



**SSE Renewables - Response to
Northern Ireland Electricity plc Transmission and Distribution
Fifth Price Control (RP5)
Strategy Paper**

4 October 2010



Northern Ireland Electricity plc Transmission and Distribution

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Strategy Paper

Introduction

SSE Renewables is pleased to respond to the Authority's draft strategy paper for NIE T&D fifth price control. As this current consultation is preliminary in nature, we have confined our comments to answering the questions as set out in the consultation.

Question 1:

Which aspects of the SEM arrangements do respondents believe should be taken into account for the NIE T&D RP5 price control?

We have assumed that output measures will be an integral part of RP5, but believe it would still be worthwhile to separate out operation of the retail market from development and operation of networks.

We believe that there should be full metering of the T&D boundary, to reduce the subjectivity of demand calculation.

Question 2:

Are there any other legislative or policy developments that the Utility Regulator should take into consideration for the RP5 price control?

As the network comprises long-lived assets, one of the most important objectives of the RP5 price control must be to ensure continuity of approach and sustainable development of the network in a manner that provides a good balance between the interests of current and future customers.

Where synergy benefits arise as a result of changing ownership structures, a fair share of these should be returned to customers in NI.

Question 3:

The Utility Regulator welcomes respondents views on the depreciation policy and profile used for the current NIE T&D price control. Do respondents agree with the current profile and are there alternatives we should consider?

Although the "kink" in the current price control exists for good historic reasons, the next price control should continue with the current uniform depreciation approach, to ensure that current customers do not face higher charges than necessary. Apart from any argument based on fairness, consistency of policy approach across price controls avoids creation of regulatory uncertainty and its concomitant risk. We therefore believe that current depreciation profiles should be retained.

Question 4:

Currently, rates, wayleaves and licence fees are classed as "uncontrollable opex". Do respondents agree with this classification?

Yes. Apart from wayleaves, there is no reason to change the current approach to the treatment of costs that are outside the control of the networks businesses. In the case of wayleaves, costs are controllable to an extent.

However the circumstances of each case are necessarily different and therefore, while establishment of a benchmark cost for various classes of works might be possible in theory, in practice it is difficult to see how a sufficiently robust costing structure could be developed for a price control.

Question 5:

The Utility Regulator welcomes views on the treatment of the proportion of a pension scheme deficit which has arisen due to early retirement deficiency costs. How do respondents think this should be funded?

In regard to the treatment of pension costs, a balance has to be struck between the level of incentives to deliver organisational efficiency and the subsequent imposition on customers of consequential implementation costs. At the same time, it is important to retain regulatory consistency in the approach to dealing with historic revenue settlements across price control periods. The consultation points out that the treatment of pension deficit costs for RP4 was established in line with Ofgem principles and we believe that this 70:30 approach should be continued into RP5 for existing costs¹. However, no new funding should be brought into the forthcoming price control.

Question 6:

The Utility Regulator welcomes any comments on the current incentive mechanisms in place for RP4. Do respondents think that these incentive mechanisms should continue for RP5?

SSE believes that incentive structures can be an effective means of promoting innovation in the absence of competition. For this reason we believe that the existing incentive structures should be retained and extended.

We note that the benefit of revenue recovered as a result of revenue protection actions is shared between customers and T&D. This policy needs to be revisited to ensure that T&D is not incentivised to make financial settlement agreements with customers without full account being taken of their consequential treatment in the wholesale settlement arrangements. Current arrangements are a reflection of the historic, monopoly market, in which all costs and revenues accrued to NIE in one way or another. If revenue protection actions result in a revised supplier aggregation volume, then it is inappropriate for T&D to appropriate any revenue that can be obtained from the customer, leaving a supplier with the wholesale market liability and the further obligation to pay use of system to T&D.

Apart from refinements to existing incentive mechanisms, we believe that new incentives should be put in place for

- Quality of service – there need to be penalties as well as rewards
- Reducing network losses - results to be proved by actual metered values
- reducing carbon from network operation – with associated reporting arrangements
- delivering capacity improvements through technology, rather than building additional wires; extending scope of the SMART programme
- Information Quality Incentive (IQI) – to encourage better forecasting of capex required over the price control period.

Question 7:

Do respondents agree on the continued RPI-X approach for the RP5 price control, or do they support developments in incentive regulation such as Totex or Menu regulation?

Yes, however, we believe it is also important to develop output measures to ensure that delivered outturn is in line with original commitment and to ensure that benefits are real before they are distributed.

Consistent with our response to Q6, it will also be key that the ‘correct’ incentive mechanisms are put in place to encourage the ‘right’ behaviours. The objective must be to ensure that network investment is not penalised (or

¹ Ofgem December 2009, chapter 10 (148/09 final proposals)

indeed rewarded) by a rate of return on marginal investment that incentivises "do nothing". The Authority should, for example, explore options to incentivise investment in smarter grid technology over more conventional solutions to ensure that the networks are in a position to meet future demands.

Question 8:

Are respondents aware of any other alternative approaches to incentive regulation, other than RPI-X, Totex or Menu regulation which they feel is appropriate for RP5, taking into account changing circumstances and the integration of renewables?

Work by Ofgem on its RPI-X@20 project, brings the above range of options together with output measures. This approach is also appropriate for Northern Ireland.

Question 9:

The Utility Regulator welcomes views on whether they should continue to use a "rolling mechanism" for controllable Opex in RP5, or alternatively a bottom-up approach supported by benchmarking?

We agree with arguments in favour of benchmarking; assumptions underlying "rolling mechanisms" cannot be assumed to have enduring validity. It is important to undertake benchmarking, to ensure that customers can have confidence that they continue to receive value for their money. However, we recognise that benchmarking can be resource intensive. As such, it is likely that there is a balance required between benchmarking and rolling approaches.

Question 10:

For RP5 should there be an allowance for Capex or should it be recoverable on an actual (pass-through) basis?

As with all regulation, the question of incentives must be addressed. We would therefore support an approach based on an allowed capex for a defined list of projects, with incentives for efficient investment and some form of output measures to ensure that commitments are delivered.

Question 11:

Do the respondents have any views on any other incentive mechanisms that should be considered for RP5?

See above.

Question 12:

The Utility Regulator is interested to hear views on the proposal that two separate price controls could be implemented in 2012 for Transmission and Distribution. What are respondents' views on this possibility?

It is important to think ahead. Recent developments have shown that structures, ownership and the competitive environment do change over time and it is important to think ahead, in the development of both legislation and regulation. We see no reason why a combined price control approach should be continued.

Question 13:

The Utility Regulator welcomes views on changing the duration of the price control to 3 years for Transmission, while maintaining a 5 year price control for Distribution. Interested parties who believe the Utility Regulator should maintain the 5 year duration for Transmission are invited to lay out specific reasons in their response as to why we should do so.

Every price control creates an element of uncertainty around both the structure and level of available revenue and capex. For long-lived assets, it is important to have a clear framework within which to plan and develop systems.

This requires stability and regulatory consistency across price control periods and time for incentives to deliver. Ofgem has recently proposed a change in approach to encourage network investment; extending price controls from five to eight years, to give investors more investment security.

In summary, investment horizons, incentive delivery and tariff stability all require longer price control periods and we believe 5 years is a reasonable compromise between investor and customer interests.

Question 14:

The Utility Regulator wishes to ascertain respondents' opinions on using Ofgem's WACC as precedent for NIE T&D. Do respondents think the Utility Regulator should continue to do this for RP5?

Given the recently-reported comments by one of the major energy sector institutional investors that, "there is an unbridgeable gap between the regulators' perception of what is a fair return on equity and what we require on incremental investment"², it is clear that Ofgem's WACC is not universally accepted as reasonable. While there are academic papers on both sides of the argument, the view of such an influential investor aligns with statements by all DNOs, that Ofgem's WACC has failed to take sufficient notice of turmoil in the financial markets and is therefore insufficient to sustain the level of investment necessary to support renewable development targets.

Question 15:

The Utility Regulator welcomes views on the treatment of a pension scheme deficit as part of the price control. What are respondents' views on the appropriate duration of a deficit recovery plan?

To avoid differential treatment of customers across time, the pension scheme deficit should be mortised over a timescale that seeks to match recovery to the profile of the liability actually being incurred.

Question 16:

The Utility Regulator welcomes views on whether the current pension deficit in respect of NIE T&D employees should be treated as debt as part of the company's gearing calculation.

The pension deficit could be viewed as debt of a sort, but it is a contingent liability, rather than the same as borrowings. The extent of the liability depends on mortality rate, investment performance and the divergence between outturns of these actual factors and regulatory or other requirements for forecasting assumptions. The pension deficit must be funded, but there are many approaches that could be taken to do this and each one would affect cashflow differently.

The most important objective of the price control in respect of pensions is to ensure that funding requirements are met in a manner that does not allow the company to benefit from windfall investment gains, at the same time while customers fund losses. On balance and on the assumption that the pension deficit is funded over time, we do not believe it would be appropriate to include this deficit in any calculation of the company's gearing.

Question 17:

The Utility Regulator welcomes respondents' opinions on continuing with setting the rate of return on a post-tax basis for the next price control. Are respondents in agreement with this?

Yes. We believe that certainty of outcome is important, as is the removal of any incentive to manipulate gearing.

Question 18:

The Utility Regulator welcomes views on the use of a Reporter for the NIE T&D RP5 price control. Do respondents think this would be beneficial?

² Neil Woodford, Invesco Perpetual, reported content of letter to Ofgem Chairman, July 2010.

Yes. Issues involved in a price control are extremely complex and the outcome will benefit from availability of specific expertise and experience.

Question 19:

The Utility Regulator welcomes views on encouraging additional consumer expertise for RP5?

Yes. Stakeholder engagement is vital to ensuring a balanced outcome of the price control negotiation.

Question 20:

Do respondents support a smart metering roll out as part of RP5?

Yes. It has been our experience that smart metering has a lot to offer customers as well as networks operators. However, the price control must ensure that delivery is efficient and rollout should be subject to output measurement..

Question 21:

The Utility Regulator is interested to hear respondent's views on the possible introduction of a fund similar to Ofgem's Low Carbon Networks Fund as part of RP5. Do respondents think this would be beneficial on a Northern Ireland/ all Ireland basis?

We believe a fund of this type is highly desirable. However it is essential that this should not be a private fund for the network owner/operator, but be fully available for 3rd party involvement. Competitive access to funding is an important means of promoting innovation, to drive end-customer interests and deliver wider policy objectives.