

## NORTHERN IRELAND ELECTRICITY RP5 PRICE CONTROL REFERENCE

### UR PAPER ON OPEX

#### Introduction

1. This paper introduces and summarises the issues arising in this RP5 price control reference in relation to NIE T&D's allowances for operational expenditure ('opex'). First, it outlines our general approach to opex allowances in RP5. Second, it explains in more detail our approach to controllable opex, including benchmarking for "business as usual" opex and our proposed treatment of new opex, including that associated with NIE T&D's new IT system, "Enduring Solution". Third, it explains what is included within uncontrollable opex, and identifies particular points that would benefit from further investigation by the Commission in this inquiry.

#### General approach and risk allocation

2. Our proposed approach draws a distinction between controllable and uncontrollable opex. In respect of controllable opex, our approach is to propose an overall allowance based on the opex that an efficient operator of the network would incur. NIE T&D bears the risk of any over or under-performance against that benchmark. That provides NIE T&D with an incentive to be efficient.
3. In respect of uncontrollable opex, we have proposed a pass-through approach. NIE T&D is therefore fully insulated from the risk associated with the items that fall within that category. That approach is justified by the fact that where opex is genuinely and wholly outside NIE T&D's control, there is no benefit to be had from incentivising efficiency, because there is nothing NIE T&D can do about this opex in any event. As discussed in more detail below, however, NIE T&D does have some control over some aspects of this category. An issue for the Commission to consider is whether any of those elements of opex should be shifted into the controllable opex category, or whether an intermediate approach (such as the introduction of new risk-sharing mechanisms) would be desirable.

#### Controllable opex

4. As noted above, if the Commission follows our overall approach to opex allowances, the main issue in respect of controllable opex (i.e. opex over which NIE T&D is able to

exercise a reasonable degree of control) is the estimation of the opex that an efficient operator would spend in this price control period. To make that exercise more manageable, we divided NIE T&D's opex into "business as usual" controllable expenditure (i.e. those items of controllable opex during RP5 that reflect or continue items of controllable opex that NIE T&D incurred during RP4 as well), and "new" controllable opex (i.e. items of controllable opex that are new in RP5).

#### "Business as usual" controllable expenditure

5. In respect of "business as usual" expenditure, we constructed a baseline level of expenditure based on NIE T&D's total opex in the year 2009/2010, after adjusting for exceptional items. We selected that year because it was the most recent year for which audited annual accounts were available. We conducted a benchmarking exercise (as described below) to determine the extent of a "catch up" efficiency adjustment that needed to be made to that baseline.
6. Our benchmarking exercise was based on data from 2008/2009 because that was the latest year for which actual cost data were available for GB DNOs – the most appropriate benchmark for NIE T&D. To ensure we were comparing like with like, we used NIE T&D's data from 2008/2009 for the benchmarking exercise. We are in the process of obtaining data from 2009/2010 to update the benchmarking analysis (alongside further sensitivity analyses) and will provide the results to the Commission when they are available.
7. Although in principle it would have been desirable to benchmark all of NIE T&D's business as usual controllable opex, we were unable to obtain reliable results in respect of NIE T&D's network repairs and maintenance costs. That was because NIE T&D was unable to provide sufficient data on the relevant cost drivers. For example, in respect of tree cutting costs (some of which are treated as opex), we wanted to follow the same approach as Ofgem, which uses the length of spans of overhead lines cut as a cost driver. NIE T&D was unable to produce data on that driver. That is unsatisfactory and reflects the broader lack of transparency and accountability in NIE T&D's operations.
8. The consequence of that lack of data is that we were only able to produce a robust benchmarking of NIE T&D's indirect opex costs (i.e. total controllable opex less network repairs and maintenance (R&M) costs). In other words, our Final Determination (FD) proposal implicitly assumes that NIE T&D's network costs for R&M

are already efficient. The results of our indirect cost benchmarking exercise showed that NIE T&D ranked 8th out of 15 for its indirect costs. That is notwithstanding having taken a conservative approach in accepting NIE T&D's assumptions as inputs for the exercise. For example, we accepted NIE T&D's submission that connections work accounts for 20% of its opex costs, even though the anecdotal evidence suggested that that figure overstates the extent of connections work undertaken by NIE T&D. That tends to flatter NIE T&D's performance in the benchmarking exercise, since those costs are excluded from the comparison with GB DNOs. It may be that the Commission can produce a more reliable estimate in the course of this inquiry, which would improve the accuracy of the benchmarking.

9. Another respect in which the exercise was biased in NIE T&D's favour was that it did not take into account the changes in NIE T&D's approach to capitalisation (discussed in our paper on capitalisation practices), whereby it has increased the proportion of work that it classifies as capex rather than opex. The reason this was not taken into account was that this information was not available to us at the time of the benchmarking exercise. We believe that further investigation of the differences in approach to capitalisation as between NIE T&D and GB DNOs to ensure that like is compared with like could add value.
10. In translating the results of the benchmarking exercise into an efficiency adjustment, we required NIE T&D to match the costs of the 75th percentile (i.e. the bottom of the upper quartile). That translated into a reduction of 10-13% in indirect costs, which in turn translated into a total opex cost reduction of 7.0-9.1% (based on the fact that indirect costs accounted for 73.2% of NIE T&D's total opex in 2008/2009). Ultimately, we decided on a catch up efficiency adjustment of 7.0%.
11. As will be apparent, that approach was conservative in at least two respects.
  - (a) First, we only required NIE T&D to match the 75th percentile of efficiency, rather than to be at the frontier (or somewhere in between).
  - (b) Second, we opted for the bottom of the range of estimates of the extent to which NIE T&D needed to improve to reach that level.
12. A further respect in which our approach in the FD was conservative was that we proposed that NIE T&D should be allowed to achieve that catch up over the course of the first two years of RP5, i.e. 2012/13 and 2013/14, rather than NIE T&D being

restricted to an allowance for efficient opex from the start of the new control period. The Commission may well consider it appropriate to impose a more challenging target on NIE T&D.

13. During the course of our price control process, NIE T&D took issue with a number of aspects of our benchmarking exercise. It is not clear at this stage how many of those issues will remain live in this inquiry in light of the many respects in which we adjusted our approach to opex between the Draft Determination (DD) and FD, particularly if the Commission conducts its own, separate benchmarking exercise. One difficulty which we had with the benchmarking exercise was that the GB DNO data provided by Ofgem were confidential and not able to be released to NIE T&D. It would obviously be preferable for all concerned if NIE T&D (or at least its external advisors) could be given access to the detail of the model, and it may be that either the more recent data that the Commission uses will not be subject to the same confidentiality issues or that the Commission can resolve such confidentiality concerns as there are in the usual way consistent with the Commission's confidentiality obligations under Articles 16(3A)-16(3D) Electricity Order. One issue of significance, however, is the treatment of wages. In our benchmarking exercise, we made an adjustment to the data to reflect differences in regional wages between the regions in which the DNOs operate. We found that weighted average wages for "professional occupations" and "skilled trade occupations" (as recorded in the Annual Survey of Household Expenditure (the "ASHE")) were 10% lower in Northern Ireland than the UK average, and therefore took the view that NIE T&D's wages should be 10% lower than the UK average for DNOs. NIE T&D contended that the adjustment should be much lower, 1.4%, based on more disaggregated data from the ASHE than that which we used. While in principle disaggregation is of course desirable as a way to improve the validity of the comparison, the disadvantage of disaggregation is a reduction in sample size, which tends to increase the volatility of the data. We consider that NIE T&D's disaggregated approach involved samples that were too small to be reliable.

#### "New" controllable expenditure

14. NIE T&D in its business plan submissions sought allowances for a number of "new" items of expenditure. The principal items (there were some other smaller items as well) were (i) workforce renewal; (ii) renewables baseline opex; (iii) real price effects ('RPEs'); and (iv) its new, "Enduring Solution" IT system. These are considered in turn below.

15. NIE T&D sought an allowance for £7.4m of "workforce renewal" in the course of RP5. We rejected that claim in its entirety. Given the state of the economy in Northern Ireland (and in the wider UK and in the Republic of Ireland), it is difficult to understand why labour costs ought to *increase* substantially over the RP5 period. NIE T&D suggested that the consequence of not allowing it to increase spending on wages was that skilled staff would leave to take up employment elsewhere, but NIE T&D was unable to provide convincing evidence to support that proposition.<sup>1</sup> Moreover, to the extent that the additional workforce opex costs anticipated by NIE T&D were associated with the extraordinary capex programme that it had proposed, they would not in fact be likely to be incurred in light of the findings that we reached in relation to capex (as to which see our paper on capex). That is something that can be revisited during the course of this inquiry if the Commission takes a different view of the amount of capex that is required.
16. The second major category of new opex claimed by NIE T&D relates to baseline opex costs associated with the preliminary development phases of the renewable energy transmission projects that it has identified. Those costs largely comprise the cost of staff planning the development of those projects. Once they have progressed beyond the planning phase, the additional costs will be treated as capex (as to which, see the explanation of Fund 3 in our paper on capex). The main issue that arises on this inquiry in relation to these costs is the salary levels of the relevant staff. NIE T&D's submission assumed that the relevant staff would need to be paid considerably more than the average salaries that it pays its staff. We do not consider that assumption to be justified and therefore proposed in the FD that the allowance should be reduced accordingly.<sup>2</sup>

The third category is RPEs, which, as the Commission will understand, relates to the extent to which NIE T&D faces inflation above (or below) that captured by RPI. NIE T&D requested an allowance of £8.8m for these effects over RP5. Our calculations, included within our supporting papers,<sup>3</sup> forecast the following annual real price effects over RP5:

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<sup>1</sup> See, for example, the mere assertion of an increase in leavers in [NIE Response to DD](#) Ch 6 §4.88.

<sup>2</sup> [FD](#) §6.35.

<sup>3</sup> Supporting Document UR-16 - RPEs Executive Summary

**Table 1: Year on Year Opex RPE**

RPE	2012/13	2013/14	2014/15	2015/16	2016/17
RPE (year on year %)	-0.1%	1.4%	1.6%	0.9%	0.8%

17. Those effects were outweighed, however, by significant negative effects (-2.1%) for each of the periods 2010/2011 and 2011/2012 that NIE T&D had not taken into account. The cumulative effect was therefore a *negative* adjustment of £3.3m over the period. The Commission will no doubt produce its own estimate of real input inflation based on the most up to date forecasts available.
18. The final category is the opex associated with NIE T&D's new Enduring Solution IT system. This IT system was required for domestic market opening in Northern Ireland. The information provided by NIE T&D in relation to those costs was a cause of serious concern for us during the price control process, and we would welcome any further investigation that the Commission is able to conduct in this inquiry. NIE T&D initially claimed the substantial sum of £22.4m. This increased to £29.4m in NIE T&D's response to the DD after a number of other submissions for various cost categories. That is an unsatisfactory way to approach the setting of an allowance for such a substantial opex item. We considered such evidence as NIE T&D was able to provide. Our final allowance for these costs was £21.4m. The reports on which that allowance was based is annexed to this paper.<sup>4</sup>

#### Ongoing efficiency adjustment

19. In addition to the 7.0% "catch up" efficiency requirement that we proposed in its FD for "business as usual" controllable opex costs (as to which, see above), we also proposed a 1% annual ongoing efficiency adjustment for all controllable opex (other than in respect of the new Enduring Solutions IT system costs), to reflect the potential to improve productivity from one year to the next that even efficient businesses have. That is consistent with recent regulatory precedent, including the Commission's

<sup>4</sup> Supporting documents UR-17 'Gemserve update report on changes to the Enduring Solution ICT and employee costs (6 July 2012)' and UR-18 'Report on NIE's revised RP5 Opex proposals for Enduring Solution ICT (25 September 2012)'

assessment of the scope for year-on-year improvements in productivity of 0.9% per annum in the 2010 Bristol Water inquiry.<sup>5</sup>

#### Total allowance for controllable opex

20. Our proposed allowances for controllable opex are set out in the following table alongside NIE T&D's initial request:

**Table 2: Controllable Opex Summary.**

£m 2009/10 prices	NIE RP5 Total	UR 5 yr Total
<b>Base level Controllable Opex</b>	174.1	167.5
7% "catch up" efficiency adjustment		-10.6
Legislative and regulatory requirements	3.7	0.5
Workforce renewal	7.4	0.0
Storm costs	1.6	1.6
AGU		0.3
Credit rating process		0.4
PAS55		0.1
Enduring Solution/ Market Opening	22.5	21.4
Renewables Baseline	19.3	9.8
<b>New Controllable Opex</b>	54.6	34.1
1% ongoing efficiency adjustment		-5.6
RPEs	8.8	-3.3
<b>Total Controllable Opex</b>	237.4	182.2

#### **Uncontrollable opex**

21. As noted above, in the FD we proposed that uncontrollable opex should be allowed on a full pass through basis. For that reason no issue of benchmarking or efficiency arises. NIE T&D is thus held risk-free by the regulatory framework for this type of opex– which makes up a substantial element of total opex. The issues for the Commission to investigate in this inquiry are: (i) to what extent these items really are outside of NIE T&D's control and should therefore be included in this category; and (ii) if the Commission considers that some items are controllable to some extent, but not sufficiently to justify treating them as fully controllable, whether an alternative risk allocation should be introduced.

<sup>5</sup> [Bristol Water](#) Appendix K §109.

22. The items that we proposed should be included as "uncontrollable" and the amounts that NIE T&D expected to spend over the course of RP5 in respect of those items are identified in the following table. It is worth noting that these are pass through and the figures are indicative.

**Table 3: NIE T&D Uncontrollable Opex Submission.**

£m 2009/10 prices	NIE T&D RP5 Total
Rates	69
Wayleaves	21.2
Licence fees	5.7
Reporter	0
Injurious affection	11.4
<b>Total Uncontrollable Opex</b>	<b>107.3</b>

23. Those are clearly substantial sums of money. Our observations on the extent to which they are genuinely uncontrollable are set out below:
- (a) Rates: NIE T&D has essentially no control over the rates it pays in respect of its network, because those are set out in the Valuation (Electricity) Order (Northern Ireland) 2003. It does have some control (at least in the long run) over the rates it pays for its other buildings, however, in so far as it can choose the number, type and location of those buildings. We note that Ofgem treats the former as uncontrollable and the latter as controllable. We would suggest that it is worth considering whether that or another kind of hybrid treatment might be preferable to treating these costs as wholly uncontrollable.
- (b) Wayleaves: These are payments that NIE T&D is required to make to landowners in respect of equipment that NIE T&D owns on their land. Unlike the position with respect to rates, there are no regulations that stipulate the amount to which landowners are entitled. Rather, those sums fall to be negotiated between the landowners (or their collective representatives) and NIE T&D. NIE T&D contends that they are uncontrollable because it treats the payments made by Scottish Power as a precedent for its negotiations.<sup>6</sup> But that is just the choice that NIE T&D has made (no doubt reflecting the fact that it has no incentive to

<sup>6</sup> [NIE Response to DD](#) Ch6 §6.13.

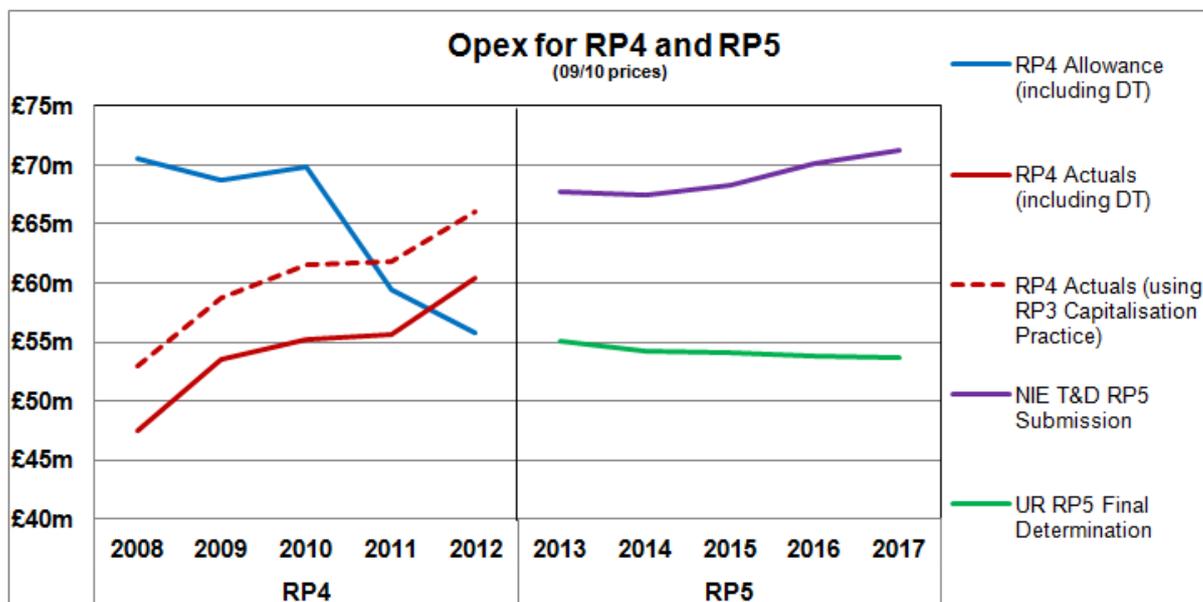
reduce costs in this area), rather than evidence that it does not have a choice. We note that Ofgem treats wayleaves as controllable, and consider that this is a matter that would benefit from the Commission's detailed appraisal.

- (c) Licence fee and reporter: These costs are entirely outside of NIE T&D's control and so in our view should be remunerated on a pass-through basis.
- (d) Injurious affection: These are damages that NIE T&D anticipates needing to pay as a result of litigation (or potential litigation) from landowners in respect of any diminution in the value of their property caused by the existence or use of public works carried out under, or in the shadow of, compulsory powers. So far no such claims against NIE T&D have proceeded to judgment. There is therefore naturally a significant degree of uncertainty as to the costs associated with these claims, and they are, to some extent, out of NIE T&D's control. However, as with all litigation which is capable of settlement, NIE T&D must have some control over the outcome and we note that Ofgem treats such costs as controllable and consider that this is, again, a matter that would benefit from the Commission's detailed appraisal.

## **Conclusion**

- 24. The UR's overall allowance for opex in RP5 is shown in the chart below against other relevant reference points in 2009/10 prices.

Chart 1: Comparison of Opex for RP4 and RP5



25. As explained above, our proposal in respect of opex removes all of the risk associated with a substantial proportion of NIE T&D's opex work, and provides substantial scope for outperformance in the remainder by setting relatively modest efficiency targets and allowing NIE T&D two years in which to meet the catch-up component. From our perspective, the main areas that call for further investigation in this inquiry are:

(i) updating of, and if possible, extension in scope of the benchmarking exercise in respect of controllable costs;

(ii) further consideration of the extent and timing of the "catch up" efficiency adjustment that should be made to NIE T&D's controllable costs;

(iii) further consideration of the allowances for RPEs and ongoing productivity improvement; and

(iv) an investigation of the categories of uncontrollable costs and whether it is possible to include efficiency incentives and protections for customers in relation to those costs.