Utility Regulator
ELECTRICITY GAS WATER

THE NORTHERN IRELAND AUTHORITY FOR UTILITY REGULATION PROPOSAL FOR THE POWER PROCUREMENT PRICE CONTROL

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Introduction and Background to the PPB Business

NIE Energy Ltd Power Procurement Business (PPB) was set up following the legacy contracts being put in place on 1 April 1992 as a separate regulated business under the Northern Ireland Electricity Transmission and Public Electricity Supply Licence. The role of PPB before the creation of the Single Electricity Market (SEM) was to purchase power under the long term legacy contracts (PPAs) from independently owned generators. Prior to the commencement of EU liberalization in 1999 all of this power was sold to suppliers in the Northern Ireland market at a Bulk Supply Tariff (BST). From then, PPB sold to suppliers of Franchise customers at the BST and sold to suppliers in the competitive markets in Northern Ireland and Ireland under various bilateral arrangements as well as providing a balancing market for the competitive market segment in Northern Ireland.

Following the creation of SEM PPB role changed significantly in some respects. The business still continues to purchase power under the long term contracts but sells that power directly to the SEM pool. Furthermore the business enters into contracts for differences (CFDs) with suppliers in both jurisdictions (Northern Ireland and Ireland). These contracts have the effect of "hedging" or "fixing" the revenue that PPB will receive for the volume of power the contract is for. Thus PPB is able to fix a significant proportion of the revenues it will receive for the power it sells to the market.

If there is a mismatch (positive or negative) between PPB cost of sales i.e. the payments it makes to generators under the contracts and revenues (pool receipts, difference payments and PPB allowed price control amount) then that amount will be collected or rebated via the Public Service Obligation (PSO) levy. The existence of this arrangement enables PPB to recover any shortfalls between costs and revenues from Northern Ireland customers and hence, aside from some small residual risks which will be discussed later, the profit margin allowed in the price control is assured.

This consultation paper puts forward proposals for the next PPB price control which will be effective from 1 April 2009 and discusses the proposals that PPB have submitted to NIAUR. Although the price control in its entirety takes into account power purchase costs, change in law costs, non-PSO revenues (market revenues received) and a correction factor, it is the Et term of the price control i.e. PPBs own allowed revenue with which this paper is concerned. PPB own costs relate to the operating costs and working capital costs of the business. The entire price control formula deals with how PPB will calculate the PSO levy amount and PPB own costs make up only one part of this. The entire price control formula is shown below:

$$\mathbf{MPPB_t = A_t + D_t + E_t - NPR_t + KB_t}$$

Where:

$MPPB_t$ = the maximum regulated PPB PSO revenue in relevant year t

A_t = the actual power purchase costs incurred in the purchase of electricity in relevant year t

D_t = excluded power procurement costs, costs for change in law, 2003/54/EC directive or SEM changes and any other amounts approved by the Authority

E_t = the allowed Power Procurement Business entitlement

NPR_t = the non-PSO revenue in relevant year t

K_{Bt} = the correction factor to be applied in relevant year t

NIAUR invites views from interested parties on the proposals discussed below.

Structure of the Current Price Control (2007-2009)

The approach to the current price control taken by NIAUR and accepted by PPB (albeit on a without prejudice basis in the context of a short duration that also highlighted disagreement with various NIAUR conclusions) was to allow a rate of return and depreciation on PPBs regulatory asset base (RAB) and an incentive amount equal to 1% of forecast PPB turnover with PPBs own operating costs and working capital costs coming out of the incentivized amount. The incentive was based on 1% of forecast turnover and this was communicated to PPB in various meetings held to discuss the proposals. This is explained further below.

The following formula sets out the calculation for PPBs own allowed revenue or entitlement (Et). This is the total amount PPB is allowed in the price control to be retained by the business itself out of which it pays its internal business operating costs.

$E_t = DEP_t + RTN_t + IC_t + PD_t$

Where:

DEP_t = means the depreciation amount used to roll forward the PPB Regulated Asset Base on a 25 year profile and the New PPB Regulated Asset Base on a 5 year profile.

RTN_t = means the allowed return on the PPB Regulated Asset Base and the New PPB Regulated Asset Base

IC_t = means the PPB incentivized amount which is dependent on the outurn performance against the targets specified in the incentive

PD_t = means the allowed PPB pension deficit cost per year, such figure to be revised in accordance with the results of each triennial actuarial valuation.

The current incentives and the weightings given to them are set out below:

PPA Costs			
Description	**Objective**	**Target / Reporting method**	**Weight**
Availability Payments	Challenge and verify availability declarations and payments	Enforcement of the contract. Demonstrated via PPB's testing (via SONI).	5%
Change in Law costs	Minimise costs passed through (FGD, SO_3, Ash disposal, etc.)	Costs minimised. Demonstrated via report to NIAUR.	10%
Coal management	Ensure minimum contracted consumption is burnt	Minimum quantity consumed. Contractual compliance demonstrated ex-post.	3%
Gas management	Ensure minimum contracted consumption is burnt	LTI3 minimum take consumed. Contractual compliance demonstrated ex-post.	3%
Gas costs	Reduce gas costs	Average cost less than average LTI3 cost. Costs demonstrated ex-post.	17%
Fuel costs during LTI3 interruptions	Reduce replacement fuel costs	Average cost does not exceed average spot price during interruptions. Costs demonstrated ex-post.	7%
CO_2 management	Meet surrender obligations	Ensure no penalties for non compliance Demonstrated ex-post.	5%
Fuel Stocking	Ensure adequate fuel supplies	Agree strategy with NIAUR/DETI and demonstrate compliance with the plan	7%

Market Activity			
Description	**Objective**	**Target / Reporting method**	**Weight**
Nomination processes	Compliance with bidding principles	Market Monitor Challenges of PPB Bids should be no greater than overall market average. Demonstrated ex-post.	5%
Market Revenue	Ensure revenue receipts are correct	Verify invoices and query all deviations. Demonstrated ex-post.	5%
CfD cover position	Implement Risk Management in accordance with plans	Agree strategy/plan with NIAUR and demonstrate implementation within the agreed framework	17%
Risk Management products	Increase product portfolio to align with	Demonstrate product portfolio development [and	6%

	Supplier / Customer needs	customer satisfaction]	
Manage counter-party risk	Minimise risk of bad debt through rigorous implementation of the Payment Security Policy	Full compliance with the PSP. Demonstrate ex-post.	5%
Manage interfaces	Ensure new interface arrangements operate effectively or are modified where deficiencies are identified	Effective operation of the interfaces with SONI and T&D. Agreed modifications and referrals to NIAUR for dispute resolution.	5%

Under the 2007-2009 control PPB had to cover its own operating costs from the ICt amount. The original value for the baseline score for the 2007-09 price control was £4M (2006/07 prices) and this figure was based on an alternative benchmarks methodology whereby PPB received 1% of forecast turnover as revenue (other than depreciation and return on assets). The benchmark approach looked at those businesses such as brokerages and other trading type businesses (e.g. a reseller of gas) and these were used as analogies as it is difficult to find a company analogous to PPB within the energy industry.

Under this incentive for FY08-09 the value of ICt for 90% achievement was £4.345M and for 100% achievement £4.563M (2008 prices). 90% achievement is seen as the baseline or expected score that PPB is likely to achieve and hence the incentive amount is based on this expected score.

The section below looks at the data received from PPB in recent months and outlines NIAUR proposals for a new PPB price control to run from April 2009.

PPB sent an original business efficiency questionnaire (BEQ) submission to NIAUR on 27 October 2008. A further supplementary submission was received on 19 November 2008 setting out PPB's assessment of price control allowances it should receive calculated on the basis of a bottom-up building blocks approach and including an updated assessment of the cost of PPB's Working Capital Facility (WCF). This latter submission was supported by a report from NERA Economic Consulting who PPB had engaged to provide analysis and advice to inform PPB's submission (PPB submitted a restated BEQ and additional information as requested by NIAUR on 5 December 2008).

NIAUR and PPB met to discuss the submissions on 19 November and again on 15 December 2008 and 8 January 2009. PPB also met with the Authority's Board Advisory Group (BAG) on 11 February 2009. Following the meeting of 11 February PPB sent further submissions in support of their proposed staff retention bonus scheme and figures showing the new costs to PPB of commodity

hedging as well as the outline of a proposed new incentive arrangement. These were received on 6 March and 13 March 2009. NIAUR also requested information regarding PPB monthly working capital cash flow position and net finance cost/income on 9 March 2009. This information was received on 30 April 2009 containing information for the completed financial year.

Duration of New Price Control

As noted above the role of PPB is very much linked to the continuing term of the long-term generation contracts. The duration of any price control for PPB must therefore take into account the potential duration of contracts and in particular the earliest cancellation dates.

NIAUR is aware that several of the long term legacy contracts have earliest cancellation dates in November 2010 but also that the earliest date for the termination of the Ballylumford contracts is March 2012 and that there is no certainty with respect to early cancellation. It is for this reason we propose that the new price control should be applicable from April 2009 until March 2012. However NIAUR reserves the right to re-open the price control if cancellation in November 2010 goes ahead as a cancellation at this date of a number of the contracts would see a change in PPB activities and possible staffing levels. It would not be appropriate for a price control set in the context of all contracts being live to continue unchanged in the event of several having been cancelled. NIAUR regards the proposed price control for 2009-12 to be largely a further continuation of the 2007-09 control with any changes reflecting a material change in circumstances.

Form of New Price Control

NIAUR is satisfied that the current form and structure of the price control is appropriate as it allows for a reasonable return and depreciation on assets as well as incentivizing PPB to carry out the business efficiently, firstly because there is a natural focus to achieve the highest possible score (and the incentives are linked to efficient business activity) and secondly because operating costs are derived from the incentive amount. This ensures that the efficient management of operating costs (other than those associated with changes in law/directives or SEM whereapproved by the Authority) lies with PPB for the duration of the price control. Therefore as described above that section of the price control associated with PPBs own costs shall be:

$$E_t = DEP_t + RTN_t + IC_t + PD_t$$

Each of these elements is discussed in more detail below.

Depreciation (DEP_t)

PPB currently has a Regulatory Asset Base (RAB) and a "New" RAB. The original PPB RAB is based on the MMC's estimate of an initial RAB of £5Million for PPB/SONI. This valuation was based on the initial market value of NIE at flotation and the observed profitability of PPB/SONI. In 1999, when implementing the separation of the PPB and SONI businesses, NIAUR split the £5Million RAB into a £4Million RAB for PPB and a £1Million RAB for SONI, with all subsequent asset acquisitions allocated to SONI. The NIAUR method to roll forward the RAB is to add inflation and deduct an allowance for depreciation based on a 25 year straight line profile[1]. Using this methodology the value of the RAB at April 2009 is £2.3Million and a depreciation amount of circa £0.25Million is due. These figures are aggregated and shown below.

The new RAB is made up of assets invested in over the last three years and is mostly IT assets. This new RAB has an opening value at April 2009 of circa £0.21M and an associated depreciation charge of circa £0.06M based on a 5-year straight line depreciation profile.[2]

Initial RAB				
period ending	**31-Mar-09**	**31-Mar-10**	**31-Mar-11**	**31-Mar-12**
RAB Value (£m)	2.302	2.053	1.804	1.555
Average Value (£m)	2.177	1.929	1.680	
Annual Depreciation (£m)	**0.249**			

New PPB RAB				
period ending	**31-Mar-09**	**31-Mar-10**	**31-Mar-11**	**31-Mar-12**
RAB Value (£m)	0.213	0.204	0.137	0.043
Average Value (£m)	0.208	0.170	0.090	
Annual Depreciation (£m)		**0.057**	**0.067**	**0.067**

NIAUR has, after taking the views of PPB into account, agreed to both the depreciation and the present value of the initial RAB at £2.3M. This is consistent with the proposal in the 2002 price control which stated "*The BST sales allowance as set in 2000 was based on the adjusted asset base for the period 1997-2002. The continuation of this allowance into 2002-05 effectively preserves*

[1] 25 Year Depreciation Profile agreed with NIAUR 1999.
[2] 5 Year Depreciation Profile agreed with NIAUR 2007.

*that asset base implicitly. The area of PPB asset value will be re-visited as part of the next stage of the evolution of the PPB".*NIAUR also accepts the value of the new RAB and has agreed that the depreciation profile should be 5 years as this is standard for IT assets.

Rate of Return (RTN_t)

In the 2007-09 PPB price control NIAUR allowed PPB the same WACC as applied in the SONI price control of 6.3%. For 2009-12 PPB has proposed that the price control should allow a rate of return on investment assets or WACC of 6.8% pre-tax real on both the initial RAB and the new RAB. The PPB proposal is based on the WACC determined by Ofgem for the 2004 Electricity Distribution Price Control Review (DPCR04).

PPB argue that NIAUR was wrong to link the SONI and PPB rates of return as SONI is engaged in very different activities and therefore faces different business risks and financing costs. NIAUR does not agree with this proposition. The PPB activity bears more resemblance to the SONI activity that it does to the activities of a distribution network business. Both are office based activities operating in a tightly defined set of market arrangements governed by a Trading and Settlement code. Both PPB and SONI have few assets in relation to turnover and both deal directly with generators and suppliers as opposed to end customers. Furthermore the SONI WACC of 6.3% has been calculated using more recent competition commission findings in 2007 whereas the PPB proposal suggests using a WACC calculated in 2004.

For the reasons outlined above NIAUR proposes that the PPB WACC should be set at 6.3%. The amounts PPB will receive under this proposal are illustrated below.

	Annual	*Annual*	*Annual*
	Apr 2009 - Mar 2010	**Apr 2010 - Mar 2011**	**Apr 2011 - Mar 2012**
Return £M	0.150	0.132	0.111

Incentive Amount (IC_t)

The current incentive amount was based on 1% of PPB forecast turnover when the price control was set and this was applicable from November 2007 until March 2009. Currently under this incentive for FY08-09 the value of the incentive amount for 90% achievement was £4.345M and for 100% achievement £4.563M (2008 prices). 90% achievement is seen as the baseline score i.e. an "expected" score that is both reasonably obtainable but also reasonably challenging. The original 90% score value was £4M (2006/07 prices) and this figure was based on an alternative benchmarks methodology whereby PPB received 1% of forecast turnover as revenue (other than depreciation and return on assets). Businesses such as brokerages and other trading type businesses (e.g. a reseller of gas) were used as analogies as it is difficult to find a company analogous to PPB within the energy industry. One company within the energy industry that was put forward by PPB as a similar business in its submissions for the current price control in 2007 was the Omani Power and Water Procurement Company. However it was agreed by both parties that the disparity between Middle Eastern business and governance arrangements made any real comparisons in terms of price control meaningless.

It is proposed that the price control for 2009-12 shall continue with this core figure of £4.345M as the incentive amount but in recognition of the extra costs PPB has legitimately incurred (which are discussed later) i.e. the extra cost of procuring a Working Capital Facility (0.52M), extra operating costs (0.11M) and extra costs of commodity hedging (0.294M) the incentive amount shall be uplifted by the aggregate of these extra costs to give a total incentive amount of £5.269M. This approach is consistent with the NIE Energy Supply price control decision taken recently, where NIAUR did not automatically apply the margin of the previous price control but rather calculated the new margin as the absolute figure allowed for margin in the existing control plus extra costs that were legitimate and justifiable i.e. increased cost of working capital. The sum of the two gave a new figure that will be the margin allowed in the new NIEES price control.

As operating costs are required to be covered by the incentive amount it is appropriate that we look at these. PPB operating costs (excluding pension adjustment costs) are shown below. The principal increase in operating costs from those of 2008/09 relates to the extra costs in salaries. The biggest element in the cost uplift is the explicit cost of PPB's IT manager. A placement student is also being replaced by a full time accounting technician, some employees were in trainee positions and those salaries have gone up in an accelerated fashion and due to maternity leave the salary amount for 08/09 was slightly lower than would have been the case under normal circumstances.

	2007/08	2008/09	2009/10	2010/11	2011/12
			2008 Prices		
	Actual	LBE	Plan	Plan	Plan
	£'000	£'000	£'000	£'000	£'000
Salaries	598.8	630.3	734.0	746.4	753.7
National Insurance	75.0	77.9	80.0	81.4	82.2
Pension - Defined Benefit	111.3	77.5	81.7	82.4	82.4
Pension - Defined Contribution	12.3	21.6	27.9	28.8	29.4
Total Salaries	**797.4**	**807.1**	**923.7**	**938.9**	**947.6**
Transport & Travel	16.8	25.3	25.8	25.8	25.8
Training	0.5	43.3	40.0	40.0	40.0
Share Save Costs	0.0	40.0	0.0	0.0	0.0
Total Staff Related Costs	**17.3**	**108.6**	**65.8**	**65.8**	**65.8**
MBIS Consultancy	234.9	267.3	200.0	200.0	200.0
CfD Trading	0.0	1.8	123.3	123.3	123.3
MBIS	**234.9**	**269.1**	**323.3**	**323.3**	**323.3**
Information Technology	**164.5**	**276.0**	**260.9**	**256.2**	**251.1**
Accommodation	0.0	23.1	38.2	37.0	35.9
Telephones	0.4	15.5	15.3	15.3	15.3
LH&P	0.0	5.6	8.4	8.4	8.4
Cleaning	0.0	3.3	5.6	5.6	5.6
Other Office Related Costs	0.0	2.5	2.5	2.5	2.5
Total Office Related Costs	**0.4**	**49.9**	**70.0**	**68.8**	**67.6**
Insurance Premiums	2.1	2.0	2.0	2.0	2.0
Printing & Stationery	3.8	8.1	9.5	9.5	9.5
Subscriptions	19.0	27.8	30.9	30.9	30.9
Audit Fees	20.5	8.0	8.0	8.0	8.0
Other	21.4	20.1	15.5	15.5	15.5
Total other	**66.9**	**66.1**	**65.9**	**65.9**	**65.9**
Corporate Charges	562.8	559.4	559.4	559.4	559.4
Land Bank Management Income	(54.5)	0.0	0.0	0.0	0.0
SONI accommodation charge	63.0	22.5	0.0	0.0	0.0
Corporate & Other Interbusiness Charges	**571.3**	**581.9**	**559.4**	**559.4**	**559.4**
Total Operating Costs	**1,852.6**	**2,158.8**	**2,268.8**	**2,278.2**	**2,280.6**

NIAUR proposes that PPB should fund its working capital facility costs from the incentive amount and the return to investors for asymmetric risks and regulatory risk should also be derived from the incentive amount. Another issue raised by PPB is the guarantee that PPB receives from NIE plc to underwrite the legacy PPAs. This will also be dealt with separately below.

Working Capital facility

PPB in its first submission to NIAUR on 27th October 2008 included a cost within operating costs for a £62M working capital facility. This was forecast to be £920K for FY09/10 (2008 prices). These are the arrangement and commitment fees associated with acquiring the facility on a 100% debt basis at 153 basis points (bps). In the 2007 submission this facility cost was forecast at £400K (2006 prices) at 63 bps. In the submission PPB stated:

- *PPB requires an overall working capital facility (WCF) of approximately £60m (the aggregate of the ordinary course of business requirement and a standby requirement to cover price deviations (mainly fuel prices)).*
  - *If PPB was to seek to procure this on a standalone basis, it would require to be partly funded with equity. The cost of such standalone financing is estimated to be in excess of £2m p.a.*
  - *The alternative is to procure a facility through NIE plc. For a £60m WCF we estimate the incremental cost to NIE to be approximately £0.92m p.a which would be on-charged to PPB. These increased costs are projected to be effective from 1 April 2009 and reflect the increased costs applicable in the current market.*

  The forecast shown in this submission uses the lower cost for the provision of PPB's working capital facility. We will provide more detail on these options and costs in a further submission.

Following this PPB changed the methodology for calculating the cost to the business of this facility. They stated in their submission of 19 November that banks are unwilling to provide PPB with financing facilities on a standalone basis. PPB sought advice from their consultants NERA, on what they felt should be the basis for calculating the cost of Viridian providing the Working Capital Facility. The advice concluded that regulatory precedent pointed to regulators calculating the cost of capital for a business on a stand alone basis and on a notional efficient gearing of 57.5% debt and 42.5% equity. Firstly NERA applied a pre tax 9% cost of equity giving a £2.37M cost of equity. They went on to explain that following discussions with PPB they understood PPB would incur arrangement fees of 3.25% over a 5 year period (65bps) and an annual commitment fee of 88bps. Therefore with a debt facility of 57.5% (£36M) the cost of the debt financed part of the WCF was calculated as £0.54M. They went on to propose

this gave a total revenue requirement to fund the WCF of 2.92M and that this should be a pass through cost in the price control.

NIAUR proposes that consistent with the current price control PPB can fund the cost of the WCF (whatever those costs are in reality) out of the incentive amount. NIAUR understands that the cost of debt finance has increased and hence the increase in the cost of the WCF has been allowed for in the proposed new incentive amount.

NIAUR is not aware of regulatory precedent for applying a WACC to the cost of a working capital facility or indeed to the cost of working capital. The examples that are ubiquitous are of a WACC being applied to debt and equity that is invested by regulated businesses in assets and these amounts are generally rolled into a Regulator Asset Base (RAB) and a rate of return or WACC (as well as depreciation) is then applied to the RAB.

NIAUR is of the view that PPB cannot pass extra costs through to customers that are due to financing issues brought about by the existence of a capital structure that its parent company decided upon. If PPB were able to simply procure the WCF on a 100% debt basis then the cost as stated above would be £920K. This is the cost of an efficient purchase of the WCF. Therefore the proposal for this price control as previously stated is that the current arrangement whereby PPB funds its WCF from the overall incentive amount should continue.

Risk

PPB has submitted to NIAUR (supported by the report PPB commissioned from NERA economic consulting) what they consider to be the return investors would require for the asymmetric risks that PPB faces. The rationale and methodology is very similar to that submitted by PPB and rejected by NIAUR for the last price control. They split these risks into three groups:

- Risk of acting as principal under the PPAs
- Risk of cost disallowance under PPB Economic Purchase Obligation (EPO)
- Regulatory Risk

These are discussed below.

Risk of acting as principal under the PPAs

In order to facilitate the creation of the NIE Energy model (which split NIE Energy supply and NIE Energy PPB out from NIE plc which is the transmission and distribution wires business) NIE plc provide a guarantee to PPB for the PPAs. Under the guarantee NIE has the obligation to assume PPB's PPA obligations. PPB has gone on to value this guarantee at between £0.74 and £1.3Million using a standard methodology for calculating the value of financial derivatives.

Notwithstanding our reservations around this methodology NIAUR is of the view that the risk associated with the PPAs has always rested with NIE plc and the existence and requirement for the guarantee illustrates this. As PPB has no assets and did not have many assets when it was part of NIE it was always the case that only the assets of NIE could carry the burden of the risk (which to the extent that it exists is, in the view of The Authority, implicitly reflected in NIE's rate of return) and the guarantee has simply made this risk explicit. NIE when proposing the NIE Energy model did not raise this issue but simply included the guarantee as part of the proposal stating that the generators would not be willing to enter contract with a company that had few assets. This seems to suggest that the risk always rested with NIE and not PPB.

PPB has also pointed out that under the terms of the guarantee NIE will have rights of recourse for any payments made under the guarantee. It does not seem a correct principle that NIE should have this right if it is underwriting the PPAs. However this right arises as a matter of law. If PPB did default on its obligations (which would be a situation directly linked to PPB being unable to collect PSO payments) then it is unclear how PPB could repay NIE.

NIAUR's position with regard to the guarantee is consistent with the last PPB price control when it was stated *"This arrangement ensures that the majority of these risks (and associated rewards in terms of rate of return) continue to rest ultimately with the wires business of NIE".* NIAUR is of the view the risk associated with the contracts always rested with T&D and the guarantee merely made this risk explicit and was required as the businesses needed to be separated to comply with directive 2003/54/EC.

PPB has also argued in discussions with NIAUR that during the period when the PPB was part of NIE they felt that the risk associated with the PPAs was in some way rewarded through the PPB price control. The previous price controls that PPB refers to were based around incentivizing PPB to maximize sales and reduce the stranded costs of the contracts, not around rewarding risk. Their assertion is also contrary to the explicit published position that NIAUR took in past price controls stating in the 2002 decision paper for the 2002-05 PPB price control *"Ofreg does not consider PPB to be an inherently risky business……even with the possibility of further market opening, PPB faces no more risk now than it has in the past. Ofreg would argue that any risks which may be associated with*

the power purchase contracts are primarily perceived risks…… Therefore they are not actually risks borne by NIE shareholders since money can be recovered from customers". It is therefore unclear why PPB are of the view past price controls rewarded the business for the risk of acting as principal. NIAUR therefore proposes that as with the last price control there will not be an allowance for the guarantee associated with the PPAs as the risk is underwritten by NIE T&D.

EPO Risks

NERA (on behalf of PPB) in their submission discuss risks relating to cost disallowed by NIAUR under PPBs Economic Purchase Obligation (EPO) licence condition. They state that PPB is required to take a range of complex decisions that influence PPA costs and are therefore subject to scrutiny under the EPO. They give various examples such as

- Ensuring generators comply with their contractual obligations
- Ensuring that availability payments are only paid for bona fide availability
- Agreeing fuel purchasing strategies with the generators
- Agreeing fuel stocking with the generators
- Purchasing CO2 permits
- Challenging cost pass through arising from change in law

They go on to value certain risks using assumed amounts that could be disallowed and assumed probabilities of disallowance. Using these assumed figures which are not backed by objective analysis or precedent they value overall EPO risk at £1.9Million. NIAUR agrees that some small residual EPO risk does exist but is of the view that these risks are of extremely low probability. Also of the six risks that PPB used to calculate the value of £1.9Million four are part of the incentive mechanism. These are:

1. Fuel Supply risk – (Fuel stocking in incentive matrix)
2. Gas Supply Contract Risk – (Gas management in incentive Matrix)
3. CFD Trading Risks – (CFD Cover Position in incentive Matrix)
4. CO2 Penalty Risks – (CO2 management in incentive Matrix)

In the paper NERA state with regard to EPO risk "*PPB has to make a range of complex decisions regarding the procurement of coal and gas, as well as energy price hedging decisions, with the clear risk that PPB's chosen strategy results in*

higher costs or lower revenues than an ex post optimal strategy determined by NIAUR". This statement fails to recognize that two of the risks talked about, fuel supply risk and CFD trading risks, are concerned with strategies that are agreed ex ante as per the incentive arrangement. Agreeing a purchasing or sales strategy up front with NIAUR further negates the risk involved. NIAUR acting in accordance with cabinet office guidelines for best practice regulation would not disallow costs if they were incurred as per a strategy already agreed. If NIAUR were to do so PPB would have its normal avenues of appeal at that stage. Furthermore NIAUR is not familiar with a methodology of attaching assumed values and probabilities to individual risks to attain overall price control revenue amounts. Rather regulated businesses receive reward for risk from there overall return on capital or the margin allowed in the price control.

NIAUR proposes that the two areas that are not agreed ex ante, gas management and CO2 management, should also be dealt with in the incentive by NIAUR and PPB agreeing strategies for both up front. NIAUR would also be agreeable to including in the incentive two other areas that PPB site as risks, purchases of CO2 and NOx abatement. PPB's views also seem to suggest that NIAUR will somehow micro manage PPB in some way and "second guess" PPB decisions in relation to running the business. NIAUR does not scrutinize the minutia of PPB activities.

Generally NIAUR is of the view that PPB is an extremely low risk business and EPO risk is minimal and as with the last price control PPB will be rewarded for these via the incentive amount. The precedent that NIAUR has never disallowed costs under EPO must be a material factor in any discussion of this issue.

Regulatory Risk

Finally on the subject of risk PPB point to the competition act. They state they are liable to penalties under the competition Act of up to 10% of turnover i.e £60M. They attach a 5% probability to the risk of one quarter of the maximum amount to give a figure of £0.75M which they argue should make up part of the overall reward for risk of acting as principal, EPO and regulatory risk i.e. £3.39 – 3.95M.

Again NIAUR is not familiar with this methodology. The competition Act binds all participants in the competitive sector of the energy industry and is not unique to PPB. Again NIAUR's view is that the risk of such a penalty is of extremely low probability (and can be managed by PPB) and the incentive amount proposed adequately remunerates PPB for the low risk profile it carries. As stated earlier this is consistent with the most recent price control.

Pensions (PD_t)

NIAUR does not propose to change the method of calculation of the PDt amount in the PPB price control. The actual figure in 2007 was £0.365M (06/07 prices) but this figure will be revised in accordance with the results of the next triennial actuarial valuation. This is forecast to be £481K reflecting an expectation that contributions will have to increase in respect of past service due to recent falls in equity values which have increased the pension scheme deficit.

New Commodity hedging costs

In 2008 PPB resumed hedging the cost of coal, gas and CO2 credits at the request of NIAUR. Below are the extra costs associated with these new activities.

2008 Prices			
	2009/10 Plan £'000	2010/11 Plan £'000	2011/12 Plan £'000
Salaries (including Bonus)	37.6	37.6	37.6
National Insurance	4.1	4.1	4.1
Pension - Defined Contribution	3.2	3.2	3.2
Total Salaries	**44.8**	**44.8**	**44.8**
Transport & Travel	1.3	1.3	1.3
Training	18.1	2.9	2.9
Total Staff Related Costs	**19.4**	**4.1**	**4.1**
Information Technology	**216.7**	**64.9**	**64.9**
Telephones	0.6	0.1	0.1
Other Office Related Costs	0.2	0.2	0.2
Total Office Related Costs	**0.8**	**0.3**	**0.3**
Printing & Stationery	0.7	0.7	0.7
Subscriptions	2.4	2.4	2.4
Other	0.3	0.3	0.3
Total other	**3.3**	**3.3**	**3.3**
Total Operating Costs	**284.9**	**117.5**	**117.5**
Depreciation	**9.3**	**9.6**	**9.2**
Total Costs	**294.2**	**127.1**	**126.6**

NIAUR proposes that these costs like other operating costs can be covered by overall incentive revenues and whilst these costs are new the increase in the incentive amount takes account of these extra costs. However the costs of commodity hedging reduce by £167K in years two and three of this proposed control and hence the incentive amount of £5.269M (2008 prices) shall be reduced by this amount to £5.102M for years two and three of the price control.

Staff Retention Bonus Scheme

PPB has proposed that NIAUR should allow extra revenue in the new price control to fund a staff retention bonus scheme. In short this scheme would reward PPB staff for remaining with the business despite the uncertainty around PPA cancellation which PPB view as a potential reason staff may look for employment opportunities elsewhere. It equates to 50% yearly bonuses for management and 40% for staff and these would be paid only if the management/staff involved remain with the business for the defined period. They have stated in a submission regarding this *"the long term future of the business is uncertain which will increasingly make it both difficult to retain staff and also, if necessary, difficult to attract high calibre staff. The skills and expertise that PPB's staff possess make them key assets of the business (and NI customers) but render them attractive to other employers. Without appropriate retention mechanisms PPB staff may seek greater security and enhanced career prospects elsewhere. In an environment where long term opportunities within PPB are limited, it is likely that remuneration and personal development opportunities (i.e. enhancing skills and competencies) will be the principal means to retain staff. We plan to address this issue through arrangements which provide deferred remuneration rights from which staff will benefit if they remain employed in PPB".*

NIAUR does not propose to allow this extra cost within the price control. PPB has not provided any evidence of staff retention problems and against a background of recession there must be doubts about its materiality. That said it is recognized that key staff of high calibre are by their nature often more difficult to replace. They are however also the staff most likely to be desirable for retention by other parts of NIE/Viridian Group which will be incentivized from a wider group sense to retain them and hence address any staffing issues arising from the potential winding-up of PPB. Furthermore any loss of such staff is also likely to have an impact on the ability of PPB to earn the incentivised portion of its incentive amount and hence the business will need to internally manage the risk of losing key staff in order to ensure adequate revenues.

Customer Benefits

During discussions with NIAUR it was suggested that perhaps PPB could identify areas where they could show demonstrable benefits to customers (other than ad hoc examples from the past) in terms of savings to customers through reduced costs. PPB put forward a number of examples demonstrating how they have made savings for customers in the past and from which customers will continue to benefit over the next number of years. These are set out below:

Initiative	Customer Value £M	Comments
Locking in Jan 2009 Rebate	107.5	Considerable effort to establish a hedging capability and 70M of hedging transactions concluded.
Kilroot FGD	47	Over the period April 2007 until October 2010, equating to 15M per annum.
Improved ETS Allocation	10 pa	Based on current ETS prices and spanning the 5 year period from Jan 2008 until Dec 2012.
NFFO NIROC Proceeds	5	Secured for electricity customers in the period April 2008 until September 2009.
Offsetting SEM credit requirements	3.6 pa	Based on current settlement reallocation and credit netting offsets totaling £145M with a LOC cost of 2.5% of the nominal amount.
Ballylumford CCGT contract extensions.	33 pa	In current prices based on a 60% reduction in availability payments, effective from 1 April 2012.

NIAUR recognizes that PPB has in the past employed its own efforts to reduce costs to customers on an ad hoc basis and wants this general attitude towards customer savings to continue. NIAUR is of the view that given its low risk profile and small operating cost base the revenues PPB will receive over and above its own costs are more than generous enough for the business to continue to do all it can to keep costs down.

Comparison with Current Price Control

Below is a table showing the NIAUR proposal for 2009/10 in comparison with the current price control which covered 2008/09. The table assumes the cost of the WCF will be at 153 basis points and procured on a 100% debt basis.

(2008 Prices)	DEPt	RTNt	ICt	OPEX	WCF	Commodity Hedging Cost	Regulated Profit
2008/09 £M	0.247	0.16	4.35	2.158	0.4	0	2.2
2009/10 £M	0.306	0.15	5.27	2.268	0.92	0.294 *	2.2

* Commodity hedging costs are £0.294M in year one only. Subsequent years will be c. £142M. The ICt amount shall be reduced to reflect this in price control years two and three.

Comparison – NIAUR and PPB Proposals

The table below shows PPBs proposal for the new price control and NIAURs proposal for the year 2009/10. The table assumes the cost of the WCF will be at 153 basis points and procured on a 100% debt basis for the NIAUR proposal and assumes a WCF cost of 2.92M for the PPB proposal.

(2008 Prices)	DEPt	RTNt	ICt	OPEX	WCF	Commodity Hedging Cost	Regulated Profit
PPB Proposal £M	0.306	0.16	9.43	2.268	2.92	0.294*	4.4
NIAUR Proposal £M	0.306	0.15	5.27	2.268	0.92	0.294*	2.2

* Commodity hedging costs are £0.294M in year one only. Subsequent years will be c. £142M. The ICt amount shall be reduced to reflect this in price control years two and three.

NIAUR/PPB Proposals and Turnover

The table below shows the proposed profits (or "net margin") before any working capital costs as a percentage of forecast turnover. We have assumed yearly forecast turnover as the average of the next three years forecast turnover for the period 2009-12 and this equates to £585M. This is consistent with the current price control in which forecast turnover was estimated as £400M in 2007 (2006 prices). Consistent with NIAURs treatment of NIE Energy Supply all costs associated with working capital come from the businesses own margin in the price control.

(2008 Prices)	DEPt	RTNt	ICt	OPEX	Commodity Hedging Cost	Regulated Profit (before working capital costs)	Profit as % of Turnover
PPB Proposal £M	0.306	0.16	9.43	2.268	0.294*	7.33	1.25%
NIAUR Proposal £M	0.306	0.15	5.27	2.268	0.294*	3.16	0.54%

* Commodity hedging costs are £0.294M in year one only. Subsequent years will be c. £142M. The ICt amount shall be reduced to reflect this in price control years two and three.

Next Steps

Responses to this consultation paper should be sent to Michael Campbell

Michael.Campbell@niaur.gov.uk

no later than **26th June 2009**.

The Utility Regulator intends to publish all comments received. If any respondent wishes certain sections of their submission to remain confidential they should submit these sections as an appendix marked confidential.