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Dear Paul

NIE REFERENCE

Thank you for forwarding to us the Utility Regulator's opening submission to the Competition Commission ("CC").

We now enclose NIE's Statement of Case. As you will appreciate, it is now some 7 months since NIE received the Final Determination of the RP5 price control, and some 6 months since NIE decided not to consent to licence modifications to give effect to the Final Determination and asked the Utility Regulator to refer the matter to the CC. In the intervening period, NIE has prepared its Statement of Case, in the form of a critique of the Final Determination (since that is the only proposal for an RP5 price control formally made to date).

Having now seen the Utility Regulator's opening submission, we have included in the Statement of Case a response to a small number of factual points raised in the opening submission, which were not raised in the Final Determination, and these are identified by reference to the opening submission, where appropriate. However, it has not been possible readily to accommodate within the Statement of Case a response to certain other points raised in the opening submission.

We have therefore set out below our comments on some of those points and should be grateful if you would treat this letter as a supplement to NIE's Statement of Case:



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New lines of inquiry

1. The Utility Regulator worked for some two and a half years on its RP5 price control review, and reached a Final Determination in October 2012 (some 7 months after the end of the RP4 period). The Utility Regulator rightly recognises (UR-2, paragraph 18) that it is now for the CC to decide what price control would best fulfil the statutory objectives laid down in the Energy Order, and that the CC may reach a different decision from those advocated by the Utility Regulator or by NIE as to how those objectives are best to be fulfilled. The Utility Regulator states that it is willing to provide such assistance as the CC may require, including in respect of matters which go beyond the defence of the Utility Regulator's Final Determination (UR-2, paragraph 21).
2. NIE welcomes the Utility Regulator's readiness to assist the CC, but is disappointed that the Utility Regulator should now suggest that the CC may wish to pursue lines of inquiry (some of them going back over matters occurring in RP3) which the Utility Regulator itself considered unnecessary or disproportionate to pursue, or in respect of which no evidence was available¹. Such a suggestion exhibits a surprising lack of confidence on the part of the Utility Regulator as to the robustness of its own approach in the Final Determination, and is unrealistic, in light of the tighter statutory timetable to which the CC must work and the range of other issues which fall to be considered.
3. Accordingly, NIE submits that the CC should be wary of pursuing new lines of inquiry before satisfying itself that they deserve to be given priority over other important issues raised in NIE's Statement of Case, and that they are genuinely relevant to the setting of a new forward-looking price control in pursuit of the relevant statutory objectives. If the CC does wish to pursue new lines of inquiry which the Utility Regulator itself did not pursue, NIE will, of course, be pleased to assist the CC so far as it is able.

Unresolved issues from RP4

4. The Utility Regulator points out (UR-2, paragraph 16) that the RP4 price control was designed to apply until 31 March 2012, and that there have been practical difficulties in seeking to apply it since then, since some of the factors in the price control equation have values allocated only up to 31 March 2012, and the price control overall was not contemplated to be appropriate for periods beyond 31 March 2012. The Utility Regulator notes (UR-2, paragraph 13) that "the RP4 licence conditions" do, however, remain in place today.
5. It may be that the Utility Regulator's words are carefully chosen so as studiously to omit expressing any opinion as to whether, or to what extent, the RP4 price control itself remains operative.

¹ For example, in respect of the identification of uncontrollable costs (UR-2, paragraph 32); the treatment of early retirement deficit costs (UR-5, paragraph 18); the accounting treatment of amounts capitalised in NIE's accounts (UR-6, paragraph 13).

6. In fact, the Utility Regulator expects NIE to observe the RP4 price control, as if it contained new values for key inputs to the price control equation. Despite NIE's request that it should do so, the Utility Regulator refused to consult on the making of interim modifications to the RP4 price control, by agreement with NIE, to substitute new values for the relevant factors in the RP4 price control, and the RP4 price control has, therefore, been left to limp on, leaving NIE in a state of uncertainty as to what objectives it is expected to achieve, in terms of capex projects, and how any transition between the current tariff levels and any new RP5 price control should be managed. Contrary to the suggestion at UR-2, footnote 19, NIE has had no practical option but to go along with this approach: its only remedy would have been to apply to the courts for judicial review of the Utility Regulator's failure to propose formal modifications. This would have been costly and slow to achieve any resolution of the problem. It is unfortunate that, in this respect, the Utility Regulator has failed to attain the high standards of transparency to which it apparently aspires.
7. The Utility Regulator has also failed to deal promptly or effectively with NIE's applications for approvals for particular expenditures under the D_t term of the RP4 price control and has refused to allow NIE to recover its full revenue entitlement, by misapplying the CA_t term of the RP4 price control. There are, therefore, a number of unresolved issues arising under the RP4 price control which can now be addressed only via the present CC investigation, by ascertaining the extent to which additional revenues should be allowed, via the RP5 price control, to make up for these deficiencies. These matters are discussed in Chapter 12 (Unresolved Issues from RP4) of NIE's Statement of Case.

Proposals for a reporter

8. The Utility Regulator draws attention (UR-2, paragraph 3) to its proposals to appoint a reporter to ensure that NIE provides accurate and consistent information to the Utility Regulator. The Utility Regulator suggests that this is necessary because of deficiencies in the level of transparency and accountability in NIE's T&D operations. NIE takes issue with this assessment of the present situation: NIE has at all times co-operated fully with the Utility Regulator to provide full and timely information to the Utility Regulator and is committed to continuing to do so. There is no proper basis for the Utility Regulator's concerns.
9. It appears that the Utility Regulator feels aggrieved at what it has characterised as objectionable features of NIE's capitalisation of certain heads of expenditure (overheads, repair and maintenance costs and tree-cutting costs). See paragraphs 27-30 below. NIE submits that there is no proper basis for the Utility Regulator's proposed adjustment to NIE's RAB. But if the Utility Regulator is troubled by the absence of precise rules as to how NIE should classify costs between opex and capex, and by the absence of any precise definition of direct and indirect costs (to facilitate future benchmarking against other GB DNOs), then the best way forward would be for the Utility Regulator to address these matters via detailed regulatory accounting

guidelines (as does Ofgem in GB). Appointing a reporter is no substitute for the adoption of clear rules, where that is what is needed.

10. It is also apparent that the Utility Regulator's capex proposals for RP5 would entail a substantial increase in the resources and expertise required by the Utility Regulator to respond in a timely way to requests by NIE for approval of particular capex projects. But that does not justify the appointment of a reporter. It merely goes to show that the capex proposals are unworkable.
11. NIE recognises that it should be accountable for its capital expenditure decisions, but that is not best achieved by regulatory micro-management of NIE's activities, which risks blurring the boundary between NIE's responsibilities and the Utility Regulator's responsibilities. Rather the Utility Regulator should recognise in the first instance the level of accountability already borne by NIE by virtue of its statutory and licence obligations (for example, safety-related obligations) which carry punitive penalties for non-compliance. While these already provide NIE with a strong driver for delivery of targeted and efficient capital expenditure, NIE has proposed to enhance these arrangements further for RP5 through the introduction of strong incentives for network performance (CML/CI) and capex efficiency. Therefore the Utility Regulator's suggestion (UR-4, paragraph 36) that NIE is resistant to the application of such incentive arrangements is incorrect.
12. In respect of regulatory reporting, NIE has asked the Utility Regulator to define at the outset of RP5 the reporting requirements needed to provide the Utility Regulator with visibility of output performance in line with Ofgem precedent. Furthermore, NIE is committed to working with the Utility Regulator to develop secondary network measures, such as load and health indices, to supplement its regulatory reporting, within an overall RPI-X regulatory framework. This would be consistent with the approach adopted by Ofgem, but recognises that the development of metrics for such secondary network outputs is a complex and substantial task. Indeed, even though work commenced much earlier in GB, the development of appropriate metrics for GB DNOs still remains "work in progress". In this regard, it should be noted that NIE has already, for a number of years, been reporting to the Utility Regulator in respect of the primary network metrics established by Ofgem for GB DNOs post-DPCR5.
13. Regrettably, the Utility Regulator has not recognised the need to specify appropriate output measures at the beginning of RP5, and clearly to define in advance the associated reporting requirements. Furthermore, the Utility Regulator has missed the opportunity to adopt a strong incentives-based framework for RP5 (as proposed by NIE), which would have provided NIE with strong and balanced incentives to minimise capex costs yet deliver improvements in network performance consistent with proven regulatory precedent in GB. Instead, the Utility Regulator proposes novel and ill-defined capex arrangements, which leave it uncertain precisely how NIE's performance will be measured and what information NIE will need to provide to the Utility Regulator to justify its expenditures to the Utility Regulator's satisfaction.

14. See further Chapter 4 (RP5 Capex – Structure) and Chapter 14 (Reporter) of NIE's Statement of Case.
15. Moreover, the Utility Regulator has apparently given no thought to the increase in regulatory risk which would arise from the interposing of a reporter between NIE and the Utility Regulator. The proposed role of the reporter and its status is described briefly at UR-8, paragraphs 10-11 and reference is made to further information provided as part of the Final Determination. Various questions remain unanswered. To whom would the reporter owe duties, and what would they be? Would the reporter's functions be limited to the review of data and reporting on its accuracy, or would it also be tasked with assessing the efficiency of particular projects? Would the Utility Regulator simply adopt the reporter's conclusions, or would it reach its own judgment? If the Utility Regulator simply adopted the reporter's conclusions, would that amount to an unlawful delegation of its functions? If it had to make up its own mind, would the Utility Regulator have the competence and resources to do so? If the Utility Regulator erred by relying on the reporter's conclusions, what legal means would be available to NIE to challenge its decision? Could any remedies be secured in a sufficiently timely manner to enable NIE to proceed with projects expeditiously to meet its statutory obligations? It is to be noted that the draft licence condition published by the Utility Regulator with its Final Determination does not address these issues adequately or at all.

The objective of protecting consumers

16. The Utility Regulator points out (UR-2, paragraphs 23-26) that there are good reasons to try to keep electricity prices in NI as low as possible, and refers to its statutory objective of protecting the interests of consumers, as if that objective required the CC to give priority to keeping prices as low as possible. NIE has no objection to having the CC scrutinise its case, and to being held accountable for its application of its price control revenues to achieve appropriate outputs (cf. UR-2, paragraph 27).
17. However, it is important that the CC should not lose sight of the fact that consumers need to be protected not only in respect of the price of electricity, but also in respect of the safety and reliability of supply. The availability of a reliable electricity supply is important to business as well as domestic customers and enables NI to compete effectively for inward investment. It is also important to balance the interests of different generations of customers, and not to defer works which ought properly to be undertaken now. It is also important to balance the interests of different groups of today's consumers (e.g. rural and urban consumers): the Utility Regulator's contention (UR-4, paragraph 3) that NIE does not need to improve its quality of service because it already meets high standards ignores the fact that NIE's average performance masks very different levels of performance in rural and urban areas, and there is a compelling case for the undertaking of extensive capital works to improve the resilience of the network serving rural areas.

Capex

18. It is also important to note that the Utility Regulator's focus on the question whether customers should be expected to finance the carrying out of particular capital works at all during RP5 (UR-4, paragraph 3) masks the fact that NIE's objection to the capex elements of the Final Determination arises, in large part, from the Final Determination's failure to allow sufficient revenues to cover the costs of capex projects the need for which is not in dispute. The CC should therefore be careful to avoid being misled into believing that NIE simply wishes to undertake more capex work than is necessary. A key question is how much revenue it needs to carry out agreed capital works. The Utility Regulator has discounted NIE's estimates of the revenues it needs to carry out agreed capex projects, by applying an unwarranted (in)efficiency adjustment, by ignoring some heads of expenditure altogether, and by making inappropriate RPE (real price effects) adjustments. It will be important for the CC to examine these matters fully.
19. In addition, NIE is legally obliged to undertake certain kinds of capex projects (e.g. to meet new legal requirements, and to connect new renewable plant to the transmission system). It is not practically open to consumers to avoid paying the efficient cost of such projects. In particular, the present policy focus (at UK and EU level) on promoting renewable energy means that the costs of the transmission network are bound to rise because of the need to connect numerous renewable generating units.
20. The Utility Regulator further misrepresents the position (UR-4, paragraphs 3 to 5) by suggesting that NIE's capex plans are excessive because:
- NIE intends to replace large parts of the network owing to the age of assets and indeed does not keep good records of its assets;
 - NIE intends to increase the network's load capacity across the board, regardless of need; and
 - NIE's asset management processes and network planning standards are substandard.
21. None of these allegations is correct:
- NIE's proposals for asset replacement are based on an examination of asset condition and risk. Indeed, NIE invited the Utility Regulator to inspect NIE's network as part of its review of NIE's proposals, but the Utility Regulator declined to do so, preferring to rely on a paper-based approach. In addition, NIE does maintain accurate records of its asset base in terms of asset age and condition. The Utility Regulator did not examine NIE's asset record systems during its review.
 - NIE's load-related expenditure plans are targeted to address particular "pinch points" on the network, with the case for investment to increase capacity clearly evidenced, including in the two cases (Granville and Limavady) referred to at UR-5, paragraph 5.
 - NIE employs sophisticated and robust methods to plan expenditure on its network and is confident that its asset management processes meet the

substantive requirements of PAS 55, which is the recognised asset replacement standard among peer DNOs. Furthermore, the Utility Regulator's consultants judged NIE's risk assessment methods to be sound.

- In respect of its network planning standards, NIE's load-related investment proposals are designed to meet the planning standards laid down in condition 19 of each of its Licences. While the Utility Regulator has recently requested that NIE undertake a review of the present standards, it has not, to date, formally adopted new standards as the applicable standards for the purpose of Licence condition 19. In any case, contrary to what is implied by UR-4, paragraph 5(c), NIE believes that the adoption of GB standards is unlikely to have a significant downward impact on the level of load-related expenditure that NIE has assessed as being required during RP5 against current planning standards. There is therefore no substance in the Utility Regulator's criticisms of NIE's asset management processes or network planning standards.

22. See chapter 2 (Executive Summary) and chapter 5 (RP5 Capex – Quantum) of NIE's Statement of Case.

Risk characteristics of the RP5 price control

23. The Utility Regulator portrays the structural features of its proposed RP5 price control (i.e. the ring-fencing of 3 capex funds, subject to different volume/pricing risks, and different approval processes) as being apt to reduce the risks to which NIE is exposed, and suggests that this should lead to a lower cost of capital (UR-2 paragraph 46).

24. NIE disagrees with that characterisation of the 3 fund structure. The 3 fund structure reduces NIE's flexibility to respond to changing demands, reduces its scope to substitute new methods of achieving particular outputs for those written into pre-existing plans, and exposes NIE to the risk of ex post decision by the reporter/Utility Regulator that particular goods or services have been inefficiently procured or provided. The 3 fund structure thus adds to the risks faced by NIE and is likely to lead to an increase in its cost of capital.

25. The efficient unit cost levels assumed in the RP5 proposals are too low, so that the "risk sharing" mechanism is asymmetric: it will be impossible for NIE to deliver the required outputs against the assumed unit costs. Nor will NIE be allowed the flexibility to manage uncertainty as to the totality of capex requirements by applying a "swings and roundabouts" approach whereby reductions in the assumed costs of one project may be offset against cost increases subsequently emerging elsewhere. Instead, the reporter/Utility Regulator will attempt to assess NIE's efficiency on a project by project basis, after the event, by a process yet to be defined and in a manner which precludes NIE from benefiting properly from the aggregated effects of efficiently managing overall investment requirements to the benefit of customers.

26. See Chapter 4 (RP5 Capex – Structure), Chapter 9 (Incentives and Innovation) and Chapter 17 (Financeability) of NIE's Statement of Case.

The proposed retrospective RAB adjustment

27. The Utility Regulator argues that its decision to reduce NIE's opening RAB by £32 million is conservative, and a larger reduction may be justified (UR-2, paragraph 43), on the basis that, during RP3 and RP4, NIE altered its capitalisation practices so as to capitalise costs already covered by its opex allowance. NIE firmly rejects these allegations, and rejects the suggestion that the figure of £32 million is a conservative one.

28. The Utility Regulator's presentation of this issue in its opening submission is extremely misleading:

- it ignores the fact that NIE takes issue with the work of the Utility Regulator's consultants, from which the figure of £32 million is derived. The work on which the Utility Regulator relies is fundamentally unsound;
- it discounts the fact that, during RP3 and RP4, NIE's obligations as to the capitalisation of expenditure were exhaustively laid down in licence condition 2, which requires NIE to draw up its accounts in accordance with relevant accounting standards. The Utility Regulator accepts that NIE has complied with licence condition 2, but proposes now to make a retrospective adjustment, by reference to "principles" which were never part of the RP4 settlement, and which is not now justified;
- the Utility Regulator's approach to this issue proceeds on the erroneous basis that the opex allowances for RP3 and RP4 were earmarked to be expended on particular activities which had been undertaken, and treated as opex, in previous periods (UR-2, paragraphs 41-42). That is not correct. There has therefore been no "double counting", since there was never any reason to expect that an expenditure which, under licence condition 2, falls to be treated as capex would be covered out of an opex allowance;
- the Utility Regulator asserts that NIE "changed its accounting practices" (UR-2, paragraph 41), even though it knows that NIE contends that there have been no relevant changes;
- instead, NIE has installed new classes of assets (capex) which reduced the need for continuing maintenance of old assets (opex). For example, NIE introduced SCADA (supervisory control and data acquisition systems) in certain large substations. This has entailed capital expenditure, but has resulted in the reduction and eventual elimination of control room and switching services agreements and associated opex. Similarly, NIE has undertaken a programme to replace transmission switchgear with modern equivalent assets, and this rendered the existing air operating systems redundant, with a resulting reduction in maintenance requirements;
- NIE has adopted new cost recording systems, which allow NIE more accurately to identify which items of repairs and maintenance expenditure fall to be capitalised, resulting in a more accurate classification of costs between capex and opex;

- NIE has increased the rate of overhead line refurbishment, which entails substantial amounts of associated tree-cutting (capex) and has therefore been able to reduce the amount of reactive tree-cutting (opex) which needs to be undertaken. The Utility Regulator's own consultant (Mott MacDonald) was satisfied that NIE's strategy for management of overhead lines (which it knew to include substantial elements of tree cutting) was appropriate and invited the Utility Regulator, before the adoption of the RP4 price control, to decide how much of this tree-cutting expenditure should be included within NIE's capex budget. The Utility Regulator did not question NIE's intention to capitalise this expenditure or apply any specific discount in respect of the amount of tree-cutting that was expected to be undertaken and capitalised as part of the asset replacement and refurbishment programmes;
- NIE has also updated its assessment of the proportion of overheads to be capitalised, so that the proportion of overheads to be capitalised and the proportion to be treated as opex continue to track the relative proportions of NIE's overall expenditure represented by direct capex and by opex. Licence condition 2 requires NIE periodically to reassess its estimate of the amount of overheads to be capitalised, and NIE's auditors consider NIE's approach to be compliant with relevant accounting standards;
- although a higher proportion of overheads has therefore been capitalised in more recent periods, the overall amount of capitalised overheads has fallen, so that the overall amounts capitalised are less than was assumed in the setting of the RP4 price control.

29. The Utility Regulator now claims (UR-6, paragraph 9) that, if it is to avoid a retrospective reduction in its RAB, NIE bears the burden of proving that any fall off in opex during RP4 which is matched by a (broadly corresponding) increase in capex is attributable to a change in NIE's underlying activities (i.e. new assets, instead of maintenance of old assets). NIE submits that there is absolutely no foundation for such an approach, and that any attempt to implement it would be disproportionate and unworkable.

30. See also Chapter 11 (RAB Adjustment) of NIE's Statement of Case.

Financeability

31. The Utility Regulator suggests (UR-7, paragraph 43) that the CC may wish to investigate whether NIE's gearing level at the start of RP5 is excessive, by virtue of borrowings made to fund "avoidable shareholder distributions" as occurred in the Bristol Water case. NIE considers such a suggestion to be mischievous. NIE has consistently maintained its gearing below the RP4 gearing threshold of 57.5% and there is therefore no basis for any finding that NIE has made excessive distributions to shareholders, so as to have weakened its financial position. To the extent that NIE has concerns about the financeability of the RP5 proposals, that is because the Utility Regulator's Final Determination fails to provide sufficient revenues for NIE efficiently to finance necessary expenditures, and fails adequately to model the effects of the proposed price control on NIE's financial position.

Inaccuracies in the presentation of the issues

32. The Utility Regulator's opening submission claims to summarise some of the issues arising in the present CC investigation. We would urge the CC to exercise caution in relying on the Utility Regulator's summary since, in some respects, it mischaracterises the nature of the dispute between the Utility Regulator and NIE. For example, the Utility Regulator suggests at UR-3, paragraph 15 that NIE seeks additional labour (i.e. wages) costs to meet workforce renewal needs, and its challenge to NIE's case proceeds on that basis. In fact, workforce renewal costs are a separate head of cost relating to recruitment, training and development of staff, to reflect the need to recruit and train a new generation of skilled engineers. Similarly, at UR-3, paragraph 16, the Utility Regulator mischaracterises the dispute about renewables baseline opex costs as being a dispute about salaries. This is incorrect: the main area of dispute relates to the allocation of managed service and supply chain overheads. See also chapter 6 (Opex) of NIE's Statement of Case.

Other matters

33. The Utility Regulator's opening submission summarises its Final Determination in respect of a number of other matters.

34. NIE does not comment on all these matters in the present letter, since they are dealt with in the relevant chapters of NIE's Statement of Case. We would point out that many of the most significant parts of NIE's case, such as the Final Determination's treatment of opex, WACC and the overall financeability of the proposals, are not discussed in this letter. They are, however, dealt with fully in NIE's Statement of Case.

Yours sincerely

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