

PJ McCloskey
Utility Regulator
Queens House
14 Queen Street
Belfast BT1 6ED

21 October 2015

Dear PJ

LICENCE MODIFICATIONS TO IMPLEMENT RP5

Please find attached NIE Networks' comments in relation to the proposed RP5 licence modification set out in the Utility Regulator's 22 September 2015 Consultation Paper.

Please let me know if you have any queries.

Yours sincerely



CARL HASHIM
Compliance Manager

L 151021 RP5 licence mods consultation – NIE Networks response

Draft licence ref	CMA FD ref, where applicable	NIE Networks' comments
Definitions		<p><u>Maximum Regulated Transmission / Distribution Revenue</u></p> <p>NIE Networks considers that the definition of Maximum Regulated Transmission Revenue, and that of Maximum Regulated Distribution Revenue, should be amended to remove the reference to "the 6 months ended 30 September 2017". The reference is superfluous and has no meaning, given that the other limbs of that definition (which refer to Regulatory Tariff Year and Regulatory Reporting Year) do not refer to any particular year and are not otherwise bounded by time. The duration of the RP5 price control is dealt with elsewhere (see in particular paragraphs 2.3 and 15). If the UR intends that the reference to "the 6 months ended 30 September 2017" is required to achieve a particular purpose, the drafting should be amended to make that purpose clear.</p> <p>Similarly, NIE Networks submits that the definition of these terms should refer to "<u>any</u> Regulatory Tariff Year" and "<u>any</u> Regulatory Reporting Year" (rather than "<u>the</u> Regulatory Tariff Year" and "<u>the</u> Regulatory Reporting Year", as proposed), given that in each case there is more than one such year. If the UR intends that the use of "the" is required to achieve a particular purpose, the drafting should be amended to make that purpose clear.</p>
Definitions		<p><u>Demonstrably Inefficient or Wasteful Expenditure</u></p> <p>The definition of "Demonstrably Inefficient or Wasteful Expenditure" proposed by the UR does not require the UR to demonstrate that expenditure is inefficient and/or wasteful before it can be determined as such. That is contrary to the clearly stated position of the CMA in its Final Determination: see paragraph 5.110 of the CMA FD.</p> <p>As currently drafted, the UR may determine expenditure "to be demonstrably inefficient and/or wasteful". As such, there is a risk that the UR might conclude that expenditure is demonstrably inefficient and/or wasteful in the absence of objective evidence in support of that conclusion. The language proposed by the UR is subjective, rather than objective, as to whether inefficiency and/or wastefulness have been demonstrated.</p> <p>This is contrary to the CMA's determination, which requires that inefficiency and/or wastefulness be objectively demonstrated and accordingly places the onus on the UR to provide evidence in support of any conclusion that expenditure has been inefficient and/or wasteful.</p> <p>While a number of alternative formulations would align with the CMA's determination, NIE Networks' preference would be to revert to the language adopted in earlier drafts of Annex 2, specifically:</p> <p><u>"... means expenditure demonstrated and determined by the Authority to be inefficient and/or wasteful, given the information reasonably available to the Licensee at the time that it made the relevant decision about that expenditure. For the avoidance of</u></p>

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		<p><u>doubt, no expenditure is Demonstrably Inefficient or Wasteful Expenditure simply by virtue of a statistical or quantitative analysis that compares very aggregated measures of the Licensee's costs with the costs of other companies."</u></p> <p>The definition should also make clear that the UR's determination that any expenditure is demonstrably inefficient and/or wasteful should be published in a reasoned decision document: see paragraph 5.110 of the CMA FD.</p>																		
Definitions	19.48	<p><u>Related Party Margin</u></p> <p>Clarification is required in respect of the treatment of depreciation on NIE Networks Services¹ assets because the UR's financial RIGS exclude the cost of the capital assets used by NIE Networks Services. The Related Party margin is overstated in the UR's financial RIGS as a result.</p> <p>The issue is illustrated by the worked example below. Under the CMA's FD the total actual costs for input into the risk sharing mechanism would be £149.5m, whereas the UR's calculation of actual costs is only £148.5m.</p> <p><u>ILLUSTRATIVE EXAMPLE</u></p> <table data-bbox="533 847 1048 1257"> <thead> <tr> <th data-bbox="533 847 981 879">Actual costs per accounts</th> <th data-bbox="981 847 1048 879">£m</th> </tr> </thead> <tbody> <tr> <td colspan="2" data-bbox="533 887 1048 919"><u>NIE Networks</u></td> </tr> <tr> <td data-bbox="533 927 981 959">Capex</td> <td data-bbox="981 927 1048 959">100</td> </tr> <tr> <td data-bbox="533 967 981 999">Opex</td> <td data-bbox="981 967 1048 999">50</td> </tr> <tr> <td data-bbox="533 1007 981 1038">Total actual costs</td> <td data-bbox="981 1007 1048 1038">150</td> </tr> <tr> <td colspan="2" data-bbox="533 1102 1048 1134"><u>NIE Networks Services</u></td> </tr> <tr> <td data-bbox="533 1142 981 1174">EBITDA</td> <td data-bbox="981 1142 1048 1174">1.5</td> </tr> <tr> <td data-bbox="533 1182 981 1214">Depreciation</td> <td data-bbox="981 1182 1048 1214">-1.0</td> </tr> <tr> <td data-bbox="533 1222 981 1254">EBIT</td> <td data-bbox="981 1222 1048 1254">0.5</td> </tr> </tbody> </table>	Actual costs per accounts	£m	<u>NIE Networks</u>		Capex	100	Opex	50	Total actual costs	150	<u>NIE Networks Services</u>		EBITDA	1.5	Depreciation	-1.0	EBIT	0.5
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¹ NIE Powerteam Limited was renamed Networks Services Limited on 16 December 2013.

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Definitions		<p data-bbox="519 799 696 826"><u>Related party</u></p> <p data-bbox="519 839 2051 930">NIE Networks does not understand why it is appropriate that an Affiliate or Related Undertaking should remain as a Related Party for the whole of the price control period even if it is no longer part of the group due to restructuring. The UR is requested to reconsider this aspect of the definition of Related Party.</p>															
2.1		<p data-bbox="519 963 2063 1054">NIE Networks submits that the UR's power to direct NIE Networks to base a forecast of Maximum Regulated Transmission / Distribution Revenue on information notified to it by the UR and make it in accordance with a methodology specified by the UR should be subject to a requirement that the UR act reasonably and consistently with the other provisions of the price control annex.</p> <p data-bbox="519 1069 1559 1096">For this purpose, NIE Networks proposes the following amendment to paragraph 2.1(b):</p> <p data-bbox="618 1110 2074 1201">"(b) where directed to do so by the Authority (acting reasonably and consistently with the other provisions of this Annex), base its forecast on any such information or make it in accordance with such methodology as the Authority may specify in the direction;"</p>															

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2.4		<p>Paragraph 2.4 provides that the provisions of paragraph 3 (which determine NIE Networks' maximum revenue) shall be deemed to apply with effect from the commencement of RP5 <u>onwards</u> "notwithstanding paragraph 15". Paragraph 15 makes provision for the disapplication of NIE Networks' price control in certain circumstances, and is carried over from the NIE Networks' existing price control provisions.</p> <p>The addition of the words "notwithstanding paragraph 15" renders paragraph 15 entirely meaningless. This is a substantive change to the existing price control provisions applicable to NIE Networks for which there is no justification or support in the CMA's FD. It is also misleading as to the purpose and effect of paragraph 15, and therefore reflects poor regulatory practice.</p> <p>NIE Networks submits that the UR should not be proposing this change at all, and certainly not as an Article 17 modification given the absence of justification for the change under the CMA's FD. The reference to "notwithstanding paragraph 15" should be changed to "<u>without prejudice to paragraph 15</u>".</p>
3.1		<p>NIE Networks should not, as is proposed by the UR, be subject to a best endeavours obligation to set Transmission / Distribution charges for years that post-date the coming into effect of these licence modifications. NIE Networks can do nothing about charges that have been set in the past. This provision should have effect from 1 October 2016, since that will be the first tariff year which commences after the licence modifications have taken effect.</p>
3.3		<p><u>Maximum Revenue Entitlement</u></p> <p>It needs to be made clear that the calculation of Maximum Regulated Transmission / Distribution Revenue for the purposes of setting tariffs in paragraph 3.3 will rely on forecast data.</p>
4.27	CMA model	<p><u>Depreciation allowances</u></p> <p>NIE Networks does not agree with the UR's proposed formula for depreciation on capital additions. It is not good regulatory practice to make material retrospective adjustments of this nature in respect of matters which were not considered as part of the CMA review. The effect of the UR's proposal would be that NIE Networks would take a disproportionate hit to 2016/17 financial performance as a result of the cumulative impact of the retrospective application.</p> <p>The proposed formula allows only for half a year's depreciation in the year additions are made to the RAB; whereas the CMA's FD model and NIE Networks' normal method of calculation is to provide a full year's depreciation in the year of addition. The UR's approach results in a reduction in the RP5 depreciation allowance of £12.7m (and hence NIE Networks' cash flow) compared to the CMA's FD model and NIE Networks' normal method of calculation. This revision was not considered, or proposed, at any time during the CMA's inquiry.</p>

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		<p>The formula should instead be:-</p> $\text{DEPNADD_Xt} = \text{DEPN-Xt} + (\text{DEPNADD_Xt-1} * \text{RPI}_t / \text{RPI}_{t-1})$ <p>where DEPNADD_X2012= zero</p> <p>It is wrong for the UR to suggest in paragraph 1.80 of the Consultation Paper that the PMICR is unaffected by the proposed change in the depreciation rate. Fitch's comment only holds true in the case where the regulatory allowance for depreciation in tariffs is aligned with the depreciation allowance. It does not hold true where a change in the depreciation allowance is being applied retrospectively. It's also wrong to say in the consumer impact table on page 3 that the CMA's FD has been reflected in customers' bills from October 2014. That is not true in respect of the depreciation assumption.</p> <p>Regulated T&D tariffs have now been set for the period up to 30 September 2016, which covers the first 4.5 years of RP5. The assumption made for tariff purposes was that the depreciation allowance would be calculated on the same basis as hitherto. The proposal to change the method of depreciation retrospectively from 1 April 2012 will mean that NIE Networks' 2016/17 income would be reduced by £12m. However the offsetting reduction in the depreciation allowance would only be c£2m, the net effect being a £10m reduction in the numerator of the PMICR calculation bringing the PMICR below 1.0.</p> <p>Paragraph 1.82 of the Consultation Paper also wrongly suggests that the effect is short term. The effect of the UR's proposal is to reduce NIE Networks' RP5 cash flow by £12m and increase the RAB by £12m. The value of the RAB is returned over 40 years – i.e. the effect is long term.</p>																															

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4.40 (D only)		<p>The definition of 'Second metering fixed allowance' (SMFA) looks incorrect. It currently reads: "... means the first metering fixed allowance amount, in a 2010 price base, for each Regulatory Reporting Year t...."</p> <p>We suggest the word 'first' is replaced with 'second' to avoid any confusion with definition of 'First metering fixed allowance'.</p>
4.37 (T only)		<p><u>Investment Projects to increase transmission system capacity</u></p> <p>In NIE Networks' view, the D5 mechanism is intended to cover projects which increase the transmission network capacity. The baseline for this test should be the transmission network capacity which the CMA assumed in its FD.</p> <p>The following points are pertinent:</p> <ul style="list-style-type: none"> • The CMA FD made the assumption that the Ballylumford units would be decommissioned and therefore there would be no need to replace the cable and no allowance was given accordingly. • The need to replace the cable has arisen because of security of supply issues and the decision by the Utility Regulator and DETI to carry out a market test exercise in March 2014 for the provision of additional adequacy margin of between 220MW and 300MW. • Following this process the Utility Regulator and DETI agreed that SONI would enter into a contract with AES which will provide 250MW of additional generation capacity, available from January 2016 • The procurement of this additional generation capacity has therefore created the need for additional transmission capacity above the level which the CMA assumed in its FD and the need to replace the cable has arisen as a result of this. • The effect of the draft modifications is that NIE Networks would be required to fund 50% of the cost of the cable notwithstanding that the need to replace the cable has arisen for reasons entirely outside NIE Networks' control. <p>In order to address this issue, NIE Networks proposes that the drafting in paragraph 4.37(b)(ii) of the Transmission licence should be amended as follows so that the exclusion of asset replacement expenditure does not apply to asset replacement projects that are driven by the transmission capacity required to import from Ballylumford.</p> <p style="padding-left: 40px;">(ii) Asset replacement expenditure (other than any asset replacement works forming part of approved projects and works associated with replacing the Ballylumford cable); and</p> <p>Separately, the UR has proposed modifying paragraph 4.37(b)(i) of the Transmission licence to provide for the UR to approve additional distribution allowances as part of an approved transmission load-related project, provided that the distribution works are wholly necessary to facilitate the load-related project. It proposes to make this change under its Article 14 powers, rather than its</p>

Draft licence ref	CMA FD ref, where applicable	NIE Networks' comments
		<p>powers to implement the CMA FD under Article 17.</p> <p>NIE Networks has two concerns with this aspect of the UR's proposals:</p> <ul style="list-style-type: none"> First, the UR's proposed language ("distribution works ... wholly necessary to facilitate transmission developments") would not support the funding of distribution works in circumstances where, say, undergrounding of distribution lines was the most cost-effective means of facilitating the transmission development but not technically the only means of doing so. NIE Networks submits that the following formulation is more apt to address the perverse and unintended consequences which the UR has recognised in its consultation document: <p style="margin-left: 40px;">"distribution works ... for which it would be reasonable to recharge the expenditure incurred to the transmission business and which are not required to increase capacity in the distribution system".</p> Second, NIE Networks submits that the above formulation is necessary properly to implement the CMA FD. Contrary to the view expressed by the UR in its consultation document, NIE Networks does not consider that the CMA FD, properly interpreted, excluded from the D5 mechanism additional costs associated with the distribution network which it would be reasonable to recharge to the transmission business and which are not required to increase capacity in the distribution system. As such, the modification should be made pursuant to the UR's licence modification duty under Article 17, rather than as a discretionary exercise of its licence modification powers under Article 14, as currently proposed.
<p>4.37 (e) Table 7 (T only)</p>	<p>5.273 5.279 App 9.4</p>	<p><u>Provisional allowances</u></p> <p>Paragraph 4.37(e) should be amended as follows to align more closely with the CMA FD:</p> <p>e) the Authority may only make a fresh assessment of projects considered in the Final Determination where there has been substantial changes to the nature or scope of these projects, otherwise, the provisional allowances for these projects shall be based on the project cost estimates are provided in Table 7 below. The list of projects in Table 7 is not exhaustive. The Licencee may apply for funding for other transmission system capacity or capability related projects under 4.37(a).</p> <p>Table 7 heading should read as follows to reflect Appendix 9.4 of the CMA FD:</p> <p>Table 7 – The Transmission Owner Business pre-determined transmission load related project provisional allowances (2010 prices)</p>

Draft licence ref	CMA FD ref, where applicable	NIE Networks' comments
4.45 to 4.50 (D) and 4.38 to 4.43 (T) and 6.18 to 6.23		<p>Change of Law</p> <p>NIE Networks objects strongly to the UR's proposed formulation of the change of law provisions (one for each of capex and opex). They represent a material deviation from the current formulation for which there is no justification or support in the CMA FD. There is nothing in the CMA FD to suggest that a substantive change to the change of law provisions is required. The UR should not therefore be proposing under its Article 17 powers any change to the change of law provision beyond the minimum necessary to fit within the new price control formulae.</p> <p>NIE Networks' current change of law provision provides for an essentially mechanistic approach to modifying NIE Networks' price control to ensure that the financial position and performance of NIE Networks is likely, so far as reasonably practicable, to be the same as if the relevant change of law had not taken place. The change of law provisions now proposed purport to afford the UR a degree of discretion as to the amounts that will be treated as change of law revenues in consequence of change of law: see, in particular, the requirement for the UR to determine whether <i>it is appropriate</i> to include an amount in the calculation of ACCOL_Xt / COLt. In addition, the UR's proposed change of law provision operates in both directions – i.e. the UR may trigger the CoL mechanism in circumstances where there is a CoL that results in a reduction in NIE Networks' costs. There is no justification or support for the change under the CMA's FD. The UR should not therefore be proposing this change under its Article 17 licence modification powers.</p> <p>NIE Networks' other concerns with the proposed formulation of the change of law provisions include:</p> <ul style="list-style-type: none"> • There is no longer an express reference to the UR having regard to (a) the period over which NIE Networks shall incur costs by reason of the relevant change of law and (b) the incremental costs (including financing costs) which NIE Networks has been or will be required to incur as a consequence of the relevant change of law. These provisions had effect to underline the essentially mechanistic nature of the assessment to be conducted by the UR in the event of change of law. Their omission is therefore detrimental to NIE Networks. • It introduces a superfluous reference to an efficient licensee. The role of the UR under the change of law provisions, in essence, is to put NIE Networks in the position that it would have been in had the change of law not occurred; it should not provide an opportunity for the UR to assess whether NIE Networks has acted efficiently in the period following the most recent price control and to revisit the efficiency mechanisms incorporated into its previous price control. Rather, the operation of the change of law mechanism should preserve the existing efficiency mechanisms and incentives. • Paragraphs 4.42 (Tx) and 6.20 (Dx) conflate the process for the calculation of ACCOL_Xt / COLt with the substantive test to be applied by the UR in making that determination. Moreover the requirement for the UR to determine that there has been "an amount that is directly attributable" to the Relevant Change of Law is inadequate to make clear that the UR's role is to determine what additional revenues should be permitted to NIE Networks in consequence of the change of law. As such, these paragraphs are muddled and unclear.

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9.1		<p><u>Tax Amount</u></p> <p>NIE Networks has two concerns with the Tax Amount provisions of paragraph 9:</p> <ul style="list-style-type: none"> • In the definition of CA_t, delete “considered appropriate by the Authority” [since that introduces an element of subjectivity for which there is no justification.] • The amount of capital allowances is based on QCE. However, not all QCE may qualify for tax allowances. NIE Networks therefore proposes the following change to the definition of QCE_Xt to QCET_Xt... <p style="text-align: center;">"QCET_Xt means the qualifying capex expenditure amount, calculated in accordance with 4.17 (QCE_Xt), <u>excluding any capital expenditure which does not qualify for capital allowances in accordance with HMRC guidelines:</u>"</p>
11.1 (in Art 14 mods)		<p><u>K factor – 11.1b)</u> Capex efficiency incentive RP4Cl_t should be £1.326m for D</p>
12.8		<p><u>Forecasts / estimates with regards to setting Transmission/ Distribution Charges</u></p> <p>We suggest that this provision be deleted. All relevant information will be provided to the UR by NIE Networks as part of the tariff submission. There should be no need to supplement this with further data.</p>
12.12 to 12.14 (Annex 2) and 6.12 to 6.14 (Annex 1)		<p><u>Restrictions on Distribution Charges</u></p> <p>Wording should be amended to make it clear that the comparison is with forecast Maximum Regulated Revenue e.g., £182.4m for 2015/16.</p> <p>The restrictions should only apply from the 2015/16 tariff year onwards. Moreover, as paragraph 12.13 requires an assessment over three successive Regulatory Tariff Years and since tariffs will not have been determined on the basis of the modified Annex 2 until the 2015/16 tariff year, no account should be taken of any Regulatory Tariff Year prior to the 2015/16 tariff year for the purpose of applying paragraph 12.13 (Annex 2) and 6.13 (Annex 1).</p>

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12.35 12.36	16.63	<p><u>Information on Tax</u></p> <p>The following amendments are proposed:</p> <ul style="list-style-type: none"> Amend paragraph 12.35(a)(i) as follows: "Information submitted to HMRC on the Licensee's tax affairs <u>relating to the calculation of the Licensee's capital allowances including the amortization of deferred revenue expenditure.</u>" Amend paragraph 12.35(b) as follows: "Information submitted to HMRC on the Licensee's tax affairs <u>relating to the calculation of the Licensee's capital allowances including the amortization of deferred revenue expenditure.</u>" Amend paragraph 12.36 as follows: "The Licensee shall, on an annual basis, publish on the Licensee's website the information supplied under 12.35(a) subject to the minimum redactions, considered necessary by the Authority, to protect commercially sensitive information."
12.38		<p><u>Statutory Accounts of Related Parties</u></p> <p>The statutory accounts of related parties may not align with 31 March. The following drafting is proposed:-</p> <p>The Licensee shall, no later than 10 months after the end of each Regulatory Reporting Year, prepare and submit to the Authority <u>the statutory accounts</u> of any Related Party , for the Regulatory Reporting Year, with whom the Licensee has had a transaction in that Regulatory Reporting Year. <u>The statutory accounts will be the latest available accounts with a period end date in the Regulatory Reporting Year.</u></p>