NORTHERN IRELAND AUTHORITY FOR ENERGY REGULATION

NORTHERN IRELAND ELECTRICITY – TRANSMISSION AND DISTRIBUTION PRICE CONTROL 2007-2012

FINAL PROPOSALS September 2006

Introduction

In December 2005 the Northern Ireland Authority for Energy Regulation - 'The Authority' published a paper outlining proposals for the Northern Ireland Electricity Transmission and Distribution price control for the fourth regulatory period (RP4) to run from 1 April 2007 to 31 March 2012. Since that paper was published Ofreg - working on behalf of the Authority – has continued to liaise with NIE with the aim of developing final proposals which would strike a fair balance between the interests of customers in terms of fair prices and the interests of shareholders in terms of a fair return to their investment. In June 2006 The Authority issued a further consultation paper in June 2006 outlining additional proposals with regard to the RP4 T&D price control. This second paper focussed on the review of NIE's capital expenditure proposals and the 'SMART' programme.

The Authority has noted the responses to the two consultation papers and has published these on its website.

Having consulted on all the necessary elements of the price control, the Authority is now in a position to issue the company with its final proposals for the RP4 T&D price control. These proposals are set out below.

If the company agrees to these proposals Ofreg will take the necessary steps to modify NIE's licence so that these proposals can take effect from April 2007.

Final RP4 Proposals

(Financial figures appearing below are quoted at 2004/05 price base, unless otherwise stated).

Price Control Duration

In December a five year period was proposed as it was considered this would lead to greater confidence by investors in the regulatory regime. This belief has not changed and a five year period is still proposed.

Operational Expenditure (Opex)

The December paper outlined the proposed new 'rolling mechanism' approach to Opex. It is proposed that the actual controllable Opex in each year of the current price control period is rolled forward with RPI indexation to become the controllable Opex allowance for the corresponding year in the next period. Thus, the controllable Opex allowance in year one of the new price control, RP4 (1) would be set equal to the actual controllable Opex in year one of the current price control RP3 (1) RPI-indexed and so on. This rolling approach would simplify the Opex calculation process while still incentivising the company to reduce costs with the savings automatically being passed back to customers in due course.

The Authority proposes two adjustments to this rolling mechanism – one in relation to disallowing £225k per annum of Opex in relation to pensions early retirement deficiency costs and a one off absolute reduction in Opex for the first two years of the new price control of £2.6m in year 1 and £1.6m in year 2.

Uncontrollable Opex which includes rates, wayleaves costs and licence fees is not to be subject to the rolling mechanism and will be recoverable on a pass-through basis subject to being reported annually to, and approved by the Authority.

NIE satisfied the Authority that it has now put in place a firm ring-fence around the network services which Powerteam provides to T&D.

Capital expenditure (Capex)

Regulated revenue includes an element to cover the costs of financing (return and depreciation) of new capital expenditure over the period. For RP4 it was proposed that the regulated entitlement would be dependent on *actual* Capex rather than *allowed* Capex. A separate mechanism would be introduced to incentivise capital efficiency (as outlined later) and NIE would be required to continue to report annually on its investments.

NIE's assessment of the overall network investment requirement for RP4 is in the region of £360m - £370m, but it has set itself the target of managing its obligations for 10% less expenditure (c£326m) through further efficiencies.

Ofreg employed Mott MacDonald (MM) as independent consultants to review NIE's Capex plans.

There are six areas where MM recommends an adjustment to NIE's planned Capex programme. The first four of these results from a difference of opinion on the appropriate engineering requirement to meet NIE's statutory and licence obligations and the fifth adjustment is a reduction of proposed expenditure because this would improve network performance above the present levels. The final adjustment relates to MM's view that there may be constraints in delivering the programme which NIE may have overlooked.

The Authority proposes that the original NIE Capex budget should be reduced to reflect the four adjustments highlighted by Mott MacDonald in relation to

(1) Transmission Auxiliary systems, reduction of £2m
(2) 110/33kV Power Transformers, £1.87
(3) Distribution Switchgear, £4.9m
(4) Distribution Network refurbishment strategies, £5.9m

In relation to the planned expenditure of £4.5m on remote control of the distribution network, MM recommend that it should be abandoned on the grounds that there is no regulatory mandate to improve overall network performance. The Authority has weighed up the arguments for this expenditure and is willing to accept it as part of the overall programme if NIE can demonstrate as part of its annual Capex reporting, the benefits which accrue to customers. The Authority therefore believes that this expenditure can be justified if NIE demonstrates the necessary network performance improvement to worst served customers.

In relation to the Delivery Shortfall risk identified by Mott MacDonald and estimated as a £10m shortfall in the expenditure programme, NIE has presented the Authority with a counter-argument in terms of its ability to plan and resource for deliver of the Capex programme.

Under the new Capex proposals where the allowance will be on actual rather than forecast expenditure the price risk to consumers of NIE not being able to meet its planned expenditure has been eliminated. The Authority therefore proposes that NIE's planned Capex budget should not be adjusted to take account of 'ramp-up' difficulties.

The Authority therefore proposes that the Capex budget for RP4 should be based on the following assessment of investment requirements:

Summary of RP4 Capex Adjustments and Recommendations			
Category	NIE RP4 Proposal (£m)	NIAER adjustment (£m)	Notes
Transmission			
Load related	30.2		
Non load related plant	28.34	(2.0) (1.87)	T auxiliary systems 110/33kV Power transformers
Non load related lines	17.25		
Distribution			
Load related	34.5		
Non load related	179.4	(4.9) (5.9)	D Switchgear D Network refurbishment
Other Expenditure			
New Business (Net)	45.6		
Network performance	4.5		
ESQCR compliance	8.0		
Metering	10.7		
Network IT	3.2		
Other Considerations			
Delivery Shortfall Risk			
SUB TOTAL	361.7	347.03	
NIE 4% Volume Reduction	(14.47)	(13.9)	
NIE 6% Efficiency Gain	(21.7)	(20.8)	
TOTAL	325.53	312.33	

Capex Efficiency Incentive

As part of the overall new conditions for the Capex programme NIE will be required to report annually to the Authority on the progress of its Capex programme and any significant changes in investment priorities.

This report will include a measure of performance against the investments outlined above. NIE will also provide an assessment of the efficiency savings which it has made against the costs projected in the derivation of the approved Capex budget. Notified efficiency gains will relate to procurement of materials and services and labour productivity. If other efficiency savings can be demonstrated the Authority will also consider these.

The proposal is that for every £1m of efficiency, the company would retain 38.9% of the efficiency, which in NPV terms equates to £389k, with customers retaining 61.1%. The calculation of 38.9% represents five years worth of return and depreciation. The 38.9% is a figure which results from the application of the depreciation profile of NIE's assets and the cost of capital proposed in the December paper. If NIE invested £1m in new capital it would be allowed a return on this investment (cost of capital) and the depreciation charge associated with the investment. Capex efficiencies will be calculated outside the RAB and the incentive added to the overall revenue entitlement in the year after the efficiency is made.

Regulatory Asset Base and Depreciation

The Regulatory Asset Base (RAB) is a measure of the value of the capital employed in the regulated business on which the company earns revenues to provide a return and to cover depreciation. The December paper stated that the Authority did not intend to change the treatment of the RAB and its depreciation for RP4. This proposal has not changed.

Cost of Capital

The proposals made in December in relation to the cost of capital have not been altered. The Authority proposes therefore that the allowed rate of return should be set at the GB Distribution Network Operator (DNO) level for the distribution portion of the T&D RAB. However, for the duration of RP4 there would be a 0.35% post tax reduction in the GB DNO rate of return in relation to the 18% of the total T&D RAB that has been assumed up to now as comprising transmission assets. With the GB DNO rate at 4.84% post-tax real, that would mean a transmission rate of return of 4.49% post-tax real.

The Authority further proposes to adjust the rate of return in year 4 of RP4 in the light of the cost of capital analysis which will be undertaken by Ofgem at its next price control review for the DNOs. However, rather than NI automatically tracking an increase in the allowed rate of return at the next GB review, it is proposed that a downward only adjustment for distribution is applied, i.e. if the DNO rate goes down, such a lower rate would be applied to NIE's distribution assets. If the DNO rate were to go up or remain the same, NIE's allowed rate of return for distribution assets would remain at 4.84% post-tax real. Any such downward adjustment as a result of the control applied to the GB DNOs at their next review would apply to NIE's distribution rate of return only. The 4.49% post-tax real return for NIE's transmission assets would remain fixed, in recognition of the fact that it had already been set at a lower level.

These proposals do not preclude the Authority adopting a different allowed rate of return from Ofgem at T&D's RP5 review. Ofreg would have an unprejudiced review of the prevailing precedents on allowed rate of return in other regulatory regimes as part of that review.

The following table sets out the proposed 'blended rate' of return for NIE T&D business.

	Allowed return (pre tax)	Allowed return (post tax)	RAB %	Blended return %
Transmission	6.41	4.49	18%	0.81
Distribution	6.91	4.84	82%	3.97
				4.78

Tax

The RP4 price control set out in the December proposals, for the first time for T&D, sets a rate of return on a post-tax basis. This means that the allowance for taxation would be based on the actual tax cost rather than an assumed 'tax-wedge' in the cost of capital calculation. The December paper set out the following proposals in relation to the post-tax approach which remain intact:

NIE has forecast its capital expenditure requirements for the duration of RP4. Tax allowances will depend on the nature of this expenditure and NIE has provided a forecast of the likely categories which the expenditure will fall into for tax purposes. The level of tax allowances will follow HM Customs and Revenue rules. NIE will be required to furnish the Authority on an annual basis with a tax return against which it can compare actual taxation with NIE's forecast. Such information will also inform the Authority of how to treat taxation at the time of the next price control review.

One of the reasons other regulators have moved to a post-tax approach to the cost of capital is that it allows the incentives to increase gearing to be mitigated. Correspondingly if NIE's gearing increases above the 57.5% used in the cost of capital model and interest costs higher than those in the financial model underpinning these proposals, the Authority intends to claw back the associated tax benefits for customers at the next review (based on the difference between actual interest and interest charges included in the financial model underpinning these proposals). This policy is the same as that adopted by Ofgem for the DNOs.

Smart

Against the success to date of the SMART programme, the Authority considers that the Smart programme should continue and expand in RP4 in line with NIE's proposal which was outlined in the June paper.

SMART1 – support, through funding, for a range of renewable installation programmes and for a small number of higher-value renewable projects. The Authority supports NIE's proposal to increase this to £727k per annum (2007/08 prices)

SMART2 – The Authority supports NIE's proposal to continue with the SMART2 programme in its present form. (i.e. where a renewable based alternative to conventional network reinforcement is confirmed and the support mechanism can be capitalised, it would be funded from T&D network capital investment plan at a 1% (pre tax) additional rate of return).

Vulnerable Customer Fund

NIE envisages establishing a £1m Vulnerable Customer Fund that would finance projects specifically targeted at combating fuel poverty by assisting low income households to access available grants and social benefits. The Authority welcomes this fund and will work with NIE to get it established as soon as possible. This Fund will be financed from NIE's own resources.

Research Capability

NIE has indicated that it would be willing to separately fund a planning and research facility up to the value of £1m during RP4 with the aim of identifying the best long-term options for network development to accommodate Government's sustainability objectives. The Authority welcomes this initiative which will be funded from NIE's own funds.

Other

The proposals for the change of law provision and the price cap, as set out in the December proposals, remain unchanged.

Ring – Fencing

The Authority has undertaken a review of the ring-fencing arrangements in NIE's licence. The Authority will amend NIE's licence to include conditions which will essentially to bring the financial ring fencing provisions for T&D, into line with those of the Distribution Network Operators in Great Britain.