The 2014 Power NI Supply Price Control

Decision Paper

19 December 2013



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; Electricity; Gas; Retail and Social; and Water. 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 paper sets out the Utility Regulator's (UR) final decisions for the next Power NI Supply Price Control (which begins 1st April 2014). This is the latest in a series of documents the UR has published in relation to this price control, the last of which was our Proposals consultation that was published in July. This decision paper outlines the rationale for the UR's decisions in relation to the main issues within the Control: customer coverage (scope) of regulated tariffs; duration of Control; operating costs (OPEX) levels and allocations; and allowed margin for Power NI.

Audience

Consumers and consumer groups; industry; and statutory bodies.

Consumer impact

This paper sets out the UR's decisions for the 2014 Power NI Supply Price Control. Once the Price Control process is complete, the framework will be agreed for Power NI's permitted costs and margin for the duration of the Control period. Subsequent tariffs will have to operate within these limits. This will therefore impact on the bills of price regulated customers. The number of non-domestic customers who may avail of a regulated tariff will also reduce as a result of this Control.

Contents

Table of Annexes

Annex	Author	Title
1	Airtricity	The Utility Regulator's Proposals for the 2014 Power NI Supply Price Control, Airtricity Response to the Utility Regulator
2	CCNI	Consultation: 2014 Power NI Supply Price Control
3	Power NI	The Utility Regulator's Proposals for the 2014 Power NI Supply Price Control, Consultation Paper. Power NI's Response
4	SONI	The Utility Regulator's Proposals for the 2014 Power NI Supply Price Control, Consultation Paper. SONI Response

Executive Summary

This decision document represents the completion of a formal review of the supply price control for Power NI. The technical licence modifications to implement the UR decisions will be issued in early 2014, with the Control itself to be in place from 1st April 2014. The UR welcomes the transparent process and constructive debates, with both Power NI and other stakeholders, which have been at the centre of this Control process. Since the introduction of competition in the supply market, the challenges facing Power NI in providing services to electricity customers now and in the future have been evolving. This price control process has been cognisant of that fact and we have discussed the issues openly with Power NI and other stakeholders throughout the project and its associated consultation phases.

Through the operation of this Control, the UR has sought to allow Power NI to recover efficiently incurred future costs so they may continue to provide the high quality services that consumers have come to expect and demand from their energy supplier, irrespective of who their electricity supplier may be. Examples of this are the UR has allowed an increase in the allowance for call centre/customer service staff and an increase for customer communication compared to the previous price control. There is also an increased IT running cost allowance for the new IT system Power NI have installed which can provide more information to customers. Overall we believe that this control determination strikes the appropriate balance between allowing Power NI the funding it requires to operate an efficient and first class energy supply business, whilst protecting customers and maintaining regulated prices as low as they can be.

Feedback to the Consultation

The UR published consultation proposals for the 2014 Power NI supply price control in July 2013 (the "Proposals")[1] and invited respondents' views on the key areas. The key areas identified were: Scope & Coverage, Duration, Operating Expenditure and Margin. The UR received responses from four stakeholders: Airtricity; the Consumer Council for Northern Ireland (CCNI); Power NI; and the System Operator for Northern Ireland (SONI).

The UR has published each respondent's full submission as Annexes to this document.

Scope & Coverage

Consistent with the Proposals consultation, the UR has decided to reduce the price regulated threshold to 50MWh annual consumption in the non-domestic market and to provide a 'Roadmap' that will automatically trigger a consultation on further price deregulation in the non-domestic sector. There will be no change to the scope and coverage of the domestic market.

The criteria that will automatically trigger a consultation on further end-user price control deregulation of the 0-50MWh pa non-domestic sector remain unchanged from our Proposals consultation:

1. *Power NI/Energia must have a combined market share (by consumed units) of less than 50% for two consecutive quarters; and*
2. *There is a minimum of 3 independent suppliers, each of which has at least 10% share of consumed units in the relevant market. For clarity,*

[1] The Utility Regulator, *The Utility Regulator's Proposals for the 2014 Power NI Supply Price Control – consultation paper,* published 23rd July 2013. A copy of this paper is available at http://www.uregni.gov.uk/uploads/publications/Power_NI_Price_Control_Consultation.pdf

what this means in practice is Power NI/Energia plus two other independent suppliers.

Duration

In line with our initial thoughts in the Approach consultation and restated in the Proposals consultation, the UR decision is to set a control for a period of 3 years. The control is therefore scheduled to run from April 2014 until March 2017.

Operating Expenditure

The UR carries out an analysis of Power NI operating costs at each price control review. Operating costs include items such as salaries, IT costs, bad debt and corporate overhead charges. As stated in our consultation paper the UR engaged expert consultants to carry out a review of the cost submissions made by Power NI. Based on these recommendations, our consultation proposed an allowance for OPEX which was lower than that requested by Power NI. Since the publication of the consultation we have had a further information exchanges with Power NI, as well as taking responses to the consultation into consideration. Following on from this, our final decisions include a number of amendments to the consultation proposals. These are further discussed in Section 3 of this paper.

The following table shows the Latest Best Estimate (LBE) for 2012/13, the Power NI proposals; the UR consultation proposals; the UR final decisions and the difference between the final decision and the Power NI's proposal (all in 12/13 prices).

Cost Category	LBE 2012/13 £m's	Power NI Proposal 2014/2015 £m	UR Consultation Proposals £m	UR Proposed Decision £m	Difference between PNI Proposal and UR Decision £m
Salaries	5.888	6.215	5.964	6.033	(0.182)
MBIS	3.409	3.243	3.083	3.083	(0.160)
Agency Costs	4.013	3.686	3.686	3.686	-
Outsourced	3.466	3.826	3.790	3.790	(0.036)
Corporate Costs	1.283	1.484	1.351	1.484	-
Bad Debt	3.228	3.263	2.960	2.960	(0.303)
Total (£m)	**21.287**	**21.72**	**20.83**	**21.036**	**0.681**

The table above highlights that the difference between the UR's final decision and the Power NI proposals is circa £681,000 (per annum).

Operating Expenditure Allocation

Power NI currently operates two different sections within their supply business. One offers the supply of electricity on a regulated basis that is subject to price control. The other is a non-price-controlled business through which Power NI offer non-price regulated offerings to non-domestic customers on the same basis as any other supplier. However, the two sections of the business share the same staff and assets. Hence these costs need to be allocated between the two separate businesses.

In our consultation proposals (at an aggregate level) 9.78% of the operating costs were to be allocated to the non-price regulated business as opposed to the 6.8% proposed by Power NI. In addition to this, the UR stated that past service pension deficit should also be allocated going forward (thus increasing the amount of passthrough to be allocated from that set out in the consultation proposals). There were a number of areas where Power NI disagreed with the drivers being used to allocate certain cost categories. Taking into account their consultation response we have amended a number of these drivers.

It is important to highlight that this allocation of costs to the non-price-controlled part of the business should not be viewed or classified as a 'disallowance'. The allocation of OPEX costs is to ensure that there is a fair proportion of the costs allocated to the unregulated business and that regulated customers are not paying more than their fair share. Power NI is entirely able to recover the costs allocated to the unregulated business through the tariffs they charge their unregulated customers.

The following table shows the final decisions on the allocation percentages (with the passthrough cost line including an allocation to the unregulated business for pension deficit cost). It should be noted that in each section the table shows the allocation of the Power NI proposal amounts and not the final UR decisions on the allowed OPEX. After final decisions on each OPEX item are taken the allocation calculations on the final allowed OPEX will be carried out. This will not materially change the figures shown below.

	2014/15[2] BEQ Costs (Power NI Proposal) £m's	Power NI proposed Allocation %	Power NI Allocation Amount £m's	UR Allocation % Decision	UR Allocation Amount Decision £m's
Salaries	£6.193	6.88%	£0.426	8.58%	£0.531
MBIS	£3.966	12.99%	£0.515	13.06%	£0.518
Agency Costs	£2.985	0.62%	£0.018	0.62%	£0.018
Outsourced Costs	£3.826	6.67%	£0.255	8.63%	£0.330
Corporate Charges	£1.484	15.34%	£0.227	17.92%	£0.266
Passthrough	£3,802[3]	2.1%	£0.080	14.36%	£0.546
Depreciation	£2.737	1.52%	£0.042	1.78%	£0.049
Total	**£24.995**	**6.26%**	**£1.564**	**9.04%**	**£2.259**

The final allocation decisions will allocate 9.04% to the unregulated business versus Power NI's proposal of 6.26% (this includes an allocation of past service pension deficit).

X Factor on OPEX to incentivise efficiency

In relation to the issue of X factor, the UR has considered all the relevant issues in detail and the UR's final decision is to apply an X factor of zero in this Control. The rationale is provided in the main body of the paper and the issue will of course be re-considered at future Controls.

[2] Passthrough and depreciation costs are not included in the total business OPEX forecast in previous page as they do not fall within the St term. Bad debts are included in the forecast but not the above as these are calculated separately for the regulated and unregulated business. The cost split between the categories in this table is different from those in the OPEX allowance table on page 4 but the aggregate total (for salaries, MBIS, Agency Costs, Outsourced Costs and Corporate Charges) is the same.

[3] The passthrough amount has increased from the consultation due to the correction for the inclusion of past service pension deficit costs.

Margin

The UR's final decision is for an allowed margin of 2.2%. This is an increase of 0.5 percentage points on the current allowed margin of 1.7% and is consistent with the margin that the UR proposed in our consultation. The UR remains acutely aware of the impact this decision will have on customer bills which we wish to ensure is kept to a minimum. Based on domestic consumption of approximately 3,800 kWh per annum, this factor in isolation from other aspects of the Control represents an increase in average household customer bills by circa 25 pence per month (or £3.00 per annum). However the UR must also ensure that regulated companies earn a sufficient return to reward the risk they face.

The UR believes the 2.2% decision to be a fair and reasonable allowance for the margin given the change in risk profile that Power NI has experienced as a result of the emergence of a competitive market. No new analysis was presented by Power NI to challenge the CEPA methodology as amended by ECA which formed the basis of the UR's July Proposals. This was not unexpected given the lengthy, constructive and iterative process of engagement between the UR, Power NI and the respective expert external consultants throughout the process of calculating an appropriate margin for a price controlled dominant in a competitive market.

Structure and Form

Respondents to the Proposals consultation largely view the existing structure and form of the control to be appropriate, as does the UR. Therefore, the UR has decided to continue with the existing structure notwithstanding the fact that the E_t term will require some drafting modifications to reflect the up to date position.

Overall Customer Impact of our decisions

The table below shows the overall differences between the UR and Power NI proposals on both OPEX and Margin, for each year of the three year control.

	Power NI Proposal	UR Decision	Difference
Margin	£11.1m	£8.14m[4]	£2.96m
OPEX	£21.72m	£21.036m	£0.68m
Total	£32.82m	£29.176m	£3.64m

As highlighted in the table above, the total difference between the Power NI proposals and the UR decision is circa £3.64m in each year of the control. This equates to a saving of £6 per annum per customer or c.1% of the regulated tariff.

Next Steps

In early 2014, the UR will formally consult upon proposed modifications to the Power NI licence that are necessary to implement the supply price control decisions as detailed in this document. In formulating the modification proposals, the UR will engage with Power NI to ensure accuracy and transparency of the required legal drafting. The UR will then duly consider all representations made during the 28 day consultation period.

Power NI will have the opportunity to accept or reject the supply price control via the licence modifications. If the licence modifications are accepted by Power NI, the supply price control is due to commence on 1st April 2014 and run until 31st March 2017. If Power NI does not accept the licence modifications, the UR may refer the matter to the Competition Commission (Competition and Markets Authority) for consideration. Their decision would be binding and final.

[4] This is based in an assumed forecast regulated turnover or £370,143,000.

Introduction

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Through the operation of this Control, the UR has sought to allow Power NI to recover efficiently incurred future costs so they may continue to provide the high quality services that consumers have come to expect and demand from their energy supplier, irrespective of who their electricity supplier may be. Examples of this are the UR has allowed an increase in the allowance for call centre/customer service staff and an increase for customer communication compared to the previous price control. There is also an increased IT running cost allowance for the new IT system Power NI have installed which can provide more information to customers. Overall we believe that this control determination strikes the appropriate balance between allowing Power NI the funding it requires to operate an efficient and first class energy supply business, whilst protecting customers and maintaining regulated prices as low as they can be.

Background

In Electricity, the primary statutory duty of the Utility Regulator (UR) is "*to protect the interests of consumers of electricity supplied by authorised suppliers, wherever appropriate by promoting effective competition*"[5].

Where competition is not sufficiently developed or effective, the UR protects consumers by regulation and this applies to the relevant areas of the electricity supply market as much as to other sectors of the energy industry. The UR decisions for the 2014 Power NI (formerly NIE Supply and then NIE Energy Supply) price control must be taken against this statutory duty backdrop. We consulted extensively and issued decisions on these competition matters during 2011 and early 2012.[6]

Although supply price controls have been removed in the electricity supply sectors in Great Britain (GB) and recently in the Republic of Ireland (RoI), this was in the context of significantly more mature markets and competition levels, as well as much greater market size and potential for truly effective competition to protect customers. This has not been the case in the Northern Ireland (NI) regulated electricity supply market, as well as other parts of the European Union (EU). Indeed, regulated end-user prices continue to operate in more than half of the Member States of the EU.[7] Up to now, due to Power NI's dominant position, all domestic customers of Power NI and their non-domestic industrial and

[5] Article 12 of the *Energy (Northern Ireland) Order 2003*.

[6] The Utility Regulator, *Regulatory Approach to Energy Supply Competition in Northern Ireland – a Utility Regulator Decision Paper,* published 11th May 2012. A copy of this document is available at http://www.uregni.gov.uk/publications/regulatory_approach_to_energy_supply_competition_in_ni_decision_paper.

[7] A joint publication of the Agency for the Cooperation of Energy Regulators and the Council of European Energy Regulators, *ACER/CEER Annual Report on the Results of Monitoring the Internal Electricity and Natural Gas Markets in 2011,* published 29th November 2012.

commercial (I&C) customers using up to 150MWh per annum are protected by a regulated tariff price control, as set out in Power NI's Supply Licence. I&C customers using above this threshold, and customers of other electricity suppliers in Northern Ireland, are not covered by the UR's supply price control regime.

However, throughout this price control process we have accepted that the issue of the "scope" of the Power NI control needed to be looked at. The UR has made evolutionary decisions to reduce the coverage of the 2014 price control which are set out later in this document.

About this document

The purpose of this document is to set out the UR's decisions in relation to setting the next price control for Power NI. The next price control period is due to commence in April 2014. We undertook the work to develop the new Control in a transparent and robust manner. The UR released an information note[8] setting out the planned timelines and various phases of the project leading up to April 2014; an 'Approach'[9] consultation which helped to shape our proposals; and a 'Proposals'[10] consultation which aided us in arriving at our final decisions.

This document sets out the UR's final decisions for the 2014 Power NI supply price control based on the best evidence available. The UR sought feedback on our proposals and these have helped us to amend our July Proposals as

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[8] The Utility Regulator, *Power NI Price Control Review 2014 – information paper,* published 9th November 2012. A copy of this paper is available at http://www.uregni.gov.uk/publications/power_ni_price_control_information_paper

[9] The Utility Regulator, *Approach to the 2014 Power NI Supply Price Control – consultation paper,* published 8th February 2013. A copy of this paper is available at http://www.uregni.gov.uk/publications/consultation_on_approach_to_the_2014_power_ni_supply_price_control

[10] The Utility Regulator, *The Utility Regulator's Proposals for the 2014 Power NI Supply Price Control – consultation paper,* published 23rd July 2013. A copy of this paper is available at http://www.uregni.gov.uk/uploads/publications/Power_NI_Price_Control_Consultation.pdf

necessary, and to shape our final determination. Sections 1 to 6 of this paper sets out our original proposals and the stakeholder feedback we have received. Each section then explains our final decision on each of the issues and the reasons why.

The following is a brief summary of what issue is the focus of each section of this decision paper:

- Section 1 details the amendments to the **scope of the control** for the non-domestic market and sets out the triggers that will prompt a consultation on further price deregulation in the non-domestic market;
- Section 2 outlines the **duration** of price control;
- Section 3 specifies the **allowance for operating expenditure**;
- Section 4 sets out the **allocation of the allowed operating expenditure** between the price-regulated and deregulated businesses in Power NI;
- Section 5 details the **allowed margin** for the price controlled part of Power NI's business;
- Section 6 outlines the **structure and form** of the 2014 Power NI price control; and
- Section 7 reviews the **timeframe and next steps** of how the price control will be implemented.

The UR received four responses to the Approach paper. Non-confidential submissions were received from the following organisations:

- Airtricity[11];
- The Consumer Council for Northern Ireland (CCNI)[12];

[11] Annex 1. Airtricity, *The Utility Regulator's Proposals for the 2014 Power NI Supply Price Control, Airtricity Response to the Utility Regulator*

[12] Annex 2. CCNI, *Consultation: 2014 Power NI Supply Price Control*

- Power NI[13]; and
- System Operator for Northern Ireland (SONI)[14]

A copy of each respondent's full submission have been published as annexes to this paper and can be found on our website – www.uregni.gov.uk.

[13] Annex 3. Power NI, *The Utility Regulator's Proposals for the 2014 Power NI Supply Price Control, Consultation Paper. Power NI's Response*

[14] Annex 4. SONI, *The Utility Regulator's Proposals for the 2014 Power NI Supply Price Control, Consultation Paper. SONI Response*

Equality considerations

As a public authority, the UR has a number of obligations arising from Section 75 of the Northern Ireland Act 1998. These obligations concern the promotion of equality of opportunity between:

i. persons of different religious belief, political opinion, racial group, age, marital status or sexual orientation;

ii. men and women generally;

iii. persons with disability and persons without; and

iv. persons with dependants and persons without.

The UR must also have regard to the promotion of good relations between persons of different religious belief, political opinion or racial groups.

In the development of its policies the UR also has a statutory duty to have due regard to the needs of vulnerable customers i.e. individuals who are disabled or chronically sick, individuals of pensionable age, individuals with low incomes and individuals residing in rural areas. Some of the above equality categories will therefore overlap with these vulnerable groupings.

In order to assist with equality screening of the proposals contained within this supply price control, the UR requested that respondents provide any information or evidence in relation to the needs, experiences, issues and priorities for different groups which they feel is relevant to the implementation of any of the proposals outlined in our February 'Approach' and July 'Proposals' consultations.

In our Approach and Proposals consultations, the UR asked the following questions regarding our equality considerations:

- *Do respondents agree that where this consultation has an impact on the groups listed, those impacts are likely to be positive in relation to equality of opportunity for energy consumers?*
- *Do respondents consider that the approach needs to be refined in any way to meet the equality provisions? If so, why and how? Please provide supporting information and evidence.*

No adverse equality considerations were highlighted by any respondent so the UR will proceed with the supply price control on that basis.

CCNI did highlight the need for the UR to engage with consumers as early as possible to ensure that consumers' priorities are delivered by the price control.

1. Scope and Coverage of the Control

UR proposals

1.1. Power NI is currently subject to price control regulation in the entire domestic market and in the non-domestic market for customers consuming up to 150MWh per annum (or with a 100 kVA Maximum Import Capacity if consumption data are unavailable).

1.2. It is appropriate that, having regard in particular to the developments that have occurred and continue to take place following retail market liberalisation, the scope and coverage of this price control regulation is kept under review – both specifically for the purposes of considering the scope of the 2014 price control for Power NI and more generally for the future. In February 2013 the UR published a consultation (the Approach consultation) indicating the approach that we proposed to take in carrying out that review.

1.3. With regard to the non-domestic market, the UR stated in our Approach consultation that we proposed to undertake an analysis of the market by reference to three market sectors representing customers consuming 0-50MWh, 50-100MWh, and 100-150MWh per annum.

1.4. The importance of carrying out a graduated analysis of the market was that it would allow us to consider our customer protection statutory duties in the context of the extent to which competition had developed (and the market position of Power NI as the former monopoly supplier had been eroded) to different extents in parts of the market representing different sizes of customer.

1.5. The three market sectors that we identified were chosen not merely because they constituted a convenient segmentation of the market for the purposes of analysing the development of competition in relation to different customers, but because they can be mapped against generally recognised categories of customer for the purposes of consumer protection.

1.6. Specifically, the 0-50MWh per annum part of the market is broadly equivalent to the statutory definition of a micro-enterprise[15], representing a category of non-domestic customers who are understood in practice to have little more buying power than an ordinary domestic customer. The 50-100MWh per annum part of the market maps against the extended definition of micro-enterprise that at the time of our Approach consultation Ofgem was considering[16] (and by the time of our later July consultation had decided to use[17]) for the purpose of defining the scope of certain supply licence conditions dealing with consumer protection matters. The 100-150MWh per annum part of the market reflects the group of customers who are more closely analogous to the currently non-price regulated part of the non-domestic market.

1.7. This is relevant because we must make decisions within the framework of our principal objective and general duties as set out in the Energy (Northern Ireland) Order 2003. Our principal objective (which is fully described in Article 12 of the Order) can briefly be summarised as the protection of the interests of consumers.

1.8. Where we consider that there is effective competition in a part of the market, we may be able to conclude that this is sufficient to protect the interests of consumers in relation to price, without the need for continuing regulatory intervention in the form of a price control.

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[15] Article 2(1) of "The Gas and Electricity Regulated Providers (Redress Scheme) Order 2008" defines the relevant consumer (micro-enterprise) as a non-domestic customer whose annual consumption is not more than 55MWh; or fewer than 10 employees and an annual turnover or balance sheet not exceeding €2million. As the UR will only be able to monitor consumption in 10MWh bands, therefore an equivalent of 0-50MWh will be used.

[16] Ofgem consultation dated 26th October 2012 titled "The Retail Market Review – Updated proposals for business".

[17] Ofgem publication dated 28th June 2013 titled "Implementation of the Retail Market Review non-domestic proposals – decision to make licence modifications".

1.9. The issues that arise in making such decisions are potentially complex. We are aware that in Great Britain – where competition has been established for much longer than in Northern Ireland and where there is a greater number of market participants – the efficacy of competition in ensuring the protection of consumers is a matter which continues to be the focus of considerable public and regulatory discussion.

1.10. For these purposes, in addition to the number of suppliers and their market shares, questions of market structure and vertical integration may be important. Moreover, it is necessary to recognise that any former monopoly supplier may enjoy a special position in the market, and that there is a large part of the customer base which (for a range of reasons) may not seek to take advantage of the competitive market.

1.11. We therefore consider that these issues need to be approached with caution and may require the incremental removal of price control regulation. We are satisfied that, in accordance with our principal objective and general duties, the right approach is to consider removing the price control only in those parts of the market in which an analysis of the available evidence is sufficient for us to conclude that customers can be adequately protected by the existence of established and effective competition.

1.12. We would not expect to be able to reach that conclusion in a part of the market in which Power NI retains a market share that is sufficient to constitute dominance.

1.13. The outcome of our Approach consultation, and our analysis of the three market sectors identified above, was set out in the consultation that was published in July.

1.14. Following our market analysis, the UR proposed to retain the price control in the 0-50MWh pa non-domestic sector; but remove coverage in the 50-100 and 100-150 MWh pa sectors.

1.15. The UR's analysis showed that Power NI (combined with its sister affiliate, Energia) retains a demonstrable position of market dominance with a 57% market share in the 0-50MWh pa market, i.e. in that part of the market which consists of those non-domestic customers which are statutorily defined as 'micro-enterprises'.

1.16. However, the dominance of Power NI/Energia in the 50-100 and 100-150MWh pa parts of the market was less clear. In particular, while they retained a very strong market position, we noted that Airtricity had also been able to establish a substantial customer base in these parts of the market. On balance we reached the preliminary view, for the purposes of consultation, that it would be appropriate to remove price control regulation in respect of these parts of the market. This was explicitly subject to the UR closely monitoring them to ensure that competition functions effectively in the future.

1.17. In addition to these proposals, the UR also proposed to adopt a roadmap that would set criteria which would automatically trigger a further consultation on the reduction or removal of the Power NI price control in the 0-50MWh non-domestic market.

1.18. The criteria to be satisfied were:

- *Power NI/Energia must have a combined market share (by consumed units) of less than 50% for two consecutive quarters; and*
- *There must be a minimum of three independent suppliers, each of which has at least a 10% share of consumed units in the relevant market. (For clarity, what this means in practice is that the market would consist of at least Power NI/Energia plus two other suppliers which are independent of them and which each have a market share of at least 10%.)* We note that this criterion is already satisfied as things stand today.

1.19. It is important to be clear that this roadmap merely outlined the basis on which a further consultation would take place, at which point all of the relevant factors would need to be considered in detail. The UR did not suggest that the automatic trigger for a consultation would necessarily involve the lifting of all or part of the residual price control, but merely the consideration of whether a further reduction in the scope of price regulation should occur. We would expect this to be subject to a range of factors, having regard in particular to the fact that in the case of the smaller non-domestic customers the need for consumer protection measures can be expected to be greater.

1.20. With regard to domestic customers, the UR clarified that we currently view the domestic market as one market, irrespective of the way in which customers decide to pay for the electricity that they consume. We have not outlined a specific roadmap for price de-regulation for the domestic market as the position in relation to that market is even more complex and will require detailed consideration of a wide range of factors, including in particular the need to ensure a high measure of protection for the interests of vulnerable consumers.

1.21. However, we have indicated the need for a general review of the effectiveness of retail competition in securing the protection of both domestic and non-domestic customers, and the implications of that for the regulatory policy framework. This formal Review has already been scheduled in the UR's preliminary Forward Work Programme for 2014/15.

1.22. In the light of this analysis, the UR asked the following question in the Proposals consultation regarding our proposals on the scope and coverage of the control:

- *The UR proposes to retain the Power NI price control for Non-Domestic customers consuming 0-50MWh or less per annum and remove coverage for those consuming 50-100 and 100-150MWh pa. Do respondents' agree with this proposal and if not, please explain your rationale?*

Feedback and UR comments

1.23. CCNI view the UR proposals for removing the price control for non-domestic consumers in the 50-150MWh sector, providing a roadmap for non domestic consumers in the 0-50MWh sector and retaining price control regulation for domestic consumers as "*sensible".*

1.24. CCNI highlight that:

> *"Without adequate protection, domestic and small business consumers are the group that is most likely to lose out in a competitive market. Without regulation in place energy suppliers can discriminate between different types of consumers. This has been seen in GB, where suppliers tagert customers they deem to be the most valuable with discounts, whilst disregarding those that they believe they can take for granted and will remain with them whatever they charge."*

1.25. Power NI does not agree with our proposals regarding the scope of the price control and contends that the non-domestic market in Northern Ireland is demonstrably competitive, consisting of four suppliers (or three if Viridian group companies Power NI/Energia are taken as one corporate entity) each of which has a market share in excess of 15% *if the non-domestic market is taken as a whole*. Power NI argues that there should be no price control applied to any part of the non-domestic market.

1.26. What follows is a summary of the main points raised by Power NI in their response to the Proposals consultation, and the UR's observations on and response to each.

1.27. Power NI contends that the UR has arbitrarily sub divided the non-domestic sector. Power NI also argues that retaining a price control for approximately 4% (by consumption) of the entire Northern Ireland non-domestic electricity market is not in the best interest of consumers.

- Our approach to the analysis of the non-domestic market was both set out and explained in the Approach consultation, where we indicated the three market sectors that we proposed to use for the purposes of that analysis. Having fully consulted on that approach, and carefully considered the responses received to that consultation, we were satisfied that it was an appropriate basis on which to assess customer protection requirements in the competitive market for the purpose of the Proposals consultation.
- We have summarised above the reasons for our approach. While it would have been possible to segment the market in different ways for the purposes of our analysis, we do not consider that the chosen approach is in any way 'arbitrary', since it was based on a clear rationale. Nor do we consider that it would have been appropriate to consider the regulated non-domestic market as a whole, given the wide range of customers – from the smallest micro-enterprises to substantial businesses – which fall within the 0-150MWh pa range. Our analysis was firmly grounded in our principal objective of protecting the interests of consumers, and the need for that purpose to have regard to the different characteristics of non-domestic customers with different levels of consumption.
- We have summarised above why we considered it appropriate to retain a price control within the 0-50MWh pa part of the market. While Power NI points out that this is a small part of the market in terms of consumption, it is important to note that it accounts by customer number for more than 80% of the non-domestic market. There are a total of c.49,000 customers in the 0-50MWh market sector out of a total c.59,000 customers in the entire non-domestic market. Therefore, while this part of the market does not account for a large

proportion of the total non-domestic consumption, it does represent the consumption of a very substantial number of micro-enterprises.

- Indeed, the representation made by Power NI only serves to emphasise the real importance of consumer protection in this market sector. Since a small part of overall non-domestic consumption is accounted for by a very large number of customers, it follows that each of those customers individually has very limited buying power. That is why micro-enterprises are recognised elsewhere as a special category of non-domestic customers requiring special protections. We cannot be satisfied that, in the light of the continuing dominance of Power NI/Energia in the 0-50MWh part of the market, retail competition has already developed to a level which is likely to be effective to ensure the protection of those customers and thus fulfil our statutory duties.

1.28. Power NI has also stated that setting a price control in the non-domestic market establishes an unrepresentative reference point and distorts the other parts of the competitive market. It argues that this is not in the interests of customers since price regulated customers may actually have to pay more than they would if there were no price regulation. Power NI also argue that the UR should not *"discriminate between suppliers and importantly [the price control] does not act as a customer protection tool".*

- As stated in both our Approach and Proposals consultations, the retention of supply price controls in parts of the market in which there remains a dominant incumbent supplier is a declared UR policy stance, having been fully consulted upon and decided during 2011 and early 2012.
- We have noted the representations of Power NI, but remain satisfied that the use of price control regulation in such circumstances serves the purpose of protecting the interests of consumers in accordance

with our principal objective and statutory duties. In particular, we consider that it will:

  - Prevent the potential for abuse of market power. An important goal of price control regulation is to ensure that prices are appropriate and fair – in other words that Power NI are not able to make excessive profits, and that prices reflect the underlying costs of supply.
  - Promote economic efficiency. A regulatory price control helps to improve economic efficiency by setting a cap on operating cost allowances.

- We have seen no evidence which would cause us to reach the conclusion that the maintenance of a price control is likely to distort the market generally or to give rise to customers paying more than they would have done in the absence of a price control. Since it has been possible for competition to develop in the other parts of the market while price controls were in place – and develop to the point to which it is possible now to consider removing price regulation in those parts of the market – we do not believe that the evidence supports the conclusion that the continuance of price regulation by itself is distortive of the market so as to prevent competition from developing.
- We do not consider that there is any basis for Power NI's implication that our proposals discriminate between suppliers. Where we have proposed to retain a price control in relation to Power NI, we have clearly demonstrated how that proposal is a reflection of Power NI's special position by virtue of its continuing dominance in the part of the market in which the price regulation would apply.

1.29. Power NI state that the UR is inconsistent in mandating managerial and operational separation between Power NI and Energia in their licences, but aggregating market shares for Power NI/Energia for the purposes of its analysis of the market.

- For the purposes of market analysis, we do not consider that there can be complete business separation between Power NI and Energia, as if they existed in separate corporate groups.
- It is correct that there are provisions for a ring-fence set out in Conditions 12, 13 and 45 of the Energia licence and Conditions 40E and 51 of the Power NI licence. However, the UR has always recognised that – while that ring-fencing is as effective as it can reasonably be made for the purposes of preventing cross-subsidies and sharing protected information – it is not the equivalent of the companies being in separate ownership. In particular, it does not preclude the co-ordination of general commercial strategy at group level, nor prevent either company acting, in accordance with publicly available information about the other, in a manner that maximises the overall interests of the group.
- For this reason, notwithstanding the ring-fencing requirements, it is recognised in a number of conditions of the licences that activities should be looked at on an aggregate group basis. For instance, in Condition 14 of each of the licences (Prohibition of Discrimination in Supply), the test of dominance is based on an aggregation of market activity across all affiliates and related undertakings. This reflects a standard approach in law which has never been disapplied in the licence of Power NI or Energia in consequence of their ring-fencing conditions.
- We have therefore concluded that there is no sound basis for not applying the usual approach to analysis in this case.

1.30. Another respondent to the proposals consultation, Airtricity, raised the point that the UR has not stated its intentions regarding the Power NI/Energia market share rising back above 50% in any part of the non-domestic market after the price control has been removed.

- Our Proposals consultation was focused on the lifting of price controls in an environment in which Power NI/Energia had a declining market share, and did not contemplate a situation in which market share might be rising. However, we agree that a symmetrical approach is appropriate and that the latter case, if it should occur, ought to be treated on the same basis as the former.
- Therefore, if the market share of Power NI/Energia (or indeed of any other entity or group) were to rise above 50% for two consecutive quarters in any of the defined parts of the Non-Domestic market, we propose that this should automatically trigger a consultation to explore the appropriate regulatory response.

1.31. Power NI has suggested that the domestic market should be disaggregated instead of being viewed as a single market, in particular by considering the market for supply to keypad customers as a market in its own right.

- At the present time, whether the UR were to separate the domestic market into two parts (keypad and non-keypad customers) or consider it as a single market, the analytical outcome would be the same – Power NI is still dominant across the whole of it. Therefore, price controls in relation to the domestic market remain justified, in accordance with the approach on which we have consulted, however the market is analysed.
- Power NI's submissions in relation to the keypad market are based not on the current data but on a prediction of the outcome of a trend in relation to the proportion of keypad customers that it supplies. As a general proposition, we do not believe that it could be appropriate for the UR to make decisions on the basis of what the position might be in

the future if current trends were to be extrapolated on a simple straight line basis.

- Aside from other considerations, it is planned that smart metering will begin to be rolled out in Northern Ireland on the timescale required by EU Directives (i.e. to achieve 80% penetration by the end of this decade). Smart meters will replace existing forms of metering and are capable of operating in both credit and (like keypad meters) prepayment modes, and of being switched between the two modes by remote communication. This is likely to substantially change any current or future market dynamics that are otherwise driven by metering.
- In any event, in the domestic market, as we have already indicated, that there are a wide range of considerations that would be relevant to any decision to lift a price control, not simply connected to market data. These would need to be fully explored in further consultations if the circumstances arose which made it appropriate to do so.
- The UR will of course keep the market data under review during the life of the price control. Moreover, as we have already noted we will be carrying out in the near future a general review of competition in both the domestic and non-domestic markets in accordance with our 2014/15 planned Forward Work Programme.

UR's final decision

1.32. Consistent with the Proposals consultation, the UR has decided to reduce the price regulated threshold to 50MWh annual consumption in the non-domestic market and to provide a 'Roadmap' that will automatically trigger a consultation on further price deregulation in the non-domestic sector. There will be no change to the scope and coverage of the control in the domestic market.

1.33. The criteria that will automatically trigger a consultation on further end-user price control de-regulation of the 0-50MWh pa non-domestic sector remain unchanged from our Proposals consultation:

1. *Power NI/Energia must have a combined market share (by consumed units) of less than 50% for two consecutive quarters; and*

2. *There is a minimum of 3 independent suppliers, each of which has at least 10% share of consumed units in the relevant market. For clarity, what this means in practice is Power NI/Energia plus two other independent suppliers.*

1.34. If the market share of Power NI/Energia (or indeed of any other entity or group) were to rise above 50% for two consecutive quarters in any of the defined parts of the Non-Domestic market, this will automatically trigger a consultation to explore the appropriate regulatory response.

1.35. The UR intends to monitor the 50-150MWh sector closely to ensure that competition is functioning effectively. This will include specific reports in relation to profits and pricing to be submitted by Power NI to the UR to facilitate that monitoring – the details of this will be discussed further and finalised with Power NI prior to the scheduled commencement of this price control in April 2014. This is in addition to two important work strands in the UR's 13/14 Forward Work Plan:

1. The UR's plan during 2014 to develop an electricity retail market monitoring system (REMM) for all suppliers that will use key indicators relevant to consumers; and

2. A review of the effectiveness of competition in the electricity supply markets and the required regulatory policy response.

2. Duration of the Control

UR proposals

2.1. In line with our initial thoughts in the Approach consultation, the UR proposed to set a control for a period of 3 years with the control running from April 2014 until March 2017.

2.2. The UR asked the following question regarding our proposals on the duration of the control:

- *Do respondents believe a control period of 3 years is appropriate? Please explain your rationale if you do not.*

Feedback and UR comments

2.3. Airtricity, CCNI and Power NI all agreed with the UR's proposal for a 3 year control period.

2.4. CCNI stated:

> *"The proposal appears to strike a fair balance between providing certainty for investment whilst allowing for adjustments to be made in a developing competitive market."*

2.5. In their response, Power NI stated:

> *"The question of duration is inextricably linked to the development of the UR's strategic roadmap";* and
>
> *"A 3 year control is a reasonable position to adopt given the changing nature of the retail electricity market."*

2.6. Power NI also asserts that a 3 year control should not be considered a long term control. The UR agrees with that assertion and characterise it as a medium term duration as opposed to a short term control that Power NI contend.

UR’s final decision

2.7. In line with the consultation proposals, the price control will be for a period of 3 years. This is scheduled to run from 1st April 2014 to 31st March 2017.

3. Operating Expenditure

UR proposals

3.1. The UR carries out an analysis of Power NI operating costs at each price control review. Operating costs include items such as salaries, IT costs, bad debt and corporate overhead charges. The UR engaged expert consultants to carry out a review of the cost submissions made by Power NI. There were detailed iterations with Power NI to understand the basis for their submissions. Following this engagement there were a number of areas where the consultants recommended that Power NI's cost submission requests be reduced.

3.2. Table 3.1 shows the Latest Best Estimate (LBE) for 2012/13, Power NI forecast for 2014/15, final consultant proposals and the UR's July Proposals for consultation (all in 12/13 prices).

Table 3.1

Cost Category	LBE 2012/13 £m's	Forecast 2014/2015 PNI Proposal £m's	UR Consultation Proposals £m's	Difference £m's
Salaries	5.888	6.215	5.964	(0.251)
MBIS	3.409	3.243	3.083	(0.160)
Agency Costs	4.013	3.686	3.686	-
Outsourced	3.466[18]	3.826	3.790	(0.036)
Corporate Costs	1.283	1.484	1.351	(0.133)
Bad Debt	3.228	3.263	2.960	(0.303)
Total (£m)	**21.287**	**21.72**	**20.83**	**(0.883)**

[18] This amount contains the running costs for the Enduring Solution system, which weren't included in the OPEX table in the July Consultation Paper.

3.3. Table 3.1 above highlights that the consultants had proposed to reduce Power NI's forecast OPEX by circa £883,000.

Salaries

3.4. Salaries have been forecast by Power NI to increase from the LBE level of £5.888m to £6.215m.

3.5. This increase is due to the fact that Power NI has forecast an increase in staff of circa seven FTE's for the year 2014/15.

3.6. We proposed that no allowance for the increase in headcount should be given, as it was in the context of increasing staff levels between FY12 and FY13.

MBIS

3.7. Within the MBIS category there are a large number of cost lines. As can be seen from Table 3.1 above there is circa £160,000 difference between the Power NI proposals for this category and those consulted on by the UR. This relates to:

- Printing and stationary (disallowance of £0.02m);
- Marketing (disallowance of £0.1m); and
- Journals/broking fees (disallowance of £0.04m).

Outsourced

3.8. The initial Power NI proposal was for £3.826m, however when this figure was being examined there was an acknowledged error of circa £36,000. Therefore the consultation proposal for outsourced was £3.790m.

Corporate Costs

3.9. In Power NI's submission, corporate charges were forecast to increase to £1.484 from the LBE figure of £1.283m. This is due to an increase in the overall level of corporate charges as well as an increase of the proportion that will be allocated to Power NI. We proposed that the allowance should remain at £1.283m.

Bad Debt

3.10. The UR proposed that the allowance for bad debt be restricted to £2.96m in 2012/13 prices, representing the average historical actual bad debt costs incurred from FY2010 to FY2013. During this period Power NI had significantly more customers than projected for FY2015. This equates to 0.672% of forecast turnover for the whole business. Therefore, the bad debt allowance for the regulated business would be set as 0.672% of the forecast regulated turnover.

3.11. The UR asked the following question regarding our proposals for the allowed operating expenditure:

- *Do respondents agree with the UR's proposals for the allowed level of Operating Expenditure for Power NI? If respondents disagree they should provide clear evidence and rationale as to their reasons.*

Feedback and UR comments

3.12. Power NI did not agree with a number of the proposals made by the UR in the consultation paper. They deemed them to be 'disallowances' by the UR. As well as carefully considering Power NI's response to the consultation proposals, we requested additional information in relation to a number of the cost areas.

3.13. In relation to the allowed level of OPEX, the other respondents did not make any substantial comments in this area. Below is the UR response to Power NI comments on the UR proposals for each operating expenditure category.

Salaries

3.14. In their consultation response, Power NI reiterated the arguments made during their interactions with the UR consultants BDO. They cited increased call handling activity, which has resulted in increased service effort. They also restated that there were increased levels of work in hedging activity as well as interconnector trading which requires one additional member of staff. Power NI argued that an additional member of staff in Strategic Development was simply to replace a member of staff who had left in 2012, therefore not actually new headcount.

3.15. The UR is of the view that an allowance for the additional 'front line' staff should not be given. Power NI have cited increased competition and switching to be amongst the reasons for increased activity. The increased activity has been managed in the LBE year without the requested additional five staff being required. Switching activity has decreased (Power NI's own forecast show a significant reduction in switching activity from 12/13 levels) and competition has been present in the market for a number of years. In addition to this, in the context of an already increased headcount and a shrinking customer base, the UR does not believe it to be appropriate to increase the cost allowance further in this area.

3.16. Our consultants also stated they felt there was insufficient evidence for the increased level of staff. With regard to the additional member of staff in trading, we have taken Power NI's rationale on board and are minded to allow this cost. We are of the view that it is a new activity and as such the cost should be allowed. We are also minded to allow for the additional member of staff in Strategic Development as this is replacing a member of staff who had previously left.

MBIS

3.17. Power NI focus on the marketing element of MBIS in their response, and state that:

> *"the main area of MBIS disallowance is under the heading of 'marketing'."*

3.18. Power NI repeated their arguments that the term 'marketing' is unhelpful in describing the cost line as, in their view, it relates primarily to customer communications.

3.19. Power NI use the example of communicating with customers regarding new product types and the importance of the requirements to explain these, and that this could result in a saving to an existing customer if they decide to take up this new product. In their interactions with our consultants, they stated that further competition in the sector will place increased demand on customer communications.

3.20. In their consultation response they state the need to ensure they keep pace with competitors in terms of communications:

> *"In forecasting marketing (communication) costs, Power NI not only considered the 'what to communicate' but the 'how to communicate'. Technology opportunities are driven by technological advancement and consumers driving need and increased expectations. Expectations are often driven by progressive competition and the need to provide similar channels e.g. competitors with mobile ready websites. If Power NI's communication methods do not evolve they risk becoming stale and losing customer interest."*

3.21. They state that they believe it is important that the UR recognises what is a reasonable amount to spend in the communication area. Power NI quote allowances per customer of £2.59 and £2.55 spent by the GB Big 6 and allowed by CER for Electric Ireland (ESB at the time). Based on these figures they believe that their forecast (which equates to £1.12 per customer) is modest and that the UR proposal of £0.95 per customer is not justified.

3.22. Whilst Power NI have cited other companies expenditure in relation to marketing activities as being much higher than that proposed by the UR, we would point to the Airtricity Gas (formerly Phoenix Supply Ltd when the control was set) allowance for marketing activities. The amount set for marketing activities in the current control for Airtricity Gas (on a per customer basis) is broadly equivalent to the amount proposed by the UR in its consultation.

3.23. We recognise the requirement to communicate with existing customers and are supportive of this. However, we are of the view, and Power NI themselves acknowledge this, that there is a 'fine line' between what can be an activity deemed as communicating with existing customers and what is deemed as customer acquisition.

3.24. In addition to this, Power NI has been operating in a competitive market for a number of years now so customer awareness of competition in the market has increased. As such, there is unlikely to be an increase (versus the current situation) in the requirement to communicate with them on issues related to this.

3.25. Finally, the UR proposal is to allow Power NI the same level of marketing as they have spent in the current financial year of circa £560,000 which in itself represents an increase in allowance from the previous control and is above historic trend when the rebranding exercise is adjusted for. We are of the view that keeping the marketing allowance at the current level of actual expenditure strikes the appropriate balance between keeping customers adequately informed and ensuring efficient spending levels.

3.26. Regarding the other (smaller) areas of broking/journals and printing & stationary, Power NI have acknowledged that the majority of the consultation proposal disallowance of £60,000 was appropriate.

Outsourced

3.27. Power NI made no further comment on this as they acknowledged that the initial cost submission contained a reconciliation error of circa £36,000, so was therefore not a disallowance. The UR will also engage with Power NI in respect to some transitional costs.

Corporate Costs

3.28. In their response, Power NI stated that citing their increased share of overall Viridian corporate charges was misleading as the apportionment methodology had remained consistent over time. They also argued that the services they receive from corporate are less costly than if they were undertake the functions as a standalone business:

> *"Undertaking such functions at a group level provides a degree of efficiency and economy of scale which could not be replicated within the business in isolation."*

3.29. Power NI also point to the fact that the increase in the forecast cost is due to a number of unavoidable IT costs such as the upgrade of the SAP system, IT refresh and the implementation of Cognos.

3.30. Following the Power NI response in coming to our final decision we have taken into account that the apportionment methodology for corporate charges has remained consistent and that the increase in costs is due to unavoidable new costs due to systems upgrades that are required by the corporate function.

Bad Debt

3.31. In their response to the Proposals consultation, Power NI highlighted their concern that averaging the bad debt figures over the previous three years means "*the bad debt allowance is based on the assumption that the next three years will be exactly the same as the last three*". They also stated the allowance for bad debt is *“demonstrably incorrect and fails to recognise the drivers of bad debt”*. Power NI identified the drivers of bad debt being the economic outlook and, to a lesser extent, market conditions.

3.32. The economic outlook presented by Power NI in their response paper is quite pessimistic and seems to suggest that the economy will not improve over the period 2014-17. It must be noted that this view appears to be formed from reports published in late 2012. Since the submission of Power NI’s response, many of these reports have since been updated and represent a substantially more positive outlook.

3.33. The table below shows GDP growth for 2013 is expected to be 0.8% higher than 2012 with a further 1% increase in growth expected in 2014. This is tracking 0.5% behind the general UK wide economy but it must be noted both are showing signs of recovery and an improvement in the economic conditions. It also highlights that the low point of GDP growth during the control period was 2011 and throughout 2012.

Table 3.2

GDP Growth (%)	2010	2011	2012	2013	2014
Northern Ireland*	0.8	0.3	-0.3	0.5	1.5
United Kingdom	1.8	0.9	0.2	1.0	2.0
Republic of Ireland	-0.4	1.4	0.4	1.1	2.2

Source: PwC[19]

[19] This data has been derived from two PwC reports; *Northern Ireland Economic Outlook,* published August 2012 and *Northern Ireland Economic Outlook,* published August 2013.
PwC Source: Office for National Statistics (ONS), PwC, Central Statistics Office, European Commission (for RoI 2013 and 2014)
PwC Note: *NI output growth measured by Gross Value Added (GVA)
Key: Shaded boxes represent estimates by PwC

3.34. Power NI highlighted that the rate of personal insolvencies was continuing to grow into the start of 2013 and in another part of their response they draw attention to the fact that increasing debt levels can further be compounded by the lag effect. The lag effect is a well understood concept that insolvencies will continue to rise for a period after the end of a recession.

3.35. An Insolvency Service report,[20] looking at the UK insolvency trend based on the recession of the early 1990's, showed a lagged effect of approximately 18 months from the end of the recession to the peak in both corporate and personal insolvencies. With regards to personal insolvencies, the report uses an example that if due to the contraction of GDP more individuals face unemployment and the associated drop in income, the likelihood that they become insolvent increases.

3.36. Power NI highlight that "*personal insolvencies in Northern Ireland hit a record high of 3,189 in 2012. This trend has continued in Q1 2013 with 3,231 insolvencies recorded over the last four quarters".* However, in line with the aforementioned lag effect, the most recent insolvency statistics for Q3 2013 shows the lowest quarterly individual insolvencies since Q3 2011 at 717.[21] It also shows signs that the trend is beginning to be reversed in Q3 2013 with 3,203 insolvencies recorded over the last four quarters.

3.37. Table 3.2 above appears to show the trough in GDP occurring in 2012 in the period from FY2010 to FY2013. GDP growth in Northern Ireland in 2014 is forecast to be almost twice the peak growth of 0.8% during the same period (experienced in 2010).

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[20] The Insolvency Service (an Executive Agency of BIS), *Insolvency and other economic factors – An introductory investigation of the link between insolvency and associated economic factors.*

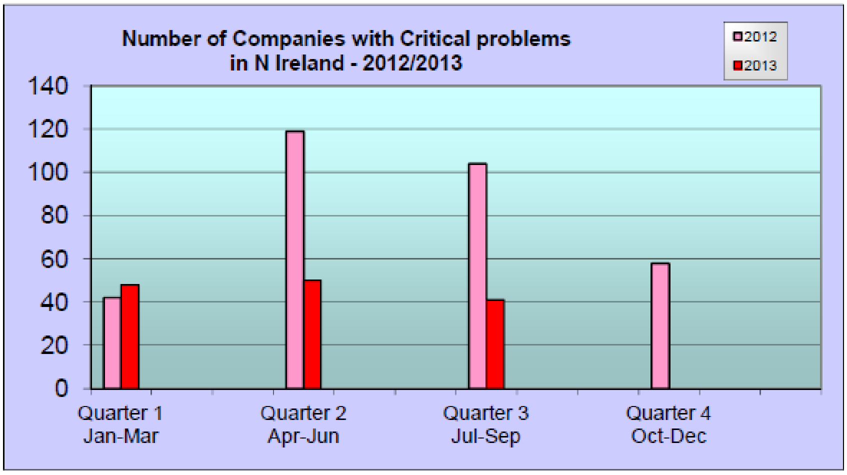
[21] National Statistics on insolvencies produced by The Insolvency Service and released on 1 November 2013. These statistics may be accessed at http://www.insolvencydirect.bis.gov.uk/otherinformation/statistics/201311/uksa/index.htm

3.38. The Ulster Bank PMI (Purchasing Managers' Index) report for October 2013[22] states that:

> *"the improvements in the Northern Ireland private sector seen in the third quarter of the year continued in October, with further solid rises in output and new orders recorded. Higher new business supported the strongest increase in employment in more than six years. Input prices continued to rise sharply and companies increased their output charges at a slightly faster pace in response."*

3.39. Furthermore regarding corporate performance, Begbies Trainor recently published their Red Flag report for Q3 2013. The Begbies Traynor report details the Northern Irish companies with 'critical problems'. These are defined as *"companies with CCJs totalling £5,000 or more and/or Winding-Up Petition or in a Voluntary Arrangement."*

Figure 3.1



Source: Begbies Traynor, *Red Flag Alert statistics for the UK Regions for Third Quarter (July-September) 2013*

3.40. The above graphic in Figure 3.1 for Q3 2013 highlights there were 41 companies with 'critical problems'. This is a circa 60% lower than the same period the previous year. Year on year trend for the first nine months of 2012

[22] Ulster Bank, *Ulster Bank Northern Ireland PMI,* published 11 November 2013.

compared to the same period in 2013 also shows an overall decrease in companies with critical problems of c 47%. This further supports the view that economic conditions are improving.

3.41. In addition to the general economic conditions, which Power NI state to be the primary driver of debt, they also cite market conditions as a reason for the increasing level of bad debt. The market related issues include the effect of (increasing domestic) competition, tariffs and more stringent revenue protection unit (RPU) practices.

3.42. The UR must highlight that competition has been in place in the domestic market since 2010. Recent evidence suggests that the number of domestic customers switching away from Power NI has significantly reduced from the levels experienced a year ago. This is recognised by Power NI in their switching assumptions within their BEQ submission to the UR. It therefore appears to be inconsistent to state there is an increased risk of bad debt from 'increasing' competition when customer attrition rates are decreasing.

3.43. Power NI highlight that the tariff has recently increased by 17.8% and believe other "*factors suggest that tariffs are likely to increase over the timeline of this review.*" The retail tariff decreased by 14.1% the previous year which demonstrates that the price regulated tariff goes down as well as up.

3.44. The UR acknowledges there has been a change to the RPU practices and Power NI has advised they believe it will remain at an increased level going forward. However, Power NI has not provided the UR with any quantification regarding the increase in level of RPU debt. Furthermore the new RPU procedures have been in place since May 2012 and the 12/13 year is included in the averaging calculation.

Passthrough

3.45. As stated in our consultation paper, there are a number of new cost items which were identified by Power NI which we feel should be treated on a pass through basis rather than set as allowances as the level of these is as yet unknown and they may not actually occur within the period of the control e.g. supplier obligation could potentially be removed/delayed by government. We recognised that there were three new cost categories for which we feel pass through recovery is appropriate and new drafting will be included in the licence modification within the E_t term. These categories are:

- European Target Model costs;
- CC&B Upgrade and hardware replacement; and
- Supplier Obligation Costs.

3.46. In our consultation we also stated that the proposed licence modification will include drafting in the E_t section that specifies that only costs which have prior approval from the UR (after appropriate scrutiny to ensure there is robust evidence to support the spend in the first instance and the level of spend in the second) will be recoverable. However, we now intend to communicate this new approval regime through a formal letter to Power NI rather than including it in the licence modifications.

3.47. Furthermore the letter will also communicate that any allowance approved under E_t will need to be assessed to ensure that it has been properly allocated between the price regulated and non price regulated parts of Power NI's business with only that amount allocated to the price regulated business being included in the Power NI regulated tariff revenue.

3.48. Power NI forecast that a number of smaller costs will occur on a one-off basis during the second and third years of the control. The UR intends to include for these items in the OPEX allowance. We proposed that an allowance of £100,000[23] per annum for the three years of the control be included as part of the OPEX allowance for these items in the consultation paper. This is not included in the table showing allowed OPEX in Section 3.

[23] This amount will also need to be allocated between regulated and deregulated business.

3.49. In their response Power NI welcomed the acknowledgement of these costs. In relation to the Supplier obligation costs, they noted that:

"Power NI expects that the energy efficiency aspects of Annex 2 of the Power NI licence will be removed when the Supplier Obligation is implemented."

3.50. We anticipate that if Supplier Obligation costs are to be recovered over the control period and the energy efficiency aspects of the current control are removed the allowance which will be given through the E_t term for supplier obligation will be net of the allowance in the control for the energy efficiency measures.

UR's final decision

Salaries

3.51. We have decided to allow for 2 additional members of staff, for the reasons cited above. This results in an allowance for salaries £6.033m.

MBIS

3.52. We are of the view that the MBIS allowance should remain unchanged from our consultation proposal of £3.083m

Outsourced

3.53. The final decision is the corrected figure for outsourced (as per the consultation document) of £3.790m.

Corporate Costs

3.54. We have taken into account Power NI's argument that the methodology for apportionment is consistent with other years. We have also considered the fact that there are a number of unavoidable IT costs which have increased the overall corporate charge. Therefore we will allow £1.484m for corporate costs.

Bad Debt

3.55. The UR's proposed allowance for bad debt was set as an average of the bad debt levels from FY2010 to FY2013. It should be noted this was in a period when Power NI had more customers than they do now. This represents an allowance of £2.96m of the forecast turnover for the entire business. This equates to a bad debt allowance equivalent to an allowance of 0.672% of turnover. Therefore, the bad debt allowance for the regulated business would be set as 0.672% of the forecast regulated turnover. This is higher than the bad debt to turnover ratio in any year from 2009 to 2013. It is also marginally higher than the ratio allowed in the Airtricity Gas control.

3.56. The Power NI bad debt levels for 2012/13 represent the peak cost over the period 2009–2013. It is also an increase of £576k from 2011/12 levels.

3.57. The UR continue to believe it to be fair and reasonable to calculate the bad debt allowance for the next three years based upon the average outturn of bad debt for the years from 2010-2013.

3.58. This is a reduction on the level forecast by Power NI. However, it provides a higher bad debt ratio than in previous price controls (and equal to the LBE percentage associated with bad debt) in recognition of the arguments Power NI have made.

Passthrough

3.59. In relation to the number of smaller costs which will occur on a one-off basis during the second and third years of the control, the UR intends that an allowance of £100,000[24] per annum for the three years of the control be included as part of the OPEX allowance for these items. Any items to be

[24] This amount will also need to be allocated between regulated and deregulated business.

recovered in E_t will need to be approved in advance and assessed for allocation between the regulated and unregulated businesses.

Operating Expenditure and Efficiency (X) factor

3.60. In the consultation paper we proposed that an X factor of 1% be applied to OPEX in the Power NI price control, being consistent with the current Airtricity Gas Supply Price Control.

Feedback and UR comments

3.61. In relation to the X factor, SONI did not support its application whereas both Airtricity and CCNI thought that its application was appropriate.

3.62. Power NI stated:

> *"Power NI fundamentally disagrees with the UR's proposed introduction of an efficiency factor and the consultation paper does not provide adequate justification for it."*

3.63. Taking into consideration the feedback received, we revisited the area of "frontier shift" (which is a calculated figure equal to real price effects less productivity growth factor less forecast RPI). Frontier shift assesses how much companies in a certain sector of the economy should outperform the general economy, as opposed to "catch up" efficiency which is applied to companies that need to actually move towards the efficiency frontier of the sector they are part of. First Economics carried out analysis for the UR in relation to this.

3.64. This analysis concluded that the resultant calculated frontier shift X factor for a retail energy company such as Power NI should be set at zero for the years 2014 to 2017. Therefore as we accept Power NI are at, or near, the efficiency frontier it is appropriate to apply an X factor of zero.

UR's final decision

3.65. On the basis of the First Economics analysis the UR had decided to reflect an X factor of zero in this Control.

Final decisions on Operating Expenditure

3.66. Table 3.3 below shows the final UR decisions on OPEX allowance.

Table 3.3

Cost Category	Power NI Proposal 2014/2015 £m	UR Consultation Proposals £m	UR Proposed Decision £m	Difference between PNI Proposal and UR Decision £m
Salaries	6.215	5.964	6.033	(0.182)
MBIS	3.243	3.083	3.083	(0.160)
Agency Costs	3.686	3.686	3.686	-
Outsourced	3.826	3.790	3.790	(0.036)
Corporate Costs	1.484	1.351	1.484	-
Bad Debt	3.263	2.960	2.960	(0.303)
Total (£m)	**21.72**	**20.83**	**21.036**[25]	**0.681**

[25] There is an amount for Depreciation of £272k which will be included in the finalised St amount.

4. Operating Expenditure Allocation

UR proposals

4.1 As highlighted in the Proposals consultation, Power NI currently operates two sides to their supply business. One offers the supply of electricity on a price regulated basis and is subject to the price control. The other is a non-price-controlled business through which Power NI offer non-price regulated supply offerings to non-domestic customers on the same basis as any other supplier.

4.2 However, the two parts of the business share the same staff, resources and assets. Hence the costs submitted by Power NI for the control, which are for the entire business, need to be allocated between these two separate businesses. The UR asked BDO to carry out the exercise to ensure the appropriate allocation of operating costs between the price regulated and unregulated parts of the business of Power NI.

4.3 It is important to highlight that allocation of costs to the price-controlled and the non-price-controlled parts of the business should not be viewed or classified as a 'disallowance'. The allocation of OPEX costs is to ensure that there is a fair proportion of the costs allocated to the unregulated business and that regulated customers are not paying more than their fair share. Power NI are able to fully recover the costs properly allocated to the price-unregulated part of their business through the tariffs they charge their non-price regulated customers.

4.4 Table 4.1 shows the Power NI proposals for allocation to the non-price regulated part of the business and the UR proposals for consultation (as recommended by BDO).

Table 4.1

	2014/15 BEQ Costs £m's	Power NI proposed Allocation %	Power NI Allocation Amount £m's	UR Proposed Allocation %	UR Proposed Allocation Amount £m's
Salaries	£6.193	6.88%	£0.426	10.55%	£0.653
MBIS	£3.966	12.99%	£0.515	13.06%	£0.518
Agency Costs	£2.985	0.62%	£0.018	0.62%	£0.018
Outsourced Costs	£3.826	6.67%	£0.255	14.49%	£0.555
Corporate Charges	£1.484	15.34%	£0.227	17.92%	£0.266
Passthrough	£1.829	4.36%	£0.080	10.52%	£0.192
Depreciation	£2.737	1.52%	£0.042	1.78%	£0.049
Total	**23.020**	**6.8%**	**£1.564**	**9.78%**	**£2.252**

Source: BDO[26]

4.5 The UR asked the following question regarding our proposals for the operating expenditure allocation:

- *Do respondents agree with the UR proposals for the allocation of the proposed allowed level of OPEX for Power NI? If not, respondents are asked to provide clear evidence and rationale as to their reasons.*

Feedback and UR comments

4.6 Power NI stated that they fundamentally disagreed with UR proposals for allocations of OPEX.

4.7 They cite their main concerns as being in three areas:

[26] Passthrough and depreciation costs are not included in the total business OPEX forecast in Table 3.1 as they do not fall within the St term. Bad debts are included in the forecast but not the above as these are calculated separately for the regulated and unregulated business. The cost split between the categories in this table is different from those in Table 3.1 but the aggregate total is the same (for salaries, MBIS, Agency Costs, Outsourced Costs and Corporate Charges) – also slight rounding difference.

- Replacing revenue with units as an allocation driver;
- Allocating debt collection team cost (within the salaries category) by units rather than by customer numbers; and
- Allocating billing system costs by a mix of units and bills as opposed to solely on bills issued.

Revenue versus Units as a Driver (various cost categories)

4.8 Power NI argues that revenues are a more appropriate driver than units.

4.9 As highlighted in the consultation paper, the UR is of the view (supported by the analysis carried out by consultants BDO) that allocating on revenues as opposed to units is problematic. BDO stated:

> *"The use of revenue as a cost driver is considered problematic for several reasons:*
>
> - *Regulated revenues are subject to K Factor adjustments, which may be substantial, due to over or under recovery in each year; and*
> - *Different prices may be charged to regulated and unregulated customers with unregulated customers, generally, having lower tariffs and thus being allocated a smaller share of costs."*

4.10 The UR is of the view that units is more appropriate as it gives a more accurate reflection (when compared to revenue) of where the business is being generated by the company and is not subject to impacts such as 'K' adjustments. It also gives an accurate picture of the actual volume of business being carried on through the unregulated business of Power NI.

Debt Collection Team Cost (within the salaries cost line)

4.11 The cost for Debt collection is within the salary cost category. It had previously been categorised within the outsourced cost category and as such was allocated on revenues. Power NI proposed that the majority of the costs within salaries be allocated on the revenue basis but that debt collection should be allocated on customer numbers. The consultation proposal was to allocate the cost on units (consistent with the proposal to change all revenue allocations to units). In their response, Power NI restated the rationale for using customers as the driver being that the enduring solution system allows for more accurate tracking of debt management activity on their system. They argued that the type of customer they have in the non-price controlled sector require minimum debt chase activity:

> *"Power NI's portfolio of customers in this sector, are overwhelmingly either governmental, local authority or blue chip commercial sites....this type of customer base ensures that the actual debt chase activity is kept to a minimum and this is supported by the analytical information available."*

4.12 They go on to state:

> *"Power NI therefore would strongly argue that there is no objective justification to change Power NI's proposed allocation from customers to units."*

4.13 However Power NI's recommended allocation would equate to less than £6,000 out of a cost of circa £928,000. This would point to the assumption that less than 0.2 of an FTE is responsible for debt management in the non-price controlled sector of their business. The UR is of the view that it is reasonable to assume that more employee effort would be required to manage the debt in relation to circa 3,000 customers. However, we accept that to allocate the cost on units is not a fair proportion either. In this context, the UR deems the equivalent of circa 1.5 FTE's is a fair and reasonable estimate of the amount of employee time.

4.14 We have amended the drivers from wholly units (as per our consultation proposal) to 20% on units and 80% on bills, with the rationale for using bills instead of customers being to remove keypad customers from the equation but use bills rather than customers to apportion the activity concerning the remainder of customers as one credit customer receives 4 bills per year but other customers receive 12 bills per year and potentially each bill sent may require action. This equates to an allocation of circa £44,000 to the non price regulated part of the Power NI business.

Billing System Costs (within MBIS cost line)

4.15 Within the MBIS cost category are the costs of the billing application and ICT costs. The consultation proposal stated that these should be allocated 80:20 by units and bills. Power NI proposed that they should be allocated on bills which would allocate only 1.46% of the cost to the non price regulated part of their business. This proposal was revised by Power NI to suggest that it should be allocated on bills but with a de-minimus level of circa £90,000 (based on a paper prepared for Power NI estimating the running cost of a steam driven unsupported billing system to serve up to 25,000 customers).

4.16 In their response to the consultation Power NI stated:

> *"Power NI accepted that £33k was instinctively not the correct amount to allocate to non price regulated in relation to billing system costs. The BDO proposal of £332k however is manifestly inequitable, unreasonable and not supported by any substantive analysis."*

4.17 Power NI have reiterated their updated proposal:

> *"Power NI proposed that the bills issued metric should be used with a £90k floor i.e. a £90k minimum reallocation if the bills metric calculated a lower amount. Power NI believes this represents a reasonable methodology to base the reallocation calculation as it is based upon expert analysis."*

4.18 As stated in our consultation paper:

> *"However the UR is uncomfortable with using a different methodology for allocation for these two costs and our view is that

the allocation methodology should be consistent across all cost categories. There is also an issue regarding the capital cost that would be required to build a standalone system which Power NI have not included in the £90,000 estimate."

4.19 Since publishing the consultation proposals, the UR asked their independent consultant to look at a breakdown of the costs which make up the billing application and ICT categories. The purpose of this was to establish the fixed and variable elements within them. Costs which are fixed should be allocated more equitably between the price controlled and non price controlled parts of the business i.e. on units and those that are variable should be allocated on the source that is driving them. Power NI and the UR's consultant engaged in discussions and analysis of the detailed cost lines to determine the proportion of the total cost for billing application and ICT which is fixed and that which is variable. Both the UR and Power NI accept that it is difficult to definitively pinpoint the proportions.

4.20 On this basis the consultant determined that a reasonable assessment would estimate that 20% of the costs are fixed and 80% are variable. In this context we are minded to allocate 20% of the cost on units and 80% of the cost on bills. This results in an allocation of circa £108,000 to the non price regulated part of the business. This is in the region of Power NI's proposal and also recognises that the non price regulated customer base is more technically complex to serve due to half hourly metering and the monthly billing cycle.

Passthrough

4.21 The UR stated in its consultation paper that any allowance approved under E_t will need to be assessed to ensure that it has been properly allocated between the price regulated and non price regulated parts of Power NI's business with only that amount allocated to the price regulated business being included in the Power NI regulated tariff revenue.

4.22 The UR also stated that it was our intention to allocate past service pension costs (which are allowed through the E_t term) between the price controlled and non price controlled parts of the business.

4.23 However, Power NI did not agree with this and stated:

"Power NI believes that the current methodology and allowance for pension recovery is correct. It would be wholly inappropriate and inequitable to reallocate a legacy issue which relates to past service prior to the concept of price or non-price control regulation to the non-price regulated business within Power NI."

4.24 The Power NI argument appears to be based on the notion that so-called 'legacy costs' should be allocated entirely to the price controlled part of the market, with the non-price regulated part of the market picking up only 'current' costs. However, the UR does not believe this logic withstands scrutiny.

4.25 The UR is unsure what it is exactly that causes the costs of a business, based only on the time period to which they relate, to be allocated specifically to the customers who are subject to a price control? The UR cannot see and has not been presented with any robust evidence that provides a logical connection between these things.

4.26 Nor can we see any good reason why domestic and micro business customers should bear all of the costs of a pension deficit which attaches itself to Power NI as an organisation, so that larger business customers can benefit from avoiding those costs.

4.27 The deficit costs are a cost of the business as a whole, and ought to be apportioned in shares calculated on a fair basis between the price controlled and non price controlled parts of the business.

UR’s final decision

Revenue versus Units as a Driver

4.28 We have decided to remain consistent with the consultation proposal that units will replace revenues as a driver.

Debt Chase (within the salaries cost line)

4.29 The cost of debt chase of £928,000 within salaries will be allocated 20% on units and 80% on bills. This equates to an allocation of circa £44,000 to the non price regulated part of the Power NI business.

Billing System Costs (within MBIS cost line)

4.30 We have decided to allocate 20% of the cost on units and 80% of the cost on bills. This results in an allocation of circa £108,000 to the non price regulated part of the business.

Passthrough

4.31 All E_t items must receive prior approval before any of the spend occurs and all E_t items will be allocated between price controlled and non price controlled business.

4.32 Past service pension costs will be allocated going forward, based on units, between the price controlled and non price controlled parts of the business.

Final Decisions on Allocations

4.33 Table 4.2 below shows the final UR determination of the allocation of the OPEX costs.

Table 4.2

	2014/15 BEQ Costs £m's	Power NI proposed Allocation %	Power NI Allocation Amount £m's	UR Allocation % Decision	UR Allocation Amount Decision £m's
Salaries	£6.193	6.88%	£0.426	8.58%	£0.531
MBIS	£3.966	12.99%	£0.515	13.06%	£0.518
Agency Costs	£2.985	0.62%	£0.018	0.62%	£0.018
Outsourced Costs	£3.826	6.67%	£0.255	8.63%	£0.330
Corporate Charges	£1.484	15.34%	£0.227	17.92%	£0.266
Passthrough	£3,802[27]	2.1%	£0.080	14.36%	£0.546
Depreciation	£2.737	1.52%	£0.042	1.78%	£0.049
Total	**£24.995[28]**	**6.26%**	**£1.564**	**9.04%**	**£2.259**

[27] The passthrough amount has increased from the consultation due to the correction for the inclusion of past service pension deficit costs.

[28] There is an amount for Depreciation of £272k which will be included in the finalised St amount and will have to be allocated – this allocation will calculated based on the units driver.

5. Margin

UR proposals

Margin

5.1. Power NI has historically accepted, at several recent price control reviews, a margin allowance of 1.7% of forecast turnover, including the last price control which is in operation until 31 March 2014. However, Power NI argued strongly at the last Control, and again in this current Control process, that this level of margin is now insufficient to compensate the business for the increased risk it faces in a competitive market.

5.2. Because of the significant focus on the margin issue at the last Control, from the outset of this Control project, the UR committed to look at this area afresh in order to determine an appropriate margin that is based on robust, transparent and theoretically-sound foundations. The calibration of margin was to be reviewed from both a theoretical and evidence-based perspective. This was undertaken by the UR with the aid of expert external advisors (ECA). We also engaged extensively with Power NI and their appointed expert advisors (CEPA).

5.3. Following lengthy interactions and a detailed review of the evidence, the UR proposed a margin of 2.2%. This was a proposed increase of 0.5 percentage points on the current allowed margin of 1.7%. The analysis underpinning the estimate indicated this to be a reasonable estimate of the appropriate margin for Power NI based on the risks they face, balancing the UR's statutory duties to protect customers while ensuring that regulated companies can finance their efficient licensed activities.

5.4. The UR is always cognisant of the impact any change may have on customer bills which we wish to ensure is kept to a minimum. As a guide, we highlighted that should the proposed increase in allowed margin take effect, this would raise the average household customer bill by circa 25 pence per month (or £3.00 per annum). This is based on domestic consumption of approximately 3,800 kWh per annum which is the average of Power NI domestic customer usage.

5.5. The UR asked the following question regarding our proposals on the allowed margin:

- *Do respondents agree with the proposed margin of 2.2%? If not, the UR would be grateful if you could explain your reasons why and provide supporting evidence.*

Collection Ratio for the S_t Allowance

5.6. Power NI's present arrangements have a mechanism that calculates the total S_t Allowed Revenue (which is the aggregate of operating costs and profit margin) for each year. This is collected on a ratio of a 67% fixed amount plus a variable amount collected on a per customer basis which is calculated as 33% of the total S_t divided by customer numbers. Hence as time moves on throughout the control Power NI will lose the per customer amount for each customer that ceases to take a supply from them and gain that amount for any new or returning customers who take up supply with Power NI. In this way Power NI total allowed revenue changes with the size of the customer base.

5.7. The UR sought a review of this apportionment to ascertain whether it was broadly correct and this was also undertaken by our consultants ECA. In their report on margin, they recommended a slight amendment to the apportionment so that it should be 70% fixed and 30% variable with customer numbers taken at the mid-point of the relevant year. As this was not a material change, the UR stated that we were minded to accept this recommendation.

5.8. The UR asked the following question regarding our proposal on the collection ratio for the S_t allowance:

- *Do respondents view the apportionment of the S_t allowance on a 70% fixed: 30% variable basis to be an appropriate calibration for amending the allowed OPEX and Margin as customer numbers increase or decrease?*

Feedback and UR comments

Margin

5.9. Respondents generally recognised and welcomed the detailed review that was undertaken for the allowed margin.

5.10. CCNI do not explicitly state their agreement for the UR margin proposal of 2.2%. However, the UR believe their agreement is implied as CCNI noted:

> *"We recognise that the exercise within the Price Control process that has reviewed the margin has been comprehensive. We also recognise that as competition develops there is a small increase in risk to the Power NI business. We trust that this comprehensive process involving Power NI representing its shareholders and the Regulator protecting consumers has produced a fair and reasonable outcome for consumers."*

5.11. Airtricity welcome the discussion around setting an appropriate margin but do not state either their support or opposition for the proposed margin of 2.2% that was set out in the UR's consultation document.

5.12. Likewise, SONI did not state their support or opposition for the proposed margin. However, they did comment that:

> *"SONI understands that selecting a relevant range requires particular expertise and experience in this area* [allowed margin] *and hence NIAUR determined to procure the services of two different consultants to provide NIAUR with the relevant advice. Perhaps it is testament to this point that in the finish, despite a quite a particular set of characteristics, the eventual range of appropriate answers was quite*

broad, making the selection of a sufficient point all the more difficult. As the monetary value of such a decision determines the underlying financeability of the business over the long term, just like the selection of a WACC point for asset-heavy organisations, the concept of 'aiming up' is just an important one. It recognises the fact that the overall cost implications of calling the point on the lower side of "right" rather than the higher side of "right" can far outweigh any benefits that might be initially associated with a persistent pursuit of cost cutting."

5.13. SONI also requested that the UR clarify SONI's 'fair bet' response to the UR's Approach consultation. SONI stated:

> *"...our agreement with NIAUR that shareholders should not expect to make supernormal or subnormal profits however we did not agree that this necessarily translates into what NIAUR terms 'a fair bet in which the chances of making money or losing money are equally balanced'. SONI explained that financial markets are underpinned by standard investors, who are in general risk adverse and require compensation, over and above a 'fair bet' where the odds are somehow equal in respect of reward or loss, in order to make investment. In the NIAUR proposals paper this has been somewhat misinterpreted as SONI stating that profits must be more than a 'fair bet'. SONI would like to see this point clarified by NIAUR in its final decision paper."*

5.14. Power NI believes that a supply margin closer to 3% (as supported by their previous analysis completed by CEPA) would be more appropriate than the 2.2% proposed by the UR. They also contend that that:

> *"...too much weight is placed by the UR on ECA's risk-based methodology particularly ECA's quantification of K risk and how investment/cost recovery risk is therefore accounted for in the UR's margin proposal. Power NI believes the CEPA method of calculating the margin based on the forecast capital requirements of*

the business, cross-checked to practical evidence of financeability constraints retail electricity trading businesses face, provides a more reliable estimate of the margin required."

5.15. In order to ensure a robust approach, ECA attempted to estimate the appropriate margin based on two separate methodologies: one taken from that advocated by Power NI's own consultants CEPA; and the second was a risk-based methodology developed by ECA around return-volatility.

5.16. The UR does not agree with Power NI that too much weight was placed on the ECA risk-based analysis. Indeed, the UR explicitly stated in the proposals consultation that we did not give superior weight to either the CEPA (capital base x cost of capital) approach or the alternative approach adopted by ECA of "returns-volatility". Our view was and remains that each provides a valuable 'sense check' for the other.

5.17. The first approach included an ECA review of the CEPA methodology and associated amendments to the margin requirement. This resulted in a Power NI margin requirement in the range of 2.1% to 2.5% of turnover, based on amendments ECA made to CEPA's methodology. While the reports are technical in nature, essentially the difference arose from a key difference in their assumptions:

- CEPA assumed that the business would use its banking facilities in full throughout the year, notwithstanding the availability of surplus equity when capital requirements are not at their peak; while
- ECA assumed that the business would use its banking facilities only when they are actually required.

5.18. The ECA alternative advanced an assessment of the margin via an appropriate reward for evidenced risk-based return volatility. This second approach resulted in a proposed margin of 1.4% for return volatility risk, plus 0.3% to 1.0% for wholesale cost risk which ECA described in paragraph 5.3 of their report. This method produced a recommended range of 1.7% to 2.4%.

5.19. Power NI provided a critique of the risk-based methodological approach adopted by ECA in their analysis in their response to the Proposals consultation. This is based on (i) capital and regulatory commitment and (ii) capital at risk. There was no new analysis presented by Power NI to challenge the CEPA methodology as amended by ECA.

Collection Ratio for the S_t Allowance

5.20. Both Airtricity and Power NI agree with the 70% fixed and 30% variable apportionment. Their support is on the basis that it is more reflective of the actual costs incurred by the business. Power NI also agreed with the UR that customer numbers should be taken at the mid-point of the relevant year.

5.21. CCNI state:

> *The only effect that this would appear to have is to marginally reduce the incentive that the apportionment mechanism provides for the company to improve its customer service. In the absence of any explanation for this change we can see no reason for it.*

5.22. In their report, ECA highlighted that the UR's arrangements for the calculation of the supply entitlement takes account of a key cost driver for the business, customer numbers. If customer numbers fall, the company would be expected to make some cost savings, but it would not realistically expect those savings to be proportionate to the reduction in customer numbers, at least not in the short run. ECA proposed the 70:30 apportionment as it was a more accurate reflection of actual costs incurred by Power NI.

UR's final decision

Margin

5.23. In line with our proposals, the UR's final decision is for an allowed margin of 2.2%. This is an increase of 0.5 percentage points on the current allowed margin of 1.7%. The UR remains acutely aware of the impact this will have on customer bills which we wish to ensure is kept to a minimum. Based on domestic consumption of approximately 3,800 kWh per annum, it represents an increase in average household customer bills by circa 25 pence per month (or £3.00 per annum). However the UR must also ensure that regulated companies earn a sufficient return given the risks they face as a business.

5.24. The UR believes this to be a fair and reasonable allowance for the margin. No new analysis was presented by Power NI to challenge the CEPA methodology as amended by ECA. That was not unexpected given the lengthy, constructive and iterative process of engagement between the UR, Power NI and the respective expert external consultants. As stated in the Proposals consultation, the constructive engagement allowed a robust and comprehensive analysis of work to be driven forward. The UR would once again like to thank all parties involved for their assistance in moving the debate along to a conclusion.

Collection Ratio for the S_t Allowance

5.25. The UR decision is that there should be a slight amendment to the apportionment of the S_t allowance. This is that the S_t allowance should be 70% fixed and 30% variable basis with customer numbers taken at the mid-point of the relevant year. This is not a material departure from the existing 67:33 arrangement but is a more accurate representation of the costs that are actually incurred by Power NI.

6. Structure and Form

UR proposals

6.1. The UR proposed to continue with the existing structure, notwithstanding the fact that the E_t term would require some drafting modifications to reflect the up to date position.

6.2. The UR asked the following question regarding our proposals on the structure and form of the control:

- *Do respondents continue to believe the existing structure and form remains appropriate for the next price control? If not, please explain what you believe the structure and form should be.*

Feedback and UR comments

6.3. SONI do not provide comment on this area and CCNI state they will *"take a view closer to the next price control is due"* owing to considerations surrounding the ongoing development of the Northern Ireland electricity market.

6.4. Airtricity *"agrees the existing structure and form are appropriate".*

6.5. Power NI *"considers the current structure and form of the price control as generally appropriate".*

UR's final decision

6.6. The UR decision is that the current structure and form of the control remains appropriate.

6.7. Drafting modifications are required to the E_t term of the Power NI licence. The UR will engage directly with Power NI through the modification drafting phase of the control. The UR will subsequently consult on all proposed licence modifications in early 2014.

7. Timeframe and Next Steps

7.1. The following table has been used throughout this price control review process. It highlights the various stages of the process and when each milestone was, or the UR anticipates it will be, achieved.

Table 7.1: Price Control Review timetable

Date	**Milestone**
November 2012	Utility Regulator information paper published
Early February 2013	Utility Regulator to send business efficiency questionnaire (BEQ) to Power NI
Early February 2013	Utility Regulator consultation paper on price control Approach to be published
26 February 2013	Stakeholder workshop
22 March 2013	Deadline for Power NI response to BEQ
22 March 2013	End of consultation period
April/May 2013	Follow-up with Power NI and other parties as necessary
23 July 2013	Utility Regulator to publish consultation paper
23 August 2013	Stakeholder seminar
August/September 2013	Follow-up with Power NI and other parties as necessary
01 October 2013	End of consultation period
19 December 2013	Utility Regulator to publish final decisions
February 2014	Utility Regulator to consult on licence modifications
March 2014	End of consultation period Deadline for Power NI to accept or reject licence modifications

7.2. In February 2014, the UR will consult upon proposed modifications to the Power NI licence that are necessary to implement the supply price control decisions as detailed in this document.

7.3. The UR will duly consider all representations made during the 28 day consultation period.

7.4. Power NI will have the opportunity to accept or reject the supply price control via the licence modifications.

7.5. If the licence modifications are accepted by Power NI, the supply price control is due to commence on 1st April 2014 and run until 31st March 2017.

7.6. If Power NI does not accept the licence modifications, the UR may refer the matter to the Competition Commission (Competition and Markets Authority)[29] for consideration. Their decision would be binding and final.

[29] The Competition and Markets Authority (CMA) will bring together the Competition Commission (CC) with the competition and certain consumer functions of the Office of Fair Trading (OFT) in order to promote competition, both within and outside the UK, for the benefit of consumers. The CMA will not initially be taking on any casework, which will remain with the OFT and CC until April 2014, but as a shadow body it will be empowered to make the necessary preparations to allow the new authority to assume its responsibilities next year.