

**NORTHERN IRELAND ELECTRICITY RP5 PRICE CONTROL REFERENCE
UR PAPER ON NIE T&D'S CAPITALISATION PRACTICES**

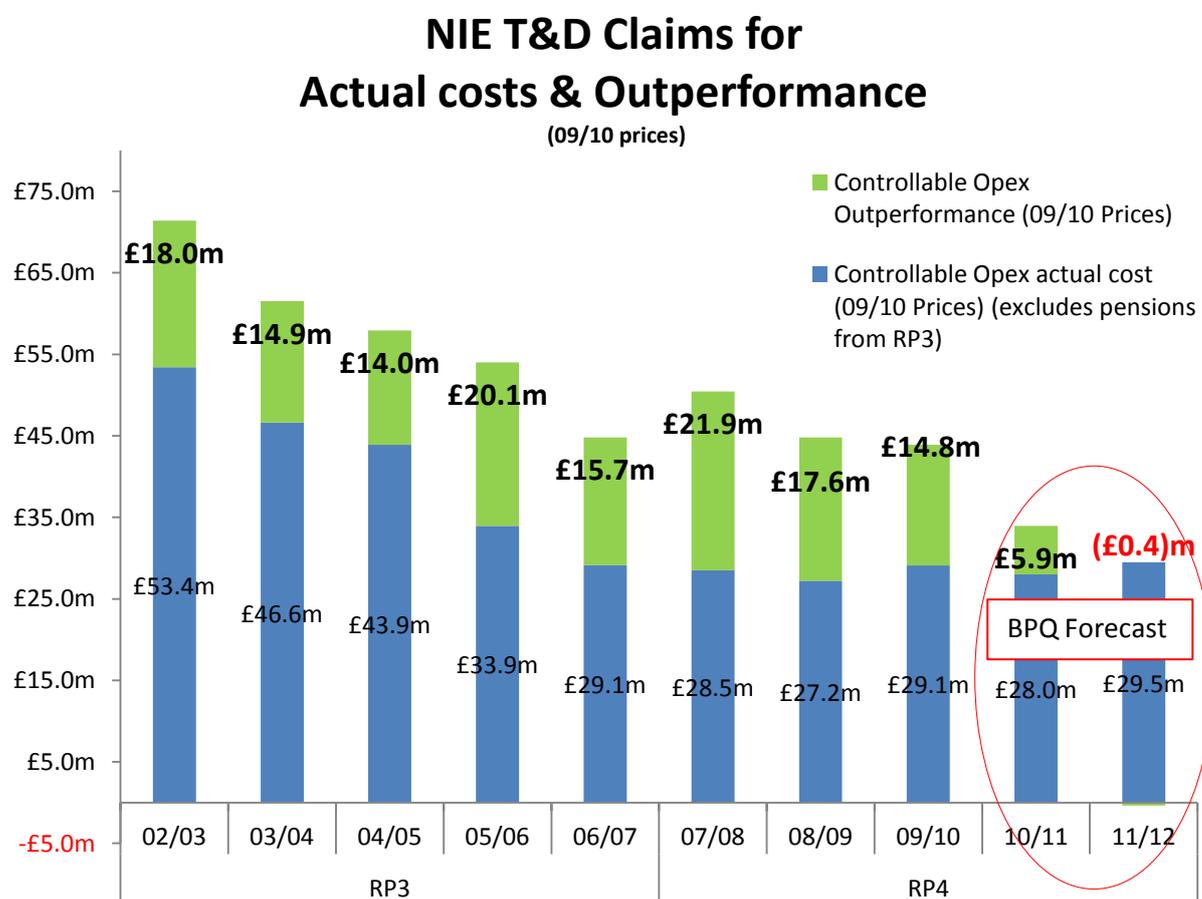
Introduction

1. This paper introduces and summarises the issues arising on this RP5 price control reference in relation to an adjustment that we proposed in the FD to make to NIE T&D's RAB to correct for NIE T&D's reclassification of costs from opex to capex in RP3 and RP4. In our view, as explained below, this issue calls for further investigation by the Commission.
2. This paper proceeds as follows. First, it sets out the basic facts that gave us concerns about the possibility that NIE T&D's change in capitalisation practices at the end of RP3, could in future have the inappropriate consequence of making customers pay twice for the same activity. Second, it sets out our view on how the question of the need for an adjustment to NIE T&D's RAB could be investigated further in this inquiry. Finally, it addresses the objections that NIE T&D has raised to the investigation of these issues.

The UR's concerns about NIE T&D's capitalisation practices

3. The starting point for our concerns about NIE T&D's capitalisation practices is the development of its opex performance over time, as illustrated in the following chart.

Chart 1: NIE T&D Claims for Actual Costs and Outperformance for RP3 and RP4 in 2009/2010 prices.



4. As will be apparent to the Commission, the reduction in controllable opex achieved by NIE T&D between 2004/2005 and 2006/2007 is extraordinary: a business that had been in the private sector since 1992 was suddenly able to reduce its controllable opex by more than one third (in real terms) in the space of two years.
5. That reduction in opex needs to be understood in the context of the incentives that were in place in respect of opex and capex at the time. The approach that we took in RP4, at NIE T&D's suggestion, was that controllable opex would be remunerated on a rolling "allowance" basis.¹ Thus the opex allowance for year 1 in RP4 was based on

¹ For completeness, it should be noted that the rolling allowance approach was subject to some adjustments, as set out in the [RP4 Final Proposals paper](#) (Sep. 2006, pages 2-3).

the actual outturn opex in year 1 of RP3, and the opex allowance for year 5 in RP4 was based on outturn opex in year 5 of RP3. In contrast, capex was remunerated on a pass-through basis. It follows that if NIE T&D could find a way, to classify as capex in RP4, what had previously been treated as controllable opex, it would retain the allowance for opex and *in addition*, benefit from an increase in its RAB. That process of reclassification would therefore increase NIE T&D's profit by £1 for every £1 of expenditure shifted. That extra £1 would come from customers, who could pay twice for the same expenditure: once through NIE T&D's opex allowance in RP4 and again over the following 40 years as a result of the increase in RAB.

6. We were concerned that a significant proportion of NIE T&D's opex saving was no more than the product of an accounting construct used by NIE T&D to profit at its customers' expense. That is self-evidently a serious matter which called for careful investigation. Our investigation revealed the following:

(a) First, there had indeed been a change in NIE T&D's approach to capitalisation in December 2005 (i.e. immediately before the dramatic reduction in opex referred to above at the end of RP3). In particular, NIE T&D issued a new version of its Network Capital Expenditure Procedures Manual at that time. Whereas the previous version of that manual had included three pages of detailed guidance on cost classification, the new version included only half a page of much more general guidance which allowed for more flexibility.²

(b) Second, there is evidence of specific costs being reclassified. Over the course of the final 2 years of RP3 and the five years of RP4, these costs added up to £35.6m of opex reclassified as capex. The report documenting that evidence was published with our draft determination³. It shows that reclassification occurred in three key areas:

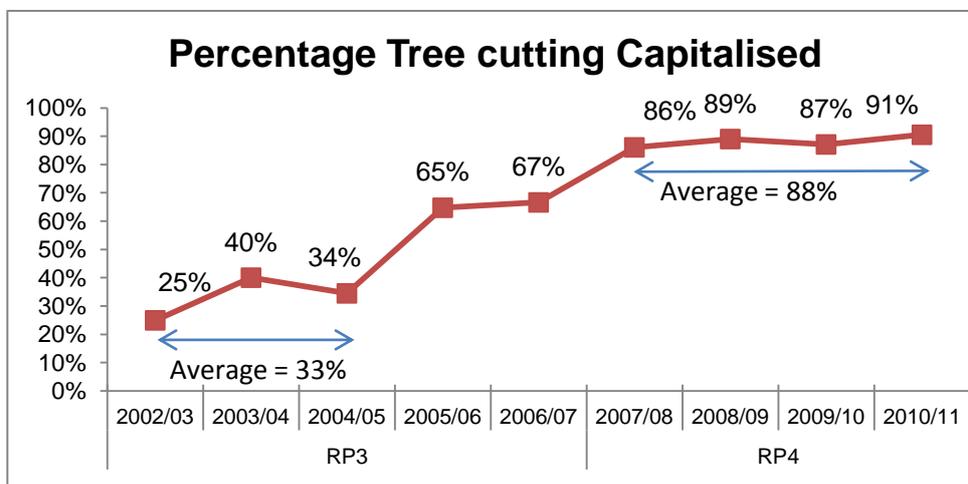
a) tree cutting: as illustrated in the following chart, costs associated with cutting trees that had previously been apportioned 67:33 opex:capex in the

² See Supporting documents UR-20 'Capitalisation Annex 1 - NIE RP3 - Managing Capital Expenditure'-(Pages 34-36 in the pdf, Pages 16/18 in Appendix 1) and in UR-21 'Capitalisation Annex 2 - NIE RP4 - MANAGEMENT OF NETWORK CAPITAL INVESTMENT' see Page 28 Appendix 1 of this document.

³ http://www.uregni.gov.uk/uploads/publications/Cap_pract_-_Confirmation_of_capitalisation_practice_materiality.pdf

period 2003-05 were subsequently allocated 12:88 opex:capex during RP4:

Chart 2: Percentage Tree cutting capitalised over RP3 and RP4



- b) repairs and maintenance: the total cost of services provided by NIE T&D's sister company NIE Powerteam Ltd had remained broadly constant at around £48m per annum between 2004/05 and 2010/11. However, the proportion that NIE T&D classified as capex increased from 58% to 71%; and
- c) overheads: NIE T&D increased their capitalisation rates for indirect costs substantially over the period without any evidence of an associated efficiency gain to reflect the reduction in indirect opex costs.

7. The calculation of the figures involved in each of these areas is given in the table below.⁴

Table 1: Consultant auditors' recommended reclassification of capex costs

2009-10 prices £m	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	Total
Repairs and Maintenance	1.6	1.6	3.2	2.4	2.6	1.8		13.2
Tree cutting	0.6	0.4	0.8	1.5	2.3	3.0	4.0	12.6
Capitalised overheads	1.0	1.6	1.5	1.4	1.4	1.4	1.5	9.8
	3.2	3.6	5.5	5.3	6.3	6.2	5.5	35.6

⁴ See also the [draft determination on Capitalisation practice published by the UR - 30th Aug 2012](#) (Table 3, page 17)

8. NIE T&D questioned those findings during our price control process. It admitted, however, that it had:

"changed the way in which it estimates the amounts to be capitalised in respect of certain heads of expenditure (or the resulting estimates) and it has employed new ways of estimating the amount of repairs and maintenance expenditure to be capitalised (based on better tools for capture of the underlying data and business process improvements).⁵

9. It also admitted (implicitly) that the increase in capitalisation that occurred in the relevant period was at least in part attributable to that change in approach to classification, rather than to changes in the work done by NIE T&D.⁶ It contended, however, that "much" of the increase in capitalisation reflected changes in the activities in question. What NIE T&D was unable to do, however, was to demonstrate with evidence that the increase in capitalisation reflected changes in the underlying activities. For example, the most compelling attempt that NIE T&D made to justify the increase in capitalisation related to tree cutting, where it claimed that there had been a shift from reactive tree cutting (which NIE T&D says should be treated as opex) to preventative tree cutting (which NIE T&D says should be treated as capex).⁷ Even in that case, however, it is plain that there has been no change in the activity carried out by NIE T&D (i.e. cutting trees) or the impact on NIE T&D's assets (i.e. fault-free power lines).
10. In light of the results of our investigation and NIE T&D's responses, we took the view that we should not include amounts in the RP5 RAB if customers had already paid for the work carried out via NIE T&D's RP3 or RP4 opex allowance. There is no justification for increasing bills in response to a technical change in NIE T&D's accounting, as NIE T&D had itself recognised in 2005:⁸

For regulatory purposes, actual expenditure is recovered either via the RAB over 40 years or via the opex allowance but not through both.

⁵ [NIE T&D's Response](#) to the Utility Regulator's Draft Determination *in respect of an Investigation into NIE T&D's Capitalisation Practice*, 27th September 2012, §1.11.

⁶ So much is implicit in NIE T&D's assertion that "*much of what the Utility Regulator condemns as wrongful capitalisation relates, in fact, to changes in the underlying activities which NIE has undertaken to improve its stewardship of its transmission and distribution network*" (emphasis added). *ibid* §1.12.

⁷ *ibid*.

⁸ Supporting document UR-22 The 'Composite Proposal' submission from NIE T&D 4th March 2005.

11. We therefore proposed in the FD to adjust the starting RP5 RAB to take out the residual, undepreciated value of the RAB additions that came about as a result of the reclassifications shown in table 1. The value of this adjustment was £31.7m⁹. We considered that that was the best way to prevent customers from paying twice.

Our proposal for this inquiry

12. In our view, it is important that the Commission should look afresh at this matter as part of its inquiry. As explained in our overview paper, this is not an appeal and the Commission's task is to determine for itself what modifications to NIE T&D's licences would be in the public interest. As the Commission will appreciate, investigating this issue effectively will require the devotion of substantial resources at an early stage in the inquiry.
13. In particular, we consider that the following avenues of inquiry are likely to be fruitful in this investigation:
 - a) Investigation of specific instances of cost reclassification – one option is for the Commission to undertake its own analysis of individual cost categories. In addition to the tree-cutting, repairs and maintenance and overheads instances that we identified in our investigation, there are a number of other areas that we think should be investigated further in this inquiry. These include: tower painting; line patrols and line survey work; unproductive time, including design costs for projects that are not commissioned; and the treatment of NIE Powerteam costs in general.
 - b) Examination of accounting manuals – in the early stages of our investigation, we sought to trace through the evolution of NIE T&D's formal estimation policies and procedures over the relevant period. We established that NIE T&D issued a new version of its Network Capital Expenditure Procedures Manual in December 2005. But despite repeated requests, NIE T&D failed to produce any further contemporaneous documentation to explain how these criteria were to be applied and how, if at all, the results were expected to differ from the results under NIE T&D's old approach to cost classification. In light of the absence of documentation that one would expect would have been produced at the time, it may (for

⁹ See [FD](#) (4.1, page 14)

example) be instructive for the Commission now to investigate NIE T&D's document retention policies.

- c) Examination of efficiency savings – a third approach would be to establish directly how much of NIE T&D's out-performance can be attributed to identifiable efficiencies, rather than start from the assumption that all out-performance is a result of efficiency unless shown otherwise.
14. Once the Commission has reached its conclusions as to the extent of NIE T&D's reclassification of opex as capex, it will then need to consider what to do about it. As noted above, our approach in the FD was to reduce NIE T&D's RAB by the corresponding amount.¹⁰ We continue to believe that that is the minimum that must be done. Any other approach involves knowingly requiring customers to pay again over the next 40 years (through the depreciation of and return on, the RAB) for the work that they have already paid as opex during RP3 and RP4.
15. Support for that approach (if it were needed) can be found in the Commission's recent *Phoenix Gas Report*¹¹, in which the Commission said:

"5.89 The intention of rewarding outperformance is to encourage the achievement of efficiencies. Therefore outperformance should be an accurate reflection of cost savings that were efficiently incurred, rather than where, for example, the regulated company provides deliberately misleading information to the regulator or where the regulator made a technical error (e.g. a calculation error).

...

5.103 ... We think that funding PNGL twice for the same expense is a technical error and that this would operate against the public interest."

16. We therefore urge the Commission to take the same approach in this case.

NIE T&D's objections to the investigation of its capitalisation practices

17. Unsurprisingly, NIE T&D's position during our price control process was that its capitalisation practices during RP4 should not be investigated at all. Its principal objection was that because it had technically complied with its licence obligations with respect to accounting (in particular, Condition 2), it followed that any adjustment to its

¹⁰ This 'corresponding amount' took account of the remaining mechanics of the price control e.g. depreciation, tax allowance, transmission adjustment, rolling opex mechanism etc.

¹¹ See [Competition Commission – PNG - Price Determination](#)

RAB based on its accounting practices in the previous price control periods was retrospective and inappropriate.¹² NIE T&D argued that our approach amounted to the ex post imposition of “implied rules” for the RP4 price control.¹³

18. That is incorrect. Whether NIE T&D is right to say that its change in practices did not breach accounting rules or its licence conditions is irrelevant. This is not a breach of licence investigation. It is an inquiry into what the public interest requires in relation to NIE T&D’s price control for RP5.
19. Moreover, it is wrong for NIE T&D to suggest that there was anything new about the principle of no double charging that guided our approach to this issue. On the contrary, NIE T&D itself proposed (and we accepted) that that should be the guiding principle of the RP4 treatment of opex and capex:

"For regulatory purposes actual expenditure is recovered either via the RAB over 40 years or via the opex allowance but not through both".¹⁴

20. NIE T&D cannot legitimately object to the application of the principle that it proposed and that provided the basis on which we accepted NIE T&D’s proposed treatment of opex and capex in RP4.
21. NIE T&D also criticised many of the details of our investigation.¹⁵ While we disagree with those criticisms, we do not see any merit in engaging in a historical debate with NIE T&D at this stage about those details. What matters now is how the Commission investigates this issue. We look forward to assisting the Commission with that investigation in due course.

¹² See the first two bullet points and the seventh bullet point in [NIE T&D's Response to the Utility Regulator's Draft Determination](#) in respect of an investigation into NIE (T&D)'s Capitalisation Practice §1.4.

¹³ *ibid.*

¹⁴ Supporting document UR-22 *NIE T&D Price Control for RP4: The Composite Proposal*, 4th March 2005, p1.

¹⁵ [NIE T&D's Response to the Utility Regulator's Draft Determination](#) in respect of an investigation into NIE (T&D)'s Capitalisation Practice §1.4