The Utility Regulator’s Approach to NIE’s Transmission and Distribution Price Control RP5

Stephen Littlechild
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Executive Summary

1. ESB has asked me to assess the UR’s approach to pensions costs, previous capital expenditure and the regulatory process generally, as exhibited in the ongoing RP5 price control review of NIE T&D.

Pensions Costs

2. The UR accepts NIE’s ongoing pension cost of £10.5m. But whereas NIE suggests a pension deficit repair cost of £66.7m, the UR proposes to reduce this to £11.8m. Its reasons are a) it declines to base the allowance on the latest estimate of the pension deficit, b) it argues that NIE T&D customers should not have to cover that part of the deficit attributable to NIE Powerteam, c) it prefers to spread the deficit over 15 years rather than the 11 years determined by the NIE T&D pension trustees, and d) it has gone back over the past three price control periods to recalculate what in its view NIE was required to contribute to or take from the pension pot.

3. In my view none of the UR’s arguments is persuasive. a) At a time of uncertainty it is prudent to have regard to the latest estimate of the pension deficit, as Ofgem did in GB. b) The accepted obligation on customers to meet NIE’s pension deficit costs should include Powerteam pension costs whether or not Powerteam is regarded as a separate entity. c) Ofgem’s decision to spread deficit costs over 15 years is understandable in the GB context where Ofgem was proposing significant increases in tariffs, but less persuasive in Northern Ireland where the UR is proposing a significant reduction in T&D charges. d) The UR’s RP4 pensions policy followed GB precedent in making limited adjustments for earlier years; Ofgem has not subsequently sought to reopen these issues, and there is no obvious case for the UR to do so in RP5.

Previous capital expenditure

4. The UR claims to have identified a change in capitalisation policy by NIE, has initiated an investigation into NIE T&D’s accounts in order to restate the regulatory accounts for previous years, and if appropriate intends to adjust the RAB for certain previous years.

5. I am advised that NIE does not accept the UR’s assertions about its capitalisation practice. I am not in a position to assess the arguments on this issue. I find it surprising that the UR has not sought to clarify and resolve this issue beforehand, rather than maximising regulatory uncertainty by including an unresolved allegation in the Draft Determination.
Assessing regulatory process

6. I have assessed the UR’s regulatory process in RP5 against the five Values that the UR has set itself. The most relevant are Transparency, Consistency and Proportionality.

Transparency

7. Transparency has been significantly impaired by the lack of real two-way engagement on the part of the UR, not least in the lack of planning of information flows during RP5 and the lack of discussion of the kinds of price control elements that the UR has had in mind. This leaves the impression that the UR has not been willing to understand the full implications of the policy that it now proposes.

Consistency

8. Consistency of the UR’s approach has been problematic in four respects. Its treatment of the pensions deficit and previous capital expenditure suggest an unwillingness to accept the implications of the UR’s own previous price control decisions. The UR’s change from active engagement to non-engagement is encapsulated in the view that “The manner in which previous price controls were carried out should not have a bearing on future price controls.” The UR’s return to the “traditional approach” to opex in RP5 makes no reference to the shortcomings that the UR had previously identified in the RP4 process, that were sufficiently serious to cause it to abandon that approach. The UR has been evasive, perhaps dissembling, on the question whether its presently proposed approach is generally consistent with GB regulation.

Proportionality

9. Proportionality is called into question by the volume of UR information requests from NIE during RP5, which were not well planned and discussed in advance, and by the likely regulatory costs of its proposed approach to capex. The UR is less sensitive to its own costs of regulation, and to the burden of regulation on the company and hence on consumers, than are GB regulators. This is the case even though the per capita cost of energy regulation by the UR is about six times that by Ofgem in GB.

10. Delivering price control determinations is said to be the UR’s bread and butter work, and a priority. However, the UR has failed to develop adequate price control workplans and timetables, has repeatedly failed to meet the timelines that it has suggested, and has unfairly blamed NIE for the slippage. The UR decided to roll over the previous price control RP4 for six months without consultation or licence modification, which is out of line with good regulatory practice. UR has indicated that capex should continue at RP4 levels but nothing has been proposed or agreed with respect to other price control determinants beyond 1 October 2012. This leaves NIE unable to make informed investment and operating plans.
Contrasting price controls

11. The Draft Determination cuts NIE’s proposed opex by about 25% and its proposed capex (Funds 1 and 2) by about 60%. These are more severe cuts than other UK regulators would normally consider reasonable.

12. The Draft Determination proposes a lower cost of capital than Ofgem has used. A ratings agency has commented that the Draft Determination “provides for more challenging financing assumptions than Fitch Ratings would normally expect for a UK regulator. … the proposals raise concerns that the financial profile of NIE could deteriorate over the next five years. … Fitch is not convinced that the draft determination actually provides for adequate capital market access for a business in a growth phase. It appears that UReg may interpret its financing duty materially different to other UK regulators.” (FitchRatings Comment, May 2012)

13. Outcomes, too, are different. The UR now proposes a price reduction of about 16% over 5 years whereas Ofgem considers that an average price increase of about 30% is necessary. This is in contrast with the last price control, where the UR was at pains to explain why the RP4 outcome for NIE was similar to that for the most comparable GB network companies because NIE faced the same issues as they did. Does NIE no longer face the same issues? Why should the situation suddenly have changed so radically?

14. There is another explanation. Recent reviews of Ofgem and ORR regulatory processes emphasise the importance of full engagement with the company and of good project management with detailed and realistic timetables. The UR process in RP5 does not bear comparison with best practice UK regulation. In several respects the UR’s conduct has fallen short of its own stated Values of Transparency, Consistency and Proportionality. I am afraid it suggests that the remarkable price reductions proposed in the Draft Determination are too good to be true; that they have been achieved, not by following the principles of good regulation, but by flouting them.

The implications for customers

15. This has direct implications for prices and customers. If a regulator is not transparent because it is unwilling to engage, if it does not act consistently with its previous price control commitments and due regulatory process, if its information requests and proposed price control arrangements put a disproportionate burden on the regulated company, and if it fails to develop and implement realistic work plans, then the company that it regulates will be unable to invest and operate in a way that best meets the needs of its customers. The company’s operating costs will be needlessly increased and its flexibility and responsiveness reduced. There will be a reluctance to invest. Regulatory uncertainty, inconsistency and lack of proportionality will impact adversely on the company’s cost of capital – in NIE’s case, as it competes for debt in the funding market against other utility companies whose regulators are more transparent, consistent and proportionate. Higher operating costs and cost of capital mean higher prices for customers.
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16. ESB, the owner of NIE, has asked me, as a former GB electricity regulator, to assess certain aspects of the present approach taken by the Northern Ireland Utility Regulator (UR) to the ongoing review (known as RP5) of NIE’s Transmission and Distribution Price Control. The specified aspects are the treatment of pensions costs and the approach to previous capital expenditure, both as set out in the UR’s Draft Determination of 19 April 2012, and the UR’s regulatory process generally during RP5.

1. The UR’s approach to pensions costs

17. NIE has proposed an allowance of £77.2m (in 2009/10 prices) to cover pensions costs during the RP5 price control period. This comprises £10.5m ongoing pension costs plus £66.7m deficit repair cost. The UR’s RP5 Draft Determination of May 2012 accepts the argument for £10.5m ongoing costs but allows only £24.3m in deficit repair costs. Further, it argues that the deficit is higher than it need have been as a result of various NIE actions in the past. To correct for this it proposes a reduction of £12.5m in the total amount allowed. UR’s proposal is thus for a net pensions allowance of £10.5m + 24.3m - £12.5m = £22.3m in RP5.

18. The UR summarises NIE’s calculation as follows.

10.2 NIE T&D’s submission was based on an actuarial assessment of the contributions required to fund ongoing costs and on a total pension scheme deficit of £150 million which took account of changes in funding position since the last formal valuation date (31 March 2011). They proposed that the deficit should be recovered over 11 years. NIE T&D assumed that consumers would fund the entire pension scheme deficit. (RP5 Summary p 25)

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19. In contrast, the UR made the following assumptions.

10.5 We reviewed the most recent actuarial valuation report, dated 31 March 2011 for the NIE Pension Scheme which reports a total deficit of £87.6 million. … we propose that 79% of the NIE Pension Scheme deficit at the formal valuation date can be allocated to NIE T&D. This equates to £69.2 million (79% x £87.6 million). In addition to this, we propose that the deficit be recovered over a period of fifteen years in line with recent GB regulatory precedent. During RP5, we therefore propose that an amount of £24.3 million can be recovered. (RP5 Summary p 26)

1.1 The date of valuation

20. The UR proposes to use the £87.6m deficit existing at the formal valuation date (31 March 2011), whereas NIE proposes an updated version to take account of market changes (adverse investment conditions) experienced since the valuation date. The figure of £150m is the deficit amount that was agreed in a recovery plan between NIE and the pension scheme trustees. The UR asserts that it “makes sense” to use the formal valuation, but gives no reason for this preference other than citing the NIE actuaries’ formal note accompanying their update, that “The information….is designed to give a broad picture of the direction of funding changes since the last actuarial valuation but does not have the same level of reliability as, and therefore does not replace the need for, formal actuarial valuations”. (RP5 Draft Determination para 11.26 p 116)

21. I understand that the UR requested NIE to bring forward its formal valuation from March 2012 to March 2011. If RP5 had proceeded according to the original timetable, this would have provided a formal valuation 12 months before the beginning of the new price control. With the present slippage in the price control review, whereby the final price control proposal is now said to be due “before the end of the year” (2012), it seems as though the new price control may not be in place until March 2013. This means that the formal valuation in March 2011 will be about 24 months out of date.

22. In setting its latest distribution price control, Ofgem took a different view. Its final proposals in December 2009, for new controls to be implemented in March 2010, were based on actuarial valuations provided by the companies as of 30 September 2009. In other words, these valuations were only 6 months away from the initiation of the price controls. Ofgem explained

“5.11. We consider that in times of significant movements in financial markets and uncertain economic conditions, that the latest valuation provides the most appropriate estimate of the level of deficit. … We … have used the September valuations provided to us by the DNOs, even where some companies have had a full triennial valuation at 31 March 2009, since there have been material changes in estimated deficits subsequent to those valuations. (Ofgem, Final proposals – allowed revenues and financial issues, 7 December 2009 p 34)

23. There are still uncertain economic conditions, and a valuation of £150m surely represents a material change in estimated deficit compared to the March 2011
valuation of £87.6m. Since the UR has committed to accounting for any subsequent change in valuation at the next price control review (RP6), it is not clear why it would be preferable to ignore the latest available information on the material change in estimated pensions deficit.

1.2 The deficit recovery period

24. NIE proposed that the deficit be recovered over 11 years, this being the period agreed with pension trustees in January 2012. The UR notes that NIE T&D is a monopoly network provider and that consumers should bear the costs of unavoidable deficit costs. It then says “All of this represents a significantly strong covenant for trustees, and provides justification for a longer deficit recovery period.” (para 11.39, p 119) Actually, although it suggests that a longer deficit recovery period is feasible, it provides no justification for a longer period.

25. The UR notes recent regulatory precedent varying from 10 to 15 years, then proposes that the allowed pensions deficit be recovered over 15 years “in line with recent GB regulatory precedent”. Ofgem considered carefully what period to choose, and opted for 15 years for two main reasons.

5.7. The impact on business and domestic consumers in DPCR5 of moving to a shorter period would be substantial.... Spreading the funding of repair payments over 15 years lowers the burden on existing customers. It also allows more time for the uncertainty to reduce about whether the deficits will diminish as the economy recovers. This will reduce the risk that consumers fund the deficits at a faster rate than is necessary during the deepest recession of the last seventy years. (Ofgem, Final proposals – allowed revenues and financial issues, 7 December 2009 p 35)

26. Whether there is more or less uncertainty about the economy now than there was in December 2009 is debateable. However, from the regulatory perspective, there is a significant difference between the situations of the GB consumers then and the Northern Ireland consumers now. Ofgem was proposing a new price control that would increase electricity distribution charges by an average of 5.6% per year in real terms – an increase of about 30% by the end of five years. (The precise rate of price change varied by distribution company, and in the highest case amounted to an increase of 11.1% per year, getting on for 70% over 5 years.) In contrast, the UR is proposing a new price control that would reduce NIE T&D charges by over 3% per year in real terms – a reduction of about 16% over 5 years for domestic customers.

27. Reducing prices is tempting for regulators – in the short term. Customers would always prefer lower prices to higher ones. But that is not really the choice that they – and the regulator on their behalf – actually face. With respect to both the pension deficit valuation date and the pension deficit recovery period, the question is whether the regulator is justified in reducing the burden on today’s customers at the expense of a greater burden (by virtue of the interest payable) on tomorrow’s customers. If network prices have to rise significantly anyway, the case for deferral may be stronger. But if network
prices are falling, or remaining broadly constant, the case for putting off the pain and storing it up for later is much less obvious. The UR’s Draft Determination does not address this issue.

28. I understand that NIE does not believe that the UR’s proposed price reductions are sustainable. NIE’s own proposal would imply a tariff increase of some 20% over 5 years. On that basis, and for consistency with Ofgem’s GB regulation, NIE is prepared to accept a 15 year deficit recovery period. But if the UR maintains that tariffs should fall instead of rise, and rejects consistency with Ofgem’s GB regulation on other issues, it is not clear what justification the UR has for extending the deficit repair period.

1.3 The treatment of Powerteam

29. The UR argues that NIE Powerteam Ltd is a separate legal entity from NIE T&D. On that basis, the UR says that the price control should not recover the share of pension deficit attributed to Powerteam. NIE, in contrast, explains that Powerteam employees are exclusively engaged on NIE-related activities. NIE should therefore be able to recover the share of pension deficit costs allocated to Powerteam.

30. The UR says
   “Powerteam effectively operates as a department of T&D. NIE T&D uses Powerteam for the majority of its subcontracted labour work on the network. Powerteam provides network services including metering, meter reading, overhead lines, customer operations and plant/technical support to NIE T&D, as well as providing other support functions under managed service contracts.” (Draft Determination, para 2.21 p 7)

31. Some of the GB networks have from time to time contracted out activities such as meter-reading or IT. One might assume from the UR’s discussion and proposal that NIE and Powerteam operate in a similar way that. In fact, that is not the case: I understand that Powerteam employs about 1000 of NIE’s 1300 staff. It is not a peripheral activity, it is the core of NIE’s staff. The two organisations operate in an integrated way. As UR’s description continues
   “Given the organisational structure, a number of business functions are shared across T&D and Powerteam. Examples include: telecoms, IT, corporate service allocations, finance, technical, facilities management, HR and business improvement.”

32. The UR acknowledged the current Powerteam arrangements in the RP4 price control through the inclusion of a specific profit-sharing term in NIE’s regulatory formula (viz. 50/50 sharing between NIE and customers). This is strong evidence that the UR endorsed the Powerteam model. There was no suggestion that this arrangement would remove or shift the obligation to fund the pension deficit. Similarly, if the Powerteam arrangement were to be discontinued, as the UR now suggests, the UR has not suggested that NIE customers should no longer cover NIE’s full pension deficit.

33. In principle, there seem to be two regulatory options. If Powerteam is regarded as essentially the same entity as NIE, then NIE’s price control should include the recovery of Powerteam’s share of the pension deficit costs. But if,
hypothetically, Powerteam were regarded as a separate entity from NIE, then the charges for Powerteam’s services to NIE should include a contribution to cover Powerteam’s share of pension deficit costs. Either way, the accepted obligation on customers of NIE to pay the pension deficit costs should include whatever share of the pension deficit costs might be deemed associated with Powerteam.

1.4 Adjusting for past actions

34. The UR argues that consumers should pay only once for costs which were either efficiently incurred or legally unavoidable. To ensure this, it says that it is necessary to carry out a historic analysis, to identify actions that were either inefficient or legally avoidable, and then to assess the impact of these actions on the present deficit. The UR identifies four types of action that have impacted on the deficit, viz: special contributions (+£77.5m), actual contributions less price control allowances (+£30.9m), benefit improvements (-£86.0m) and early retirements (-£61.9m), net total -£39.5m. This is equivalent to -£36.7m in 2009/10 prices, of which NIE’s 91% share would be £33.4m. Paid back to consumers over 15 years this would be -£12.5m during RP5.

35. The UR’s aim that customers should pay only once for costs is a valid consideration. But it is not the only one. In its recent statement Principles For Economic Regulation (BIS April 2011), discussed further below, the Government says

- the framework for economic regulation should provide a stable and objective environment enabling all those affected to anticipate the context for future decisions and to make long term investment decisions with confidence
- the framework of economic regulation should not unreasonably unravel past decisions…

36. The deficit-related actions that the UR has identified date back to price control periods RP4, RP3 and RP2, almost 15 years in some cases. Furthermore, the UR itself has previously addressed these issues. In its PR4 price control proposal of December 2005 the UR made an explicit adjustment relating to pension costs.

NIE has argued that pensions should be allowed on the same rolling basis proposed for controllable costs. The Authority accepts that most of the company’s pensions costs should be allowed on this basis. However, following precedent set in the price control for the GB Distribution Network Operators (DNOs), the Authority considers that 30% of the pension costs relating to early retirement deficiency costs should be disallowed. This is an amount of c£225k per annum and will be deducted from the rolling Opex calculation. (p 6)

37. The pensions-related actions now identified by the UR were all ascertainable shortly after the time they occurred, at least in general terms. When it set the RP4 price control, the UR must be presumed to have considered the situation and decided, like Ofgem, that it would make an explicit adjustment only for those items related to early retirement payments. For the UR now to reopen
these issues and to take a different approach is surely to “unreasonably unravel past decisions”.

38. It might be argued that NIE took certain actions subsequent to the UR’s RP4 decision in December 2005. The Draft Determination suggests that NIE might have made further contributions during RP4. But these would contribute to reducing the pension deficit rather than to increasing it.

39. In proposing to reduce the pension deficit over 15 years, the UR argues that this is “consistent with recent GB regulatory practice.” But are the other elements of its pension proposals equally consistent with recent GB regulatory practice?

40. Ofgem has considered pensions issues carefully, in numerous consultations. Having done so, it has made no calculations over the last three price control periods, and made no corresponding adjustment to the allowable pension deficits. On the contrary, Ofgem has emphasised that customers will pay such pension deficits as exist at the end of March 2010, apart from the aforementioned adjustment for early retirement pensions. For Ofgem, the main issue has been how best to ensure that pension costs are minimised on a forward-looking basis.

41. In sum, neither the objective of providing a stable environment to encourage investment, nor consistency with previous UR decisions, nor “consistency with recent GB regulatory practice”, would support the UR’s present proposal to reduce NIE’s allowed revenue by calculating the impact on the pension deficit of NIE’s actions over the last three price control periods and retrospectively adjusting for that.

42. The UR’s pensions proposals leave the impression that the UR is acting on an opportunistic rather than principled basis, seeking any justification for a short-term price reduction.

2. The UR’s approach to previous capital expenditure

43. In setting the RP4 control, the UR adopted a new approach to the treatment of capex and controllable opex. Controllable opex was based on a five year rolling mechanism, while the RAB was updated to reflect actual capex on an ongoing basis.

44. In evaluating experience to date, the UR notes that during RP3 NIE’s controllable opex fell from £53.5m in year 1 to £29.1m in year 5. In its RP5 Draft Determination the UR says there was a step change of 23% between year 3 (£44m) and year 4 (£33.9m). It says that, in year 4 of RP3, NIE made changes to its capitalisation practice, so as to increase the proportion of expenditure that is characterised as capex rather than opex. The UR says that this was not made known when it set the control. Had the UR known of this, it might have adjusted the RP4 controllable opex allowance accordingly. Accordingly, the UR initiated an investigation into NIE T&D’s accounts. UR’s intention is to restate the regulatory accounts for the period from 2005/6 onwards, to assess the extent of any double payment that consumers may have
made during RP3 and RP4, and if appropriate to adjust the RAB for the relevant years of RP3 and RP4. The UR’s recent press release (9 July 2012) says that an interim report suggests that there has been a material double payment by customers.

45. Whether it is reasonable to describe the £10.1m fall in opex from year 3 to year 4 of RP3 as a “step change” is debatable, given that there were varying but substantial reductions from each year to the next during that period, totalling £24.4m in four steps. The phrase suggests that there was something suspicious about a significant cost reduction from year 3 to 4. However, a regulator would not find such a pattern of operating cost reduction surprising. A company engaged in debate with its regulator about the scope for future cost reductions is unlikely to announce a major cost reduction as it goes into those negotiations. Such a company would find it better to make the cost reductions after the next control is agreed. Indeed, so familiar is this practice that Ofgem introduced a price control modification precisely to address this issue, which the UR now proposes to adopt, whereby a company is allowed to keep opex savings for a fixed period of five years, regardless of when they are made.

46. I am advised that NIE does not accept the UR’s assertions about its capitalisation practice. I am not in a position to assess the arguments on this issue. But I do find it surprising that the UR should make this rather serious allegation about NIE’s conduct in its Draft Determination, rather than seek to resolve it beforehand. The alleged change in capitalisation policy is said to have taken place in about December 2005, during RP3. That was over six years ago. If the UR had not identified this issue during the course of RP4, it would have done so at an early stage during the course of the RP5 review, once it had received answers to the questions it put to NIE. Why was the UR’s present concern not discussed with NIE immediately, with the aim of resolving it before a public statement on the price control? Quite apart from the aspersion cast on the company and the implications for the adequacy of regulatory supervision and the regulatory relationship, the present approach has surely maximised the extent of regulatory uncertainty on this issue, which will have adverse implications for the cost of capital and hence for prices to customers.

3. The UR’s regulatory process during RP5

47. Against what criteria should one evaluate the UR’s regulatory process? The UR’s website, under the heading “About Us: Who we are”, sets out the Values to which it aspires. First among these is “Be a best practice regulator: transparent, consistent, proportional, accountable and targeted”. These are the five Principles of Regulation initially defined by the Better Regulation Task Force in 1997. They have subsequently been made applicable to, or been adopted by, other UK utility regulators. They have also been used by other UK utility regulators as the benchmark against which to assess their own regulatory process.²

² E.g. Independent PR08 Programme Evaluation, Report to the ORR Board, 5 August 2009, s 3.6.
48. The present Government has recently stressed the importance of a sound regulatory framework in its *Principles For Economic Regulation* (BIS April 2011). These principles are “intended to articulate the factors that are key to the high level design of the frameworks for economic regulation, not to guide detailed application of regulators’ judgement in carrying out their functions”. Nevertheless, they are consistent with and enhance the Five Principles, and provide some further insight into the meaning and importance of these principles.

49. The aim of the present section is to assess how far the UR’s regulatory process in RP5 is consistent with its five Values. In the limited time available, I have not sought to assess every UR regulatory action against every regulatory Value. Rather, I have examined a number of aspects of the UR’s process that at first sight do not appear to be fully consistent with some of these Values.

4. Targeted

50. The Value that regulation should be targeted is principally addressed to the question whether particular activities should be regulated in detail or subject to competition. It is generally accepted that T&D networks have limited prospects for competition, and require regulation. I therefore do not explore this Value here, other than to note that, within the area of T&D regulation, there is a question whether the proposed regulatory approach is well targeted on the areas of concern. This can be dealt with under the Value of proportionality.

5. Accountable

51. The Value that regulation should be accountable is discussed in a section headed “Reinforcing accountability”, where the BIS Principles say:

31. Effective accountability of a regulatory framework therefore depends on transparency, a requirement to explain decision making, exposure to scrutiny and the right to challenge decisions.

32. Open and committed consultation about proposals plays an important role in strengthening transparency. It ensures that all parties can see and understand the logic and direction of travel of a regulator’s deliberations.

33. At the same time, publication of the reasons for regulatory decisions after the event provide clarity about their basis and rationale to help guide assessments of whether they were appropriate and proportionate judgements.

52. Since the RP5 process is not yet complete, it is premature to assess whether the UR will fully explain “the reasons for regulatory decisions after the event”. It is fair to say that the RP5 Draft Determination of April 2012 does indeed explain its reasoning so far. Similarly, “exposure to scrutiny and the right to challenge decisions” are not presently at issue. Of more immediate concern is the first point cited above. “Effective accountability of a regulatory framework depends on transparency”.


6. Transparent

53. This discussion of accountability reinforces the importance of the first of the regulatory Values: **transparency**. Is the UR’s consultation process such as to strengthen transparency? Is it ensuring “that all parties can see and understand the logic and direction of travel” of the UR’s deliberations?

54. The UR’s main published documents in RP5 have been the Strategy Paper of July 2010, the Update of May 2011 and the Draft Determination of April 2012. These do not seem particularly problematic from a transparency perspective. They set out and explain the main aspects of the UR’s thinking. Of more concern is the regulatory process **between** the publication of these documents. The critical question here is the extent of real engagement.

55. Documents issued by the UR (e.g. Draft Determination paras 9.43, 9.47), and the published minutes of its Board meetings, make reference to meetings and engagement with NIE. In contrast, NIE has told the UR that there has been little or no real engagement on the price control during this period.

To date, the flow of information has been very much one-way - from NIE to the UR. Apart from the information provided in the Strategy Paper Update (which in the main was limited to confirmation of separate price controls, five year duration, and continuation of RPI-X and post tax WACC) and an initial assessment of capex (which revealed a very low figure for RP5 capex which is not at all credible) the UR has provided very little insight into how its thinking is developing.

As you know from our earlier representations, by this stage in the process NIE would have preferred to have had more meaningful two-way interaction in the form of discussion and debate with senior UR staff and your consultants on the emerging positions the UR is minded to adopt across the various workstreams in formulating its Draft Determination. This would have been more in keeping with previous UR reviews of NIE’s price controls and Ofgem’s reviews of the Distribution Network Operator (DNO) price controls in GB, where in each case there was substantive two-way dialogue at an earlier stage. (Letter J O’Mahoney to S Lynch 16 Feb 2012)

56. The UR responded as follows.

The Utility Regulator disagrees with NIE that the flow of information has been very much one-way. The Utility Regulator has required time to gather information and understand NIE’s submission. NIE will have ample opportunity during the consultation period to express its views and the Utility Regulator will be happy to fully engage with NIE during consultation period. It should be noted that the interaction between the Utility Regulator and NIE for this price control is not a negotiation. The manner in which previous price controls were carried out should not have a bearing on future price controls. (Letter T Wishart to J O’Mahoney 22 March 2012)

57. The UR’s practice stands in contrast to practice in GB, which has evolved over time but has always incorporated a significantly greater extent of mutual discussion than exhibited during RP5. For example, in the GB energy sector, it would be normal for Ofgem and the companies to discuss the design and timetabling of the price control review, the design of the initial Business Plan
Questionnaires in the light of data availability and the time and costs involved, and the work and findings of consultants advising the regulator on opex and capex. It would be standard practice for these consultants to visit the companies, to try to understand the reasons for the companies’ own plans and to test out their own thoughts on the companies’ engineers and management. There would also be at least one meeting between the top regulatory team and each company before the publication of any Draft Determination, at which ideas and arguments would be exchanged. This makes it possible for each company to understand and explore the development of the regulator’s thinking on the price control.

58. My understanding is that very little such engagement happened in RP5, and to the extent that it did happen it was largely ignored by the UR. For example, the UR discussed the original form of the data tables with NIE in May 2010. The UR said that the format of the questionnaire would be similar to the information reported internally within NIE. The company reviewed and responded to the UR’s draft questionnaire in June 2010, in anticipation of the formal questionnaire being issued later that month.

59. At a meeting on 2 July 2010 the UR indicated that the questionnaire was unlikely to be issued before the end of October. When, in October, the UR issued a second draft questionnaire seeking comments from NIE, it asked for them within one week. But the scope of the questionnaire had changed substantially from the first draft. Historical information on operating costs was requested for RP3 that had never been requested before, and when the official questionnaire was issued in late October 2010 it was accompanied by a substantial number of questions the detail of which had not been discussed with NIE. The BPQ and questionnaire were much more detailed than in any previous price control review. NIE have said that the UR indicated that this would limit the number of follow-up information requests, but that turned out not to be the case.

60. Another example of the lack of real engagement is the UR’s approach to the collection of data about NIE Powerteam. At the initial meeting in May 2010, the UR had discussed Powerteam and were to give consideration to whether a separate questionnaire would be required. It was only in October 2010 that NIE was made aware of the requirement to complete a questionnaire for Powerteam. The first draft BPQ provided for Powerteam was essentially the same as for NIE T&D except for the company name change, even though the businesses are quite different. NIE had to redraft the Powerteam BPQ to make it relevant.

61. The lack of engagement may have contributed to the UR being unsympathetic and unrealistic in terms of timescales for responses to their demands for information. For example, the UR failed to realise that it is not straightforward for NIE to respond to data requests for RP2 and RP3 when staff have moved on and the information is not readily available. A number of UR information requests after the BPQ were marked urgent, requiring a response the next day or within the next two days. Yet, as I suggest below, the price control process as a whole lacked any coherent timetable. NIE’s perception is also that the UR have some relatively inexperienced staff, who are not well coordinated, do not
have a good understanding of the information they receive and do not pay particular attention to detail.

62. I am astonished that the UR’s engineering consultants did not even deem it necessary or appropriate to make site-visits to the company’s network and premises. Thus, not only is it difficult for the company “to see and understand the logic of the UR’s direction of travel”, there must also be a question as to whether the UR has taken every available opportunity fully to inform itself about the relevant circumstances of the company that it regulates. More generally, although the UR has asked many questions and obtained much information, the lack of real two-way engagement up to the issue of the Draft Determination increases the chances that the UR may not have understood fully the information that the company has provided, or the circumstances in which it is to be applied, or the implications of particular directions of travel.

63. In correspondence and elsewhere, the UR repeatedly affirmed that there would be an opportunity for full engagement with the company during the consultation period on the Draft Determination. However, given that NIE has not been consulted on the UR’s thinking hitherto, its priority at this late stage is to prepare its response to the Draft Determination. Moreover, there must be a question whether a regulator can be as open-minded to information, discussion and argument after it has publicly committed to a Draft Determination as it can be before that.

64. The lack of engagement during RP5, by the UR and its consultants, leaves the impression that the UR has demanded information from NIE but not sought to get or understand NIE’s views. It is understandable that a regulator should seek to take a tough line with a regulated company. But in doing so the UR does not seem to have been willing to try to understand the full picture. It seems to have avoided information, views or consequences that are inconvenient for the line that it wishes to take.

7. Consistent

65. As regards the regulatory Value of consistency, under the sub-heading “Coherent, adaptable but stable regulation”, the BIS document says

25. Efficient investment is an important part of promoting the long-term interests of consumers. It is important that the regulatory frameworks avoid adding undue uncertainty to the business environment.
26. To a large extent this is achieved by building a stable and transparent regulatory environment with a long track record of consistent regulatory decision making. A history of rational regulatory decisions, which can be objectively justified, creates an expectation that a narrow set of outcomes will follow a given set of circumstances. This in turn will help both investors and consumers to predict regulatory decisions. On the other hand, piecemeal, ad hoc or unanticipated changes in policy or regulatory responsibilities are likely to erode investor confidence and increase the cost of capital.

66. In discussing predictability, the document says
• the framework for economic regulation should provide a stable and objective environment enabling all those affected to anticipate the context for future decisions and to make long term investment decisions with confidence
• the framework of economic regulation should not unreasonably unravel past decisions, and should allow efficient and necessary investments to receive a reasonable return, subject to the normal risks inherent in markets

67. It is to be expected that a regulator will seek to evaluate previous policy and practice, to make adjustments where appropriate, and to explore innovations. Nonetheless, at least four aspects of consistency – or inconsistency – in the RP5 process and Draft Determination are potentially concerning.

7.1 Respect for previous UR policy

68. It has already been noted that the UR’s proposed policy on pensions and on previous capital expenditure in the RAB suggest an unwillingness to accept the UR’s previous policy on these issues. A change of direction going forwards is understandable, but to recalculate previous price control entitlements as if different regulatory rules had been in operation is another matter. The proposed policies do not seem consistent with the principle that “the framework of economic regulation should not unreasonably unravel past decisions”.

7.2 Consistency of regulatory process

69. There has also been an explicit change in the UR’s regulatory approach. The UR’s RP4 proposals explained the reasons for the UR’s approach at that time.

Following difficult negotiations between Ofreg and NIE the second price control for the T&D business was eventually settled following the 1996 referral to the Monopolies and Mergers Commission. The third price control (RP3) was agreed between the regulator and the company but not without hard negotiations and extensive and expensive work agendas for both parties. It was felt by both parties that a satisfactory outcome could be reached for the price control for the fourth regulatory period (RP4) by adopting a collaborative approach. (p 3)

70. In contrast, when NIE expressed its concern about the lack of real engagement during the RP5 process, as discussed above, the UR rather bluntly responded, “The manner in which previous price controls were carried out should not have a bearing on future price controls.” (T Wishart letter to J O’Mahoney 22 March 2012) It is difficult to reconcile this stance with the UR’s Value of consistency. There appears to be no recognition of the problematic history that caused the UR to take the approach it did in RP4, or of the potential disadvantage of instigating a return to such a problematic relationship in future.
7.3 Consistency with traditional price control approach

71. In its RP4 proposals, the UR summarised what it called “the traditional approach” to setting the opex allowance.

“The work typically involved an examination of the company’s operating cost base, benchmarking it against the cost bases of other electricity network companies both nationally and internationally, and undertaking a very detailed item by item analysis of individual expenditure categories.” (p 5)

72. The UR commented that this method was “time-consuming and resource-intensive, and differences in the way that companies report their costs adds to the difficulty in ensuring that efficiency comparisons are made on a like-for-like basis”. The UR also explained the problem of capex underspend in the traditional approach to the capex allowance. These concerns led the UR to take a different approach in RP4.

“In a move away from the traditional methods applied to a price control a number of new approaches to incentive mechanisms were introduced for RP4. These included a ‘rolling’ Opex mechanism and setting Capex using actual rather than forecast expenditure. An evaluation of these mechanisms will be required to assess the appropriateness of continuing with them in RP5.” (RP5 Strategy Paper p 2)

73. In its RP5 Draft Determination, the UR moves into reverse. “For RP5 we are minded to return to a traditional RPI-X type price control, with allowances designed to incentivise NIE T&D to control its operating and capital costs.” (para 4.14 p 15) The rolling opex mechanism is replaced by a five year lag mechanism, as used in GB, and the ex post capex mechanism is replaced by an ex ante capex allowance with provision for a Reporter.

74. It is understandable that a regulator should review the operation of the various components of a price control, and where appropriate propose changes on a going-forward basis. Two aspects of the present proposal are of some concern, however. First, in proposing a return to the “traditional approach” to opex, the UR makes no reference to the shortcomings that it had previously identified in the RP4 process, that were sufficiently serious to cause it to abandon that approach. Second, there is no acknowledgement or exploration of the additional regulatory burden – that might be expected to have similar shortcomings - associated with the proposed ex ante capex allowance and Reporter system. In consequence, whether this increased regulatory involvement can be fairly described as “a traditional RPI-X type price control” or an “allowance designed to incentivise NIE” is questionable. The regulatory burden is examined further below.

7.4 Consistency with GB regulation

75. Previous UR documents have identified consistency with regulatory policy in GB as an important consideration. Indeed, GB inputs have at times been critical inputs in setting the NIE control. For example, “For RP3, the Utility Regulator made extensive use of comparisons with Great Britain’s distribution
network operators and historical savings in setting the baseline revenue and efficiency targets.” (UR Strategy Paper p 12)

76. NIE has stressed to the UR the importance of this issue for its own business, because of the implications for investor confidence, cost of capital and ultimately prices to customers.

“As set out in our response to the UR’s consultation on a cross-utility approach to network price controls, it is most important that the regulatory framework within which NIE operates maintains a clear and stated alignment with GB regulatory precedent. This means having an approach consistent with that applied by Ofgem to the GB DNOs. Given Ofgem’s influence on most of the UK electricity industry, maintaining a link to GB precedent and current approach is crucially important to support investor confidence in the electricity industry in NI.” (J O’Mahoney letter to S Lynch 16 Feb 2012)

77. The UR responded by saying “Alignment with GB: The Utility Regulator can confirm that the price control follows the philosophy of the Zeus consultation.” (T Wishart letter to J O’Mahoney 22 March 2012)

78. This is a somewhat troublesome response, not simply because it illustrates a reluctance to engage, as discussed above. It also epitomises a classic “Sir Humphrey” technique: answering a question slightly different to the one that was actually posed, in such a way as to appear to give a reassuring answer, when in fact this is not the case. The “philosophy of the Zeus consultation” refers to the UR’s proposal for a cross-utility approach to network price controls within Northern Ireland. While the relevant discussion document did indeed make reference to the GB approach, it did not propose “a clear and stated alignment with GB regulatory precedent”. It is evident from numerous aspects of the present paper that the UR’s proposed approach is explicitly not aligned with GB regulatory precedent in many critical respects.

79. Accordingly, a more honest and constructive response to NIE’s letter would have been to acknowledge NIE’s concern and to identify and invite discussion of those aspects on which the proposed price control approach might be said to differ from GB precedent, and the reasons for the UR taking its chosen approach. In the absence of such a response, there necessarily remains some doubt to whether, or to what extent, the UR proposals are in fact aligned with GB precedent, and a residual suspicion of the UR’s regulatory consistency. In consequence, investors will be uncertain how far they should factor some additional risk element into the cost of capital in Northern Ireland.

8. Proportional

80. Under the subheading “Effective and proportionate regulation”, the BIS document says

40. Economic regulation, as with most forms of regulation, imposes costs on regulated companies. These costs derive from the regulatory cost the regulators impose on their sectors and the administrative cost of running the regulatory institutions. Costs in these sectors tend to be passed through to end
consumers. It is important that they are proportionate and outweighed by the benefits achieved for consumers.

8.1 Regulatory burden

81. NIE has drawn attention to the burden imposed by the RP5 price control review process. Examples include answering almost 300 questions and populating some 45 spreadsheets in response to the Business Plan Questionnaire (BPQ), providing 15 BPQ support papers and 43 strategy papers, answering 150 follow-up questions on opex and related issues plus over 300 follow-up questions on capex. (Letter of J O’Mahoney to S Lynch 16 Feb 2012) In addition, many of the follow-up questions went back to previous price control periods, even back to privatisation, which were particularly time-consuming to answer.

82. The UR’s Draft Determination notes that it received narratives, spreadsheets and databases for a dozen different activities of NIE T&D and also NIE Powerteam. It also says “Although we did not request them, we were pleased to receive supporting papers” relating to some 16 issues. (para 4.21) Lest it be thought that NIE brought additional and unnecessary work upon itself in respect of these support papers, note that they were all on matters integral to a modern price control, provided by consultants well experienced in providing similar material to and for regulators in GB.

83. The proposals in the UR’s Draft Determination are also likely to increase the costs of implementing and monitoring the price control. For example, the proposed approach to capex (para 9.82 et seq) will require the UR to specify in some detail what capex is to be delivered (Fund 1), and to approve subsequent proposals related to renewable generation (Fund 3), which will require cost-benefit analyses. A Reporter is required to verify actual volumes delivered and actual costs incurred, to report on asset management practices and the development of asset health indices, and (for Fund 2) to verify the need for the work that is undertaken and whether or not the costs have been incurred efficiently.

8.2 Regulatory costs

84. The costs imposed by the UR’s questions and proposals have been and will be substantial. As the BIS document recognises, over the long term these costs will be passed on to customers.

85. Are the costs imposed by the UR nonetheless proportionate? All regulators argue that the cost of their offices is relatively small per customer, and is therefore worth incurring. But the leading UK regulators have shown considerable sensitivity to this burden, and have sought to reduce it. Statements by Ofgem3 and Ofwat4 illustrate this. Such awareness is not apparent in the UR’s recent price control statements.

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3 For example, Ofgem has said “We also recognised that the requirement for a single historical data request during a price control placed too heavy a burden on the DNOs to produce data that their systems were not developed to provide.” (Ofgem, Electricity Distribution Price Control Review, Methodology and Initial Results, 8 May 2009, para 1.12 p 6)

4 Ofwat's response to the draft determination is also indicative of the sensitivity of UK regulators to the burden imposed by the regulatory process.
86. The BIS document continues

41. As organisations, regulators should be efficient and well run, maximising the benefit they can deliver with their available budgets. As regulators, their interventions and tools should deliver desired outcomes in the least burdensome way, based on the established best practice for designing regulation. This means imposing requirements only where necessary, considering alternatives to regulation and minimising the risk of unintended consequences.

87. What is the evidence on the costs of the UR relative to regulatory costs elsewhere in the UK? Consider the evidence provided by the accounts of each regulatory body for the year ended March 2011. Ofgem’s annual cost recovered in licence fees is £31m. Divided by the 60.4m population of GB this amounts to 51p per head of population. The annual cost of Ofwat plus WICS in Scotland is £17.9m + £3.9m = £21.8m, or 36p per head. The total cost of energy plus water regulation in GB is therefore about 87p per capita. In Northern Ireland, the annual cost of UR is £7m. Divided by the population of 1.8m this is about £3.89 per head. In other words, the per capita cost of regulation by UR is about four and a half times the comparable cost of regulation in GB.

88. UR’s accounts show the breakdown in cost by sector. Water regulation costs £1.6m, an annual cost of 89p per head. This is more than double Ofwat’s annual cost (32p) but less than 20% higher than the cost of water regulation in Scotland (75p).

89. The higher cost of regulation by UR derives mainly from the energy sector. There, the annual cost is £3.7m for electricity + £1.7m for gas, an average of £3.00 per head. Energy regulation by the UR thus costs about six times per capita what Ofgem costs in GB.

90. This calls into question whether the UR is acting proportionately in devoting so many resources to energy regulation, and whether it is designing its regulatory approach in such a way as to work within, and to make best use of, the resources that it has available.

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4 For example, Ofwat has said “The way we set and monitor outputs has become increasingly complex and data intensive for us, the companies, and other regulators and stakeholders. This was confirmed in ‘Lessons from our approach to setting price limits (PR09)’, a report we published in December 2010. This document detailed concerns from stakeholders that the price review process had become increasingly burdensome and complex and – as a result – less transparent. …As the complexity has grown, so the risk of unintended or undesirable consequences and conflicting outputs has increased. … Setting detailed outputs also tends to fuel detailed monitoring – with the danger that real issues are lost in detail. In turn, this monitoring tends to feed even more detailed outputs at the following price reviews, as adjustments are made in the light of experience.” (Ofwat, Future price limits – a consultation on the framework, 22 Nov 2011, s 3.2 p 20)
8.3 Timely regulatory decisions

91. In its discussion of proportionate regulation, the BIS document says

43. As well as being cost-effective, regulatory decisions need to be made in a
timely manner. Infrastructure investments have long lead times. Delays to
key decisions can cause uncertainty and raise the costs to industry or leave
consumers unprotected.

92. In its draft Forward Work Plan of October 2010, the UR said of the RP5 price
control review:

This will require intensive work over the next two years scrutinising
investment plans, financing and operating costs and establishing appropriate
price controls. We see this as a priority project and we will divert resources
from other projects if this becomes necessary. (p 12)

In his Foreword to the UR’s 2010-11 Annual Report, the Chairman said “We
continue to focus on our bread and butter work such as delivering price control
determinations.” What then is UR’s record with respect to the timing of
delivery of RP5?

93. The RP4 price control was due to expire on 31 March 2012, with the next
control due to begin in April 2012. The UR issued a timeline to NIE on 4
February 2010. This showed the BPQ issueing in May 2010, and the Final
Determination issueing in November 2011. However, the BPQ did not issue
until October 2010. The UR issued a new timeline to NIE indicating that the
Final Determination would slip to March 2012.

94. The UR’s Strategy Paper in July 2010 said that the next consultation phase
would be in Q4 2010. No consultation materialised at that time.

95. On 6 October 2011 the UR announced a 6 months extension of RP4. It said
that “a Draft Determination will be issued this winter”, there would be
consultation on it from December 2011 to March 2012, a Final Determination
would be published in August 2012 and the licence modification process
would take place from August to September 2012. However, no Draft
Determination was forthcoming in winter 2011. It was not issued until April
2012.

96. The Draft Determination said that RP5 would now be implemented from 1
October 2012, and reaffirmed that the previous price control RP4 would be
extended from 1 April to 30 Sept 2012. It now said “This has been necessary
because of delays in receiving the full RP5 submission from NIE T&D. As a
result we needed more time to complete a robust assessment …” (Summary
para 3.2) It said that the final price control would be published by the end of
the year. This seems to imply that RP5 will not be implemented until 2013.
There was no explanation or discussion of the implications of this further
delay.

97. NIE acknowledges that parts of the BPQ information were provided two
weeks late, on 14 February 2011; that the capex databases were not completed
until early April; and that the BPQ data split between T&D was not provided until 11 March 2011. However, it says there is no reason why this should have delayed the price control process. The capex databases were essentially a summary of more detailed information already provided. As regards the T&D split, the whole of the Draft Determination except the impact on tariffs is on a combined basis, for which data was provided in February.

98. The UR has also been late with a number of other recent price controls. The minutes of the UR Board meeting of December 2011 record the Board’s concern at the delay in the overall price control process for Power NI.

99. The UR’s timetable and plans for RP5 have turned out not to be realistic. They have been changed belatedly, with little or no notice to, or discussion with, the company whose revenues and investment are at stake, and whose participation should be an integral part of the regulatory process. It is implausible, and ungracious, for the Draft Determination to blame a regulatory delay of six months - perhaps more realistically a year - on a few weeks’ delay by NIE in responding to a few elements of the BPQ. The UR was already five months late in issuing the BPQ.

8.4 The present situation

100. Are things any better now and looking forward? There is as yet no acknowledgement that the UR’s last published timetable has gone awry. The UR has provided no timetable for the future.

101. Nor has the UR provided any explanation whether NIE is presently subject to the RP4 price control that was supposed to expire at the end of March 2012, or presently without a valid price control at all. NIE expressed its concern on this score to the UR.

The UR’s decision to roll over the RP4 price control was taken without consultation and without licence modifications. The approach is out of line with Ofgem’s practice in extending price controls. As you know we have legal advice that licence modifications are required. (Letter J O’Mahoney to S Lynch, 16 Feb 2012)

102. In response, the UR noted NIE’s comments and said

“In order to facilitate the Utility Regulator’s response to NIE’s concerns the Utility Regulator requests that NIE provides details of the legal advice it has highlighted.” (Letter T Wishart to J O’Mahoney, 22 March 2012)

103. But surely, whether a major regulated entity does or does not have a valid price control for a period of at least six months is a matter that goes beyond “a response to NIE’s concerns”? On such a fundamental issue it is surprising that the UR had not taken its own legal advice long ago, and taken action accordingly.

104. The lack of clarity on price control is becoming increasingly serious. The Draft Determination (para 4.18) stated that “RP4 will be extended from 1 April 2012 to 30 September 2012”. However, no formal licence modifications
have been implemented in this regard. I understand that the UR has indicated that, until the RP5 control is implemented, capex should continue at RP4 levels. However, nothing has been proposed by the UR or agreed with NIE in relation to opex, pensions, incentives or allowed returns beyond 1 October 2012. That is less than 3 months away. Consequently, NIE is unable to make informed investment and operating plans for its business. How can this be in the interests of customers?

105. The UR’s failure to set and meet realistic targets continues. For example, the UR initiated its investigation into changes in capitalisation practice on 20 February 2012. It said that “The UR expects to resolve this investigation in a timely manner.” Informally, a senior UR official indicated to NIE that the investigation should only take about two weeks. However, the Draft Determination in April 2012 announcing the investigation said that it would be completed during the three month consultation period – that is, by 19 July 2012, five months after it was initiated. Then on 9 July the UR announced that “the process of information gathering is taking longer than the consultant auditors first anticipated”. There is no revised date for publishing the final report of the investigation, other than that it will allow time for responses to be considered before the Final Determination of RP5 – the date of which is itself no longer specified other than “by the end of the year”.

8.5 The UR’s capability – a proportional approach?

106. This lack of forward workplans, and the series of significant and largely unexplained delays, plus a lack of attention and sensitivity to the fundamentals of an important utility business, is not a very impressive record of how a regulatory body deals in a timely manner with what it describes as its “bread and butter work”, as a “priority project to which it will if necessary divert other resources”. The basic practicalities of running and regulating a utility business that serves a population of nearly two million people seem to have been overlooked.

107. This in turn raises many questions. Has the UR, in this price control review, bitten off more than it can chew? Were its 300 questions, 45 spreadsheets and over 450 follow-up questions more than it could digest? Had it properly thought through the implications of the approach it decided to take? Why did it fail to learn the same lessons about over-complexity and simplification as the other UK utility regulators? Why does it seem to have forgotten the lessons that it had learned earlier? Is it now more concerned with politics and presentation and the short term, with trying to deliver a price control that is seen to be tough on a privatised utility? Has it been insufficiently concerned with the practicalities of regulation and with the longer term implications of its attitude for future investment? Has it, in sum, fallen short on one of its key Values, and lost some sense of proportion?

108. The UR’s poor record on delivering the present price control review does not bode well for its ability to implement the significantly more intensive regulatory role that it envisages as a result of the price control itself. The Draft Determination proposes a significantly more active role for the UR than in the past, particularly with respect to specifying and approving the capex
programme. The UR will also have to monitor and respond to the considerable information to be provided by the Reporter. With this increased degree of regulatory involvement, there must be a question whether the UR has the quantity and quality of resources to discharge its proposed responsibilities in a constructive and timely manner.

9. **Contrasting price controls**

109. The UR’s proposals on pensions costs and previous capex, and its regulatory process generally, should be viewed in the context of the rest of the price control as a whole. Consider the main components of its building block approach.

110. The UR proposes to cut NIE’s business plan opex by about 25% and its business plan capex (Funds 1 and 2) by about 60%. These are more severe cuts than other UK regulators would normally consider reasonable.

111. The UR proposes a lower cost of capital than Ofgem has used. A ratings agency has commented as follows.

> “the Draft Determination … provides for more challenging financing assumptions than Fitch Ratings would normally expect for a UK regulator. … the proposals raise concerns that the financial profile of NIE could deteriorate over the next five years. … Fitch is not convinced that the draft determination actually provides for adequate capital market access for a business in a growth phase. It appears that UReg may interpret its financing duty materially different to other UK regulators.” (FitchRatings Comment, May 2012)

112. These observations, taken with my findings above, confirm my view that there is a significant difference between how the UR is now approaching RP5 and how Ofgem and other UK utility regulators approach a price control review in GB – and, for that matter, how the UR itself previously approached RP4.

113. Not surprisingly, outcomes, too, are different. The UR now proposes a price reduction of about 16% over 5 years whereas Ofgem considers that an average price increase of about 30% is necessary. This outcome is in contrast with that in RP4, where the UR was at pains to explain why the outcome for NIE was similar to that for the most comparable GB network companies because NIE faced the same issues.\(^5\) Does NIE no longer face the same issues? Why should the situation suddenly have changed so radically?

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\(^5\) “The capped revenue in the first year of RP4 is a 2.8% real increase on the level of regulated revenue today. Increases in revenue entitlement were a feature of the last distribution review in GB (where for example, regulated revenues for Scottish Hydro, Swalec and Sweb, the three companies most comparable to NIE in terms of their scale and network characteristics, increased by over 4% in real terms on average). Ofgem explained that the increases were necessary because of ‘the need for increased investment, combined with additional tax and pension costs facing companies’. NIE faces those same issues.” (UR Proposals Paper 14 December 2005, p 19) In the latest Ofgem review, the average annual price increase of the same three GB companies described as most comparable to NIE is 6%, slightly higher than the average increase of 5.6% for all GB companies.
114. It is of course possible that other UK regulators are out of step with the UR. Perhaps the UR has found a new and better way to regulate and set prices for the benefit of customers. However, an examination of recent reviews of the price control processes of two other UK regulators suggests a different explanation.

115. Ofgem invited the views of its stakeholders on its recent price control review process. In general there was strong support. Foremost among the specific areas of good practice were full engagement with the distribution network operators and with the Authority, and strong project management that was vital to timely delivery. One lesson learned was the need for even more time and engagement devoted to “bringing the network companies with us”.  

116. The Office of Rail Regulation commissioned an independent review of its recent price control review process. As noted above, it evaluated the process against the five principles of good regulation. There, too, there was strong support for the price control process from stakeholders. There, too, openness, engagement and effective project management were key elements. The ORR was particularly diligent with respect to setting a detailed and realistic timetable well in advance, and keeping to it.

117. How different has been the UR process in RP5 as detailed above! It does not bear comparison with best practice UK regulation. Sad to say, in

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6 “A committed and accessible DPCR5 team: External stakeholders, including DNOs welcomed the effort the DPCR5 team made to ensure they were available to discuss aspects of the price control. Also, the effort the price control team demonstrated in working to deadlines to ensure delivery provided external parties confidence that the programme was running to schedule….

An informed and engaged Committee of the Authority: The DNOs welcomed the time spent with the Committee of the Authority to present their views. They appreciated the opportunity to have direct access to the decision makers and found the Committee members engaged and well briefed.

Strong project management: We had a stand alone and well qualified project management team. This was vital to the timely delivery of the project, provided a focal point for the team and made sure there was sufficient time for us to produce well written documents. …

Well structured external engagement: DNOs and other external stakeholders found the process of workshops between consultation documents useful in order to inform and provide early exposure to our thinking. DNOs also welcomed the time spent in bilateral meetings with senior members of the team and working groups established to help develop proposals.” Ofgem, Electricity Distribution Price Control – Review of process, 9 July 2010.

7 “Bringing the network companies with us: The DPCR5 process demonstrated that we need to build in time to ensure the network companies (and other stakeholders) understand fully where our thinking or approach to key issues has changed, and the implications of these changes.”

8 “1.1 The 2008 Periodic Review (PR08) followed current practice for UK regulators. It passed without disorder or confusion on the part of ORR, Network Rail and most stakeholders. ORR managed the programme well. There was strong leadership and effective project management of what was an immensely complex task. …

1.2 The process was open, inclusive and undertaken without visible rancour….

1.3 Stakeholders generally felt this was a process in which they were actively encouraged to participate with most taking the opportunity to do so” (Independent PR08 Programme Evaluation, Report to the ORR Board, 5 August 2009, p 5)

9 “3.8.2 It published its initial consultation paper in August 2005, nearly four years before the new funding arrangements would be implemented. This early start was appropriate …

3.8.17 Section 4 set out ORR’s proposed timetable for the review. The description was detailed, and in the event ORR met the timetable it had set out.” [This four-year-ahead timetable specified two dozen milestone actions over the Preparation phase and Formal review phase, each specified by month and year.]
several respects it is an example of how not to regulate. In these respects the UR’s conduct has fallen short of its own stated Values of Transparency, Consistency and Proportionality. And I am afraid it suggests that the remarkable price reductions proposed in the Draft Determination are too good to be true; that they have been achieved, not by following the principles of good regulation, but by flouting them.

10. The implications for customers

118. Inadequacies of regulatory process are not simply a matter between regulator and regulated company. They have consequences for prices and customers. If a regulator is not transparent because it is unwilling to engage, if it does not act consistently with its previous price control commitments and due regulatory process, if its information requests and proposed price control arrangements put a disproportionate burden on the regulated company, and if it fails to develop and implement realistic work plans, then the company that it regulates will be unable to invest and operate in a way that best meets the needs of its customers. The company’s operating costs will be needlessly increased and its flexibility and responsiveness reduced. There will be a reluctance to invest. Regulatory uncertainty, inconsistency and lack of proportionality will impact adversely on the company’s cost of capital – in NIE’s case, as it competes for debt in the funding market against other utility companies whose regulators are more transparent, consistent and proportionate. Higher operating costs and higher cost of capital mean higher prices for customers.