

**NIE Energy Limited
Power Procurement Business (PPB)**

**The NIAUR proposal for
the Power Procurement price control**

Response by NIE Energy (PPB)

CONFIDENTIAL

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1. Introduction

NIE Energy Power Procurement Business (PPB) welcomes this opportunity to respond to the consultation on NIAUR's price control proposals for the business.

Overall, we consider that the proposed price control does not make proper provision for the shareholder capital required to support the business and does not properly reflect the significant customer value PPB adds through its effective management of the PPAs and its trading activities in the SEM.

There are a number of areas of the proposals with which we agree. These include: the duration, the form of the price control, the allowances for depreciation (DEP_t) and the treatment of pension costs (PD_t).

2. Customer value

NIAUR's paper underplays the substantial value that PPB has secured for customers over recent years. Ongoing benefits being delivered by PPB include those that arise from negotiating a reduction in the pass-through of FGD costs at Kilroot, obtaining improved EU ETS allocations, securing the NFFO NIROC proceeds, and offsetting SEM credit requirements. Together these are currently delivering £30-£35m of annual benefit for Northern Ireland customers. The most recent of PPB's initiatives have included establishing commodity hedging arrangements to deliver the £107.5m PSO rebate that resulted in the 10% reduction in electricity prices from January 2009.

PPB also creates other less easily quantifiable value in the wider functioning of the market. For example, PPB has developed innovative risk management products that ultimately assist competition in the retail market. PPB also led the recent establishment of a CfD trading platform through which nearly all non-directed CfDs for the 2009/10 tariff year have been, or will be, traded. This is a major step towards creating a liquid contract market which should also enhance the prospects of effective retail competition.

PPB will continue to identify opportunities to realise value for customers and mitigate the risks to which customers would otherwise be exposed. For example, PPB is promoting customers' interests in the process for the replacement of the, recently expired, long term gas supply arrangements for Ballylumford.

When viewed in the context of the considerable quantum of customer value available through the continued assiduous discharge by PPB of its functions, we believe there is scope for NIAUR more commensurately to reward PPB within its price control.

3. Areas of disagreement

3.1 PPB's Financing Costs

NIAUR's proposals in respect of the allowance for PPB's financing costs are predicated on the erroneous proposition that PPB can be 100% debt financed. As PPB has clearly stated in its previous submissions and in dialogue with the Authority's Energy Board Advisory Group (BAG), discussions with the banks have confirmed that 100% debt funding for PPB is impossible. Indeed, as NIAUR is aware, PPB has been unable to enter into commodity hedging arrangements with financial counterparties without the support of parent company guarantees. We consider NIAUR's approach is inconsistent with its statutory obligation to have regard to the need to secure that PPB is able to finance its activities and that its assumption that the business can be 100% debt financed would not withstand external scrutiny.

NIAUR has argued that "PPB cannot pass extra costs through to customers that are due to financing issues brought about by the existence of a capital structure that its parent company decided upon". Whether or not the capital structure of PPB reflects the choice of Viridian is irrelevant:

First, PPB has not asked to be remunerated on the basis of PPB's actual capital structure, but rather on a basis that draws upon regulatory precedent. We are not asking NIAUR to include an allowance for the actual equity investment - rather NIAUR has been asked to allow for the cost of PPB's funding requirements based on an efficient capital structure in line with regulatory precedent, which assumes 57.5% gearing (resulting in a structure with £26m equity). Whilst this precedent applies to network businesses with significant assets we believe that it represents a viable basis for calculating the allowance for the costs of financing PPB in comparison with NIAUR's approach which assumes there is no equity in, and no need for equity support for, the business.

Secondly, the requirement for PPB to be financed on a stand alone basis exists whatever its capital structure. This reflects regulatory precedent and the public policy imperative to separate regulatory businesses. Accordingly PPB's licence prohibits, *inter alia*, cross subsidy from other affiliated businesses (and did so even before the introduction of the SEM and the corporate re-organisation of the former NIE businesses).

3.2 Consideration of Risk

We are disappointed that, notwithstanding our clear description and valuation of the risks, NIAUR has not provided any substantive consideration or critique of PPB's submissions in respect of the various risks faced by the business. NIAUR hasn't provided any alternative valuation of the appropriate remuneration for the various risks which it acknowledges are borne by PPB.

NIAUR acknowledges the existence of EPO risk, albeit at a low level. While PPB welcomes NIAUR's statement that it would not disallow costs if they were incurred in accordance with an agreed strategy, over recent years NIAUR has tended not to give comfort on economic purchasing decisions *ex ante*. If NIAUR intends not to make any special provision within the price control for EPO risks, PPB would request a revision to the EPO licence condition aimed at facilitating strategies on specific elements of EPO to be agreed.

However, even with such measures, there remain risks, such as those arising from acting as principal under the PPAs which remain (and are not risks carried by the alternative benchmark businesses such as brokerages that are quoted by NIAUR) and which ought to be properly remunerated.

On page 15 of the consultation paper, NIAUR states that the risk associated with the PPAs has always rested with NIE and to the extent that it exists, the risk is implicitly reflected in NIE's rate of return. We fail to see how this is so, since the allowed rate of return is based on the rate of return allowed to the GB DNOs who do not have this risk.

3.3 The Incentive Arrangements

Given the strong link between incentives and the delivery of customer value, PPB is disappointed that NIAUR has neither made reference in the consultation paper to, nor taken up, the two proposals to enhance the incentives PPB made in March. We would invite NIAUR to give further consideration to these proposals.

First, we suggested extending the upside revenue potential beyond £200k to more closely align it with the maximum quantum at risk in the event of under-performance against the baseline target.

Second, there is a desire among suppliers for greater liquidity in the contract market and in particular a concern to see greater volumes of contracts offered. The RAs have encouraged PPB to offer the maximum volume of contracts possible. We believe our proposal effectively to provide PPB with a brokerage fee incentive in respect of CfD sales would help stimulate and support competition in the retail market. PPB has taken the lead in the recent development of a CfD trading platform that should help create some liquidity and depth in the contract market. A price control incentive arrangement would ultimately help sustain the development of the market and benefit retail competition in the medium and longer term.

3.4 The staff retention bonus scheme

We have advised NIAUR of our concerns in relation to staff retention given the uncertainty that exists over PPB's future, including, as stated by NIAUR, uncertainty over the staffing levels required. Contrary to NIAUR's view, no assurances can be given that displaced staff would be redeployed in an affiliated business and recruitment of replacements for staff who choose to leave PPB early would be difficult due to both the shortage of suitable resources and the uncertainty over PPB's continued existence.

If NIAUR is unwilling to provide a staff retention incentive, PPB will be exposed to the risk that essential skills will become unavailable to the business through staff attrition. Accordingly, in that event, and where PPB is unable to attract suitable alternative staff through recruitment, PPB would expect to be able to recover any additional operating costs which might arise from the need to employ consultants or other specialist support.

We believe it would be more cost effective to provide an opex allowance for a staff retention arrangement than to expose Northern Ireland customers to the risk of diminished customer value as a consequence of PPB losing critical knowledge and expertise.

3.5 Rate of Return (RTN_t)

With regard to the rate of return (RTN_t), while we continue to disagree with the adoption of the same allowed WACC for PPB as applies under the SONI price control, we are prepared to accept this element of NIAUR's proposals given that this represents a relatively small element in PPB's overall price control.

4. Key Points

Over the short to medium term PPB provides the best prospect for exercising local control over wholesale generation costs and the price control should remunerate and incentivise PPB accordingly.

We have proposed:

- (i) that the price control should recognise the cost of the equity required to support PPB based on an efficient capital structure. NIAUR's proposals are based on an erroneous assumption that PPB can be 100% debt financed and ignore precedent. Given the requirement that PPB must be able to finance itself on a standalone basis without cross subsidy, NIAUR's proposals would not withstand external scrutiny;
- (ii) improvements to the incentive mechanism comprising a more symmetrical incentive arrangement and an incentive around CfD sales which together could provide a way to bridge some of the shortfall in NIAUR's proposals and underpin a continuing proactive approach by PPB to its functions - we would welcome NIAUR's response; and
- (iii) the EPO licence condition should be modified to align it with NIAUR's assurance that costs would not be disallowed if they were incurred in line with an agreed strategy.