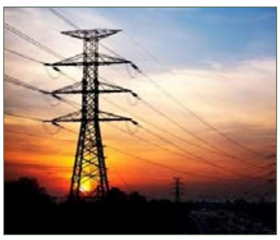
Power NI - Power Procurement Business Price Control 2015 – 2017

Final Determination

July 2015


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 the centre of 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

Power NI Power Procurement Business (PPB) was set up following the creation of legacy contracts put in place on 1 April 1992 and is regulated as a separate business under Annex 3 and Schedule 3 of the Power NI Electricity Supply Licence.

In October 2014 the Utility Regulator, after analysing the value to consumers, took a decision that the two remaining legacy contracts should remain in place but be kept under review. The UR analysis encompassed a proposal from PPB which reduced their current costs by £2.4 million per annum alongside a 'gain share' mechanism.

This Final Determination sets out the Utility Regulator's Decision on the PPB price control, 2015-2017 which takes effect from 1 April 2015 and is applied through the October 2015 Electricity tariffs. This Final Determination represents a further reduction in costs as proposed by PPB in response to the cancellation of the legacy contracts.

Audience

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

Consumer impact

This Final Determination reflects a £2.675million reduction in PPB's operating costs which will benefit consumers through a reduced PSO charge.

If there is a mismatch (positive or negative) between PPB cost of sales i.e. the payments it makes to generators under the contracts and revenues, but excluding operating costs and PPB allowed price control amount then that amount will be collected or rebated via the Public Service Obligation (PSO) levy which. The PSO is levied on all NI electricity consumers.

Content

1. Summary of Determination

1.1. On 2 April 2015 the Utility Regulator (UR) published a Draft Determination consultation paper, outlining the proposals for the Power NI Energy Ltd Power Procurement Business (PPB) price control to apply from 1 April 2015 for a period of two years.

1.2. Two confidential responses were received to the Draft Determination. There were no disagreements relating to the duration of price control, structure and allowance for depreciation. Reservations were raised about the allowed rate of return, incentive amount and the gain share mechanism.

1.3. This paper outlines the UR's determination regarding the various elements of the price control which were discussed in the Draft Determination consultation paper. The UR Final Determination proposes no changes to the Draft Determination.

The main elements of the Final Determination are:

1. The structure of the PPB Price Control remains consistent with all previous PPB Price Controls.
2. The PPB offer to reduce their costs by £2.4m per annum has been incorporated into the Final Determination.
3. The allowed Operating Expenditure (OPEX) is capped at 2014/15 OPEX levels.
4. A gain share mechanism will be implemented were any surplus up to £10m, resulting from PPB's good management of the two remaining legacy power purchase contracts, is split 80:20 between customers and PPB for the year in question. Any surplus in excess of £10m will be shared on a 90:10 basis.
5. PPB's Weighted Average Cost of Capital (WACC) will be set at 5.42%.
6. The duration of the price control will be from 1 April 2015 to 31 March 2017 with the option to extend up to 23 September 2018.

PPB's revenue entitlement is summarised below;

Table 1.1: Summary of PPB's Entitlement Amount

Et Formula							
£m	DEPt	RTNt	OPEX	WCF	Total ICt	ICt Profit	Profit (inc DEP, RTN)
Current Price Control Decision (in 2014 prices)	0.377	0.103	2.594	1.747	6.204	1.863	2.342
UR Proposed Decision (in 2014 prices)	0.293	0.044	1.976	0.622	3.529	0.931	1.268
Difference from Current Control	-0.084	-0.059	-0.618	-1.125	-2.675	-0.931	-1.074

2. Introduction and Background to the Power Procurement Business (PPB)

2.1. PPB was set up following the creation of legacy contracts being put in place on 1 April 1992 as a separate regulated business under the Northern Ireland Electricity Transmission and Public Electricity Supply Licence (now the Power NI Supply License). The role of PPB before the creation of the Single Electricity Market (SEM) was to purchase power under the long term legacy contracts from independently owned generators. These long term legacy contracts are known as the Generating Unit Agreements (GUAs) Prior to the commencement of EU liberalization in 1999 all of this power was sold to suppliers in the Northern Ireland market at a Bulk Supply Tariff (BST). From then, PPB sold to suppliers of franchise customers at the BST and sold to suppliers in the competitive markets in Northern Ireland and Ireland under various bilateral arrangements as well as providing a balancing market for the competitive market segment in Northern Ireland.

2.2. Following the creation of the SEM, PPB's role changed. The business still continues to purchase power under the long term contracts but it sells that power directly to the SEM pool. The business also enters into contracts for differences (CFDs) with suppliers in both jurisdictions (Northern Ireland and Ireland). These contracts have the effect of “hedging” or “fixing” the revenue that PPB will receive for the volume of power the contract is for. Therefore PPB is able to hedge a significant proportion of the revenues it will receive for the power it sells to the market.

2.3. If there is a mismatch (positive or negative) between PPB cost of sales i.e. the payments it makes to generators under the contracts and revenues (pool receipts, difference payments and PPB allowed price control amount) then that amount will be collected or rebated via the Public Service Obligation (PSO) levy. The existence of this arrangement enables PPB to recover any shortfalls between costs and revenues from Northern Ireland customers and hence, PPB’s profit margin is defined in the Price Control.

3. Context of the Current Price Control

3.1. This price control is the last price control for PPB in advance of the new wholesale market arrangements which will take effect from 2017[1]. For this reason the duration of this Price Control will be 1st April 2015 to 31st March 2017 with the option to extend up to 23rd September 2018.

3.2. This extension date of 23rd September 2018 coincides with the expiry date of the remaining legacy GUAs that PPB hold. The role of PPB is very much linked to the continuing term of the two remaining long-term GUAs.

Table 3.1: Active GUA contracts

Company	Generating Unit	GUA Contracted Capacity (MWs)	Fuel Type	Contract Expiry Date (CED)
AES Ballylumford	CCGT 10	106	Gas	23 September 2018 (with a five year extension option)
AES Ballylumford	CCGT 20	510	Gas	23 September 2018 (with a five year extension option)

3.3. In October 2014 The UR took a decision that the two remaining GUAs that PPB hold with AES would remain in place at this time[2]. The UR may however cancel these contracts at any time, subject to a 180 day notification period.

3.4. The decision to retain the remaining GUA contracts was informed by our analysis of the value of these contracts to consumers. This analysis included consideration of a proposal from PPB which reduced their current costs by £2.4 million per annum alongside a 'gain share' mechanism.

3.5. This price control implements the proposal that PPB made with additional efficiency savings as determined to be appropriate by the UR.

[1] Integrated Single Electricity Market High Level Design Decision - http://www.allislandproject.org/en/wholesale_overview.aspx?article=d3cf03a9-b4ab-44af-8cc0-ee1b4e251d0f

[2] Review of Generating Unit Agreements in Northern Ireland - http://www.uregni.gov.uk/uploads/publications/2014-10-10_GUA_Decision_Paper.pdf

4. Gain Share Mechanism

Utility Regulator Decision

4.1. The UR's decision encompasses a gain share mechanism. The effect of the gain share is that any surplus up to £10m, resulting from PPB's good management of the GUA contracts is split 80:20 between customers and PPB for the year in question. Any surplus in excess of £10m will be shared on a 90:10 basis.

4.2. Two exceptions will apply to this gain share:

1. UR is currently considering a number of applications from PPB in relation to recoverable costs. If approved, these will be a component of PPB's excluded costs and will increase the Dt cost. Given that these relate to historic activity under the gain sharing arrangement this inclusion could be seen to artificially reduce the surplus in a future year which would reduce the share PPB would earn.

2. PPB holds carbon credits that were obtained as a result of surplus free allowances that were allocated to the generators during Phase 2 of the European Union's Emissions Trading Scheme (ETS). As a consequence PPB is currently meeting its ETS obligations by drawing down on these free allowances rather than incurring the cost of purchasing EUAs. PPB's GUA costs are therefore currently understated. If the value of these allowances were not removed from the calculation of the surplus then customers would not benefit fully from those free allowances. An adjustment for these carbon credits will be added to the cost side of the calculation, thereby reducing the gross surplus, to ensure customers obtain the full value.

4.3. There was an objection raised to the 'gain share' in consultation with a suggestion that the PPB's gain share proportion should be less than that proposed or that an additional loss share should be implemented.

4.4. We have assessed these measures but do not consider them to be appropriate for the following reasons:

- PPB's offer to reduce their costs by £2.4m per annum was accompanied by the gain share as proposed.
- PPB would have to exceed a surplus of £14m on the GUA contracts in order to recoup this £2.4m.

5. Price Control Final Determination Elements

5.1. PPB's own allowed revenue or entitlement (Et) is calculated by the following formula:

Et = DEPt + RTNt + ICt + PDt

DEPt = means the depreciation amount determined from the depreciation of the PPB Regulated Asset Base on a 25 year profile and the New PPB Regulated Asset Base on a 5 year profile.

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

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

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

The **Et** allowance is the amount to be retained by PPB, out of which it pays its internal business operating costs.

Utility Regulator Decision

5.2. The UR Final Determination on PPB's revenue entitlement is summarised below;

Table 5.1: Summary of PPB's Entitlement Amount

Et Formula							
£m	**DEPt**	**RTNt**	**OPEX**	**WCF**	**Total ICt**	**ICt Profit**	**Profit (inc DEP, RTN)**
Current Price Control Decision (in 2014 prices)	0.377	0.103	2.594	1.747	6.204	1.863	2.342
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Difference from Current Control	-0.084	-0.059	-0.618	-1.125	-2.675	-0.931	-1.074

Depreciation (DEPt)

5.3. PPB has a relatively small Regulatory Asset Base (RAB). There is no ‘new’ RAB proposed for the Price Control period. In 1999, when implementing the separation of the PPB and SONI businesses, UR allocated a RAB of £4m to PPB.

5.4. The UR has determined that the value of the RAB at April 2015 is £0.950 million (in Oct 2014 prices) and a depreciation amount of £0.292 million is applicable.

The figures for the duration of the price control are shown below.

Table 5.2: Depreciation (DEPt)

DEPt						
Initial RAB						
Period Ending	31-Mar-15	31-Mar-16	31-Mar-17	31-Mar-18	31-Mar-19	31-Mar-20
RAB Value (£m)	0.950	0.658	0.366	0.073	0.000	0.000
Average Value (£m)		0.804	0.512	0.220	0.037	0.000
Annual Depreciation (£m)		0.292	0.292	0.293	0.073	0.000

Rate of Return (RTNt)

5.5. The UR has determined that PPB should be allowed a Weighted Average Cost of Capital (WACC) of 5.42%.

5.6. PPB’s RAB is almost fully depreciated as illustrated above, therefore the WACC and the associated return is a small component of the entitlement amount.

Table 5.3: Rate of Return (RTNt)

RTNt					
	Annual Apr 2015 - Mar 2016	Annual Apr 2016 - Mar 2017	Annual Apr 2017- Mar 2018	Annual Apr 2018 - Mar 2019	Annual Apr 2019 - Mar 2020
Return	0.044	0.028	0.012	0.002	0.000
Depreciation	0.292	0.292	0.293	0.073	0.000
TOTAL	0.336	0.320	0.305	0.075	0.000

Incentive Amount (ICt)

5.7. The UR has determined the following Incentive Amount;

Table 5.4: Incentive Amount (ICt)

ICt Formula				
£m	**OPEX**	**WCF**	**Total ICt**	**ICt Profit**
Current Price Control Decision (in 2014 prices)	2.594	1.747	6.204	1.863
UR Proposed Decision (in 2014 prices)	1.976	0.622	3.529	0.931
Difference from Current Control	-0.618	-1.125	-2.675	-0.931

OPEX

5.8. The UR has determined that PPB's OPEX will be capped at 2014/15 levels. The UR has determined this cap appropriate in order to drive further internal efficiencies.

Working Capital Facility (WCF)

5.9. The UR has determined a total cost of £0.622m for the working capital facility.

5.10. This reflects PPB's offer to reduce the size of the WCF to £20m. PPB will bear the risk both on cost and size of the facility required.

Profit

5.11. The UR has determined that the profit element of the ICt amount will be £0.931m. This represents a reduction of 50% on the previous Price Control.

5.12. It should be noted that this profit element must be considered in the context of the proposed 'gain share' incentive mechanism outlined in section 4.

Pension Deficit (PDt)

5.13. The UR published a position paper in December 2014 regarding cost recovery of pension deficit costs by regulated companies.

5.14. This determined that “Historic” pension deficits incurred before the 31 March 2015 will remain recoverable from customers but any new “incremental” deficits incurred after this date will become the responsibility of the shareholder

5.15. The UR determines that the pension cost of £104k included in PPB’s total OPEX figure is allowable as it relates to past service costs i.e. a “historic” deficit.

6. Next Steps

6.1. The UR will revise PPB’s licence to reflect this Final Determination and consult on these changes prior to implementation before the end of August 2015.