NIE Energy Limited
Power Procurement Business (PPB)

Assessment of Potential Financing Options for Utility Networks

Utility Regulator Consultation Paper

Response by NIE Energy (PPB)

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Introduction

NIE Energy – Power Procurement Business ("PPB") welcomes the opportunity to respond to the consultation by the Utility Regulator on Assessment of Potential Financing Options for Utility Networks and in particular, the report prepared for the Utility Regulator by First Economics (FE).

Specific Comments

The three constituent business groupings.

PPB notes FE's categorisation of the constituent parts of a regulated networks business and the activities each sub-grouping performs. PPB consider that it is likely to be very difficult to isolate and distinguish new "projects" from capital expenditure relating to renewals and replacement, that fall within the characterisation of responsibilities of the "operating" business. Any distinction would likely only apply for large, discreet projects that have very limited consequential impact on the existing network, for example, in the construction of a new interconnector.

We would also note that it is impossible to isolate capex and opex when seeking to deliver a least cost solution for customers. For example, there is often a trade-off between lower cost transformers that had higher losses and therefore higher opex costs. Unless both the capex and the resulting opex are fully considered over the lifetime of the asset, there is substantial scope for inefficient decision making. Hence the responsibility for "procuring" the project needs to be carefully considered and it would seem logical for the party that will be responsible for operating it for the duration of its economic life to be closely involved in the investment decision and to ensure synergy with existing assets. This is important even for simple matters such as standardisation of equipment to, for example, minimise spares costs, etc.

The additional benefits of explicit separation of the "operating" and "projects" business units is not at all clear. We would imagine that most significant investments are already delivered by third party contractors procured by the utility to deliver the project. In such circumstances, most of the efficiency of explicit separation should already be captured and it is not clear to us what the additional benefits of further separation are and whether they would out-weigh the additional transactions costs arising from the additional complexity of the arrangements.

The discussion on the higher risks of the operating business tainting the capital recovery business, driving up its financing costs is somewhat confusing. The level of risk in the combined activity will be a blend of their individual risks and the paper does not explain why FE considers that the combined risk exceeds the sum of the individual risks. It also appears to indicate that investors are not able to assess anything other than simple risks which is clearly at odds with the evidence and experience in the markets.

Is financing sub-optimal

There is little analysis to support the supposition that financing is sub-optimal and the paper itself indicates that any evidence produced is "circumstantial". The value of this analysis is questionable and seems to ignore studies that have been undertaken by, for example, Ofgem who continue to support the equity model.

Third party involvement

The analysis does not appear to make a balanced assessment and doesn't adequately consider the risks, threats and costs associated with third party involvement. For example we expect it will be very difficult for a third party to internalise and optimise the project design to minimise whole of life costs where the investment will be embedded within an existing complex network. One would expect such analysis is best completed by the party ultimately responsible for the asset throughout its useful life as it interacts as part of the overall network. In addition, we would expect most large projects will already benefit from a large degree of competitive procurement and therefore it is difficult to identify the value added by the FE proposals.

Separation of RABco and potential financing

The proposition of separating RABco and Networkco and seeking to separately finance RABco at a lower financing cost requires that there are two tests to be satisfied, namely (i) to ensure RABco is not dependent on Networkco for its income and (ii) to give its lenders the maximum possible security. The paper indicates that the first is easy to satisfy by imposing licence conditions on suppliers to collect money from customers to pay RABco. However it is not clear how exposure to supplier default is managed or what happens should any of the assets fail or become redundant.

On the second challenge in respect of maximising security for investors, the paper fails to recognise that all these options have already been tried in Northern Ireland and could not be delivered. For example, the buyout of power purchase agreements at Ballylumford through the Contract Buyout Agreement (CBO) is a

purely financial arrangement that securitised a future payment stream and was to have been backed by a legislatively backed guarantee (i.e. through primary legislation). However, as this progressed, it became clear that Government would not and could not deliver the legislation, not least because it would effectively be seen as part of the Government's Public Sector borrowing requirement. In the event, the only way to get the financial institutions to conclude the transaction was for NIE to be counter-party to the CBO such that it was strongly asset backed. The PSBR issue would similarly apply to any Government fall-back guarantee and would also potentially be in breach of State-Aid rules (this was evidenced from the failure to obtain clearance for a government support scheme announced by Northern Ireland's Direct rule Minister in 2003).

The other alternative proposed is to confer licence rights to entitle RABco to collect income from customers. This does not remove regulatory risk and PPB is a case in point since it has licence pass-through rights for all its costs and, despite numerous assurances by the Utility Regulator that such rights would not be varied, as the financial institutions will not accept the "pass-through right" as any form of security, PPB cannot secure financing facilities in its own right. Counter-parties will not accept the licence pass-through assurance as an acceptable form of credit support and hence PPB must procure such facilities and support from its parent company.

It is therefore wholly evident from real experience that explicit Government support is not viable (as re-iterated by Victor Hewitt at the forum on 12 January) and that licence enshrined rights are not acceptable to financial institutions who require a strong and sustainable balance sheet.

Conclusions

There is little evidence in the paper to confirm the current model is not working and indeed the equity model remains the model of choice in the UK. There is no consensus or evidence that the mutual model will deliver for customers in the long term whereas the equity model has a long track record. It is also unclear if adequate incentives to deliver sustainable efficiency and performance can be devised.

All of the "innovative" options to minimise risk through either Government or licence under-pinning have been tried in Northern Ireland over the last ten years and none have been capable of delivery. This is unlikely to be any easier in the current financial climate given the current Government funding deficits (and PSBR) and the increased aversion to risk in the financial markets.