

NIE ENERGY (PPB) PRICE CONTROL 2009- 2012

DECISION PAPER

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Executive Summary

On 29 May 2009 the Utility Regulator published a consultation paper, [find Doc. here](#) , outlining the proposals for the PPB price control to apply from April 2009 until March 2012. Responses were received from PPB and the Consumer Council for Northern Ireland (CCNI). Overall CCNI were supportive of NIAUR proposals and commented “the Utility Regulator’s approach to this price control has been diligent and robust and the proposals do aim to minimize the cost of the PSO to the consumer whilst maintaining the viability of the company”.

PPB in their response indicate their agreement on various proposals these being duration, structure and form, allowance for depreciation and the treatment of pension costs. PPB also accepted the 6.3% allowed rate of return albeit with reservations, as this is a relatively small element of the overall price control.

Following the consultation responses NIAUR met again with PPB on 3 July 2009 to discuss further the initial proposals with specific emphasis on PPB’s financing costs and proposed staff retention scheme. These will be discussed later in this paper.

This paper outlines the Utility Regulator’s decisions regarding the various elements of the price control which were discussed in the consultation paper.

Structure and Duration of the New Price Control (2009-2012)

In the consultation paper of 29 May 2009 NIAUR proposed that the current structure and form of the PPB price control should remain unchanged for the new price control for the period April 2009 to March 2012. There were two respondents to the consultation, NIE Energy (PPB) and the Consumer Council for Northern Ireland (CCNI). PPB agreed with the proposal to continue with the current structure and form of the control and with duration to be April 2009 to March 2012.

Utility Regulator Decision

The Utility Regulator decision is that the current structure and form of the PPB price control shall remain unchanged and the duration of the control will be April 2009 to March 2012. This price control paper is concerned with the E_t term of the overall price control which is the calculation of PPB's allowed revenue or entitlement. This is the total amount PPB is allowed in the price control to be retained by the business itself out of which it pays its internal business operating costs. This formula is shown below.

$$E_t = DEP_t + RTN_t + IC_t + PD_t$$

Where:

DEP_t = means the depreciation amount used to roll forward the PPB Regulated Asset Base on a 25 year profile and the New PPB Regulated Asset Base on a 5 year profile.

RTN_t = means the allowed return on the PPB Regulated Asset Base and the New PPB Regulated Asset Base

IC_t = means the PPB incentivized amount which is dependent on the outturn performance against the targets specified in the incentive

PD_t = means the allowed PPB pension deficit cost per year, such figure to be revised in accordance with the results of each triennial actuarial valuation.

Depreciation (DEP_t)

PPB was the only respondent on the issue of depreciation and the company accepted the proposals set out in the NIAUR consultation paper.

Utility Regulator Decision

As per the proposals in the consultation paper the values for depreciation will be those set out in the tables below. The initial Regulatory Asset Base (RAB) will be depreciated on a 25 year straight line basis and the New RAB on a 5 year straight line basis, this being the standard depreciation profile for an IT asset base.

Initial RAB				
<i>period ending</i>	31-Mar-09	31-Mar-10	31-Mar-11	31-Mar-12
RAB Value (£m)	2.302	2.053	1.804	1.555
Average Value (£m)	2.177	1.929	1.680	
Annual Depreciation (£m)	0.249			

New PPB RAB				
<i>period ending</i>	31-Mar-09	31-Mar-10	31-Mar-11	31-Mar-12
RAB Value (£m)	0.213	0.204	0.137	0.043
Average Value (£m)	0.208	0.170	0.090	
Annual Depreciation (£m)		0.057	0.067	0.067

Rate of Return (RTN_t)

The Utility Regulator proposed that PPB should be allowed the same Weighted Average Cost of Capital (WACC) as applied in the SONI price control of 6.3%. For 2009-12 PPB proposed that the price control should allow a rate of return on investment assets or WACC of 6.8% pre-tax real on both the initial RAB and the new RAB. The PPB proposal was based on the WACC determined by Ofgem for the 2004 Electricity Distribution Price Control Review (DPCR04).

In its response PPB indicated that while it continues to disagree with the adoption of the same WACC as applies under the SONI price control, it was prepared to accept the rate of return proposed by NIAUR on the basis that it made up only a small element of the overall price control revenue.

Utility Regulator Decision

As per the consultation paper the WACC shall be set at 6.3%. This shall apply to both the Initial RAB and New RAB. The amounts PPB will receive for the three years of this price control are illustrated below.

	<i>Annual</i>	<i>Annual</i>	<i>Annual</i>
	Apr 2009 - Mar 2010	Apr 2010 - Mar 2011	Apr 2011 - Mar 2012
Return £M	0.150	0.132	0.111

Incentive Amount (IC_t)

The current incentive amount was based on 1% of PPB's forecast turnover when the price control was set and this was applicable from November 2007 until March 2009. Currently under this incentive for FY08-09 the value of the incentive amount for 90% achievement was £4.345M (2008 prices). 90% achievement is seen as the baseline score i.e. an "expected" score that is both reasonably obtainable but also reasonably challenging.

In the consultation paper it was proposed that the price control for 2009-12 should continue with this core figure of £4.345M as the incentive amount but in recognition of the extra costs PPB has legitimately incurred (which were discussed and explained in the consultation paper) i.e. the extra cost of procuring a Working Capital Facility (0.52M), extra operating costs (0.11M) and extra costs of commodity hedging (0.294M) the incentive amount should be uplifted by the aggregate of these extra costs to give a total incentive amount of £5.269M. PPB would take its own operating and financing costs from this incentive amount.

In its response, PPB argued that the proposals assumed PPB could be fully debt financed which it states has been confirmed to be impossible and in any event PPB is required to function and be financed on a stand alone basis. PPB also expressed its disappointment at the consideration and valuation of risk in the proposals and also that NIAUR had not taken up any of its previous proposals to enhance the incentive arrangements. NIAUR continues to disagree with PPB's views with regard to risk. NIAUR's position was fully articulated in the consultation paper and that position has not changed.

On 3 July 2009 PPB met with NIAUR to discuss the NIAUR consultation proposals and their response. PPB indicated that the proposal fell short of their expectation of what the business should earn as a margin. They cited the customer benefits that have arisen from their activities in the past (discussed in the consultation) but more specifically they reiterated that PPB cannot be 100% debt financed.

Their proposal had calculated the cost of providing a Working Capital Standby Facility (WCF) to PPB as £2.92M, based on an optimal capital structure with an efficient gearing ratio of 57.5%. NIAUR's proposal was to continue to allow the cost of procuring the facility on a 100% debt basis as is the case in the current price control and thus allowing a cost of £0.92M.

NIAUR is unable to determine the actual cost of the WCF for PPB because the working capital requirements for the entire Viridian group are processed through Viridian treasury. All inter company loans/borrowings flow through treasury and the overall working capital amount is procured on a group basis as opposed to an individual company basis. PPB argued that NIAUR should treat PPB as a stand

alone entity and calculate the cost of PPB financing on an efficient gearing i.e. 57.5%.

During the discussions PPB indicated that they would be prepared to accept a calculation by NIAUR on a higher gearing stating that they could understand why NIAUR may argue that a company like PPB which has full cost pass through rights could be more highly geared and still be less likely to encounter financial distress, due to the fact it can expect to recover money from customers via the PSO tariff regardless of any disparity between costs and revenues.

After further reflection NIAUR accepts PPB's contention that the PPB WCF would require to be funded in part by equity. NIAUR is of the view that the WCF cost should be calculated based on a gearing ratio of 85%. This results in a calculation of £1.64M as the cost of the Working Capital Facility and hence under this proposal the Incentive amount (ICt) would increase to £5.99M as shown in the tables below:

(2008 Prices)	DEPt	RTNt	ICt	OPEX	Commodity Hedging Cost	Regulated Profit (before cost of Working Capital Facility)**	Profit (before cost of Working Capital facility) as % of Turnover
NIAUR Decision £M	0.306	0.15	5.99	2.268	0.294*	3.88	0.66%

* Commodity hedging costs are £0.294M in year one only. Subsequent years will be c. £0.127M. The ICt amount shall be reduced by £0.167M to reflect this in price control years two and three.

** There is a distinction between the proposed allowed cost of PPB procuring the stand-by working capital facility from Viridian and working capital costs/revenues which result from cashflow. PPB's paper of 19 November to NIAUR points to the NERA calculation of what is described within the NERA paper as a stand-by Working Capital Facility. The PPB paper of 19 November also states "Following its separation from NIE, banks are unwilling to provide PPB with financing facilities on a stand alone basis and so PPB's facilities are provided by Viridian".

The table below is a comparison of this NIAUR decision for the price control 2009-12 with the 2007-09 price control showing regulated profit after the proposed allowed cost of the stand by working capital facility.

(2008 Prices)	DEPt	RTNt	ICt	OPEX	WCF	Commodity Hedging Cost	Regulated Profit
2008/09 £M	0.247	0.16	4.35	2.158	0.40	0	2.20
2009/10 £M	0.306	0.15	5.99	2.268	1.64	0.294*	2.20

* Commodity hedging costs are £0.294M in year one only. Subsequent years will be c. £0.127M. The ICt amount shall be reduced by £0.167M to reflect this in price control years two and three.

Utility Regulator Decision

As shown above the Utility Regulator decision is to allow a working capital facility calculation based on 85% debt and 15% equity. This is the only change from the proposals in the consultation paper and results in an IC_t amount of 5.99M as shown in the tables above. The tables show the full amount of PPB allowed revenue (2008 prices) being the aggregate of depreciation, return and incentive. This gives a total allowed revenue of £6.45M (2008 prices). The tables also show PPB operating costs and commodity hedging costs which when taken from the total allowed revenue result in a profit of £3.88M before the cost of procuring the WCF. The second table shows profit of £2.2M after this cost.

Pensions (PD_t)

NIAUR did not propose to change the method of calculation of the PD_t amount in the PPB price control. The actual figure in 2007 was £0.365M (06/07 prices) but this figure will be revised in accordance with the results of the next triennial actuarial valuation. This is forecast to be £481K reflecting an expectation that contributions will have to increase in respect of past service due to recent falls in equity values which have increased the pension scheme deficit.

Utility Regulator Decision

As per the consultation, pensions shall be dealt with in the new price control on the same basis as they are currently.

Staff Retention Bonus Scheme

PPB had proposed that NIAUR should allow extra revenue in the new price control to fund a staff retention bonus scheme. In short this scheme would reward PPB staff for remaining with the business despite the uncertainty around PPA cancellation which PPB view as a potential reason staff may look for employment opportunities elsewhere. It would equate to 50% yearly bonuses for management and 40% for staff and these would be paid only if the management/staff involved remain with the business for the defined period.

PPB in their response, expressed their view that it would be more cost effective to provide an allowance for a staff retention arrangement than to expose NI customers to the risk of diminished customer value as a consequence of losing critical knowledge and expertise. They also state that if NIAUR is unwilling to provide an uplift to operating costs to allow for a staff retention incentive and they subsequently lose staff through attrition, then where PPB is unable to attract

suitable replacement staff, PPB would expect to be able to recover any additional costs it incurs through the employment of consultants or other specialist support.

Utility Regulator Decision

NIAUR did not propose to allow any extra revenues in the new price control for PPB to pay for a staff retention bonus scheme. This remains our view. PPB should manage staff retention internally from the overall price control revenues.

Contract Cancellation

The consultation paper stated “NIAUR is aware that several of the long term legacy contracts have earliest cancellation dates in November 2010 but also that the earliest date for the termination of the Ballylumford contracts is March 2012 and that there is no certainty with respect to early cancellation. It is for this reason we propose that the new price control should be applicable from April 2009 until March 2012. However NIAUR reserves the right to re-open the price control if cancellation in November 2010 goes ahead as a cancellation at this date of a number of the contracts would see a change in PPB’s activities and possible staffing levels. It would not be appropriate for a price control set in the context of all contracts being live to continue unchanged in the event of several having been cancelled”.

Utility Regulator Decision

As outlined above and in the consultation document the Utility Regulator reserves the right to re-open the 2009-2012 PPB price control in the event that one or more of the contracts are cancelled before 31 March 2012.

Next Steps

A response from NIE Energy (PPB) to this decision paper is due no later than 16 October 2009. A licence modification process to implement the new price control for the period 01 April 2009 – 31 March 2012 will follow. NIE Energy (PPB) should send their response to Michael.Campbell@niaur.gov.uk