PPB Price Control

May 2019 to September 2023

Consultation Paper

26 September 2018

About the Utility Regulator

The Utility Regulator is the independent non-ministerial government department responsible for regulating Northern Ireland's electricity, gas, water and sewerage industries, to promote the short and long-term interests of consumers.

We are not a policy-making department of government, but we make sure that the energy and water utility industries in Northern Ireland are regulated and developed within ministerial policy as set out in our statutory duties.

We are governed by a Board of Directors and are accountable to the Northern Ireland Assembly through financial and annual reporting obligations.

We are based at Queens House in Belfast. The Chief Executive leads a management team of directors representing each of the key functional areas in the organisation: Corporate Affairs; Markets; and Networks. The staff team includes economists, engineers, accountants, utility specialists, legal advisors and administration professionals.

Our Mission	Value and sustainability in energy and water.
Our Vision	We will make a difference for consumers by listening, innovating and leading.

Our Values

Be a best practice regulator: transparent, consistent, proportional, accountable, and targeted.

Be a united team.

Be collaborative and co-operative.

Be professional.

Listen and explain.

Make a difference.

Act with integrity.

Abstract

This is a consultation on a proposed Final Price Control for the Power Procurement Business (PPB). The Control will run from April 2019 to a maximum of September 2023.

The Utility Regulator has the power to cancel the remaining Generating Unit Agreements (GUAs) that are overseen by PPB ahead of 2023. Should that power be exercised, the Final Price Control period will align with the termination date of the agreements.

The GUAs and PPB have resulted in a positive economic return for consumers in recent years. This Control will seek to align PPB's return on its activities and its incentives with the best interests of consumers under the new I-SEM and in the final years of the business's operation.

Audience

Energy industry stakeholders, electricity licence holders, electricity consumers, electricity consumer representatives and policy makers.

Consumer impact

While the GUAs overseen by PPB can have a material impact on consumers in Northern Ireland, and have had very significant impacts historically, the impact of PPB's Price Control itself is relatively small, as the business costs around £2m per annum to operate. This paper is focused only on the necessary task of regulating PPB to the end of its life as a business, rather than the potentially more impactful question of cancellation of the GUAs.

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1. INTRODUCTION AND BACKGROUND TO PPB

The Power Procurement Business (PPB) was established in 1992 as a guaranteed purchaser following the creation of long term power purchase contracts (known as Generating Unit Agreements (GUAs)) as part of the privatisation of the Northern Ireland electricity industry. PPB was originally a separate regulated business under the Northern Ireland Electricity Transmission and Public Electricity Supply licence, and now sits under the Power NI Electricity Supply licence.

This document is a consultation paper on a new Price Control to be applied to PPB effective from 1 April 2019 to 23 September 2023, or whenever the final GUA is terminated (whichever occurs sooner). It will replace the existing control, which came into force in April 2015.

Since the creation of the Single Electricity Market (SEM), PPB has purchased energy from the independent generators under the long term contracts, while also making payments for availability. PPB sells this energy into the SEM pool, while also retaining revenues under the SEM's Capacity Payment Mechanism, as well as any ancillary services revenue.

If there is a mismatch (either positive or negative) between PPB's costs and its revenues, that amount will be collected or rebated via Northern Ireland's Public Service Obligation (PSO) levy.

The details of the remaining GUAs are outlined below:

Generating Unit	GUA Contracted Capacity (MW)	Fuel Type	Contract Expiry Date
CCGT 10	106	Gas	23 September 2023
CCGT 20	510	Gas	23 September 2023

Table 1.1: Remaining GUAs

These remaining GUAs can be cancelled subject to a 180 day notification period. The Utility Regulator intends to carry out a comprehensive review of the GUAs within this price control period, considering their value from both an economic and policy perspective.

The Utility Regulator is now consulting on a final price control for the Power Procurement Business in order to determine the returns the company should earn under the revised I-SEM arrangements, and to ensure that the interests of consumers are protected. The control will be set via a similar process adopted in previous price control reviews for PPB. Following this consultation stage, the Utility Regulator will publish a Decision Paper and a consultation on associated licence modifications in January 2019. A final decision on the associated licence modifications will then be published in April 2019, with the control to come into force in May 2019.

2. CALCULATION OF EXISTING PRICE CONTROL

There are three main elements of the existing price control, which has been in force since April 2015:

1. PPB core allowance
2. Depreciation and Return
3. Gain-sharing mechanism / PPB's share of the gross surplus

2.1 PPB Core allowance

PPB's Core allowance covers:

- Operating Expenditure (Opex)
- Working Capital Facility
- Profit

Operating Expenditure (Opex)

For the existing price control, the Utility Regulator capped PPB's Opex allowance at £1.98m (2014 prices).

Working Capital Facility

In the existing price control, PPB's Working Capital Facility was set to £0.62m. This represented a £1.13m reduction from the Working Capital Facility in the previous price control. Although PPB indicated that this allowance is lower than the true cost of the facility, they were prepared to bear the risk on both the cost and size of the facility required in exchange for the introduction of the gain sharing mechanism.

Profit

In the existing price control PPB's baseline profit element was set at £0.93m. This was a 50% reduction from the profit element within the previous price control of £1.82m.

The core allowance element of PPB's current price control is the sum of these elements:

Core allowance = Opex + Working Capital Facility + Profit

£1.98m + £0.62m + £0.93m = £3.53m

2.2 Depreciation and Return

Depreciation and Return were based on an initial RAB of £0.95m for period ending 31 March 2015. This was depreciated at an annual rate of £0.29m. Return was based on the average value of the RAB throughout the year, and a pre-tax real rate of return of 5.42%.

The allowances were therefore (in October 2014 prices):

	2015/16	2016/17	2017/18	2018/19
Depreciation	£0.292m	£0.292m	£0.293m	£0.073m
Return	£0.044m	£0.028m	£0.012m	£0.002m

2.3 Gain-sharing mechanism

As part of PPB's offer to reduce their core allowance within the current price control, they were allowed a financial gain sharing mechanism.

The gain sharing mechanism is structured so that any gross surplus up to £10m is split 80:20 between customers and PPB. Any surplus in excess of £10m is split on a 90:10 basis. The gain share replaced the incentives contained within the Core Allowance element of the previous price control.

The amount earned by PPB under the gain sharing mechanism since it was introduced is:

Year Ending	Total Surplus / Deficit	PPB's Gain Share Revenue	Customer Gain Share
31 March 2016	-£0.383m	£0.000m	-£0.383m
31 March 2017	£7.048m	£1.410m	5.639m
31 March 2018	£18.299m	£2.830m	£15.469m

The gains in surplus seen in the past two years have been primarily driven by higher SEM revenues, offset against relatively stable costs on the GUA side of the calculation.

The total revenue to PPB under the existing price control since its implementation is:

£m		**2015/16**	**2016/17**	**2017/18**
Depreciation		£0.294	£0.300	£0.313
Return		£0.044	£0.029	£0.013
PPB Core allowance	Opex	£1.990	£2.030	£2.111
	Working Capital	£0.626	£0.639	£0.664
	Profit	£0.938	£0.957	£0.995
Pension Deficit		£0.481	£0.481	£0.481
PPB's share of gross surplus		£0.000	£1.410	£2.830
Total		**£4.373**	**£5.846**	**£7.407**

3. NEW PRICE CONTROL

Given the scope and duration of the remaining GUAs, the Utility Regulator believes that the Power Procurement Business does not require the same incentives and remuneration to achieve value for consumers. The Utility Regulator has therefore taken a rigorous approach to PPB's cost proposals for this final price control.

This price control will run from 1 April 2019 until the last remaining GUA has been cancelled or expires in September 2023. The Utility Regulator intends to carry out a comprehensive review of the GUAs within this price control period, considering their value from both an economic and policy perspective.

3.1 OPEX

PPB's historical and forecast Opex (as described in their Business Efficiency Questionnaire from June 2018) is shown in Table 4.1:

	15/16	16/17	17/18	18/19	19/20	20/21	21/22	22/23	23/24
	Actual			LBE[1]	Forecast				
	£m	£m	£m	£m	£m	£m	£m	£m	£m
Opex (Ex. Exceptional Items)	2.676	2.481	2.828	3.795	2.833	2.906	3.010	3.090	3.999
I-SEM Project Costs	0.450	0.726	0.957	1.007	-	-	-	-	-
Opex (ex. I-SEM Project Costs)	2.226	1.755	1.871	2.788	2.833	2.906	3.010	3.090	3.999

Table 3.1 PPB's Actual and Forecast Operating Expenditure

After excluding specific I-SEM project costs[2], PPB's forecast Opex increases by £0.96m from £1.87m in 2017/18 (the last full year of actuals), to a forecasted £2.83m in 2019/20 (the first year of the new price control).

The main drivers for this forecasted £0.96m increase are the following items (the remainder of the changes are small variations in other Opex items):

[1] Latest Best Estimate
[2] These costs are explored in more detail below in section 3.2

	2017/18	2019/20	
	Actual	**Forecast**	**Difference**
	£m	**£m**	**£m**
Central Trading Team	0.000	0.205	*0.205*
Consulting / Legal	0.057	0.157	*0.099*
IT & Telecoms (I-SEM)	0.004	0.401	*0.397*
Corporate Charges	0.382	0.536	*0.154*
Total	**0.443**	**1.298**	***0.855***

- *Central Trading Team:* a team of nine employees (eight analysts and one manager) will provide a Centralised I-SEM Operational Trading Team that will conduct 24/7 trading on behalf of both PPB and Power NI. The Utility Regulator has engaged with Power NI and PPB and proposes to confirm within this control that the costs of this function are to be split 50 / 50 between the businesses.

  The manager and six of the analysts were recruited directly for these roles, while one member of staff from both Power NI and PPB have been transferred. PPB's staff levels have reduced from 11 to 10 to reflect the transfer.

  While the Central Trading Team (CTT) will undertake trading for both Power NI and PPB, they will only operate under specific, ring-fenced instructions from each business. At no point will Power NI be informed of PPB's trading strategies, and vice-versa.

  In additional to staff costs, the costs in the table above also include costs for CTT Training and CTT facilities, although these are negligible.

- *Consulting / Legal:* this relates to general consultancy and legal costs the business incurs in normal operation e.g. covering price controls, licence modifications and general ongoing contractual issues, depending on what is going on and what issues arise.

- *I-SEM IT and telecoms:* PPB require new systems to enable effective participation in I-SEM, operating on a 24/7 basis. The costs describe above reflect the various IT and telecoms costs associated with these systems, including licence fees, maintenance fees and support fees. At present, these costs are estimated.

- *Corporate Charges:* these are forecast to increase as a result of overall corporate costs being higher, particularly as a consequence of greater governance and compliance obligations that means, for example, there are more non-executive directors, and obligations relating to, for example, risk governance, health & safety and GDPR.

Opex Decision

PPB's Opex for the last year of Actuals (2017/18) excluding exceptional items and specific I-SEM project costs was £1.87m. The Utility Regulator sees this as an appropriate baseline for future costs.

Of the four additional costs described above, the Utility Regulator sees rationale in providing additional allowance for the Central Trading Team. This CTT will consist of nine employees, shared on a 50/50 basis between Power NI and PPB. As described above, of the 4.5 employees that will be paid for by PPB, one of these will have transferred from the main Power Procurement Business. This price control will therefore only allow cost recovery for an additional 3.5 employees, and will allow these costs explicitly. Based on the forecast cost of £0.21m for 4.5 employees, the Utility Regulator allows £0.16m for an additional 3.5 employees.

The remainder of the costs (Consulting / Legal, IT and telecoms, and Corporate Charges) appear to be Business as Usual costs, or where costs have legitimately increased, are only estimated at this stage. The Utility Regulator considers that an additional £0.3m is sufficient to collectively cover these cost items.

PPB are able to apply for the recovery of costs under the D_t term of their price control for any cost items that were not taken into account when setting the allowed PPB entitlement. Rather than approving these costs on ad hoc basis, the Utility Regulator instead proposes to provide PPB with a fixed allowance each year to deal with such individual costs items. This will be coupled with a threshold that will allow claims for significant amounts for discrete cases, but will not allow claims for small amounts. The Utility Regulator proposes to set an allowance of £50,000 per year for such items. Items over and above this value will be considered separately on an exceptional basis, and only insofar as they individually exceed a cost of £50,000. These values are proposed based on the most recent D_t allowances given, totalling around £89,000 over the past two year period combined.

PPB's annual Opex Allowance will therefore be:

£1.87m + £0.16m + £0.30m + £0.05m = £23.8m (2017 prices)

A comparison of requested Opex vs. Allowed Opex for the first year of the price control is provided in the following table:

	£m
Requested Opex	2.833
UR Opex Decision	
Baseline Opex	1.871
Central Trading Team	0.159
C/L, IT and Corporate Charges	0.300
Fixed Dt allowances	0.050
Total	**2.380**

3.2 I-SEM SPECIFIC COSTS

As shown in Table 3.1, PPB have described the following I-SEM project specific costs:

	2014/15	**2015/16**	**2016/17**	**2017/18**	**2018/19**	
	Actual	**Actual**	**Actual**	**Actual**	**Forecast**	**Total**
	£m	£m	£m	£m	£m	£m
I-SEM Project	0.046	0.450	0.726	0.957	1.007	3.185

These are project costs that are estimated will be incurred by the Viridian Group in developing systems to prepare for I-SEM. The Utility Regulator has engaged with the Viridian Group with regard to these costs and indicated in 2016 that PPB should face 14.5% of the total Viridian I-SEM project costs for the purposes of cost recovery under its Price Control.

For PPB, the Utility Regulator proposes to treat these as a D_t item so that approval is provided once they are known. PPB have indicated that this is also their preferred option. Only the actual cost items will be allowable; there will be no return or depreciation allowance included.

3.3 DEPRECIATION AND RETURN

At the start of the current price control, the value of the existing Regulatory Asset Base (RAB) was set at £0.95m (October 2014 prices) at April 2015, and depreciated at £0.29m per year.

	£m	**£m**	**£m**	**£m**	**£m**	**£m**
	2014/15	**2015/16**	**2016/17**	**2017/18**	**2018/19**	**2019/20**
RAB (end of year)	0.950	0.658	0.366	0.073	0.000	0.000
Return		0.044	0.028	0.012	0.002	0.000
Depreciation		0.292	0.292	0.293	0.073	0.000

The existing RAB will therefore have been depreciated by the start of the new price control, and the allowances for existing Return and Depreciation can be set to zero.

3.4 PROFIT

In the last price control, PPB were given a profit allowance of £0.93m (October 2014 prices). Given the revenues earned by PPB through the gain sharing arrangements, the Utility Regulator considers a value of £0.93m to be higher than necessary, implying an approximately 40% profit margin on the costs incurred in running the business, before gain sharing which potentially adds significantly more. The Utility Regulator therefore proposes a more modest amount based on 10% of forecast Opex and Capex. Based on the Opex allowance of £2.38m (and Capex of £0) described above, the Utility Regulator therefore provides a profit allowance of £0.238m (October 2017 prices).

3.5 WORKING CAPITAL FACILITY

The Working Capital Facility in the current price control was set at £0.62m (October 2014 prices). PPB have stated in their responses to the BEQ that they expect the new price control allowance to continue at this level, with the opportunity to recover the remainder of their Working Capital costs through the gain sharing arrangement.

However, given the reduction in the profit allowance described above, the Utility Regulator provides an allowance of £1.0m for the Working Capital Facility (October 2017 prices).

3.6 PENSION DEFICIT COST

An allowance of £0.48m per year was included in the previous price control to cover the pension deficit cost.

In December 2014, the Utility Regulator published a position paper on pension deficit recovery. The position within this paper was that while historic pension costs could be recovered 100% from consumers, any future pension deficit costs may not be recovered from consumers and are to be funded 100% from shareholders. The cut-off date for past pension deficit costs was 31 March 2015.

The Utility Regulator therefore proposes not to include any allowance for pension deficits costs within this new price control.

3.7 PPB's SHARE OF THE GROSS SURPLUS

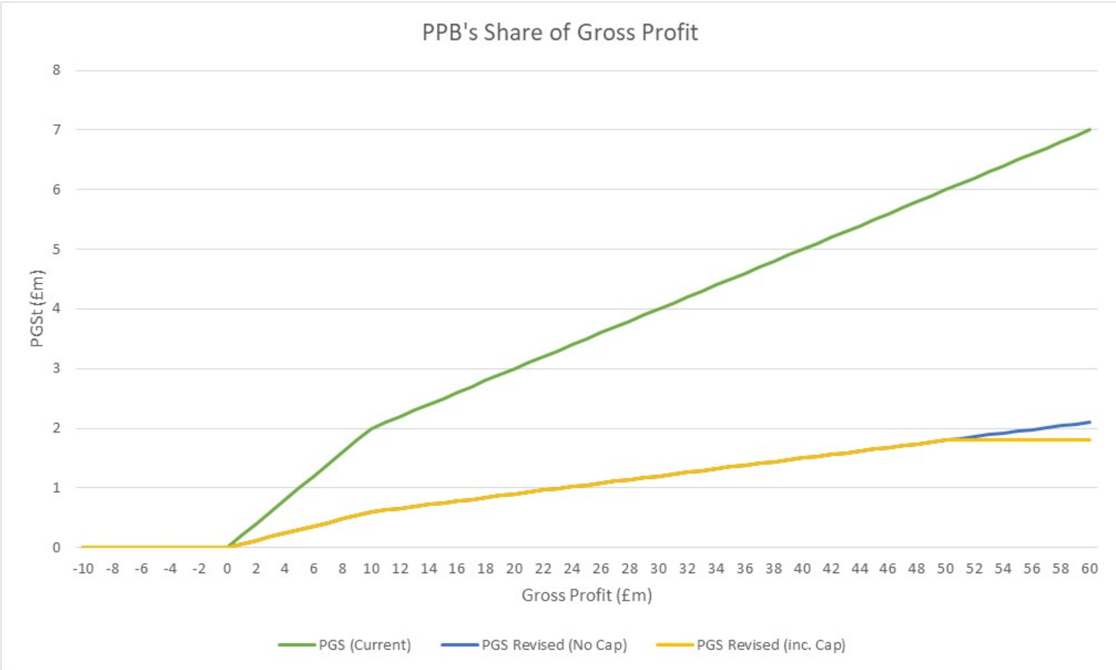
For the new price control, the Utility Regulator proposes to amend PPB's gain sharing mechanism to reflect the winding down of the business and reduced need for consumers to share the gains flowing from the GUAs with PPB. The new allowances will be as follows:

(a) where the gross surplus is less than zero: PGS_t = zero;

(b) where the gross surplus is greater than zero and less than or equal to £10m: PGSt = GS_t * 6%;

(c) where the gross surplus is greater than £10m: PGS_t = £0.6m + ((GSt - £10m) *3%)

The Utility Regulator also proposes to cap PPB's maximum share of the gross profit at £1.8m[3], as indicated in the following diagram:



3.8 TOTAL ALLOWANCES

Under the E_t formula in the price control, PPB's total allowances for the remainder of its lifetime are shown in the following table. A comparison against the allowances in the current price control is also provided:

£m	**Deprec.**	**Return**	**Core Allowance**			**Pension Deficit**	**Total**
			Opex	**Working Capital**	**Profit**		
Current P.C. (2014 prices)	0.293	0.012	1.976	0.622	0.931	0.481	**4.315**
Current P.C. (Oct 2017 prices)	0.313	0.013	2.111	0.664	0.995	0.481	**4.577**
New P.C. (Oct 2017 prices)	0.000	0.000	2.380	1.000	0.238	0.000	**3.618**
Difference	**-0.313**	**-0.013**	**0.269**	**0.336**	**-0.757**	**-0.481**	**-0.959**

[3] Gross Profit of £50m would need to be earned before this cap would be met.

PPB can also earn an additional maximum of £1.8m each year under the terms of the gain sharing allowance. For comparison, within the BEQ, PPB had requested an Opex allowance of £2.83m.

4. WIND-UP COSTS

This will be the final PPB Price Control and will see the business through to its winding up, in 2023 or sooner depending on whether or not the Utility Regulator decides to cancel the remaining GUAs before this time.

There will be certain costs associated with winding up, which the Utility Regulator proposes to set as part of the final price control.

While PPB have not included any specific costs within their BEQ, some of the issues they have submitted for consideration in liaison with us include:

1. PPB assume there will have ten employees at the time of cancellation.
    - In the first instance PPB will offer a Voluntary Selective Severance Scheme (VSS) to all staff; the expectation is that a redundancy payment based on month's salary for each year of service. For those eligible to access their pension, it would be paid as though they were retiring at their normal retirement age.
    - For those who do not wish to take Voluntary Redundancy, PPB would seek to re-train and redeploy within the Viridian Group. This would be facilitated by extending the VSS more widely across the Viridian Group to reduce staff numbers by the number of PPB staff who wish to be redeployed.

2. There will likely be a pension deficit relating to PPB staff that will need to be paid off at the point of business cessation.

3. Business wind-up: there will remain a number of activities that will require PPB staff to remain after the last day of trading.
    - There will remain settlement activities to conclude. These are done in arrears: one month for the GUAs, two months for DS3. The balancing market will operate M+4 and M+13 resettlement, although the latter of these is usually small.
    - PPB's offices and IT systems will require significant housekeeping, and all physical documents will need to be sorted through and those that are

required to address queries, resettle and/or which need to be retained for a Statutory minimum period will need to be placed in storage.

- Any staff re-training activities will need to be conducted post contract expiry.

PPB assume that it will take six months to conclude all these activities following the last day of PPB trading.

The Utility Regulator considers that the Viridian Group is large enough to absorb the employees and the costs associated with retraining at the time of expiry of the GUAs, and therefore proposes not to allow any specific allowance for such costs.

Further, we note that any cancellation of the GUAs requires six months' notice. The Utility Regulator considers that arranging document storage and re-training of staff should occur during this period. The Utility Regulator recognises that there will be settlement activities to conclude, in the months after cancellation of the GUAs has taken effect.

The remaining items appear to be legitimate, but will be difficult to quantify precisely ahead of time and we do not consider it fruitful to build in a detailed cost-submission programme (such as the existing D_t process). To this end, the Utility Regulator recommends the introduction of a Z_t term into the price control. Z_t shall have a value of zero in every year, except that year immediately following the termination of the last remaining GUA. In that year, Z_t shall take a value of £0.2m.

Further, the E_t term shall be payable on a pro-rata basis in any year in which the last remaining GUA terminates, up to the date of termination.

5. RESPONDING TO THIS CONSULTATION

The Utility Regulator is keen to hear all stakeholder views on the proposals set out in this consultation paper.

Responses to this consultation should be forwarded to reach the Utility Regulator before 5pm on 24 October 2018 to:

Kenny Dane
The Utility Regulator
Queens House
14 Queen Street
Belfast
BT1 6ED
Email: kenny.dane@uregni.gov.uk

Your response to this consultation may be made public by the Utility Regulator. If you do not wish your response or name made public, please state this clearly by marking the response as confidential. Any confidentiality disclaimer that is automatically produced by an organisation's IT system or is included as a general statement in your fax or coversheet will be taken to apply only to information in your response for which confidentiality has been specifically requested.

Information provided in response to this consultation, including personal information may be subject to publication or disclosure in accordance with the access to information regimes; these are primarily the Freedom of Information Act 2000 (FOIA) and the Data Protection Act 1998 (DPA). If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things with obligations of confidence.

In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Authority.

ANNEX 1 CURRENT PRICE CONTROL STRUCTURE

PPB's revenue allowance is described in Annex 3 of the Power NI Electricity Supply licence. In any relevant year, the maximum regulated PPB PSO revenue is to be calculated in accordance with the following formula:

$$M_{PPBt} = A_t + D_t + E_t + PGS_t - NPR_t + K_{Bt}$$

where:

M_{PPBt}	means the maximum regulated PPB PSO revenue.
A_t	means the actual power purchase costs incurred in the purchase of electricity.
D_t	means: (a) The allowed charge for excluded power procurement costs and changes in law. (b) any reasonable costs incurred by PPB in complying with the requirements imposed on the Licensee under legislation and other legal requirements through which Directive 2003/54/EC and/or 2009/72/EC is implemented. (c) any reasonable costs incurred by PPB in complying with the requirements imposed on the Licensee under the arrangements for the SEM. (d) any other amounts, not included in the revenues under the Successor Distribution Licence or another Annex of this Licence, requested by the Licensee and approved by the Authority.
E_t	means the allowed PPB entitlement.
PGS_t	means PPB's share of the gross surplus.
NPR_t	means the non PSO revenue in relevant year t.
K_{Bt}	means a correction factor.

The PPB price control effectively determines the allowed PPB entitlement (E_t), as well as determining PPB's share of the gross surplus (PGS_t).

The allowed PPB entitlement is derived using the following formula:

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

where:

DEP_t means the depreciation amount allowed in respect of the PPB Regulatory Asset Base (RAB).

RTN_t means the allowed return on the PPB RAB.

IC_t means the PPB core allowance.

PD_t means the allowed PPB pension deficit cost of:

(i) £0.481m per year; or

(ii) Such other amount as reasonably determined by the Authority.

Depreciation

The depreciation amount is derived from the values in the following table (note: the value in each relevant year is to be adjusted by RPI. Please see the licence for further details)

	2015/16	2016/17	2017/18
Depreciation	£0.292m	£0.292m	£0.293m

Return

The allowed return on the PPB RAB is derived from the values in the following table (note: the values in each relevant year are to be adjusted by RPI. Please see the licence for further details):

	2015/16	2016/17	2017/18
Return	£0.044m	£0.028m	£0.012m

Core allowance

The core allowance for the current price control is set at £3.529m, with adjustments for RPI in each relevant year.

Pension Deficit Cost

As described above, the allowed pension deficit cost is:

(i) £0.481m per year; or

(ii) Such other amount as reasonably determined by the Authority.

PPB's share of the gross surplus

PPB's share of the gross surplus is derived from the following formulae:

(a) where the gross surplus is less than zero: PPB's share = zero;

(b) where the gross surplus is greater than zero and less than or equal to £10m: PPB's share = gross surplus * 20%;

(c) where the gross surplus is greater than £10m: PPB's share = £2m + ((Gross Surplus - £10m) *10%)