NORTHERN IRELAND ELECTRICITY plc

Maximising Customer Value Options for Northern Ireland Energy Holdings (The Moyle Capital Rebate)

NIE's Response

28 April 2006.

MOYLE CAPITAL REBATE

Introduction

Moyle Interconnector Limited (Moyle) has obtained a £30m capital rebate from Scottish Power Transmission Ltd under the BETTA arrangements. NIAER's consultation paper explains that:

- £1.5m has been used to avoid a call on the Collection Agency Agreement in 2006/07;
- £4.5m has been added to reserves in light of uncertainty over capacity receipts;
- £10m has been approved by NIAER as a "founding investment" in the proposed Renewable Equity Fund; and
- £14m balance is the subject of NIAER's current consultation.

Background

The mutual model represented by the arrangements surrounding Moyle and Northern Ireland Energy Holdings Limited (NIEH) is one under which all of the risk of any underperformance is transferred from the providers of capital onto customers, or potentially to government if the model fails. Electricity customers in Northern Ireland underpin the financing of Moyle by making good any shortfall if Moyle is unable to earn sufficient revenues from the sale of interconnector capacity to cover all of its costs.

NIE entered the Collection Agency Agreement with Moyle on the understanding that any surpluses would be returned directly to customers. We regard any other application of surplus funds as being inconsistent with that premise, potentially exposing customers to further risk which is incremental to the risk that has already been transferred to them under the mutual model.

Renewable Equity Fund

NIAER's paper explains that it has already approved NIEH investing £10m of the capital rebate in a Renewable Equity Fund (REF) to be established by a private sector consortium. This would be the "founding investment" and would be spread across a portfolio of projects. The fund would be sold once the portfolio of projects is fully operational (5-10 years later) and NIEH's share of the dividends and repaid capital would then be returned to customers.

It is surprising that NIAER made this decision in advance of this consultation process. The approval appears premature, particularly since the investment gives rise to a number of significant questions of a commercial, legal, regulatory and customer interest nature.

The paper gives no clear explanation as to the level of due diligence carried out by NIEH and/or NIAER prior to deciding to invest £10m of the capital rebate in this way. For example:

- What criteria have been used as the basis for selecting this fund and for testing the expertise and bona fides of its promoters?

- How will it be judged as to whether the right investments are made in the best projects in terms of risk/reward balance?

- What safeguards are in place to protect the value of the investment of £10m of customers' money if the investments turn out to be loss-making?

Furthermore, has NIAER satisfied itself that, in approving this investment, it is not in breach of the new non-discrimination obligation under Article 12(6) of the Energy (Northern Ireland) Order 2003? There may be grounds on which NIAER could be open to challenge that it is discriminating between those generators who could receive amounts out of, or benefit from, the investment and those who could not. One type of generator would have a right to benefit and one would not.

Other potential legal and regulatory issues arise as follows:

(i) Would investment of £10m in the REF put Moyle in breach of NIAER's 2nd Direction which effectively states that surpluses are to be applied for network purposes?

(ii) Would Moyle be in breach of the "prohibited activities" condition in its licence?

(iii) Might the diversion of £10m of customers' money into the REF be seen as an unlawful tax on electricity customers to fund renewable projects?

(iv) Does the Renewable Equity Fund, supported by the founding investment approved by the Authority, raise any competition or state aid issues as against private sector investment which might be assumed would continue to occur in this renewables area?

NIAER may well have already considered all of these issues before making its decision, but there is no indication in the paper to that effect.

Preferred options

NIE considers there are three key principles that should govern the return of surplus funds to customers:

- The treatment of surpluses should not expose customers to any further risk which is incremental to the risk that has already been transferred to them under the mutual model (for example investment risk in unrelated assets).

- The “inter-generational equity” test should be balanced against the value to customers inherent in the use of surpluses to shield them from unusually high tariff increases in any particular year.

- It should be for NIAER to make the final determination as to how surplus funds are returned to customers subject to the application of the other tests.

These principles should apply whether the surplus funds become available as a result of favourable market conditions for the sale of interconnector capacity, or as in this case, by way of a capital rebate.

NIE considers there is a strong case for surpluses to be applied to bring a measure of tariff relief in years when customers are faced with unusually high price increases. The value is certain, significant, but short-lived. We argued for that to happen this year, but the argument was not accepted.

Our preference now is to retain the remaining surplus within Moyle to offset future Collection Agency payments which are likely to arise unless market conditions change in a way that considerably enhances the value of Moyle’s interconnector capacity. Under this option the value is certain and the impact on electricity prices is likely to be material since, as suggested in NIAER’s paper, Moyle is not expected to have substantial auction proceeds over the next few years.

An alternative and simple option is to buy-down some of the Moyle bonds. The advantage of this option is that it acknowledges the inter-generational equity argument, as noted in NIAER’s paper.

We would also support the application of surpluses by way of grants to directly offset electricity industry costs such as the energy efficiency levy and the costs of establishing full market opening in NI and the Single Electricity Market. These options would have a greater annual impact than buying down the Moyle bonds in the market (since, for example, the depreciation period for the supporting IT systems would be shorter than the term of the bonds). Grants towards the cost of network infrastructure including interconnection are other options, although the impact on electricity prices would be diluted because of the longer depreciation period.

With all of these options, the return of the surplus in the form of a reduced electricity bill is direct, transparent, and certain, and customers are free to make the decision as to how they wish to apply the savings.

Regulatory controls

In responses to previous consultations we have echoed some of the corporate governance concerns that are recognised elsewhere as arising with the mutual model. Although mutual models may facilitate lower financing costs, there is a risk that, without the proper level of governance and ongoing regulatory oversight, they may begin to operate against customers' interests.

NIE's view is that it should therefore be for NIAER to make the final determination as to how surplus funds are returned to customers. To the extent that NIAER feels it is constrained by a Direction that it has previously issued, it should review that Direction.

All-island underpinning of Moyle

Finally, NIAER has suggested that, in the context of the all-island electricity market, the responsibility of underpinning the Moyle financing arrangements should be spread across all customers on the island. We believe there is validity in that argument (since Moyle brings value to the all-island energy market) and we would support it.