Power NI Price Control Review 2014

Information Paper

09 November 2012

Introduction

1. This Information Note explains the Utility Regulator's plans and timetable for a new review of Power NI's price control arrangements. It is not a formal consultation paper, but is intended as an initial briefing for customers, Power NI, other retailers and other interested parties on the process that we will follow over the next 12-15 months and the key issues which we expect to consider during this time.

Background

2. Power NI (formerly known as NIE Energy Supply or NIEES) is the largest retailer of electricity in Northern Ireland. The company used to be the monopoly supplier to all electricity customers, but in recent years has faced competition from rival retailers as part of the deregulation and liberalisation of the island's energy markets.

3. As at March 2012, Power NI and its sister company within the Viridian Group, Energia, supply just over half (57%) of the electricity consumed in Northern Ireland. Other users are supplied by one of six rival retailers, of which Airtricity (24% share of market by units sold) and ESBIE (17%) have by far the biggest customer bases.

<u>Table 1: Units sold, March 2012</u>

	GWh			% of total	
	Power NI/ Energia	Other retailers		Power NI/ Energia	Other retailers
Domestic credit	150	36		81%	19%
Domestic keypad	79	10		89%	11%
Smaller SMEs	52	58		47%	53%
Larger SMEs	74	102		42%	58%
Large energy users	38	90		30%	70%
Total	392	296		57%	43%

Notes: smaller SMEs (small and medium enterprises) are classed as business premises with electrical demand below 70 kVA; larger SMEs are business premises with electrical demand above 70 kVA but below 1 MW; and large energy users are business premises with electrical demand above 1 MW. These are not official classes or market segments but are used to divide the non domestic market into large and small for the purposes of this paper.

Table 2: Customer numbers, March 2012

	No. of customers			% of total	
	Power NI/ Energia	Other retailers		Power NI/ Energia	Other retailers
Domestic credit	417,930	72,930		85%	15%
Domestic keypad	255,867	23,632		92%	8%
Smaller SMEs	35,289	19,228		65%	35%
Larger SMEs	2,174	2,587		46%	54%
Large energy users	68	105		39%	61%
Total	711,328	118,482		86%	14%

4. In recognition of Power NI's dominance in the market, prices to household customers and some, but not all, business customers are currently capped by a price control – i.e. a condition in Power NI's licence which requires the company to keep its tariffs below a fixed ceiling. The control acts to protect Power NI's customers against the exercise of market power and from increases in prices that might otherwise come about in a market where competition remains quite new.

5. The current price control was put in place on 1 April 2012 and is designed to run until 31 March 2014. At the time of writing, it seems highly unlikely that competition will have developed sufficiently by this point to protect all groups of customers. We are therefore working on the assumption that we will need at this time to put in place a new control , informed by the review outlined in this paper.

Timetable and Process

6. An outline timetable for the new review is set out in table 3.

Table 3: Review timetable

Date	Milestone
November 2012	Utility Regulator information paper published
End January 2013	Utility Regulator consultation paper on price control methodology to be published
End January 2013	Utility Regulator to send business efficiency questionnaire (BEQ) to Power NI
February 2013	Stakeholder workshop
Mid-March 2013	End of consultation period
End March 2013	Deadline for Power NI response to business plan

	questionnaire
April/May 2013	Follow-up with Power NI and other parties as necessary
End June 2013	Utility Regulator to publish draft decision for consultation
July 2013	Stakeholder seminar
End September 2013	End of consultation period
December 2013	Utility Regulator to publish final decision
January 2014	Utility Regulator to consult on licence modifications
February 2014	End of consultation period Deadline for Power NI to accept or reject licence modifications

7. As shown the timetable envisages that we will publish three documents between now and December 2013:

   - an initial consultation paper in late January 2013, in which the we will explain the options that we have when defining and calibrating Power NI's new price control and seek views from stakeholders on what we think might be the best approach;
   - a draft decision paper by the end of June 2013, which will contain provisional calculations of the Power NI operating costs and margin which are included in the St formula of the price cap formula; and
   - a final decision paper in December 2013.

We envisage that the entire process will be an iterative one and we will engage with Power NI and other stakeholders throughout.

8. We will issue a business plan questionnaire to Power NI at around the same time as the initial consultation paper, which will need to be populated and returned to us by no later than 31 March 2013. This will be when we expect Power NI to provide us with historical cost information, expenditure forecasts and supporting evidence for this data.

9. We hope that a wide range of interested parties will participate in the review process, including customers/customer representatives and rival retailers.

10. Power NI will need to participate fully in the consultation process alongside other stakeholders. Our ability to issue a final decision by December 2013 will then be dependent on the company providing us with timely and robust information by the above-stated deadlines.

11. Ultimately, the review will conclude with a proposal from the Utility Regulator to modify Power NI's licence. Power NI will be asked to consent to this modification in early 2014.

Issues to be considered during the review

12. The issues to be considered in the review will be set out in detail in the January 2013 initial consultation paper. The paragraphs below give a high-level overview of the issues we expect to cover.

Duration

13. Power NI was originally regulated via price controls that were fixed in advance for a period of five years. It has also more recently been subject to shorter term price controls of 1 year or 2 years duration.

14. The decision that we take about the duration of the next price control will need to take account of likely developments in competition. If there are grounds for thinking that competition will become increasingly well entrenched, or even if we find it hard to predict with any certainty how the competitive market will develop in the coming years, there will be an argument for setting a relatively short control so as to ensure that we have an opportunity to revisit Power NI's price control arrangements before too long. Conversely, if we can be fairly certain that certain customers are likely to need regulatory protection for the foreseeable future, there will be benefits in terms of incentives for cost efficiency in reverting to a longer price control.

15. We expect to consider this choice in more detail later in the process.

Structure/form of control

16. Power NI's current price control is fixed using the formula:

$$M_{st} = G_t + U_t + S_t + K_t + J_t - D_t + E_t$$

where, in year t:

M_{st} is the maximum average revenue that Power NI may collect per kWh of electricity supplied to customers;

G_t refers to the cost per kWh of the electricity that Power NI purchases on behalf of customers, which, so long as Power NI complies with its Economic Purchasing Obligation, is passed directly through to customers;

U_t covers the cost per KWh that Power NI pays for using the electricity network (these costs are regulated through the NIE Transmission and Distribution (T&D) price control);

S_t is an allowance set by the Utility Regulator to cover Power NI's own costs;

K_t is a correction factor which provides for under or over-recoveries in the previous year to collected by the business (under-recovery) or given back to consumers (over-recovery) in the current year;

J_t encompasses costs associated with buy-out from the Northern Ireland Renewables Obligation, with the D_t term representing any savings on the buy-out NIEES achieves; and

E_t is associated with costs which are uncontrollable and are passed through to customers on a 100% basis. These costs include licence fees; IT projects required in order to put in place the systems and processes to open domestic markets and allow customers to switch supplier such as NI2007 and Enduring Solution Stages 1 and 2; and past pensions deficit.

17. We have no specific intentions at present to modify this formula or to put in place an alternative form of control. Interested parties may, however, wish to alert us to improvements that we can make in this review when we consult next year.

Opex

18. One of the main work areas during the review will be to estimate the efficient level of Power NI's own operating costs allowance (these costs along with profit margin make up S_t in the above formula). These costs are mainly the operating expenditures that Power NI incurs in providing retail services to customers, including its staff costs, out-sourced billing and customer service costs, corporate overheads and provisions for bad debts. These costs are separate to the pass through operating cost items that Power NI recover through the tariff as part of the E_t mentioned above.

Table 4: Power NI's Opex allowances, 2012/13

	£m (2010/11 prices)
Staff costs	4.9
Materials and bought-in services	6.3
Bad debts	2.5
Outsourced expenditure	3.1
Corporate overheads	1.1
Total	**17.9**

19. When setting Power NI's 2012-14 price control, we asked Power NI for forecasts and breakdowns of each of these cost items and then challenged the projections that we received line by line. We could take the same approach to cost assessment in the current review.

20. We could also look at Power NI's operating costs in a much more aggregated way. For example, we might look to see whether costs can be expected to move naturally with a particular rate of change relative to RPI-measured inflation and simply roll forward today's costs at this rate.

21. Alternatively, it may be possible to benchmark costs per MWh to the costs incurred by other retailers in Northern Ireland or in the UK more generally.

22. We are currently exploring these options in more detail.

Margin

23. The other input to the S_t term in Power NI's current price control is an allowance for profit. The margin within the 2012-14 was set equal to 1.7% of Power NI's forecast turnover, consistent with the approach we have taken in previous reviews.

Table 5: Power NI's upfront profit allowance, 2012/13

	£m (2010/11 prices)
Net margin	8.9

24. Power NI has argued that it was wrong to simply rollover the approach we have used in the past. During the last price review, it made a number of submissions requesting that we should set an allowance for profit according to a capital base x cost of capital calculation, where the capital base comprised mainly the working capital and cash balances that an efficient retail business needs to hold in order to maintain reasonable credit quality in the eyes of outside investors.

25. We rejected the particular approach that Power NI put forward on the grounds that we could not see evidence that the company held, or needed to hold, the amount of capital that it was claiming for in its submissions. However, we recognise that we need to review the margin we allow in our price control calculation with reference to an up-to-date analysis of the relationship between risk and return and ascertain if the current level is too high, too low or appropriate for the next control period.

26. We will want to consider, in particular, what metric(s) we can use to define an allowance for profit – e.g. margin x turnover, capital base x cost of capital, profit

per customer, etc. – and what market evidence exists to help us benchmark the profits that owners of retail energy businesses expect to earn and assess their position relative to that of Power NI.

27. For the avoidance of doubt, we would not expect Power NI to resubmit the work that it has provided to us in the past in this area without significant modifications to address the concerns that we have previously raised.

Concluding remarks

28. This is not meant to be an exhaustive summary of all of the issues that we will be considering during the next 12-15 months, but it does highlight the key areas in which early thought is required.