NIE Energy Supply Price Control 2010/2011

Proposals for Consultation

21st January 2010
Executive Summary

This document forms a further one year Supply Price Control for NIE Energy Supply (2000-2005, 2005-2007, 2007-2009, and the latest being a one year Price Control for the period 2009-2010). This one year control covers the period 1st April 2010 until 31st March 2011. The new price control is being introduced at a time of advancement in energy retail competition which will bring about a period of change for the Northern Ireland electricity industry.

This price control deals with one element of the final tariff formula (S, Term) and in the main sets the total revenue NIEES can recover from customers for the duration of the control. As NIEES has minimal assets, this control follows the standard regulatory precedent, regarding price controls for Supply companies without assets, i.e. the Allowed Revenue will consist of operating costs and a margin related to turnover. In keeping with the UK regulatory precedent, working capital costs are derived from the business’s margin. NIEES have again highlighted to the UR the enhanced working capital pressures due to SEM arrangements as an issue that should require some recognition in terms of the quantum of the Margin. Our current position is that the UR recognised the step change in working capital commitment brought about by the creation of SEM in setting the 09/10 price control. This is discussed further in the section on margin.

The last one year price control was applicable to all customers except for non-domestic customers with an annual consumption greater than 150MWh, as it was proposed that these customers would become de-regulated and be removed from the price control. This tranche of deregulation did take place as part of the 2009/2010 Price Control decision.

NIEES are proposing a further tranche of deregulation as part of this 1 year Price Control. NIEES is proposing an arrangement that would include c3,000 additional sites and the deregulation would apply to those groups of sites which would consume in total >150MWh per annum as a group i.e. a group of small sites purchasing electricity as a single entity or as a single customer. Whilst further deregulation impacts upon the price control parameters with regard to allowable operating costs and net margin it will form part of a separate consultation exercise (i.e. a separate paper). The UR is currently seeking some further information from NIEES, and will consult separately on this deregulation proposal as soon as is feasible. The UR consider that a full analysis of deregulation and it affects up until now is required, and market participants views sought before any further deregulation can take place. Any decision regarding this price control will assume no further de-regulation setting the baseline allowable revenues which can be adjusted to take account of further de-regulation in the event it is implemented. The quantum of these adjustments will be discussed as part of the separate consultation.

The Utility Regulator has undertaken a series of meetings with NIEES, beginning 18th September, with the latest meeting taking place on 11th December 2009. Information was requested from NIEES in relation to the actual outturn figures in 2008/2009 and these were analysed against the allowance permitted in the
2008/2009 Price Control. It is on the basis of the data submitted and the meetings/discussions held that we have formed our proposals outlined below.

- Form and Scope will remain as they are currently (except for the proposed additional deregulated category, which would include c3,000 additional sites\(^1\) which would as group entities consume in total a similar volume of units to the initial customer grouping that was deregulated on 1 April 2009 i.e. >150MWhs;
- Duration is set from April 2010 until March 2011, with the view to carrying out a longer term review in spring 2010;
- The allowed margin for 2010/11 will remain at the same level, being £10.491m or be set as 1.7% of actual turnover;
- NIEES total Allowed Revenue is £28.349m; and
- The proportion of Gross Profit apportioned to fixed costs remains the same as the previous price control at 67%.

N.B. It should be noted that although the UR has received detailed actual supply costs for 08/09 (and these have been used to inform the proposal for the operating cost allowance discussed later), other actual, or latest best estimate information pertaining to the current year will be taken into account as part of this price control process.

**NIEES Price Control to Date**

The original NIEES price control ran from April 2000 to March 2005, a series of shorter controls were subsequently carried out covering the periods 2005-07, 2007-09, and a further one year control covered the period 2009-2010. This one year price control covers the period 1 April 2010 to 31 March 2011.

References in this document to NIEES, NIE Supply or the Supply business, should be taken to refer to NIE Energy Supply.

**Changing Environment**

A primary reason for the series of shorter term controls in the past number of years is so that it can be revised in light of any developments that have been identified due to any decisions taken with regard to the current ongoing review of supply margins and K-factors. This workstream could have an impact on future NIEES price controls. In addition to this, the environment in which NIEES is operating could also be impacted with any developments in retail competition.

It is anticipated that a longer term Price Control will be set in the next review and will take effect from April 2011.

**The Price Control and Tariffs**

The allowed unit price of electricity (M) is made up of a number of components:

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\(^1\) NIEES sites only. Does not include sites that are already with other suppliers.
\[ M_t = G_t + U_t + S_t + K_t + (J_t - D_t) + E_t \]

In year \( t \),

\( G_t \) refers to the cost of the electricity which NIEES purchases and so long as NIEES complies with its Economic Purchasing Obligation, this will be passed directly through to customers.

\( U_t \) covers the costs of using the electricity network; these costs are regulated through the NIE Transmission and Distribution (T&D) price control.

\( K_t \) is a correction facility whereby under or over-recoveries in the previous year can be collected by the business (under-recovery) or given back to consumers (over-recovery).

\( J_t \) encompasses costs associated with buy-out from the Northern Ireland Renewables Obligation with the \( D_t \) term representing any savings on the buy-out NIEES achieves.

\( E_t \) is associated with costs arising from implementation of the Single Electricity Market (SEM) and European Directive concerning the internal market for electricity including retail market opening, along with uncontrollable costs which are passed through to customers on a 100% basis. These latter costs include licence fees, NI2007 establishment costs and past pensions deficit.

Therefore, most of NIE Energy Supply’s costs are straight pass-through costs which are subject to other price controls or regulations and thus, this price control review deals with the \( S_t \) term of the tariff formula which is in effect NIEES’ own operating costs and margin allowed by the regulator. This amount must be sufficient to finance an efficient business and would normally comprise:

<table>
<thead>
<tr>
<th>Operating costs</th>
<th>Capital expenditure</th>
<th>Depreciation</th>
<th>Return on assets/ Profit margin</th>
</tr>
</thead>
</table>

The Allowed Revenue, minus the cost of all electricity wholesale purchases i.e. \( U_t \), \( G_t \), \( K_t \) and \( (J_t - D_t) \) and minus any market costs i.e. \( E_t \), is currently collected on a ratio of 67% for fixed costs plus a variable charge on a per customer basis (33%). These amounts are currently:

Fixed: £20.337m  Variable: £12.65 per customer

NIEES currently has minimal assets and therefore a return on assets for investors is not a consideration within the Allowed Revenue. There are no current plans for the price control duration to formulate a Regulatory Asset Base (RAB) based on capital expenditure (however, this will change after NIEES completes Stage 3 of the Enduring Solution Project) and thus the St Allowed Revenue will consist only of
operating costs plus a margin (forecast depreciation amounts are residual due to the transfer of Keypad metering to the Transmission and Distribution business).

**Approach**

The Utility Regulator instigated the ‘kick-off’ meeting, with NIEES, for the Supply Price Control on 18th September 2009. A series of other meetings took place on the 30th September (this meeting included CCNI), 19th October, 3rd November, 9th November, with the latest being 11th December 2009.

In the interim period between 19th September and 11th December a number of areas of information were requested from NIEES. NIEES also submitted a paper on 16th of October detailing their position. Information requested included the actual outturn figures for 2008/2009 and various other submissions such as working capital analysis. The data provided was examined and analysis carried out to determine variance between allowed Operating Expenditure and actual outturn. Based on the data provided and analysis carried out the Utility Regulator formulated a number of proposals, which were discussed with NIEES. On the basis of these proposals NIEES provided further analysis and detail of cost pressures for 2010/2011. NIEES are currently carrying out their internal planning, and the UR expects to receive the Latest Best Estimate for 2009/2010, showing the performance year to date and the likely outturn for financial year ending March 2010, during this consultation response period.
Proposals
Form and Scope

NIEES proposed that the current form and scope of the price control should continue, including K factor. However, similarly to the 2009/2010 Price Control they have suggested certain factors are taken into consideration and scope should take account of the following:

i. NIEES has proposed a further deregulation. This would include approximately 3,000\(^2\) additional sites which would consume in total a similar volume of units to the initial customer grouping, which was deregulated on 1 April 2009. The previous category which was deregulated included non-domestic customers with annual consumption greater than 150 MWh. The new criteria covering both the first phase of deregulation and the new proposed phase would be:
   a. Individual sites consuming > 150 MWhs per annum; or
   b. Group entities where their collective sites would consume in aggregate more than 150 MWhs per annum.

ii. As part of the last price control the increasing value of supply risks, for example working capital, agency transaction volumes and bad debt were taken into consideration. NIEES have proposed that such risks are taken into account in this price control.

Utility Regulator Proposal

There are a number of work-streams such as the review of K factors and supply margins which are likely to have a direct impact on the NIEES price control formulae. The Utility Regulator is also intending to publish its Roadmap paper in Spring 2010. This will discuss the options in relation to a longer term price control (beginning April 2011) in the context of a competitive environment. It is anticipated that the work in relation to a longer term review will begin early 2010. As a result of this, the Utility Regulator deems that it is prudent that the price control should cover a period of one year i.e. 2010/2011.

Therefore, it is proposed that the current form of the price control shall remain the same for the period as well as the scope (all customer classes) with the possible exception for the proposed new tranche of deregulated customers. The new proposal for deregulation being Individual sites consuming more than 150 MWhs per annum or Group entities where their collective sites would consume in aggregate more than 150 MWhs per annum. Whilst this proposal impacts upon the price control decision, it will form part of a separate consultation exercise.

Duration

NIEES proposed that the 2009/2010 price control should be extended (as allowed per the license conditions). The rationale for this being the short time period

\(^2\) NIEES sites only. Does not include sites that are already with other suppliers.
elapsed since the end of the implementation of the previous price control. This would also allow for the work to implement a longer term review to begin early 2010.

**Utility Regulator Proposal**

The Utility regulator does not agree with the NIEES proposal to extend the current price control to take in the period 2010/2011.

The Utility Regulator recognises that there is an essential requirement for a long-term review to take place. This review should commence early 2010 and put in place a multi-year control (exact duration to be confirmed) beginning in April 2011. This review would examine, in detail, both the Operating Expenditure and Margin of NIEES. It should also take account of best practice and benchmark against relevant industry standards.

However, due to the finalisation of the workstreams such as K factor, tariff structure and the development of Roadmap, which will have an impact on the NIEES price control, the Utility Regulator is proposing a one year price control.

**Operating Costs**

NIEES has proposed that their allowed operating expenditure should remain at the level set in the 2009/2010 price control being £19.258 million.

**Utility Regulator Proposal**

The current position of the UR is based on the fact that significant recurring efficiencies have been made and as such these should be reflected in the new 2010/2011 Supply Price Control.

Emphasis is put on the fact that these efficiencies were gained in 2008/09 and are likely to be repeated again in 2009/10 (at twice the level experienced in 2008/2009 for the Northgate efficiency described below). As a result of this, NIEES have been able to retain them for a two year period without any efficiency factor applying in either the 2007-09 or 2009-10 price controls.

Based on this, the UR would wish for these efficiencies to be reflected in the 2010/2011 allowed regulated St Operating costs. Our analysis indicates that the potential impact of the efficiencies evidenced for the 6 month period October to March in 08/09, and carried over for the full 12 month period of 09/10, should result in a reduction in allowed St Operating costs in the region of £2 million.

However, NIEES have identified additional cost pressures not present in the 2008/09 actual outturn operating cost base. These include those faced in the onset of competition, such as increased staff costs for call handling and additional communication costs. In addition to this, there is likely to be increased pension costs (included in the salaries line in table 1.1), agency transaction costs and Energy efficiency costs. Whilst we recognise the potential for additional costs
(albeit that these have not been agreed and may not materialise as they are not part of the current cost base), the UR is confident that in the event that the extra possible costs presented by NIEES materialise, the level of potential efficiencies for 2010/11 will be sufficient to fully offset these.

Thus, the UR has decided to use the last set of actual outturn figures for accuracy. This will result in a reduction in allowed operating expenditure to the 2008/2009 actual figures, being £17.858 m (to be indexed into 10/11 prices).

It should also be reiterated that this allowance will be revisited when the UR undertakes the full review in early 2010.

Rationale for UR Proposal

The rationale for the reduction in allowed operating expenditure has been based on the review of the data submitted by NIEES in terms of the actual out turn versus the allowed operating expenditure and indeed the ‘Latest Best Estimate’ (LBE) for 2008/2009 as submitted to NIAUR at the end of November 2008. The LBE for 08/09 and forecast for 09/10 were used to test the reasonableness and establish the allowed operating expenditure for 2009/2010.

NIEES have substantially outperformed the forecast for 2008/09 which they submitted to the UR as part of the 2007 to 2009 Supply Price Control. As demonstrated in Table 1.1 below. There is also a significant variance in the LBE for 2008/09 submitted to the UR at the end of November 2008 (as part of the 2009/10 Supply Price Control) and the Actual outturn.
Table 1.1
Table showing the comparison between Allowed St Operating Costs, Actual, and BEQ submitted to the UR (NB 08/09 allowed and actual shown in 08/09 Prices - Decision Paper reflects 06/07 Prices)

<table>
<thead>
<tr>
<th>St Operating Costs</th>
<th>2008/09 Allowed St (Indexed up to 08/09 Prices) £m</th>
<th>2008/09 Actual Outturn £m</th>
<th>Difference £m</th>
<th>% Change</th>
<th>2008/2009 BEQ/LBE submitted to the UR end of November 2008 £m</th>
<th>Difference between LBE and Actual Outturn £m</th>
<th>Difference</th>
<th>2009/2010 Allowed OPEX Per the Supply Price Control £m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries</td>
<td>2.368</td>
<td>3.299</td>
<td>0.931</td>
<td>39.3%</td>
<td>2.47</td>
<td>0.829</td>
<td>33.6%</td>
<td>2.528</td>
</tr>
<tr>
<td>Bad Debt</td>
<td>2.039</td>
<td>2.083</td>
<td>0.044</td>
<td>2.2%</td>
<td>2.44</td>
<td>-0.357</td>
<td>-14.6%</td>
<td>2.498</td>
</tr>
<tr>
<td>MBIS excl licence fees</td>
<td>5.239</td>
<td>5.678</td>
<td>0.439</td>
<td>8.4%</td>
<td>5.63</td>
<td>0.048</td>
<td>0.9%</td>
<td>5.812</td>
</tr>
<tr>
<td>Inter-business</td>
<td>0.897</td>
<td>0.906</td>
<td>0.009</td>
<td>1.0%</td>
<td>0.72</td>
<td>0.186</td>
<td>25.8%</td>
<td>0.715</td>
</tr>
<tr>
<td>Depreciation</td>
<td>0.017</td>
<td>0.015</td>
<td>-0.002</td>
<td>-11.8%</td>
<td>0.08</td>
<td>-0.065</td>
<td>-81.3%</td>
<td>0.06</td>
</tr>
<tr>
<td>NI2007 Retail Ongoing</td>
<td>0.324</td>
<td>-0.324</td>
<td>-100.0%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(0.605)</td>
</tr>
</tbody>
</table>

Source: NIEES & UR 2009/10 Decision Paper

The full net efficiencies for the year 2008/2009 were £1.05 million (difference between allowable operating expenditure and actual outturn operating expenditure).

There are also significant differences between the LBE submitted to NIAUR in at the end of November 2008 and the actual out-turn. The most significant variances relate to Salaries and the Northgate contract. As shown above these were approximately £0.8 million (33.6%) higher and £1.95 million (24.9%) lower respectively than the forecast submitted in the LBE. Across these two categories overall this has led to a net movement of £1.15 million lower than anticipated operating costs for NIEES in the year 2008/2009.

Figure 1.1 below shows the allowed St Operating expenditure against what the actual outturn was. The figures for 2007/2008 and 2008/2009 are shown in 2006/2007 prices as per the decision paper.
These variances (in terms of both forecast and LBE) have been discussed with NIEES and explanations provided. The bulk of this difference, between allowed operating costs and actual outturn costs, is due to Northgate costs being £2.151 (26.8%) less and salaries being £0.931 (39.3%) more than forecast. This is a net efficiency of £1.22m. These two categories are inextricably linked as the Northgate costs are associated to outsourcing of managed services which includes activity such as looking after the billing system, IT helpdesk, debt management and call handling.

NIEES took the decision around October 2008 to in-source some of these activities. As part of the re-procurement of the a wider Business Process Outsourcing (BPO) contract, the resources for call handling and some of debt management were in-sourced under TUPE rules, which entitled all outsourced staff to move across to NIEES. Not all of the out-sourced staff took up the opportunity to move across and as a result NIEES used agency staff to ‘top up’ resource requirements in call handling.

NIEES have acknowledged that they have made significant efficiencies as a result of this exercise mid-way through 2008/2009, and acknowledge that these efficiency gains have been carried over into the 2009/2010 year also. In fact, the changes in the outsourcing arrangements took place in October 2008, with approximately 6 months to the end of the Financial Year 2008/2009. In addition to the six months of saving made in 2008/2009, it is anticipated that the efficiencies gleaned this financial year (2009/2010) will be at around twice the level of 2008/2009 given that there will be savings gained over a twelve month period.

However, NIEES have identified additional cost pressures not present in the 2008/09 actual outturn operating cost base. These include those faced in the
onset of competition, such as increased staff costs for call handling and additional communication costs. In addition to this, there is likely to be increased pension costs (included in the salaries line in table 1.1), agency transaction costs and Energy efficiency costs. Whilst we recognise the potential for additional costs (albeit that these have not been agreed and may not materialise as they are not part of the current cost base), the UR is confident that in the event that the extra possible costs presented by NIEES materialise, the level of potential efficiencies for 2010/11 will be sufficient to fully offset these.

Margin

The level of margin set in the last price control was £10.49m. This margin was set to recognise the increased working capital pressures and overall risk profile of the business at the time of the last price control. NIEES have expressed ongoing concerns over the increased working capital pressures brought about by the inception of SEM, which changed the timing of payments for NIEES from monthly to weekly invoicing.

Table 1.2 details a Working Capital Analysis for a six year period from Financial Year 2002/2003 to 2008/2009. The table highlights that the financing costs for Working Capital have increased from the inception of SEM, where they moved from a profit of £1 million in 2007/2008 to a cost of £3.1 million in 2008/2009. However, this was the position at the end of 08/09 only and will constantly fluctuate.

<table>
<thead>
<tr>
<th>Working Capital Analysis Actuals</th>
<th>2002/03 £m</th>
<th>2003/04 £m</th>
<th>2004/05 £m</th>
<th>2005/06 £m</th>
<th>2006/07 £m</th>
<th>2007/08 £m</th>
<th>2008/09 £m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest receivable</td>
<td>1.4</td>
<td>1.8</td>
<td>0.5</td>
<td>1.4</td>
<td>1.0</td>
<td>2.2</td>
<td>0.7</td>
</tr>
<tr>
<td>Interest on K</td>
<td>0.3</td>
<td>0.2</td>
<td>0.5</td>
<td>0.2</td>
<td>0.0</td>
<td>(0.5)</td>
<td>(0.6)</td>
</tr>
<tr>
<td>Finance Costs</td>
<td>0.1</td>
<td>(0.7)</td>
<td>(3.2)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Profit / (Loss)</strong></td>
<td>1.7</td>
<td>2.0</td>
<td>1.0</td>
<td>1.6</td>
<td>1.1</td>
<td>1.0</td>
<td>(3.1)</td>
</tr>
</tbody>
</table>

Source: NIEES

Utility Regulator Proposal

NIEES highlighted to the UR the enhanced working capital pressures due to SEM arrangements as an issue that should require some recognition in terms of the quantum of the Margin. However, this issue of extra working capital commitment due to the step change in payment timings brought about by the formation of SEM was dealt with by the UR when setting the 09/10 control. The analysis carried out of the “swing” in financing costs from £1M income in 07/08 to £3.1M cost in 08/09 resulted in a change in the regulated margin from c.1.5% of turnover to c.1.7% of
turnover (these percentages are not exact because under the present form of control the UR sets a margin figure based on NIEES forecast turnover. The margin figure remains as set regardless of whether actual turnover is higher or lower than forecast). As stated however, this increase in net margin of c.0.2% of turnover from the previous price control has taken account of the step change in working capital commitment due to the creation of SEM. The margin of c.1.7% of turnover compares to 1.3% for ESB Customer Supply (a supplier operating in the SEM) and 1.5% for Phoenix Supply (which also has a penalised ‘K’ factor regime more restrictive than NIEES).

With this in mind the UR is minded to allow the current margin figure to remain constant for the 10/11 price control i.e. £10.49M in recognition of the fact the figure was set only 10 months ago and this price control is for one year only. However, the UR can also see the rationale for setting the net margin for the 10/11 control as 1.7% of actual turnover. This method ensures that the net margin of the business fluctuates with overall turnover and allows a higher margin amount in times of higher turnover. This greater amount can be used to offset the larger working capital commitment associated with a larger turnover. In like manner the margin amount falls as turnover falls.

This methodology is consistent with UK regulatory precedent and the phoenix supply price control set by the UR. It also removes the uncertainty around setting a percentage net margin based on a forecast rather than actual turnover. It is highly likely that when setting the enduring price control to begin in April 2011 the current form of price control will be changed, and the regulated net margin will be set as a percentage of actual turnover.

The UR welcomes respondents views on which proposal is more appropriate
Figure 1.2

Chart showing the NIEES allowed margin in £’s million in the previous three Price Controls and the proposed margin for 2010/2011 (should the margin be set at £10.491M)

Allowed Margin in £’sm - Figures Indexed up by RPI to relevant Price Control Year Prices

Source: NIAUR decision Papers indexing rates per Office for National Statistics

Allowed Revenue ($t$)

Total Allowed Revenue

The allowed revenue figure is the total of operating costs and the allowed margin (should the margin be set at £10.491M):

<table>
<thead>
<tr>
<th></th>
<th>2010/11 Proposed</th>
<th>2010/11 Allowed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Operating Costs</td>
<td>£19.258</td>
<td>£17.858</td>
</tr>
<tr>
<td>Net Margin</td>
<td>£10.491</td>
<td>£10.491</td>
</tr>
<tr>
<td>Total $S_t$</td>
<td>£29.749m</td>
<td>£28.349m</td>
</tr>
</tbody>
</table>

Fixed: Variable Ratio

The ratio of fixed to customer variable proportions of the Allowed Revenue minus the cost of electricity purchases is currently proposed by NIEES 67:33 which remains unchanged from the current price control.
Utility Regulator Proposal

NIAUR is content to continue with the current fixed: variable ratio of 67:33.

How to Respond

Responses are invited on any of the issues raised in this paper and in particular on:

- The methodology for setting the margin; and
- Allowed Operating Costs.

Please also suggest any alternative relevant measures/actions.

Responses to this consultation paper should be sent to:

Nicola Sweeney
Utility Regulator
Queens House
14 Queen Street
BELFAST
BT1 6ED
E-mail: nicola.sweeney@niaur.gov.uk

By Thursday 18th February 2010.

Unless marked as confidential all responses will be published.

Individual respondents may ask for their responses, in whole or in part, not to be published, or that their identity should be withheld from public disclosure. Where either of these is the case, we will ask respondents to also supply us with the redacted version of the response that can be published.

As a public body and non-ministerial Government department, we are bound by the Freedom of Information Act (FOIA) which came into full force and effect on 1 January 2005. According to the remit of the Freedom of Information Act, it is possible that certain recorded information contained in consultation responses can be put into the public domain. Hence, it is now possible that all responses made to consultations will be discoverable under FOIA - even if respondents ask the Utility Regulator to treat responses as confidential. It is therefore important that respondents note these developments and in particular, when marking responses as confidential or asking the Utility Regulator to treat responses as confidential, should specify why they consider the information in question to be confidential.