

**Approval by the Utility Regulator of NIE Energy's
1 October Tariff Increase - A Background Briefing**

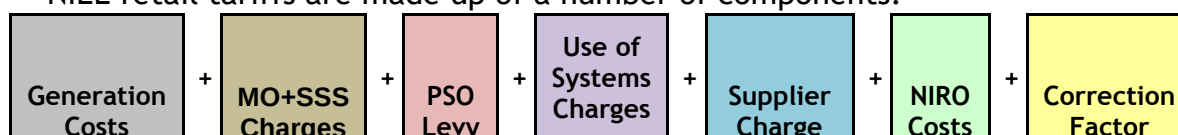
Summary

The Utility Regulator has approved a 33.3% increase in NIE Energy (NIEE) tariff for domestic electricity customers from 1 October 2008. This paper sets out the background and reasoning behind our decision.

Background

While the electricity market has been fully open for retail competition since 1 November 2007, in practice, for some classes of customers, in particular, domestic consumers, NIEE does not face effective competition from other suppliers. The Utility Regulator therefore takes an active role in scrutinising and approving NIE Energy's retail tariffs which are the final prices customers pay.

NIEE retail tariffs are made up of a number of components:



Several of these components are common across all suppliers and the final customer must pay these regardless of who their supplier is:

Tariff	Service	Regulatory Instruments
MO Charges (Market Operator)	Costs (including Imperfection costs) of Single Electricity Market Operator (SEMO)	SEMO Revenue & Tariffs 2008-09
SSS Charges (System Support Service)	For system planning, operation and despatch	SONI Price Control 2007-10
PSO Levy	Public Service Obligation costs which are spread across all Northern Ireland customers	PPB Price Control 2007-2009 and annual approval of other costs
Use of System Charges	Costs of transmission and distribution of electricity across the wires network	T&D Price Control 2007-2012

Table 1: Tariff Components common across all suppliers

These costs are regulated because they represent parts of the industry which remain under monopoly ownership and therefore not open to competition. Independent suppliers are free to enter the market and purchase power. However, they must add on the tariffs outlined above before setting the final price to sell to customers.

The remaining components of NIEE tariffs, because of the level of competition in the market, are all subject to regulatory scrutiny:

Cost	Service	Regulatory Scrutiny
Generation Costs	Costs of procuring electricity including capacity payments	Competitive wholesale market; approval of NIEE hedging methodology
Supplier Charge	Charge to supply electricity to customers including operating costs	NIEE Supply Price Control 2007-2009
NIRO Costs	NIRO costs relate to government obligation on suppliers to sell a proportion of their output as renewables	Audited on behalf of NIAUR by Ofgem as part of its UK-wide audit
'K' Correction Factor	The difference between allowed revenue and actual recovered revenue; from year to year out-turn prices and volumes will be different from forecasts which can lead to both over and under-recovery.	Analysis of variances between forecasts used for setting tariffs and out-turn costs

Table 2: Remaining Components of NIEE tariffs

Annual Price Review

The 33.3% increase in domestic tariffs from 1 October is on top of a 14% within year tariff increase in July which cumulatively is an increase of approximately 53%. Overwhelmingly the key driver for both increases has been the increase in generation costs. This is illustrated in the table below which analyses by key component the required revenues of NIE Energy for all customers comparing the forecast revenue underlying tariffs for the year beginning 1 October 2008 with the equivalent last year.

Component	Nov 07 (12 months)£m	Oct 08 (12 months)£m	12 months Movement £m	% change	Contribution to Overall Change
Generation¹	301.8	547.2	251.1	83.2%	99.1%
Network Costs (UoS)	119.5	130.5	11.0	9.2%	4.3%

¹ Generation costs comprises of energy, capacity payments, MO costs, NIRO Costs, first-year effect and any correction factor (K factor)

PSO	23.2	8.0	-15.2	-65.5%	-6.0%
SSS	6.5	11.1	4.6	70.8%	1.8%
Supply	29.1	31.0	1.9	6.5%	0.7%
Total	480.1	727.8	253.4	52.8%	100.0%

Table 3: Price Increase Comparison

Overall the required revenues of NIE Energy for the year commencing 1 October 2008 are 52.8% up compared with the requirement (on a 12 month basis) from 1 November 2007.

Increased generation costs - which comprise energy, capacity payments, MO costs, NIROCs, first year effect and any adjustment for over/under recovery in the previous year (the K factor) - account for almost all of the change with an increase of 83% compared to last year. The key driver behind the increase in generation costs is the increase in international fuel prices with gas prices doubling. These price pressures have been reflected in the hedging contracts which NIEE struck in April-June 2008 period, with the average contract cost rising by 81.2% compared with the previous year. After energy costs the next largest component of NIEE's generation costs is the cost of SEM capacity payments, which reflect the fixed costs of generation plant. This size of the capacity pot is determined by the SEM Committee and it has increased (in Sterling) by 29% this year, a reflection of a significant increase worldwide in the cost of generating equipment.

The PSO cost covers a number of costs which have a public service element to them and include costs such as initial system costs of retail market opening; excess costs of some renewable contracts (NFFO contracts); the excess costs of the long-term contracts with Ballylumford and Kilroot (which remain from the 1992 privatisation) including the cost of installation of FGD (Flue Gas Desulphurisation) at Kilroot which falls entirely on customers; the energy efficiency levy; and landbank costs. The PSO costs have fallen by around two-thirds this year. This reflects to a large extent the current high prices of fuel which has reduced considerably the excess cost of both the long-term and NFFO contracts.

Network costs have increased by around 9% this year and this reflects an increase in T&D's core entitlement (accounting for around 50% of the increase) with the remaining 50% accounted for by other factors including a wind cluster study, NW grid reinforcement, the interconnector to Rathlin Island, and retail market on-going costs, all of which were outside the core entitlement agreed in the 2007-12 T&D Price Control.

SSS costs while a relatively small proportion of total tariff costs have increased by about 70% this year. This, to a large degree, reflects carry-overs from the previous year. When this is removed the increase is around 27% which reflects an expansion of the SO's duties within the SEM.

The Supply entitlement has increased by around 6.5%. The entitlement of NIEE is regulated and is based on a fixed charge along with a per customer charge. This increase reflects inflation, some additional entitlement for customer numbers and an increase in some pass-through items including market opening costs.

Comparisons with ROI and GB Suppliers

ESB has announced an interim increase of 17.5% in July and is expected to announce a further increase in January. The combined impact of ESB's two-stage increase is likely to be less than in Northern Ireland for two reasons. The relative strength of the Euro relative to Sterling over the last year will cause a divergence between NI and ROI by approximately 15% while the decision by ESB to give back windfall-free carbon receipts of €300m will widen the differential by a further 10%. (The value of the equivalent carbon receipts in NI is already passed to customers, so no equivalent step is possible here.)

Currently it is estimated that NI prices are broadly similar to ROI (this comparison does not include any allowance for a further proposed increase in January).

In GB all the big six supply companies have announced two price increases since January with increase in energy prices being the key explanation cited.

Company	First Increase	Second Increase	Total Increase
EDF Energy	7.9 % (Jan)	17% (July)	24%
British Gas	15% (Jan)	9% (July)	25.3%
E.On	9.7% (Feb)	16% (Aug)	27.3%
Scottish and Southern Energy	14.2% (Mar)	19.2% (Aug)	36.1%
npower	12.7% (Jan)	14% (Aug)	28.5%
Scottish Power	14% (Jan)	9% (Aug)	24.3%

Table 4: Comparisons with GB Suppliers

Comparisons between NI and GB (and indeed between suppliers in GB) are difficult as the comparison is often dependent on the time period chosen.

To date this year the increases in GB have been less than those announced in Northern Ireland. One likely explanation is difference in duration of hedging contracts owned by GB companies compared with NI. Typically electricity suppliers have a portfolio of hedging contracts with different durations. To date this year electricity price increases in GB have tended to be lower than that which might be expected given underlying energy price increases; this suggests that historical hedges made at a time when prices were lower may so far have mitigated the impact of the underlying increase in energy prices. Over time, as these cheaper contracts expire, there may be continuing upward pressures on the prices of GB suppliers. The relative immaturity of the SEM which has been in existence for less than a year has not yet allowed this portfolio effect to develop in the SEM. It is interesting to note that when the comparison is done over a longer period (for example over the 3 years since December 2005) the differences between NI and GB are reduced. Over this period NIE Energy has seen the third highest price increase with prices increasing by just under 70%. Scottish and Southern's and npower's have been marginally higher at just over 70% while the remaining 4 GB suppliers have seen increases in the 40% to 60% range.

NI domestic consumer prices have been around or below the GB average in recent years but the latest increase of 33.3% has caused domestic consumer prices in NI to rise significantly above GB. The table below shows comparisons of domestic electricity prices (inc VAT) based on an annual consumption of 3300 kWh at 24 July 2008 from Energy Watch plus the August increases (see table above) for E.On, npower and Scottish Power.

Company	Estimated Annual Bill based on consumption of 3300 kWh	NIE v Comparator Company/Region
EDF Energy	£450	30%
British Gas	£458	28%
E.On	£489	20%
Scottish & Southern Energy	£473	24%
npower	£484	21%
Scottish Power	£470	24%
GB Average	£471	24%
NIE Energy	£585	NA
ESB (£=1.23 Euro)	£585	0%
GB Comparator Regions	£489	20%
Scottish Hydro	£478	22%
Swalec	£510	15%
Sweb	£479	22%

Table 5: Company and Regional Comparisons of Annual Bill

On average NIE Energy prices are currently estimated to be 24% above the GB average which falls to 20% on average for comparator regions which have similar characteristics to NI.

Impact

For NIE Energy domestic consumers using 3300 kWh per annum on standard credit this tariff review will increase their bill by £146 per annum to £585. Average weekly bills will increase by £2.81 to £11.25.