

**Power NI (Formerly NIE) Energy
Ltd –
Power Procurement Business
Price Control 2012 - 2015**

Decision Paper

26 April 2012

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1 **Executive Summary**

- 1.1 On 21 December 2011 the Utility Regulator published a consultation paper, outlining the proposals for the Power NI (formerly NIE) Energy Ltd Power Procurement Business (PPB) price control to apply from April 2012 until March 2015. One confidential response was received from PPB.
- 1.2 There were no disagreements put forward on a number of proposals; these being duration, structure and form, incentive weightings and allowance for depreciation. Reservations were raised about the allowed rate of return.
- 1.3 The Utility Regulator met with PPB prior to the receipt of responses on 13 February 2012 and, following the consultation responses, the Utility Regulator met again with PPB on 28 February 2012.
- 1.4 This paper outlines the Utility Regulator's decisions regarding the various elements of the price control which were discussed in the consultation paper:
- The current structure and form of the PPB price control shall remain unchanged.
 - The duration of the price control will be three years.
 - The allowed incentive amount is to be reduced by 10%
 - The decisions on allowed depreciation (DEP_t), allowed Rate of Return (RTN_t) and allowed Incentive Amount (IC_t) are summarised below.

Table 1 – Summary of DEP_t , RTN_t and IC_t allowances

<i>2010 Prices (£m)</i>	DEP_t	RTN_t	IC_t
Utility Regulator Decision	0.330	0.090	5.436

2 Introduction

- 2.1 Power NI (formerly NIE) Energy Ltd Power Procurement Business (PPB) was set up following privatisation in April 1992 as a separate regulated business under the Northern Ireland Electricity Transmission and Public Electricity Supply Licence. The role of PPB before the creation of the Single Electricity Market (SEM) was to purchase power under the long term legacy contracts (PPAs) from independently owned generators. Prior to the commencement of EU liberalisation 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 SEM PPB's role changed significantly in some respects. The business still continues to purchase power under the long term contracts but sells that power directly to the SEM pool. Furthermore the business 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. Thus 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.
- 2.4 On 21 December 2011 The Utility Regulator consulted on the proposals for the PPB price control for the period covering April 2012 to March 2015. One confidential response was received from PPB. This paper set out the Utility Regulator's decisions taking into consideration the response received.

3 Structure and duration of the Price Control

- 3.1 In the consultation paper of 21 December 2011 the Utility Regulator proposed that the current structure and form of the PPB price control should remain unchanged for the new price control for the period April 2012 to March 2015. There was a single confidential response to the consultation. No objections were raised to continuing with the current structure. There were also no objections raised to the three year duration of the price control.

Utility Regulator Decision

- 3.2 The Utility Regulator decision is that the current structure and form of the PPB price control shall remain unchanged and the duration of the control will be April 2012 to March 2015. This price control paper is concerned with the E_t term of the overall price control which is the calculation of PPB's allowed revenue or entitlement. This is the total amount PPB is allowed in the price control to be retained by the business itself out of which it pays its internal business operating costs. This formula is shown below:

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

Where:

DEP_t = means the depreciation amount 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.

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

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

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

As no objections were raised to the proposed weightings changes the following shall apply for the price control beginning April 2012:

4 Incentive Target Weightings

4.1 In the consultation paper there was a proposed amendment to the incentive target weightings as one of the previous targets is no longer relevant. No objections were raised to the changes in incentive targets.

Utility Regulator Decision

4.2 The following incentive target weighting will be applied for the April 2012 – March 2015 price control:

Table 2 – Incentive Target Weighting – PPA Costs

PPA Costs			
Description	Objective	Target / Reporting method	Weighting
Availability Payments	Challenge and verify availability declarations and payments	Enforcement of the contract. Demonstrated via PPB's testing (via SONI).	5%
Change in Law costs	Minimise costs passed through (FGD, SO ₃ , Ash disposal, etc.)	Costs minimised. Demonstrated via report to UR.	10%
Gas management	Ensure minimum contracted consumption is burnt	LTI3 minimum take consumed. Contractual compliance demonstrated ex-post.	3%
Gas costs	Ensure minimum gas costs	Ensure an effective gas purchasing strategy is developed and implemented. Demonstrated ex post.	17%
CO ₂ management	Meet surrender obligations	Ensure no penalties for non compliance. Demonstrated ex-post.	5%
Fuel Stocking	Ensure adequate fuel supplies	Agree strategy with UR/DETI and demonstrate compliance with the plan	7%

Table 3 – Incentive Target Weighting – Market Activity

Market Activity			
Description	Objective	Target / Reporting method	Weighting
Nomination processes	Compliance with bidding principles	Market Monitor Challenges of PPB Bids should be no greater than overall market average. Demonstrated ex-post.	5%
Market Revenue	Ensure revenue receipts are correct	Verify invoices and query all deviations. Demonstrated ex-post.	5%
Settlement Reallocations	Effective utilisation of Settlement reallocations (e.g. with the regulated NIE Energy Supply business)	75% of PPB's market revenue reallocated under SRAs (unless otherwise agreed with UR)	7%
CfD and Commodity cover position	Implement Risk Management in accordance with plans	Agree strategy/plan with UR and demonstrate implementation within the agreed framework	20%
Risk Management products	Increase product portfolio to align with supplier/ Customer needs	Demonstrate product portfolio development [and customer satisfaction]	6%
Manage counter-party risk	Minimise risk of bad debt through rigorous implementation of the Payment Security Policy	Full compliance with the PSP. Demonstrate ex-post.	5%
Manage interfaces	Ensure new interface arrangements operate effectively or are modified where deficiencies are identified	Effective operation of the interfaces with SONI and NIE T&D. Agreed modifications and referrals to UR for dispute resolution.	5%

5 Depreciation (DEP_t)

5.1 No objections were raised regarding the value of the original RAB or the “new” RAB

Utility Regulator Decision

5.2 As per the proposals in the consultation paper the values for depreciation will be those set out in the tables below. The initial Regulatory Asset Base (RAB) will be depreciated on a 25 year straight line basis.

Table 4 – Initial RAB

Initial RAB				
<i>period ending</i>	31-Mar-12	31-Mar-13	31-Mar-14	31-Mar-15
RAB Value (£m)	1.601	1.345	1.089	0.833
Average Value (£m)	1.473	1.217	0.961	
Annual Depreciation (£m)	0.256			

5.3 The new RAB is made up of assets invested in over the last six years and is mostly IT assets. This new RAB has an opening value at April 2012 of circa £0.07M and will be fully depreciated by April 2015.

Table 5 – New RAB

New PPB RAB				
<i>period ending</i>	31-Mar-12	31-Mar-13	31-Mar-14	31-Mar-15
RAB Value (£m)	0.072	0.024	0.006	0.000
Average Value (£m)	0.048	0.015	0.003	
Annual Depreciation (£m)		0.070	0.026	0.011

6 Rate of Return (RTN_t)

6.1 The Utility Regulator proposed that PPB should be allowed the same Weighted Average Cost of Capital (WACC) as applied in the SONI price control. Reservations have been raised regarding the level of return proposed in the consultation. However, given the small asset base it is acknowledged that there would be limited impact of a change to the WACC.

Utility Regulator Decision

6.2 WACC should be set equal to that of SONI at 5.68% for the new price control. This takes into account the reduction in the tax rate from 28% to 26% in 2012. The amounts PPB will receive under this proposal are illustrated below.

Table 6 – Rate of Return

	Annual	Annual	Annual
	April 2012 – Mar 2013	April 2013 – Mar 2014	April 2014 – Mar 2015
Return	0.086	0.070	0.055

7 Incentive Amount (IC_t)

- 7.1 The current incentive amount was based on 1% of PPB forecast turnover when the price control was set for 2007-09 and this formed the basis for the subsequent price control - November 2009 until March 2012. Currently, under this incentive for financial year 2011-12 the value of the incentive amount for 90% achievement is £5.823m and for 100% achievement £6.043m (2008 prices). 90% achievement is seen as the baseline score i.e. an “expected” score that is both reasonably obtainable but also reasonably challenging.
- 7.2 In the consultation paper it was proposed that the price control for 2012-15 should continue with this core figure of £5.823m. However in recognition of the reduced revenue as a result of the cancellation of the Generator Unit Agreements for the coal/oil fired Kilroot Generating Units No. 1 and No. 2 as of 1 November 2010¹, it was proposed that this figure be adjusted for inflation and reduced by 10%.
- 7.3 This 10% reduction to the total IC_t amount was chosen to reflect the reduction in revenue and responsibility of the PPB business, whilst recognising the functions still carried out by the business. The proposals are illustrated below the DEP_t and RTN_t elements are also included and are as defined previously.

Table 7 – Summary of allowances

	IC _t					
2010 Prices (£m)	DEP _t	RTN _t	OPEX	WCF	Total IC _t	Profit
Current Price Control	0.317	0.156	2.526	1.701	6.040	2.286
Utility Regulator Decision	0.330	0.090	2.273	1.531	5.436	2.052

Where:

$$\text{Profit} = (\text{DEP}_t + \text{RTN}_t + \text{IC}_t) - \text{OPEX} - \text{WCF}$$

- 7.4 The Utility Regulator met with the licensee on 13 February 2012 to discuss the Utility Regulators consultation proposals.

Utility Regulator Decision

- 7.5 The original proposal put forward by PPB requiring a margin in excess of £5.5m per year was not deemed appropriate for the purposes of this price control. A similar approach had previously been proposed for the recent

¹ Decision paper on the cancellation of generating unit agreements in Northern Ireland – 10 June 2010

http://www.uregni.gov.uk/uploads/publications/100610_GUA_Cancellation_Decision_Paper_Final.pdf

Power NI price control, this proposal was also rejected by the Utility Regulator².

7.6 The IC_t amount for the 2012-2015 PPB price control will be set at £5.436m.

Profit share proposal

7.7 PPB put forward a new proposal that would involve a form of profit share, where the business provided a benefit to consumers. This proposal was discussed further with PPB on 28 February 2012 and PPB provided further detail on the design of such an arrangement on 29 March 2012. This proposal will be considered in full by the Utility Regulator. However, it is not included for the purposes of the current decision but will be separately considered for inclusion during the price control period.

² For a detailed explanation please see Power NI (Formerly NIE Energy Supply) Price Control 2011-2013, Decision Paper, October 2011

8 Contract Cancellation

- 8.1 The consultation paper highlighted that all contracts could be cancelled subject to a 180 day notification period. There is no certainty with respect to cancellation of the remaining contracts³.
- 8.2 The consultation paper stated “However, with potential further cancellation in mind UR reserves the right to re-open the price control if further contracts are cancelled during this price control as this would see a change in PPB activities and possible operating costs. It may not be appropriate for a price control set in the context of all existing contracts to continue unchanged in the event of any future cancellation.”

Utility Regulator Decision

- 8.3 As outlined above and in the consultation document the Utility Regulator reserves the right to re-open the 2012-2015 PPB price control in the event that one or more of the contract are cancelled before 31 March 2015.

³ For further information please see the recent consultation Paper on Relevant Considerations in Relation to the possible Cancellation of Generating Unit Agreements in Northern Ireland (http://www.uregni.gov.uk/uploads/publications/2011-03-10_GUA_Consultation_on_Relevant_Considerations.pdf) and the further consultation paper on the same issue(http://www.uregni.gov.uk/uploads/publications/2011-09-09_2nd_Consultation_re_GUAs.pdf)

9 Other Issues

- 9.1 Whilst not specifically consulted on, the Utility Regulator's intention is to modify the PPB part of the Power NI supply licence regarding Past Service Pension allowance (currently recovered as "pass-through" via E_t) to ensure that any decision made on "Regulatory Pension Principles" as an outcome of the current Utility Regulator review of NIE Ltd Pension deficit (RP5) is applied equally to PPB.
- 9.2 The proposed licence change is included in Appendix B and reflects the changes applied to the Power NI licence⁴. These changes have since been accepted by Power NI. All other relevant licence changes are included in the Appendix B.

⁴ For further information see page 9 of "Power NI - Article 14 Notice for Price Control with Proposed Modifications" 16 December 2011

10 **Next Steps**

- 10.1 Licence changes will be required to be updated to reflect the decisions set out above. The Utility Regulator will draft the appropriate wording needed in the licence and consult on these changes prior to implementation.