

# **Northern Ireland Electricity Transmission and distribution price controls 2012-17**

**Final determination**

23 October 2012

## 1 ABOUT THIS DOCUMENT

- 1.1 This document outlines our final determination for the fifth price control for Northern Ireland Electricity Ltd. This control will apply from 1 January 2013 to 30 September 2017. It is referred to as RP5.
- 1.2 This document contains a summary of the analyses we have undertaken to reach our final position for RP5.
- 1.3 We have also prepared an executive summary paper that includes further information about our analyses and the final determination. The paper can be accessed by clicking [here](#).
- 1.4 This price control will affect the network tariffs that are paid by all those who consumes electricity in Northern Ireland, or who generates electricity in Northern Ireland or Ireland and participates in the Single Electricity Market.
- 1.5 We published our draft determination, which set out our initial proposals, on 19 April 2012. The consultation closed on 19 July. We received 32 responses to the consultation and have published these on our website alongside this document<sup>1</sup>. We would like to thank all respondents and attendees at the stakeholder events for the time and effort they contributed to this process.
- 1.6 We have also published a separate document that outlines the key points made in each of the consultation responses, along with our comments on these. This responses document is also available on our website<sup>2</sup>
- 1.7 We assessed the consultation responses in the light of our statutory duties. In coming to our final decisions we fully and carefully considered each of the responses. We also carefully considered any new information that NIE T&D submitted.
- 1.8 The outcomes that we expect to be delivered during the RP5 period (2013-17) are summarised in Table 1.1.
- 1.9 This price control will be implemented through modifications to NIE T&D's licence. These modifications are published for consultation in a separate document<sup>3</sup>. NIE T&D and other interested parties have four weeks to respond to the consultation on these.

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<sup>1</sup> [http://www.uregni.gov.uk/electricity/price\\_control/](http://www.uregni.gov.uk/electricity/price_control/)

<sup>2</sup> [http://www.uregni.gov.uk/electricity/price\\_control/](http://www.uregni.gov.uk/electricity/price_control/)

<sup>3</sup> [http://www.uregni.gov.uk/electricity/price\\_control/](http://www.uregni.gov.uk/electricity/price_control/)

**Table 1.1: Expected outcomes for RP5**

Strategic theme	Expected outcomes (to be delivered within the revenues we set)
Security of supply	<p>Maintain and develop an economic, safe, stable and reliable network.</p> <p>Ensure a timely and effective response to all new demands on the network (new connections, load growth &amp; renewables).</p>
Sustainability	Facilitate delivery of the renewable target in the Department of Enterprise, Trade and Investment's (DETI) Strategic Energy Framework.
Customer service	Maintain continuous good customer service (as measured by 'customer minutes lost' and Guaranteed Standards of Service' metrics).
Other	<p>Have effective business processes and information and reporting systems in place to ensure that regulatory reporting is transparent.</p> <p>Design and implement a programme to achieve best practice in asset management. This should include measuring asset condition and serviceability effectively (using, for example, load and asset health indices) in order to ensure that plans for the next price control period (RP6) are fully justified in terms of need, optimum intervention strategies, efficient costs and appropriate risk sharing.</p>

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## **2 INTRODUCTION**

- 2.1 In our role as The Northern Ireland Authority for Utility Regulation (the Utility Regulator), our principal statutory objective is to protect the interests of electricity consumers. We do this in relation to electricity generation, transmission and supply. We also regulate the water and gas industries in Northern Ireland.
- 2.2 The transmission and distribution of electricity are generally accepted as being monopoly activities. In Northern Ireland the assets that are required to carry out these activities are owned by the transmission and distribution business of Northern Ireland Electricity Limited. The company is also responsible for planning, developing and maintaining these systems. We refer to Northern Ireland Electricity Ltd as NIE T&D throughout this document.
- 2.3 We ensure that consumers receive value for money from these monopoly activities through a process of setting price controls. Typically, we review these price controls every five years. The objective is to ensure that NIE T&D does not abuse its monopoly position by charging prices that are too high. At the same time we must ensure that the company can finance its licensed activities.
- 2.4 This is the fifth price control that has been set for NIE T&D since it was privatised in 1992. The price control process is referred to in this document as RP5. This document sets out our final determination for the funding of the electricity transmission and distribution networks for the next five years.

### **Consultation process**

- 2.5 For RP5 we have focused on increasing the transparency of our process, by actively engaging with representatives of a wide range of stakeholder groups, not just the company.
- 2.6 Our public consultation on our approach to RP5 began with a strategy paper in July 2010. We held open workshops for stakeholder representatives during this consultation period.
- 2.7 We published an update to this strategy paper, along with the responses to this consultation in May 2011.
- 2.8 In parallel to the public consultation, we have worked with NIE T&D to develop the Business Process Questionnaire (BPQ) and to understand the company's subsequent submission.

- 2.9 When preparing our draft determination, we were mindful of the requirement to ensure transparency of our 'minded to' position to all interested parties. This meant that NIE T&D was provided with a copy of our draft determination 24 hours before publication. This was a significant difference to RP4.
- 2.10 We published our RP5 draft determination on 19 April 2012. Our consultation<sup>4</sup> closed on 19 July 2012, 13 weeks after it was published. We received 32 responses to the consultation, one of which was submitted as being confidential. With the exception of this confidential response, we have listed the respondents below and posted their responses on our website, along with our consideration of the points raised.

Advice NI

Age NI

Age Sector Platform (ASP)

CBI Northern Ireland

Consumer Council for Northern Ireland (CCNI)

Commissioner for Older People for Northern Ireland

Endesa Ireland

Energia

Electricity Supply Board (ESB) (this included a response from Professor Stephen Littlechild)

Farm Woodlands Ltd

Firmus Energy

Gaelectric Developments

Major Energy Users' Council (MEUC)

Manufacturing NI

National Energy Action Northern Ireland (NEA NI)

NIE Limited

Northern Ireland Chamber of Commerce (NICC)

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<sup>4</sup> [http://www.uregni.gov.uk/uploads/publications/RP5\\_Draft\\_Determination\\_-\\_Main\\_Paper\\_19-04-12.pdf](http://www.uregni.gov.uk/uploads/publications/RP5_Draft_Determination_-_Main_Paper_19-04-12.pdf)

Northern Ireland Electricity Pension Scheme  
Northern Ireland Environment Link  
Northern Ireland Renewables Industry Group (NIRIG)  
Phoenix Natural Gas Ltd  
Property Compensation Consultants Ltd  
Prospect Trade Union  
Renewable Energy Systems Limited  
Smart Grid Ireland  
System Operators Northern Ireland (SONI)  
SSE  
Ulster Farmers' Union  
Unite - the Union  
Unite Regional Co-ordinating Committee  
Viridian Group Limited

- 2.11 The draft determination followed earlier engagement that we had undertaken with stakeholders during 2010 and 2011. This included consulting on our overall strategy<sup>5</sup> and holding three workshops that we hosted with CCNI during the consultation period. We also held three workshops for stakeholder groups during the consultation period<sup>6</sup>.
- 2.12 We would like to thank all respondents and attendees at the stakeholder events for the time and effort that they have contributed to this process.
- 2.13 We note that some respondents raised concerns about the process we followed to reach our draft determination. In Appendix B we describe the process that we followed.

## Structure of this document

- 2.14 This final determination sets allowed revenues for NIE T&D over the period 2013-17. The revenue we have allowed for will enable the company to recover

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<sup>5</sup> [http://www.uregni.gov.uk/publications/strategy\\_paper\\_for\\_nie\\_td\\_price\\_control\\_rp5/](http://www.uregni.gov.uk/publications/strategy_paper_for_nie_td_price_control_rp5/)

<sup>6</sup> [http://www.uregni.gov.uk/publications/rp5\\_industry\\_briefing](http://www.uregni.gov.uk/publications/rp5_industry_briefing)  
[http://www.uregni.gov.uk/publications/rp5\\_ur\\_ccni\\_briefing](http://www.uregni.gov.uk/publications/rp5_ur_ccni_briefing)  
[http://www.uregni.gov.uk/publications/rp5\\_renewables\\_briefing](http://www.uregni.gov.uk/publications/rp5_renewables_briefing)

its operating costs, depreciation and a reasonable return on investment. These revenues will be collected from customers and generators through charges for use of the transmission and distribution systems. All costs are in 2009-10 prices unless stated otherwise.

2.15 In preparing our final determination we have focussed our analysis on the following areas:

- capital expenditure (capex);
- capitalisation practices;
- operating expenditure (opex);
- pensions;
- connections;
- incentives;
- innovation;
- environment, health & safety;
- the weighted average cost of capital (WACC);
- the regulatory asset base (RAB);
- depreciation; and
- financeability.

2.16 Each of these areas is considered in turn in this document. In each chapter, we first explain whether or not there has been new information or other external factors that could result in further consideration of our determination. We then provide a summary of our responses to the issues raised, followed by our final determination position.

## **Our statutory duties**

2.17 In coming to our final determination we have been mindful of our statutory duties. These duties are defined in legislation<sup>7</sup> and are set out below. We have tested our final determination against our statutory duties to ensure that we are complying fully with them.

2.18 Our principal objective in carrying out our functions in relation to electricity is:

*“to protect the interests of consumers of electricity supplied by authorised suppliers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities*

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<sup>7</sup> See Appendix C for full details



*connected with, the generation, transmission, distribution or supply of electricity.”*

2.19 In addition, we must also have regard to:

- (a) *“the need to secure that all reasonable demands in Northern Ireland or Ireland for electricity are met; and*
- (b) *the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under Part II of the Electricity Order or this Order.”*

2.20 A more detailed description of our statutory duties can be found in Appendix C.

### **Legislative changes & government policy**

2.21 We have also considered the impact of recent changes in legislation and in government policy for energy, as well as how these changes were reflected in NIE T&D's RP5 submission. The key changes are discussed below.

2.22 It is our duty to have regard to government policies and targets while ensuring that those policies are delivered in a manner that is efficient and beneficial to end consumers.

2.23 The RP5 price control must be considered in the context of recent legislative and policy developments regarding the ownership and operation of electricity networks, renewable electricity generation and demand-side participation in the wholesale market.

2.24 Specific examples that form part of the new framework include the Third European Internal Market Directive (IME3), the Renewable Energy Strategy (RES) Directive and the Strategic Energy Framework<sup>8</sup>. Of greatest significance for electricity networks are government targets for generation of electricity by renewable sources and the associated policy of smart metering.

2.25 In September 2010, the Department of Enterprise, Trade and Investment (DETI) published its Strategic Energy Framework. This included a target that 40% of electricity consumption should be generated by renewable sources by 2020. However, the Department also voiced concern about the impact that this could have on prices. In its overview DETI states:

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<sup>8</sup> [http://www.detini.gov.uk/strategic\\_energy\\_framework\\_\\_sef\\_2010\\_-3.pdf](http://www.detini.gov.uk/strategic_energy_framework__sef_2010_-3.pdf)

*“Northern Ireland will also be considering the need to minimise costs to consumers in relation to electricity grid investment and increasing levels of renewable generation. We recognise that investment is needed in the short to medium term in order to deliver long term benefits, including net savings to consumers.*

*As Northern Ireland has the highest levels of fuel poverty in the United Kingdom we must ensure that our desire to develop a more sustainable and secure energy supply is not detrimental to energy consumers.”*

2.26 IME3 requires each member state to undertake a cost benefit analysis to assess the viability of the installation of smart meters for electricity and gas supplies to domestic customers. After the completion of this work DETI announced<sup>9</sup>, on 31 July 2012, that smart meters would be rolled out for electricity customers in Northern Ireland. This work is currently ongoing for Northern Ireland but is not yet sufficiently advanced to allow funding for any investment to be included in this final determination. We will be consulting separately in relation to the roll out of smart meters.

### **Transmission System Operator certification for Northern Ireland**

2.27 Under EC Directive 2009/72/EC, which has been transposed into Northern Ireland law in The Gas and Electricity (Internal Markets) Regulations (Northern Ireland) 2011, Transmission System Operators (TSOs) are required to be certified As being independent.

2.28 We recently published guidance<sup>10</sup> for those TSOs in Northern Ireland that are seeking certification under the IME3 legislation, setting out the means by which certification can be achieved.

2.29 Implementation of IME3 could potentially result in a transfer of ownership of the transmission network and/or a reallocation of major transmission functions including planning, development and maintenance.

**2.30** This final determination has been prepared on the basis that NIE T&D's current structure will remain in place. However, changes to the final determination may be required pending any decision regarding TSO certification. We will undertake a separate consultation if NIE T&D's licence needs to be amended.

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<sup>9</sup> <http://www.northernireland.gov.uk/news-deti-310712-northern-ireland-to>

<sup>10</sup> [http://www.allislandproject.org/en/sem\\_publications.aspx?year=2011&section=2](http://www.allislandproject.org/en/sem_publications.aspx?year=2011&section=2), see document SEM-11-103

### **3 DURATION**

#### **Update from draft determination**

- 3.1 In the draft determination we confirmed that RP4 would be extended from 1 April 2012 to 30 September 2012. We will implement RP5 from 1 January 2013, which means that RP4 has been further extended to 31 December 2012.
- 3.2 The change to a start date of 1 January 2013 has been necessary to:
- complete a robust assessment of the submission itself and to deal with the significant issues that were subsequently identified;
  - carry out analysis on further significant information that NIE T&D provided after the consultation on our draft determination closed;
  - carry out an investigation into NIE T&D's capitalisation practice; and
  - consult on the approval criteria and incentive mechanisms for RP5 Fund 3 (Investments for renewable electricity).

#### **Introduction**

- 3.3 In December 2011, our Board decided that in light of the material gap between NIE T&D's submission for capital investment and the proposed allowance based on our assessment, it would be appropriate to allow NIE T&D more time and the opportunity to justify its proposals. Further engagement on capital investment took place during January and February 2012 and NIE T&D was asked to submit additional justification for its investment proposals. The company used this opportunity to submit an additional request for a further £169.3 million of capital investment; this request has required further analysis and consideration.
- 3.4 In January 2012, the Board decided that an investigation into changes in capitalisation practice was required. This investigation began in February 2012. The process of obtaining and analysing information took much longer than originally envisaged. However, the benefit of this investigation has outweighed the impact of the delay in starting RP5.
- 3.5 This final determination sets out NIE T&D's allowed revenues for transmission and distribution, for the period 1 January 2013 to 30 September 2017. The revenue is set at a level to allow the company to recover operating costs, depreciation and a reasonable return on investment. These revenues will be collected from customers through 'use of system' charges over the next four

years and nine months (to apply to both the transmission and distribution businesses).

- 3.6 As a result of these events, the draft determination was not published until 19 April 2012. In the draft determination, we indicated that we expected to engage with NIE T&D during the consultation period, particularly in relation to financeability and pension costs. However, on 7 June 2012 NIE T&D wrote to us stating that it did not wish to engage with us on these matters until after the consultation period had closed.
- 3.7 In addition to our engagement with the company, we also received 32 responses to the RP5 draft determination, all of which have required careful consideration.
- 3.8 NIE T&D raised concerns about the application of an extension period for RP4. The company would have preferred formal licence modifications to reflect the calculation of allowed revenues for the extension period. NIE T&D also flagged up that a number of cost items previously approved under the Dt term<sup>11</sup> of NIE T&D's licence would require an additional allowance to cover the period 1 April to 31 December 2012.
- 3.9 The formulae in NIE T&D's licence are generally capable of being applied beyond RP4. This has been demonstrated as we have used the RP4 formulae to determine the tariff amounts required for 2012-13. We included allowances for approvals under the Dt term of NIE T&D's licence within the tariffs. There are two terms that cannot be populated, but these did not impact on the calculation of the tariffs.
- 3.10 We have taken a pragmatic approach to extending the application of the licence formulae for RP4 until 31 December 2012; we consider that they can continue to apply until they are replaced by RP5. We did not see a practical solution other than to extend RP4 and use the existing price control formulae. The alternative would have been to have had a separate consultation for the extension period. This would have resulted in an additional workload for both NIE T&D and us and may have resulted in a longer extension for RP4 until issues were resolved.
- 3.11 However, within the current price control formula actual capital investment is added to the RAB and the associated return and depreciation collected through the tariffs. The amount of capex to be spent is not defined in NIE T&D's licence;

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<sup>11</sup> This allows for consideration of costs that could not be foreseen or adequately quantified during the previous price control

instead it is stated in the RP4 final determination. In order to allow NIE T&D to continue with its capital investment programme, our Board has approved a further capex budget for the six-month period of 1 October 2012 to 31 March 2013.

- 3.12 The amount of capital investment specified in this final determination covers the five years from 1 October 2012 to 30 September 2017. In the licence modifications, the amount that is subject to the RP5 risk management and incentivisation mechanisms is defined as the amount approved minus the actual spend over the three months between 1 October 2012 and 31 December 2012.
- 3.13 The actual investment over those three months will be added to the RAB in line with the RP4 mechanism.
- 3.14 For the purposes of this final determination, we have undertaken all of our analyses for the five-year period from 1 October 2012 to 30 September 2013. We have then adjusted the outcomes to reflect the shorter duration of RP5.
- 3.15 The licence modifications that we are consulting on will apply from 1 January 2013.

## **4 CHANGE TO CAPITALISATION PRACTICE DURING RP3 & RP4**

### **Update from draft determination**

- 4.1 We have removed the revenue adjustment as a result of using the same formula for tax in during the period that the money was recovered in. We have reassessed the reduction to take account of asset disposal policy, although because the final amount to be recovered is immaterial we will not make an adjustment. We intend to make a RAB adjustment of £31.7 million to reflect changes in NIE T&D's capitalisation practice.

### **Introduction**

- 4.2 In our draft determination for RP5 we stated that we had engaged a consultant auditor to investigate how much of NIE T&D's outperformance since 2005 had been due to changes made to the company's capitalisation practices. This investigation was completed during the summer and on 30 August 2012 we published a separate draft determination covering this topic.
- 4.3 In this draft determination, we identified £35.32 million of adjustments in respect of capitalisation practice and asset disposals treatment. Most of this adjustment related to the company's capitalisation practice. We detailed the findings of the report that the consultant auditor produced as part of our audit investigation. This indicated that a significant amount of the outperformance that NIE T&D had reported resulted from a change in its capitalisation practice since 2005, rather than from efficiency improvements.
- 4.4 In this chapter we discuss the audit investigation that we carried out into NIE T&D's capitalisation practice and the responses we received to that consultation. We also set out our final determination.
- 4.5 We received two responses to our draft determination on capitalisation practice. We have considered these responses and have updated our final position based on our consideration of the additional points and information provided.

### **Background**

- 4.6 For the period covering RP3 and RP4 NIE T&D's controllable opex costs were significantly lower than its agreed allowance. We identified that some of this

outperformance may have occurred because of changes in NIE T&D's accounting practices in relation to the capitalisation of certain costs. On further investigation it was discovered that, when compared with practices in the earlier years of RP3, an increasing proportion of certain cost items were being capitalised.

4.7 As a result of this change, reported operational expenditure on these items fell significantly while the reported capitalised spend (capex) increased. This created a situation whereby consumers in Northern Ireland could effectively be paying twice for certain costs:

- first through the opex allowance; and
- secondly through the return and depreciation that NIE T&D receives from its RAB.

4.8 NIE T&D asserted that the decrease in opex was part of its outperformance over the period.

### **Summary of responses to draft determination**

4.9 We received two responses to the consultation on this issue. One of these, the response from NIE T&D, also included a report from KPMG. NIE T&D had employed KPMG to undertake an independent review of the company's capitalisation practice.

4.10 In its detailed response on this issue, NIE T&D rejected the proposals in the draft determination. The report from KPMG categorised concerns into five main areas: RP4 rules, our consultant auditor's report on the matter, asset disposals, revenue adjustment and RAB adjustment.

4.11 The other respondent stated that they supported our investigation to changes into NIE T&D's capitalisation practice and our draft determination findings.

4.12 This respondent did, however, raise concerns about the fact that we had not detected the change in practice for a period of seven years. The respondent asked us to consider imposing further sanctions on NIE T&D, under Article 45 of the Energy Order 2003. They added that if no further sanctions were considered appropriate then an explanation should be given as to why this was the case.

**RP4 rules**

- 4.13 NIE T&D's response states that no rules are implied in the RP4 price control (beyond the provisions of licence condition 2) that control how the company should estimate the amounts of expenditure to be capitalised. NIE T&D contests that our attempt to introduce rules has no foundation in fact or principle.
- 4.14 NIE T&D further states that it has compiled its regulatory accounts in accordance with condition 2 of its licence; the company asserts that condition 2 allows NIE T&D to periodically reassess the amounts to be capitalised. NIE T&D's response also adds that its auditors had been satisfied that the company's regulatory accounts complied with condition 2 of its licence.
- 4.15 In its response, NIE T&D contests that our draft determination was an attempt to reopen the RP3 and RP4 price controls.

**Our consultant auditor's report**

- 4.16 NIE T&D's response states that our proposed adjustments were based on erroneous analysis and findings by our consultant auditors. NIE T&D also stated that we had failed to take the relevant facts and considerations into account.
- 4.17 NIE T&D contested that our consultant auditor's work included important errors that rendered the conclusions unreliable. NIE T&D asserted that its consultants, KPMG, identified deficiencies in the information our consultants had used and which formed the basis of the conclusions in the consultant auditor's report. In page 6 of its report, KMPG stated that:
- "we do not consider that the consultants have provided any evidence to support their conclusion that there have been changes in capitalisation practices".*
- 4.18 NIE T&D and their consultants KPMG comment on a number of our findings and summarise the criticisms in paragraphs 3.25 to 3.37 of the response.

**Asset disposals**

- 4.19 In its response, NIE T&D agreed that proceeds from the sale of plant and equipment are not excluded services under the terms of its licence. However,



NIE T&D disagreed with our proposed adjustment regarding the regulatory treatment of these proceeds.

4.20 NIE T&D has stated that our conversion of the adjustments to deal with the asset disposals are incorrect, and do not reflect the terms of NIE T&D's licence. NIE T&D considered that its calculation of controllable cost allowance was consistent with its licence, by reference to the 2006 Direction, and that our adjustments were unjustified.

4.21 NIE T&D also highlight the fact that the 2006 Direction recognises that the proceeds of sale of scrap should be applied as a reduction in operating costs, rather than a reduction in the RAB.

### **Revenue adjustment**

4.22 NIE T&D's response asserted that our computation of the required revenue adjustment was incorrect.

4.23 NIE T&D stated that Annex 2 of its licence prescribes that RP4 revenues should be calculated using a vanilla WACC approach. This is the pre-tax cost of debt and the post-tax cost of equity and adding a separate allowance for tax.

4.24 NIE T&D contest that using a vanilla WACC approach plus tax has the effect of increasing allowed RP4 revenues, rather than our proposed reduction of £2.65 million.

4.25 NIE T&D state that the difference has arisen as a result of our use of a pre-tax approach. The company asserts that this approach does not take account of proposed capitalisation adjustments. These adjustments affect the company's tax capital allowance pools, and have the effect that the company has to pay more in tax.

### **RAB adjustment**

4.26 NIE T&D rejected the conclusions in the draft determination. The company asserts that there was no sound basis on which to reclassify expenditure, and that the reclassification will result in a reduction on the amounts added to the RAB during RP3 and RP4. Furthermore, NIE T&D has also stated that it rejects any proposal to make consequential adjustments to the revenue allowance for RP5.

- 4.27 NIE T&D also reject the suggestion that it has changed its capitalisation practice. NIE T&D has stated that changes to opex and capex result from changes in the underlying nature of NIE T&D's activities. NIE T&D further notes that its accounts have been prepared in accordance with all relevant accounting standards and licence obligations. This was confirmed by KPMG.
- 4.28 NIE T&D's response asserts that we failed to recognise that RP4 has worked effectively and to the benefit of consumers. The company also noted that we have received annual updates from NIE T&D as to its outturn capex and opex, but have not raised any objections until now.

### **Our comments to respondents**

- 4.29 The section below details our responses to issues raised by respondents to our draft determination.
- 4.30 One respondent raised concerns that we had failed to detect this change in practice over a period of seven years.
- 4.31 It is standard regulatory practice, at each five-year price control review, to examine the reasons for any 'outperformance' in the previous control period. In this case we examined the RP4 period (which lasted from 2007 to 2012). By definition, such an examination can only be conducted retrospectively. We typically wait until the end of the price control period before conducting any examination. This also allows the company some flexibility in its expenditure between years within a control period.
- 4.32 It is also standard practice for us to then make adjustments for any outperformance that was not in accordance with the ex-ante rules for the price control period. In the case of RP4, we are proposing to make an adjustment in order to follow the principle that a cost item cannot be recovered through both the opex allowance and the RAB. Doing so would be double counting and not an efficiency gain.
- 4.33 A respondent also raised the possibility of further sanctions being imposed on NIE T&D.
- 4.34 As we are not stating that NIE T&D has broken any accounting rules or regulations we are not of the opinion that any further sanctions should be placed upon NIE T&D. Rather we consider that the RAB should be adjusted, as NIE T&D should not gain from double counting which arises due to a change in

capitalisation practice. Changes in capitalisation practice include changes to the extent of capitalisation for any cost item.

4.35 In its response, NIE T&D stated that there are no implied rules in the RP4 price control that control how the company should estimate the amounts of expenditure to be capitalised.

4.36 We consider that it is NIE T&D's licence and the adoption of the 'Composite Proposal' that govern the rules, or principles, on which the RP4 price control were based.

4.37 The opex chapter of our RP4 final determination refers to a December Composite Proposal paper as "*outlining the proposed new "rolling mechanism" approach to opex*".

4.38 Page 3 of the December paper clearly refers to the Composite Proposal, stating that:

*"NIE has presented to NIAER its 'Composite Proposal' which would form the basis of a five year T&D price control for RP4."*

4.39 The paper goes on to state:

*"The principles behind the Composite Proposal include:*

- A rule-based approach to the Opex allowance that strengthens efficiency incentives and shares the savings with customers;*
- A Capex allowance based on actual rather than forecast expenditure, together with strengthened Capex efficiency incentives;*
- An allowed rate of return on assets consistent with established precedent".*

4.40 It is important to realise that the Composite Proposal, and indeed the price control, are based on principles and not specific rules. One of these underlying principles was that actual expenditure cannot be recovered through both opex and capex. In our view, by changing its capitalisation practice NIE T&D is not consistent on this point.

4.41 Page 1 of the Composite Proposal document made explicit reference to the measurement of opex and capex expenditure stating:

*"The use of actual expenditure to determine future revenue entitlement removes ambiguity around the allocation of costs as between opex and capex. For regulatory purposes actual expenditure is recovered either via the RAB over 40 years or via the opex allowance but not through both."*

4.42 The explanation given in the Composite Proposal above is clear and states that expenditure cannot be counted twice. The Composite Proposal also makes

clear, consistent references to encouraging efficiency savings at various points throughout the paper.

- 4.43 We also believe that the requirement for practice to be applied consistently is enshrined in condition 2 of NIE T&D's licence. Paragraph 3(b) requires NIE T&D to prepare annual accounts on a consistent basis. NIE T&D refers to the requirements and interprets this as having to prepare accounts using consistent accounting policies. However paragraph 4(a) of condition 2 goes further than paragraph 3 in that it states that:

*"The Licensee shall not, in relation to the accounting statements in respect of a financial year, change the bases of charge, apportionment or allocation referred to in sub-paragraph (b) of paragraph 3 from those applied in respect of the previous financial year, unless the Authority shall previously have issued directions for the purposes of this Condition directing the Licensee to change such bases in a manner set out in the directions or the Authority gives its prior written approval to the change in such bases. The Licensee shall comply with any directions issued for the purposes of this Condition".*

- 4.44 We consider that this goes considerably further than simply requiring NIE T&D to apply the same accounting policies. In our view it also requires the company to apply consistent detailed application bases to the apportionment and allocation of charges. We further note that neither NIE T&D nor KPMG refer to paragraph 4(a) of licence condition 2 in their response.
- 4.45 The NIE T&D response also asserts that our consultant auditor's work contained important errors that rendered the conclusions unreliable. NIE T&D refers back to a report that KPMG carried out on its behalf which raised issues concerning our consultant's conclusions.
- 4.46 Following further discussion with our consultant auditors, we consider that both NIE T&D and KPMG have not recognised the depth of investigation that has taken place, by characterising the investigation as a simple data analysis. Over the past number of months we have had at least four meetings with NIE T&D, undertaken numerous clarification telephone calls, and raised a large number of clarification questions with the company.
- 4.47 In a detailed evaluation of the consultant auditor's work KPMG states that it has identified errors and inconsistencies. After reviewing the information provided by KPMG to support this statement we have found no inconsistencies within our initial figures or reasons to change the amounts identified as being opex decreases due to capitalisation.

4.48 Page 29 of KPMG's report states that:

*"KPMG have performed a high level review of the mathematical accuracy of the calculations within the analysis summary spreadsheet supporting the Consultants' report and note that there are a number of mathematical errors included in the formulas and calculations, including the following:"*

4.49 In conjunction with our consultant auditors, we have evaluated and reviewed the calculations in the summary table and have found no mathematical errors.

4.50 In conjunction with our consultants, we have considered each of the points raised by KPMG, and have found that any of the perceived errors in the treatment of an individual expense have arisen due to consistent application of the methodology as outlined in the consultant's report.

4.51 Considerable engineering rigour has also been applied to each classification and the report explains the reasoning behind them.

4.52 NIE T&D also raised objections to the methodology we had used to calculate asset disposals and revenue adjustment. Following a review of our calculations and methodology we accept the arguments that NIE T&D put forward. We are therefore proposing to make no RAB adjustments in relation to these items. This is covered in further detail in the final determination section below.

4.53 The final issue that NIE T&D raised in its response concerned our adjustment of its RAB. NIE T&D asserted that we have no sound basis on which to reclassify expenditure. Furthermore, NIE T&D rejects the suggestion that it has changed its capitalisation practice and states that the company is fully compliant with all appropriate accounting standards.

4.54 We are of the opinion that NIE T&D has been very careful to define its terms when describing whether or not there was a change in its capitalisation practice. NIE T&D says it has not made a change to capitalisation as defined by a particular accounting standard, IAS8. Instead, it asserts, it made a smaller change relating to the way in which it estimated the amounts to be capitalised. It is important to note that we have never concluded that NIE T&D had changed its policy in the sense meant by the accounting standards. The point was rather that NIE T&D has changed the way in which the policy has been applied in practice. It is also important to note that NIE T&D has not denied that a change had taken place. NIE T&D has stated in its response that, in some cases, it re-assessed the estimates of the amounts to be capitalised under particular heads of expenditure.

*“NIE has, however, in some cases, re-assessed the estimates of the amounts to be capitalised under particular heads of expenditure (notably overheads), or it has used more sophisticated methods to identify amounts to be capitalised, through business process improvements and improved data collection tools which provide better visibility as to the purpose for which costs are incurred (notably in respect of some elements of repairs and maintenance expenditure). But these new methods of estimation, or new estimates, do not amount to changes in the basis on which the accounts are prepared, or the accounting policies used.”*

- 4.55 NIE T&D places considerable emphasis on the fact that it has not changed its accounting policies in relation to the capitalisation of costs. IAS8, “Accounting policies, changes in accounting estimates and errors”, draws a distinction between accounting policies that are broad principles under which accounts are prepared, and accounting estimates that represent detailed application of those policies. For example capitalising an amount of overhead is an accounting policy whereas arriving at the percentage of overheads to be capitalised represents an accounting estimate.
- 4.56 Changing the underlying accounting estimates can have an impact on the financial statements without changing the underlying financial statements.
- 4.57 While we have never claimed that NIE T&D has changed its accounting policy in relation to the capitalisation of costs over the period under review, our analysis does demonstrate that over the period there were changes in accounting estimates that have had a material impact on the allocation of costs between opex and capex.
- 4.58 To clarify, we do not believe, nor have we ever asserted, that any accounting rules have been broken.
- 4.59 A final statement that NIE T&D makes is that we have failed to recognise that RP4 has worked effectively and to the benefit of consumers.
- 4.60 We are aware that NIE T&D did achieve significant outperformance of the price control even after the proposed corrections. However, additional cost savings brought about from a change in capitalisation practice are not efficiency savings, but a result of a change in accounting practice. This change has resulted in a material impact on NIE T&D’s future profitability, to the detriment of consumers in Northern Ireland.

**Final determination**

4.61 Following a review of the responses received, along with further internal analysis, we have detailed our conclusions below. These cover the three categories of asset disposal, revenue adjustment and the RAB adjustment.

**Asset disposals**

4.62 Our draft determination proposed an adjustment of £0.9 million. In its response NIE T&D has highlighted that the company's asset disposal calculations are in line with the 2006 Direction that we issued.

4.63 Our draft determination calculation was based on an adjustment in the year of the disposal occurring, rather than five years later. On further consideration of both NIE T&D's response and the 2006 Direction we accept that a five-year incentive for NIE T&D is appropriate. By adjusting the figure in this manner an adjustment of £0.045 million is required for asset disposal. As this figure is deemed to be immaterial we propose that no adjustment will be made for asset disposals.

**Revenue adjustment**

4.64 Our draft determination proposed an adjustment of £2.7 million to the revenue allowance within RP4, based on using a pre-tax WACC. In its response, NIE T&D stated that the adjustment had been overstated and that a vanilla WACC approach should be taken, along with the addition of a separate allowance for tax. By adopting this approach, no adjustment would be made.

4.65 We have accepted that using a vanilla WACC and tax allowance is in keeping with the formula defined in NIE T&D's licence for the period when this money was recovered from customers. We therefore propose that no adjustment is to be made with respect to revenue adjustment.

**RAB adjustment**

4.66 The draft determination proposed an adjustment of £32.7 million. This comprised £31.7 million in capitalisation practice adjustments and £0.9 million for asset disposals. We do not consider that any adjustment is required to the

original capitalisation figure and so we are not persuaded to change our original position.

- 4.67 As the RP4 opex allowance was based on RP3 actual opex we expect the cost basis to remain constant to avoid any double counting. We have determined that the opex allowance in RP4 remains unchanged and that an adjustment of the RAB will be carried out at the start of RP5.
- 4.68 This will ensure that consumers are not paying twice. We have determined an adjustment to the RAB of £31.7 million.

## Summary

- 4.69 The principle stated by NIE T&D within its Composite Proposal was that, “for regulatory purposes”, consumers do not pay twice.
- 4.70 We have also taken into account the responses received to the draft determination and the arguments presented.
- 4.71 In light of this, we have concluded that no adjustment should be made with respect to asset disposals and revenue adjustments.
- 4.72 However we have not changed our position in relation to NIE T&D’s capitalisation practice and we are making an adjustment of £31.7 million to the RAB. This adjustment will be applied from the beginning of RP5.
- 4.73 This adjustment will mean that NIE T&D will only keep the outperformance element that was efficiently incurred, and that consumers will not pay twice for any cost item.



## **5 RP5 CAPEX**

### **Changes since draft determination**

- 5.1 NIE T&D has submitted additional data to support its request. We have undertaken a complete assessment of the capital expenditure that we consider justified during RP5. Based on this, the total amount for Funds 1 and 2 capex has increased from £314 million to £395 million over five years.

### **Introduction**

- 5.2 In this chapter we discuss the amount of capex expenditure that is being allowed for the RP5 period. We explain how any requirements for capital investment that cannot be identified clearly at this stage will be assessed.
- 5.3 We also explain how we have engaged with NIE T&D and other stakeholders since we published our draft determination. We identify any changes we have made as a result of this engagement and the responses we received to the draft determination.

### **Engagement since we published the draft determination**

- 5.4 Immediately after we published the draft determination we provided NIE T&D with the reasoning behind the amount of money for capex Funds 1 and 2 that we had allowed for in our draft determination. We also responded to the 35 questions that NIE T&D submitted to us relating to the capex chapter of the draft determination.
- 5.5 During the consultation period, NIE T&D provided further information to support its requested capex.
- 5.6 During the consultation period we held two workshops with NIE T&D to discuss how the fund mechanisms would work. This included the allocation of price and volume risk and tracking of the required outputs. We also met the company and SONI before we published a further consultation paper on the approvals process for investment under Fund 3.
- 5.7 Capex issues were also discussed at the three stakeholder workshops that we held in June 2012.
- 5.8 Following receipt of NIE T&D's response we submitted 55 written questions to NIE T&D to seek further clarification on claims made in the company's

response. We also held two full-day workshops with NIE T&D to discuss the issues it had raised and to clarify the information necessary to justify the expenditure identified for the RP5 period.

- 5.9 NIE T&D provided us with significant additional factual information during this process. This included load duration curves for substations, full copies of survey reports and evidence of specific quality of supply issues.
- 5.10 Based on a rigorous reassessment of all of the information that NIE T&D provided, our consultants SKM identified the amount of investment that it considers to have been justified. We have scrutinised this to verify that it is consistent with the policy decisions of our Board. We have proposed modifications to NIE T&D's licence which reflect our final determination.
- 5.11 The results from this exercise are presented in Appendix D.
- 5.12 As proposed in our RP5 draft determination, we issued a further consultation concerning the process for investment under Fund 3. The consultation closed on 27 September 2012.

### **Summary of responses**

- 5.13 Of the 32 responses to our draft determination, 19 referred to the review of capex in RP4 and our proposals for capex in RP5. We received seven responses to our further consultation on the approvals process for Fund 3.
- 5.14 The most detailed response was from NIE T&D. The company provided a commentary on each investment proposal that we had not considered to be fully justified before we issued our draft determination. This information was reviewed by SKM, along with the answers to the questions we submitted and the data provided by NIE T&D throughout this process.
- 5.15 Six respondents referred to the process that we had followed to reach our draft determination and the principles applied. One concern raised was that our consultants had not undertaken site investigations as part of their assessment. These respondents stated that this information had been provided by NIE T&D. NIE T&D's response to the draft determination also stated that we had not accepted any of NIE T&D's offers to arrange site visits.
- 5.16 We would like to emphasise that at all times throughout this capital assessment process we have accepted the factual accuracy of all of the data that NIE T&D provided to us. Our consultants do not consider it typical for a

third party to undertake site visits as it is of limited value in validating data. The factual information that NIE T&D provided in its initial submission was insufficient to support its capex claim. NIE T&D has provided significantly more data since our draft determination. The money approved in our final determination is largely as a result of the additional evidence that NIE T&D provided concerning the condition of the network assets and NIE T&D's asset management strategies.

- 5.17 Five respondents focused on the affordability of the services that NIE T&D provides for both business and domestic customers. We note these concerns, and have ensured that only capital investments that NIE T&D has supported with clear justifications are approved.
- 5.18 In addition to NIE T&D, four respondents highlighted the importance of investment to maintain performance standards. However, no respondents identified any shortcomings in the current performance standards. None of the four provided any evidence to support their claims that the capex spend should be higher than the amount proposed in our draft determination.
- 5.19 Four respondents from the renewables sector highlighted the need to ensure that processes are in place to support the prompt approval of investments for renewable generation. We outlined the processes in our draft determination on Fund 3, published in July 2012.
- 5.20 We received seven responses to the Fund 3 consultation. Respondents were generally in favour of the proposed principles and approach. However, some respondents raised concerns about how we could demonstrate compliance with the Renewable Energy Strategy (RES) Directive if a proposal by NIE T&D does not meet the approval criteria. We will at all times comply with all legislative requirements. However, it is also essential that the solutions that NIE T&D propose comply with their duty to ensure that the network is efficient, economic and coordinated.
- 5.21 The responses to the Fund 3 draft determination also contained some additional useful suggestions at an operational level that we will consider in relation to the approval processes. We will discuss these further with NIE T&D.
- 5.22 One respondent raised concerns about NIE T&D's asset management processes. They encouraged the company to adopt a recognised auditable standard such as PAS55. We support this approach and welcome the progress that NIE T&D has made in this area.

5.23 Only NIE T&D made specific comments about the proposed risk sharing mechanism for RP5 and our review of RP4 capex. We present our final determination of the mechanism to be adopted in the following sections.

5.24 Our comments on each of the points made by the respondents are presented in Appendices E, F and H.

### **Final determination**

5.25 The details of our final proposals for RP5 capex are presented below. Any changes to the draft determination are identified. For the avoidance of doubt, this final determination is based on NIE T&D's current capitalisation policies, practices and allocations. We require NIE T&D to notify us before any changes in methodology, allocation percentages, practices or policy are implemented. The final reconciliation at the end of RP5 will take any changes into account. The purpose of this is to help ensure transparency and measurement of actual costs and outputs, such that consumers pay a fair price and that NIE T&D is only rewarded once for any efficiency savings and customers are only charged once for any costs.

5.26 European legislation requires us to separate the licence that NIE T&D holds into two licences: one for transmission and one for distribution. We will be consulting on these changes in line with the timetable for implementation of IME3. These licences will have separate annexes specifying how much NIE T&D is allowed to charge for using each system. Each licence will reflect the amounts allowed under this final determination. For the avoidance of doubt, the four individual expenditure limits specified here apply specifically to each fund and licensed activity. They are as follows:

- Distribution Fund 1: £202.4 million;
- Distribution Fund 2: £31.3 million;
- Transmission Fund 1: £92.4 million; and
- Transmission Fund 2: £11.6 million.

5.27 The total expenditure is included for presentation purposes only and cannot be reallocated between the four areas.

5.28 Under the proposed licence modifications, the revenue that NIE T&D will receive through tariffs is equivalent to the return and depreciation that would be due if the company invested these amounts during RP5. The actual spend will

be used for the final reconciliation. For the avoidance of doubt, any efficiency payments due to NIE T&D under this determination will continue to be made into RP6, where appropriate. For example, an efficiency saving made in year 3 of RP5 will be reflected in tariffs for the first two years of RP6.

5.29 The RAB will be increased each year in line with actual investment, but this will not start to be reflected in tariffs until RP6.

5.30 Respondents raised conflicting concerns about the amount of capex that NIE T&D requires during RP5. While some felt that the full amount should have been allowed, others were concerned that the less well-off in society would not be able to afford that increase. To ensure that we provide NIE T&D with sufficient capital expenditure, while protecting customers, we employed SKM<sup>12</sup> to undertake a full review of all of the information that NIE T&D provided. We also provided SKM with copies of all of the consultation responses that related to capex.

5.31 SKM based its assessment on all of the information that NIE T&D has provided to date. This includes:

- the original submission, including 43 supporting papers;
- responses to analysis that we shared with NIE T&D in October 2011;
- responses to questions that were sent to the company in January 2012;
- the company's response to the draft determination; and
- the company's responses to questions we sent in July/August 2012.

5.32 We also assessed the comments that NIE T&D submitted in relation to the proposed risk sharing mechanism.

## Fund 1

5.33 Fund 1 covers asset replacement and refurbishment (both planned and unplanned). It also includes capitalised tree-cutting. This is work that is within NIE T&D's control. NIE T&D monitors the condition of the assets and the amount of replacement is determined by the company's assessment of what is required to maintain a safe and reliable network in an economical way. This type of investment is subject to expert opinion, and best practice in this area involves effective asset management systems and processes. The exact requirements are difficult to predict. We are therefore putting a mechanism in

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<sup>12</sup> Sinclair, Knight & Merz: the company has technical knowledge and detailed experience of similar price controls in GB and Rol.

place within this fund to allow NIE T&D flexibility within the overall allowance to reprioritise investment and balance expenditure across the identified categories.

5.34 This approach has not changed from our draft determination. However, we have now included an allowance for areas of expenditure where NIE T&D has only been able to identify historical expenditure. We referred to these areas as 'input driven' items. We accept that this work will continue to be necessary. The objective of this is to allow NIE T&D to manage these costs as it best sees fit. It will also ensure that the company obtains the full benefit of any efficiency that can be obtained by reducing these costs and planning investment within the other categories.

### **Objective of Fund 1**

5.35 A key objective of this price control is to incentivise NIE T&D to improve efficiency, thereby reducing the unit cost of replacing assets in this and subsequent price controls. Under the arrangements, NIE T&D will benefit from lower costs, but not from deferring allowed investment.

5.36 Within the classified areas of expenditure NIE T&D takes the unit cost and volume risk under this fund. This means that if the unit costs are less NIE T&D will benefit from this saving for a period of five years (into RP6 if appropriate). However if the costs are higher NIE T&D will not be made whole until five years after the investment.

5.37 Customers are protected from lower standards of performance and excessive costs by:

- the standards with which NIE T&D must comply under its licence, including payments under the Guaranteed Standards Scheme;
- incentives to maintain the performance for current customer minutes lost;
- incentives towards the end of RP5 to measure and reduce losses;
- obligations on NIE T&D under Northern Ireland law; and
- ongoing reporting of NIE T&D's outputs and efficiency.

5.38 In addition, we require NIE T&D to demonstrate that it has efficiently incurred costs associated with installing assets. This will allow the appropriate level of cost allocation where work is not completed within RP5 and will ensure that appropriate allowances are set for RP6.

**Fund 1 mechanism**

- 5.39 Under this fund, NIE T&D has the flexibility to change the range of assets replaced. In areas where volumes are identified NIE T&D is able to increase or decrease the volume of units in one classification. However, it cannot exceed the overall allowance without incurring a five-year penalty.
- 5.40 The allowance for 'input driven' items does not have any volumes identified and this amount of money will remain fixed. Any saving made in this area will be retained by NIE T&D for a five-year period and any overspend will result in the company being penalised for five years.
- 5.41 While there is considerable churn among the individual assets listed on the replacement programme at any one time, at a macro level the total number in each category will vary less. The annual reporting will allow NIE T&D to provide a detailed explanation of the variance between the actual outturn and the plan.
- 5.42 The price control mechanism for this fund will place the risk of asset failure with NIE T&D. The company will determine which assets are highest priorities for replacement. The initial allowance is primarily based on the outputs of the asset replacement modelling that SKM undertook (and as adjusted for historical investment by NIE T&D). However, the final reconciliation will ensure that NIE T&D is only rewarded for the assets that have actually been installed.
- 5.43 An efficient spend clause will be added to NIE T&D's licence to reflect the statutory obligation on the company to develop and maintain an efficient, coordinated and economic system. The Reporter will verify the asset replacement work each year and sign off the actual spend that is added to the RAB. (It should be noted that this will not impact on the amount of money that NIE T&D can claim through tariffs during RP5.)
- 5.44 At the end of RP5 we will undertake a final reconciliation to calculate the residual efficiency payments that NIE T&D can claim during RP6. This will allow the company to keep any efficiency gains or be penalised for inefficiency for five years. The residual entitlement will be equivalent to actual expenditure being added to the RAB in y+5, plus any efficiency gains for five years.
- 5.45 During RP5, the amount that NIE T&D can collect through tariffs to cover the return and depreciation of the new assets is capped. Customers are not taking any risk related to NIE T&D choosing to defer capex.

**‘Input driven’ items**

5.46 There are a number of areas where NIE T&D does not allocate costs against individual units of asset replacement. These areas can be defined as the indirect costs of managing the network. We are seeking to incentivise NIE T&D to report its asset replacement volumes and costs correctly, and to focus its attention on revealing efficiencies in these costs. It is therefore proposed to group together all capex costs that NIE T&D has indicated that it cannot currently attribute to individual asset replacement nor provide measureable outputs due to their historical reporting methods into a single classification. We will refer to these as ‘input driven’ items for the purpose of RP5, as we cannot measure the physical output in terms of network assets replaced. NIE T&D can reallocate allowances between the different items identified below up to the total cap of £7.1 million for transmission and £44.8 million for distribution. The ‘input driven’ items identified by NIE are:

- fault and emergency;
- additional costs associated with replacing assets in storm conditions;
- reactive work;
- capitalised overheads;
- public realm work;
- additional overheads associated with the new roads and street works legislation;
- real price effects (RPE);
- ESQCR data collection and assessments.

**Real price effects for capex**

5.47 The capex programme is subject to different inflationary pressures than the basket of goods that are included in RPI. We have considered the impact of real price effects and the approach used by other regulators.

5.48 We have followed closely the RPE analysis that Ofgem uses and have included an amount of £0.6 million for capex RPEs in the ‘input only’ costs allowed to be recovered during RP5. As actual amounts will be reflected in tariffs after five years, no final reconciliation will be required for this. It should be noted that this is significantly less than the amount that NIE T&D requested (£58 million).



- 5.49 The key reason for the difference in our figures is that in its analysis NIE T&D did not consider the impact of reductions in the real price of labour and construction during the 2010 and 2011 period. Our analysis followed Ofgem's approach, including the weights that were allocated to labour and materials. In its calculations, NIE T&D used a weighting of 45% for materials, as opposed to the 20% that Ofgem uses for the GB distribution network operators (DNOs).
- 5.50 NIE T&D's calculations were based on its full request for capital expenditure, while our analysis is based on our final determination. Our methodology is discussed in Appendix I.

### **Amount allowed for Fund 1**

- 5.51 In light of the difference between the amount of capex that NIE T&D consider necessary for RP5 and our assessment of the correct amount, we undertook further benchmarking analysis in order to assess and challenge our figures and to make sure that they were appropriate. SKM used the same approach that Ofgem used to calculate the volumes of asset replacement for the GB DNOs at its most recent price control. This compares the age at which assets are being replaced, then looks for any special circumstances that would result in more or less of each asset type being replaced.
- 5.52 NIE T&D has provided us with additional factual information about the methods used to prioritise assets for replacement. When combined with SKM's modelling, this has provided us with assurance that the number of assets that should be replaced during RP5 should be increased from that in our draft determination.
- 5.53 This increase in asset replacement will result in higher costs to customers than would otherwise have been the case; however this is balanced with the need that customers have for a reliable network. In the context of the additional information provided by NIE T&D, we consider that the volumes of asset replacement that are allowed for during RP5 represent an appropriate balance between our duties to protect customers while ensuring that NIE T&D remains compliant with its licence and legislation.
- 5.54 Benchmarking by SKM has shown that the direct costs associated with NIE T&D's capex plan are efficient. However, the indirect cost benchmarking that was undertaken for us by Cambridge Economic Policy Associates (CEPA) identified room for further improvement in this area. SKM has proposed a

reduction in the amount that NIE T&D can recover for indirect costs of 10%, to remove this inefficiency. This is reflected in our recommended allowance for indirect cost projects. This replaces the X-factor of 1% across Funds 1 and 2 in our draft determination.

5.55 NIE T&D has accounted for indirect costs in two ways in its submission to us. The majority are identified in specific requests, such as capitalised overheads, while the remainder are included within the unit costs used to estimate the cost of each investment requirement.

5.56 We have applied the 10% reduction to all of these indirect costs, irrespective of how they have been included in the capex request. The amount of capex allowed for planned and unplanned asset replacement for the transmission and distribution systems is shown in Table 5.1.

**Table 5.1: Fund 1 allowance**

<b>Fund 1 capex</b>	<b>Transmission</b>	<b>Distribution</b>
Overhead lines, cables, plant and equipment	£85.3m	£157.6m
Input only items	£7.1m	£44.8m
<b>Total</b>	<b>£92.4m</b>	<b>£202.4m</b>

5.57 The amounts allowed for Fund 1 are compared with the company's submission and our draft determination in Table 5.2.

**Table 5.2: Fund 1 allowance and variance from draft determination**

<b>Fund 1 capex</b>	<b>Transmission</b>	<b>Distribution</b>	<b>Total</b>
NIE T&D submission	£119.0m	£357.3m	£476.3m
Draft determination	£74.6m	£118.8m	£193.4m
Final determination	£92.4m	£202.4m	£294.8 <sup>13</sup> m

<sup>13</sup> Note: Fund 1 now contains all capitalised overheads.

**Annual reporting of Fund 1**

5.58 NIE T&D will be required to report its progress on asset renewal and the 'input driven' items each year. This will primarily be through the capex database, although a narrative report will also be required.

5.59 The information to be provided on an annual basis for each programme includes:

- average unit costs;
- actual spend and number of units installed;
- expected spend and number of units to be installed before the end of RP5; and
- the reasons for any change from the original programme.

5.60 This information will be verified by the Reporter, who will also comment on the implications of any changes to the programme. The unit costs will be assessed and any efficiency identified.

5.61 The formal report at the end of each annual review will be provided to NIE T&D by the Reporter. This will allow the company to incorporate any feedback into its plans for the remainder of the price control.

**Final reconciliation of Fund 1**

5.62 At the end of RP5, a final review will determine the combined efficiencies (positive or negative) identified each year into revenue adjustments to be applied during RP6. We will only consider the expenditure for the 'input driven' items when setting efficiency revenue adjustments in RP6.

**Fund 2**

5.63 Fund 2 covers less predictable investments, which are triggered by factors over which NIE T&D has less control. This includes:

- load related investment;
- metering (excluding Smart metering, which is in Fund 3); and
- connections.

5.64 Capital costs associated with changes in legislation will also be accounted for here, if they have not been included in Funds 1 or 3. These costs must be

approved in advance and in accordance with any 'change in law' provisions included in NIE T&D's licence.

- 5.65 Working with SKM, we have reassessed each of the projects that NIE T&D has requested for Fund 2. NIE T&D has provided significant additional data relating to the loading patterns on each of the assets that it would like to upgrade. We have discussed how the company interprets and implements the planning standards at the workshops we held.
- 5.66 We acknowledge that NIE T&D will have to respond to exceptional weather events. We intend to consult on the definition of "exceptional events" and where these criteria are met, the incremental capital costs of repairs to the network will be logged up under Fund 2.

## **Objective of Fund 2**

- 5.67 The investments covered by Fund 2 are undertaken in response to increases in demand, additional connections to the system or changes to metering requirements. The volume of investment required here during RP5 will be determined by customer behaviour, and the risk associated with this is placed with customers.
- 5.68 The purpose of Fund 2 is to ensure that NIE T&D is only exposed to the cost risk for these investments.
- 5.69 As stated in our consultation on Fund 3 processes, we are concerned that the current planning standards for the transmission and distribution systems do not adequately reflect emerging issues, such as embedded generation and demand-side management. Any logging up of investments under Fund 2 will be dependent on NIE T&D undertaking a comprehensive review of these standards during the first year of RP5 and fully documenting its current prudent investment criteria.

## **Fund 2 mechanism**

- 5.70 Our recommended allowance is based on an assessment of the best information that is currently available to us, provided by NIE T&D, against the current network operating and planning standards required under the licence. These standards have not been formally reviewed since 1999. As such, they do not reflect changes in technology that have taken place over the past 13 years

in either control systems or embedded generation. The equivalent standards for GB have been updated a number of times since 1992.

- 5.71 NIE T&D has stated verbally that it intends to review these standards. In this final determination, we are asking NIE T&D to review these standards (under condition 19 of the company's licence) within the first year of RP5. We require NIE T&D to consult on the assumptions it intends to apply when assessing network capacity. Investments in years two to five will be assessed against the updated standard. Any projects that do not meet this standard will not be classified as efficient. NIE T&D will lose five years of revenue associated with any projects that cannot be demonstrated to be efficiently incurred based on the information and standards at the time the decision was made to proceed with capital investment.
- 5.72 In addition to the planning standards NIE T&D is currently operating a prudent investment strategy. The involves the company monitoring actual load growth and only approving investment once it has identified that there is a high probability that equipment could be required to operate above its rated capacity for a significant number of hours a year. This has been demonstrated in the company's submission and verified by SKM as part of its review of RP4. Therefore it is our intention to request that this strategy is documented and approved to allow this also to be considered when deciding to proceed with investment.
- 5.73 As part of the annual reporting cycle, the Reporter will assess the projects that NIE T&D undertakes. The Reporter will also audit NIE T&D's decision making process, to ensure that projects the company intends to initiate during the following year are necessary and efficient.
- 5.74 Fund 2 will not include those projects where the scope could change as a result of the increase in renewable generation. Three projects have been transferred to Fund 3. NIE T&D originally requested £43.4 million to cover these projects.
- 5.75 Actual spend on connections (net of customer contributions) will be added to the relevant RAB at the end of the reporting year in which it is incurred and will be recovered via tariffs. This will be subject to an obligation to invest efficiently and in accordance with the connection charging rules. We provide further detail in Chapter 8.
- 5.76 It is expected that expenditure on conventional meters under Fund 2 will reduce as the smart meter roll out commences towards the end of RP5. The actual

cost of metering will be added to the RAB each year and the amount collected via tariffs will also reflect the expected actual spend. The smart meter programme will be approved via Fund 3.

## **Amount allowed for Fund 2**

5.77 SKM has reviewed all of the information that NIE T&D has provided in relation to these projects. This includes significant information about the loading on each of the assets that were identified by the company as being overloaded.

5.78 Some of NIE T&D's claims were supported by the data provided. However, the need for a number of projects could not be substantiated. We require NIE T&D to provide a statement describing how it interprets the updated planning standards and prudent investment strategy. This will increase transparency and will provide a framework for assessing the requirements for future price control periods.

5.79 The amount ringfenced for connections is £37.3 million, with £20.5 million ringfenced for metering.

5.80 The amounts identified for the starting position for Fund 2 are listed in Table 5.3. There are some significant changes from the draft determination. These are:

- based on new information, six projects that were not allowed in the draft determination are now included;
- two projects worth £28 million have been reallocated from transmission into Fund 3 as the appropriate detail has not yet been provided by NIE T&D to allow approval due to uncertainties about the specification required;
- capitalised overheads related to Fund 2 have been reallocated to Fund 1;
- the impact of the change to the connection charging policy has been reassessed.

**Table 5.3: Fund 2 allowance and variance from draft determination**

<b>Fund 2 capex</b>	<b>Transmission</b>	<b>Distribution</b>	<b>Connections and metering</b>	<b>Total</b>
NIE T&D's submission	£60.1m	£142.9m	£96.8m	£299.8m
Draft determination	£34.7m	£41.0m	£45.5m	£121.2m
Final determination	£11.5m <sup>14</sup>	£31.1m <sup>15</sup>	£58.0m	£100.6m

## Innovation

5.81 In its submission, NIE T&D requested £14.9 million for innovation. With one exception, the proposals have not yet been developed in sufficient detail. We propose to allow the funding requested for online monitoring of transmission transformers as part of the asset replacement allowance as this is where any benefits will be obtained. We have identified that the large amounts of small-scale wind generation expected to connect to the distribution system is likely to be the main driver for capex innovation during RP5. We therefore propose to transfer spending on this area to Fund 3. No specific allowance is proposed at this stage. This will allow NIE T&D a grace period in which to consider the issues that it expects to face and to scope robust trials for smart grids (prior to larger scale roll out of successful technologies towards the end RP5).

## Annual reporting of Fund 2

5.82 Annual scrutiny by the Reporter is essential to reduce risk for both customers and NIE T&D under this fund. NIE T&D will take the risk that the Reporter agrees that the company's investments are necessary and efficient. We will mitigate this risk by approving the assumptions, standards and processes that are used to assess the need for investment. The Reporter's assessment will be

<sup>14</sup> Voltage support projects have been moved to Fund 3 as the capacity required is still to be determined. These assets are essential for the dispatch of renewable generation and the TSO project DS3 will feed into the specification. Capitalised overheads have moved to Fund 1.

<sup>15</sup> Capitalised overheads associated with Fund 2 projects have been moved to Fund 1.

based on these standards. This will be an annual process, timed so that it is co-ordinated with NIE T&D's submission of the annual capex reporting and database. Prompt feedback from us will allow NIE T&D to take corrective action in a timely manner and will reduce risk associated with an efficiency review at the end of the price control.

5.83 In addition to the reporting for Fund 1 programmes, we require information about the reasons for investment for each Fund 2 project. This will include:

- existing loading on the assets, including the number of hours above the rated capacity under normal operation;
- expected changes in demand over the coming years; and
- a description of how the planning standards and prudent investment strategy have been applied in each case.

5.84 We would expect this information to be readily available as it would form part of NIE T&D's decision making process.

5.85 Where we request it, this information will be verified by the Reporter, who will also comment on the implications of any changes to the programme. The unit costs will be assessed and any efficiency identified.

5.86 The formal report at the end of the annual review will be provided to NIE T&D. This will allow the company to incorporate any feedback into its plans for the remainder of the price control period.

## **Final reconciliation of Fund 2**

5.87 The projects included in Fund 2 are mostly driven by customer behaviour such as load growth and requests for new connections. Additional investment due to increases in demand (peak demand within a supply area) will be logged up at the end of RP5 and NIE T&D will be made whole for that investment. Symmetrically, projects that cannot be demonstrated to be required will be logged down. This is facilitated by the additional annual reporting and scrutiny by the Reporter of the need for and efficiency of the investment.

5.88 NIE T&D will be only be able to add necessary and efficiently incurred spend onto the RAB as assessed by the Reporter. This will ensure that any projects that are not completed will have the appropriate allowance identified to complete the projects in the next regulatory period. NIE T&D is taking the costs risk in Fund 2 for asset replacement that is carried out for load related



reasons although customers take the risk associated with any additional works required due to load growth. As the company is taking little risk in Fund 2, there is no additional incentive. NIE T&D could only defer expenditure by providing a lower standard of security of supply. As customers would be exposed to a lower standard of service as a result, there will be no reward for deferring capex in Fund 2.

- 5.89 At the end of RP5, the final reconciliation will determine the combined efficiencies (positive or negative) identified each year into revenue adjustments to be applied during RP6. The output of the annual Reporter's reviews will identify the projects to be logged up or down.
- 5.90 The adjustment that is made to NIE T&D's income will ensure that the company is made whole for any necessary and efficiently incurred investment made during RP5; conversely, any payments customers have made through tariffs associated with projects that were not delivered will be deducted.

### **Fund 3**

- 5.91 In its submission to us for RP5, NIE T&D proposed that the costs for developing the network to accommodate the additional renewable generation after the preliminary development stage should be assessed as an additional capex allowance within the price control.
- 5.92 In our draft determination, we recognised the potential benefits of a two-stage approach. We have allocated the costs for accommodating additional renewables to capex Fund 3. This allows both the construction and pre-construction costs to be assessed as the case of need for a particular project is proven. It also reduces the total amount of cost risk faced by both NIE T&D and consumers.
- 5.93 On 31 July 2012, after the consultation period for our draft determination had closed, DETI announced<sup>16</sup> that it intended to roll out smart meters for electricity consumers in Northern Ireland. Any costs associated with this roll out will be assessed and recovered under Fund 3. We will be consulting on the implementation of this policy, including the roles and responsibilities of each party involved with the process.

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<sup>16</sup> <http://www.northernireland.gov.uk/news-deti-310712-northern-ireland-to>

- 5.94 We accept that NIE T&D will need to undertake trials and investment related to smart grids during RP5. However, the proposals included in the company's submission require further development. These trials and any subsequent investments will be included in Fund 3.
- 5.95 In its response to our RP5 draft determination, NIE T&D requested a fixed allowance for the development of the network for renewable generation, without any specified outputs. We are not able to grant such an allowance as it would not be compatible with our duty to protect consumers. This is covered further in Appendix E.

### **Objective of Fund 3**

- 5.96 While we acknowledge the need for investment for renewable generation and smart networks, the amount of investment that will be necessary during RP5 is uncertain. The details of the smart meter roll out, including NIE T&D's role in that process, have still to be considered.
- 5.97 The purpose of Fund 3 is to ensure that NIE T&D can undertake these activities without having to wait for the next price control. However, the uncertainty associated with these items could be significant and only projects that have been clearly identified with clearly defined value will be approved.

### **Fund 3 mechanism**

- 5.98 We have consulted separately on the mechanism to be used to assess investments under Fund 3. This consultation closed on 27 September 2012. The major concern that respondents raised was the additional time required to assess requests from NIE T&D and any the impact that any delay might have on the commercial position of individual wind farms.
- 5.99 The methodology defined in the consultation paper will form the basis of approvals of Fund 3 investments.
- 5.100 Customers will be funding these investments over 40 years. Our scrutiny of proposed investments is essential to ensure that we protect them from unnecessary costs, and to ensure that the expected outputs are delivered. While our duties differ from those of NIE T&D, the information that we require is similar to that which the company needs in order to demonstrate compliance with its legal obligations.

- 5.101 Where our analysis requires additional information, this can sometimes be obtained from other sources. An example of this is modelling undertaken by the transmission system operator. We will work with both NIE T&D and SONI to agree the information required to undertake our assessments. We will agree a timetable with NIE T&D to ensure that our governance has as little impact as possible on the time required to implement the projects.
- 5.102 As stated in our consultation paper, incentives will be specific to each project.
- 5.103 In our draft determination, we specified that we would have a lower WACC for Fund 3 projects. This is because NIE T&D is not exposed to the same level of risk that it is exposed to in Fund 1 and Fund 2. These risks include price risk, volume risk and the risk of real price effects for those projects. It is worth stating that no allowance for the real price effects is included within the Fund 3 projects. As we are including an allowance for these under Fund 1, we will apply the same WACC to all investments. WACC is discussed further in Chapter 12.

### **Amount allowed for Fund 3**

- 5.104 No funding for Fund 3 projects will be included in the tariffs at the start of RP5. As each item is approved, it will be added to the amount that NIE T&D is entitled to recover in tariffs each year.
- 5.105 NIE T&D's latest estimate for spend under Fund 3 is shown in Table 5.4. This has decreased by £111 million since we published our draft determination.
- 5.106 The individual approvals that we will make for projects within Fund 3 will specify incentivisation mechanisms, including the implications if the outcomes identified are not fully delivered.

**Table 5.4: Fund 3 latest best estimate**

<b>Fund 3 capex<sup>17</sup></b>	Transmission	Distribution
Medium-term plan	£76.8m	
Wind farm clusters	£7.0m	
Voltage support <sup>18</sup>	£28.4m	
Coolkeeragh - Magherafelt	£15.0m	
Tyrone-Cavan Interconnector	£89.0m	
Renewable Integration Development Plan (RIDP)	£7.2m	
Smart metering		TBD
Smart grid trials		TBD
<b>Total</b>	<b>£223.4m</b>	<b>TBD</b>

### Reporting of Fund 3

5.107 Fund 3 projects will have the same reporting requirements as Fund 1 and Fund 2, with the following additional requirements:

- biannual progress reports for each project (both renewables and smart investments);
- post-project appraisals, including verification by the transmission system operator that the specified functionality has been delivered;
- a biannual overall update on the amount of renewable generation connected to the system, including the amount of firm access – this should include the overall progress towards a grid that can support the amount of renewable generation required to meet the 40% target.

5.108 A Renewables Grid Liaison Group, comprising NIE T&D, the Utility Regulator, SONI and representatives of developers of renewable generation has been

<sup>17</sup> Latest best estimate August 2012.

<sup>18</sup> Reallocated from Fund 2 after our draft determination.

established. The Group will discuss and facilitate progress in the development of the Northern Ireland grid and renewable connections so that renewables targets are achieved.

5.109 The biannual reports on the renewables projects will also be discussed at the Group's meetings and will be published to increase transparency to all stakeholders

5.110 As described in our Fund 3 consultation paper, the Reporter will verify Fund 3 reporting, when requested to do so by us.

### **Licence modifications**

5.111 The licence will allow NIE T&D to claim depreciation and return for:

- the opening RAB for RP5 (specific value in licence, based on regulatory accounts as adjusted for capitalisation practice);
- the amount approved for Funds 1 and 2 (values per year for each fund specified in the licence);
- the actual spend on connections and conventional metering;
- any approvals under Fund 3;
- a final reconciliation applied during RP6, equivalent to NIE T&D being held neutral for any logged up/down expenditure; and

5.112 The audit of statutory and regulatory accounts will include the actual capex spend in each year. These actual audited values will be added to the RAB to assist the annual reporting process and to ensure that the data are available for the final reconciliation.

5.113 Any residual efficiency benefit that NIE T&D is due over RP6 will be detailed in the licence to apply for RP6.

5.114 Further details of the proposed modifications to NIE T&D's licence are contained in a separate consultation.

### **Summary**

5.115 Table 5.5 below shows our final proposals for RP5 capex.

**Table 5.5: RP5 capex summary**

		NIE T&D submission		Our final determination	
Fund	Spend area	Transmission	Distribution	Transmission	Distribution
1	Asset replacement	£119.0m	£357.3m	£92.4m	£202.4m
2	Load related capex Network IT; network performance; non-network IT	£60.1m	£142.8m	£11.6m	£31.3m
R	Ring-fenced for metering	£0.0m	£37.5m	£0.0m	£20.5m
	Ring-fenced for connections and alterations	£0.0m	£59.3m	£0.0m	£37.3m
<b>Subtotal</b>		<b>£179.1m</b>	<b>£596.9m</b>	<b>£104.0m</b>	<b>£291.5m</b>
		<b>£776.0m</b>		<b>£395.5m</b>	
3	Medium-term plan	£70.3m	£0.0m	TBD	
	Wind farm clusters	£17.6m	£0.0m	TBD	
	RIDP	£127.2m	£0.0m	TBD	
	Tyrone - Cavan Interconnector	£76.0m	£0.0m	TBD	
	Smart grid trials				TBD
	Smart metering				TBD
<b>Subtotal</b>		<b>£291.1m</b>	<b>£0.0m</b>	<b>TBD</b>	<b>TBD</b>
<b>Total</b>		<b>£470.2m</b>	<b>£596.9m</b>	<b>TBD</b>	<b>TBD</b>
		<b>£1,067.1m</b>		<b>TBD<sup>19</sup></b>	

<sup>19</sup> NIE T&D latest best estimate is £223 million for the transmission projects.

## 6 RP5 OPEX

### Update from draft determination

- 6.1 Following publication of our draft determination, we received detailed comments from NIE T&D and other stakeholders to our RP5 opex proposals. We considered all views and have updated our position based on additional or new information provided.
- 6.2 Since the draft determination was published we have reassessed a number of cost items. After analysis of new evidence the following changes have been made to the opex allowance:
- the base year amount used in our decision has increased due to a modelling issue;
  - the efficiency factor applied to controllable opex has reduced from 9% to 7%;
  - meter reading and 'Enduring Solution' allowances have increased based on new information received from NIE T&D;
  - the renewables baseline allowance has decreased to ensure no double counting with a previously approved allowance;
  - other controllable opex has increased marginally; and
  - real price effects have decreased by £3.3 million.
- 6.3 The total change in RP5 controllable opex since the draft determination is an increase of £14 million, from £257 million to £271 million. No changes have been made to the uncontrollable opex amount. The uncontrollable opex allowance is £88.8 million.
- 6.4 In the draft determination, we proposed that NIE Powerteam Ltd should be treated like any other third party and references to NIE Powerteam Ltd should be removed from NIE T&D's licence. Due to the pension arrangements, this is no longer possible. (See pensions chapter for further information.)
- 6.5 We do expect NIE T&D to demonstrate that services delivered by NIE Powerteam Ltd are competitive. Monitoring of market testing and procurement arrangements should also occur on a regular basis (annually) to ensure that the arrangements are in the best interests of consumers.

## Introduction

- 6.6 Our draft determination proposed a total opex allowance of £257 million. This included £168.2 million for controllable opex, and £88.8 million for uncontrollable opex. Our proposals compared with NIE T&D's submission for opex which totalled £345 million.
- 6.7 Controllable opex includes payroll, repairs and maintenance, IT & telecoms, corporate costs, insurance, property costs, professional services and meter reading. Uncontrollable opex includes items such as rates, wayleaves and licence fees.
- 6.8 The results of our analysis for the draft determination showed that NIE T&D is capable of achieving further efficiencies to drive down costs for consumers.
- 6.9 Our controllable opex proposals were subject to economic benchmarking to compare NIE T&D's opex with that of the GB DNOs. We applied an efficiency factor of 9% to the first two years of the price control, on the basis that NIE T&D should be able to reduce costs over that time. We used actual costs in 2009-10 as our base amounts, then adjusted for one-off and non-recurring costs. We also applied an X factor of -1.
- 6.10 In the draft determination as well as reviewing NIE T&D's expenditure, we assessed the opex costs of NIE Powerteam Ltd. We did this by reviewing the working relationship between NIE T&D and NIE Powerteam Ltd and the relative efficiency of NIE Powerteam Ltd as a service provider.
- 6.11 It was our conclusion that NIE Powerteam Ltd was not subject to competition or regulation. We were minded to bring the current arrangements between NIE T&D and NIE Powerteam Ltd to an end and have NIE T&D demonstrate competitive procurement and report evidence of this to us.

## Summary of responses

- 6.12 Of the responses received, 15 made specific references to the RP5 opex element. One of these responses was marked as confidential and not for publication. Responses referred to both controllable and uncontrollable opex.
- 6.13 NIE T&D provided a substantial response to the opex proposals in our draft determination. After our draft determination was published, the company



reduced its opex submission from £345 million to £332 million to demonstrate its commitment to achieving efficiency gains.

- 6.14 For controllable opex, some respondents commented that it was unrealistic to expect NIE T&D to maintain labour costs at or below inflation over the next five years. These respondents felt that the salaries currently offered by NIE T&D are misaligned with those offered by the wider energy sector. Several respondents raised concerns that we used the Standard Occupational Classification to compare NIE T&D's highly specialised and skilled workforce with the workforce in Northern Ireland.
- 6.15 For uncontrollable opex, three respondents commented on our proposed approach to wayleaves. All remarked that the proposed allowance was not high enough. Two stated that they did not agree that wayleaves are semi-controllable.
- 6.16 Two respondents referred to rates; both disagreed that rates are semi-controllable, and one believed that the proposed allowance was not high enough.
- 6.17 Two responses dealt with 'injurious affection' claims. Both stated that the amount we proposed was not sufficient, and one also believed that NIE T&D's submission was in fact inadequate.
- 6.18 One respondent who referred to licence fees supported the proposed cost treatment.
- 6.19 Our draft determination proposal for controllable opex suggested that an efficiency factor of 9% be applied during the first two years of the price control. Two respondents supported this proposal.
- 6.20 Ten responses were received with regard to NIE Powerteam Ltd and our comments. Some respondents thought that current arrangements between NIE T&D and NIE Powerteam Ltd should be brought to an end and NIE T&D should tender for services by way of competitive procurement.
- 6.21 Several responses raised concerns about our findings that there are no service level agreements (SLAs) or even benchmarking activities between Powerteam and other similar operators. Such respondents would support and encourage us in bringing to an end the current arrangements between NIE T&D and NIE Powerteam Ltd and the introduction of more competitive procurement activities.

- 6.22 Other respondents point out that NIE Powerteam Ltd's activities are of their nature inherently part of the network provider's activities and that employees of NIE Powerteam Ltd regard themselves as NIE T&D employees and strongly resent the fact that we said that they should be treated as any other third party supplier of services.
- 6.23 NIE T&D's response restates the original objectives of setting up NIE Powerteam Ltd, and the benefits and commercial justification for operating NIE Powerteam Ltd as a separate in-sourced provider of electrical engineering services. At the time of the RP5 price control NIE T&D emphasised the independent 'arm's-length' nature of the relationship. Following the draft determination NIE T&D has also emphasised the close integration of the two companies and the shared pension scheme. NIE T&D continues to maintain that there are clear benefits for consumers and that NIE Powerteam Ltd has been a key enabler of efficiency savings.
- 6.24 NIE T&D believes that our assessment of NIE Powerteam Ltd costs throughout the draft determination is fundamentally wrong. The company states that NIE Powerteam Ltd is an integral part of the NIE T&D organisation and that its only function is to undertake activities that form part of NIE T&D's business.
- 6.25 NIE T&D states that there is no need for us to specify how management should meet its overall efficiency targets. It feels that NIE Powerteam Ltd has brought a commercially focussed culture where managers understand the importance of cost control and cost reduction. It also notes that their remuneration is partly dependent on delivery. The current model has no adverse consequences for customers of NIE T&D as only NIE T&D's efficiently-incurred costs (including costs efficiently incurred in the activities undertaken by NIE Powerteam Ltd) are passed on to customers. NIE T&D believes that our role should go no further than identifying efficiency targets and incentive mechanisms.
- 6.26 NIE T&D also state that the NIE Powerteam Ltd model has no adverse consequences for customers. Contrary to the impression created by us, NIE Powerteam Ltd's activities are subject to effective price control regulation as part of NIE T&D's activities. There is therefore no justification for its proposal to bring the current arrangements between NIE T&D and NIE Powerteam Ltd to an end. NIE T&D is of the opinion that our reluctance to recognise that NIE Powerteam Ltd's efficiently incurred costs form an essential part of NIE T&D's

funding requirement has resulted in a number of confused and inconsistent proposals for cost allowances throughout the draft determination.

## Final determination

### Controllable opex

6.27 For our final determination, we reassessed our analysis to ensure that there were no errors, omissions or inaccuracies. We also took account of any new information provided by NIE T&D.

6.28 We adjusted our modelling in order to:

- amend the previous inclusion of an adjustment made for what we classed as a 'one-off' cost in the base year<sup>20</sup>. This adjustment has now been excluded and has increased the base year amount by £600,000 a year.
- adjust the efficiency factor from 9% to 7%. This is because in the draft determination we included the full cost of the market opening systems in our benchmarked efficiency factor. NIE T&D provided additional evidence to show that the responsibilities and costs of the GB DNOs are lower so an adjustment was required. We accept NIE T&D's position.

6.29 NIE T&D provided a large amount of information after the draft determination was published regarding salary levels. The aim of providing this additional information was to show the significant labour market pressures the company faces, the upward trend of NIE T&D's skilled labour wages, and the fact that people are increasingly prepared to move away from Northern Ireland in order to maximise their salaries.

6.30 Our analysis of a large number of job adverts has allowed comparisons to be drawn between NIE T&D's salary scales and those of the wider market in Northern Ireland. In most cases that we reviewed, NIE T&D's rates are broadly similar to, or above, those offered by competitors and can therefore be classed as competitive. Evidence from job adverts also suggests that there is a vibrant labour market in many of the skilled staff categories that NIE T&D employs. However to date this has not had a large impact on NIE T&D's business. This was illustrated by the low labour turnover rates in comparison

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<sup>20</sup> Re-billing charges. By initially making the adjustment our base year amount would have been unnecessarily low. This has now been rectified.

with the wider market. It is also shown by the fact that there is significant interest in the vacancies that NIE T&D offers.

- 6.31 Our draft determination included salaries in the benchmarking exercise and we have not been convinced by new information that any uplift should be applied; the allowance proposed in the draft determination is unchanged.
- 6.32 In NIE T&D's response to the draft determination they questioned some of the figures behind our opex proposals. The cost items questioned included meter reading, costs associated with Rathlin Island, the Enduring Solution programme and a baseline for renewables work. Each of these is discussed in turn.
- 6.33 NIE T&D provided information showing a number of overheads associated with meter reading. We have now agreed with NIE T&D's proposed costs for fleet and fuel, mileage, IT, phones and other support costs. However, we do not agree with NIE T&D's submission for salary costs. Following a bottom-up analysis of salaries and a review of the meter reading figures which NIE T&D supplied, we have decided on an allowance of £13.8 million for meter reading. This compares with NIE T&D's submission of £19.8 million. Costs associated with keypad meters remain as proposed in our draft determination.
- 6.34 The Enduring Solution is the IT system that is used to support competition in the retail market. Our draft determination figures for this system were based on NIE T&D's November 2011 submission. NIE T&D submitted revised Enduring Solution costs in early July 2012, after the draft determination had been published. The revised submission made further changes to the figures analysed for the draft determination. The July submission identified costs of £29.4 million, an increase of £6.9 million from the original BPQ projections. The biggest change relates to applications (mainly SAP<sup>21</sup>) support costs. We have completed further detailed analysis of the figures and IT costs that NIE T&D provided. We have decided on an allowance of £21.4 million for the RP5 period.
- 6.35 In relation to the renewables baseline, NIE T&D accepted the level of resources we proposed in the draft determination, but not the salary levels. It is worth noting a reduction of £6.7 million in NIE T&D's position since our draft was published. We do not accept NIE T&D's views concerning salary levels and the allocation of managed service charge/supply chain costs. We have

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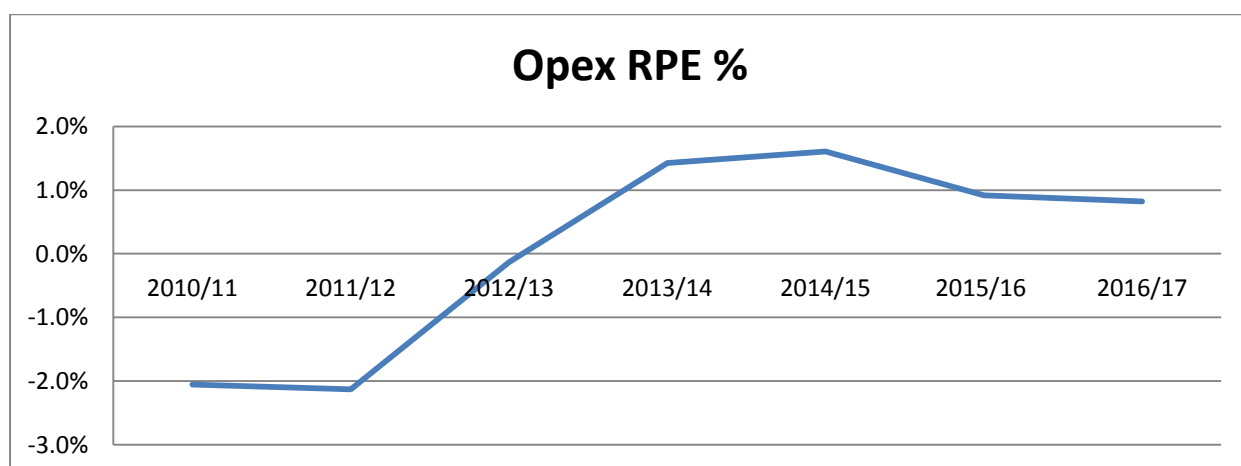
<sup>21</sup> SAP is an IT system that NIE T&D use.

decided to use the allowance in the draft determination as our base, and we have deducted an amount of £804,000 from our draft determination proposal as a separate allowance has since been provided to NIE T&D for related work via the Dt term of its licence.

6.36 Of allowances previously disallowed, we reviewed NIE T&D's submission on Rathlin Island costs again and approved £0.2 million of operating costs. We have also decided to approve allowances for storm costs, AGUs, credit rating process and PAS55.

6.37 The final major change to the opex allowance relates to RPEs. This is the percentage above inflation that opex costs may be in RP5. NIE T&D asked for an amount of £8.7 million in relation to opex RPEs but we rejected this in the draft determination. We have since reviewed the extensive work that Ofgem and Ofwat have undertaken in this area.

6.38 Supported by economic consultants, we completed an assessment of RPEs for both capex and opex. The analysis shows that for opex (mainly labour) there is a positive RPE over the RP5 period. The RPE is approximately 1% a year over the period. However, there was a significant negative RPE for the period 2010 and 2011. This is illustrated in Figure 6.1.



**Figure 6.1: Opex RPE for 2010 to 2017**

6.39 As the cost base we refer to is 2009-10 it is important to include the impact of RPEs from that time. This results in an overall negative allowance of -£3.3 million.

6.40 This is significantly less than the amount that NIE T&D requested. The key reason for the difference in our figures is that NIE T&D did not consider the impact of the 2010 and 2011 period in its analysis. In addition, our analysis followed Ofgem's approach, including the weights allocated to labour and materials. NIE T&D used a weight of 72% for specialist labour whereas we adopted Ofgem's weight of 26%.

6.41 We have increased some other cost lines by £1.4 million due to the justifications and information provided by NIE T&D.

6.42 As outlined in the draft determination, we propose to apply an X of 1 to the controllable opex costs. A summary of our controllable opex decision is shown below.

**Table 6.1: RP5 controllable opex**

<b>£m</b>	<b>NIE T&amp;D's submission</b>	<b>Draft determination</b>	<b>Final determination</b>
Controllable opex with efficiency factor applied	174.2	144.9	156.9
'New' opex submitted by NIE T&D	63.3	28.5	29.3
Additional allowances approved since draft determination	0	0	1.4
Controllable opex before X of -1 is applied	0	173.3	191.1
<b>Controllable opex with X of -1 applied</b>	<b>237.5</b>	<b>168.2</b>	<b>182.2</b>

### **Uncontrollable opex**

6.43 Uncontrollable opex allowances remain unchanged from the draft determination.

6.44 We are of the view that while it may be possible for NIE T&D to exert some control over rates and wayleaves, it is recognised from the additional information submitted that these cost items are currently calculated using

formulae from legislation or other sources<sup>22</sup>. Therefore we no longer propose to apply a risk sharing allocation.

**Table 6.2: RP5 uncontrollable opex**

£m	NIE T&D's submission	Draft determination	Final determination
<b>Uncontrollable opex</b>	<b>107.3</b>	<b>88.8</b>	<b>88.8</b>

### Opex summary

6.45 The overall impact of changes to our draft determination proposals is shown below. These figures are for a five-year period.

**Table 6.3: RP5 opex summary**

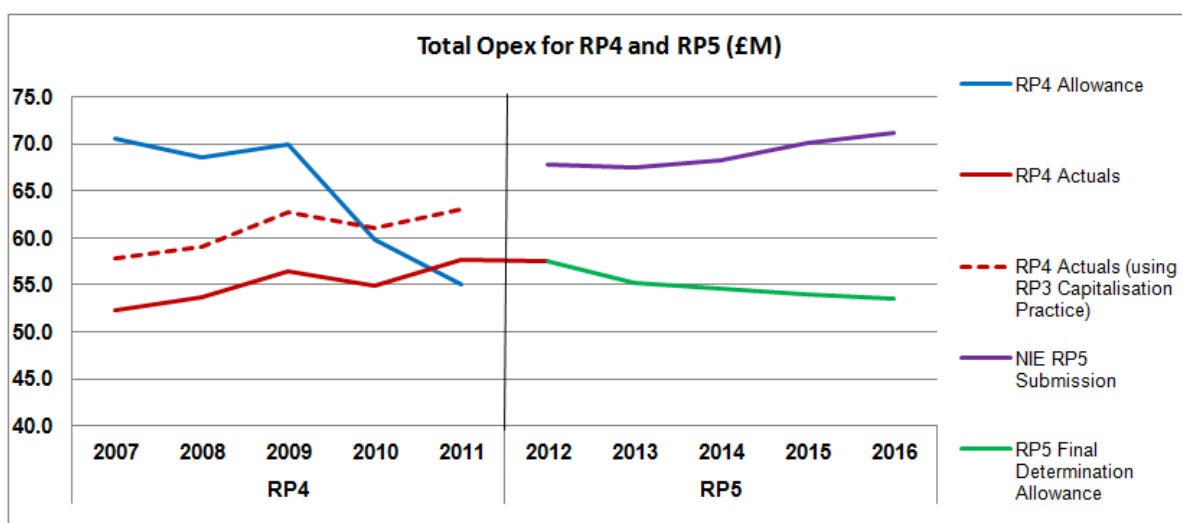
£m	NIE T&D's submission	Draft determination	Final determination
Controllable opex	237.5	168.2	182.2
Uncontrollable opex	107.3	88.8	88.8
<b>Total opex</b>	<b>344.8</b>	<b>257.0</b>	<b>271.0</b>

6.46 We have considered all of the information provided in response to the draft determination. This results in an increase in opex of £14 million when compared with the draft determination. The opex allowance which we propose for RP5 is £74 million (21%) lower than the original submission from NIE T&D, and £61 (18%) million lower than the company's adjusted submission which accompanied its response to our draft determination.

6.47 A more appropriate comparison is to compare the allowance with the RP4 run rate. Figure 6.2 shows the allowance and actual opex levels for RP4 (these figures include Dt items). It also shows the actual opex level had NIE T&D not changed its capitalisation practice. It can be seen that in the RP4 period NIE

<sup>22</sup> For example, NIE T&D's rates liability is currently set out in the Valuation (Electricity) Order (Northern Ireland) 2003. NIE T&D's wayleave rates are based on Scottish Power's wayleave rates which are in line with the rates recommended by the Electricity Networks Association (ENA). The ENA acts on behalf of the UK electricity network companies.

T&D significantly outperformed against its allowance. The opex allowance we have set for RP5 is a similar level to the RP4 expenditure. It decreases over the period due to the impact of the efficiency factors we have put in place.



**Figure 6.2: Comparison of opex for RP4 and RP5**

6.48 We have adjusted our allowances to reflect the 4 year, 9 month duration for RP5 taking account of the application of the efficiency adjustment over a two-year period, as shown below:

**Table 6.4: RP5 opex summary, with allowances for 4 years 9 months**

£m	NIE T&D's submission	Draft determination	Final determination (5 years)	Final determination (4 yrs 9 mths)
Controllable opex	237.5	168.2	182.2	173.6
Uncontrollable opex	107.3	88.8	88.8	84.3
<b>Total opex</b>	<b>344.8</b>	<b>257.0</b>	<b>271.0</b>	<b>257.9</b>

### NIE Powerteam Ltd

6.49 We continue to believe that the current arrangements regarding NIE Powerteam Ltd unacceptably complicate the regulatory process, with insufficient evidence of benefits for consumers.



- 6.50 As stated in the draft determination it became clear during our RP5 analysis that the two businesses are closely integrated and that accounting for the separate legal entities is achieved through sophisticated cross-charging and cost allocation.
- 6.51 In the draft determination we said that we were minded to bring the current arrangements between NIE T&D and NIE Powerteam Ltd to an end and remove any references to NIE Powerteam Ltd from NIE T&D's licence. However, this is no longer practical or possible, due to the pension arrangements.
- 6.52 There does not appear to be sufficient evidence that consumers benefit from the current arrangements; nor is there evidence to support the assertion that NIE Powerteam Ltd is competitive. We therefore expect NIE T&D to demonstrate that services delivered by NIE Powerteam Ltd are competitively procured and market tested; this should help ensure that the arrangements are in the best interest of consumers.
- 6.53 We also expect all activities involving NIE Powerteam Ltd to be properly catalogued within NIE T&D's activities to enable proper monitoring and evaluation of the services provided by NIE Powerteam.

## **7 PENSIONS COSTS IN RP5**

### **Update from draft determination**

- 7.1 Since we published our proposals in relation to pensions in the draft determination and in response to our queries, we have received additional detailed information from NIE T&D.
- 7.2 NIE T&D's response to the draft determination indicates that projected pension costs have increased by a net amount of £2.3 million from the amounts analysed for our draft determination. The increase reflects an additional amount required by NIE T&D to pay pension costs during the RP4 extension period.
- 7.3 We have engaged with NIE T&D, the pension scheme's trustees (NIEPS) and the pension scheme's actuary to gain a better understanding of their responses and to allow them to elaborate on key points.

### **Introduction**

- 7.4 In the draft determination, we proposed to use a different approach to pension cost recovery than had been used at earlier price controls. We also introduced a set of pension principles.
- 7.5 It should be noted that NIE T&D also proposed a different approach to pension cost recovery in RP5 than any approach adopted in previous price controls. The company requested that full pass-through of both ongoing and deficit repair costs should be allowed.

### **Proposed allowance**

- 7.6 In its pension submission, NIE T&D requested £10.5 million of ongoing costs and £66.7 million of deficit repair costs to be allowed. In addition, NIE T&D expected that a £20.4 million underperformance in the pensions allowance for RP4 would also be recovered. NIE T&D's proposals rested on a total pension scheme deficit of £150 million (at September 2011), to be recovered over 11 years (from 31 March 2011).
- 7.7 The 'pension principles' that we proposed in the draft determination were as follows:

- NIE T&D should be allowed to recover the efficient ongoing pension costs for employees who are members of either the defined benefit pension scheme or the defined contribution scheme.
- NIE T&D should be allowed to recover any deficit repair costs, associated with the defined benefit pension scheme, which it cannot legally avoid.
- Pension scheme trustees have a legal obligation to manage the pension fund prudently and in accordance with good investment principles and actuarial practice. Assuming that these legal obligations are complied with, there is little opportunity for NIE T&D to achieve efficiencies in the way it manages the defined benefit scheme, other than by closing the scheme to new members.
- Pension deficits that occur in any price control period may have been influenced by avoidable or inefficient actions taken in previous price control periods. To ensure that electricity consumers do not pay twice, it is important to take account of these effects.
- Pension deficits will be based on the most recent formal actuarial valuation.

7.8 In line with these principles we proposed that the full recovery of requested ongoing costs and £24.3 million of deficit repair costs would be factored into the RP5 price control allowance. We did not agree that NIE T&D should be able to recover any amounts paid during RP4 for pension costs that were in excess of the regulated allowance. Our proposals were based on a total pension scheme deficit of £87.6 million (at 31 March 2011), adjusted in line with our proposed principles, to be recovered over 15 years (from 31 March 2011).

**Table 7.1: NIE T&D and RP5 draft determination figures for pensions**

	Ongoing costs	Deficit repair costs
NIE T&D	£10.5m	£66.7m
Draft determination	£10.5m	£24.3m

- 7.9 We also proposed a negative adjustment of £12.5 million in respect of previous actions by the company that we considered were legally avoidable and which contributed to the £87.6 million deficit.

### Summary of responses

- 7.10 Of the 32 responses that we received, eight commented on the proposed pension allowance.

### Deficit amount

- 7.11 NIE T&D asserted that we had '*entirely ignored the deficit repair plan agreed between NIE and the pension scheme trustees*'. The company commented that we had based our pension allowance proposals on the deficit calculated at the most recent formal valuation date of 31 March 2011, rather than on a deficit calculated for the funding updated at December 2012 and subsequently agreed in a recovery plan on 9 January 2012.
- 7.12 NIE T&D also stated that '*... The Competition Commission concluded that the updated valuations appeared to be the most recent data available to them, and so they considered it appropriate to rely on them*<sup>23</sup>'.
- 7.13 Two other respondents also questioned the deficit amount that we had used. The trustees of the pension scheme commented that our proposals would change their view on the strength of the sponsor covenant.
- 7.14 In contrast, one respondent asked why we would allow for any deficit recovery at all.

### Deficit recovery period

- 7.15 NIE T&D disagreed with our deficit repair proposals in almost all respects. However, it was open to the idea of a 15-year recovery period so long as we provided a clear statement of intent that this period would not be extended at each future price control review.

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<sup>23</sup> Paragraph 3.19

- 7.16 Two other respondents also had concerns about the use of a 15-year recovery period due to risks in deferring costs and inconsistency with the scheme's funding recovery plan.

### Regulated fraction

- 7.17 NIE T&D asserted that all of the current pension deficit is attributable to the company's regulated business activities and has arisen '*purely as a result of adverse investment conditions and increases in life expectancies in the last 5 years*<sup>24</sup> (ie. the period covered by RP4)'. On this basis, the fact that NIE Powerteam Ltd was a separate legal entity was not relevant.
- 7.18 Another respondent commented that any regulated fraction should be applied using a calculation that takes account of length of service, with each relevant employer participating in the NIEPS.
- 7.19 One respondent also argued that NIE Powerteam Ltd's pension costs should be recoverable from consumers, because NIE Powerteam Ltd's employees are exclusively engaged in activities for NIE T&D.

### Historical adjustments

- 7.20 NIE T&D regarded our proposed adjustments in respect of RP2 and RP3 of a retrospective nature. However, as regards RP4, NIE T&D expected that there would be a truing-up of any under- or over-recovery of pension costs in RP5.
- 7.21 One respondent stated that it viewed our proposals regarding historical adjustments as retrospective in nature and contrary to regulatory practice in GB and elsewhere.
- 7.22 Another respondent also questioned our intention to review historical price control periods, characterising our approach as '*inappropriate*'. It stated that it was inappropriate to consider decisions taken up to 15 years ago, and that the draft determination had not considered the circumstances in which those decisions were made.

### Ongoing costs

- 7.23 Respondents generally agreed with our proposal to allow submitted ongoing pension costs that had been subject to an actuarial review by the Government

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<sup>24</sup> Page 156 of NIE T&D's response.

Actuary's Department (GAD). One respondent however proposed that our principle on the application of only legally unavoidable costs to deficit recovery should also be extended to ongoing costs.

## **Final determination**

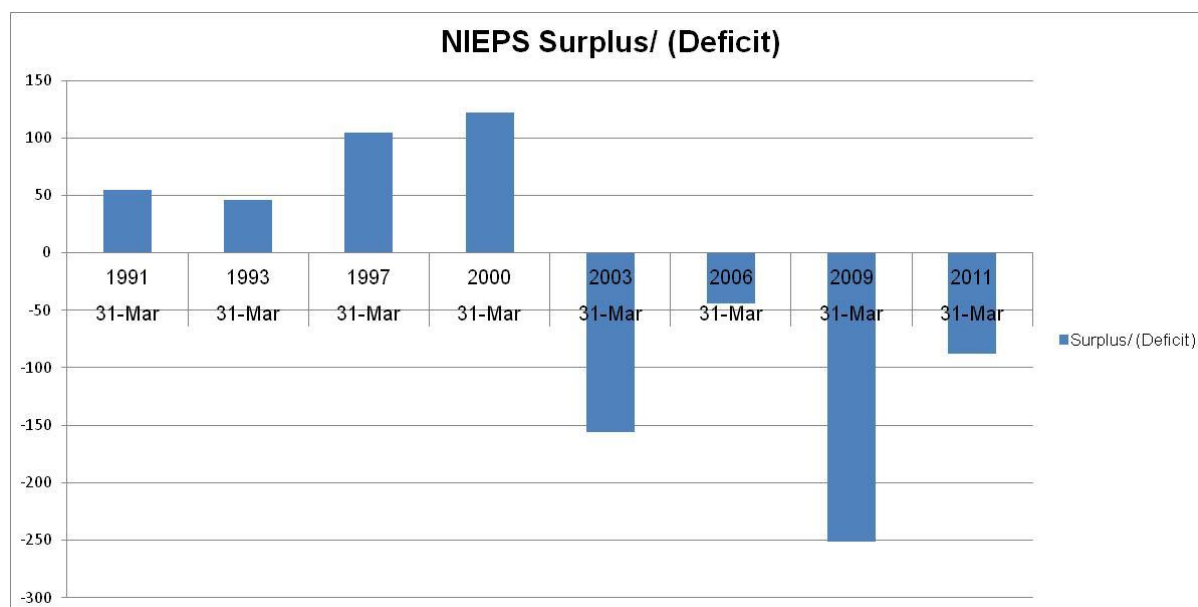
- 7.24 Our final determination is based on our consideration and analysis of the responses to the draft determination and feedback from the stakeholder workshop events.
- 7.25 We were presented with a proposal to recover pension deficit repair costs for the first time in RP4. We adopted the rolling opex approach for determining allowances for these costs, and the Ofgem approach to apply an adjustment for a percentage of the costs associated with previous early retirements (ERDCs)<sup>25</sup>. Ofgem did not make any other adjustments for historic actions. We are persuaded of the value of maintaining consistency with the RP4 approach, unless there is good reason to make changes. We therefore intend to continue with the ERDC adjustment in RP5, but have revised the calculation methodology to bring it into line with that adopted by Ofgem.
- 7.26 Our draft determination proposals put NIE T&D in a much stronger position in relation to the recovery of pension costs than in any previous price control. This is because, apart from a one-off adjustment for historical avoidable costs, consumers would in future effectively underwrite deficit recovery costs that are applicable to the regulated company.

## **The deficit amount to use in the price control allowance**

- 7.27 Figure 7.1 shows that the company's pension scheme has shifted from a surplus to a deficit position since privatisation. By the time of the formal actuarial valuation in March 2011, the scheme deficit was £87.6 million. However, NIE T&D used the results of a later actuarial informal funding update to agree a deficit recovery plan. The deficit amount agreed with the trustees was £150 million.

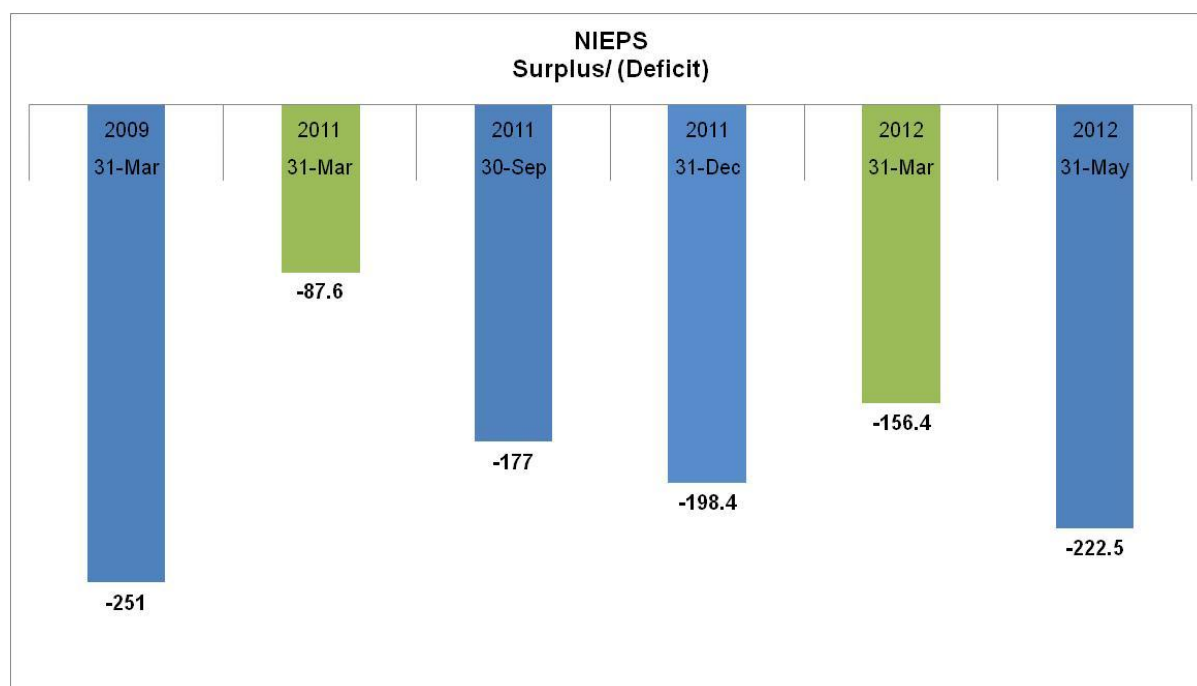
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<sup>25</sup> The December 2004 RP4 Proposals paper states (Page 6)

**Figure 7.1: NIEPS Surplus/ Deficit at each formal valuation date<sup>26</sup>**

7.28 At the time that the draft determination was published we considered it appropriate to use the results of the most recent formal actuarial valuation. We carefully examined the change in deficit position since we received the results of the 31 March 2011 valuation in January 2012. Figure 7.2 shows the deficit position since 2009.

<sup>26</sup> The data has been extracted from formal actuarial valuation reports at each relevant date

**Figure 7.2: NIEPS surplus/deficit at recent funding updates<sup>27</sup>**

7.29 Due to the nature of pension deficit recovery costs and the dependency on triennial formal actuarial valuations, we have decided to treat these costs differently from other opex. Consistent with our pension principles, we will re-determine deficit recovery costs on the basis of the deficit at each triennial formal valuation. We expect the next formal valuation to be on 31 March 2014 but, given the recent volatility in valuations, if we consider it appropriate and with adequate notice, we may ask NIE T&D to bring this valuation forward by 12 months. Any actuarial information received from NIE T&D will be subject to robust review.

7.30 This means that the pension revenue to be collected via the annual tariff process will be adjusted<sup>28</sup> from October 2015 onwards (at the latest) to reflect the level of pension deficit stated in the 31 March 2014 formal valuation. This approach further reduces the cash flow risk to NIE T&D, and maintains consumer tariffs more in line with current costs.

7.31 Although one of our pension principles is that deficits will be based on the most recent formal actuarial valuation, we have decided to take into account changes in the deficit position as the deficit since 31 March 2011 has

<sup>27</sup> Data extracted from funding updated provided by NIE T&D.

<sup>28</sup> Any adjustments made, or truing-up/ -down of figures, will be done so on an NPV-neutral basis.



increased. This is a one-off action in order to reduce the potential tariff volatility in October 2015.

- 7.32 For the RP5 final determination we will base allowances on the deficit amount quoted at 31 March 2012. This amount is £156.4 million. We commissioned the Government Actuary's Department (GAD) to review the reasonableness of the assumptions used for the 31 March 2012 update. The GAD concluded that the changes in financial assumptions between 31 March 2011 (the results used in our draft determination) and 31 March 2012 are reasonable overall, reflecting the pension scheme's statement of funding principles and changes in gilt yields (which are used to derive the discount rates used to value the liabilities). Real yields on index-linked gilts decreased significantly between March 2011 and March 2012. In turn, this has led to a decrease in the discount rates used to value the NIEPS's liabilities, which has increased the value of the liabilities.

### **The deficit recovery period to apply**

- 7.33 In our draft determination we referred to the Pensions Regulator's statement that the period over which consumers fund pension scheme deficits through price allowances need not be the same as the period over which scheme sponsors are expected to repay deficits<sup>29</sup>. Specifically, the Pensions Regulator comments *'such a period is for the purposes of setting the amount of pension costs that consumers should bear during a price control period. This should carry no direct implications for whether employers pay greater pension contributions based on a shorter recovery plan into their pension scheme'*.
- 7.34 In addition to this, a Q&A document that followed on from the Pensions Regulator's statement of December 2009 states as follows: *'It is a matter for the economic regulators the extent to which pension costs can be recouped from consumers, and the period over which this can occur – and hence the impact of pension deficits on consumers' bills. In forming their view of the appropriate recovery plan length, trustees still need to take into account the strength of the employer's covenant, the employer's overall financial*

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<sup>29</sup> <http://www.thepensionsregulator.gov.uk/docs/deficits-statement-dec-2009.pdf>

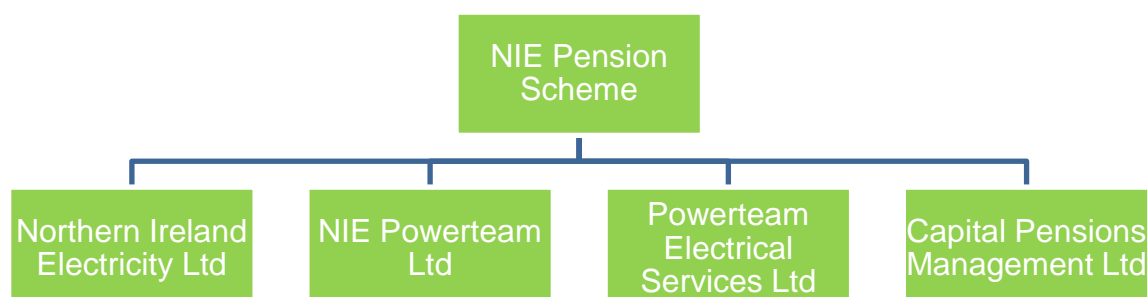
*circumstances, and the impact of any price controls. This decision by trustees will not necessarily lead to consumers paying higher prices<sup>30</sup>.*

7.35 We have decided that a 15-year recovery period is appropriate because of the strength of the covenant provided by our regulatory pension principles, and because 15 years is consistent with the period adopted by other regulators. Ofgem applied a 15-year recovery period in DPCR4/5. In addition, the Competition Commission was clear in its 2010 Bristol Water inquiry that a regulator can depart from the recovery period agreed with trustees on the grounds that “*a longer recovery period smoothes the effect of the inter-generational transfer arising from the deficit*”.

7.36 A 15-year recovery period will apply from 31 March 2012 until 31 March 2027. This period may be changed at future price control reviews to take into account all relevant circumstances at the time.

### The regulated fraction

7.37 The NIE Pension Scheme membership is as follows:



7.38 In our draft determination, we recognised that the regulated business, NIE T&D, is not the only employer that participates in the NIEPS. As such, we determined that NIE T&D’s consumers should not reasonably be expected to meet the NIEPS’s pension costs in their entirety.

7.39 NIE T&D strongly disagreed with our proposal that part of the pension deficit should be attributable to NIE Powerteam Ltd. The company stated that ‘...*whether costs are legally attributable to NIE or NIE Powerteam should not*

<sup>30</sup> <http://www.thepensionsregulator.gov.uk/docs/gas-deficits-statement-Jan2010.pdf>

*be relevant for price control purposes*'. The effect of NIE T&D's statement is that NIE Powerteam Ltd staff carry out regulated activities, and their pension liability should therefore be covered by the NIE T&D pension allowance.

7.40 In the draft determination, we presented three options to calculate the proportion of the total pension scheme deficit that sits with NIE T&D.

- Option 1 calculated the proportion of the total scheme liability which related to active members of NIE T&D only.
- Option 2 calculated the liability based on 'legal' liability and therefore last employer.
- Option 3 calculated the deficit based on length of service with each entity.

7.41 We proposed to use option 2. NIE T&D asserted that it could not accept our proposal that the 'last employer' would be an appropriate basis for calculating the regulated fraction.

7.42 Our rationale for choosing option 2 was that each participating employer is legally responsible for the pension liabilities in respect of its current employees (covering all of their service), and for past employees where it was the last employer.

7.43 However, following consideration of stakeholder responses and a further consideration of the treatment other regulators have used in similar circumstances, we have decided to apply a different treatment in our final determination. We will attribute 99.26% of the pension scheme deficit to NIE T&D<sup>31</sup>. This new option is chosen on the basis that NIE Powerteam Ltd provides services exclusively for the T&D business and ultimately charges its pension costs through to NIE T&D via its charge-out rates. Ofgem used this approach for United Utilities, an associated service company, because 100% of the service company's activities were carried out for the regulated business. We regard this as a strong regulatory precedent. On the basis of this regulatory fraction, and the informal valuation as at 31 March 2012, the amount of scheme deficit that is applicable to NIE T&D is £155.2 million.

7.44 We did consider choosing option 3, which would attribute 93% of the scheme deficit to NIE T&D, and was based on the length of service with past employees with NIE T&D. However, on balance, we placed greater weight on

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<sup>31</sup> A small proportion of the overall pension scheme deficit is attributable to other unregulated participating employers. Their proportion has therefore been excluded from the fraction.

remaining consistent with our approach for RP4 and the Ofgem approach to the United Utilities case.

## Historical adjustments

7.45 Our draft determination proposed adjustments to take into account the net impact of using a historical surplus to:

- take an employer pension contribution holiday,
- improve benefits,
- pay enhanced early retirement costs.

7.46 We also took account of the effect of historical special/extra contributions that the company paid on top of its regulated allowance. We considered the period 1992-2012. These considerations resulted in an overall net adjustment of -£33.4 million (and -£12.5 million during RP5).

7.47 In the draft determination we explained that we thought it appropriate to make this adjustment for a number of reasons:

- RP4 was the first time that pension deficit repair costs had been presented to us, and RP5 was the first time that we had comprehensively considered the appropriate treatment of these costs.
- We had also developed a new set of pension principles under which consumers would underwrite future deficits (apart from the one-off historical adjustment).
- We also noted that NIE T&D did not wish to continue with the rolling opex approach that had been used for RP4, and had pointed out that it remained exposed to the risk of under-recovery.

7.48 Having considered the responses received, for our final determination we will ignore the effect of any historical legally avoidable actions apart from costs arising from early retirements. We will also ignore the effect of special or extra contributions that the company had paid. In its response to the draft determination, NIE T&D noted that it *“did not seek to recover the value of special contributions paid”*. In addition, correspondence from NIE T&D to us, dated 28 October 2005, states that *‘NIE will be carrying the risk that the actual level of contributions payable during RP4...will be higher... and has a clear incentive to ensure that any such cost increases are minimised’*. We will

therefore not allow recovery of any contributions paid by NIE T&D that were in excess of the company's pensions allowance in RP4.

- 7.49 Whilst we are starting with new pension principles for RP5 which essentially remove the deficit risk from NIE T&D going forward, the remainder of our approach is consistent with the approach we signalled in RP4 and that which is adopted by Ofgem.

### Early retirement costs

- 7.50 Ofgem allows all pension deficits relating to the regulated companies, with the exception of the cost of providing certain enhanced pension benefits granted under previous severance arrangements which were not funded at the time (ERDCs). A correspondence to us from NIE T&D on 28 October 2005 stated that the company '*would be prepared to adopt the GB approach which treats the pensions cost as an uncontrollable cost except for the 30% disallowance in respect of ERDCs (£225k per annum)*<sup>32</sup>'. RP4 followed Ofgem precedent by disallowing an amount in respect of ERDCs<sup>33</sup>.
- 7.51 We are still of the view that an adjustment is required to account for unfunded ERDCs in RP5. However, we consider that the adjustment should be made using a different method to that which was applied in RP4 (although still be consistent with Ofgem's approach).
- 7.52 In our draft determination, we recognised that an element of efficiency was achieved from the early retirement exercise and that consumers benefited from this. Rather than propose an adjustment in respect of 100% of early retirement costs funded from a historic surplus, we proposed to make an adjustment for 50% instead. Ofgem's reason for applying a 30% disallowance (rather than 100% or 50%<sup>34</sup>) was a pragmatic one that was subject to public consultation.
- 7.53 To remain consistent with our assumption for RP4 (which assumed that 30% of early retirement deficiency costs should be borne by the shareholder), we have decided to apply an aligned adjustment for ERDCs in RP5. The

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<sup>32</sup> This adjustment was calculated as: 30% x 26% x £2.9 million (30% was the disallowance; 26% was the fraction of the total pension scheme deficit which could be attributed to ERDCs by the scheme actuary; £2.9 million was the past service pension cost paid by the company in 2004-05).

<sup>33</sup> ERDCs are the additional liability borne by the pension scheme due to a member taking early retirement rather than retiring at the normal retirement age.

<sup>34</sup> See page 58 of the September 2004 paper by Ofgem (Electricity Distribution Price Control Review: Update paper).

adjustment for ERDCs will be -£41.2 million in total over fifteen years, and -£14.7 million during RP5.

### Ongoing costs

- 7.54 Our assessment of ongoing pension costs was subject to actuarial review by the GAD. For the final determination, our proposal remains unchanged. NIE T&D will receive a five-year allowance of £10.5 million for ongoing pension costs, which when adjusted for a 4 year 9 month price control is £10.0 million.

### Conclusion

- 7.55 This final determination, and our associated regulatory principles, essentially allocates the unavoidable risk of pension deficit costs with consumers rather than with NIE T&D shareholders. NIE T&D will however remain responsible for a proportion of deficit costs that is attributed to ERDCs. These principles are consistent with those adopted by Ofgem and with what was signalled in RP4.
- 7.56 We have reviewed the pension principles that we proposed in our draft determination in light of stakeholder responses. The principles that we will adopt going forward are as follows:
- NIE T&D should be allowed to recover the efficient ongoing pension costs for employees who are members of either the defined benefit pension scheme or the defined contribution scheme.
  - NIE T&D should be allowed to recover any deficit repair costs, associated with the defined benefit pension scheme for both NIE T&D and NIE Powerteam Ltd, which it cannot legally avoid.
  - Customers will achieve the benefit of any surplus which may exist during future price controls.
  - Pension scheme trustees have a legal obligation to manage the pension fund prudently and in accordance with good investment principles and actuarial practice. Assuming that these legal obligations are complied with, there is little opportunity for NIE T&D to achieve efficiencies in the way it manages the defined benefit scheme, other than by closing the scheme to new members.

- Pension deficits that occur in any price control period may have been influenced by avoidable or inefficient actions taken in previous price control periods. We will adjust for the impact of unfunded ERDCs.
- Pension deficits will be based on the most recent formal actuarial valuation.

7.57 As noted above, as a one-off action we will base the pension deficit for RP5 on the funding update at 31 March 2012.

7.58 In our final determination we will:

- allow deficit recovery over 15 years, starting on 31 March 2012; and
- apply a historical adjustment to take account of previous avoidable actions.

7.59 Changes from our draft determination proposals are that:

- we will base the deficit repair allowance on a total NIEPS deficit of £156.4 million;
- no regulated fraction will be applied to exclude NIE Powerteam Ltd deficit costs from NIE T&D's pension allowance; and
- the historical adjustment only takes account of legally avoidable actions that were recognised at the start of RP4 rather than since privatisation. The adjustment is applied using the same criteria that were agreed for RP4, based on Ofgem precedent. The adjustment will take account of deductions already made during RP4.

7.60 For ongoing costs we will allow the amount that NIE T&D has requested. Our position remains unchanged since the draft determination.

7.61 NIE Powerteam Ltd ongoing pension costs will be charged to NIE T&D via the hourly charge out rate. Deficit costs will be covered by NIE T&D's pension allowance and this is reflected in NIE Powerteam Ltd's special treatment in the licence.

**Summary of pension allowance****Table 7.2: Summary of RP5 pension allowances**

<i>2009-10 prices</i>	NIE T&D's submission	Draft determination	Final determination (5 years)	Final determination (4 yrs 9 mths)
Total scheme deficit	£150m	£87.6m	£156.4m	£156.4m
Regulated fraction	100%	79%	99.26%	99.26%
Deficit recovery period	11 years	15 years	15 years	15 years
Deficit considered for NIE T&D	£150m	£69.2m	£155.2m	£155.2m
<b>Deficit recovery in RP5</b>	<b>£66.7m</b>	<b>£24.3m</b>	<b>£63.1m</b>	<b>£58.4m</b>
Adjustments				
Actuals vs allowance (incl. effect of contribution holiday in RP2)	0	+£26m	No adjustment	No adjustment
Special contributions made by the company	0	+£65m	No adjustment	No adjustment
Benefit improvements	0	-£72m	No adjustment	No adjustment
Early retirements	0	-£53m	-£42.3m <u>+£1.1m</u> -£41.2m	-£42.3m <u>+£1.1m</u> -£41.2m
<b>Adjustment in RP5</b>	<b>£0m</b>	<b>-£12.5m</b>	<b>-£15.2m</b>	<b>-£14.7m</b>
<b>NET DEFICIT RECOVERY IN RP5</b>	<b>£66.7m</b>	<b>£11.8m</b>	<b>£47.9m</b>	<b>£43.7m</b>
<b>Ongoing costs</b>	<b>£10.5m</b>	<b>£10.5m</b>	<b>£10.5m</b>	<b>£10.0m</b>



## 8 TREATMENT OF CONNECTIONS

### Update from draft determination

- 8.1 We are not making any changes in respect of the treatment of distribution connections. We have revised the amount to be collected via tariffs during the transition to 100% chargeability for distribution connections.

### Introduction

- 8.2 We asked NIE T&D to review their connection charging statement in November 2010. As a result, both we and NIE T&D have undertaken public consultations on the method of charging for connections to the NI distribution system. In September 2012, NIE T&D submitted a revised statement of charges to us that reflects the decisions we made based on these consultations.

- 8.3 The decisions that we made include:

- to remove the connections subsidy for domestic customers and small businesses from 1 October 2012;
- to amend the format, layout and contents of the statement of charges in order to bring them into line with the statements that are produced by DNOs in GB;
- to increase the transparency and granularity showing the way in which costs for various connection types are constructed;
- to include more detailed information about the requirements and costs of complying with grid code and trading and settlement code;
- to include more detailed information about the requirements and costs associated with control systems (SCADA) and communications;
- to include information about Operation & Maintenance costs that are charged to the connectee and the payment options available;
- to explain to the customer, as part of the connection process, how the connection offer had been arrived at;
- to give information about what would be provided as part of a connection offer; and
- to make other changes as may be required or arising as part of the review process.

- 8.4 On 24 September 2012, we approved the updated version of NIE T&D's statement of charges for connection to the Northern Ireland Electricity Distribution System.
- 8.5 NIE T&D published the approved statement of charges on 1 October 2012<sup>35</sup>.

### Summary of responses

- 8.6 Of the 32 responses we received, ten made specific reference to connections.
- 8.7 Many of the respondents commented on the removal of the 40% subsidy. It should be noted that the decision to remove this subsidy was taken outside the scope of the RP5 price control. The draft determination simply reflected this decision.
- 8.8 Other responses mentioned vulnerable customers and suggested that some form of financial assistance should be provided to these customers.
- 8.9 A number of respondents referred to the issue of contestability, saying they would welcome the introduction of contestability at the earliest opportunity.
- 8.10 NIE T&D provided additional information in relation to its forecasts and the run-off period of the old charging system.

### Final determination

- 8.11 The decision to change to 100% chargeability for distribution connections was made before our draft determination. Our draft determination covered costs to be recovered by NIE T&D during RP5 and provided information about the audit that we undertook of NIE T&D's connection charging.
- 8.12 We have worked with NIE T&D over the summer to fully understand the costs and processes associated with the transition to 100% chargeability for connections.
- 8.13 We acknowledged that there would be a transition period, during which time NIE T&D installs connection assets relating to offers it had already made. Accordingly there will still be a need for some subsidy to be included in the asset base. This amount is ring-fenced in Fund 2 (see Chapter 5). However, it will only include connection applications received before 1 October 2012 and

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<sup>35</sup> <http://www.nie.co.uk/Connections>

completed before 1 October 2014. Any new connection applications that are received after that date will be charged based on the revised connection policy.

- 8.14 NIE T&D has stated that connection offers that have been accepted by connectees are not time-limited. It is not uncommon for connection works associated with housing developments to be completed some four or five years after the date on which the offer was accepted.
- 8.15 Our decision on removing the 40% subsidy<sup>36</sup> clearly stated, that the subsidy would only include connection offers made before 1 October 2012 and completed before 1 October 2014. A time limit has therefore been applied to all connection applications received after our decision was published on 18 April 2012. We accept that ensuring that the connections are completed before 1 October 2014 will be challenging for NIE T&D. The company will need to make this time limit clear in any connection offers it makes.
- 8.16 However, this time limit does not include any existing connection offers made before the decision was published. We therefore accept that the offers will have to be honoured. NIE T&D stated in its submission that these could take several years to be completed. Given this position a RAB will still be required to allow NIE T&D to recover monies outstanding as a result of the subsidy.
- 8.17 NIE T&D has demonstrated that as RP5 progresses the amounts added to the RAB will fall. This predicted phasing will extend throughout the RP5 period. NIE T&D has indicated that in the fifth year of RP5 only 10% of existing connection offers will be outstanding.
- 8.18 With regard to housing sites where a customer wishes to connect a new housing development with 12 or more Domestic Premises or to extend an existing development of fewer Domestic Premises, the customer will pay a standard connection charge for each Domestic Premise. This will be assuming the customer will provide, without charge to NIE T&D, all Low and High Voltage cable trenching, joint holes and suitable back-filling material for bedding and blinding cables, including service cable trenching and backfilling but excluding any system development work unrelated to the provision of electricity supplies to the development.
- 8.19 This connection charge will be based on the average cost of a domestic premise in a new housing development with 12 or more Domestic Premises or

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<sup>36</sup> [http://www.uregni.gov.uk/uploads/publications/Electricity\\_connection\\_policy\\_decision\\_paper\\_-\\_April\\_2012.pdf](http://www.uregni.gov.uk/uploads/publications/Electricity_connection_policy_decision_paper_-_April_2012.pdf)

an extended existing development of fewer Domestic Premises previously connected in Northern Ireland over the past year.

- 8.20 There will be no site specific charges for betterment or increase in capacity in future phases.
- 8.21 In addition to the standard connection charge for each Domestic Premise, a customer will also be liable for charges relating to any unforeseen costs incurred in providing the connection. Such charges may arise from circumstances such as but not limited to; departure from standard construction methods, customer requirements resulting in inefficient scheduling of work and unusually low density of the development. Such additional charges may be invoiced separately.
- 8.22 This standard connection charge will be reviewed and approved annually by us and will form part of NIE T&D's annual Statement of Charges. This payment will cover the total cost of providing the entire necessary infrastructure to provide a supply to each dwelling on that development and the developer will not be asked for any additional contribution other than as described above. In addition, NIE T&D will not be permitted to ask the developer to provide any contribution to upgrade the system to meet potential future demand.
- 8.23 NIE T&D has updated its original connections submission to reflect the removal of the 40% subsidy and the phased reduction in connection related assets being added onto the core distribution RAB. The actual additions will vary depending on the uptake of connection offers and the speed by which connections will be completed. As stated in our final determination on capital expenditure, NIE T&D will be kept neutral to any variance from this amount.
- 8.24 As part of its response NIE T&D provided a forecast of the impact that the transition between charging methodologies will have on the RAB. The amounts shown in the table below will be used for tariff purposes, the amount forecast by NIE T&D will be used to calculate the return and depreciation that it will be allowed to collect during RP5. These calculations will be updated annually during RP5 to reflect the actual costs incurred.
- 8.25 We also required NIE T&D to provide regular reports on connections and the timing of connections so that we can monitor NIE T&D's performance in this area. We discuss reports in this area in more detail in Chapter 18. The use of the Reporter will be essential in this area.

8.26 With regards to contestability it is still our intention to consider the options and consult fully on this area.

**Table 8.1: – Summary of additions to connection RAB in RP5**

<b>£k</b>	<b>12/13</b>	<b>13/14</b>	<b>14/15</b>	<b>15/16</b>	<b>16/17</b>	<b>RP5 Total</b>
NIE T&D's net connections costs	7,512	3,769	2,271	1,517	764	15,834
RASW <sup>37</sup> costs (net connections)	761	380	228	152	76	1,598
Total non-recoverable alterations	3,908	3,946	3,948	3,946	3,973	19,721
RASW costs (non-recoverable alterations)	20.4	20.4	20.4	20.4	20.4	102
<b>Total net connections capex</b>	<b>12,201</b>	<b>8,116</b>	<b>6,468</b>	<b>5,636</b>	<b>4,834</b>	<b>37,255</b>

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<sup>37</sup> RASW is Road and Street Works

## 9 INCENTIVES

### Update to draft determination

- 9.1 We have considered NIE T&D's response to the proposals in our draft determination regarding the asymmetrical nature of Customer Minutes Lost (CML) and Customer Interruptions (CI). As a result, we have decided to introduce an amended symmetrical incentive for network performance. All other incentives will remain unchanged from those outlined in the draft determination.

### Introduction

- 9.2 The overall purpose of incentives is to encourage the best use of limited resources, and to ensure that NIE T&D takes the right decisions when considering capital and operating expenditure approaches.
- 9.3 We are keen to introduce new incentives, such as a distribution loss incentive and health and load indices. However to do so we need detailed measurements and base line information. We encourage NIE T&D to develop these areas during the RP5 period so that we are in a position to consider additional incentives later in RP5 or in RP6.
- 9.4 Since our draft determination, we have given further consideration to incentives relating to customer services and worst served customers<sup>38</sup>.

### Summary of responses

- 9.5 Of the 32 responses we received to our draft determination, seven made specific references to incentives.
- 9.6 All respondents supported the principle of incentives, although many suggested alternatives to the proposed incentive structure. Many respondents said that they preferred a greater focus on outputs rather than inputs; these respondents considered the role of incentives to be limited.
- 9.7 NIE T&D responded as follows in relation to the use of planned outages in incentive calculations: *"NIE T&D proposes a network performance incentive based on customer minutes lost (CML) and customer interruptions (CI) as a result of unplanned outages on the distribution network. NIE T&D proposes to*

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<sup>38</sup> 'Worst served customers' are customers who experience the worst quality of supply

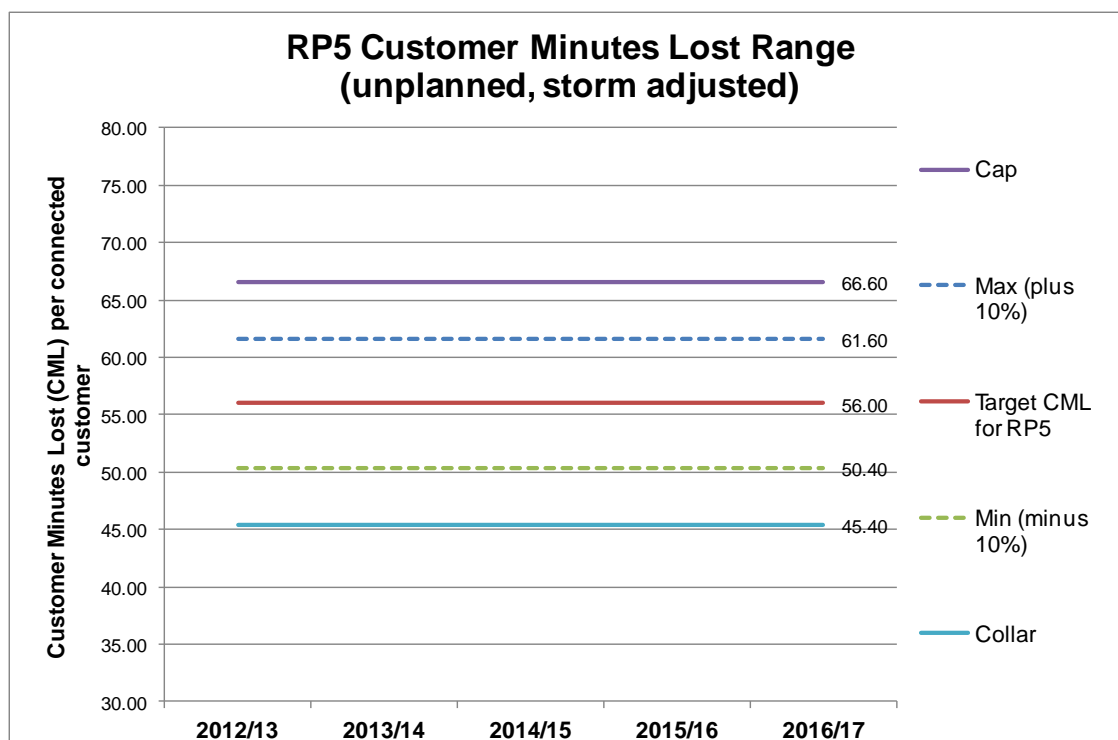
*exclude planned outages, outages resulting from transmission faults and the levels of service received by their worst served customers. An incentive would be based on performance (excluding weather-related events) against annual targets for CML and CI resulting from faults affecting NIE T&D's distribution network."*

- 9.8 In our draft determination we proposed an asymmetric incentive in order to maintain CML at its current level. This was in the form of a penalty of £0.18 million per customer minute lost beyond the threshold of 10% above the target CML.
- 9.9 In response to our proposal NIE T&D stated:
- "Annual network performance statistics will exhibit natural fluctuations because of the random nature of network failures and particularly the influence of external factors such as weather and third party interference. Without a symmetrical incentive mechanism, NIE would bear the risk of being penalised for uncontrollable negative outcomes on the one hand but not rewarded for positive ones."*
- 9.10 A number of respondents recommended that we introduce a distribution losses incentive and customer service incentive.

### **Final determination**

- 9.11 To increase the focus on outputs we intend to extend the range of incentives to include a distribution loss incentive and health and load indices.
- 9.12 Having considered NIE T&D's submission, we will exclude planned outages and transmission outages from the network performance incentives for customer interruptions and customer minutes lost during RP5. As stated in Chapter 5, we intend to consult on the criteria for "exceptional weather events". Any supply interruptions that meet these criteria will also be excluded from the network performance incentives. We intend to consider the inclusion of planned outages in the future, particularly for RP6.
- 9.13 Network performance incentives will be structured as a symmetrical incentive. This will feature a range within which the CML may fluctuate without penalty or reward. This range, or 'dead band', will provide flexibility for NIE T&D, permitting the company to achieve targets while allowing for any 'natural fluctuations' that may occur. We will use a development of our draft determination proposal to apply an incentive to variances that are greater than 10% from the target CML.

9.14 For the final determination the variance band will be both plus and minus 10% of the target CML. Figure 9.1 illustrates the dead band with the applicable CML.



**Figure 9.1: RP5 Customer minutes lost range (unplanned, storm adjusted)**

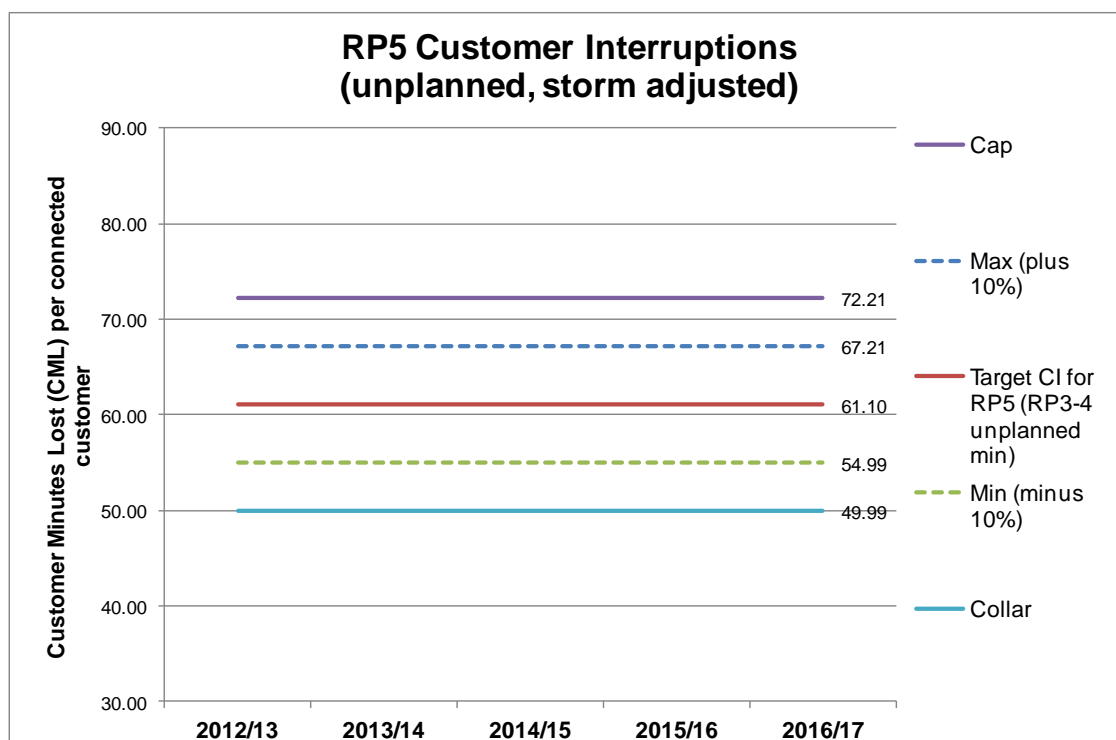
9.15 In the event that CML goes beyond the specified range we will use the same rate as agreed by Ofgem for SSE Hydro, as it is the most comparable DNO in GB. As outlined in our draft determination, this incentive penalty/reward is £0.18 million per CML outside of the +/- 10% threshold.

9.16 The target CML will be 56. In practice this means that in the event CML goes above the upper range threshold of 61.60, a penalty of £0.18 million per CML above the limit will be applied. Correspondingly, in the event that CML goes below the lower threshold of 50.40 a reward of £0.18 million per CML below the limit will be applied. In both instances a cap and collar of five times the annual incentive rate (a maximum of £0.9 million) will apply to any reward or penalty.

9.17 We will use a similar approach as the CML incentive for the incentive for CI. A specified target number of CI will have a dead band range of +/- 10%. The target CI for the RP5 period is 61.10. For each CI above or below the upper or



lower limits, a penalty or reward of £0.03 million will apply, as we proposed in our draft determination. Figure 9.2 illustrates the dead band with the applicable CI numbers. In both instances a cap and collar of five times the annual incentive rate (a maximum of £0.15 million) will apply to any reward or penalty.



**Figures 9.2: Customer interruptions symmetrical incentive**

- 9.18 In the draft determination we proposed introducing new standards in relation to connections, worst served customers and queries. After considering further evidence on the practicality and cost of the standards we proposed in the draft determination, they will not be introduced at present. We will consider their development further during the RP5 period and the impact worst served customers have on the CML calculations
- 9.19 In January 2006 a Revenue Protection Programme was introduced. The purpose of this was to incentivise NIE T&D to recover revenue and share the benefit with consumers.
- 9.20 The incentive allowed NIE T&D to retain 50% of any recovered amount that is in excess of the allowed additional costs of providing the service. As well as sharing the recovered monies, customers also benefit in full from the prevention

of any further illegal abstraction that would otherwise have occurred but for the intervention of the Revenue Protection Service.

- 9.21 Our draft determination noted that the revenue protection unit service has provided a net benefit for consumers during RP4. We believe that this work should be resourced to ensure that illegal extraction is kept to a minimum and we have decided that it should continue in RP5 on the same basis as it did in RP4, i.e. any recovered amount will be shared 50:50 between NIE T&D and consumers. We will require regular reporting of this area during RP5.

## **10 INNOVATION**

### **Update to draft determination**

- 10.1 We have not made any changes to the draft determination in this section. However we have reassessed the amount of capex allowed for online monitoring of transformers. This is covered in Chapter 5.

### **Introduction**

- 10.2 In the draft determination we stated that funds for innovation programmes had been requested as part of NIE T&D's capex submission and had been assessed as part of that submission.
- 10.3 In this chapter we set out our final position, having taken account of any additional information presented by NIE T&D and the responses received.

### **Summary of responses**

- 10.4 Of the 32 responses received, six included specific references to our innovation proposals.
- 10.5 One respondent raised concerns that there is no guarantee that the RHI (Renewable Heat Incentive) is to be rolled out to small scale businesses in Northern Ireland and raised doubts as to whether the RHI is actually going to be rolled out.
- 10.6 The same respondent proposed that the Sustainable Management of Assets and Renewable Technologies (SMART) programme ought to be maintained should the Renewable Heat Incentive not materialise. The respondent also highlighted their reservations in relation to the decision to discontinue the Vulnerable Customer Programme. Another respondent also asked us to note that 'vulnerable customer' status can be applied to a section of their membership and that this should be taken into consideration.
- 10.7 One respondent suggested that an expansion of the existing Sustainable Networks Programme could offer substantial 'unknown' benefits for customers at a relatively minor cost.
- 10.8 One respondent requested that a cost benefit analysis is undertaken before the Vulnerable Customer Programme is discarded. The reported £7 million of unclaimed benefits the scheme has helped identify suggests that it may provide a cost-effective use of money.

- 10.9 One respondent raised concerns that as the Vulnerable Customer Programme delivered good results and clearly benefited many of the people categorised as being fuel poor, then why would a similar programme not be funded under RP5.
- 10.10 One respondent asked about the consideration that had been given to the equality implications, costs and social benefits of discontinuing the programme, particularly given the relative vulnerability of particular equality groups, including older people to fuel poverty. The view was expressed that consideration should be given to Social Tariffs as a means to reduce fuel poverty. Given the serious health implications of fuel poverty it was proposed that older people in receipt of Pension Credit should be the first focus of any such schemes.
- 10.11 Another respondent agreed with NIE T&D and us in that the fast follower principle is generally appropriate for introducing innovation schemes. The respondent also stated that innovations require a regulatory framework that encourages natural monopoly businesses to justify taking risks or introducing new ideas. However they were disappointed that our position on innovation was being considered as part of the review of NIE T&D's capex proposals.
- 10.12 They also stated that there is a significant difference between an obligation to plan, develop and maintain the system and an incentive to improve the planning, development and maintenance of the system. They highlighted that there are natural incentives to innovate in a competitive market, whereas a regulated natural monopoly business requires justification for taking risks or introducing new ideas in the form of well-designed incentives.
- 10.13 One respondent stated that the Low Carbon Network Fund initiative by Ofgem is held out as an exemplar to utilities and regulatory authorities throughout Europe. It also believes that Northern Ireland should be able to utilise a similar initiative to encourage innovation in the development of the robust grid infrastructures that can cope with the transition to a low carbon economy with the capability to allow integration of the planned growth in renewables.
- 10.14 That respondent also stated that had we initiated a similar programme to the LCNF (Low Carbon Network Fund) there is no doubt they would have received innovative working proposals to test the range of possible solutions to critical problems.

10.15 However other parties agreed with our conclusions on the cost of developing the use of advancing technology.

10.16 NIE T&D commented that our proposals on innovation were deficient because:

- they do not encourage innovation and they create weak incentives for cost efficiency;
- they do not provide NIE T&D with sufficient flexibility to meet its obligations in the face of increasing uncertainty;
- we have proposed no provision for funding innovation through smart technology in RP5. Without this funding NIE T&D will be unable to assess emerging technologies and participate in collaborative research to factor this into future planning of the network.

### **Other factors**

10.17 The Department of Enterprise, Trade and Investment (DETI) plans to introduce a Northern Ireland Renewable Heat Incentive (NIRHI) scheme (subject to appropriate legislation being approved by the NI Assembly).

10.18 The NIRHI is a financial incentive scheme worth up to £25 million of investment over the first four years. The aim of the scheme is to promote the uptake of renewable heat.

10.19 The following renewable heat technologies will be supported in the first instance:

- solid biomass and solid biomass contained in municipal waste (including CHP);
- ground and water source heat pumps;
- geothermal (including CHP);
- solar thermal (at capacities of less than 200 kWth);
- biogas combustion (except from landfill gas but including CHP; at capacities of less than 200 kWth); and
- biomethane injection.

10.20 Ofgem will administer the NIRHI on behalf of the DETI and in accordance with the NIRHI Scheme Regulations 2012 once they come into force. The overarching policy, detailed legislative framework and tariff rates for the scheme are the responsibility of DETI.

- 10.21 To achieve an uptake of renewable heat technologies, DETI intends to introduce the NIRHI in two phases. From the date that it comes into force, the NIRHI will be available to parties in non-domestic sectors with eligible installations, and to producers of biomethane in the non-domestic sector. During phase two of the scheme, in addition to expanding the non-domestic scheme, the DETI intends to introduce support for the domestic sector.
- 10.22 DETI and Ofgem have developed guidance notes for applicants registering for the scheme. These were subject to a four-week consultation process. All responses should have been submitted by 18 October 2012.
- 10.23 DETI expect the NIRHI to be open for applications before the end of 2012.

### **Final determination**

- 10.24 As discussed in the draft determination we recognise the success the Vulnerable Customer Programme has had. However, our position from the draft determination remains; if a similar programme is to be implemented responsibility for that programme should sit with an appropriate external body funded through other means.
- 10.25 Our position regarding the SMART programme was that we no longer considered it appropriate for it to continue. The imminent introduction of DETI's NIRHI scheme reinforces this position and therefore the programme will not continue into RP5.
- 10.26 With regards to NIE T&D's submission within RP5 to fund smart technology the amount that we consider to have been already justified is included in capex Fund 1.
- 10.27 We recognise the need for further investment in these areas, particularly with the synergy between control systems for smart grids and smart meters. However, we do not consider NIE T&D's plans to be sufficiently developed at this stage to allow funding. We have therefore moved this to capex Fund 3, to provide NIE T&D with opportunity to develop this further. This is described in more detail in Chapter 5.
- 10.28** We have not introduced a scheme similar to the Low Carbon Network Fund (LCNF) used by Ofgem. We expect NIE T&D to be fast followers. We regard our approach to considering innovation under capex fund 3 allows NIE T&D to

consider innovative solutions and utilise third party expertise where appropriate.

## **11 ENVIRONMENT AND SAFETY**

### **Update to draft determination**

11.1 We have not made any changes to the draft determination in this section.

### **Introduction**

11.2 NIE T&D has an environmental management system in place that is certified to the internationally recognised ISO14001 standard. This requires the company to produce an environmental management report each year. The report provides a summary of NIE T&D's environmental performance during the previous financial year. It also outlines the company's targets and objectives for the forthcoming financial year.

11.3 NIE T&D has demonstrated that it is committed to delivering its environmental requirements. We encourage the company to continue to resolve all of the issues identified in its environmental reports.

11.4 Under its licence NIE T&D is not required to report to us on its environmental performance. However, reports created for the company's environmental management system are available on its website.

11.5 Neither is NIE T&D required to report to us on its health and safety requirements. This is monitored by the Health and Safety Executive for Northern Ireland, which has responsibility for public safety aspects of the Electricity Supply Regulations.

### **Summary of responses**

11.6 Of the 32 responses to the draft determination that we received, only one other respondent and NIE T&D commented on the proposals on environmental and safety issues.

11.7 One respondent was disappointed that the draft determination did not provide any outputs on environmental and safety issues. The respondent also urged us to bring forward suggestions for monitoring outputs in environmental and safety issues as soon as possible and to ensure that these are subject to full public consultation.

11.8 NIE T&D stated that it is important to specify and agree, as soon as possible:



- the substantive reporting requirements, including the extent of any environmental benchmarking to be undertaken; and
- the form in which reports are to be delivered, including the development of appropriate templates for reporting.

11.9 NIE T&D also asserted that the additional costs to the company of complying with such requirements should be fairly reflected in the RP5 revenue allowance.

11.10 NIE T&D was also concerned that if it spent only the capex that we were allowing for in the draft determination this would result in an increase in the number of safety related incidents. NIE T&D asserted that as it would need to continue to invest to avoid these outcomes, our proposals amount to underfunding the investment required to maintain a safe system.

### **Final determination**

11.11 As stated in Chapter 5 of this final determination, we have reviewed all of the evidence provided by NIE T&D to support its request for capital investment during RP5. We have fully considered any information related to safety issues that NIE T&D has provided and we have reflected this in our final determination for capital investment.

11.12 We expect NIE T&D to provide additional reporting to us in relation to environmental and safety issues. We expect these reports to be in a similar format to those that are prepared for internal use; we therefore do not consider that there will be overheads or additional costs as a result of this requirement. This is discussed further in Chapter 18.

## 12 THE WEIGHTED AVERAGE COST OF CAPITAL

### Update from draft determination

- 12.1 Taking account of the responses to the draft determination, we have updated our view on the proposed cost of debt and gearing parameters. We have also considered NIE T&D's views in relation to the cost of equity, and given further thought to the application of a separate weighted average cost of capital (WACC) for Fund 3 of the capex programme.
- 12.2 One of the inputs into our calculation of NIE T&D's WACC is a forecast of RPI for the period 2012-13 to 2016-17. Our draft determination allowed for average inflation of 3.35% a year. This was in accordance with forecasts that the Office for Budget Responsibility (OBR) published in November 2011.
- 12.3 The OBR subsequently updated its forecasts in March 2012<sup>39</sup>. The latest set of numbers envisages average inflation of 3.15% a year over the five-year period 2013-17. We have used the updated inflation figure of 3.15% in our calculations for the cost of debt for the final determination.
- 12.4 We have adjusted gearing from 60% to 50%.

### Introduction

- 12.5 NIE T&D originally submitted a vanilla WACC of 5.34% (real) for RP5. This was made up of:
- a post-tax cost of equity of 7.7% (stated by NIE T&D as being in line with the average expected return on equity in Ofgem's 2009 DPCR5 determination);
  - a pre-tax cost of debt of 3.6%; and
  - an adjusted level of gearing of 57.5%.
- 12.6 NIE T&D response to the draft determination proposed a vanilla WACC of 5.7% (real) for RP5. This was made up of:
- A post-tax cost of equity of 7.7%
  - A pre-tax cost of debt of 4.3%; and
  - An level of gearing of 60%.
- 12.7 In our draft determination we proposed two separate WACCs:

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<sup>39</sup> HM Treasury (2012), Budget report 2011.

- a conventional WACC for business-as-usual investment (4.45% post-tax real); and
- a renewables WACC for Fund 3 of the capex programme (4.0% post-tax real).

12.8 The proposed renewables WACC was lower because of the perceived lower systematic risk attached to Fund 3 investments.

### **Summary of responses**

12.9 Of the 32 responses that we received, 7 commented on the WACC

12.10 In its response to the draft determination NIE T&D was of the view that our proposed cost of debt and allowed return on equity were both inadequate.

12.11 NIE T&D argued that our proposed cost of capital compared unfavourably with the expected return under Ofgem's price controls. NIE T&D stated that we were expecting its investors to bear at least as much risk as investors in the GB DNOs for a considerably lower expected return.

12.12 The company argued that our approach to calculating the allowed cost of debt constituted poor regulatory practice, lacked credibility and would have an adverse impact on the company's financeability. NIE T&D stated that we had underestimated an appropriate cost of debt because we used an embedded cost of debt approach; this, the company stated, ignored factors specific to Northern Ireland that influence the borrowing costs of utilities in Northern Ireland.

12.13 Another respondent also asserted that a higher WACC should be applied, given the locational factors that affect the perception of risk specific to NIE T&D.

12.14 NIE T&D and three other respondents disagreed that two separate WACCs should be applied for conventional and renewables investment.

12.15 One respondent also commented that more up-to-date inflation forecasts should be taken into account since the draft determination was published, which would increase the proposed WACC for the final determination.

## Final determination

12.16 We have reviewed our bottom-up assessment of the WACC that we proposed in the draft determination and taken account of stakeholder responses. The cost of debt, gearing and cost of equity have been updated since our draft determination. Each of these is discussed in turn below.

## Cost of debt

12.17 Our draft determination calculated a cost of debt based on a blended average of the actual interest rates applicable to NIE T&D's two main tranches of debt. The resulting cost of debt was 3.20% (pre-tax real). To calculate an appropriate cost of debt, NIE T&D prefers Ofgem's approach which is to refer to the ten-year trailing average of two iBoxx indices plus a Northern Ireland premium.

12.18 Our approach follows that adopted by the Competition Commission in its price control inquiries into Heathrow/ Gatwick (2007), Stanstead (2008), and Bristol Water (2010). In all three cases, the calculation was a combination of:

- the company's observed actual fixed-rate debt costs; and
- a forward-looking estimate of the cost of any new debt that a company may have needed to take on in the forthcoming control period.

12.19 In its calculation of the price control for NATS<sup>40</sup> the CAA used the Competition Commission's methodology, as did ORR in calculating the price control for Network Rail<sup>41</sup>. These regulators first sought to remunerate embedded debt costs pound-for-pound, and made assumptions about the cost of debt only when new finance is required.

12.20 We do not see any reason to move from the approach detailed in the draft determination for the cost of debt, and intend to follow the Competition Commission's approach for the final determination.

12.21 The nominal cost of debt within our WACC lies above current secondary yields for both A and BBB rated debt. The Iboxx corporate non-financial 10-year maturity series for A and BBB rated bonds shows that the yield on utility bonds has fallen steadily since the end of 2009. We therefore expect that NIE

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<sup>40</sup> <http://www.caa.co.uk/docs/5/ergdocs/20100527NERLCP3Proposals.pdf>

<sup>41</sup> <http://www.rail-reg.gov.uk/upload/pdf/383.pdf>

T&D should be able to raise any new debt required in RP5 at or below its embedded cost of debt.

12.22 We have updated the cost of debt to take account of updated inflation figures based on HM Treasury's latest forecast. The average inflation over the 5 year period is 3.15%.

**Table 12.1: OBR March 2012 RPI forecasts<sup>42</sup>**

	12/13	13/14	14/15	15/16	16/17
% change	2.9%	2.2%	2.9%	3.8%	4.0%

12.23 The real cost of debt that we are using in the WACC calculation is 3.39%. This has been converted from a nominal weighted average cost of debt of 6.65%<sup>43</sup> using the formula:  $(1 + \text{real cost of debt}) = (1 + \text{nominal cost of debt}) / (1 + \text{forecast inflation})$ <sup>44</sup>.

## Gearing

12.24 In our draft determination we stated that we considered that a 60% gearing level for both the transmission and distribution networks should apply. However, there was an internal inconsistency in our WACC calculation.

12.25 The assumed gearing figure in the WACC should be in line with the equivalent figure in the modelling of NIE T&D's financeability, at least at the start of the control period. If this is not the case there is the risk of a logical inconsistency between the financeability assessment and the setting of charges in the price control.

12.26 In developing an assumption for gearing to use in our modelling we have adopted a figure that is closer to NIE T&D's actual gearing figure at the start of RP5. We also consider that a lower level of gearing is more appropriate during a growth phase and when there is some investment uncertainty (timing

<sup>42</sup> Source: HM Treasury (2012), Budget report 2011.

<sup>43</sup> See RP5 Draft Determination, April 2012 (page 168).

<sup>44</sup>  $(1+6.65\%)/(1+3.15\%) = 3.39\%$

and quantum) associated with funds 2 and 3. We consider that this level of should allow NIE T&D to maintain a solid investment-grade credit rating.

12.27 The gearing level to be applied in the final determination is 50%.

### **Cost of equity**

12.28 NIE T&D has argued that our proposed cost of capital compares unfavourably with the expected return under Ofgem's price controls. One of its contentions is that Ofgem deliberately provides GB network companies with additional return outside of the headline WACC calculation.

12.29 Ofgem's DPCR5 proposals did provide for an expected return in excess of the headline 6.7% cost of equity. This related to:

- payouts from service quality incentives that Ofgem put in place in the 2005-10 period; and
- revenue rewards that companies earned under Ofgem's IQI<sup>45</sup>.

12.30 The revenues available under the Ofgem model are very clearly earned financial rewards.

12.31 It should be noted that there is much less of a gap between the allowed cost of equity and the expected return under the recent RIIO based price controls. This weakens NIE T&D's argument that Ofgem deliberately sets low costs of capital and seeks to provide returns by other means. It would be very difficult for us to explain why we should match revenues that GB companies have earned from good behaviour under a mechanism that is not in place in Northern Ireland. We therefore consider that we should set the right allowed return for NIE T&D based on its risk profile, regardless of whether this turns out to be higher or lower than the WACCs that Ofgem uses. We see no reason to think that NIE T&D will not be able to attract and retain equity capital if the cost of capital is set at the right level in Northern Ireland. This is irrespective of the returns that other companies might be earning in other jurisdictions.

12.32 Each of the parameters of the cost of equity is discussed in turn below.

12.33 In our draft determination we proposed a risk-free rate of 2.0%. This took account of the risk-free rates that other regulators have applied in recent determinations. Our proposal remains unchanged for the final determination.

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<sup>45</sup> Information Quality Incentive – this relates to the menu regulation incentives that Ofgem has in place.

- 12.34 First Economics proposed that we should assume a range for the expected market return of 6.5-7.0%, which is in accordance with the Competition Commission's thinking. When taken alongside the proposed risk-free rate of 2.0%, we proposed an equity risk premium of 4.8% in the draft determination. We have increased this to 5.0% for the final determination. This is more in line with the RIIO T1 proposal to use an equity risk premium of 5.25%.
- 12.35 In our draft determination, First Economics assessed the relative systematic risk that is faced by NIE T&D's shareholders. The main determinants of this risk included demand variability, cost variability, regulation and the company's cost/revenue structure. First Economics' analysis concluded that NIE T&D exhibits negligible revenue risk, relatively low cost risk and has a 'normal' sized RAB relative to ongoing expenditure. They recommended a range of 0.4 to 0.425. Having considered this advice, we still proposed an asset beta of 0.42. This remains unchanged for the final determination.
- 12.36 Based on each of the above parameters and a gearing level of 50%, the cost of equity (post-tax real) is 5.70%

## Renewables WACC

- 12.37 In our draft determination we said that we considered Fund 3 capex investment to be lower risk as capex allowances will be set on a rolling basis throughout RP5 once the full scope and timing of the work is known. For the final determination, however, we have decided to apply a uniform WACC across all investment. Following GB precedent, renewables driven investments will be remunerated using the same rate of return as transmission and distribution assets.
- 12.38 In January 2010 Ofgem published its final proposals on the Transmission Access Review (TAR)<sup>46</sup>. This set out its approach to facilitating additional renewables-driven investments within the price control period under the Transmission Investment Incentives (TII) scheme. In those proposals, Ofgem stated:
- "We consider that the projects for which we have made funding proposals do not differ materially in their risk profiles from the other projects remunerated by*

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<sup>46</sup> [http://www.ofgem.gov.uk/Networks/Trans/ElecTransPolicy/tar/Documents1/100118\\_TOincentives\\_final\\_proposals\\_FINAL.pdf](http://www.ofgem.gov.uk/Networks/Trans/ElecTransPolicy/tar/Documents1/100118_TOincentives_final_proposals_FINAL.pdf)

*the current TPCR4 cost of capital, especially given the time horizon for our proposals is limited at this stage to the end of March 2012”.*

12.39 Our view is that we have structured Fund 3 projects in such a way as to reduce the systematic risk in comparison with Fund 1 or Fund 2 investments. We accept that this is a novel approach and it may be more appropriate to experience the process for Fund 3 in practice before implementing a specific WACC for these investments. We have therefore decided to allow the same rate of return on renewables-driven investments and NIE T&D’s transmission and distribution assets.

### **WACC summary**

12.40 We believe that we have reduced the risk for a number of the components of the price control and that the WACC reflects the level of risk NIE T&D is exposed to. This includes the following aspects:

- Fund 2 capex – the logging up/down mechanism therefore consumers are taking volume risk;
- Fund 3 capex – efficient pass-through and incentive mechanisms therefore consumers are taking both volume and price risk, because the capex allowance cost is determined post tender;
- no contestability in connections;
- customers will effectively underwrite pension deficit costs;
- uncontrollable opex will be ‘trued-up’.

12.41 Table 12.2 shows the WACC for RP5. It should be noted that the equity beta and therefore the post-tax cost of equity value are lower than the draft determination figures as a result of the change in gearing.



**Table 12.2: RP5 WACC**

	<b>RP4</b>	<b>NIE T&amp;D submission</b>	<b>NIE T&amp;D response to draft determination</b>	<b>Draft determination</b>	<b>Final determination</b>
Gearing (%)	65.0%	57.5%	60.0%	60.0%	50.0%
Pre-tax cost of debt (%)	3.6	3.6	4.3	3.2	3.39
Risk-free rate (%)				2.0	2.0
Equity risk premium				4.8	5.0
Debt beta				0.1	0.1
Asset beta				0.42	0.42
Equity beta				0.90	0.74
Post-tax cost of equity (%)	6.7	7.7	7.7	6.32	5.70
<b>Vanilla WACC (real) (%)</b>	<b>4.69</b>	<b>5.34</b>	<b>5.7</b>	<b>4.45</b>	<b>4.55</b>

12.42 The vanilla WACC (real) to be applied in RP5 is 4.55%.

## 13 DEPRECIATION AND RAB STRUCTURE

### Update to draft determination

13.1 We have not made any changes to the draft determination in this section.

#### Introduction

- 13.2 In our draft determination we discussed the issues relating to NIE T&D's RABs and the associated depreciation policy for each RAB. We have also considered comparable information that Ofgem and the Commission for Energy Regulation (CER) publish.
- 13.3 We considered that there should be separate RABs for transmission and distribution. We also noted that there were a number of smaller RABs relating to IT and metering assets.
- 13.4 We proposed to continue the depreciation rates that were used in RP4. NIE T&D's Core RAB is currently depreciated using a 'kinked' method over 40 years; the first 20 years are depreciated at 3% and the remaining 20 years are depreciated at 2%.
- 13.5 However, the residential market opening RAB and non-residential market opening RAB are legacy systems that will be almost fully replaced by the 'Enduring Solution'. The depreciation period for these RABs is currently ten years. We considered that changing from ten to five years would be more appropriate, and more reflective of the assets themselves.
- 13.6 At present, non-network IT and telecoms investments are expensed rather than added to the RAB. We proposed to continue with this policy, and to apply it to other similar items of spend (ie the network management IT system and network IT systems).
- 13.7 We also explained our concerns in relation to the treatment of asset disposals in RP4. We further consulted on this in our draft determination on the investigation into the company's capitalisation practice<sup>47</sup>.

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<sup>47</sup> [http://www.uregni.gov.uk/uploads/publications/Draft\\_determination\\_fin\\_Capitalisation\\_Practice\\_investigation\\_v4\\_GI.pdf](http://www.uregni.gov.uk/uploads/publications/Draft_determination_fin_Capitalisation_Practice_investigation_v4_GI.pdf)

**Responses to the draft determination**

13.8 Of the 32 responses, two commented on depreciation. One respondent suggested that 50 years would be a more appropriate depreciation period.

NIE T&D stated that it was content with our proposals in respect of:

- the separation of the transmission and distribution RABs;
- the acceleration of depreciation in respect of legacy IT systems; and
- the proposal to treat network IT and telecoms investments as expensed rather than added to the RAB (except SCADA).

**Our view of the responses**

13.9 We see no reason to change the proposals put forward in our draft determination

13.10 In relation to lengthening the depreciation rate, we will consider this again for the next price control, RP6. However, at this stage we see no strong reason to move away from the current depreciation lives.

**Final determination**

13.11 We have decided to apply the depreciation rates that are shown in Table 13.1 for the RP5 period.

13.12 The opening RABs for RP5 will be the actual capex on each RAB on 1 January 2013.

13.13 We have detailed each of the RABs for the RP5 period in table 13.2. This shows the opening RAB, capex additions, depreciation and closing positions. We have also shown the return for each RAB based on the WACC (as discussed in Chapter 12).

**Table 13.1 Depreciation rates for RP5**

<b>RAB name</b>	<b>RAB category</b>	<b>RAB status</b>	<b>Proposed depreciation life (years)</b>
Distribution (& Rathlin) RAB	Core	Currently active	40
Transmission (& Renewables) RAB	Core	Currently active	40
NI2007 Residential M. O. RAB	Non-core	Currently active	5
Keypad RAB	Non-core	Currently active	15
Enduring Solution RAB	Non-core	Currently active	10
FEMO 2007 Non residential M.O. RAB	Non-core	Currently active	5
Old North/South Interconnector RAB	Non-core	Almost expired	40
Fund 3 capex RAB	Non-core	Proposed for RP5	40
<b>Tyrone Cavan Interconnector RAB</b>	<b>Core</b>	<b>Proposed for RP5</b>	40

**Table 13.2: RAB and return tables**

<b>Distribution (&amp; Rathlin) RAB</b>					
<b>Regulatory period</b>	<b>RP5</b>	<b>RP5</b>	<b>RP5</b>	<b>RP5</b>	<b>RP5</b>
<b>Start Period</b>	<b>Jan 2013</b>	<b>Oct 2013</b>	<b>Oct 2014</b>	<b>Oct 2015</b>	<b>Oct 2016</b>
<b>End Period</b>	<b>Sep 2013</b>	<b>Sep 2014</b>	<b>Sep 2015</b>	<b>Sep 2016</b>	<b>Sep 2017</b>
Number of months in period	9	12	12	12	12
Opening Value	£793m	£770m	£782m	£798m	£816m
Capitalisation Practice adjustment	-£26m				
Capital additions	£34m	£54m	£59m	£61m	£62m
Depreciation	-£31m	-£42m	-£43m	-£43m	-£44m
Other <sup>48</sup>	£0m	-£0m	-£0m	£0m	£0m
Closing Value	£770m	£782m	£798m	£816m	£834m
Average RAB	£782m	£776m	£790m	£807m	£825m
Vanilla WACC applied	4.55%	4.55%	4.55%	4.55%	4.55%
WACC Return	£27m	£35m	£36m	£37m	£37m

<sup>48</sup> Other covers asset disposal and rate of return roll up

<b>Transmission (&amp; Renewables) RAB</b>					
<b>Regulatory period</b>	<b>RP5</b>	<b>RP5</b>	<b>RP5</b>	<b>RP5</b>	<b>RP5</b>
<b>Start Period</b>	<b>Jan 2013</b>	<b>Oct 2013</b>	<b>Oct 2014</b>	<b>Oct 2015</b>	<b>Oct 2016</b>
<b>End Period</b>	<b>Sep 2013</b>	<b>Sep 2014</b>	<b>Sep 2015</b>	<b>Sep 2016</b>	<b>Sep 2017</b>
Number of months in period	9	12	12	12	12
Opening Value	£212m	£211m	£221m	£231m	£243m
Capitalisation Practice adjustment	-£6m				
Capital additions	£12m	£20m	£22m	£23m	£23m
Depreciation	-£8m	-£11m	-£11m	-£12m	-£12m
Other	£0m	£0m	£0m	£0m	£0m
Closing Value	£211m	£221m	£231m	£243m	£254m
Average RAB	£212m	£216m	£226m	£237m	£248m
Vanilla WACC applied	4.55%	4.55%	4.55%	4.55%	4.55%
WACC Return	£7m	£10m	£10m	£11m	£11m

<b>NI2007 Residential M. O. RAB</b>					
<b>Regulatory period</b>	<b>RP5</b>	<b>RP5</b>	<b>RP5</b>	<b>RP5</b>	<b>RP5</b>
<b>Start Period</b>	<b>Jan 2013</b>	<b>Oct 2013</b>	<b>Oct 2014</b>	<b>Oct 2015</b>	<b>Oct 2016</b>
<b>End Period</b>	<b>Sep 2013</b>	<b>Sep 2014</b>	<b>Sep 2015</b>	<b>Sep 2016</b>	<b>Sep 2017</b>
Number of months in period	9	12	12	12	12
Opening Value	£17m	£11m	£3m	£2m	£0m
Capital additions	£0m	£0m	£0m	£0m	£0m
Depreciation	-£6m	-£8m	-£0m	-£2m	-£0m
Other	£0m	£0m	£0m	£0m	£0m
Closing Value	£11m	£3m	£2m	£0m	£0m
Average RAB	£14m	£7m	£3m	£1m	£0m
Vanilla WACC applied	5.69%	5.73%	5.76%	5.76%	5.76%
WACC Return	£0.60m	£0.39m	£0.15m	£0.07m	£0.00m

<b>Keypad RAB</b>					
<b>Regulatory period</b>	<b>RP5</b>	<b>RP5</b>	<b>RP5</b>	<b>RP5</b>	<b>RP5</b>
<b>Start Period</b>	<b>Jan 2013</b>	<b>Oct 2013</b>	<b>Oct 2014</b>	<b>Oct 2015</b>	<b>Oct 2016</b>
<b>End Period</b>	<b>Sep 2013</b>	<b>Sep 2014</b>	<b>Sep 2015</b>	<b>Sep 2016</b>	<b>Sep 2017</b>
Number of months in period	9	12	12	12	12
Opening Value	£13m	£13m	£14m	£14m	£13m
Capital additions	£2m	£2m	£2m	£2m	£2m
Depreciation	-£1m	-£2m	-£2m	-£2m	-£2m
Other	£0m	£0m	£0m	£0m	£0m
Closing Value	£13m	£14m	£14m	£13m	£13m
Average RAB	£13m	£14m	£14m	£14m	£13m
Vanilla WACC applied	4.55%	4.55%	4.55%	4.55%	4.55%
WACC Return	£0.46m	£0.62m	£0.62m	£0.62m	£0.61m

<b>Enduring Solution RAB</b>					
<b>Regulatory period</b>	<b>RP5</b>	<b>RP5</b>	<b>RP5</b>	<b>RP5</b>	<b>RP5</b>
<b>Start Period</b>	<b>Jan 2013</b>	<b>Oct 2013</b>	<b>Oct 2014</b>	<b>Oct 2015</b>	<b>Oct 2016</b>
<b>End Period</b>	<b>Sep 2013</b>	<b>Sep 2014</b>	<b>Sep 2015</b>	<b>Sep 2016</b>	<b>Sep 2017</b>
Number of months in period	9	12	12	12	12
Opening Value	£22m	£21m	£19m	£16m	£14m
Capital additions	£1m	£0m	£0m	£0m	£0m
Depreciation	-£2m	-£2m	-£2m	-£2m	-£2m
Other	£0m	£0m	£0m	£0m	£0m
Closing Value	£21m	£19m	£16m	£14m	£11m
Average RAB	£22m	£20m	£18m	£15m	£13m
Vanilla WACC applied	4.55%	4.55%	4.55%	4.55%	4.55%
WACC Return	£0.73m	£0.91m	£0.80m	£0.68m	£0.57m

<b>FEMO 2007 Non residential M.O. RAB</b>					
<b>Regulatory period</b>	<b>RP5</b>	<b>RP5</b>	<b>RP5</b>	<b>RP5</b>	<b>RP5</b>
<b>Start Period</b>	<b>Jan 2013</b>	<b>Oct 2013</b>	<b>Oct 2014</b>	<b>Oct 2015</b>	<b>Oct 2016</b>
<b>End Period</b>	<b>Sep 2013</b>	<b>Sep 2014</b>	<b>Sep 2015</b>	<b>Sep 2016</b>	<b>Sep 2017</b>
Number of months in period	9	12	12	12	12
Opening Value	£4m	£2m	£0m	£0m	£0m
Capital additions	£0m	£0m	£0m	£0m	£0m
Depreciation	-£2m	-£2m	£0m	£0m	£0m
Other	£0m	£0m	£0m	£0m	£0m
Closing Value	£2m	£0m	£0m	£0m	£0m
Average RAB	£3m	£1m	£0m	£0m	£0m
Vanilla WACC applied	4.55%	4.55%	4.55%	4.55%	4.55%
WACC Return	£0.10m	£0.05m	£0.00m	£0.00m	£0.00m

<b>Old North/South Interconnector RAB</b>					
<b>Regulatory period</b>	<b>RP5</b>	<b>RP5</b>	<b>RP5</b>	<b>RP5</b>	<b>RP5</b>
<b>Start Period</b>	<b>Jan 2013</b>	<b>Oct 2013</b>	<b>Oct 2014</b>	<b>Oct 2015</b>	<b>Oct 2016</b>
<b>End Period</b>	<b>Sep 2013</b>	<b>Sep 2014</b>	<b>Sep 2015</b>	<b>Sep 2016</b>	<b>Sep 2017</b>
Number of months in period	9	12	12	12	12
Opening Value	£1m	£1m	£1m	£1m	£1m
Capital additions	£0m	£0m	£0m	£0m	£0m
Depreciation	-£0m	-£0m	-£0m	-£0m	-£0m
Other	£0m	£0m	£0m	£0m	£0m
Closing Value	£1m	£1m	£1m	£1m	£1m
Average RAB	£1m	£1m	£1m	£1m	£1m
Vanilla WACC applied	4.55%	4.55%	4.55%	4.55%	4.55%
WACC Return	£0.03m	£0.04m	£0.04m	£0.04m	£0.04m

## **14 FINANCEABILITY**

### **Update from draft determination**

14.1 We considered all of the responses to our draft determination carefully, and have adjusted our approach in light of this feedback.

14.2 Over the course of the consultation period we met Fitch, Moody's, and Standard and Poor's ratings agencies to discuss our draft proposals and our financial modelling. In our final decisions we have taken into consideration the approach and views of the ratings agencies. We have also expanded our analysis to include additional functionality to stress test our assumptions.

### **Introduction**

14.3 In our draft determination we summarised our position on NIE T&D's financeability by stating that the company could finance its base case activities without the need for new equity or the need to retain dividends. We also pointed out that the company faced certain challenges. These included the large programme of new investment in relation to renewables and interconnection as well as the potential short-term additions to the pension fund over and above the regulatory allowance. We considered that to meet these challenges the company would inevitably need to retain dividends and/or inject fresh debt and equity.

### **Responses to draft determination**

14.4 The main responses in relation to financeability came from NIE T&D and one other respondent.

14.5 A respondent made the point that the gearing we had assumed in our WACC calculation was not consistent with the gearing assumptions in our financeability analysis.

14.6 NIE T&D stated that in order to compete for efficient funding the company has to retain a strong investment credit rating at BBB+ or above.

14.7 The company provided additional analysis to substantiate its view on financeability. The assumptions the company had used were different from those that we had used in the draft determination.



- 14.8 After the draft determination was published, Fitch placed NIE T&D on 'ratings watch negative'. NIE T&D quoted the press release that Fitch had issued which stated that "the reduced PMICR (post maintenance interest cover ratio) in isolation indicates the lower end of investment-grade or even speculative grade ratings"<sup>49</sup>.
- 14.9 NIE T&D also referred to regulatory risk and the impact that this would have on the company's financeability.
- 14.10 NIE T&D stated that it believed our assessment on NIE T&D's credit metrics was "fundamentally flawed and... materially overstated" due to: pension costs, excluded capital expenditure and the start date for RP5.

### **Impact of the consultation responses**

- 14.11 We have based our analysis on the notional gearing that a company in NIE T&D's position might reasonably have, rather than having tied ourselves to NIE T&D's actual capital structure. In considering the financeability of this notional gearing, however, we took as a starting point NIE T&D's actual capital structure at the start of the period (being 47% as at 31<sup>st</sup> March 2012), which we approximated to a notional gearing of 50%.
- 14.12 Our analysis suggested that NIE T&D's financeability would be stronger at this level of gearing than at higher levels, at which we consider the company might not be able to maintain the necessary financial profile over the RP5 period.
- 14.13 The notional level of gearing in the WACC should be consistent with the assumption made in the financeability. We have therefore set the gearing level in the WACC to 50% as discussed in Chapter 12.
- 14.14 NIE T&D's own evidence suggests that electricity companies can potentially finance themselves at lower ratings. We would propose a target credit rating of BBB+ to A-.
- 14.15 In conducting their financeability test, NIE T&D had assumed expenditure projections and treatments of issues (such as operating costs and pensions) which reflected the company's view of these issues.
- 14.16 We consider that by assessing the financeability of what we regard as an efficient company we have fulfilled our statutory duty with regards to

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<sup>49</sup> [Fitch Press release](http://us.mobile.reuters.com/article/Deals/idUSWLB990320120517) - <http://us.mobile.reuters.com/article/Deals/idUSWLB990320120517>

financeability. This is consistent with the Competition Commission's approach to the Bristol Water referral.

14.17 Regarding the actual company situation and how this may relate to financeability we believe it is relevant to refer to the company's licence condition 3 'Availability of resources'. This states that:

*"The Licensee shall at all times act in a manner calculated to secure that it has sufficient resources (including, without limitation, management resources, financial resources and financial facilities)".*

14.18 In this regard in our final determination we have made it clear which financeability assumptions are the result of licensed obligations (such as the growth and maintenance of the network) and which financeability assumptions are not (such as the impact of capitalisation practices and pension adjustment).

### **Financial modelling**

14.19 To help analyse the financial impacts of our decisions, we included the following functionality in our financial model:

- It models the accounts of NIE T&D (balance sheet, profit and loss account and cash flows) that result from the decisions of the price control.
- It provides a framework for specifying the assumptions for alternative outturn scenarios that differ from those that underlie the price control calculations.
- It provides a framework for assessing the impact of different variables such as adjustments for historical pension costs and capitalisation practices.
- It provides a framework to assess the extent to which the company can manage its own financial structure and the significance of this on the different scenarios.
- It uses these inputs and assumptions to compute the consequent key financial indicators relevant to the company's credit rating.

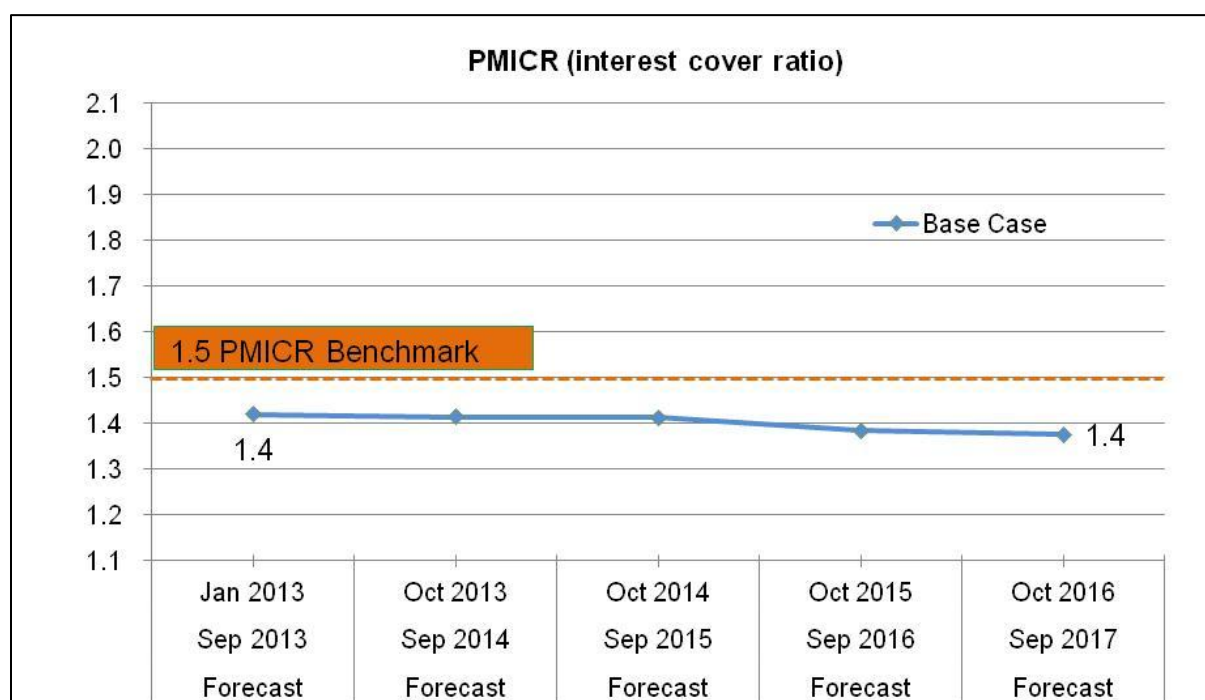
## Financeability test for RP5

14.20 We initially assessed NIE T&D's financeability on a 'base case'. We define the base case as business as usual for the company<sup>50</sup>. This would exclude the large growth that may occur under the renewables programme (Fund 3 capex) and any adjustments for capitalisation practice and pensions. The modelling assumes that NIE T&D takes full dividends<sup>51</sup> during the RP5 period.

14.21 Our modelling highlights the financing challenge for the business given its debt obligations and the cost of that debt. We note that Fitch has suggested a PMICR value of 1.4 in relation to NIE T&D. We regard 1.4 as an acceptable level but regard 1.5 to be a more desirable benchmark.

14.22 The PMICR for the base case is detailed in Figure 14.1 below.

**Figure 14.1: PMICR for RP5 without renewable capex**



14.23 The graph demonstrates that during the RP5 period NIE T&D are at or above the 1.4 level highlighted by Fitch for most of the RP5 period.

<sup>50</sup> In the base case, we assume that NIE T&D spend their full allowances for Capex (fund 1 and 2), opex and pensions. We do not assume an out performance

<sup>51</sup> The term full dividends means that the company takes all of its dividend entitlement. The entitlement is calculated as, (the closing RAB value)\*(the cost of equity)\* (RAB value, assumed to be financed by equity).

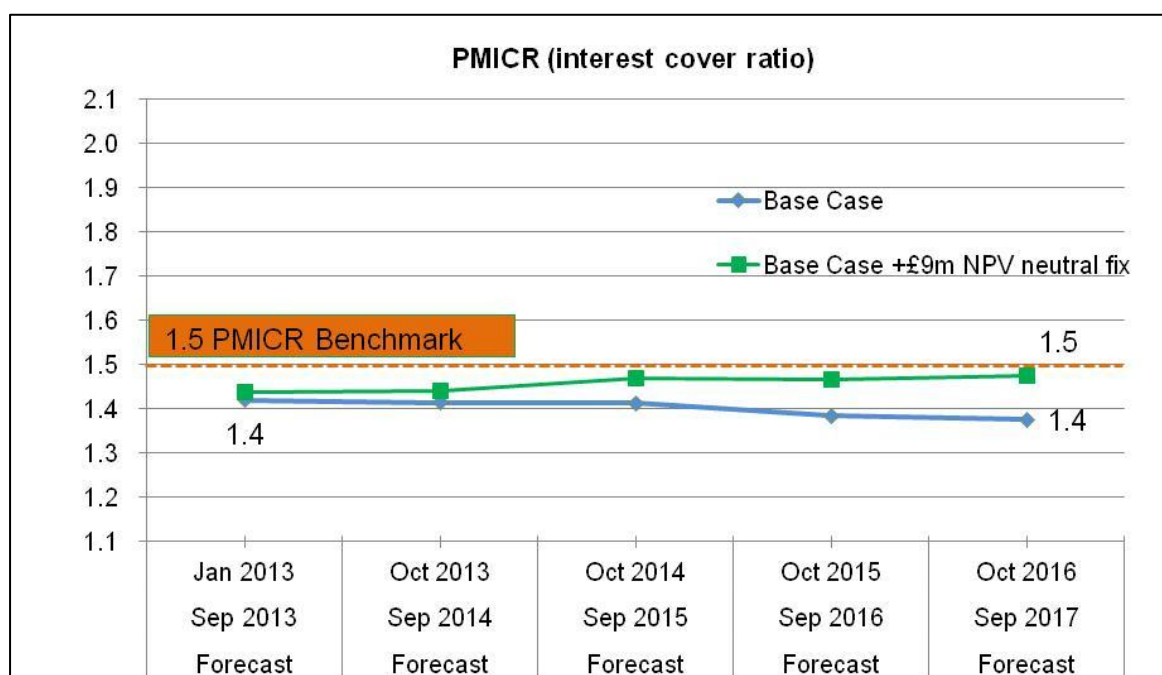
- 14.24 We do not consider this level of PMICR coverage to be ideal. However, we note the impact of the 'real/nominal mismatch' which is affecting the ratio that measures real return over the nominal interest costs.
- 14.25 The 'real/nominal mismatch' becomes a bigger issue during periods of higher inflation. Inflation is remunerated to the company by increasing the RAB value each year and hence the effect is spread over a long period of time. The company obtain a real return on the inflated RAB value each year. On the other hand the company must pay for interest costs on a nominal basis. The PMICR ratio is calculated using real income divided by nominal interest costs – hence the mismatch<sup>52</sup>.
- 14.26 We recognise that NIE T&D has not issued, nor have assumed any issue of index-linked debt in their modelling, which, in some form, could alleviate this ratio. Other regulators however, have assumed indexed linked debt in their tests for financeability.
- 14.27 Further, in nominal terms, NIE T&D is assumed to have relatively high interest costs compared to some other regulated utilities which further puts strain on this ratio.
- 14.28 We propose to correct for this timing issue by moving revenues from the next price control (RP6) into this price control (RP5) in an NPV neutral manner. , such that there is no transfer of value from consumers to the company.. Our modelling shows that the inclusion of £9million of 'financeability revenue' would sufficiently improve the PMICR.
- 14.29 The PMICR after this fix is included in the company revenues is detailed in Figure 14.2 below. We refer to this scenario as 'base case + £9 million NPV neutral fix'.

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<sup>52</sup> Please refer to publications in 2006 and 2010 by First Economics on the real/nominal mismatch.

<http://www.first-economics.com/financeability2.pdf>

<http://www.first-economics.com/financeability2010.pdf>

**Figure 14.2: PMICR for RP5 with NPV neutral adjustment**

14.30 In relation to gearing, our analysis shows that NIE T&D's actual gearing averages 50% during the RP5 period for both the 'base case' and the 'base case + £9m NPV neutral fix' scenarios.

### Capex for renewables and interconnection

14.31 No funding to support renewables generation (Fund 3 capex) has been requested or approved in our final determination. However, we acknowledge that there will be capital expenditure in this area during the RP5 period.

14.32 Considering the significant level of capex estimated for renewables (£223 million) this would represent significant growth of the company's RAB (>20% growth in real terms). It is prudent to assume that new capital will be needed. We would expect an investment of this scale to be funded through a mixture of both debt and equity.

14.33 From NIE T&D's submission we noted that as well as debt via intercompany loans the company has also indicated lower dividends and an equity injection towards the end of RP5.

14.34 Consistent with regulatory practice elsewhere, the onus would normally be on the company to resolve financing issues through its dividend policy and/or an equity injection. Ofgem's RIIO Handbook, for example, notes:

*"Under the RIIO model, we will not advance cash flow in light of apparent short-term dips in cash flow metrics. We will seek to understand the reason behind such failures (e.g. high capital expenditure relative to RAV) but the onus will be on the company to resolve the situation, including by injecting equity and/or reducing dividend payments as they see fit. In contrast, when relative expenditure levels decrease, the company may choose to remove equity if it considers this appropriate, e.g. through the payment of special dividends."*<sup>53</sup>

14.35 We have modelled scenarios where NIE T&D spends £223 million on Fund 3 capex. In these scenarios NIE T&D can provide the necessary equity for Fund 3 from dividend retention.

14.36 If the scenario does arise where the company needs to raise new equity, we would regard it as reasonable to consider the efficient costs<sup>54</sup> of raising equity as a recoverable cost. If this situation were to arise we would expect detailed discussions with NIE T&D before scrutiny and approval of the costs<sup>55</sup>.

### **Financeability analysis for capitalisation practice and pension adjustments**

14.37 As noted above we considered separately the impact of adjustments which we believe could have been avoided by the company.

14.38 We have recently consulted on the capitalisation practice adjustment in detail. The impact of the £31.7 million RAB adjustment reduces the forecast interest coverage ratios by around 3%. The impact is not significant in financeability terms because the adjustment is being spread over 40 years.

14.39 Unlike the capitalisation practice adjustment, the proposed adjustment for pensions is a revenue adjustment as opposed to a RAB adjustment. NIE T&D shareholders have to pay the adjustment over 15 years. The impact on financeability is therefore more significant.

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<sup>53</sup> Paragraph 12.27 of Ofgem's Handbook for implementing the RIIO model, October 2010.

<sup>54</sup> For example Ofgem and Ofwat allow for transaction costs of 5% on raising new equity.

<sup>55</sup> For example the raising of new equity to support the growth of the company, should be in with the notional gearing in their WACC i.e. 50% equity.

14.40 We consider that any cash requirements resulting from the change in capitalisation practice, and our subsequent RAB correction, are a matter for the company. We do not consider that this will be material however given that the RAB is depreciated over 40 years. We also consider that any remaining mismatch between pension allowances and the funding schedule agreed with the pension trustees is also a matter for the company. However, we expect that this mismatch should now be significantly reduced with our final determination on pension costs.

### **Summary**

14.41 Having reviewed the financial ratios, and in particular, the PMICR, we are assured that NIE T&D can finance its base case activities without the need for new equity.

14.42 To recognise the impact of the real/nominal mismatch, we have included a sum of £9 million in the company's revenue over the RP5 period which will be reclaimed during a future price control period, in an NPV neutral manner.

14.43 Further, we recognise that the company faces certain challenges, particularly the significant additional investment programme for renewables and interconnection as well as a RAB adjustment for capitalisation practice and a revenue adjustment for pensions. This will inevitably require the company to reinvest (i.e. retain dividends and/or inject fresh equity). Our modelling/analysis shows the level of reinvestment to be appropriate and proportional.

## **15 REVENUE ENTITLEMENT**

### **Update to draft determination**

15.1 We have updated our analyses to reflect this final determination.

### **RP5 Revenue**

15.2 We have calculated the revenue that NIE T&D would have received based on their submission. This is £1.17 billion over 4 years 9 months. This is shown in Table 15.1. We have shown the investments required to integrate renewable generation and interconnection (fund 3) separately due to the uncertainty about their timing. The total revenue entitlement based on NIE T&D's submission without these costs would be £1.11 billion over 4 years 9 months.

15.3 Our proposals are also shown in table 15.1. Again the revenue entitlement is shown with and without the cost of integrating renewable generation and interconnection. Excluding fund 3, the revenue entitlement would be £920 million. When the indicative costs for fund 3 are included, the entitlement increases to £958 million. These values cover the 4 years 9 months of RP5.

15.4 We have used the cost apportionment provided by NIE T&D to split the costs in the categories above across transmission and distribution. As a result the tariffs in RP5 should be fully cost reflective.



**Table15.1 – Our RP5 revenue proposal - Without renewables**

<b>Transmission entitlement</b>					
<b>Revenue Block\Financial Year</b>	<b>2012/13 9 mths</b>	<b>2013/14</b>	<b>2014/15</b>	<b>2015/16</b>	<b>2016/17</b>
Return on RABs	£7.3m	£9.9m	£10.1m	£10.6m	£11.1m
Depreciation of RABs	£7.8m	£10.8m	£11.2m	£11.5m	£12.0m
Tax Entitlement	£2.0m	£2.4m	£2.4m	£2.5m	£2.6m
Controllable Opex	£4.2m	£5.5m	£5.5m	£5.4m	£5.4m
Uncontrollable Opex	£2.0m	£2.7m	£2.7m	£2.7m	£2.7m
Pension costs (ongoing & deficit repair)	£0.9m	£1.2m	£1.1m	£1.1m	£1.1m
Pension avoidable deficit	-£0.2m	-£0.2m	-£0.2m	-£0.2m	-£0.2m
Non Network Capex	£0.2m	£0.3m	£0.3m	£0.3m	£0.3m
Known Dt costs	£0.2m	£0.2m	£0.1m	£0.0m	£0.0m
NPV neutral revenue adjustment	£0.1m	£0.1m	£0.3m	£0.4m	£0.5m
<b>Final Determination - Transmission</b>	<b>£24m</b>	<b>£33m</b>	<b>£33m</b>	<b>£34m</b>	<b>£35m</b>
<b>Distribution entitlement</b>					
<b>Revenue Block\Financial Year</b>	<b>2012/13 9 mths</b>	<b>2013/14</b>	<b>2014/15</b>	<b>2015/16</b>	<b>2016/17</b>
Return on RABs	£28.8m	£37.4m	£36.8m	£37.3m	£37.9m
Depreciation of RABs	£42.7m	£56.9m	£47.4m	£50.3m	£48.7m
Tax Entitlement	£10.1m	£12.2m	£8.8m	£9.4m	£8.6m
Controllable Opex	£23.8m	£31.2m	£31.0m	£30.8m	£30.7m
Uncontrollable Opex	£11.4m	£15.1m	£15.1m	£15.1m	£15.0m
Pension costs (ongoing & deficit repair)	£10.0m	£13.3m	£13.2m	£13.2m	£13.2m
Pension avoidable deficit	-£2.1m	-£2.9m	-£2.9m	-£2.9m	-£2.9m
Non Network Capex	£1.3m	£1.7m	£1.7m	£1.7m	£1.7m
Known Dt costs	£1.2m	£1.2m	£0.4m	£0.0m	£0.0m
NPV neutral revenue adjustment	£0.4m	£0.8m	£1.5m	£2.3m	£2.7m
<b>Final Determination - Distribution</b>	<b>£128m</b>	<b>£167m</b>	<b>£153m</b>	<b>£157m</b>	<b>£156m</b>
<b>Total entitlement</b>					
<b>Final Determination - Total</b>	<b>£152m</b>	<b>£200m</b>	<b>£186m</b>	<b>£191m</b>	<b>£191m</b>
<b>Draft Determination - Total</b>	<b>£142m</b>	<b>£184m</b>	<b>£175m</b>	<b>£167m</b>	<b>£167m</b>
<b>Change in Revenue</b>	<b>£10m</b>	<b>£16m</b>	<b>£11m</b>	<b>£24m</b>	<b>£24m</b>

**Table15.2 – Our RP5 revenue proposal - With renewables**

Transmission entitlement					
Revenue Block\Financial Year	2012/13 9 mths	2013/14	2014/15	2015/16	2016/17
Return on RABs	£7.8m	£12.0m	£13.9m	£16.5m	£19.3m
Depreciation of RABs	£8.4m	£12.9m	£14.4m	£16.7m	£18.7m
Tax Entitlement	£1.8m	£2.0m	£2.2m	£2.3m	£2.6m
Controllable Opex	£4.2m	£5.5m	£5.5m	£5.4m	£5.4m
Uncontrollable Opex	£2.0m	£2.7m	£2.7m	£2.7m	£2.7m
Pension costs (ongoing & deficit repair)	£0.9m	£1.2m	£1.1m	£1.1m	£1.1m
Pension avoidable deficit	-£0.2m	-£0.2m	-£0.2m	-£0.2m	-£0.2m
Non Network Capex	£0.2m	£0.3m	£0.3m	£0.3m	£0.3m
Known Dt costs	£0.2m	£0.2m	£0.1m	£0.0m	£0.0m
NPV neutral revenue adjustment	£0.1m	£0.1m	£0.3m	£0.4m	£0.5m
<b>Final Determination - Transmission</b>	<b>£25m</b>	<b>£37m</b>	<b>£40m</b>	<b>£45m</b>	<b>£50m</b>
Distribution entitlement					
Revenue Block\Financial Year	2012/13 9 mths	2013/14	2014/15	2015/16	2016/17
Return on RABs	£28.8m	£37.4m	£36.8m	£37.3m	£37.9m
Depreciation of RABs	£42.7m	£56.9m	£47.4m	£50.3m	£48.7m
Tax Entitlement	£10.1m	£12.2m	£8.8m	£9.4m	£8.6m
Controllable Opex	£23.8m	£31.2m	£31.0m	£30.8m	£30.7m
Uncontrollable Opex	£11.4m	£15.1m	£15.1m	£15.1m	£15.0m
Pension costs (ongoing & deficit repair)	£10.0m	£13.3m	£13.2m	£13.2m	£13.2m
Pension avoidable deficit	-£2.1m	-£2.9m	-£2.9m	-£2.9m	-£2.9m
Non Network Capex	£1.3m	£1.7m	£1.7m	£1.7m	£1.7m
Known Dt costs	£1.2m	£1.2m	£0.4m	£0.0m	£0.0m
NPV neutral revenue adjustment	£0.4m	£0.8m	£1.5m	£2.3m	£2.7m
<b>Final Determination - Distribution</b>	<b>£128m</b>	<b>£167m</b>	<b>£153m</b>	<b>£157m</b>	<b>£156m</b>
Total entitlement					
<b>Final Determination - Total</b>	<b>£153m</b>	<b>£204m</b>	<b>£193m</b>	<b>£202m</b>	<b>£206m</b>
<b>Draft Determination - Total</b>	<b>£143m</b>	<b>£187m</b>	<b>£179m</b>	<b>£174m</b>	<b>£180m</b>
<b>Change in Revenue</b>	<b>£10m</b>	<b>£17m</b>	<b>£14m</b>	<b>£28m</b>	<b>£26m</b>

## 16 IMPACT ON ELECTRICITY TARIFFS

### Update to draft determination

- 16.1 We have updated our analyses to reflect comments made by NIE T&D on our draft determination and the revenue the company is allowed to collect under this price control.

### RP5 Tariffs

- 16.2 Following publication of our draft determination, NIE T&D reworked our analysis of the impact that our proposals would have on tariffs. The company used its more detailed tariff model and actual metered data for this analysis. It also highlighted an error in our model concerning the amount of revenue that was being collected from customers. The revenue collected through TUoS<sup>56</sup> in tariff year October 2011 – September 2012 was reduced by 7% as SONI had an over-recovery in the previous year.
- 16.3 We have updated our analysis based on the information that NIE T&D provided. In our final determination we are reallocating the costs associated with obsolete retail market IT systems from the PSO into the DUoS tariff and accelerating depreciation. This will reduce the PSO levy in future years. To ensure a like for like comparison between base year tariffs and future tariffs we have added in the portion of the PSO levy that was associated with those systems into our base year costs<sup>57</sup>.
- 16.4 Table 16.1 shows the impact that NIE T&D's proposals would have had on the network charges paid for by a selection of customer types. The average domestic bill would have increased by £106 in total over five years, excluding RPI inflation, and before network expansion for renewables and interconnection.
- 16.5 The impact of our final determination is shown in Table 16.2. This shows that, excluding RPI inflation and before network expansion for renewable generation, network charges should remain relatively flat over RP5<sup>58</sup>.

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<sup>56</sup> Transmission Use of System Tariff

<sup>57</sup> See a description of the various tariffs:

[http://www.uregni.gov.uk/uploads/publications/October\\_2012\\_Draft\\_Retail\\_Tariff\\_Background\\_Briefing.pdf](http://www.uregni.gov.uk/uploads/publications/October_2012_Draft_Retail_Tariff_Background_Briefing.pdf)

<sup>58</sup> The domestic customer type is based on 4041 kWh per year) and the Half hourly metered EHV customer is based on 27 GWh per year connected at 33kV. Comparisons of electricity costs across Europe are based on a standard consumption by domestic customers of 3300 kWh per year. The values should therefore be adjusted accordingly if they are to be used in such a comparison.

- 16.6 The current best estimate of investment on renewables and interconnection would result in a further increase of £18 on the average domestic bill over the five years.
- 16.7 For large energy users, the impact is much greater due to the fact that the majority of the investment for renewables and interconnection is on the transmission network. Therefore, customers in the category 'Half hourly metered EHV' could see their network charges increase by £55,892 over the RP5 period.
- 16.8 In the case of domestic consumers, the network charges make up in the region of 20% of electricity bills.
- 16.9 In summary, our proposals would result in little change over the five years of RP5 on the network charges paid by consumers. It is important to remember that these figures all exclude RPI inflation, which is applied to NIE T&D's allowed revenue each year.

**Table 16.1: Impact of NIE T&D request on network charges (excluding renewables and interconnection)**

Customer Type	Current Average Cost	Annual Cost for Average Use (TUoS + DUoS) £/year					Total Additional Cost over 5 years
		12/13	13/14	14/15	15/16	16/17	
Domestic	£132	£146	£146	£152	£159	£165	£106
Small Business (Quarterly Billing)	£497	£548	£549	£571	£599	£619	£399
Half hourly Metered MV <70kVA	£1,107	£1,220	£1,222	£1,271	£1,333	£1,376	£889
Half hourly Metered MV	£7,652	£8,436	£8,451	£8,791	£9,217	£9,513	£6,149
Half hourly Metered HV	£39,163	£42,912	£43,127	£44,895	£47,064	£48,804	£30,988
Half hourly Metered EHV	£124,927	£135,408	£136,866	£142,668	£149,524	£156,312	£96,142

**Table 16.2: Impact of our proposals on network charges (excluding renewables and interconnection)**

Customer Type	Current Average Cost	Annual Cost for Average Use (TUoS + DUoS) £/year					Total Cost over 5 years
		12/13 <sup>59</sup>	13/14	14/15	15/16	16/17	
Domestic	£132	£141	£136	£126	£129	£129	-£1
Small Business (Quarterly Billing)	£497	£529	£510	£473	£485	£485	- £5
Half hourly Metered MV <70kVA	£1,107	£1,179	£1,137	£1,052	£1,080	£1,078	-£9
Half hourly Metered MV	£7,652	£8,157	£7,862	£7,272	£7,465	£7,448	-£55
Half hourly Metered HV	£39,163	£41,137	£39,841	£37,248	£38,258	£38,343	-£987
Half hourly Metered EHV	£124,927	£127,808	£124,867	£118,984	£122,322	£123,560	-£7,095

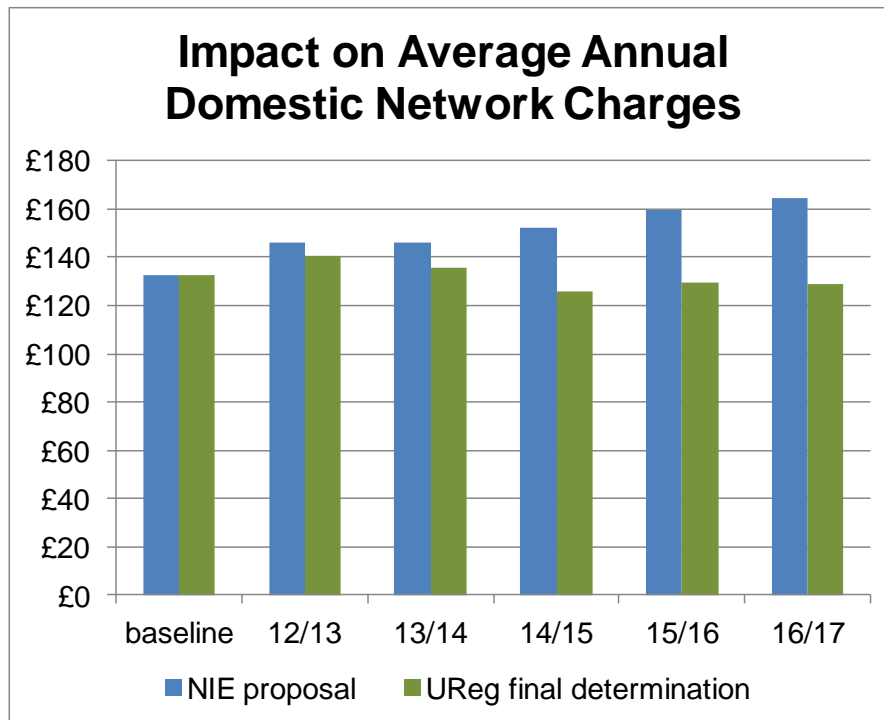
**Table 16.3: Potential impact of investment in renewable integration and interconnection**

	Potential additional cost of investment for renewables and interconnection over RP5 <sup>60</sup>
Domestic	£18
Small Business (Quarterly Billing)	£66
Half hourly Metered MV <70kVA	£136
Half hourly Metered MV	£895
Half hourly Metered HV	£9,274
Half hourly Metered EHV	£55,892

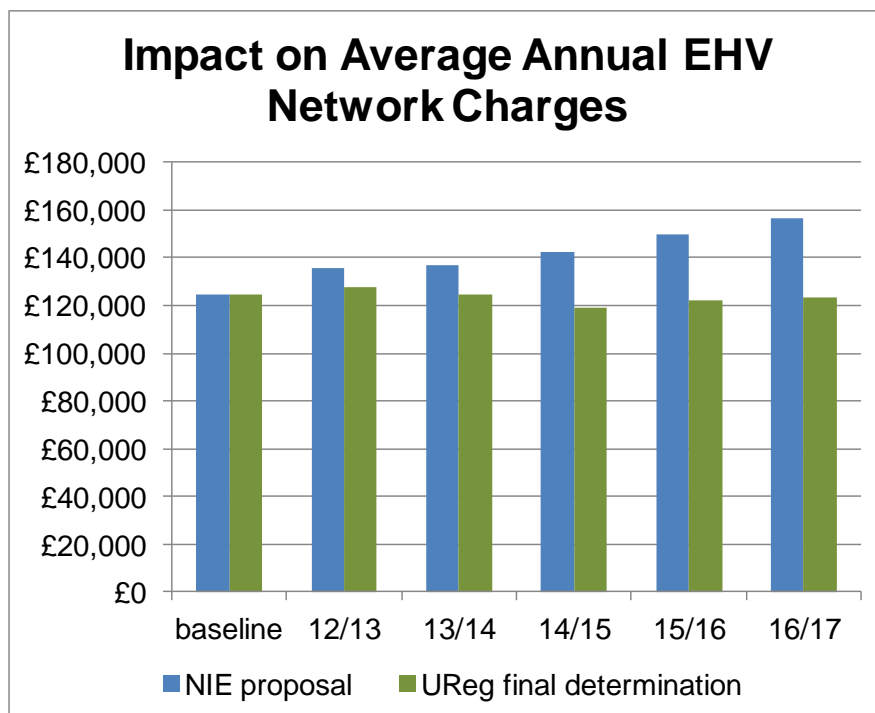
<sup>59</sup> This covers 3 months of RP4 extension and 9 months of RP5

<sup>60</sup> This is based on the NIE latest estimate for RP5. Please note that the cost of capital investment is recovered over 40 years, therefore the impact of renewables investment will continue to increase during RP6 and the total cost will be considerably higher if all of the expected network capacity is required. Most of the increase is seen in the TUoS tariffs in the final two years of RP5.

**Figure 16.1: Impact on domestic customers (excluding inflation, renewables and interconnection)**



**Figure 16.2: Impact on EHV customers (excluding inflation, renewables and interconnection)**



## 17 THE REPORTER

### Update from draft determination

- 17.1 In our consultation on cross utility price controls<sup>61</sup> we highlighted the need to try to address the issue of asymmetry of information between the regulator and the regulated company.
- 17.2 In our draft determination we explained that we intended to introduce a Reporter to the electricity network price controls. This initiative followed on from the positive contributions we have seen through the Reporter role in water regulation.
- 17.3 A Reporter is an independent professional appointed by a regulator to act as an auditor, certifier and commentator on aspects of the regulatory submissions that a company is required to make.

### Introduction

- 17.4 The Reporter would help us to fulfil our statutory duties (as outlined in Chapter 3). We expect that the Reporter would have a thorough knowledge of the technical, operational, financial and regulatory aspects of the electricity industry. To ensure that the Reporter has the necessary skills he or she may be assisted by a team with appropriate qualifications and competencies to fulfil this role.
- 17.5 The scope of the role that is undertaken by Reporters varies depending on the complexity, size, regulatory history and culture of the regulated company.

### Summary of responses

- 17.6 Of the 32 responses that we received to our draft determination, eight commented on the introduction of a Reporter. Of these, five supported the Reporter function, two did not support it, and one was unsure about the value that would be added by having this new role.
- 17.7 The reasons supplied by the respondents in respect of a Reporter are detailed in appendices E and F, together with our response.
- 17.8 Those respondents who supported the introduction of a Reporter gave a number of reasons. These included that the Reporter would:

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<sup>61</sup> [http://www.uregni.gov.uk/publications/proposals\\_for\\_a\\_cross\\_utility\\_approach\\_to\\_network\\_price\\_controls/](http://www.uregni.gov.uk/publications/proposals_for_a_cross_utility_approach_to_network_price_controls/)

- address asymmetry of information between the regulated company and regulator;
- improve the supply of the information that the regulator requires;
- ensure stronger scrutiny and accountability in relation to price control issues;
- have potentially positive impacts on consumer tariffs;
- help improve transparency; and
- represent value for money.

17.9 There was also support for the 'independent' nature of the Reporter's role.

17.10 The reasons given by those who did not support a Reporter function can be summarised as followed:

- the role would not necessarily add significant value;
- the Reporter would neither improve the speed or the efficiency of the project approval process;
- there would be increased costs in respect of the Reporter function and the regulatory company's requirement to increase support staff for this function;
- the Reporter function would possibly result in higher costs and delays, and reduce the number of project approvals;
- there was insufficient clarity about how the Reporter function might influence timescales for project approval;
- the Reporter function was indicative of a move towards a micro-management regulatory model;
- Ofgem had considered a Reporter function and did not anticipate recommending the introduction at this stage; and
- Ofwat have previously used the Reporter approach and had found it to be of no benefit.

17.11 We respond to these issues in detail in Appendices E and F.

## **Final determination**

17.12 Having carefully considered respondents' comments we are still of the view that the benefits from introducing a Reporter outweigh the costs. The main benefits include the fact that the Reporter will independently verify performance and will ensure that information is of a better quality and is



provided in a more complete form. This should improve the efficiency of the approvals process.

- 17.13 We believe that the introduction of a reporter reduces risk to NIE T&D as they will undertake annual assessments of the company's performance which will provide assurance and reduce the risk associated with the efficiency review at the end of the price control period.
- 17.14 The Reporter's role and scope are set out in detail in the Terms of Reference in Appendix L. This is deliberately flexible so that the scale of the work can vary, as required. The Terms of Reference are very detailed and will be issued to NIE T&D. The regulated company will then tender and recommend a shortlist of suitable Reporters. We will then appoint the Reporter from this shortlist, if we consider one of the firms to be suitable. We will explain our reasoning if we are not able to appoint one of the Reporters on NIE T&D's shortlist.
- 17.15 It is expected that the Reporter will be in place from 31 August 2013. This will be a licence requirement.

## 18 ANNUAL REPORTING

### Update to draft determination

18.1 We have not made any changes to the draft determination in this section.

#### Introduction

18.2 In the draft determination we identified the reports that NIE T&D currently provides to us each year. The information in the reports allows us to apply the RP4 price control effectively. We also identified a number of additional reports that we require to ensure that we can monitor the operation of the RP5 price control effectively and increase transparency for external stakeholders.

#### Summary of responses

18.3 NIE T&D was the only respondent to comment on the annual reporting requirements that were discussed in the draft determination.

18.4 The introduction and role of the Reporter is covered in Chapter 19 so is not discussed further here.

18.5 NIE T&D's response stated the following in relation to annual reporting:

*"The Utility Regulator's reporting requirements should be specified at the outset of RP5. We will work with the Utility Regulator to agree an appropriate template having regard to the arrangements in place for the DNOs and we will identify what is within the capability of our existing reporting arrangements. Provision should be made for the recovery of any additional costs associated with staff and systems."*

#### Final determination

18.6 At the start of RP5 we will standardise annual reporting in order to:

- allow NIE T&D to collate and process the information in an efficient and pro-active manner;
- ensure that we have all of the information we need to monitor progress during RP5;

- ensure that the information is provided in the right format and in a timely manner;
- facilitate the Reporter's verification process.

- 18.7 Reporting requirements will be included as a licence requirement for RP5.
- 18.8 We will require a full annual report covering all of the areas identified below.
- 18.9 As discussed further in Chapter 19 we will appoint a Reporter for RP5.
- 18.10 We intend to publish an annual report summarising NIE T&D's performance with respect to the main issues that arise during RP5. We will include within this report: time taken to connect new customers and generators (Connections); network performance (CML/CI); and investment in the network (Capex).

### **Capex**

- 18.11 At present NIE T&D submits a Capital Investment Report to us each year. This is a high-level text summary of how the capex plan has been implemented in the previous year. For RP5, the initial capex plan will be defined in a capex database, which will also form the basis of the ongoing annual reporting. This will contain more detailed information than the previous summary report and will be presented in a structured format that we will determine. The database has already been used to collate information about how the capex programme was implemented during RP4. A version of the database for use during RP5 will be provided to NIE T&D prior to 1 January 2013.
- 18.12 We will continue to require capex reporting on an annual basis; the database and the associated narrative report will be submitted three months after the end of each financial year. NIE T&D will need to specify which fund the costs have been allocated to.
- 18.13 Where requested to by us, the Reporter will verify the data and associated processes behind the information that NIE T&D submits.

### **Financial**

- 18.14 The statutory and regulatory financial accounts, which have been verified by external auditors, will continue to form the cornerstone of the annual financial

reporting. These will be supported by monthly, three-monthly and six-monthly statements.

18.15 These statements will reconcile with the published accounts for the appropriate periods. The statements will include a breakdown for the published line items. We will decide on structure and the level of detail to be included in these statements, aligning where appropriate with NIE T&D's internal reporting.

18.16 The breakdowns for line items will be as follows:

- Published turnover to including a breakdown that provides sufficient detail to allow monitoring of the price control (to be specified when the licence conditions for RP5 are finalised).
- Published operational costs (opex) to including a breakdown that provides sufficient detail to allow monitoring of the price control (to be specified when the licence conditions for RP5 are finalised).
- Published information on cash flows, property, plant and equipment, and intangible assets in a format that provides enough detail for us to monitor the price control (to be specified when the licence conditions for RP5 are finalised).

18.17 Other financial reporting requests will be required for RP5. The exact nature of these will be discussed with NIE T&D to align with their current internal reporting arrangements.

18.18 The RP4 review also indicated that NIE T&D's annual tax report to us requires more detailed information. During RP5, the tax report (provided in a format agreed with us in advance) should be accompanied by:

- an annex illustrating a full reconciliation with the amounts shown in the capex database (annual reports); and
- an annex showing a record of the tax return presented to HMRC (we expect NIE T&D to claim all capital allowances that are eligible to be claimed).

18.19 All financial reports that are currently provided will continue to be required. These reports will be amended as necessary to ensure that full reconciliation can take place with other relevant reports.

**Pensions**

- 18.20 At present, NIE T&D is not required to provide any annual reports to us regarding its pension scheme. Any decisions that are made with pension scheme trustees regarding schedules of contributions or deficit recovery plans do not require prior consent from us.
- 18.21 NIE T&D will be required to provide all actuarial updates to us in a timely manner over the RP5 period. This should include visibility of:
- formal actuarial valuation reports (within 15 months of the valuation date);
  - annual actuarial funding updates (within 12 months of the valuation date); and
  - correspondence regarding the schedule of contributions and deficit recovery plan as discussed with the pension scheme trustees (if this supersedes any information that had previously been provided to us).
- 18.22 We should also be told about any changes in:
- the benefits that are in place for scheme members or
  - the rules of the scheme that could affect the level of employer contributions required when such changes are being discussed by the company and pension scheme trustees.
- 18.23 We consider that it is necessary to have visibility of the ongoing and deficit repair contributions that all contributors to the NIEPS pay into the pension scheme each year, in comparison with the allowance provided via the price control. Any variances should be explained in detail. This information should be provided in a format that is decided by us.

**Connections**

- 18.24 Previously NIE T&D reported on connections through its Capital Investment Report. We are content for this to continue. However this will only be in parallel to a specific, more detailed, connections report. This is to be provided on an annual basis in an agreed format although we may request interim reports on specific areas if and when necessary.
- 18.25 Any additions to the RAB that result from the difference between connection estimates and actual costs will be entered into the capex database and verified by the Reporter.

- 18.26 Also, regular reports will be provided to us detailing the number of connection offers made, timing of these and the status of each connection in terms of delivery. This will include actual costs against estimated costs and the reasons for variances.
- 18.27 We have now approved a new Statement of Charges for Connection to the Northern Ireland Electricity Distribution System. NIE T&D will be required to report (provided in a format pre-agreed with the Utility Regulator) on all aspects of the statement of charges including those listed above.

### **Network Performance**

- 18.28 In addition to the current quarterly reporting on customer complaints, the format of the annual system performance report will be reviewed and a summary made public. This will include the publication of statistics relating to:
- customer interruptions: planned, unplanned and due to exceptional events;
  - customer minutes lost (average duration of interruptions): planned, unplanned and due to exceptional events.
- 18.29 In relation to other incentive areas, we will require reporting on the CML and CI metrics in order to determine the level of incentive payments required. We will also continue the reporting from RP4 in relation to the revenue protection scheme.
- 18.30 We expect to work closely with NIE T&D during RP5 in developing the reporting for Load and Health indices and measurement of losses.

### **Environmental and Health & Safety**

- 18.31 NIE T&D will be required to undertake more reporting of its environmental and Health & Safety requirements during the RP5 period. The format and content will be in a format decided by us. We note that the Ofgem's RIIO handbook specifically lists both Safety and Environmental Impact as part of the output categories. We will consider reporting outputs similar to the RIIO model.

- 18.32 As part of these new requirements the company will be obliged to produce performance and benchmarking figures of its environmental requirements.
- 18.33 We will also require NIE T&D to provide more reporting on its safety requirements during RP5. We will develop the relevant requirements and templates as part of the company's overall annual reporting requirements. It is expected that health & safety reports will focus on:
- Health & Safety legislation both current and planned;
  - Demonstrate Health & safety compliance;
  - Health & Safety performance including year on year comparisons and benchmarking;
  - Director's inquiries and local inquiries including current status and the required changes to policy documents, guidelines, training and specifications.
- 18.34 We intend to liaise with HSENI on all aspects of Health & Safety requirements.

## **19 LICENCE MODIFICATIONS**

### **Update from draft determination**

- 19.1 In the draft determination, we proposed removing all references to Powerteam Ltd. However given the outcome of decisions for the final determination it is necessary for reference to Powerteam Ltd to remain for the present. Review of the regulatory account requirements is carried forward to be addressed on a cross utility basis in a future work stream.
- 19.2 We have undertaken a review of the aspects of the licence related to RP5. This is specified in a separate consultation.

### **Introduction**

- 19.3 The proposed modifications to NIE T&D's licence required to implement RP5 are published along with this document. As expected, modifications have centred on Annex 2 with a smaller number of consequential changes to the main body of the licence.
- 19.4 We have added one new condition in relation to the function of the reporter.
- 19.5 A formal consultation period is required for the proposed modifications by Article 14 of the Electricity (Northern Ireland) Order 1992.

### **Summary of responses**

- 19.6 There were no responses specific to this section.

### **Final determination**

- 19.7 The formal notice opening a public consultation on the proposed NIE T&D licence modifications is published on our website. This "Article 14 notice" details the proposed modifications that will put the final determination for the RP5 price control into action. It also gives details of how any interested persons can respond to the consultation, and the deadline for responses to be received.



## **20 LIST OF APPENDICES**

Appendix A: Glossary

Appendix B: Process followed for RP5

Appendix C: Statutory duties

Appendix D: RP5 capex assessment

Appendix E: Comments on NIE T&D response to RP5 draft determination

Appendix F: Comments on other responses to RP5 draft determination

Appendix G: Comments on responses to draft determination on capitalisation practice

Appendix H: Comments on responses to draft determination on Fund 3 approach

Appendix I: Real Price Effects

Appendix J: Pensions methodology

Appendix K: Annex 2 tables

Appendix L: Terms of reference for the reporter