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24 October 2018

Dear Kenny,

PPB Price Control May 2019 to September 2023 – Consultation

Power NI Energy Power Procurement Business (PPB) welcomes this opportunity to respond the Utility Regulator's (UR) final price control consultation paper for the business for the period from May 2019 to September 2023.

The following sections provide comments on, and responses to the consultation paper in the order raised in the consultation paper.

Section 3 - New Price Control

The opening paragraph to section 3 states that "*the Utility Regulator believes that the Power Procurement Business does not require the same incentives and remuneration to achieve value for customers*". There is no basis to this statement and no evidence or justification is provided. The objective of maximising the value of the GUAs for customers does not change just because the GUAs are in their final years.

In our response to the Business Performance Questions, that we submitted along with the BEQ response, we provided detail on both the benefits and value PPB has delivered for customers in the current price control period and the benefits the business will provide in I-SEM, utilising its knowledge, experience and innovation to continue to deliver value for customers. The benefit of such activity will persist for the duration of the GUAs.

<u>Section 3.1 - OPEX</u>

The Opex for the business has changed following the commencement of the I-SEM and the actual Opex incurred in 2017/18 is not a sound basis for projecting Opex over the period from May 2019 to September 2023. PPB has provided a detailed forecast of Opex in the BEQ submission and that submission provides a comprehensive assessment of the costs of operating the business in that period. The purpose of the BEQ was to provide such detailed information to the UR yet it has been ignored without justification.

Without prejudice to this objection to the UR's proposed methodology, there are errors in the UR's proposals in relation to the four additional costs identified. We address each of these below.

(i) Central Trading Team (CTT)

As a result of the UR approach to provide a base allowance based on the actual 2017/18 Opex, the UR proposes to only allow for an additional 3.5 employees on the basis that one of the employees transferred from PPB. This could be a proxy approach if the 9 CTT employees were all paid equally. Hence deducting on the basis of a simple average is incorrect. A more appropriate adjustment would be a deduction 2/10^{ths} (20%) rather than 2/9^{ths}.

Further, the UR methodology only considers the cost uplift in 2019/20 whereas in the BEQ salary progression increments are included to reflect the development of these junior analysts into Analysts and Senior Analysts over time.

If the UR continues with the approach of adding uplifts to the 2017/18 outturn then the CTT uplift should reflect an average of the uplift over the period from 2019/20 to 2023/24 which averages £224k and the hence the "adjusted uplift" would be £180k (80% of the BEQ average CTT staff related costs for PPB).

(ii) Consulting / Legal, IT and Telecoms, and Corporate Charges)

The UR arbitrarily states that an additional allowance of £300k is sufficient to collectively cover these cost items but there is no justification for not providing substantially the full allowance as submitted in the BEQ response. We provided detailed explanation on the drivers of the cost changes as part of our BEQ submission and subsequent responses to UR queries and as a result we cannot reconcile with the UR's proposed allowances.

In relation to Consulting / Legal costs, PPB has to deal with complex contractual and commercial matters and licence issues. There has always been a core legal cost in the management of the GUAs and in the general operation of the business and legal costs, as we approach the termination of the contracts and the closure of the business, are to be expected. The costs in 2017/18 were unusually low and a better indication of costs can be seen by considering the average over the 3 years of PC15-18 which was £217k. PPB believes its forecast was, and remains, reasonable.

In relation to the I-SEM IT and Telecoms costs, these are forecast opex costs for the infrastructure, software, licence, and 24/7 support costs for both PPB staff and 50% of the CTT costs that are required to enable participation in the new markets. These systems and the resulting costs are essential to enable PPB and the CTT to trade in the new markets and there is no justification to disallow such ongoing costs.

In relation to Corporate Charges we had already provided clarification as to the drivers of the increases, where notwithstanding that PPB's overall allocation is lower, the underlying corporate costs are higher, particularly as a consequence of additional compliance requirements relating to risk governance, data protection, health & safety, and cyber security. As a result of these legislation changes and governance enhancements to ensure best practice, the Group has appointed a Risk and Governance Manager, a Group Data Protection Officer and a Health & Safety Officer and also incurs costs for additional expert external advice.

In relation to the allowance for the recovery of costs under the D_t term, the proposed allowance of £50k in aggregate for all costs that are individually lower than £50k potentially only provides for 1 cost item. This is not a reasonable approach and PPB considers that the allowance for aggregate items less than the threshold should be set at twice the threshold. Hence where the threshold is to be £50k (above which claims can be individually made), the allowance should be £100k.

PPB considers the correct basis to set the Opex allowance is as submitted in the BEQ submission. However, if the UR methodology of applying uplifts to the 2017/18 base were applied, the Total Opex allowance should be :

	£m	Comments
Requested Opex	2.833	From page 13 of Consultation paper
Opex based on 2017/18 with uplifts for cost increases		
Baseline Opex	1.871	From page 13 of Consultation paper
Central Trading Team	0.180	80% of the average of the 2019/20 and 2023/24 CTT cost uplift
Consulting/Legal	0.099	Provides an amount that remains lower that the average incurred in 2015/16 to 2017/18
I-SEM IT and Telecoms	0.397	New costs for I-SEM
Corporate Charges	0.154	As per BEQ reflecting additional Governance obligations
Total before change to D_t recovery rights	**2.701**	
Fixed Dt allowances	0.100	Twice the deminimus threshold
Total including change to D_t recovery rights	**2.801**	

Section 3.2 – I-SEM Specific Costs

We agree that these costs will be recoverable as a D_t cost.

Section 3.3 – Depreciation and Return

We agree that these allowances can be set to zero.

Section 3.4 – Profit

The consultation paper states that "*Given the revenues earned by PPB through the gain sharing arrangements, the UR considers a value of £0.93m to be higher than necessary*". There is no justification for this statement and it ignores the background of how the current figure was determined. PPB had provided a detailed paper from NERA prior to PC12-15 being agreed which provided critical assessment of the net margin required for PPB, that covered both working capital and risk capital. The actual price control that was agreed provided a lower allowance but also established an incentive arrangement that helped bridge the gap between the margin PPB considered reasonable and the base allowance provided in the price control.

In August 2014 the UR were considering contract cancellation on the premise that when the cost of PPB was taken into account, the contracts would not provide value for customers. PPB's modelling showed the contracts to be substantially more valuable for customers and the business committed to its view by offering up both a reduction in Opex and a reduction in excess of £2m in the combined Working Capital / Profit elements, the aggregate of which was much lower than PPB's costs. This substantial upfront reduction was combined with a gain sharing arrangement which provided that PPB could recover that upfront reduction in the circumstances where the contracts outturned as valuable for customers as PPB had projected, but with PPB bearing the risk that it might not.

The table below summarises the reductions between PC12-15 and PC15-18 which shows that overall base reduction implemented.

	IC_t			
Oct 2017 prices (£m)	**OPEX**	**WCF**	**Profit**	**Total IC_t**
PC12-15	2.771	1.867	1.990	6.628
PC15-18	2.111	0.664	0.995	3.770
Reduction	**- 0.660**	**- 1.203**	**- 0.995**	**- 2.858**
Aggregate reduction in Working Capital and Profit		**£2.198m**		

This clearly shows the £2.2m p.a. reduction in PPB's Working Capital and Profit elements that PPB had voluntarily offered be placed at risk through the gain sharing arrangement. As is shown on page 8 of the consultation paper, PPB was successful in delivering c£21m of value from the GUAs for customers. This is substantially greater than the UR estimate for this period which was set out in the 10 October 2014 decision paper[1] and which concluded that even after the £2.4m p.a. reduction in PPB's entitlement, the value of the GUAs for customers over the 3 years from April 2015 would be less than £4m (before any gain sharing).

Under the gain sharing arrangement PPB has, on average over the 3 year period, earned £1.41m p.a. which is £0.8m p.a. less than it had foregone. It is therefore incorrect to intimate that PPB has been over-remunerated by the current price control when in fact it has only recovered 64% of that which it had given up. Together with the Opex reduction, PPB's annual revenue recovery in PC15-18 was over £1.4m lower (in 2017 prices) relative to the PC12-15 allowances.

The fundamental margin requirement to remunerate PPB for its working and risk capital has not changed and the current price control already provides for a low baseline allowance for these elements with PPB bearing the risk that it will not be fully remunerated if it is unable to capture benefits for customers and hence a share of the gains to make up that shortfall.

There is no basis or justification to reduce the baseline "profit" element of the allowance by a further £0.76m and basing the margin on a percentage of Opex ignores the fundamental values PPB is managing where PPB's turnover is in the range £150m - £200m.

PPB is an asset-light business that manages a range of risks and as we have already noted above, the business has provided detailed papers as part of previous price control engagements setting out the detail behind these risks and the net margins required to remunerate those risks. The UR has also previously adopted a percentage of turnover as the basis of the PPB allowance (using 1% of turnover when there were much lower market risks than exist today).

Determining the margin on the basis of Opex has never been a consideration and there is no precedent for such an approach. We also note the CMA decision in relation to SONI concluded that a margin of 0.5% on SONI's "collection agent"

[1] *Review of Generating Unit Agreements in Northern Ireland – Decision Paper 10 October 2014*

turnover was required. PPB is exposed to a much greater range of risks than that incurred as a “collection agent”, for example, relating to the PPA Guarantee, Trading risks relating to Financial legislation under EMIR and REMIT etc.

Even considering a simple net margin of 1% of Turnover, before financing costs, would equate to a net margin (profit) of approximately £1.6m p.a. based on the turnover estimate in the BEQ submission although given the significant increases in commodity prices since the submission, PPB’s estimated turnover is close to £200m and a 1% net margin would be £2m.

It is therefore evident that the existing profit margin allowance, that PPB proposed in conjunction with the Gain Sharing arrangement, already provides a very tight margin.

Section 3.5 – Working Capital Facility

We have already mentioned the WCF in our comments above on profit and the fact that the allowance is currently much less than the underlying cost (and for which gain sharing was a risk the business took to make up the deficit). The proposal to increase the allowance to £1.0m is arbitrary, and still remains below a minimum estimate of the cost of providing such a facility.

In addition, the Working Capital requirements under I-SEM are greater given the volatility in the markets, the increased difficulty in achieving feasible schedules in the DAM, the risks arising from obligations in relation to balance responsibility (which also means PPB is required to provide collateral to the Balancing Markets to cover situations where the generating units are unable to deliver the DAM volumes). The CfD element of the Reliability Options adds further to revenue volatility and risk.

We therefore estimate that the size of the facility needed in I-SEM has increased to £25m and notwithstanding that PPB could not actually secure such a facility on a standalone basis, the minimum cost of providing this facility is estimated to be £1.46m The detail behind this calculation is set out in the table below.

	Values	Comments
Minimum WCF	£25m	*The minimum required facility*
Gearing	50%	
Non contingent	25%	*Applies to both equity and debt*
Contingent	75%	
Costs of Equity and Debt		
Cost of Equity (pre-tax nominal)	11.82%	*Mid-range value*
Cost of Contingent Equity (pre-tax nominal)	9.05%	*Cost of Equity less cost of Risk Free (3.28%) + 0.5%*
Cost of Debt (pre-tax nominal)	5.28%	*Mid-range value*
Cost of Contingent Debt (pre-tax nominal)	0.80%	*40% of Debt Margin (2%)*
Capital Requirement		
Equity	£3.13m	*Based on gearing and contingent and non-contingent splits*
Contingent Equity	£9.38m	
Debt	£3.13m	
Contingent Debt	£9.38m	
Net Cost		
Equity	£0.37m	*Derived from applying the relevant costs to the relevant capital requirement values*
Contingent Equity	£0.85m	
Debt	£0.16m	
Contingent Debt	£0.08m	
Total WCF Cost	**£1.46m**	

<u>Section 3.6 – Pension Cost Deficit</u>

The UR appears to misunderstand the application of the cut-off date and the fact that all pension liabilities that have been accrued before the cut-off date continue to be fully funded by customers. It is only pension liabilities that accrue to pensionable service after that date that are wholly borne by the employer. Any deficit that arises relating to pension liabilities that were accrued prior to the cut-off date (e.g. as a result of increasing longevity, market performance, etc.) remain recoverable from customers over the term of the liability (i.e. until the last payments are made to pensioners from the pension scheme).

While we agree that on the basis the existing deficit payments are reflected in Opex, then the PD_t term can be currently set to zero, but should the deficit increase such that additional payments are required to meet that deficit, then that uplift would need to be reflected at that time through the PD_t term.

Section 3.7 – PPB's Share of the Gross Surplus

As we have already stated above, "*the winding down of the business*" does not reduce the need for customers to share gains with PPB through a weakened incentive arrangement. The gain share mechanism was designed to provide a strong incentive for PPB to manage and trade the GUAs effectively and efficiently, and also to enable PPB to clawback its WCF cost shortfall and a reasonable profit in circumstances where there were also substantive benefits generated for customers. As we note above, while PPB captured a gainshare averaging £1.4m p.a. over the last 3 years, this was still £0.8m less than the revenues it had foregone (relating to the WCF and profit components and excluding opex) and at the same time customers have benefited by c£21m.

As the cessation of PPB approaches we expect it will become increasingly difficult to retain the skilled resources needed to maximise the value for customers and any dilution of the incentive would exacerbate that situation.

A further key point is that the introduction of I-SEM has (i) increased the volatility in scheduling and hence revenues streams, and (ii) reduced payments under the capacity mechanism. These changes reduce the scope for gain-sharing and thus for PPB to earn back the revenue reductions it exposed itself to.

PPB therefore rejects the proposal to arbitrarily reduce the gain share percentage by 70%. The existing framework has delivered on its objective to capture value for customers, by providing a strong incentive which has enabled PPB to claw back 64% of the revenues it had foregone and justifying its faith in the value of the GUAs for customers. If anything the incentive should be strengthened, particularly at the lower end given the exposure to regulatory risk, as evidenced by lower capacity revenues, higher Generator TUoS charges etc and the higher I-SEM Opex.

The concept of a cap is also counter-intuitive as there should always be an incentive to create greater value for customers.

Section 3.8 – Total Allowances

The residual allowances that will apply over the course of the final price control are the core allowances and the gain share.

PPB's Opex estimate for 2019/20 of £2.833m was provided as part of the BEQ. The UR methodology ignores genuine Opex costs and, notwithstanding our disagreement with the approach, we have set out a corrected table above in our response to Section 3.1 that uses the 2017/18 actuals as the base with adjustment for identified uplifts, mainly relating to I-SEM. That methodology gives an Opex figure of £2.801m (which is close to the costs we provided in the BEQ).

In our response to Section 3.4, we have calculated a minimum cost for the Working Capital Facility to be £1.46m which on its own is greater than the UR's proposals for the combined allowances for the WCF and Profit of £1.238m.

We have also described above why we consider the current gain-sharing arrangement has delivered on its objectives, even though PPB has not fully recovered the value it has foregone. We have also highlighted that the challenges in the I-SEM are more severe and hence any dilution of the incentive arrangement would be unwarranted and a bad outcome for customers.

To maintain a simple structure for the price control, we would therefore propose that the Opex allowance should be uplifted in line with BEQ submission and that the WCF, profit components and gain sharing arrangements be carried forward on their current basis. This will still result in a net reduction in PPB's allowances compared to those recovered in PC15-18, as shown in the following table.

£m	**Deprec.**	**Return**	**Core Allowance**			**Pension Deficit**	**Total**
			Opex	**WCF**	**Profit**		
Current PC (Oct 17 prices)	0.313	0.013	2.111	0.664	0.995	0.481	4.577
PPB Proposal (Oct 17 prices)	0	0	2.833	0.664	0.995	0	4.492
Difference	**- 0.313**	**- 0.013**	**0.722**	**0**	**0**	**- 0.481**	**- 0.085**

This shows a reduction over the current price control allowances while at the same time covering the significant opex and working capital uplift arising from the introduction of I-SEM. It also provides ongoing strong incentives to capture value for customers and where that is successful also enabling PPB to recover the full cost of its WCF and a more reasonable net margin / profit.

Section 4 – Wind-up Costs

The consultation paper states in the third paragraph that "*PPB have not included any specific costs within the BEQ*" in relation to wind-up costs. This is incorrect as PPB did provide a forecast of such costs where they are possible to forecast. Hence PPB had included the operating costs for the closure of the business in the period between October 2023 and March 2024 and also to cover some ongoing costs beyond that date relating to the production of Accounts, Audit, Taxation, Corporate costs, data and document storage and the later destruction of files and data, etc (in compliance with all statutory obligations).

There are costs that are very difficult to estimate at this time. The first relates to the costs incurred transitioning the PPB staff to either becoming a pensioner or to redeploy the staff elsewhere within the Viridian Group (which may involve offering selective severance elsewhere within the Group). Secondly there will be Pension costs that arise on closure that will need to be funded but the cost of that could vary significantly between now and 2024.

Staff Retirement / Redeployment

The UR states that "*the Viridian Group is large enough to absorb the employees and the costs associated with retraining*…". This statement contradicts the Licence requirement for PPB to remain separate from other Associated Businesses and assumes that other Viridian businesses will hold back from recruiting in order to accommodate PPB staff at that time. This is not a viable proposition since as we have already highlighted, PPB needs to retain its staff, knowledge and expertise until the last day of trading to enable it to maximise the capture of value for customers. Hence the process to seek to redeploy those staff who wish to be redeployed can only occur after PPB ceases trading in the SEM. It may be fortuitous that there are some vacancies at that time that could accommodate redeployment but that cannot be predicted now. Therefore the cost of transitioning PPB staff to retirement or another role with the Viridian Group (whatever the Group activities might be at that time) can only be determined at the time (and to the extent there are vacancies at that time then that could possibly reduce the cost).

Pension costs

The other cost that may be material relates to the closure of the final salary pension arrangements for the PPB members of the final salary pension scheme. At the point of PPB closure there remains a risk that the assets will not fund the liabilities for the PPB members. In normal circumstances where the business continues to operate then any such variation would be picked up through the ongoing operation of the scheme and the employer would be obliged to make additional contributions to cover any funding gaps that emerge. However where, as is the case for PPB, the business ceases trading, this cost must be crystallised at closure.

This ongoing liability is not a liability attributable to the wider Viridian Group (with the exception of liabilities that accrue after the cut-off date) and hence it must be valued at the point of business closure. Pension schemes are increasingly managing this issue through a Buy-in whereby a pensions provider takes on the pension payment obligations (including the risk that the liabilities could increase e.g. through having to pay pensions for longer). There is a market for such products and the best terms can be secured from the market at the time. It is not possible to precisely calculate the cost of procuring such products today and hence why we stated that the cost cannot be determined until a Buy-in transaction is contemplated.

Predictable wind-up costs

The UR proposes a Z_t allowance of £0.2m that would apply in the year PPB ceases to trade. PPB set out in its response to the Business Performance Questions the costs the business would incur after the last day of active trading. We stated that the run-off activities and staff redeployment would take 6 months and hence we had simply continued with the ongoing business costs through to the end of March 2024. If the price control were to continue to apply until 31 March 2024 then that would cover such costs.

We had also highlighted in our BEQ submission that there would be costs in the subsequent 7 years where there are statutory obligations with costs relating to accounts, audit, taxation, data and document storage and corporate costs. The total included for these longer term wind-up costs was £428.6k (this was included in the 2023/24 Opex costs in the BEQ).

Conclusion on Wind-up costs

Our comments above highlight that the proposed allowance of £0.2m is wholly insufficient and does not reflect the wind-up costs that will be incurred. If the price control is specified to run until 6 months after the cessation of trading (i.e. to 31 March 2024), then the Z_t term would need to cover the longer term costs spanning the 7 years where there are statutory obligations and which we forecast to be £0.43m. If the price control were to cease from October 2023, them the Opex in the 6 months run-off would also need to be included and this is forecast to be a further £1.49m (£1.92m in total).

Finally the Z_t allowance will also need to be increased by the outturn cost of staff redundancy / redeployment and the costs required to address the pension scheme liabilities for the PPB members of the final salary section of the pension scheme. These costs will be transparently identifiable and hence will not require any significant regulatory resource or oversight at that time.

I would be happy to discuss this response with you at the earliest opportunity.

Yours sincerely,

Roy Foreman
Managing Director, PPB