



# Northern Ireland Electricity Transmission and Distribution Price Control Review (RP5) 2012-2017

An Introduction to the Reference  
to the Competition Commission

30 April 2013

## NORTHERN IRELAND ELECTRICITY RP5 PRICE CONTROL REFERENCE

### UR OVERVIEW PAPER

#### Introduction

1. This paper introduces and summarises the issues arising on this reference made by the Northern Ireland Authority for Utility Regulation (the “UR”) in relation to Northern Ireland Electricity Ltd’s (“NIE T&D”) operation of the electricity transmission and distribution networks in Northern Ireland.
2. The purpose of this paper is to assist the Commission by setting out the legal and factual context for the reference and identifying what we consider to be the main issues that the Commission will need to investigate. As explained in more detail below, we have a statutory duty to assist the Commission during this inquiry. We propose to fulfil that duty by providing the Commission with information and sector-specific regulatory expertise and by helping to identify the range of reasonable conclusions that the Commission could arrive at in order to construct an overall price control package that serves the principal objective of protecting consumers and that provides sufficient resources to finance the operation and development of the network. This is not an appeal, however, so we do not consider our role to be to defend the specific proposals we made in the Final Determination (FD)<sup>1</sup> to the exclusion of other reasonable proposals that the Commission may ultimately prefer.
3. As the Commission will see from the terms of reference, in addition to a straightforward “price control” reference, we have also referred a closely related question that is motivated by our concerns about the level of transparency and accountability in NIE T&D’s operations. As discussed below, we consider that effective reporting is an essential prerequisite for effective regulation and are taking measures to improve the quantity and quality of information that we collect from NIE. We also proposed in the FD the establishment of an independent Reporter, whose function would be to assist us to ensure the consistency and accuracy of NIE T&D’s regulatory submissions. As explained below, however, the overall level of reporting that we envisage will take place is much less extensive and onerous than is standard practice in GB for similar companies.

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<sup>1</sup> [Web link to the UR-9 RP5 Final Determination \(FD\)](#)

4. This paper proceeds as follows. First, it sets out the legal framework, both in relation to our powers and duties and in relation to this reference. Second, it explains the procedural background to this reference and how it came to be made. Third, it explains our overall perspective on the matters that are raised in this inquiry. Fourth, it identifies and briefly introduces what we consider to be the six main issues for the Commission to investigate in this inquiry (each of which is also the subject of a separate paper explaining the issues in more detail).

### The legal framework

5. The legal framework governing the regulation of electricity transmission and distribution in Northern Ireland is principally set out in two pieces of legislation: the Energy (Northern Ireland) Order 2003 (the “**Energy Order**”) and the Electricity (Northern Ireland) Order 1992 (the “**Electricity Order**”). Relevant Articles of those Orders are provided as supporting papers for ease of reference.<sup>2</sup>
6. The Energy Order establishes the UR<sup>3</sup> and sets out our objectives, powers and duties. The details of and relationship between our various duties and objectives is somewhat complex, but at its core is a simple, “*principal objective*”: “*to protect the interests of consumers.*”<sup>4</sup> In pursuing that objective, we are required to have regard, among other things, to “*the need to secure that all reasonable demands in Northern Ireland or Ireland for electricity are met*” and “*the need to secure that licence holders are able to finance the activities*”.<sup>5</sup>
7. The Electricity Order sets out the licensing regime for electricity in Northern Ireland. Until the introduction of the EU legislature’s Third Energy Package, the transmission and distribution of electricity were both governed by a single licence under Article 10(1) Electricity Order. Such a licence was granted by what was then the Department of Economic Development to NIE T&D on 31 March 1992, when the electricity transmission and distribution network in Northern Ireland was privatised. Since then, however, that licence has been divided into two separate licences: a transmission licence<sup>6</sup> under Article 10(1)(b) Electricity Order and a distribution licence<sup>7</sup> under Article

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<sup>2</sup> UR-10 Articles 12 and 13 - Energy Order (Clean)

<sup>3</sup> Article 3 Energy Order.

<sup>4</sup> Article 12(1) Energy Order.

<sup>5</sup> Article 12(2) Energy Order.

<sup>6</sup> [http://www.uregni.gov.uk/uploads/publications/NIE\\_-\\_Successor\\_Transmission\\_Licence\\_-\\_Final\\_Published\\_11\\_March\\_2013.pdf](http://www.uregni.gov.uk/uploads/publications/NIE_-_Successor_Transmission_Licence_-_Final_Published_11_March_2013.pdf)

10(1)(bb) Electricity Order.<sup>8</sup> Those are the licences that form the subject of this reference.

8. As a licensed participant in the transmission of electricity,<sup>9</sup> and as a licensed distributor of electricity, NIE T&D is subject to a number of statutory obligations and licence conditions. In particular, NIE T&D is required to “*develop and maintain an efficient, coordinated and economical system of electricity distribution which has the long-term ability to meet reasonable demands for the distribution of electricity*”.<sup>10</sup>
9. In addition, NIE T&D is subject to a number of specific duties that are incorporated as conditions of its licences. NIE T&D’s price control conditions, which form the subject of this inquiry, are set out in Condition 42 and Annex 2 in each licence.
10. The Electricity Order provides for two mechanisms by which those licence conditions (including the price control conditions) can be modified. First, they can be modified with the consent of the licence holder.<sup>11</sup> Failing that, Article 15 empowers us to make a reference to the Commission requiring the Commission “*to investigate and report on*” the following questions:

“(a) whether any matters which—

(i) relate to the carrying on of activities authorised or regulated by a particular licence; and

(ii) are specified in the reference,

operate, or may be expected to operate, against the public interest; and

(b) if so, whether the effects adverse to the public interest which those matters have or may be expected to have could be remedied or prevented by modifications of the conditions of the licence.”

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<sup>7</sup> [http://www.uregni.gov.uk/uploads/publications/NIE - Successor Distribution Licence Document - 11\\_March\\_2013.pdf](http://www.uregni.gov.uk/uploads/publications/NIE_-_Successor_Distribution_Licence_Document_-_11_March_2013.pdf)

<sup>8</sup> UR-11 Article 15 - Electricity Order (Clean)

<sup>9</sup> It should be noted that although NIE T&D *owns* the electricity transmission network in Northern Ireland, it does not *operate* the transmission system. The transmission system operator for Northern Ireland is SONI which is subject to a separate licence under Article 10(1)(b) Electricity Order. In addition, SONI is also licensed under Article 8(6) Electricity Order to operate the Single Electricity Market that joins the electricity transmission system in Northern Ireland with the system in the Republic of Ireland. Neither of those licences is at issue in this inquiry.

<sup>10</sup> Article 12(1)(a) Electricity Order. See Article 12(2)(a)(i) for the analogous obligation in relation to transmission.

<sup>11</sup> Article 14 Electricity Order.

11. In addition to deciding whether there are any adverse public interest effects as set out above, the Commission is also required to specify in its report “*modifications [of licence conditions] by which those effects could be remedied or prevented*”.<sup>12</sup>
12. In considering the “*public interest*”, the Commission is required to have regard to all of the same matters that form the subject of our duties, including (especially) the principal objective to protect customers.<sup>13</sup> We are required to assist the Commission in that task.<sup>14</sup> In addition to our assistance, the Commission can also make use of its investigatory powers under ss 109-116 Enterprise Act.<sup>15</sup>

### **The procedural background to the reference**

13. NIE T&D’s current price control licence conditions were put in place on 1 April 2007 as a result of our fourth price control review process (RP4), which ended in agreement with NIE T&D. It was initially envisaged that those conditions would operate until 31 March 2012, after which they would be replaced by new price control conditions reflecting the result of the fifth price control review process (**RP5**). The RP5 price control process took longer than anticipated. The relevant RP4 licence conditions remain in place today.
14. The details of the procedural history of the RP5 price control review are not in general germane to the Commission’s task on this inquiry. Nevertheless, because it is inevitable that some references will be made to various of the documents generated by us, NIE T&D and others during that process, a short chronology of the process is provided in a supporting paper.<sup>16</sup>
15. In summary, our price control process concluded with the publication of our Final Determination (“**FD**”) on 23 October 2012 and associated licence modification proposals. NIE T&D responded on 20 November 2012 with a short letter rejecting the licence modifications and suggesting that a reference should be made to the Commission.<sup>17</sup> We offered NIE T&D the opportunity to expand on its reasons, but NIE

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<sup>12</sup> Article 16(1)(c) Electricity Order.

<sup>13</sup> Article 15(7) Electricity Order.

<sup>14</sup> Article 15(6) Electricity Order.

<sup>15</sup> Article 15B Electricity Order.

<sup>16</sup> UR-12 Chronology of Key RP5 Documents

<sup>17</sup> UR-14 L 121120 NIE T&D Response to Final Determination Letter 1

T&D declined in a letter dated 29 November 2012 on the basis that its position was clear from its various submissions during the price control process.<sup>18</sup>

### **Our position on this inquiry**

16. As will be apparent from the procedural background to this reference set out above, it is common ground as between us and NIE T&D that NIE T&D's current price control licence conditions operate against the public interest. It was only ever envisaged that they would operate until 31 March 2012, and there are several practical difficulties with their continued operation beyond that date.<sup>19</sup> More fundamentally, we consider, and NIE T&D also contends, that the public interest requires a new price control to reflect the needs of the network and consumers over the next five years, rather than the needs of the period 2007-2012 that are reflected in the design of the current price control.
17. In our view, the issue for the Commission on this inquiry is therefore not *whether* the status quo needs to be replaced, but *what* it needs to be replaced with. In that regard, it bears emphasising that the Commission is to look at NIE T&D's price control arrangements afresh and must arrive at a price control that it considers best serves the public interest, having regard to the matters that form the subject of our statutory duties referred to above.
18. The Commission's task is therefore not merely to choose between the competing proposals set out previously by us in the FD and those set out by NIE T&D in its various submissions to us or to the Commission in this inquiry. The Commission is not constrained to select one or other of the parties' preferred methodologies and calculations. This inquiry is not an appeal from or review of our FD and associated licence modifications<sup>20</sup>.
19. An important corollary of that proposition is that the Commission is free to conclude that the public interest requires a price control that is in some or all respects more

<sup>18</sup> UR-15 L 121129 NIE T&D Response to Final Determination Letter 2

<sup>19</sup> In particular, several important terms in the price control equations are only defined for years up to and including 2012. Although we have agreed with NIE T&D some pragmatic interim solutions to those problems, it is self-evidently not in the public interest that such interim solutions should continue indefinitely.

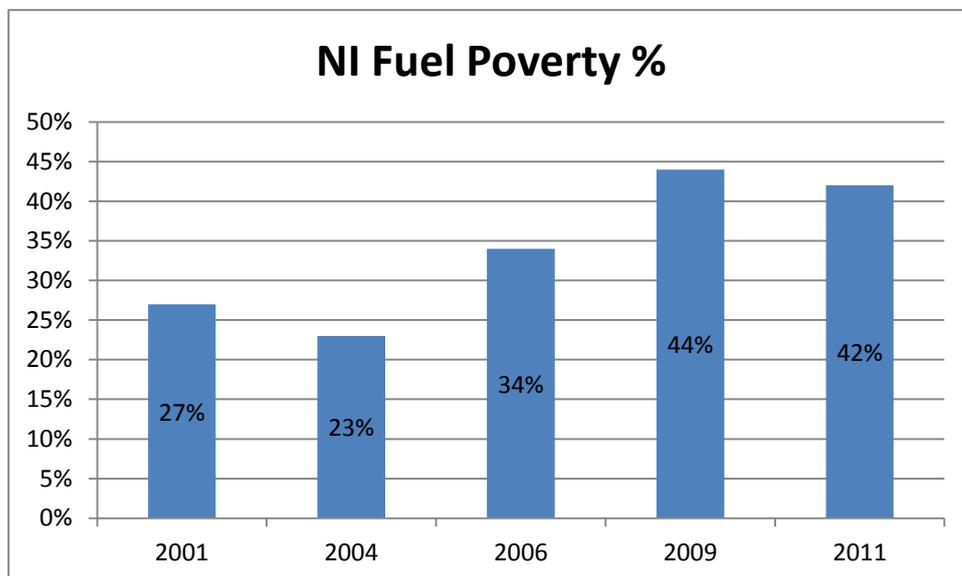
<sup>20</sup> [http://www.uregni.gov.uk/uploads/publications/RP5 - Annex 2 - 17 October 2012 - Sent to Board - FINAL 20 Oct 2012.pdf](http://www.uregni.gov.uk/uploads/publications/RP5_-_Annex_2_-_17_October_2012_-_Sent_to_Board_-_FINAL_20_Oct_2012.pdf) and [http://www.uregni.gov.uk/uploads/publications/RP5 - NIE plc Licence - 17 October 2012 - Sent to Board with minor FD edits.pdf](http://www.uregni.gov.uk/uploads/publications/RP5_-_NIE_plc_Licence_-_17_October_2012_-_Sent_to_Board_with_minor_FD_edits.pdf)

challenging for NIE T&D than that which we proposed in the FD. That could be (for example) because the Commission takes into account more recent evidence that supports a different conclusion or simply because the Commission exercises its judgment to select a different solution from the range of reasonable solutions that are available.

20. Consistent with the Commission's broad powers and duties, we propose to take a similarly broad approach to our statutory duty to assist the Commission on this inquiry. We do not see our role as merely to advocate for the particular proposals that we made in the FD and to defend them from such objections as NIE T&D might now raise. On the contrary, we propose to identify for the Commission the important issues arising on this price control and set out our views on the range of reasonable solutions to those issues.
21. That range will include (but not be limited to) the proposals set out in the FD. It is in the nature of economic regulation that on many issues there is substantial scope for reasonable regulators to differ. The statutory scheme (as set out above) is that once a reference has been made, customers in Northern Ireland are entitled to the benefit of the Commission's expertise and judgment on those issues. That is so irrespective of whether the particular proposal that we made in its FD accorded with NIE T&D's submissions. It is therefore our duty, on behalf of customers in Northern Ireland, to provide the Commission with appropriate information to help it decide all of the important issues that warrant investigation on this reference. That includes drawing the Commission's attention to areas in which we consider the Commission could well decide to impose a more challenging price control on NIE T&D.
22. Our views on the issues arising for determination on this inquiry are summarised briefly below and set out in more detail in the suite of papers that are included with this reference. As a preliminary and overarching observation, however, we consider that it is important to draw the Commission's attention to the economic context for this inquiry in Northern Ireland.
23. As the Commission will be aware, Northern Ireland has been hit particularly hard by the series of economic crises that have struck the wider United Kingdom, Europe and the globe in recent years. In addition to the many other forms of hardship that those crises have caused, one implication of relevance to this inquiry is the extent of fuel

poverty in Northern Ireland that has resulted from them. As shown in the following chart, fuel poverty is at historic highs.<sup>21</sup>

**Chart 1: Northern Ireland Fuel Poverty Levels.**



24. In addition, it is worth bearing in mind the impact of electricity prices on the competitiveness of businesses in Northern Ireland. Although domestic consumers and small industrial and commercial (I&C) consumers pay electricity prices that are in line with the EU average, large I&C consumers pay electricity prices that are among the highest in Europe.<sup>22</sup> That has obvious consequences for the resilience of the economy in Northern Ireland to the external economic pressures that have been weighing on it in recent years.
25. The Commission will be well aware that the inevitable consequence of increasing the prices that NIE T&D is permitted to charge for transmission and distribution is that retail prices for electricity will also increase. Any increase in retail prices can only increase the extent and severity of fuel poverty and lack of business competitiveness in Northern Ireland.
26. Needless to say, to the extent that price increases are necessary to finance the business activities that NIE T&D is required to carry out to fulfil its statutory obligations in relation to the electricity network in Northern Ireland, it must be in the public interest

<sup>21</sup> [http://www.uregni.gov.uk/uploads/publications/Mid\\_term\\_review\\_140711.pdf](http://www.uregni.gov.uk/uploads/publications/Mid_term_review_140711.pdf) (page 3) and [http://www.nihe.gov.uk/heca\\_2012.pdf](http://www.nihe.gov.uk/heca_2012.pdf)

<sup>22</sup> UR, [NI Electricity Prices: data and comparisons](#) 26 March 2013, p 5.

that they should be allowed. But it should not be forgotten that the “*primary objective*” of electricity regulation is the protection of the interests of consumers (Article 12(1) Energy Order) and that the Commission must have regard to the need to protect the interests of (amongst others) individuals with low incomes (Article 12(3)(c) Energy Order).

27. Against that background, we urge the Commission to subject NIE T&D’s claims to careful scrutiny, both as to whether its proposals offer sufficient value for money for Northern Ireland customers and as to whether they really need to be carried out in this price control period, rather than at a later stage. Most of all, mechanisms must be put in place to ensure that NIE T&D is held accountable for the money that it receives and that customers derive real benefit from the substantial sums that they are required to pay towards the electricity network in Northern Ireland.

### **The key issues on this reference**

#### Overview

28. As the Commission will already be aware, the basic building blocks of the economic regulation model that we apply to NIE T&D are opex, capex and cost of capital. These building blocks affect the price control as follows:
  - (a) Opex during a price control period is (subject to some adjustments, such as for efficiencies, which can run into the following period) fully funded with revenues from customers within that same price control period.
  - (b) Capex within a price control period is added to the regulatory asset base (RAB), on which NIE T&D earns a return (in the form of allowed revenues from customers) over a period of 40 years. That reflects the principle that capex should be spent creating or increasing the useful lives of assets that provide benefits for customers over a long period. It would therefore be unfair for the entire burden of paying for a new asset to fall on today's customers.
  - (c) The cost of capital determines the return that NIE T&D is allowed to earn on its RAB. It has the most significant effect on tariffs because any increase in the cost of capital increases the amount that customers have to pay for the entire current value of the electricity network.

29. Significant issues arise on this reference in relation to each of those building blocks. In addition, a number of more specific issues arise, such as how to deal with the extensive pension deficit for which NIE T&D is liable, whether adjustments need to be made to reflect certain changes in capitalisation practices that could result in customers paying twice for the same expenditure, and what needs to be done to improve the transparency and accountability with which NIE T&D spends customers' money. All of those issues are explored in more detail in the accompanying papers, which are briefly summarised below.
30. A preliminary point, however, is the period of time in respect of which the Commission will need to determine NIE T&D's allowed revenues. In light of the passage of time since the time when NIE T&D's RP4 price control was scheduled to end, we propose that the new RP5 price control should run for four years and nine months from 1 January 2013. It should also be noted that we can provide the Commission with the tariff impact of the various proposals set out below now or at a later stage in the inquiry if that would be of assistance.

### Opex

31. In the FD, we proposed that NIE T&D should be given an allowance of £182.5m for its controllable opex (i.e. that part of NIE T&D's opex over which it has a reasonable degree of control), compared with £237.4m requested by NIE T&D. This allowance was based on a benchmarking exercise to test NIE T&D's general opex efficiency level as well as a detailed analysis of some significant new items of opex that NIE T&D said it required for RP5. We also proposed that NIE T&D's opex should be subject to an ongoing 1% efficiency adjustment.
32. We invite the Commission to conduct its own analysis of NIE T&D's opex needs and reach its own view of what customers should be required to pay for NIE T&D's controllable opex. In addition, there is the question of what should be done about NIE T&D's uncontrollable opex. In the FD we proposed that they should be remunerated on a "*pass through*" basis, meaning that any costs incurred by NIE T&D (whether efficient or otherwise) are passed on to customers. This inquiry provides an opportunity for the Commission to investigate the extent to which those cost items are all genuinely "uncontrollable", and whether there is any scope for introducing some form of risk sharing to protect consumers against inefficient spending on those items.

Capex

33. The capex issues raised in this inquiry are by any measure extraordinary. NIE T&D has proposed that customers in Northern Ireland should pay for “business as usual” capex of **£776m** over the five years of RP5, which is more than twice what it spent over the course of RP4. That request was made against a background of falling demand for electricity and above-standard performance of the network consistently throughout the past decade. In addition, NIE T&D said that it will need to spend substantial sums on large projects such as providing infrastructure for new renewable generation and for smart metering.
34. Standard practice for network utilities is to develop comprehensive asset management processes that produce robust risk based forecasts of the optimum interventions. Networks are continuously evolving as work is done on them and top grade asset managers record all this as it is needed to understand performance issues and decide on the right interventions to deal with them. One issue for the Commission to investigate in relation to capex is what kind of structural mechanism is appropriate to cope with the range of capex projects that need to be considered. In the FD, we proposed a three fund approach that provides flexibility as to the approach to risk allocation that is taken in relation to different forms of capex:
- (a) Fund 1 was largely confined to asset replacement and refurbishment, which is substantially within NIE T&D’s control. We proposed that unit cost risk should be shared between NIE T&D and customers in accordance with normal RPI – X principles, with NIE T&D retaining any efficiency rewards or penalties for five years. We proposed that volume risk, however, should be allocated to customers, subject to an overall cap on the amount of work undertaken by NIE T&D within this fund, which is based on our asset management modelling. Fund 1 also included an allowance for certain activities the outputs of which NIE T&D says it is unable to measure (including fault and emergency work). Because that allowance is above and beyond the work that our asset management modelling suggests will be required, it provided an additional degree of risk protection for NIE T&D.
- (b) Fund 2 was intended to cover work that is less predictable than Fund 1 and was largely in respect of work that is necessary because of changes in customers’ needs, such as increases in demand in particular local areas that call for an increase in capacity. As with Fund 1, we proposed that unit cost risk should be

shared between NIE T&D and customers with NIE T&D taking risk of over and under reward for five years in accordance with normal RPI – X principles. In light of the greater uncertainty as to how much of this work will be required, however, we proposed a mechanism that insulates NIE T&D from virtually all volume risk. In particular, we have approved those (few) projects for which NIE T&D has been able to produce a sufficient evidence base. For the other projects, we proposed that NIE T&D should be permitted to bring forward proposals in each year of RP5 for the projects that it considers necessary in the following year. We would then approve those on an *ex ante* basis.

- (c) Fund 3 was intended to cover large projects for which there is even greater uncertainty than in Fund 2, both as to timing and cost. We proposed that nothing should be set in stone in relation to these projects, so as to protect NIE T&D from risk and to preserve flexibility to allow work that is necessary for customers to be carried out. Therefore, we proposed that these projects should be approved on a case-by-case basis throughout RP5 to ensure delivery of Government targets in a timely manner.
35. In addition to the question of structure, it will be necessary for the Commission to determine the quantum of capex to be allowed. In relation to unit costs, that will require, as a minimum, building on our benchmarking exercise. In relation to the volume of capex, it will require a combination of investigating and evaluating the evidence base for a number of particular projects that NIE T&D has proposed, as well as an asset management modelling exercise to cover more general categories of asset replacement work.

### Pensions

36. As at 31 March 2012 (the last date for which we have been able to verify NIE T&D's estimates), the NIE Pension Scheme had a deficit of £156.4m. This inquiry raises a number of important questions as to how the burden of making a deficit good should be split between customers and shareholders of NIE T&D.
37. The most important issue arising on this inquiry is the extent to which customers should be required to pay for decisions taken by NIE T&D in the past that have caused the deficit to increase by more than it otherwise would have. A particularly compelling case for allocating costs to shareholders arises in relation to the costs of early retirement programmes.

38. In the FD we followed the RP4 approach in regard to the early retirement programmes. In addition we proposed to allocate the remaining deficit risk to consumers. Through those programmes, NIE T&D reduced its opex but increased its future pension liabilities. Because NIE T&D's shareholders received a substantial proportion of the benefit of the opex reduction, we consider that it would be unfair to require customers to bear all of the costs of the increased pension liabilities. An issue for the Commission to investigate is therefore what proportion of those costs customers should be required to pay.
39. In addition, the Commission will also need to consider the period over which the cost of repairing the deficit should be spread and the date at which the deficit should be valued for price control purposes.

#### Capitalisation Practices

40. An important issue that calls for detailed investigation by the Commission on this inquiry arises in relation to certain changes that NIE T&D made to its capitalisation practices at the end of RP3, which we believe could have the effect of requiring customers to pay twice for the same expenditure: once during RP3/RP4 through opex allowances and again over the next 40 years through the RAB.
41. In essence, our concern is that in the last two years of RP3, NIE T&D changed its accounting practices so that significant amounts of what had previously been recorded as opex began to be accounted for as capex. NIE T&D benefited from that change, because it was paid in RP4 for its opex allowance whether or not money was spent, whereas capex was added to the RAB on a pass-through basis. Customers therefore could end up paying twice for the same costs: once through NIE T&D's RP3/RP4 opex allowance and a second time over the next 40 years through the allowed return on and of NIE T&D's RAB.
42. We consider that customers must not be required to pay twice for the same expenditure. Accordingly, an adjustment to the RAB is required to prevent that from happening. That is consistent with the approach taken by the Commission recently in *Phoenix Gas*, where the Commission said that "*funding [a regulated utility] twice for*

*the same expense ... would operate against the public interest*".<sup>23</sup> The question for the Commission is how large an adjustment is required.

43. In the FD, we took a conservative approach, proposing an adjustment of £32m based on the instances where the evidence that we had managed to obtain showed clearly that expenditure had been reclassified from opex to capex. We hope, however, that the Commission can use its investigatory powers and experience to determine a more comprehensive adjustment. In total, NIE T&D has indicated that it achieved £140m of opex outperformance over the course of RP4 and RP3 and it is not at all clear how much of that figure is attributable to genuine efficiency improvement and how much has been engineered through changes to accounting practices. It may be that by requiring NIE T&D to produce evidence of any efficiencies and by further investigating the documented changes in NIE T&D's approach, the Commission will be able to arrive at a more precise quantification of the effects of changes in NIE's accounting changes.

#### Cost of capital and financeability

44. The final substantive element of the price control for the Commission to investigate concerns the cost of capital and NIE T&D's financeability.
45. This is an area in which we consider more recent evidence points towards lower allowed revenues that we set out in the FD. We note, in particular, that our cost of capital assessment of 4.55% (real, vanilla) in the FD built as far as possible from the views that the Commission expressed on the cost of capital in its 2010 Bristol Water inquiry. Since that time, however, there is reason to think that the costs of debt and equity finance have fallen, principally as a result of the actions taken by governments and central banks to stimulate economic growth (e.g. quantitative easing). We hope that the Commission will be able to undertake a wide-ranging review of the cost of capital parameters, with a view to establishing where the risk-free rate, equity-risk premium, and NIE T&D's equity beta and cost of debt are likely to sit during RP5.
46. We also urge the Commission to take a step back and consider the cumulative de-risking impact of the various other building blocks of the price control process that the Commission ultimately settles on. At least as far as the proposals in the FD are concerned, we consider that NIE T&D gets significantly more protection from

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<sup>23</sup> [Phoenix Gas](#) §5.103.

systematic risk than its utility sector peers in GB. That would suggest that there are grounds to consider that NIE T&D's cost of equity might be lower than GB energy networks.

### Reporter

47. As will be apparent from the foregoing, and from the detailed papers accompanying this overview, in addition to the specific price control issues arising on this reference, we also have broader concerns about the level of transparency and accountability in NIE T&D's operations. The capitalisation practices referred to above, and NIE T&D's claim that a substantial proportion of its capex relates to items for which it cannot identify any outputs, are emblematic of those concerns.
48. We consider that the present state of affairs is unsatisfactory. It creates opportunities for NIE T&D to profit at customers' expense. It also saps us of confidence in NIE T&D's claims about the need for capex, which makes it difficult to balance our duty to protect customers with our duty to ensure NIE T&D's activities can be financed. Indeed, the importance of proper reporting is only going to grow over the next price control period, which is why we consider it essential that something should be done about this now.
49. For those reasons, we are separately taking a number of steps to increase the transparency and accountability of NIE T&D's activities. We have already instructed NIE T&D to bring its planning standards up to date. We are implementing a system of annual reporting on capex to ensure that only those sums that are actually spent on improving the network are added to the RAB. It should be emphasised, however, that the aggregate level of reporting even after those proposals are put in place will be well below the levels required by GB regulators for similar companies.
50. We also proposed in the FD that those efforts should be supported by the creation of an independent Reporter, based on the success of the reporting model experienced in the water sector in NI and in England & Wales. The Reporter would be required to assist us to ensure that the information provided by NIE T&D in its regulatory submissions is consistent, comparable, reliable and accurate. We would use the Reporter to audit and investigate particular issues of concern, such as (for example) NIE T&D's financial accounting or its capital expenditure database. A copy of our

proposed terms of reference for the Reporter, which set out its functions in more detail, has been published with the FD in Appendix L<sup>24</sup>.

51. An area in which the Reporter will be of particular assistance is the implementation of our capex proposals. As explained above and in more detail in the accompanying paper, in RP5 we will be (i) monitoring the volumes of assets replaced or built by NIE T&D; (ii) monitoring unit costs; and (iii) appraising proposals for further projects on an annual basis. We will, in practice, need substantial assistance with these tasks if they are to be completed satisfactorily. The Reporter would be able to contribute usefully to this work.
52. As the Commission will appreciate, the appointment of a Reporter will not materially change our power to require NIE T&D to produce information or documents. Moreover, many of the functions that we would like the Reporter to carry out could (and would) be carried out for us by consultants in the absence of a Reporter. The principal advantages of the Reporter, however, seem to us to be its independence (it would be chosen by NIE T&D, subject to our approval) and the fact that it would be embedded within NIE T&D, which would help it to spot potential problems before they arise, and also to increase its understanding of the business and therefore the quality of the advice that it provides to us.

## **Conclusion**

53. This paper and the papers that accompany it are intended to introduce the Commission to those issues and to communicate our initial views in relation to them. Once the Commission has had an opportunity to consider them, we would welcome the chance to discuss with the Commission what further information and documentation would be of assistance to the Commission in the next phase of the investigation.

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<sup>24</sup> [http://www.uregni.gov.uk/publications/rp5\\_appendix\\_l\\_terms\\_of\\_reference\\_for\\_the\\_reporter](http://www.uregni.gov.uk/publications/rp5_appendix_l_terms_of_reference_for_the_reporter)

## Appendix 1- Our Statutory Duties

The principal objective of the Utility Regulator in carrying out its electricity related functions is:

*to protect the interests of consumers of electricity supplied by authorised suppliers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the generation, transmission, distribution or supply of electricity.*

The interests of consumers include their interests in the fulfilment by the Authority when carrying out its functions as designated regulatory authority for Northern Ireland, of the objectives as set out in Article 36(a) to (h) of the Electricity Directive.<sup>25</sup>

And also having regard to:

- (a) *the need to secure that all reasonable demands in Northern Ireland or Ireland for electricity are met; and*
- (b) *the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under Part II of the Electricity Order or this Order (the Energy (NI) Order 2003)*

In performing its duty, the Utility Regulator shall have regard to the need to protect the interests of

- i. *individuals who are disabled or chronically sick;*
- ii. *individuals of pensionable age;*
- iii. *individuals with low incomes; and*
- iv. *individuals residing in rural areas;*

This however does not imply that regard may not be had to the interests of other descriptions of consumer.

Subject to (a) and (b) above, the Authority is required to carry out its respective electricity functions in the manner which it considers is best calculated:

- I. *to promote the efficient use of electricity and efficiency and economy on the part of persons authorised by licences or exemptions to supply, distribute or participate in the transmission of electricity;*
- II. *to protect the public from dangers arising from the generation, transmission, distribution or supply of electricity;*
- III. *to secure a diverse, viable and environmentally sustainable long-term energy supply;*
- IV. *to promote research into, and the development and use of, new techniques by or on behalf of persons authorised by a licence to generate, supply, distribute or participate in the transmission of electricity; and*
- V. *to secure the establishment and maintenance of machinery for promoting the health and safety of persons employed in the generation, transmission, distribution or supply of electricity;*

The Utility Regulator is also to have regard, in carrying out the above functions, to the effect on the environment of activities connected with the generation, transmission, distribution or supply of electricity.

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<sup>25</sup> European Parliament and Council Directive 2009/72/EC concerning common rules for the internal market in electricity

Recent legislation from Europe Directive 2009/72/EC (“IME3 Directive”) has amended and expanded our duties and functions. Amendments to the principle objective and original general duties are accounted for above, with additions and other changes outlined below. For the purposes of implementing the IME3 Directive, the Department have made Regulations which implement the necessary changes into domestic law. This includes the Utility Regulator being designated as the national regulatory authority (NRA) for Northern Ireland. Designation as a NRA necessitates a blend of assuming additional responsibilities and a requirement to reinforce and ensure the organisation’s independence while carrying out its activities. Additional responsibilities include:

- electricity transmission and distribution ownership unbundling ;
- publishing consumer guidance <sup>26</sup>;
- a duty on the Authority to consult and co-operate with other authorities (Agency for the Cooperation of Energy Regulators (ACER), GB, and other Member States);
- and increased industry monitoring duties.

The strengthening of the Utility Regulator’s independence takes the form of a general requirement to be independent, as well as specific measures to be applied to the Utility Regulator’s activities. The Utility Regulator is now to function as the issuer of licences, including for a newly created distribution licence category, without the requirement for Departmental consent. The newly created distribution licence category includes the requirement to separate the current combined transmission and distribution licence held by NIE T&D.

Certain functions in relation to electricity have been added specific to monitoring activities. These are drawn from Article 37 of the IME3 Directive and are detailed below. Please note the paragraph lettering refers to the original lay out in the Directive.

*(g) monitoring investment plans of the transmission system operators, and providing in its annual report an assessment of the investment plans of the transmission system operators as regards their consistency with the Community-wide network development plan referred to in Article 8(3)(b) of Regulation (EC) No 714/2009; such assessment may include recommendations to amend those investment plans;*

*(h) monitoring compliance with and reviewing the past performance of network security and reliability rules and setting or approving standards and requirements for quality of service and supply or contributing thereto together with other competent authorities;*

*(i) monitoring the level of transparency, including of wholesale prices, and ensuring compliance of electricity undertakings with transparency obligations;*

*(j) monitoring the level and effectiveness of market opening and competition at wholesale and retail levels, including on electricity exchanges, prices for household customers including prepayment systems, switching rates, disconnection rates, charges for and the execution of maintenance services, and complaints by household customers, as well as any distortion or restriction of competition, including providing any relevant information, and bringing any relevant cases to the relevant competition authorities;*

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<sup>26</sup> [http://www.uregni.gov.uk/uploads/publications/UR\\_Implementation\\_of\\_IME3\\_July\\_11.pdf](http://www.uregni.gov.uk/uploads/publications/UR_Implementation_of_IME3_July_11.pdf)

*(k) monitoring the occurrence of restrictive contractual practices, including exclusivity clauses which may prevent large non-household customers from contracting simultaneously with more than one supplier or restrict their choice to do so, and, where appropriate, informing the national competition authorities of such practices;*

*(m) monitoring the time taken by transmission and distribution system operators to make connections and repairs;*

*(q) monitoring the implementation of rules relating to the roles and responsibilities of transmission system operators, distribution system operators, suppliers and customers and other market parties pursuant to Regulation (EC) No 714/2009;*

*(r) monitoring investment in generation capacities in relation to security of supply;*

*(s) monitoring technical cooperation between Community and third-country transmission system operators;*

*(t) monitoring the implementation of safeguards measures as referred to in Article 42.*

## Appendix 2 - List of Supporting Documents

Reference	Suite of supporting papers
UR-1	Article 15 Referral Notice
UR-2	Northern Ireland Electricity RP5 Price Control Reference UR <b>Overview Paper</b>
UR-3	Northern Ireland Electricity RP5 Price Control Reference UR Paper on <b>Opex</b>
UR-4	Northern Ireland electricity RP5 price control reference UR paper on <b>Capex</b>
UR-5	Northern Ireland Electricity RP5 Price Control Reference UR Paper on <b>Pensions</b>
UR-6	Northern Ireland Electricity RP5 Price Control Reference UR Paper on NIE T&D's <b>Capitalisation Practices</b>
UR-7	Northern Ireland Electricity RP5 Price Control Reference UR Paper on <b>Cost Of Capital And Financeability</b>
UR-8	Northern Ireland Electricity RP5 Price Control Reference UR Paper on the <b>Reporter</b>
UR-9	RP5 Final Determination
UR-10	Articles 12 and 13 – The Energy (Northern Ireland) Order 2003
UR-11	Article 15 – The Electricity (Northern Ireland) Order 1992
UR-12	Chronology of key RP5 documents
UR-13	RP5 Draft Determination
UR-14	NIE Response to Final Determination – letter 1
UR-15	NIE Response to Final Determination – letter 2
UR-16	RPEs Executive Summary
UR-17	Gemserv update report on changes to the Enduring Solution ICT and employee costs (6 July 2012)
UR-18	Gemserv Report on NIE's revised RP5 Opex proposals for Enduring Solution ICT (25 September 2012)
UR-19	GAD Review of NIE Pension Scheme - 19 May 2011
UR-20	Capitalisation Annex 1 - NIE RP3 - Managing Capital Expenditure
UR-21	Capitalisation Annex 2 - NIE RP4 - MANAGEMENT OF NETWORK CAPITAL INVESTMENT
UR-22	NIE's RP4 Composite Proposal
UR-23	Glossary
UR-24	Additional Document Index – excel spreadsheet which includes: <ul style="list-style-type: none"> <li>• third party responses to the price control consultations</li> <li>• detailed comments on the responses;</li> <li>• detailed appendices to the Draft and Final Determinations</li> </ul>