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COMMENT ON UTILITY REGULATOR'S DRAFT DETERMINATION ON NIE TRANSMISSION AND DISTRIBUTION PRICE CONTROL

Dear Kevin,

ESB has reviewed the Utility Regulator's Draft Determination on the proposed price control for NIE and, as owner of NIE, offers the following observations.

Background

By acquiring NIE and promising to undertake significant capital expenditure, ESB made a firm commitment to Northern Ireland's electricity customers. This decision was predicated on a belief that Northern Ireland was an investor friendly location with a modern well developed regulatory apparatus. In particular, ESB had an expectation that fair and timely regulatory judgements would be rendered, honouring past agreements, giving due regard to precedent, and delivered in an open and transparent manner.

From that background, we are very unhappy at the general thrust of the Draft Determination, its stark departure from established regulatory norms in mature jurisdictions and by the specific proposals in respect of certain major cost elements.

We have experience of regulatory processes in Ireland and internationally, and in particular with the long-established practice in Great Britain. Consistency over time, giving rise to reasonable predictability of outcomes and credibility of the governing regime, is one of the bedrocks of good regulatory practice, and is especially important in the energy industry which has long lead times and investment cycles.

External Assessment

There are a number of important respects in which the approach adopted by the Utility Regulator is so much at variance with established regulatory practice that we engaged Prof. Stephen Littlechild, former head of OFFER, and now an eminent international consultant on regulatory matters (as well as adviser to Ofgem, among other regulatory authorities), to

review the Draft Determination. We wished to establish whether or not, by reference to what an investor in a regulated industry in the UK may reasonably expect, the proposals set out in the Draft Determination are consistent with good regulatory practice in respect of the matters concerned.

You will find Prof. Littlechild's views attached to this letter of response. His analysis and his emphatic conclusions demonstrate that the approach of the Utility Regulator in relation to the Draft Determination has been deficient and unsatisfactory.

Major Individual Issues

Considering first the individual cost issues on which specific proposals are made, the main points on which the Draft Determination proposes to depart materially from what might reasonably be expected are in relation to:-

- (a) the insufficient level of capital expenditure envisaged;
- (b) the review and retrospective adjustment of the allowable pension deficit repair costs;
- (c) the stated intention to make retrospective adjustments pending an investigation into capitalisation policies;
- (d) the proposal to introduce "*contestability*" in respect of much of NIE Powerteam's activities, and the proposal concerning recoverability of NIE Powerteam's employee pension costs;
- (e) return on investment.

(a) Capital Expenditure

The Draft Determination proposes to strike out large blocks and categories of capital expenditure which in NIE's judgement are necessary in order that the network can meet the needs of customers and to enable NIE to satisfy its statutory and licence obligations. This is a matter of fundamental concern to ESB as Ultimate Controller of NIE and as investor in that company. ESB in acquiring NIE gave undertakings in relation to investment in the network and to the welfare of customers in Northern Ireland. ESB must take the most serious view of proposals which grossly underfund the investment required to ensure a safe, secure, reliable network in Northern Ireland.

(b) Pensions

In relation to pension deficit repair costs, the Draft Determination envisages reviewing actions taken as far back as fifteen years ago, under price controls that by any normal reckoning are closed and final. Regulated entities have a reasonable expectation that decisions and practices of this vintage, long since settled, will not be reopened. The proposals here, which would entail reviewing matters in the knowledge of the Utility Regulator for many years and already retrospectively reviewed by it, would have the effect of dismantling all expectation of regulatory stability, and are contrary to the uniform practice in this respect in Great Britain and elsewhere. In effect the principle behind the Utility Regulator's proposals would require that each future price control would need to consider the current financial impact of each of those retrospective decisions and "true up" or "true down" the liability on the regulated utility arising from those historic decisions.

This would explicitly design a structural instability into the price control process with all the consequences that such instability would entail. A statement by the Utility Regulator that this is a “one off” adjustment does not and will not ease those concerns. The Utility Regulator will wish to take note of Prof. Littlechild’s observations on the pension issue, as on the other issues raised in this response.

(c) Capitalisation Policy

ESB is extremely concerned about the way in which the issue of the internal capitalisation policies of NIE and the OPEX allowance has been approached. This approach has the potential to adversely affect the reputation of NIE and the wider ESB Group. On the headline point, ESB accepts that it is right to review the performance of NIE at the end of a price control period. It is wrong, however, to seek to retrospectively change the basis of the RP4 price control. The capitalisation issue was addressed explicitly and in a considered way in the RP4 process, when the UR determined that the issue should be approached at a high level on the basis of fundamental principles, and drew its conclusions accordingly. I refer to the UR’s papers of December 2005 and September 2006 which state very clearly a preference for a high-level approach rather than a “traditional” approach for reasons stated by UR to include a wish to be “collaborative”, and to avoid “expensive and expansive work”. While I accept that the Utility Regulator is entitled to adopt a more detailed approach to RP5, it would be improper now, and inconsistent with minimal standards of regulatory certainty, to re-open the RP3/RP4 determinations in the manner proposed.

(d) NIE Powerteam

A proposal that NIE be required to put substantial transmission and distribution work out to tender, rather than be entitled to deploy NIE Powerteam for that work, misunderstands the position of NIE Powerteam as a core part of NIE’s business. NIE Powerteam was established, with NIE employees but as an entity legally separate from NIE, as a management initiative to provide focus and priority to a distinct set of activities. The Utility Regulator acknowledges (and implicitly endorses) the current arrangements with NIE Powerteam in various provisions of NIE’s licence, including those which implement the RP4 price control. The essential point is that NIE Powerteam’s activities are of their nature inherently part of the network provider’s activities. This is borne out by the fact that 1,000 of NIE’s 1,200 employees are assigned to NIE Powerteam. The UR’s proposal appears to be predicated on the mistaken assumption that NIE Powerteam is a simple service provider. This is clearly not the case. As regards the pension rights of employees of NIE Powerteam, these are identical to those of NIE and the associated costs should be recoverable from customers in the same way as those associated with NIE employees.

(e) Return on Investment

The various proposals set out in the Draft Determination would, as well as underfunding the amount needed by NIE to satisfy its statutory and licence obligations, have the effect of allowing NIE insufficient revenue to provide ESB as investor with a reasonable return on its investment. Under the Utility Regulator’s “minded to” position on WACC and taking account of the inadequate provisions for pensions, OPEX and incentives, NIE’s return on equity during RP5 would be less than 2%. The effective return would be lowered further taking into consideration the Utility Regulator’s proposed underfunding in respect of capex. There is no rational reason why the Utility Regulator should expect NIE’s investors to bear at least as much risk as investors in GB DNOs, but for a massively lower return. On the contrary, when regulatory risk, relative scale of operation, and peripheral location are factored in to the consideration, an argument for a higher return is compelling.

I want to respond to a specific comment at paragraph 16.7 in the Utility Regulator's draft proposals. In response to the NIE statement that NIE will need to compete for funding with the other 15 UK DNOs, the UR stated that:

The primary determinant of NIE T&D's ability to obtain and maintain investors confidence is whether the returns that NIE T&D can offer investors sits no lower than NIE T&D's cost of capital. If we were to follow NIE T&D's proposal, electricity customers in NI could incur higher charges than necessary. In practice, the equity investor in NIE T&D is currently ESB and it is not obvious that NIE T&D is "competing" with the other DNOs for ESB's equity investment.

Emphasis added



This response misses the point completely. NIE will require access to capital markets to raise funding necessary for its future investment programme and will need to compete with other DNOs for this purpose. A comment that NIE is not competing with other DNOs for ESB's equity investment is entirely irrelevant. These matters are of fundamental and profound importance to all and demand much greater consideration by the Utility Regulator. This is evidenced by the public comments of Fitch Ratings which were independently offered, are objectively based and indicate a clear negative sentiment should the Utility Regulator's proposals be maintained in their current form.

It is clear that a decision to proceed on the basis envisaged in the Draft Determination could not fail to have serious consequences as regards ESB's investment and perspective in Northern Ireland.

Bankability of NIE

Related to the question of return on equity is that of NIE's capacity to fund the investments necessary to maintain and develop the networks.

The overall effect of the proposals set out in the Draft Determination would be to deprive NIE of the revenue appropriate to its functions and which is available, by efficient and innovative operation within a mature regulatory framework, to DNOs in Great Britain. An inevitable consequence would be a decline in NIE's creditworthiness and therefore in its capacity to raise efficiently the finance necessary for its activities. The Utility Regulator will be aware that the T&D licence requires NIE to maintain an investment-grade rating.



The financeability of NIE's business would be adversely affected by the heightened regulatory risk that is introduced by the Draft Determination. Ratings agencies and investors place heavy reliance on the stability and predictability of the regulatory regime and implementation of the proposals in the Draft Determination would significantly undermine confidence in the regulatory model. The proposals as presented would also severely affect the financial position of the company and would hamper NIE's ability to access the capital markets. The recent commentary from Fitch provides evidence that the Draft Determination introduces significant concerns for investors with regard to the regulatory model and with regard to NIE's ability to maintain its investment grade credit rating and ability to raise finance in the market. To forestall this outcome, ESB expects that the Utility Regulator will recognise the need to make substantial revisions across the whole range of proposals set out in the Draft Determination.

Conclusion on the Proposals

The upshot of the proposals set out in the Draft Determination would be a price control which would not in the best interests of NI customers, and to damage materially the earning capacity and financial position of NIE, on a basis that is not consistent with GB regulatory practice, involves overturning established principles of good regulation, and is not justified by arguments presented in the Draft Determination itself and is not supported by evidence.

Regulatory Process

There is also the matter, upstream of the particular proposals in the Draft Determination as published, of the general approach taken to the process of developing this document, involving considerations of consultation, timeliness and timetables, the quality of the Utility Regulator's engagement with NIE, and ultimately the depth of the Utility Regulator's understanding of the T&D business.

It appears to ESB that there has been a serious lack of consultation and dialogue by the Utility Regulator with NIE in connection with RP5. In the normal course of a well-run regulatory process there would have been extensive two-way engagement, involving site visits, face-to-face meetings between consultants and access to consultants' reports. This would have led to the progressive development on both sides of a thorough understanding of the imperatives which should guide the process. This bilateral process ought to have occurred prior to the publication of a document setting out proposals to make material changes in the way regulation is conducted and the entitlements of a regulated entity are established.



Conclusion on the Draft Determination and Process

ESB has experience of working in many countries throughout the world and we are very surprised and disappointed by what appears to us to be the unilateral and inconsistent approach taken so far by the Utility Regulator in relation to RP5.

ESB understands that NIE remains committed to co-operate to the fullest extent with the Utility Regulator, and to make available its detailed knowledge and expertise in a meaningful two-way engagement. The common objective of ESB, NIE, and the Utility Regulator must be to meet the needs of customers, in the short and long terms, by providing for comprehensive infrastructure development, and tightly-controlled expenditure in the delivery of that infrastructure, within a framework that allows for meaningful remuneration of investment consistently with mature regulatory practice.

Yours sincerely,

Peter O'Shea
Head of Regulation and Strategy

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