

**NIE Supply Price Control**

**2007 - 2009**

**Decision Paper**

**5 December 2007**

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**Executive Summary**

This document forms a further continuation of NIE Supply’s present price control (2000 – 2005, extended 2005 – 2007); this extension covers 1st April 2007 until 31st March 2009, straddling the introduction of new all-island wholesale arrangements and the introduction of full retail market opening from 1st November 2007.

These new arrangements bring change and uncertainty for all market participants, not least NIE Supply. The changes in the market environment have necessitated transfers of costs across NIE businesses to facilitate market access for new suppliers including transfer of meter reading and the associated Keypad asset base from NIE Supply to the Transmission and Distribution business which will reduce NIE Supply’s costs each year, although customers will still pay for these, just through a different component of the tariff.

This paper outlines the Utility Regulator’s decisions with regard to the supply business entitlement, that is, the St term. The decisions have been made with regard to the public consultation (three responses) and discussions with NIE Supply.

Form: RPI-X.

Scope: All customer classes.

Duration: 1st April 2007 – 31st March 2009.

Operating Costs: Adjustments to Salaries and Bad Debt provision; current pension costs included and deficit to be treated as 100% pass-through; total operating expenditure for 2007/08 decreases by 16% on 2006/07 and increases during 2008/09 by 1.5% on 2007/08.

X Factor: Set at 0 for the price control period.

Margin: Set at 1.8% as per the Regulatory Authorities’ previous decision in relation to regulating PES businesses in the SEM. **NIE Energy Supply Price Control 2007 - 2009**

The Supply business, previously held by NIE plc, was transferred to NIE Energy Limited on 1st November 2007; reference in this document to NIE Supply or the Supply business should be taken to refer to NIE Energy Supply business.

**Price Control to Date**

NIE Supply’s current price control is a two year extension of that set to run from April 2000 to March 2005. The original price control included an incentive to roll-out keypad meters to 100,000 customers, to ensure £10 million lifetime savings by investing in energy efficiency measures, increasing sales of renewable energy and a reduction in allowed revenue (St) of 3% in real terms per annum. The extension to this control included a further 75,000 keypad meters, an additional £6 million lifetime savings from energy efficiency measures, development of the eco-tariff and a 3% reduction in operating costs in real terms for a further two years.

The current price control has been successful in meeting these objectives; the target of 175,000 keypad meters has been surpassed, the energy efficiency levy has produced almost 390,000 tonnes of carbon savings, almost £90million in customer savings and earned NIE an incentive of £1.95 million since 2000[[1]](#endnote-1).

**Changing Environment**

A primary reason for the extension to the 2000 price control to cover the period 2005-2007 was the European Directive requirement to open the retail electricity market to all customers, including domestic customers, by 1st July 2007. With the development of the Single Electricity Market, it was decided to delay retail market opening until 1 November 2007 to coincide with the Go-Live date for the all-island wholesale market.

The changes to the market will also bring change for NIE’s supply business; NIE’s Supply and PPB businesses have been transferred to NIE Energy and the Supply business is required to purchase electricity from the pool and is able to hedge the price/quantity risk by purchasing Contracts for Differences (CfDs). (These hedging arrangements have been agreed for the first year of operation of the Single Electricity Market). Also, from 1st November the business faces the potential of domestic customers switching to other suppliers. These changes bring a requirement for additional resources, primarily salaries and, potentially, some degree of additional risk. However, any increased risk on trading will be largely mitigated by the retention of a K factor allowing NIE Supply to pass through 100% of electricity purchasing costs for the first year of the new market so long as it complies with the Economic Purchasing Obligation outlined in its licence. Similarly, any increased risk from retail competition in the domestic sector will be largely mitigated (as experience in GB suggests) by the low risk, in the short-term, of competing suppliers entering the market and hence customer-switching.

Other changes include the transfer of meter reading from Supply to T&D from April 2007 to facilitate retail market opening from April 2007, reducing Supply costs by around £2.95 million each year; Keypad assets have also been transferred to T&D as part of common services unbundling, reducing the Supply asset base on which customers pay a return to investors to zero thereby reducing Supply’s revenue requirement by £0.9 million each year. (These costs will now be recovered by T&D and be paid for by customers through the Use of System Tariffs (Ut term)).

**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 NIE Supply purchases and so long as NIE 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 the buy-out relating to the Northern Ireland Renewables Obligation with the Dt term representing any savings on the buy-out NIE achieves.

Et is associated with one-off costs such as, those arising from implementation of the Single Electricity Market (SEM) and European Directive concerning the internal market for electricity including retail market opening, along with uncontrollable costs which are passed through to customers on a 100% basis. These latter costs include licence fees, NI2007 establishment costs and past pensions deficit.

Therefore, most of NIE Supply’s costs are straight pass-through costs which are subject to other price controls or regulations and thus, this price control deals only with the St term of the tariff formula which is in effect the revenue NIE Supply is allowed by the regulator to collect from customers to cover its own core costs. This amount must be sufficient to finance an efficient business and would normally comprise:

|  |
| --- |
| Operating costs |
| Capital expenditure |
| Depreciation |
| Return on assets/ Profit margin |

The Allowed Revenue minus the cost of electricity purchases (recovered through the Gt term) is currently collected on a ratio of 62% for fixed costs plus a variable charge on a per customer basis (38%). These amounts are currently:

Fixed: £16.697m Variable: £13.3623 per customer

The supply business, having given over responsibility for meter reading and the associated assets (Keypad meters) to the Transmission and Distribution business to facilitate full market opening, currently has relatively few fixed assets and therefore depreciation (other than residual depreciation after transfer of metering assets) is not a consideration within the Allowed Revenue, neither is a return on assets for investors. There are no current plans for capital expenditure and thus the Allowed Revenue minus the cost of electricity purchases (the St term) will consist only of operating costs and residual depreciation plus a margin.

**Approach**

The Utility Regulator requested data from NIE Supply on 30 March 2007. The first partial response to the Business Efficiency Questionnaire was returned to us on 2 May 2007 with a request for missing data sent by the Utility Regulator on 22 June 2007. Additional data were supplied by NIE Supply on Friday 29 June 2007. We analysed the data provided, formulating supplementary questions which were discussed at a meeting between the Utility Regulator and NIE Supply on 24 July 2007. On 31 July 2007 NIE Supply re-submitted data and answers to the supplementary questions and those arising from the meeting. The Utility Regulator used the data and information supplied by NIE Supply to evaluate NIE Supply’s proposals and formulate the price control proposals. A consultation document outlining the Utility Regulator’s proposals was published on Friday 24th August 2007 and the consultation period ended on 21st September 2007. Three responses were received from NIE Supply, Airtricity and ESBIE. These responses, along with additional financial information relevant to the 2007/08 tariff increase of 3.9% have been considered in making the decisions outlined in this paper.

**Proposals**

**Form and Scope**

NIE proposed that the current form and scope of the price control should continue i.e. revenue is subject to RPI-X and the control will cover all NIE Supply customers; one respondent suggested the price control be restricted to domestic and small business customers and thus large energy users should not come within the scope of the price control.

**Utility Regulator Decision**

The Utility Regulator is still of the view that with new retail and wholesale market arrangements and the uncertainty this brings, it would be prudent to allow the present approach to continue until the impact becomes clearer. Since the establishment of retail market opening the majority of large users have migrated to other suppliers and the Utility Regulator takes the view that NIE Supply’s remaining customers still require the safeguard of regulated tariffs while competition has yet to develop. We still consider that there is enough clarity on tariffs for larger users to ensure no cross-subsidy is being applied and consider the costs associated with further separation of financial information are too high when balanced with the potential benefits to be gained by doing so. Thus the decision is that the current form (RPI-X) and scope (all customer classes) of the price control remain the same for the period.

**Duration**

NIE Supply considered that the period of the price control should be relatively short so it can be revised in light of developments in the SEM and after retail market opening. NIE proposed a three year price control running from April 2007 until March 2010 including activation of its Economic Purchasing Obligation from 1 November 2007. The Utility Regulator considered a number of options with regard to the period of the price control; a five year control may be desirable for many reasons, not least stability for tariffs and the opportunity for incentive regulation to work effectively, as well as certainty for shareholders. However, the new market arrangements bring uncertainty and whilst we are more sure of the likely pace of retail market opening, we are not yet sure how best to regulate NIE Supply under the new wholesale market arrangements. Since the all-island market went live on 1st November, a one year price control to April 2008 would add little additional information, experience, nor certainty to new arrangements from then. Accordingly we proposed that the price control period run from April 2007 to April 2009 which will include 17 months operation within the new market environment. One respondent did suggest the price control period should be aligned with the re-aligned tariff year (October to September).

**Utility Regulator Decision**

NIE Supply has agreed with the Utility Regulator and therefore the price control will run from 1st April 2007 until 31st March 2009. Alignment with the tariff year will be considered as part of the overall on-going exercise of observation, information-gathering, discussions and decision-making between now and the next price control review.

**Operating Costs**

The Utility Regulator proposed adjustments to NIE Supply’s proposed operating costs with regard to 2 areas of expenditure – salary costs and bad debt.

**Salaries**

The Supply business has included additional costs for:

|  |  |  |
| --- | --- | --- |
| 2007/08 | 3 | New trading and settlement functions within the business in the new market framework |
| 2 | Field Service personnel for customer-facing field work |
| 2 | Support Services personnel |
| 2008/09 | 2 | salaries relating to NFFO |
| 1 | IT function |

Whilst the Utility Regulator was satisfied of the requirement for some additional staff, we were not convinced that all the additional posts are necessary. We accepted the requirement for three trading and settlement posts and proposed allowing the two Field Service Staff transfers from T&D with respondent adjustments to the T&D price control to reflect the transfer. We proposed to allow two Support Service personnel (1 debt and 1 cashier) on the basis that the bill for agency staff is reduced accordingly over the next 2 years. The IT post during the second year was also approved however, the Utility Regulator proposed just one staff member to manage NFFO, as per our agreement with NIE Supply outside of the price control process.

**Utility Regulator Decision**

The Utility Regulator will allow NIE Supply proposals as outlined above. NIE Supply’s response expressed ‘disappointment that NIAUR has disallowed 1 settlement position relating to the NFFO contracts’ however, the decision with regard to the management of these contracts, including number of staff required, was agreed between NIE Supply and the Utility Regulator in a process outside of the price control process and this decision purely reflects what had already been agreed. The price control allowance for salary costs will be:

|  |  |  |  |
| --- | --- | --- | --- |
| **2006/07 Prices** | **2006/07** | **2007/08** | **2008/09** |
|  | **£m** | **£m** | **£m** |
| **Salaries including on-costs** | **1.794** | **2.153** | **2.254** |

Along with associated reductions in agency costs of £88,000 in 2007/08 and £87,000 in 2008/09 to reflect the recruitment of full-time staff in support services (£85.9K and £82.8k in 2006/07 prices).

**Bad Debt**

NIE Supply states that the Utility Regulator’s decision not to prevent domestic customer switching on the grounds of debt will increase Supply’s exposure to bad debt and therefore it will incur additional debt management costs. Whilst we recognised exposure to bad debt may be expected to increase in a fully open retail market, we remained unconvinced of the requirement for increasing bad debt provision. An analysis of customer numbers revealed a large proportion using prepayment or regular payment methods to pay for electricity and NIE Supply’s forecast suggested an expectation that most of those customers switching over the period of the price control were likely to be small business users who may be blocked from switching on the basis of debt.

**Utility Regulator Decision**

The Utility Regulator has accepted the policy of keeping bad debt provision at 0.4% of turnover; NIE Supply’s original figures have been revised to reflect the 3.9% increase in tariffs from 1st November 2007 giving bad debt provision of:

|  |  |  |  |
| --- | --- | --- | --- |
| **2006/07 Prices** | **2006/07** | **2007/08** | **2008/09** |
|  | **£m** | **£m** | **£m** |
| **Bad Debt 0.4% of Turnover** | **1.855** | **1.932** | **1.941** |

**Licence Fees**

The Utility Regulator has accepted Supply’s suggestion that licence fees, since they are non-controllable costs for the business, should be treated as 100% pass-through to customers and, as such, will be removed from the St term, which this paper deals with, to the Et term.

**NI2007**

These on-going costs relating to new systems associated with the development of the all-island market and retail competition were not included in NIE Supply’s original submission but will now be included in the Supply entitlement, adding £0.459 million over the two year period. Establishment costs to date have been collected through the Et term however, on-going costs are considered to be legitimate operating expenses.

**Pensions**

The Utility Regulator has decided to address the pensions deficit issue for the supply business by treating future payments to deal with the current deficit as 100% pass-through to customers and thus, the payment will move from the St term to the Et term which will ensure customers pay only the contributions that are necessary to tackle the current deficit.

As for the Transmission and Distribution business, following precedent set in the price control for the GB Distribution Network Operators (DNOs), we consider that 30% of the pension costs relating to NIE’s decision to allow early retirement should be disallowed. This is an amount of c£0.167m per annum deducted from the contribution calculation leaving approximately £1.973m per year to be collected under the Et term.

**Total Operating Costs**

Total Operating Costs have been set at £35.586m (2006/07 prices) for the two year period April 2007 until March 2009.

|  |  |  |  |
| --- | --- | --- | --- |
| **2006/07 Prices** | **2006/07** | **2007/08** | **2008/09** |
|  | **£m** | **£m** | **£m** |
| **Salaries** | **1.794** | **2.153** | **2.254** |
| **Bad Debt** | **1.855** | **1.932** | **1.941** |
| **MBIS** | **5.076** | **4.889** | **4.987** |
| **Inter-business Charges** | **3.955** | **0.863** | **0.854** |
| **Northgate Charges** | **7.101** | **7.632** | **7.641** |
| **NI2007** | **-** | **0.132** | **0.308** |
| **Total Operating Costs** | **19.781** | **17.602** | **17.985** |

MBIS costs include insurance, light, heat and power, marketing, communications, rent and rates, training costs and other sundry expenses; final MBIS costs outlined above have taken account of moving the licence fee to the Et term and the reduction in agency staff costs to reflect additional full-time staff.

The reduction in inter-business charges is primarily due to the transfer of meter reading to the Transmission and Distribution business resulting in a reduction of payment to Powerteam from the Supply business for these services.

Northgate charges include billing, call centre, debt management and IT costs (meter-reading costs are also included up to March 2007); the increase is driven primarily by large increases in IT and printing and mailing costs with smaller increases in bill printing and call centre costs.

**Depreciation**

Depreciation amounts are residual to the transfer of Keypad metering assets to Transmission and Distribution and will amount to £0.128m over the period of the price control:

|  |  |  |  |
| --- | --- | --- | --- |
| **2006/07 Prices** | **2006/07** | **2007/08** | **2008/09** |
|  | **£m** | **£m** | **£m** |
| **Depreciation** | **1.069** | **0.111** | **0.017** |

**Margin**

**Utility Regulator Decision**

Since the supply business has relatively few assets on which a return could be earned and whilst we understand that in the long-term margins are likely to increase in a competitive market, in their decision paper *Regulation of ESB and NIE in SEM: A Decision Paper[[2]](#endnote-2)* the Regulatory Authorities (RAs) decided to continue with prevailing margins for PES businesses. The decision will be reviewed after one year of new market arrangements, in November 2008. We therefore propose to set the margin at 1.8% for the duration of the price control however, this will be subject to the outcome of the aforementioned review.

The Utility Regulator has set a higher margin for NIE Supply than that for Phoenix Supply Limited due to a higher degree of risk of competitors entering the market. Consultation responses implied support for a higher margin to encourage competition considering NIE Supply’s market dominance; one respondent stated that although other suppliers face higher risk and higher costs, the ability to cover their costs is constrained by the decision on NIE Supply’s margin.

**Allowed Revenue (St)**

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

|  |  |  |
| --- | --- | --- |
| **2006/07 Prices** | **2007/08** | **2008/09** |
|  | **£m** | **£m** |
| **Total Operating Costs** | **17.602** | **17.985** |
| **Depreciation** | **0.111** | **0.017** |
| **Net Margin** | **6.911** | **6.997** |
| **Total St** | **24.624** | **24.998** |

**Fixed: Variable Ratio**

**Utility Regulator Decision**

The ratio of fixed to customer variable proportions of the Allowed Revenue (St) minus the cost of electricity purchases is currently 62:38. NIE proposed to change this to 67:33 on the basis of a larger proportion of their costs being fixed and not varying with customer numbers. The Utility Regulator has accepted this on the basis of information and data supplied by NIE Supply. The next price control review for implementation from April 2009 will include a thorough analysis of the nature of NIE Supply’s costs and set an appropriate ratio at that time.

The total Allowed Revenue (St) figure is then used to calculate the fixed:customer cost ratio amounts:

Fixed (67%) £16.624m

Customer Variable (33%) £ 10.55 per customer

**X Factor**

The X factor is the minimum average rate by which costs must decline after adjusting for inflation. Downward adjustments arise by either reducing costs and/or increasing productivity. The choice of X is critical; too low and the firm makes excess profits, too high and the viability of the business is threatened. An appropriate X factor is one which challenges the firm and promises gains for consumers.

**Utility Regulator Decision**

NIE Supply proposed an X factor of zero, stating ‘operating cost productivity growth is unlikely to differ from trend TFP growth and that the privatisation effect is ‘likely to be past’ and that ‘any present deviation from trend will be caused by change associated with market opening and the SEM. These will increase costs.’

Whilst the Utility Regulator accepts that there will come a time when the business is so efficient that further gains will be difficult, if not impossible to achieve, our analysis suggests that the company has not yet reached this stage however, in the context of new market arrangements affecting the Supply business at the input and output ends of the business, and the uncertainty with regard to costs and savings achievable in the new markets, we have decided to set X at zero for the current and next financial year. The effect of an X factor of zero will be observed by the Utility Regulator over the next two years and will inform future decisions regarding regulation of the PES business.

**Energy Efficiency**

Over the period of the price control NIE’s allowed operating costs have included costs for delivering energy efficiency and sustainable energy obligations within the framework of the price control:

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Price Control Targets - Energy Efficiency etc** | **2000/01 £m** | **2001/02 £m** | **2002/03 £m** | **2003/04 £m** | **2004/05 £m** | **2005/06 £m** | **2006/07 £m** |
|
| **2006/07 Prices** | **0.268** | **0.170** | **0.142** | **0.219** | **0.439** | **0.259** | **0.355** |

The target of £2 million customer lifetime savings per annum was originally set in 2000; this was subsequently increased to £3million customer lifetime savings per annum. To date NIE Supply has been active in promoting renewable energy, including the eco-tariff, micro-generation and other energy efficiency initiatives such as energy saving bulb promotions, condensing boiler initiatives and insulation cash back schemes.

The Utility Regulator has carried out a short review of the appropriateness of the obligations going forward and has agreed with NIE Supply that the energy efficiency and sustainable energy obligations of the Supply business will remain the same for the duration of this price control i.e. £3 million customer lifetime savings each year until 2009. A more comprehensive review of these obligations will be carried out in 2009 when the price control will also be reviewed comprehensively. Accordingly, the following has been approved (within operating costs) to enable NIE Supply to meet the targets:

|  |  |  |
| --- | --- | --- |
| **Price Control Targets - Energy Efficiency etc** | **2007/08 £m** | **2008/09 £m** |
|
| **2006/07 Prices** | **0.293** | **0.286** |

**Endnotes**

1. Taken from ‘The Northern Ireland Energy Efficiency Levy – A Review’; the Utility Regulator; March 2006 available at <http://ofreg.nics.gov.uk/pdf%20files/The%20Energy%20Efficiency%20Levy%20Programme%20-Review.doc> [↑](#endnote-ref-1)
2. CER/NIAUR: *Regulation of ESB and NIE in SEM: A Decision Paper* (AIP-SEM-07-304\_SEM\_Regulation\_Decision[1].pdf) available at <http://www.allislandproject.org/en/generation.aspx?article=4ad994c7-e273-485d-a30f-c658a34e90f7> [↑](#endnote-ref-2)