Power NI - Power Procurement
Business Price Control 2015 – 2017

Draft Determination
Consultation
April 2015
About the Utility Regulator

The Utility Regulator is the independent non-ministerial government department responsible for regulating Northern Ireland’s electricity, gas, water and sewerage industries, to promote the short and long-term interests of consumers.

We are not a policy-making department of government, but we make sure that the energy and water utility industries in Northern Ireland are regulated and developed within ministerial policy as set out in our statutory duties.

We are governed by a Board of Directors and are accountable to the Northern Ireland Assembly through financial and annual reporting obligations.

We are based at Queens House in the centre of Belfast. The Chief Executive leads a management team of directors representing each of the key functional areas in the organisation: Corporate Affairs; Markets; and Networks. The staff team includes economists, engineers, accountants, utility specialists, legal advisors and administration professionals.

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### Our Mission

Value and sustainability in energy and water.

### Our Vision

We will make a difference for consumers by listening, innovating and leading.

### Our Values

Be a best practice regulator: transparent, consistent, proportional, accountable, and targeted.

Be a united team.

Be collaborative and co-operative.

Be professional.

Listen and explain.

Make a difference.

Act with integrity.
Abstract

Power NI Power Procurement Business (PPB) was set up following the creation of legacy contracts put in place on 1 April 1992 and is regulated as a separate business under Annex 3 and Schedule 3 of the Power NI Electricity Supply Licence.

In October 2014 the Utility Regulator (UR), after analysing the value to consumers, took a decision that the two remaining legacy contracts should remain in place but be kept under review. The UR analysis encompassed a proposal from PPB which reduced their current costs by £2.4 million per annum alongside a ‘gain share’ mechanism.

This draft determination consultation sets out the UR’s proposals for the next PPB price control, 2015-2017 which takes effect from 1 April 2015 and is applied through the October 2015 Electricity tariffs.

Audience

Energy industry stakeholders; electricity licence holders; electricity consumers; electricity consumer representatives and policy makers.

Consumer impact

This draft determination reflects a £2.675 million reduction in PPB’s operating costs which will benefit consumers through a reduced PSO charge.

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, but excluding operating costs (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 which is levied on all NI electricity consumers.
1. Introduction and Background to the Power Procurement Business (PPB)

1.1. Power NI Power Procurement Business (PPB) was set up following the creation of 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 (now the Power NI Supply License). 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.

1.2. Following the creation of the SEM, PPBs role changed. The business still continues to purchase power under the long term contracts but it 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 hedge a significant proportion of the revenues it will receive for the power it sells to the market.

1.3. 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, PPB’s profit margin is defined in the Price Control.

1.4. This draft determination consultation paper puts forward proposals for the next PPB price control which will be effective from 1 April 2015 for a period of two years, with the option to extend to 23rd September 2018, the first expiry date for the Generating Unit Agreements. The option to extend the Price Control will be informed by developments in relation to the re-design of the Single Electricity Market.
Structure of this paper:

1.5. In terms of structure:

- **Chapter 2** provides the context of the current price control and GUA contract;

- **Chapter 3** provides a summary of the current Price Control Structure and formulae;

- **Chapter 4** considers the elements of the Price Control Determination

- **Chapter 5** outlines the Financial Gain Sharing Arrangement

- **Chapter 6** details the Proposed Price Control Structure

- **Chapter 7** outlines the Draft Determination Summary

- **Chapter 8** provides details on how to respond to this consultation.
2. Context of the Current Price Control

2.1. In October 2014 The Utility Regulator (UR) took a decision that the two remaining PPAs that PPB hold with AES would remain in place at this time\(^4\). This was informed by our analysis of the value of these contracts to consumers which included consideration of a proposal from PPB which reduced their current costs by £2.4 million per annum alongside a ‘gain share’ mechanism.

2.2. Consequently the cost reduction and ‘gain share’ proposal was considered in the analysis for this price control.

2.3. The role of PPB, as outlined in the introduction section, is very much linked to the continuing term of the two remaining long-term Generating Unit Agreements (GUA).

2.4. The GUA contracts that remain as per the UR decision in October 2014 are outlined below.

\textbf{Table 2.1:} Active GUA contracts

<table>
<thead>
<tr>
<th>Company</th>
<th>Generating Unit</th>
<th>GUA Contracted Capacity (MWs)</th>
<th>Fuel Type</th>
<th>Contract Expiry Date (CED)</th>
</tr>
</thead>
<tbody>
<tr>
<td>AES Ballylumford</td>
<td>CCGT 10</td>
<td>106</td>
<td>Gas</td>
<td>23 September 2018 (with a five year extension option)</td>
</tr>
<tr>
<td>AES Ballylumford</td>
<td>CCGT 20</td>
<td>510</td>
<td>Gas</td>
<td>23 September 2018 (with a five year extension option)</td>
</tr>
</tbody>
</table>

2.5. The remaining two contracts can be cancelled subject to a 180 day notification period. However the October 2014 decision to retain these contracts, while keeping their value to consumers under review, has resulted in the need for a price control determination for the 2015 to 2017 period.

2.6. It is worth noting that the GUA contracts summarised in the table below have been cancelled, the analysis of their value to consumers at the time of cancelation having supported the decision.

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### Table 2.2: Cancelled GUA contracts

<table>
<thead>
<tr>
<th>Company</th>
<th>Generating Unit</th>
<th>GUA Contracted Capacity (MWs)</th>
<th>Fuel Type</th>
<th>Contract Expiry Date (CED)</th>
</tr>
</thead>
<tbody>
<tr>
<td>AES Kilroot</td>
<td>G1</td>
<td>260 (oil), 195 (coal)</td>
<td>Coal/Heavy Fuel Oil</td>
<td>Cancelled with effect from 1 November 2010</td>
</tr>
<tr>
<td>AES Kilroot</td>
<td>G2</td>
<td>260 (oil), 195 (coal)</td>
<td>Coal/Heavy Fuel Oil</td>
<td>Cancelled with effect from 1 November 2010</td>
</tr>
<tr>
<td>AES Kilroot</td>
<td>GT1</td>
<td>29</td>
<td>Distillate</td>
<td>Cancelled with effect from 1 November 2012</td>
</tr>
<tr>
<td>AES Kilroot</td>
<td>GT2</td>
<td>29</td>
<td>Distillate</td>
<td>Cancelled with effect from 1 November 2012</td>
</tr>
<tr>
<td>AES Ballylumford</td>
<td>GT1</td>
<td>58</td>
<td>Distillate</td>
<td>Cancelled with effect from 1 November 2012</td>
</tr>
<tr>
<td>AES Ballylumford</td>
<td>GT2</td>
<td>58</td>
<td>Distillate</td>
<td>Cancelled with effect from 1 November 2012</td>
</tr>
<tr>
<td>Coolkeeragh ESB</td>
<td>GT8</td>
<td>58</td>
<td>Distillate</td>
<td>Cancelled with effect from 1 February 2013</td>
</tr>
</tbody>
</table>
3. Structure of the Price Control

3.1. The structure of this price control remains largely consistent with previous price controls for PPB. The existing structure continues to be appropriate as it allows for a reasonable return and depreciation on assets.

3.2. This draft determination follows an assessment and review of the UR Business Efficiency Questionnaire (BEQ) submission from PPB and the proposal received from PPB to reduce costs and introduce a gain share mechanism which contributed to the decision not to cancel the GUA contracts.

3.3. 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 PPB’s own allowed revenue (the \( E_t \) term) which is subject to a determination within this Price Control by the Utility Regulator.

3.4. PPB’s own costs relate to the operating costs and working capital costs of the business. The entire price control formula addresses how PPB will calculate the PSO levy amount and PPB’s own costs make up only one part of this. The detail of the price control calculation is contained in the Power NI Licence in Annex 3\(^2\). The Formula is shown below:

\[
MPPB_t = A_t + D_t + E_t - NPR_t + KB_t
\]

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 \( t \)

\( KB_t \) = the correction factor to be applied in relevant year \( t \)

3.5. The main structure of the current price control remains unchanged from the previous price control, allowing a rate of return and depreciation on PPBs regulatory asset base (RAB) with PPB’s own operating costs and working capital costs coming out of the incentivised amount. These components are further explained below.

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

\[ Et = DEPt + RTNt + ICT + PDt \]

\( DEPt \) = means the depreciation amount determined from the depreciation of the PPB Regulated Asset Base on a 25 year profile and the New PPB Regulated Asset Base on a 5 year profile.

\( RTNt \) = means the allowed return on the PPB Regulated Asset Base and the New PPB Regulated Asset Base

\( ICT \) = means the PPB incentivised amount which is dependent on the outturn performance against the targets specified in the incentive

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

3.7 The current incentives and their respective weightings, which applied to the 2012 to 2015 Price Control are set out in Schedule 3 of the Power NI Supply Licence. It is proposed to replace these by a gain share mechanism in this Price Control 2015 to 2017, which is detailed in Section 6 of this paper. This gain share mechanism has the advantage of reducing the regulatory burden and better aligning the benefits (incentives) for PPB with consumer benefits.

3.8 We propose that this price control runs for the period 1st April 2015 – 31st March 2017 with the option to extend up to 23rd September 2018. However, should we resolve to cancel the remaining GUA contracts over the course of the price control period we reserve the right to re-open the price control as this would fundamentally change PPB’s role and possibility its existence.

http://www.uregni.gov.uk/publications/electricity_supply_licence_nie_energy_ltd01_04_2014
4. Price Control Draft Determination

4.1. This section considers each element of the formula for calculating PPB’s own allowed revenue or entitlement (Et). This allowance is the total amount PPB is permitted through the price control to be retained by the business itself, out of which it pays its internal business operating costs.

4.2. Our analysis is informed by the information submitted by PPB, namely:-

i. the UR Price Control Business Efficiency Questionnaire (BEQ) PPB submission; and

ii. the PPB £2.4m per annum cost reduction and gain share mechanism proposal which was submitted and considered as part of the decision not to cancel the GUA contracts;

Depreciation (DEPt)

4.3. PPB currently has a Regulatory Asset Base (RAB); there is no ‘new’ RAB. The original PPB RAB is based on an estimate of an initial RAB of £5 Million 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, UR split the £5 Million RAB into a £4 Million RAB for PPB and a £1 Million RAB for SONI, with all subsequent asset acquisitions allocated to SONI.

4.4. Using the current UR methodology the value of the RAB at April 2015 is £0.950 million (in Oct 2014 prices) and a depreciation amount of circa £0.292 million is due.

These figures are aggregated and shown below.

Table 4.1 Depreciation

<table>
<thead>
<tr>
<th>Period Ending</th>
<th>RAB Value (£m)</th>
<th>Average Value (£m)</th>
<th>Annual Depreciation (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>31-Mar-15</td>
<td>0.950</td>
<td>0.804</td>
<td>0.292</td>
</tr>
<tr>
<td>31-Mar-16</td>
<td>0.658</td>
<td>0.512</td>
<td>0.292</td>
</tr>
<tr>
<td>31-Mar-17</td>
<td>0.366</td>
<td>0.220</td>
<td>0.293</td>
</tr>
<tr>
<td>31-Mar-18</td>
<td>0.073</td>
<td>0.037</td>
<td>0.073</td>
</tr>
<tr>
<td>31-Mar-19</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td>31-Mar-20</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
</tbody>
</table>

4.5. UR are minded to accept both the depreciation and the present value (Oct 2014
prices) of the initial RAB at £0.950M, which is consistent with previous price control decisions.

**Rate of Return (RTNt)**

4.6. In the 2012-15 PPB price control UR allowed PPB the same WACC as applied in the SONI price control of 5.68%\(^4\).

4.7. In its response to the BEQ, PPB proposed a WACC of 7.94%, which was the mid scenario of a range of scenarios within their submission. One of the drivers for that number was a claim of a higher risk profile associated with the comparatively asset light nature of their business.

4.8. The UR acknowledges that PPB operates a relatively asset light business. However as stated in the decision for the current price control UR believe the PPB activity bears more resemblance to the SONI activity than it does to the activities of a distribution network business. Both PPB and SONI have few assets in relation to turnover and both deal directly with generators and suppliers as opposed to end customers.

4.9. Considering these factors we have decided to apply the SONI WACC which is consistent with previous price control decisions. We are therefore minded to permit PPB the proposed SONI WACC of 5.42% this WACC is currently out for consultation as part SONI’s Price Control Draft Determination\(^5\).

The following table sets out our proposals in this regard:

**Table 4.2 Rate of Return (RTNt)**

<table>
<thead>
<tr>
<th></th>
<th>Annual</th>
<th>Annual</th>
<th>Annual</th>
<th>Annual</th>
<th>Annual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return</td>
<td>0.044</td>
<td>0.028</td>
<td>0.012</td>
<td>0.002</td>
<td>0.000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>0.292</td>
<td>0.292</td>
<td>0.293</td>
<td>0.073</td>
<td>0.000</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>0.336</td>
<td>0.320</td>
<td>0.305</td>
<td>0.075</td>
<td>0.000</td>
</tr>
</tbody>
</table>

\(^4\) SONI Draft Determination Pre-Tax WACC

\(^5\) Draft Determination to the Price Control 2015 – 2020 for the Electricity System Operator for Northern Ireland (SONI)
**Incentive Amount (ICt)**

4.10. The ICt amount has three elements; Opex, Working Capital and Profit. Each of these elements are summarised in turn below.

4.11. It is the incentive amount to which PPB’s 2014 price control offer to reduce operating costs by £2.4m (in 2013 prices) applies. The impact of this offer on the ICt term is summarised in the following table and explained below.

*Table 4.3 ICt Amount as proposed by PPB compared to UR Draft Determination*

<table>
<thead>
<tr>
<th>ICt Formula</th>
<th>£m OPEX</th>
<th>WCF</th>
<th>Total ICt</th>
<th>ICt Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Price Control Decision (in 2014 prices)</td>
<td>2.594</td>
<td>1.747</td>
<td>6.204</td>
<td>1.863</td>
</tr>
<tr>
<td>Current Price Control Decision (in 2013 prices)</td>
<td>2.536</td>
<td>1.708</td>
<td>6.064</td>
<td>1.821</td>
</tr>
<tr>
<td>PPB Offer - reduction (in 2013 prices)</td>
<td>0.400</td>
<td>1.100</td>
<td>0.910</td>
<td></td>
</tr>
<tr>
<td>- net impact (in 2013 prices)</td>
<td>2.136</td>
<td>0.608</td>
<td>3.654</td>
<td>0.910</td>
</tr>
<tr>
<td>- net impact (in 2014 prices)</td>
<td>2.185</td>
<td>0.622</td>
<td>3.738</td>
<td>0.931</td>
</tr>
<tr>
<td>UR Proposed Decision (in 2014 prices)</td>
<td>1.976</td>
<td>0.622</td>
<td>3.529</td>
<td>0.931</td>
</tr>
<tr>
<td>Difference from Current Control</td>
<td>-0.618</td>
<td>-1.125</td>
<td>-2.675</td>
<td>-0.931</td>
</tr>
</tbody>
</table>

4.12. Note that PPB’s offered reduction was made in October 2013 prices. The table above shows the elements converted to 2014 prices. The total incentive amount proposed by PPB is £2.466m/annum less than the previous price control determination and £2.675m/annum less as proposed by the UR in this draft determination. The following sections elaborate on the reasoning for these reductions.

**Opex**

4.13. PPB’s OPEX includes staff related costs, office expenses, professional and other fees.

4.14. The OPEX allowance for the current price control is £2.594m. However, over the last three years PPB’s actual total OPEX (excluding exceptional items) was £2.1m. This is set out in further detail in Appendix A.

4.15. As part of the 2014 offer, PPB proposed a reduction in OPEX of £400k (£409k in 2014 prices). Applying this reduction gives a proposed OPEX of £2.185m. PPB have stated that this is achieved by savings in both staff and other operating costs.

4.16. Overall, this results in an aggregate annual OPEX reduction of c20% and is
broadly in line with PPB’s actual OPEX over recent years.

4.17. However, we note that from PPB’s BEQ submission their latest best estimate total OPEX (excluding exceptional items) for 2014/15 is £1.976m (see Appendix A). For this Draft Determination for the 2015-17 price control we propose to cap PPB’s OPEX allowance at this level which represents a further efficiency challenge and a reduction of c24% to the current price control allowance.

Working Capital Facility (WCF)

4.18. PPB has in place a working capital facility (WCF) provided by the Viridian Group. PPB evaluate the current size of this facility to be £55.8m. The cost allowed in the current Price Control is £1.7m (although PPB evaluate the cost to be much greater). In their BEQ PPB provided us with a proposed minimum cost of this working capital facility of £1.43m (based on a lower facility size of £20m).

4.19. PPB’s 2014 offer also included a proposal to reduce the size of the WCF to £20m and stated that PPB would bear the risk both on cost and size of the facility required. The offer proposed to reduce the facility cost on a pro-rata basis to £0.622m (representing a £1.125m reduction).

4.20. PPB indicated that they believed this allowance is lower than the true cost of the facility (as was confirmed in their BEQ submission) but they are prepared to bear this risk in the context of their overall proposal.

4.21. Given that PPB have accepted bearing the risk in terms of both the reduced size of the WCF and the cost for the providing the facility, we have allowed a pro-rata sum of £0.622m as reflected in Table 4.2 above.

Profit

4.22. PPB’s 2014 offer proposes a reduction of the profit element within ICT by 50% from £1.821m to £0.931m.

4.23. It should be noted that this profit element needs to be considered in the context of the proposed ‘gain share’ incentive mechanism which forms part of this draft determination, the detail of which is discussed in Section 5 of this report.
Pension Deficit (PDt)

4.24. This item is not specifically consulted on as it is a “pass-through” cost via Et. Any pension deficit costs incurred by PPB will be treated on a consistent basis to that of Power NI’s supply business and UR policy. These costs are identified in Appendix A.

Summary of allowed operating costs

4.25. The following table summarises our draft determination proposals in relation to PPB’s own operating costs (the Et term of their price control).

Table 4.4 Summary of allowed operating costs

<table>
<thead>
<tr>
<th>Et Formula</th>
<th>£m</th>
<th>DEPt</th>
<th>RTNt</th>
<th>OPEX</th>
<th>WCF</th>
<th>Total Ict</th>
<th>Ict Profit</th>
<th>Profit (inc DEP, RTN)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Price Control Decision (in 2014 prices)</td>
<td>0.377</td>
<td>0.103</td>
<td>2.594</td>
<td>1.747</td>
<td>6.204</td>
<td>1.863</td>
<td>2.342</td>
<td></td>
</tr>
<tr>
<td>Current Price Control Decision (in 2013 prices)</td>
<td>0.368</td>
<td>0.100</td>
<td>2.536</td>
<td>1.708</td>
<td>6.064</td>
<td>1.821</td>
<td>2.289</td>
<td></td>
</tr>
<tr>
<td>PPB Offer - reduction (in 2013 prices)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>- net impact (in 2013 prices)</td>
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<td></td>
<td></td>
<td>2.185</td>
<td>0.622</td>
<td>3.798</td>
<td>0.931</td>
<td></td>
</tr>
<tr>
<td>UR Proposed Decision (in 2014 prices)</td>
<td>0.293</td>
<td>0.044</td>
<td>1.976</td>
<td>0.622</td>
<td>3.529</td>
<td>0.931</td>
<td>1.268</td>
<td></td>
</tr>
<tr>
<td>Difference from Current Control</td>
<td>-0.084</td>
<td>-0.059</td>
<td>-0.618</td>
<td>-1.125</td>
<td>-2.675</td>
<td>-0.931</td>
<td>-1.074</td>
<td></td>
</tr>
</tbody>
</table>

4.26. The above reflects an overall savings compared to the previous price control of £2.675m per annum and a reduction in profit of £0.931m.

4.27. Consistent with previous price control decisions the above table also shows the PPB’s allowed profit including the depreciation and return elements. Overall profit under the Et term is reduced by c£1.1m compared to the current price control and represent a margin on forecast turnover of c0.8%, while noting that this needs to be considered alongside any profit element PPB may earn out of the proposed ‘gain share’ mechanism which is outlined in Section 5.
5. Gain Share Mechanism Proposal

5.1. In addition to the cost reduction described in Section 4 we propose to introduce a financial gain sharing arrangement which will better align the benefits (incentives) on PPB with consumers’ benefits, while at the same time reducing the regulatory burden.

5.2. The gain share proposal is structured so that any surplus up to £10m, resulting from PPBs good management of the GUA contracts is split 80:20 between customers and PPB for the year in question. Any surplus in excess of £10m will be shared on a 90:10 basis.

5.3. The ‘gain share’ will replace the current incentives contained within the IC₃ element of the price control formula. We believe this mechanism will provide PPB with a stronger incentive to maximise the consumer benefit of the contracts as both PPB and consumer benefits will be aligned.

5.4. We also believe that as well as providing PPB with this stronger signal, the proposed mechanism is simpler, more transparent and will require less of an administrative burden than the current arrangements.

5.5. In summary, the gross surplus on which the total ‘gain’ is calculated for any year is determined from the difference between aggregated revenues PPB earns, less the costs PPB pay out under the terms of the contracts, less PPB’s own operating costs (described in the previous section). This surplus is then split between consumers and PPB according to the percentages outlined above.

5.6. To put this mechanism in context the gross surplus based on the 2014/15 tariff submission is calculated to be £5.55m. However, accounting for the exceptions that are set out below this gross surplus is adjusted to £2.39m. This difference is due to the exclusion of the benefit of free carbon allowances that were allocated to the GUA plant under the EU Emissions Trading Scheme. It would not be appropriate for these allowances to be included in the gain share calculations as this is a benefit that has already been captured for consumers. Based on this estimate the gain would be split £0.48m to PPB and £1.91m to Consumers.

5.7. Hence, for PPB to gain significantly from this mechanism the net benefit of the contracts would need to be significant and in which case consumer would benefit proportionately. It is worth noting that for PPB to make up their proposed reduction in price control allowance of £2.4m per annum, the gross surplus of the contracts would need to be £14m per annum.
5.8. Proposed amendments to the price control formulae in relation to this mechanism are set out in Section 6.

**Exceptions to Gain Share**

5.9. Two exceptions are being proposed in relation to the gain share mechanism to adjust the calculation of the gross surplus. These are detailed below:

I. UR are currently considering a number of applications from PPB in relation to recoverable costs. If approved, these will be a component of PPB’s excluded costs and will increase the Dt cost. Given that these relate to historic activity under the gain sharing arrangement this inclusion could be seen to artificially reduce the surplus in a future year which would reduce the share PPB would earn.

II. As described above PPB holds carbon credits that were obtained as a result of surplus free allowances that were allocated to the generators during Phase 2 of the European Union’s Emissions Trading Scheme (ETS). As a consequence PPB is currently meeting its ETS obligations by drawing down on these free allowances rather than incurring the cost of purchasing EUAs. PPB’s GUA costs are therefore currently understated. If the value of these allowances were not removed from the calculation of the surplus then customers would not benefit fully from those free allowances. It is proposed an adjustment for these carbon is added to the cost side of the calculation, thereby reducing the gross surplus, to ensure customers obtain the full value.
6. Proposed Price Control Structure

6.1. We propose that the new structure of the price control will remain largely consistent with the current price control, with the main changes being proposed in relation to the ‘gain share’ mechanism set out in this paper.

6.2. In line with previous PPB price controls, these proposals have implications for the Power NI Supply Licence\(^6\). The UR has considered these implications and presents them here so that consultation respondents understand the resulting implications of the price control.

6.3. Assuming the price control as proposed was to take effect, the following sections of the licence would be affected: Schedule 3 and Annex 3.

6.4. Annex 3 of the Supply Licence contains the formulae utilised to determine the revenues allowed to PPB within a price control period. Should the decision be taken to proceed with the gain share mechanism, this section of the Supply Licence would need to be updated to reflect that decision.

\textit{Proposed amendments to the Price Control Formula}

6.5. As described earlier PPB’s current price control formula is as follows:

\[
\text{MPPB}_t = A_t + D_t + E_t - \text{NPR}_t + \text{KB}_t
\]

6.6. In this formula, MPPB\(_t\) represents the PPB Amount which is the amount to be charged or rebated to NIE. The KB\(_t\) term is the correction factor that reconciles for the fact that when the tariff is set, estimates are made of all PPB’s costs under the GUAs, it’s price control entitlement, and the revenues PPB will earn from the various markets, and invariably such estimate will outturn to be incorrect and the KB\(_t\) term enables that forecasting error to be reconciled in the following year.

6.7. The remaining terms are the relevant terms that determine the magnitude of any surplus or deficit of market revenues compared to the aggregate of (i) the cost of the GUAs (At and Dt) and the PPB price control allowances (Et).

6.8. Using this formula the Gross (before any gain share) Surplus (GS) is determined as: \(\text{NPR}_t - \text{At} - \text{Dt} - \text{Et}\).

\(^6\) Most recent version of licence available online at [http://www.uregni.gov.uk/electricity/licences/](http://www.uregni.gov.uk/electricity/licences/)
6.9. To accommodate the gain share mechanism a new term, PGSt, is proposed to be included within the formula that would enable PPB to retain its share of the gross surplus. Where the surplus is between zero and £10m, PPB’s share would be 20% and where the surplus is greater than £10m, PPB’s share would be 20% of £10m plus 10% of (surplus – £10m).

6.10. This would result in the charge restriction formula becoming:

\[ MPPB_t = A_t + D_t + E_t + PGSt - NPR_t + KB_t \]

6.11. In addition to the above it is proposed that definition of ICt in the formula is amended to reflect the removal of the existing incentive mechanism and that to reporting obligations for in relation to the proposed PGSt term are included.
7. Draft Determination Summary

7.1. We have considered in detailed submissions from PPB, including their BEQ submission and their price control offer made in 2014 during our consideration of the GUA contracts.

7.2. Our proposed decision in relation to the allowed costs, the Et element, the subject of this PPB price control draft determination is set out in the following table:

Table 7.1 Draft Determination Summary

<table>
<thead>
<tr>
<th>Em</th>
<th>DEPn</th>
<th>RTNt</th>
<th>OPEX</th>
<th>WCF</th>
<th>Total ICt</th>
<th>ICt Profit</th>
<th>Profit (inc DEP, RTN)</th>
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<tbody>
<tr>
<td>Current Price Control Decision (in 2014 prices)</td>
<td>0.377</td>
<td>0.103</td>
<td>2.594</td>
<td>1.747</td>
<td>6.204</td>
<td>1.863</td>
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<td>UR Proposed Decision (in 2014 prices)</td>
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<td>0.044</td>
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<td>0.622</td>
<td>3.529</td>
<td>0.931</td>
<td>1.268</td>
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<td>-0.059</td>
<td>-0.618</td>
<td>-1.125</td>
<td>-2.675</td>
<td>-0.931</td>
<td>-1.074</td>
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</tbody>
</table>

7.3. We are minded to accept both the depreciation and the present value of the initial RAB at £0.950M as this is consistent with previous price control decisions.

7.4. We have not accepted PPB’s proposals in relation to WACC but have decided to apply the SONI WACC, which is consistent with previous price control decisions.

7.5. We propose to hold PPB to their price control proposals made during our consideration of the GUA contracts in relation to ICt profit and costs of working capital.

7.6. In relation to OPEX we propose to cap PPB’s allowance at £1.976m based on their latest best estimate costs for 2014/15. As a result PPB’s ICt allowance will be 43% lower than provided for in the current price control.

7.7. We are minded to accept proposals for the introduction of a ‘gain sharing’ mechanism to replace the current incentives contained within the ICt element of the price control formula. We believe this mechanism will provide PPB with a stronger incentive to maximise the consumer benefit of the contracts as both PPB and consumer benefits will be aligned.

7.8. Based on 2014/15 tariff submissions it is estimated that PPB will receive an additional benefit of £0.48m under the gain share arrangement. This amount will vary year on year and PPB’s benefit will be proportional to consumers benefit on a 80:20 basis up to the first £10m and 90:10 bases thereafter.
How to Respond

7.9. Responses are invited on any of the issues raised in this paper

7.10. Responses to this consultation paper should be sent to:

Natalie Dowey
Utility Regulator
Queens House
14 Queen Street
BELFAST
BT1 6ED

E-mail: nataliedowey@uregni.gov.uk

All responses must be received by 17.00 on Thursday 14th May 2015

Unless marked as confidential all responses will be published.

7.11. 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.

7.12. 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.
### Appendix A

<table>
<thead>
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