

Power NI's 1 July 2013 Tariff Review

A Regulatory Briefing

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Summary

The Utility Regulator (UR) has verified a 17.8% increase in the Power NI tariff for domestic electricity customers to take effect from 1 July 2013. This paper sets out the background and reasoning behind the increase, which is almost entirely due to wholesale gas price increases related to power generation.

Background

The electricity supply market has been fully open to competition since 1 November 2007 and since June 2010, a number of suppliers have entered the domestic market. Since this time there has been an ongoing steady level of customer switching activity in the market. However, whilst facing competition from other suppliers, Power NI is still dominant in this sector of the market. The UR therefore takes an active role in scrutinising Power NI's proposed retail tariffs which are the final prices customers pay. The UR also continues to set a price control that sets allowances for Power NI's operating costs and profit margin. In addition to this, any other Power NI own costs that are passed through the tariff (which are not allowed for in the price control e.g. licence fees) must be approved by the UR. The aggregate of the price control allowances and pass through costs are the supplier charge.

Power NI retail tariffs for this upcoming year are made up of a number of components:

Retail Tariff	=	Wholesale Costs	+	SSS Charges & Cairt	+	PSO Levy	+	Use of Systems	+	Supplier Charge	+	NIRO Costs	+	Correction Factors
What Customers Pay		Generation costs (cost of procuring electricity), Capacity costs, Imperfections (costs of electricity constraints), and MO charges		For system planning, operation and despatch		Public Service Obligation costs which must be spread across all customers		Costs of transmission and distribution of electricity		Costs to supply electricity to customers e.g. meter reading, billing		Net costs of NI Renewable Obligation - NIRO costs relate to government obligation to sell a proportion of their output as renewables		The difference between allowed revenue and actual recovered revenue (mechanism whereby differences between forecasts for tariff setting and actuals can be recouped or returned to customers) and first year effect
Split 13/14 100%		58%		4%		2%		22%		9%		2%		3%
Split 12/13 100%		62%		3%		2%		25%		9%		1%		-2%

Figure 1: Components of Power NI tariff from 1 July 13¹

¹ The first year effect relates to the time lag in revenues collected from customers due to the quarterly billing cycle which is linked to quarterly meter reads. This is an increase in a year when there is a tariff increase, as it takes actual revenue received some time (approximately three months) to catch up with the tariff change.

Several of these components are common across all suppliers and the final customer will pay these regardless of who their supplier is. These components are all subjected to regulatory review and approval:

- Market Operator (MO) charges;
- SSS charges (System Support Service);
- Cair_t Charges (if applicable);
- PSO Levy (Public Service Obligation); and
- Use of System charges (UoS).

These costs are regulated because they are levied to recover the costs of parts of the industry which are natural monopolies. Independent suppliers are free to enter the market and purchase power. They will usually add on the charges outlined above before setting the final price to sell to customers. This is because they are required to pay these charges in order to transport the power to the customer.

For the purpose of setting a 1 July tariff, forecast estimates for these network components have been used to derive the Power NI revenue requirement for them. This is due to the fact that the final tariffs for the network components will not be finalised until August 2013. These are discussed in further detail in the Northern Ireland network charges section below.

The remaining components of Power NI's tariffs are subject to regulatory scrutiny.

Cost/Tariff	Regulatory Scrutiny
Generation costs	Competitive and regulated wholesale market; approval of Power NI hedging methodology by UR; annual approval of Gt statement (forecast of Power NI wholesale costs).
Supplier charge	Application of Power NI Supply Price Control 2012 – 2014 and any other costs approved on a pass through basis
NIRO costs	Audited on behalf of the UR by Ofgem as part of its UK-wide audit.
Correction factors	Analysis by the UR of variances between forecasts used for setting tariffs and out-turn costs; agreement to the 'first year effect'.

Table 1: Remaining components of Power NI tariffs

Summary Review

Power NI's regulated tariffs are usually re-set and verified at the start of each October for the following 12 months. This was last done for October 2012. The table over the page analyses the required revenues of Power NI for all of its regulated customers² by key component. It compares the forecast revenue requirement underlying tariffs for the period beginning 1 October 2012 with the equivalent forecast tariff revenue requirement for 1 October 2013. This is to aid comparison between the tariff revenue requirement as last set in October 2012, and the new revenue requirement for the period October 2013 to September 2014.

However, it should be noted that this is an 'in-year' review, with the new tariff rate beginning on 1 July 2013. This new rate will recover the Power NI revenue requirement for a 15 month period from 1 July 2013 to end September 2014.

Due to the in-year nature of this tariff review, the 17.8% increase verified by UR has essentially two components:

1) A normal change (an increase for this review), due to the required revenue for the 12 month period October 2013 – September 2014 being higher than that required for the previous period October 2012 – September 2013.

2) The cumulative forecast under recovery for Power NI's revenues for the period October 2012 – September 2013. The under recovery for the period October 2012 to April 2013 is known and the rest is forecast based on likely out turn costs against what was forecast for costs when the current tariff was set. This amount needs to be taken into account, and so makes up part of the total 15 month revenue requirement (period July 2013 to September 2014). It is therefore part of the new unit rate applicable from the 1 July 2013 which will collect all forecast required revenues for the 15 month period July 2013 – September 2014.

² Power NI supplies some customers in some sections of the market that are competitive, where tariffs are not reviewed by the UR.

Table 2 below illustrates the key data behind the first component described above.

Component	Oct 2012/13³ £m	Oct 2013/14 £m	12 month movement % Change
Generation	168.7	186.6	11%
Capacity	39.2	42.6	9%
Other (MO, Imperfections, NIROC)	22.5	25.5	13%
UoS	92.3	93.3	1%
PSO	7.5	6.7	(10%)
SSS	11.2	9.9	(12%)
Cair T	-*	6.7	100%*
Supply costs	32.5	36.5	12%
Correction Factors	(7.7)	12	255%
TOTAL ALLOWED REVENUE	366	420	15%

Table 2: Price change comparison in total revenue terms. Please note, the figures in this table refer only to Power NI costs. Figures for last year have been re-stated.

**An amount £5.4m for Cair, was not included in 2012/13 tariff requirement, it was therefore included in the £23.1m under-recovery which is explained further below. Cair, is also further explained in Northern Ireland Network Charges section.*

Table 2 shows an overall movement in the tariff basket for the period October 2012 to September 2013 compared to the tariff basket for October 2013 to September 2014 of 15%.

As described on page four, in addition to the October 2013 tariff, which has been set using forecast input costs to be recovered for the period October 2013 to September 14, there is a forecast under-recovery of £23.1m to the end of September 2013. This is the cumulative forecast under recovery for the period October 2012 to September 2013. This also needs to be taken into account. This amount is being recovered by increasing tariffs at 1 July 2013 by 17.8% which is the weighted average of the normal 1 October 2013 increase (15%) plus the increase necessary to recover the £23.1m shortfall.

As demonstrated in Table 2, there have been increases across most of the costs areas. Specifically, attention is drawn to the level of increase in wholesale costs (comprising of generation, capacity and other costs) which are forecast to increase by over £24m from October 2012. These costs alone make up 58% of the total costs associated with the tariff for the period October 2013 to September 2014. The main drivers of the increase in these costs relate to an increase in the wholesale cost of gas used for power generation. It should also be noted that coal prices have fallen slightly over the past year, and there has also been a decrease in the price of carbon emissions which have both helped to reduce the impact of the increase in gas prices.

³ To aid comparison, the 2011/12 amount has been restated for the same demand that Power NI have forecast for October 2012 – September 2013.

Network charges and levies (UoS, PSO and SSS) have been forecast to remain fairly static, only decreasing overall by approximately 1% when compared with October 2012.

Also shown in the table 2, there has been an amount included for Cair_t this year of £6.7m. The equivalent amount for last year was £5.4m. This amount was not included in the revenue requirement in October 2012, and is therefore included in the £23.1m under recovery amount.

There has been a large increase in correction factors which includes the first year effect (see footnote 1) and an under recovery due to Power NI costs outturning higher than expected in the previous tariff year. With regard to over and under recoveries, if Power NI over-recover because underlying actual costs out-turn lower than forecast, this over recovery will be returned to customers at the next tariff review. Similarly, if Power NI under recover because underlying actual costs out-turn higher than forecast, this under-recovery will be included in customers tariffs at the next tariff review. This process is in line with Power NI's Tariff Methodology Statement and the Power NI licence originally approved by the UR.

The following sections discuss the cost components in Table 2 in more detail.

Generation costs

Component	Oct 2011/12 (12 mths) £m	Oct 2012/13 (12 mths) £m	12 month movement % Change
Generation	168.7	186.6	11%
Capacity	39.2	42.6	9%

Table 3: Generation costs

Generation costs

Table 3 shows that the forecast generation costs for the period October 2013 to September 2014 have increased by 11% from the forecast generation costs for the period October 2012 to September 2013 (which were forecast in July 2012).

Forward gas prices for the upcoming tariff year (October 2013 to September 2014) are higher over the contracting period this year than they were for the last year (October 2012 to September 2013). As part of the approval of Power NI forecast generation costs, the UR has analysed forecast forward gas prices and forecast forward SEM pool prices. This tariff year (October 2013 to September 2014), these costs are 11% higher when compared with the same period last year.

Power NI continue to have a low level of hedging this year. Last year at the end of July, Power NI had obtained hedges for 30% of their forecast customer demand and this year as of April it was below 30% for the period October 2013 to September 2014. When Power NI purchases hedges they are buying electricity on a forward basis at a fixed price.

Power NI provided the UR with detailed forecast wholesale cost inputs. These were scrutinised by the UR. The following information was provided:

- Power NI's demand forecast (as a proportion of the all-island demand forecast published by the Regulatory Authorities along with the Validated Plexos model for Directed Contracts 2013-14);
- Power NI's System Marginal Price (SMP) forecast;
- Power NI's capacity charges model;
- A breakdown of energy hedging;
- Details of currency hedging;
- Details of losses; and
- Credit requirements.

The UR analysed all the information provided. The forecast SMP was independently verified using the published formula for pricing directed contracts. Hedges were reviewed to ensure they align with the approach detailed in Power NI's hedging methodology statement. The cost of hedges already entered into was verified, as was the expected premiums on hedges yet to be entered into. The capacity charges model was analysed in detail and was deemed to be robust. The remainder of forecast costs, which make up a much smaller proportion of total generation costs than energy and capacity costs were verified by the UR and appear reasonable.

Capacity costs

In the SEM, generators receive a capacity payment as a contribution to fixed investment and operating costs. The total amount is revised annually to reflect the cost of new peaking capacity and the amount of capacity required to meet generation security standards. Suppliers in turn pay a capacity charge which is profiled monthly. The total capacity charge (for the entire all island market 2013/14) has increased by around 3% since 2012/13.

In addition to this the weakening of sterling against the Euro results in an increase in the capacity charges forecast for 2012/13 of 5.3% in Sterling terms for the year 2013/14.

Due to Power NI's customers usage profile, their capacity charges (which were based on the indicative capacity pot for tariff setting purposes) are 9% higher for 2013/14 (October 2013 to September 2014) than for the same period the previous 2012/13 year.

Northern Ireland Network Charges

Part of the Power NI tariff is made up of network charges which are regulated. The network charges are approved by the UR on an annual basis and details of the charges which take effect each October are usually published in August.

The Power NI tariff review is to take effect from 1 July 2013 and as such the annual network tariff review has not been completed when Power NI are setting tariffs now. Therefore, the UR requested information from each of the regulated companies detailing their latest best estimates of their network charges for 2013/14 and any anticipated changes and assumptions made.

The UR scrutinised these submissions and consider that they, at this stage, are robust estimates that reflect the likely network charges for the 2013/14 tariff year. We note that the submissions are **indicative estimates** and the information provided was of a higher level than that we request and receive for the full annual tariff review.

We will continue with the annual network tariff setting process and publish a paper detailing the approved network charges in August 2013. These charges will apply to all electricity suppliers.

Network charges are made up of the following elements:

- Distribution Use of System (DUoS) charges;
- Transmission Use of System (TUoS) charges;
- System Support Services (SSS) charges;
- Northern Ireland Public Service Obligation (PSO) charge and
- Collection Agency Income Requirement (CAIR)

Distribution Use of System

Distribution Use of System (DUoS) charges relate to the costs of investing, operating and maintaining the distribution network⁴ in Northern Ireland. The method of calculating NIE's regulated entitlement is set out in annex 2 of its licence. The licence and network charges reflect the conditions specified in the NIE price control for regulatory period four (RP4) as we are awaiting the outcome of a competition commission referral in relation to the next regulatory period (RP5). It is anticipated that the DUoS charges for 2013/14 will be at the same level as 2012/13.

Transmission Use of System

Transmission Use of System (TUoS) charges relate to the costs of investing and maintaining the transmission network⁵ in Northern Ireland. The method of calculation used for the distribution network charges also applies to the transmission network. Based on the information available, it is anticipated that transmission network charges could increase. An estimated increase of 5% has been used to set the required revenue for TUoS. This increase is mainly due to the development of the network to support renewable generation. We will continue to scrutinise these costs as part of the annual network tariff review.

System Support Services

System Support Services (SSS) charges cover the cost of SONI and ancillary services required to operate the transmission system safely and reliably. A decrease in these costs in the region of 12% has been estimated.

⁴ The distribution network covers voltages below 110kV.

⁵ The transmission network covers voltages above 110kV.

Public Service Obligation

The PSO is a levy which is charged at a flat rate on all units of electricity demand. It relates to costs such as land bank, NISEP and market opening costs. It is estimated that these costs will remain flat and the charges will be at a similar level to those applied in 2012/13.

Collection Agency Income Requirement

Collection Agency Income Requirement (CAIR) relates to the costs of running the Moyle Interconnector. Up until 2012, the sales of capacity had covered its costs meaning that the CAIR was zero. However, in 2012 it had forecast a shortfall in its income due to loss of sales due to outages, introduction of a new interconnector in the SEM, and increased bond payments due to indexation. The amount to be collected under the CAIR charge for 2013/14 is currently anticipated to be in the region of £20M for the whole Northern Ireland Market. Power NI's portion of this, as highlighted in table 2, is £6.7m. Recent correspondence between UR and Moyle, which is available on our website⁶, provides further information in relation to the restoration of Moyle to full capacity and the associated financial impact on consumers.

Overall the network charges component of the Power NI tariff (DUoS, TUoS, SSS & PSO) has decreased slightly from last year. Therefore, these have not contributed at all to the 17.8% Power NI tariff increase.

The Cair_t, however is a new additional charge in this years' tariff revenue requirement (as discussed previously it was levied last year but not included in the tariff and so is part of the £23.1m under recovery for the period October 2012 to September 2013).

Supply Costs

Total supply costs have remained largely flat for the tariff year 2013/14 from the previous 2012/13 tariff year. The allowed revenues associated with the pass through elements have fallen slightly (900K) and there has been a slight increase in the fixed allowance element of allowed costs due to inflation (570K). Supply costs in total make up around 9% of the tariff for this year. Last year supply costs also made up 9% of the total tariff cost.

So whilst table 2 (on page 4) shows supply costs increasing by 12% from last year, supply costs have actually remained flat in terms of actual revenue amount to be collected compared to last year. However, this amount is to be collected across less units due to a lower Power NI forecast demand for this tariff year (due mostly to expected customer losses). Hence, when last year's overall supply cost is restated to be comparable with this year i.e. reduced to bring the total down to the current Power NI demand forecast, the supply cost per unit is 12% higher. Many costs of running the supply business e.g. IT, billing, salaries, and accommodation are fixed

⁶http://www.uregni.gov.uk/publications/correspondence_between_the_ur_and_moyle_interconnector_regarding_the_repair/

costs that do not reduce immediately as customer numbers reduce hence the cost is smeared over a lesser number of units.

Correction Factors

If the amount of revenue recovered in any one year by Power NI exceeds or falls short of the amount allowed, the correction factor operates in the following year to give back any surplus with interest, or to recover any deficit with interest, as appropriate. Energy charges were higher than anticipated in the last year and this is the principal driver of the new under-recovery which accumulated over the last tariff year. Due to the increase in the tariff, the level of first year effect has increased (increasing the overall tariff) when compared with last year.

Power NI make a formal submission to the UR each month showing the under or over recovery position in the business each month. A breakdown and analysis is also provided to the UR. This account also forms part of Power NI's annual external audit.

In terms of the first year effect, Power NI submitted their calculations for determining the amount to be included in the tariff. These calculations and the underlying assumptions were checked for reasonableness.

Forecast Under Recovery Period October 12 - September 13

There is a forecast under recovery of £23.1m for the period October 2012 to September 2013. The under recovery for the period Oct 12 to April 13 is known and the rest is forecast based on likely out turn costs against what were forecast in the tariff. This amount needs taken into account and so makes up part of the total 15 month revenue requirement (period July 2013 to September 2014) and is thus part of the new unit rate applicable from the 1st July which will collect the 15 month revenue requirement.

Recent Tariff Changes

For Power NI domestic customers using 3,300 kWh per annum on standard credit, this tariff review will see a movement in a customer bill from £505 (incl. VAT) per annum to £595 (incl. VAT), a increase of £90 on an annual bill.

The graph below takes a customer with average consumption of 3,300 kWh per year, and compares the average bill (inc VAT) for July 2013, October 2012, and October 2011.

This graph shows that wholesale costs have increased since last year and that network costs have risen slightly since last year (due to the inclusion of the CAIR cost). It also shows that residual costs, made up of supply costs and correction factors, have also increased slightly. The graph also illustrates the high proportion of a customer bill which relates to generation costs.

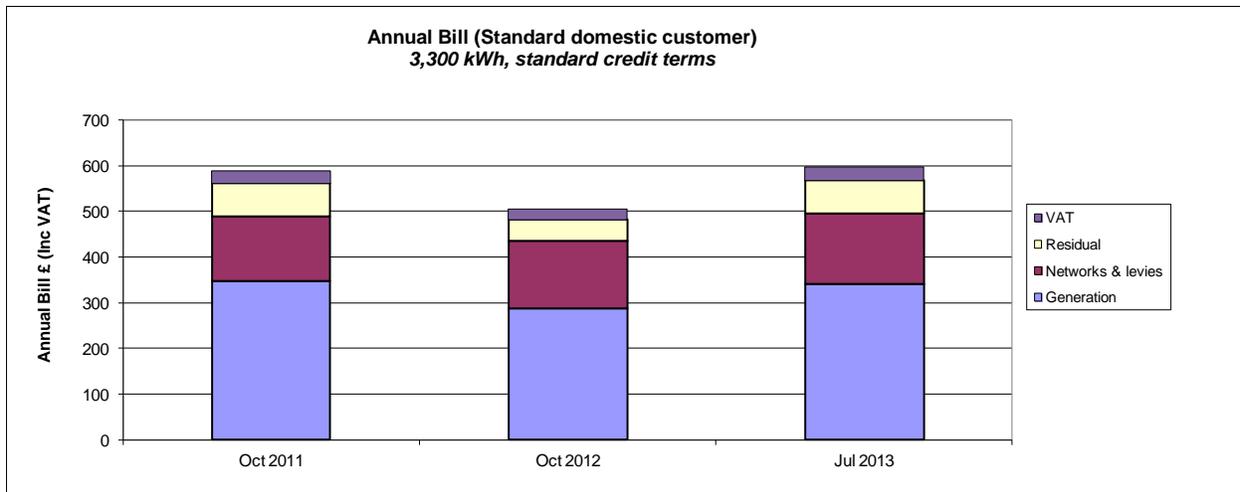


Figure 3: Recent tariff changes based on an average annual customer usage of 3,300kWh (inc VAT). [Note: in the chart above, 'Networks & Levies' includes SSS charges, PSO Levy, & Use of System charges and for this year CAIR charges. Residual costs include Supply costs and Correction factors. Generation includes wholesale and NIRO].

Historic Comparison with GB

Power NI % Price Change	Effective Date	GB Comparison
0% Price Change	October 2010	NI domestic prices around 11% higher than GB average and 7% higher than GB comparator regions.
18.6% Price Increase	October 2011	NI domestic prices around 13% higher than GB average and 10% higher than GB comparator regions.
14.1% Price Decrease	October 2012	NI domestic prices around 4% lower than the GB Comparator regions and slightly lower than the GB average.
17.8%	July 2013	NI domestic prices around 5% higher than in the GB Comparator regions and around 8.7% higher than the GB average.

Table 5: Historical Power NI price adjustments compared to GB

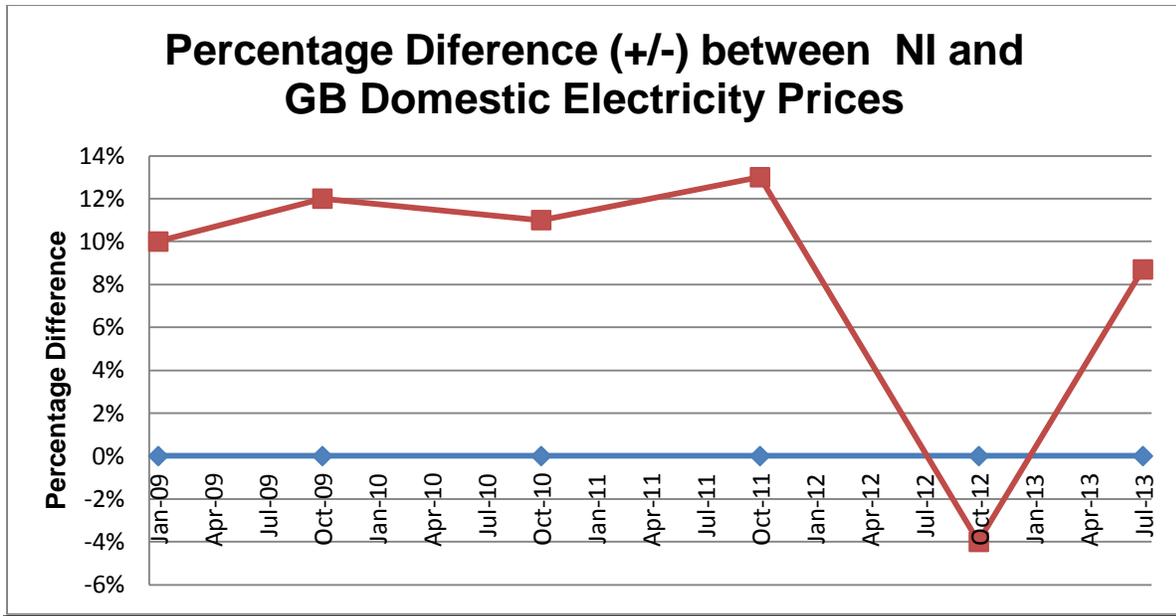


Figure 4: NI v's GB (GB Comparator Region) – comparison is of domestic standard tariffs.

The long-run trend is for electricity prices in Northern Ireland to be c.10% higher than those in GB (reasons are discussed after figure 5). Last year was an unusual year (with NI being circa 5% cheaper than the GB average) and this was noted in our previous briefing paper.

The graph overleaf compares the July 2013 prices for Northern Ireland to the May 2013 standard tariffs (as per Consumer Focus Price Comparison Factsheet May 2013) for the larger suppliers in GB.

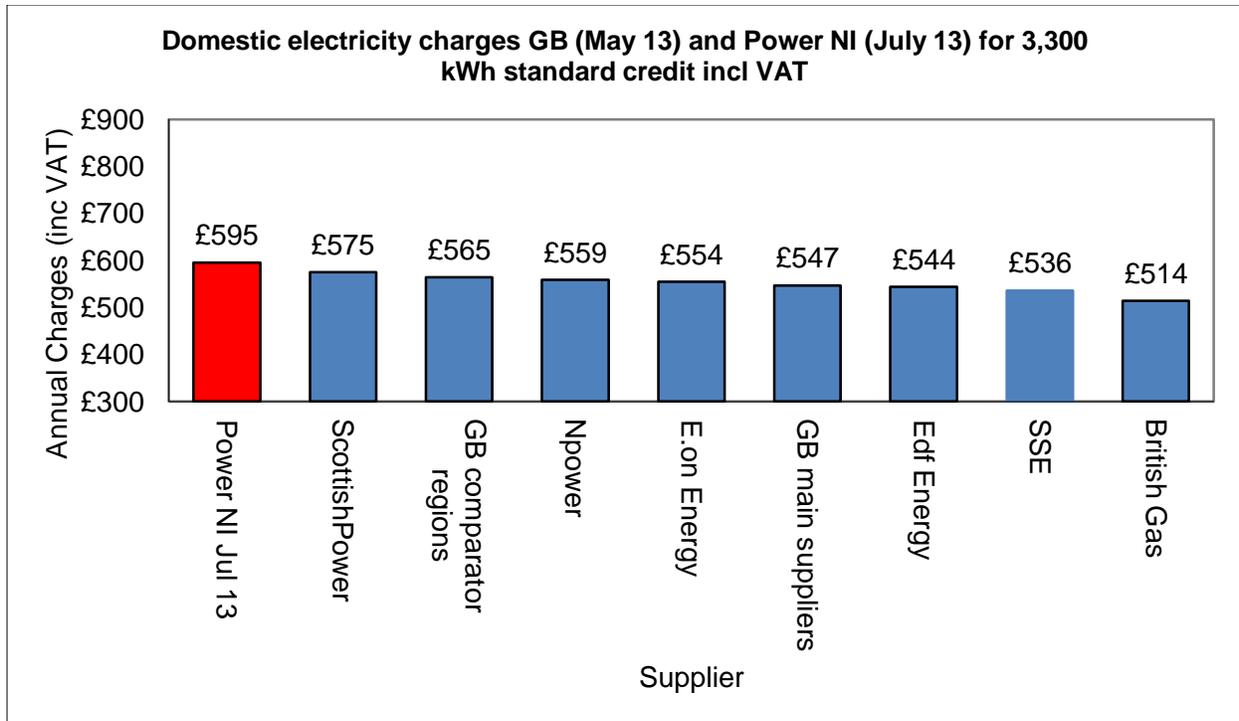


Figure 5: Power NI tariffs per average customer compared to GB

From the graph it can be seen that Power NI's tariff is c.5% higher than the current GB comparator regions.

Last year the NI prices were c.4% lower than the GB comparator regions. However, historically electricity prices in Northern Ireland have tended to be higher (c10%) than in Great Britain. Key factors that have historically led to higher prices in Northern Ireland are:

- higher energy transport costs as Ireland is at the end of the supply chain geographically;
- economies of scale in Great Britain owing to the size of the market there compared to Northern Ireland;
- dispersed rural network in NI; and
- the different fuel mix in GB (i.e. Northern Ireland has a reliance on gas, GB's generation mix is spread between nuclear, gas and coal).

Comparison with Europe

The following graph compares the July 2013 prices for Northern Ireland to the most recent available official data for other countries in Europe including ROI (and relates to the second half of 2012).

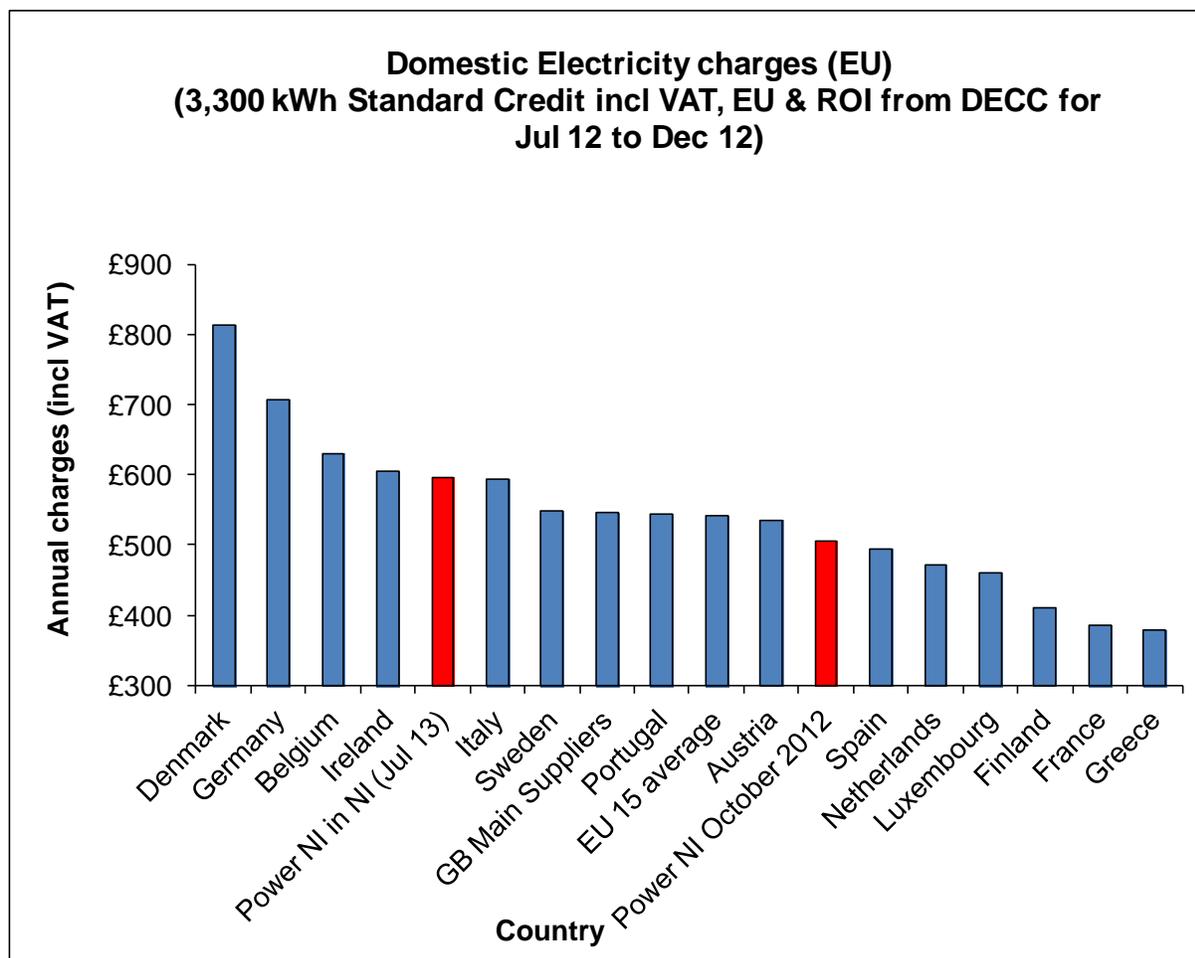


Figure 6: Power NI p/kWh tariffs compared to EU including ROI⁷ - medium consumers refers to annual consumption of 2,500 – 4,999 kWh. Quarterly Energy Prices DECC Table 5.6.2.

It should be noted that the data from the rest of the EU relates to the average for the period July 2012 – December 2012 (so figures for Europe are circa six months out of date). From the graph, it can be seen that Northern Ireland October 2012 tariffs (i.e. those most comparable to the European data) are around the middle of the range of other countries shown in the graph. The upcoming increase moves NI prices to higher end of the spectrum. This position may be more favorable when more up-to-date EU data becomes available. This will be reported in the coming months in the regular UR Quarterly Transparency Reports, published on our website.

⁷ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/171915/qep_mar_2013.pdf
Table 5.6.2