Energy Supply Price Control* (submitted to the UR on 28th March 2011), Power NI sited one of the reasons for the postage remaining at a slightly higher level was the potential for in year tariff reviews.

"While NIEES have included an effect of customer switching on postage costs this will be offset additional communications which will be required. Examples of such communications included but are not limited to –

- *The real prospect of within year tariff changes will require communications to all customers including Keypad"*

However, as noted above IME3 costs associated with in-year reviews would be allowed as pass-through (after appropriate approval). This would only relate to writing to non keypad customers only (i.e. above the cost of bill 'stuffers' normally sent out to all customers post tariff review).

The category where proposed disallowances were made related to 'other' costs. Included in this category were Marketing expenses of approximately £0.4m, loss of synergies of £0.36m (additional outsourced IT costs of £200k, accommodation of £50k, relocation costs of £30k and consultancy of £75k) and Energy Efficiency costs.

The UR proposed an allowance of £0.227m for marketing (09/10 level) and a complete disallowance of the loss of synergies as this related to the divestment. In addition to this, we stated that that we would potentially disallow a proportion of the Energy Efficiency cost on advice from the EST. The Power NI submission forecast a cost of £0.213m for 2011/12 and £0.291m for 2012/13.

The EST advised that an efficient cost of energy saving per kWh is .35 pence per kWh of energy saved. This is based on NISEP cost per kWh of energy saved targets. Power NI set their target at 42.64 GWh per year for the two years of the control. The appropriate cost allowance to achieve this target is therefore £0.15m per year for the two years of the control.

In their response CCNI stated:

"The impact of ESB's takeover of NIE plc should have very little or no impact on the cost structures of NIEES. Any financial impact should have been taken account of within the sale of NIE to ESB."

Power NI stated:

"The loss of synergies line items were also disallowed in the NIAUR proposal. Items such as accommodation and relocation are not related to the divestment of NIE but rather the pre-existing desire for physical business separation and therefore exit of Power NI Contact Centres from NIE sites. This activity has been on the agenda and discussed with NIAUR over some time and would have occurred regardless of the sale of NIE."

On further consideration, moves for complete separation of the businesses (in line with the Power NI licence) is a positive step in terms of relocation of accommodation and the UR would consider allowing for this element of the 'loss of synergies' category.

In terms of the costs associated with IT POWER NI stated in their response:

"The remaining synergy costs which have been rejected are due to a reduction in the economies of scale available to Power NI as a member of a smaller Viridian Group. Power NI believes NIAUR have adopted an inequitable asymmetrical view towards these costs; costs which would be significantly higher if the business undertook the activities on a standalone basis. In past price control determinations NIAUR have been consistently reducing opex allowances reflecting the economies of scale available to Power NI as the Viridian Group expanded. To disallow increases in these costs now the Group has reduced in size reflects an inconsistent approach. It is not appropriate for NIAUR to penalise Power NI for being part of a smaller group."

We asked Power NI for some further clarification on what the IT costs actually entailed. The estimated costs are included to cover the additional costs of running unbundled systems, including Power NI's new separate Enduring Solution related systems. The costs relate to infrastructure, LAN, WAN, hardware and software support maintenance. It has been included in the loss of synergies category as it is unclear at this stage whether it will be charged through the Managed Service (following a change request) or as a recharge through Group Technology.

We had noted in the Consultation that we would not allow this cost as there wasn't sufficient detail to support it, but would consider it if Power NI could provide further justification. However, the UR would still maintain that this expenditure is as a direct result of the divestment and as such should be borne by the shareholder. Therefore, the UR is not minded to allow this additional £200k.

In relation to the Consultancy spend of £75k, since the URs consultation paper was published, Power NI have provided some further detail on this. Power NI have explained that, whilst NIE and Power NI were separate businesses they did benefit (via Group) from the embedded expertise provided by NIE in certain areas. As you would expect NIE have much greater requirements in relation to procurement, HR, insurance, and pensions than Power NI. These areas significantly impacted NIE while mostly only marginally directly affecting Power NI; as such NIE had resourced accordingly. The advice was given via Group and not always explicitly undertaken by Group. Going forward, it is likely Power NI will have requirements around procurement, pensions etc and acting as a standalone business in that regard, they have included a cost element for some consultancy advice in that area. Examples of this in the short to medium term are the procurement considerations driven primarily by new EU Directives, particularly relating to agency contracts. In addition to this, new EU Directives are driving the new Agency Workers legislation, which will have a significant impact on Power NI, with close to 25% of the staff in front office roles being agency staff

Similarly to the IT expenditure, the UR is of the opinion that this additional consultancy spend is as a direct result of the divestment and as such should be paid for by customers. In light of this the UR is minded to not allow this consultancy spend.

In terms of Marketing expenses:

The proposed levels of communication costs are characterised as a freeze, however at 2009/10 levels. In real terms therefore, this is a reduction of the 2010/11 approved levels and a disallowance of submitted forecast. Power NI argues that with increased competition, customer communication must also increase to avoid confusion. Customer confusion will manifest itself in greater volumes and duration of calls. Power NI considers the submission made as justifiable and extremely efficient, representing only 14% of the levels approved by CER in the last ESB Customer Supply Price Control

The UR consultation paper highlighted that marketing costs increased from £0.227m in 2009/10 to £0.487m in 2010/11, and drop to around £0.393m in each of 2011/12

and 2012/13. The UR did not receive sufficient justification from POWER NI to support this increase in marketing costs from 2009/10 levels.

As noted above Power NI suggest that the level of spend for 10/11 of £0.487m was an ‘approved’ level of spend. This is incorrect. An allowed level of ***overall*** operating expenditure was approved with the view that Power NI should manage the individual cost lines within this overall level. The decision to allocate this level of expenditure to marketing/communication activities was Power NI’s.

CCNI noted:

“The Consumer Council does not believe that marketing expenses undertaken to win new customers should be recovered through consumers and therefore should not be allowed in the supply price control. It is not reasonable to expect customers to pay for marketing material which aims to increase the business value for shareholders. It is however appropriate for marketing material aimed at improving customer awareness to be allowed provided this spend on marketing is carefully monitored and appropriate.”

Power NI also noted that:

‘Although increasing customer share was not the context in which this submission was made (demonstrated by the levels requested being manifestly lower than would be required for a proactive marketing campaign). Power NI consider any consequential benefit and brand support from proactive communication as an entirely reasonable aspect of a price control determination.’

As expressed in the consultation paper, the UR believes that some degree of marketing spend is necessary to maintain customer awareness. However, efforts to win or retain customers are about increasing or maintaining the value of the business for shareholders, and should therefore be funded by shareholders rather than customers. Therefore, as per the consultation paper the UR decision is to freeze marketing expenses at 2009/10 levels (227k).

Utility Regulator Decision

The allowable amount for MBIS proposed in the Consultation Paper has been reduced to take into account the advice from the EST. The £0.213m for 2011/12 and £0.291m for 2012/2013 proposed in the consultation paper will be reduced (as per advice from the EST) to £0.15m

As per the consultation paper the UR decision is not to allow the higher level of marketing costs requested by Power NI and therefore the marketing allowance will remain at the 09/10 level of £0.227m.

The UR decision is to allow the cost in relation to relocation and accommodation of £80k per annum (part of loss of the synergies cost line). However in line with the consultation paper additional IT costs of £200k and Consultancy spend of £75k will not be allowed.

The table below shows the new allowance for the MBIS cost category:

	POWER NI Forecast			**UR Decision**	
	2010/11 LBE	**2011/12**	**2012/13**	**2011/12**	**2012/13**
Agency Costs	3.057	2.988	3.078	2.988	3.078
Postage	0.876	0.896	0.896	0.896	0.896
Other	2.355	2.679	2.854	2.17	2.244
Total MBIS	**6.288**	**6.563**	**6.829**	**6.054**	**6.218**

Bad Debt

In the consultation paper the UR accepted Power NI's arguments that there would be an increase in bad debts with more competition, as customers switch and leave unpaid final debt and keypad switches could leave 'stranded' debt. However, we proposed to increase the bad debt level to 0.5% (from LBE of 0.45%) rather than 0.56% given that competition had been in place for 10 months and bad debt has not risen above 0.45%.

Since the UR assumed a slightly greater level of switching, this led to slightly lower revenues in the consultation proposals.

Bad Debts	**Outturn**		**Forecast**	
	2009/10	**2010/11**	**2011/12**	**2012/13**
POWER NI Figures	Actual	LBE		
Revenues (£'m)	605.5	545.7	546.1	528.2
Bad Debt (%)	0.45%	0.45%	0.56%	0.56%
Bad Debts (£'m)	2.75	2.43	3.04	2.98
UR Proposal				
Revenues (£'m)			535.4	508.4
Bad Debt (%)			0.5%	0.5%
Bad Debts (£'m)			2.677	2.542

In their response Power NI stated:

"Power NI forecast bad debt to be 0.56% of total revenue for the two year duration of this control. NIAUR by contrast has proposed a bad debt level of 0.5%..."

and

"Power NI believes that debt levels remaining unchanged is an unrealistic target... In addition the level of final bill debt and stranded debt in the case of keypad customer switching will increase with competition and can only be recovered through costly legal channels"

The UR proposed an increase in the level of bad debt allowance to recognise that bad debt could increase with competition.

In terms of Phoenix, Power NI make reference to fact Phoenix Supply receive 1% of credit customers. However, it should be highlighted that in terms of Phoenix that only 45% of Phoenix Supplies customers are credit customers. Power NI also state:

"Additionally Phoenix Supply are not exposed to the levels of competition equivalent to Power NI and therefore do not have the same level of final bill debt"

We would argue that this is premature of Power NI to state this. Since competition began in June last year, Power NI have lost approximately 7% of customers in 13 months of competition. In the Gas supply market, Phoenix Supply have lost approximately 3.4% of their customers in the 8 months (since November) of competition. It should also be highlighted that 55% of total switching in the gas market occurred in June which would imply that switching is 'ramping up'. The ability to switch gas keypad customers became available at the end of August, which will expose Phoenix Supply further to competition and therefore relatively (in terms of % of total customer base) expose them to the same level of risk of final bill debt.

In addition to this, historically the level of debt has been worse in the gas market with a different industry structure and with Electricity having the common services model which ensures more accurate meter reading and less debt associated with poor meter reads.

However, we do recognise that whilst there was competition in the credit market for 10 months of the previous financial year keypad switching in electricity has only recently become available. This does increase the potential for 'stranded' debt on the keypad if the customer switches away from Power NI. In light of this, we are minded to allow Power NI the level of bad debt requested in their submission level of 0.56%.

Utility Regulator Decision

The UR, will allow an increase in the allowance for bad debt to 0.56%, recognising that there is likely to be some increase in the level of bad debt with unpaid final bills and 'stranded debt' from keypad switching.

Bad Debts	**Updated Forecast**	
	2011/12	**2012/13**
POWER NI Figures		
Revenues (£'m)	561.15	561.15
Bad Debt (%)	0.56%	0.56%
Bad Debts (£'m)	3.14	3.14
UR Decision		
Revenues (£'m)	550.15	540.11
Bad Debt (%)	0.56%	0.56%
Bad Debts (£'m)	3.08	3.02

Outsourced

The consultation paper highlighted that POWER NI' LBE for 2010/11 and forecast for 20011/12 and 2012/13 for outsourced costs were as follows:

Outsourced costs	**Forecast (2010 prices)**		
	2010/11 LBE	**2011/12**	**2012/13**
	£m	**£m**	**£m**
Total outsourced	2.975	3.036	3.063

The UR noted in the consultation that these remain relatively constant in real terms from the LBE figure for 2010/11 and accepted them as reasonable.

Utility Regulator Decision

The UR will allow the forecast costs for Outsourcing at £3.036 for 2011/12 and £3.063 for 2012/13.

Corporate Charges

In relation to corporate charges, Power NI put in a submission which is laid out below but subsequently increased the amount requested to £1.281. The UR proposed that this remained at the 10/11 LBE level of 1.055, as the increase in the level of Corporate charges was as a direct result of the divestment of NIE plc, and as such should be borne by the shareholder.

£'m	**2009/10 Actual**	**2010/11 LBE**	**2011/12**	**2012/13**
Corporate Charges	1.081	1.055	1.001	1.022

In their response to the consultation, with specific regard to the corporate charges VPE state:

"consultation paper proposes to disallow an increase in corporate charges …. We do not consider the divestment of NIE plc as relevant in this context. The entity subject to price control is NIE Energy Supply and its parent company activities should be considered out of scope for the purposes of determining whether corporate charges have been efficiently incurred. The only relevant question in our view is whether the services in question could be more efficiently procured in the current environment, either from the parent company or elsewhere – not in the context of a corporate structure which no longer exists."

Power NI state:

"Corporate charges have historically been incurred as a function of activities carried out on behalf of Power NI at a Viridian Group level. As with all group owned businesses certain activities will be conducted on their behalf bringing to bear some economies of scale and general oversight."

However, even taking these consultee views into consideration, the UR would maintain that the allowable Corporate Charges should remain at the 2010/2011 LBE level. As stated in our consultation paper (and with a similar rationale to loss of synergies), we believe that corporate charges have increased directly as a result of the shareholder decisions in relation to the divestment of NIE plc, and as such should be borne by the shareholder and not expected to be passed onto customers.

Utility Regulator Decision

The UR decision is to not allow the increased cost for corporate charges of £1.28m.

£'m	2009/10 Actual	2010/11 LBE	2011/12	2012/13
Corporate Charges	1.081	1.055	1.055	1.055

Depreciation

In the consultation paper the UR highlighted that POWER NI forecast depreciation charge increases from negligible levels up to 2010/11 to £55k in 2011/12 and £2.815m in 2012/13.

This increase results from a POWER NI forecast capital expenditure of approximately £14m between 2010/11 and 2012/13 primarily on new systems for the Enduring Solution project which the Utility Regulator is aware of. The assets are being depreciated over 5 years which is appropriate for such IT systems. However, the agreed level of depreciation will be determined at the completion of the Enduring Solution project (once all costs are known and finalised and approved as recoverable) rather than agreeing a specific amount at this time.

It should also be noted that the consultation paper did not refer specifically to the fact a rate of return (WACC) will also be included in the depreciation amount for Enduring solution. Power NI will receive a rate of return on its Regulatory Asset Base (RAB) which the business has made capital investments on in the same way a network business receives a return on capital. However the UR has allowed this depreciation and return to be collected via the Et in the tariff formula as they will be based on actual capex as opposed to a forecast of capex and are not known at this time of setting the St allowance. For this depreciation and return on a Regulatory Asset Base to be included in the St the figures would need to be available as the St is calculated by reference to a fixed amount that is then split 67%: 33% with 67% being fixed and 33% variable with customer numbers. However power NI will receive a rate of return (via Et) on the Enduring Solution RAB after it is commissioned in June 2012.

The UR therefore accepts the forecast depreciation figures for 2011/2012 of £55k only at this point, with the figure for 2012/2013 to be agreed at a later stage.

Utility Regulator Decision

The UR will allow the 2011/2012 depreciation amount of £55k only, with the figure for 2012/2013 to be agreed at a later stage.

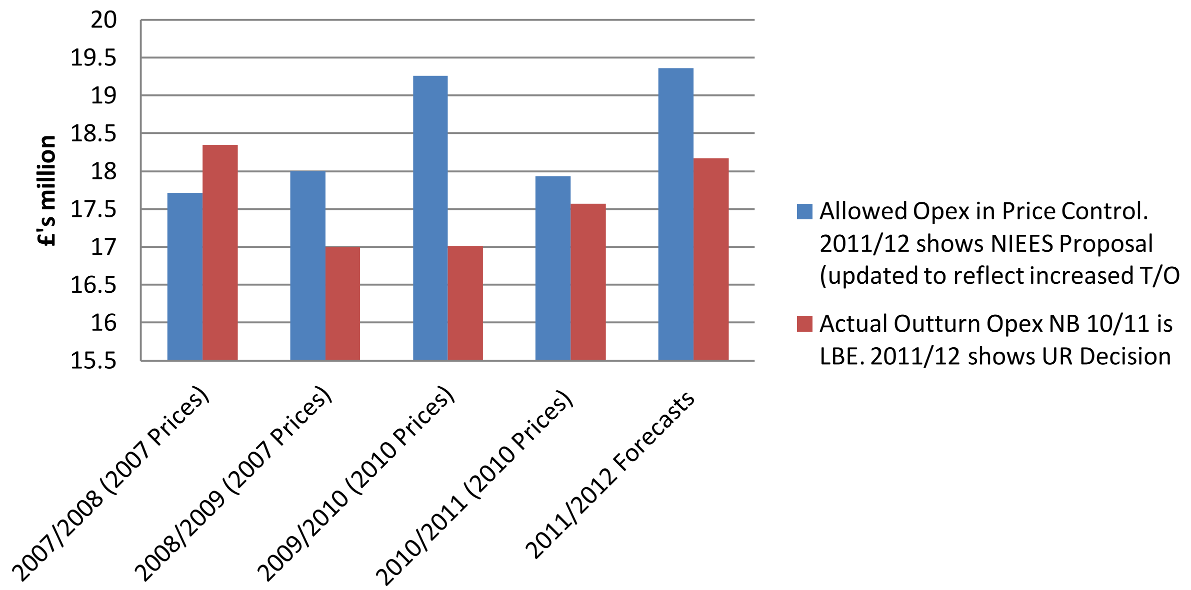
OPEX Summary

In summary the following table sets out our Opex proposals for the Control Period:

£'m	Power NI Costs and Forecasts			UR Decision	
	2010/11	**2011/12**	**2012/13**	**2011/12**	**2012/13**
Staff Costs (incl Agency Staff)	4.827	5.344	5.559	4.945	4.945
MBIS (excl Agency Staff)	6.288	6.563	6.829	6.054	6.218
Bad debts – **NB** with updated turnover	2.429	3.14	3.14	3.08	3.02
Outsourced	2.975	3.036	3.063	3.036	3.063
Corporate Charges	1.055	1.281	1.281	1.055	1.055
Sub-total	**17.574**	**19.364**	**19.872**	**18.17**	**18.301**
Depreciation	0.014	0.055	2.815	0.055	TBC
Pass-through items	3.437	4.951	2.515	TBC	TBC
Total opex	**21.025**	**24.271**	**25.046**		

The table and graph below show the Operating Expenditure allowance given to Power NI and the correlating actual outturn.

Year	**2007/2008 (2007 Prices)**	**2008/2009 (2007 Prices)**	**2009/2010 (2010 Prices)**	**2010/2011 (2010 Prices)**	**2011/2012 Forecasts**
Allowed Opex in Price Control. 2011/12 shows POWER NI Proposal (updated to reflect increased T/O)	17.713	18.002	19.259	17.933	19.364
Actual Outturn NB 10/11 is LBE. 2011/12 shows UR Decision	18.349	16.998	17.013	17.574	18.17


Allowed St Vs Actual St Outturn
20
19.5
19
18.5
18
17.5
17
16.5
16
15.5
£'s million
2007/2008 (2007 Prices)
2008/2009 (2007 Prices)
2009/2010 (2010 Prices)
2010/2011 (2010 Prices)
2011/2012 Forecasts
Allowed Opex in Price Control. 2011/12 shows NIEES Proposal (updated to reflect increased T/O
Actual Outturn Opex NB 10/11 is LBE. 2011/12 shows UR Decision

Margin

Approach to determining Margin

We highlighted in our consultation paper that Regulated networks provide their returns to the owners of the business through a return on the value of assets invested in the business. The assets in the business are known as the Regulatory Asset Base (RAB) and the company receives a rate of return which covers the cost of debt and also gives a return on equity invested in the RAB. A supply business is not asset focussed in the same way that a network business is and so we need an alternative approach to providing some reward to the owners of the business (albeit Power NI will from FY 12/13 have a RAB that will receive a return). The more orthodox approach (for example the approach taken for previous PowerNi Controls, Phoenix Supply Limited Controls, and previously taken for the regulated supply entities in RoI and in GB) is to allow a margin on turnover. The margin should to some degree reflect the riskiness of the activity, so that it is appropriate that a business facing full commercial and competitive risks should earn a higher margin than one that is either in a monopoly or de facto monopoly position or is not facing full competition or has a licence that contains regulatory arrangements that insulate it from the risk a normal commercial organisation in the same market would face.

It was also noted in the consultation that a regulated supply business can achieve an actual margin higher than that allowed by the regulator if it manages to reduce its costs below what the regulator had allowed, when the Price Control is set.

Power NI have argued strongly that they are in a changed environment and as such deserve a much higher level of reward than in previous Controls. They stated:

"In the determination of the allowed net margin NIAUR look to regulatory precedent as justification for the 1.7% proposal. Power NI have consistently argued that given the fundamental changes in the financial, wholesale and retail electricity markets, historic precedents are no longer appropriate but rather a structured building block approach should be adopted. To support such an exercise Power NI engaged NERA Economic Consulting to provide expert, independent advice which has been shared with NIAUR at the relevant stages of analysis."

In the consultation paper we stated that the UR believes that for the coming Control period, Power NI will still operate in an environment where limited competition has actually occurred in the domestic market. Although Power NI is losing some market share in these sectors, **we do not believe that over the limited 2 year duration period of this price control the development of actual competition will be significant enough to fundamentally change Power NI's dominant position**. In addition to this, we believe that consumers, rather than Power NI, take "market risk" through allowed cost pass-through of costs facilitated by the operation of the "k" factor and the likelihood of in-year tariff reviews when allowed input costs vary significantly from actual cost inputs (including notably unhedged wholesale costs).

In their response to the UR consultation NEA NI agreed with the UR on this point:

“NEA NI would support the NIAUR’s comments in relation to the level of market risk that NIEES are now exposed to following the introduction of competition into the electricity market in Northern Ireland.”

In the consultation we also indicated that we didn’t see a need to change the basis on which the allowed return is determined, or that there is a need to significantly increase the return provided to Power NI. We therefore proposed a net margin of 1.7% of allowable turnover to determine Power NI’s maximum allowed revenues. This was the implied margin previously as set in the 09/10 control and is consistent with the last control (although it was a fixed amount of money in both the 09/10 and 10/11 controls). We proposed to fix the margin at this percentage (1.7%) of actual regulated electricity sales turnover (to be agreed with the UR) rather than fixing an amount of money with an implied margin of this level (1.7%). This was to make the approach consistent to that adopted with Phoenix Supply.

Power NI stated in their response:

‘the consultation paper misleadingly characterises the 2010/11 price control, describing it as being determined on an absolute %, where in effect it was a carry forward of an absolute net profit of £10.5m from the previous price control.’

In terms of the form of the 2010/11 control, this was consulted on last year and the UR decided to keep the form the same – i.e. give an allowed margin which was a fixed amount of money as opposed to calculating the margin as a percentage of actual allowable turnover. However, it should be highlighted that the Decision Paper for the Price Control which ran from April 2010 to March 2011 stated that it was very likely that we would move to a percentage of turnover. It should also be noted that, whilst the amount of money allocated as an allowed margin was fixed, the amount was an explicit implied percentage of the estimated turnover provided by Power NI.

The 2010/11 Price Control decision paper stated:

“the UR has decided to keep the margin as proposed in the consultation. This will result in a fixed allowed margin for the price control of £10.491 million. This equates to c.1.7% margin on an assumed turnover of circa £600M as opposed to the NIEES proposal of £12M or a 2% margin. However, it is likely that in the longer term price control from 2011 onwards it will move to a floating margin i.e. calculated as a percentage of actual turnover.”

As well as the above in light of Power NI’s presentation to our BAG we felt that to give due consideration to the proposals put forward by NERA, on behalf of Power NI, the UR should also employ an expert to provide a critique of the NERA methodology and the assumptions within it. The UR employed First Economics to carry out this role.

Based on their critique of the NERA methodology, First Economics (having fully analysed the two papers submitted by NERA and had an iteration with the NERA consultants) have advised the UR not to accept the NERA methodology. The reasons are discussed further in the section “Margin - Power NI Proposal”.

Benchmarking

In their response Power NI highlight that they did not necessarily agree with the benchmarks that the UR referred to in the consultation and noted a number of other benchmarks that they felt were relevant. These included the Tasmanian regulator allowing a margin of 3.7% and IPART in Australia allowing 5.6%.

However, Power NI themselves state:

"While benchmarking in this case can provide a general guide to the range of applicable margin levels it is inherently unreliable as the particular circumstances and drivers for the margin levels vary significantly, dependent upon market conditions and circumstances."

On this basis, the UR would argue that the most relevant comparison to Power NI is Phoenix Supply which is the only other regulated price controlled energy supplier in NI. The market in which Phoenix operate is now open to competition. Phoenix are now in a position where they can potentially lose as high a proportion of their customer base.

Margin as a function of risk

In their response to the consultation Power NI discuss their risk in terms of under recovery due to risks on generation costs in terms of Pool Price, Volume and hedging options. They state:

"These asymmetric risks expose Power NI to only an expected cost or loss. Retail competition means that under-recoveries are increasingly unlikely to be recouped in later years while the operation of the price control means that over-recoveries must be returned. A substantial under-recovery is not a remote possibility."

In our consultation we indicated that the UR believes the K factor in Power NI's licence continues to fully operate in a manner to protect Power NI from under-recoveries as well as passing back over-recoveries to customers. This is particularly the case during the limited two year horizon of this Price Control. Furthermore:

- The risks that Power NI describe which may affect the ability to recoup any under recoveries are not exclusive to Power NI, for example a general increase in wholesale prices will require other suppliers to increase prices too. This will provide scope for Power NI to increase their pricess without losing market share. Given the fact that the Power NI market share is still likely to be around 80-85% by the end of this two year control, Power NI will have the ability to recoup any under recovery.

- In terms of passing back over recoveries Power NI argued (both during iterations and in their consultation response) that they cannot retain these, so the K has the effect of capping profits but not insulating Power NI from losses. The UR is firmly of the view that the K will insulate Power NI from making losses as outlined above. In addition to this, if Power NI have to pass back an over recovery then they will be pricing below prevailing market prices. This

will represent a problem for Power NI competitors, and may well lead to migration back to Power NI. It is reasonable to assume that those customers who have switched away from Power NI are price sensitive. Therefore, whilst passing back an over recovery means Power NI cannot make extra profits (as they argue competitors can) those same competitors are faced with competing with tariffs that are artificially low in the subsequent year. However, the UR wishes to avoid any large over or under recoveries and will consider all submissions for in year reviews in this context.

- As stated in the consultation the UR has agreed, and confirmed with Power NI, that it will conduct 'in year' tariff reviews when it appears that a K factor adjustment may be required. By adjusting tariffs early, rather than waiting until the end of the tariff year end, it will prevent the K factor becoming too large. We have also agreed to discuss a protocol with Power NI to ensure any in-year review happens expediently.

- The UR believes that the K factor mechanism has worked well to date. It does not anticipate that changes during the coming price review period will be significant enough to change that.

Margin – Power NI Proposal

In their response to the consultation, Power NI express their opinion that:

"The net margin should be assessed in terms of a fair rate of return on the capital required to manage the business."

They indicate that Power NI is fundamentally a risk management business, with returns more likely to be influenced by Market risks, Operational risks, and regulatory risks. They also state that:

"Energy retail businesses such as Power NI need risk capital to cover the above-mentioned risks, and retail margin must provide a fair return on this capital requirement."

In our consultation, we indicated that the proposed margin would be 1.7% of actual turnover. As highlighted above, we are now minded to fix this amount of money, with that in mind the margin will need to be calculated on *forecast* turnover. Since the Price Control submissions, Power NI have submitted their regulated forecast turnover for the Tariff Year (which runs from October 2011 to October 2012).

The average regulated turnover across tariff years 2010/2011 and 2011/2012 is circa £522 million. This would result in a margin of £8.87 million i.e. 1.7% of turnover.

However NERA have suggested that Power NI shareholders need to have access to a total capital requirement of £162.7 million in order to effectively manage the business. This has been challenged by First Economics as being a fundamentally flawed approach to use in assessing the margin the UR should allow Power NI. First Economics have argued that this amount of capital doesn't actually exist. Rather Power NI need to have the ability (most likely through their shareholder) to

‘drawdown’ capital if it was required to meet unforeseen in-year cost shocks above normal working capital requirements. Note that this would only be an in-year issue, as either in-year tariffs reviews, or the normal end of year reviews, would readjust tariffs to return any capital employed to the shareholder). First Economics describe this as contingent capital and as such they advise it should not attract a rate of return in the same way actual capital spent/employed (for example in a network business) would, at most it might expect to receive some compensation for being made contingently available for example via an allowance for the cost of an arrangement fee. Even if the UR we were to accept a NERA-type methodology, we believe our allowed margin adequately rewards shareholders in most foreseeable business scenarios. For example, NERA on behalf of Power NI have suggested that an appropriate rate of return on capital is 11.7% (although it has been highlighted by First Economics this rate appears to be too high). However based on this rate of return our allowed margin of £8.87 million would provide a “return” on circa £76 million of capital. NERA indicated that the ***working capital*** requirement is £25 million, therefore our planned allowed margin already provides a return on 3 times the level of normal working capital requirement.

Moreover, based on the critique provided by First Economics, the rate of return as calculated by NERA is at least 1.25% too high. This is based on a number of elements that make up the rate of return assumed by NERA. These include an Equity risk premium of 6%, which has been used by NERA on a number of their reports but hasn’t been accepted by the UK Regulator. In their assumption of the Beta (which cost of capital is sensitive to) NERA have used the beta of UK-listed Centrica. However, NERA itself recognises two key factors that distinguish the two companies: Centrica’s direct exposure to upstream production activities; and the benefit that Power NI takes from being an incumbent supplier operating under a price control. To think that these two things cancel each other out, especially if NERA has not recognised the full benefit that Power NI gets from its ability to pass its electricity purchase costs through to customers is a significant assumption and one that FE thought the UR couldn’t endorse without significant further evidence.

Based on the same calculation, with a rate of return of 10.45%, our allowed margin would result in a return provided on £85million of capital.

First Economics also comment that the NERA concept of return on capital is fundamentally different from what they consider should be taken into account by a regulator when assessing a margin or return. NERA’s concept of the assessment of the margin concludes that a full rate of return should be paid for “risk capital” in the same way as a rate of return should be allowed for actual debt and equity capital employed by a network company. This is in spite of the fact the risk capital may not be actually employed at all and if it is will be recoverable via the price control arrangements. They conclude therefore that it is more akin to contingent capital and as such should not attract a full rate of return.

Required Margin

Power NI point to the NERA analysis and ascertain that they require a Margin of £17.8 million. As stated previously, First Economics have advised the UR not to accept this analysis.

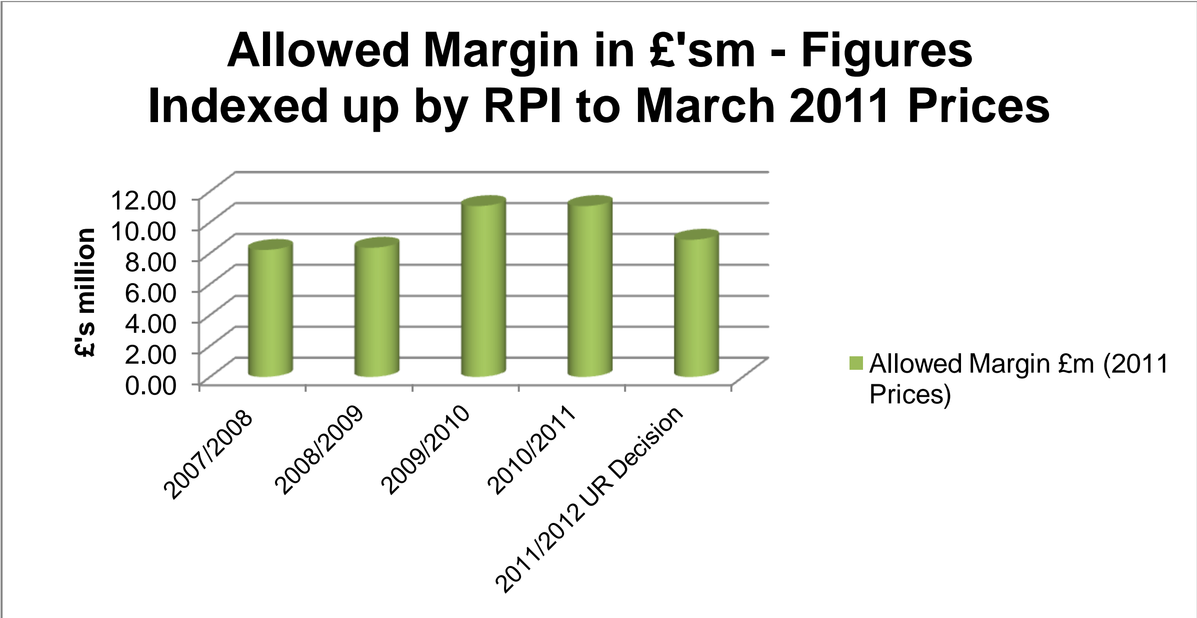
Therefore the UR is minded to maintain the proposed allowance set out in the consultation paper of 1.7%, but based on forecast turnover. This equates to an allowed margin of £8.87 million.

Utility Regulator Decision

The UR decision is to allow Power NI a margin of £8.87 million, based on 1.7% of forecast turnover of £522 million.

The table and graph below show the allowed margin in £'s million over the last number of years of the price control (the figures have been indexed up to March 2011).

Year	2007/2008	2008/2009	2009/2010	2010/2011	2011/2012 UR Decision
Allowed Margin £m (2011 Prices)	8.21	8.35	11.05	11.05	8.87



Allowed Revenue (S_t)

Total Allowed Revenue

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

	2011/12		2012/13	
	Power NI Proposal £m	UR Decision £m	Power NI Proposal £m	UR Decision £m

Total Operating Costs	19.364	18.17	19.872	18.301
Net Margin	17.8	8.87	17.8	8.87
Total St	**37.164**	**27.04**	**37.672**	**27.171**

The calculation of the appropriate allocation of operating costs for the de-regulated section of Power NI's business will be calculated using the same methodology employed in the 09/10 price control determination.. This allocation will then be removed from the operating costs figures in the table above which shows the operating costs for the entire Power NI business.

Fixed: Variable Ratio

As discussed in the Form and Scope section of the paper, the ratio of fixed to customer variable proportions of the Allowed St Revenue will remain at 67:33 unchanged from the current price control.

Utility Regulator Decision

The UR proposal is to continue with the current fixed:variable ratio of 67:33.

Other Issues

It should be highlighted that, in the event that the current rate of Corporation Tax changes in Northern Ireland the UR will consider the impact this could have and may deem it necessary to reopen the Price Control.

In addition to this, whilst not specifically consulted on, the UR's intention is to modify the Power NI licence regarding Past Service Pension allowance (currently recovered as 'pass-through' via Et) to ensure that any decision made on 'Regulatory Pension Principles' as an outcome of the current UR review of NIE ltd Pension deficit (RP5) is applied equally to Power NI

Next Steps

A response by POWER NI to this Decision Paper is due no later than Tuesday 1st November 2011. A licence modification process to implement the new price control for the period 1 April 2011 – 31 March 2013 will follow.

Power NI should send their response to Nicola Sweeney at nicola.sweeney@uregni.gov.uk