



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

Supplementary submission to the  
Competition Commission following  
NIE T&D's Statement of Case

24 May 2013

## UR'S RESPONSE TO NIE T&D'S STATEMENT OF CASE

### Introduction

1. This paper sets out our response to NIE T&D's Statement of Case ("SoC") dated 10 May 2013. The SoC is a 377 page document, accompanied by voluminous annexes and appendices. According to NIE T&D, it was prepared over the past six months. As the Commission will appreciate, it has not been possible to prepare a full response to the points of detail raised in the SoC in the two weeks that the Commission has allowed us. Instead, this paper sets out our response to the points of principle raised in the SoC, with our submissions on the points of detail to follow in due course (as noted below).
2. As we explained in our introductory overview submissions (UR-2), this inquiry is not an appeal from or review of our Final Determination ("FD"). The Commission is not being asked to choose between the positions set out in our FD and the SoC. Rather, the Commission's task is to decide for itself what changes should be made to NIE T&D's licence conditions in respect of the next price control period. In this context, we emphasise that our role is to give the Commission expert advice and guidance to inform the Commission's own independent assessment of the revenue that NIE T&D requires in RP5 and the appropriate accompanying regulatory arrangements. That is of course no substitute for the Commission's own factual investigations and analysis of the issues before it.
3. This paper proceeds as follows. First, we respond to NIE T&D's submissions on the approach to this inquiry, and in particular to the question of what NIE T&D wrongly describes as the "*new lines of inquiry*" that we have asked the Commission to pursue. Second, we provide a short summary of our response to each of the substantive chapters of NIE T&D's SoC, indicating the points on which our detailed submissions are to follow. Third, we provide more detailed submissions on the important points of principle raised in the SoC. Finally, we conclude by reminding the Commission of the important issues that NIE T&D would prefer the Commission did not investigate, namely those matters in respect of which we have asked the Commission to consider whether, in its judgment, a more favourable determination for customers should be made than that set out in our FD.

## Approach to this inquiry

4. As noted above and in our introductory overview submissions (UR-2), this inquiry is not an appeal from or review of our FD and associated licence modifications. Several important points flow from that observation, as set out below.
5. **First**, the procedure by which the FD was made or particular issues were dealt with is largely irrelevant to this inquiry. That is why we did not burden the Commission in our introductory submissions with an account of the many respects in which NIE T&D's engagement with our price control process was unsatisfactory. NIE T&D, however, has wrongly sought to treat this inquiry as a quasi-judicial review of our price control process (see, for example, Ch 2 §§1.16-1.22, Ch 7 and Ch 11 §§4.6-4.36 and 5.21ff). We reject the criticisms made by NIE T&D of our processes but do not propose to waste the limited amount of time that the Commission has by addressing them here, since on any view they are irrelevant to the issues under consideration in this inquiry.
6. **Second**, this inquiry must not be a one-way bet for NIE T&D. The inquiry should involve more than the Commission's appraisal of NIE T&D's "shopping list" of requests for additional revenue. The scheme of the statutory framework is that customers in Northern Ireland are entitled to the benefit of a fresh and independent assessment by the Commission. It is for that reason that we have drawn to the Commission's attention issues on which we consider that one could reasonably reach conclusions that are different from those set out in the FD. Contrary to NIE T&D's submissions, that does not betray any "*lack of confidence*" on our part in respect of our approach in the FD.<sup>1</sup> Nor are we proposing that the Commission should pursue lines of inquiry that we "*considered unnecessary or disproportionate to pursue, or in respect of which no evidence was available*".<sup>2</sup> Rather, we are proposing that the Commission should revisit judgment calls that we made in the FD on issues in respect of which reasonable regulators could differ. Customers in Northern Ireland have a right to the benefit of the Commission's judgment on all issues, not just on those on which NIE T&D would like the Commission to focus.
7. **Third**, and related to this, the outcome of this inquiry should not turn on the robustness or otherwise of the analytical work that we conducted as part of our review. We note that NIE T&D considers that there are flaws in a number of aspects of our analysis. As

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<sup>1</sup> NIE T&D Cover Letter §2.

<sup>2</sup> *ibid.*

explained below and elsewhere in our submissions, we disagree. In particular, for ease of reference, the Commission should note that Appendix E (UR-27)<sup>3</sup> to our FD provides a detailed response to those criticisms that NIE T&D made in its response to our DD, which largely form the basis for the criticisms that it repeats in the SoC. In any event, however, even if NIE T&D were right that our analysis was flawed in some respects, it would not follow that our FD proposal provided for insufficient revenues to satisfy NIE T&D's legitimate requirements. In order to set opex and capex allowances, an allowance for pension costs, a weighted average cost of capital and the starting value of NIE T&D's Regulatory Asset Base ("RAB"), the Commission will need to form its own view (which will inevitably require at least some primary analysis) in at least the following areas:

- (a) an assessment of the efficiency of NIE T&D's opex, using benchmarking or other techniques;
- (b) costing of future increments and decrements to historical opex;
- (c) an assessment of the efficiency of NIE T&D's capital unit costs, using benchmarking or other techniques;
- (d) an assessment of the required volumes of capital works together with mechanisms for incentives and addressing uncertainty;
- (e) estimation of real price effects (RPEs);
- (f) estimation of the normal rate of ongoing productivity growth for an efficient network company;
- (g) analysis of the proportion of NIE T&D's RP4 opex out-performance that was achieved through cost reclassification rather than efficiency improvement; and
- (h) estimation of the weighted average cost of capital.

8. Moreover, it bears emphasising that in some cases the issues that we have suggested would benefit from the Commission's particular attention do not require any further factual investigation on the part of the Commission. For example, in respect of the

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<sup>3</sup>UR-27:

[http://www.uregni.gov.uk/publications/rp5\\_appendix\\_e\\_comments\\_on\\_nie\\_td\\_response\\_to\\_rp5\\_draft\\_determination](http://www.uregni.gov.uk/publications/rp5_appendix_e_comments_on_nie_td_response_to_rp5_draft_determination)

treatment of early retirement deficit costs (UR-5 §18), we have already identified for the Commission what we consider to be the correct adjustment as a matter of first principles: customers should bear 50% of the cost of the deficit and NIE T&D's shareholder should bear the other 50%. The only question that we have asked the Commission to consider is whether that principled approach should be adopted in RP5, or whether (as in our FD proposal) a 70:30 split in NIE T&D's favour should be adopted in light of Ofgem's precedent and the approach that we took in RP4. It does not surprise us that NIE T&D should want to discourage the Commission from considering these issues (since NIE T&D is concerned to deliver a price control outcome that primarily serves the interests of its shareholder). But we - who under our statutory duties have to have regard to a much wider range of considerations and stakeholders - urge the Commission to fulfil its own similar statutory duties by investigating these issues carefully.

9. **Fourth**, we urge the Commission, in addition to considering the various individual issues raised on this inquiry, to consider whether the overall package gives NIE T&D appropriate incentives to act in the best interests of customers. We are particularly concerned that NIE T&D's proposals, as set out in its SoC, are an attempt to cherry-pick involving the inconsistent application of approaches that would have the combined effect of incentivising regulatory gaming on a large scale. NIE T&D's approach can be summarised as follows:
  - (a) In respect of opex and pensions, NIE T&D contends that the rolling allowance approach from RP4 should be replaced with an allowance that provides for entirely new (and substantial) categories of opex and for a new 15 year programme of paying down the pension deficit, neither of which would have been funded during RP5 if the rolling approach had been continued. We agree with that approach. However, NIE T&D wants to have it both ways, contending that if the rolling approach would have yielded a higher allowance for NIE T&D in respect of a particular line of expenditure, it should get the benefit of that higher allowance as well. Thus, because a rolling approach in RP5 would have given NIE T&D credit for its over-contribution to the pension scheme in RP4, NIE T&D contends that it should be given that credit under the new approach. That is emblematic of NIE T&D's approach of seeking to cherry-pick only those aspects of regulatory approaches that operate in its favour.

- (b) In respect of capex, NIE T&D contends that it should be given an allowance based on its "*desk top*" calculations of its capex requirements, and that it should retain any "*efficiencies*" measured against those calculations over RP5. Critically, NIE T&D says that it must be given full flexibility as to what it actually does in respect of capex in RP5, which it says means that it must not be required to account for how, or even if, it has actually spent that capex allowance. So if NIE T&D subsequently decides that it can delay a particular project from RP5 to RP6, it will retain as an "*efficiency*" the full cost of that project in RP5, and may ask for customers to fund that project again during RP6. There can be no logging up or logging down of NIE T&D's RAB according to whether such projects were actually required or whether the delay was efficient. Similarly, if NIE T&D's "*desk top*" calculations of its unit costs turn out to have been very conservative, which is an entirely probable scenario, that inaccuracy in its estimate will automatically be considered an "*efficiency*" for which NIE T&D should be rewarded.
- (c) NIE T&D also says that at the end of a price review period, there must be no review by the regulator to correct for even the most egregious of instances of regulatory gaming. According to NIE T&D, save for cases of breach of licence conditions, any such review of what has taken place in the previous price control period would be retrospective and undermine certainty. For that reason, NIE T&D says that our proposal that an adjustment should be made for the impact that NIE T&D's change in approach to capitalisation had on NIE T&D's RAB during RP4 is impermissible. In contrast, however, such "*looking back*" is permissible and indeed desirable where it operates in NIE T&D's favour. Thus, NIE T&D is free now to characterise on a retrospective basis contributions that it made to its pension scheme that date back to RP<sub>3</sub> as contributions in respect of early retirement deficits.
- (d) In respect of cost of capital, NIE T&D contends that it should be given a return which is based on an estimate of cost of debt that exceeds NIE T&D's actual cost of debt and an estimate of cost of equity that exceeds NIE T&D's actual cost of equity. The latter proposal is based on the expected return on equity allowed by Ofgem, including incentives for good behaviour by GB DNOs to which NIE T&D has not been subjected. This is yet another instance of cherry-picking, in this case of elements of the Ofgem regime. NIE T&D wants rewards for good behaviour similar to those allowed by Ofgem without being required to behave

well or to bear the risk of corresponding penalties for bad behaviour as the GB DNOs must.

10. The combined effect of those proposals is clear. First, the cherry-picking of favourable parts of regulatory approaches necessarily results in customers paying more than they would pay under any coherent and principled approach to economic regulation. Second, the combination of approaches that NIE T&D proposes would create perverse incentives for NIE T&D to make customers pay more for it to deliver less. The excessive return on capital proposed by NIE T&D would create strong incentives for NIE T&D to do whatever it can to increase its RAB. The combination of a "no review" rule with an allowance based approach to capex with no requirement for NIE T&D to show that it has actually spent the allowance at all (let alone on desirable capex projects, further let alone on the capex projects on which the allowance was actually based) creates strong incentives for NIE T&D to overstate its capex requirements at this stage (both in terms of volume and unit cost) and then for it to defer projects to the next price control period so that customers pay twice.
  
11. It is clear that NIE T&D's approach as described above would operate against the public interest and should therefore be rejected by the Commission. But we also urge the Commission to treat NIE T&D's submissions of fact - especially with respect to its estimates of its opex and capex requirements over RP5 - with a degree of caution in light of the incentives set out above.

#### **Overview of our position on the issues raised in the Statement of Case**

12. NIE T&D's submissions on the issues of substance in this inquiry are set out in Chapters 4-17 of its SoC. Our response to those submissions is, in summary, as follows:
  
13. Ch 4 (Capex Structure): Our principal concern in relation to capex is that NIE T&D has failed to justify for large swathes of its planned capital programme or to reflect adequately the changes in circumstances that have occurred since it prepared its original capex submission. In the presence of significant uncertainty as to the volumes of work that an efficient company would take on in RP5, the Commission cannot realistically ask customers to pay NIE T&D a fixed lump sum. It is instead much better to provide NIE T&D with a smaller baseline allowance for schemes that have been properly justified and to provide for flexibility to add to this baseline within RP5 whenever a need for additional work is properly identified and when there is certainty

that new assets will actually be delivered. We acknowledge in that regard that the need for some of this capex is outside of NIE T&D's control (in particular that which is driven by demand growth and supply growth from renewable generation).

14. Ch 5 (Capex Quantum): NIE T&D claims that our proposal in the FD leaves it with a substantial shortfall vis-à-vis the actual amounts that it proposes to spend on capex during RP5. We will respond to the points of detail about particular projects that NIE T&D has made in this Chapter in due course. For the moment, however, we note that at least in respect of Fund 2 (which relates to projects intended to upgrade the network in response to changing customer requirements rather than just to replace existing assets), our proposal allows NIE T&D to produce a business case for capex work at any stage during RP5. If any of the items of work that we have rejected so far ultimately turn out to be required, our proposal ensures that customers will fund them. In that way Fund 2 addresses uncertainty in connection with demand growth. Similarly, the uncertainty in connection with supply growth and with the question of whether NIE T&D will develop any innovative new projects during RP5 is accommodated under Fund 3.
15. Ch 6 (opex): In relation to controllable opex, NIE T&D complains that our allowance of £182.m leaves it with a shortfall of £53.7m. Most of that alleged shortfall reflects the combined effects of different assumptions about efficiency and real price effects. Those items are the subject of NIE T&D's Chapters 7 and 8, as discussed below. The remaining points relate to items of new opex and are individually less material (the alleged shortfalls are all less than £10m per item and add up to £24m). Our main concern in relation to those items is that the Commission should rigorously challenge NIE T&D's costings. It is very easy for a company to highlight increments to its opex while staying silent about offsetting decrements. Part of the Commission's task in this inquiry should be to investigate these possible decrements, such as those resulting from network automation.
16. Ch 7 (Efficiency): NIE T&D takes issue with three aspects of our appraisal of its efficiency: (i) our benchmarking of its indirect opex costs; (ii) our proposal of a 1% ongoing opex efficiency target; and (iii) our treatment of capex efficiency. NIE T&D's criticisms of these aspects of the FD are addressed below and in more detailed submissions that we will provide in due course. We note in particular that it is concerning that NIE T&D considers that there is no more room left for it to improve on opex efficiency such that it considers that an ongoing efficiency target is

inappropriate.<sup>4</sup> Even the most efficient utilities (of which, as explained below, NIE T&D is not one) continue improving their productivity – both in relation to opex and capex – from one year to the next. There is no reason why NIE T&D should be different in that respect. We note in that regard that NIE T&D has claimed significant payments in respect of efficiencies in its capex programme over the last two years. These relate solely to direct costs and cover activities that are classified as both opex and capex. These improvements were not reflected in the allowances that we proposed in our FD or (as far as we understand it) in the costings that underlie NIE T&D's proposals in its SoC.

17. Ch 8 (Real Price Effects): It is common ground that, because our price control is set in real prices and the revenue allowance is adjusted year to year to reflect changes in RPI, a further adjustment (up or down) should be made to reflect the extent to which the prices for inputs that NIE T&D needs to purchase change at a rate that differs from RPI. Estimating that difference is largely a technical exercise, but our estimate (a negative adjustment of £3.3m for opex and a positive adjustment of £600k for capex) differs substantially from NIE T&D's estimates (positive £10.4m for opex and £37.5m for capex). The main difference relates to the treatment of labour costs in the years 2010/11, 2011/12 and 2012/13, where it is common ground that (i) real labour costs in the economy were falling; but that (ii) NIE T&D's real labour costs did not fall. NIE T&D contends that its above-market pay increases should automatically pass through to customers. Our position is that opex and capex allowances should increase by no more than the cost inflation that an efficient company would have experienced during these three years. To do otherwise would negate the purpose of the separate benchmarking of NIE T&D's costs and of requiring it to eliminate the efficiency gap between its own costs and the efficiency frontier at the start of RP5. As NIE T&D notes, this effect alone accounts for £39.1m (i.e. 77%) of the gap between our determination on this issue and NIE T&D's submission in its SoC.<sup>5</sup>
  
18. Ch 9 (Incentives and Innovation): NIE T&D's submissions on incentives and innovation essentially repeat its complaints about the other aspects of our FD as set out above. As summarised above and explained in more detail below and in our introductory submissions, we consider that the combined effect of our proposals on all of the building blocks of NIE T&D's price control create the right incentives for NIE T&D to act in customers' interests during RP5. In addition to those aspects of our proposed price

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<sup>4</sup> Ch 7 section 3.

<sup>5</sup> Ch 8 Table 8.2.

control, NIE T&D also criticises our proposed network performance incentives in relation to customer minutes lost ("CML") and customer interruptions ("CIs") as being too challenging because they are based on the best annual performance achieved by NIE T&D during RP4.<sup>6</sup> But in our view it is appropriate to set NIE T&D's target by reference to the best performance that it achieved in RP4 because its performance in recent years show that the CML and CI metrics are on a downward (i.e. improving) trend.<sup>7</sup> That trend has continued in 2012/2013. In any event, our proposal of a dead band and penalty/reward cap and collar provide a safety net that protects NIE T&D from excessive penalties. At a more general level, as we indicated in our introductory submissions on capex (UR-4), we are in favour of a move to a more outcome (in the sense of CML, CI, health and load indices etc) oriented system of economic regulation and have specifically asked NIE T&D to improve its measurement of such outcomes so as to facilitate that approach in the future. However, it should be noted that such outcome oriented approaches to regulation remain in their infancy and that, in particular, NIE T&D has not yet developed the requisite metrics. For RP5 we have therefore sought to allow for and incentivise innovation through the other aspects of our price control design.

19. Ch 10 (Pensions): NIE T&D has accepted all of the proposed "pension principles" set out in the FD. That is not surprising because those principles are very accommodating from NIE T&D's perspective: they require customers to make good the entire cost of NIE T&D's pension deficit from RP5 going forward other than 30% of the liabilities associated with early retirements. As noted below, we have asked the Commission to consider whether that approach is excessively generous to NIE T&D. Notwithstanding that agreement in principle, however, NIE T&D has proposed two substantial exceptions to that approach. First, NIE T&D asks that it should be allowed an additional £24m to compensate for the fact that its pension contributions during RP4 exceeded its RP4 allowances. Second, it asks that special shareholder contributions in 2005 and 2007 should be allocated to and offset against its £41.2m share of early retirement liabilities. Neither claim withstands scrutiny. The first is an attempt retrospectively to revise the risk allocation that NIE T&D signed up to at the start of RP4 and to cherry-pick between (on the one hand) the rolling approach to pension contribution allowances that was taken during RP4 and that it is common ground should not apply during RP5 and (on the other) the new approach that effectively

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<sup>6</sup> Ch 9 §3.14.

<sup>7</sup> See fig 13.1 in our DD.

indemnifies NIE T&D for its outstanding deficit going forward. The second is an attempt to re-write history by hypothecating the special contributions made in 2005 and 2007 to the payment of early retirement liabilities where no such link existed at the time.

20. Ch 11 (RAB Adjustment): In relation to our proposed adjustment to NIE T&D's RAB to reflect its radical change in capitalisation practices, the following key facts are common ground: (i) At the end of RP3, NIE T&D proposed and we accepted that its expenditure in RP4 should be remunerated either as opex or as capex but not both; (ii) NIE T&D changed its approach to capitalisation during RP3; (iii) The effect of that change was that expenditure that had previously been classified as opex was reclassified as capex without any change in the underlying activity; and (iv) as a result, NIE T&D was paid for that expenditure once through the RP4 opex allowance, and will now be paid a second time through the return of and on the RAB over the next 40 years. The questions for the Commission on this inquiry are: (i) should an adjustment be made; and (ii) if so, how much. Our position is that all the Commission needs to know to decide the first question in the affirmative is common ground: customers cannot be required to pay twice. As to the second, the Commission has before it competing reports from us and NIE T&D. As explained below, we have also identified some further approaches that the Commission might take to quantifying the extent of adjustment required.
21. Ch 12 (Unresolved Issues from RP4): In this Chapter, NIE T&D invites the Commission to resolve three issues that arose between us and NIE T&D in the course of RP4: (i) the approval of capex efficiency payments in respect of 2009/10, 2010/11 and 2011/12; (ii) our decision not to approve additional costs of £1.3m in respect of the Enduring Solution IT system during RP4; and (iii) our interpretation of the capital allowances term in the RP4 price control. As explained below, all three are RP4 issues for us to deal with (or that we have already dealt with) and do not require consideration by the Commission. As to the first of these issues, NIE T&D is right to note that it remains outstanding. The issue is that although NIE T&D's claimed efficiencies in respect of 2007/08 and 2008/09 were modest (£340k and £210k respectively) and approved by us without an audit, its claims for the later years of RP4 have been much more substantial (£590k, £1.1m and £1.78m respectively) and therefore call for more detailed consideration. We have now completed an audit of those claims, a copy of which we have provided to NIE T&D and once validated, we will provide to the Commission. In our view, this is an RP4 issue and should be dealt with by us in the

usual way rather than by the Commission, although it is worth noting that the direct cost efficiencies claimed here have not been reflected in either our FD or NIE T&D's proposals in its SoC. The second issue is effectively a request by NIE T&D for the Commission to "look back" and review a decision that we have already taken in RP4. The RP4 opex mechanism did not provide for any specific allowance for NIE T&D's new Enduring Solution IT system, so NIE T&D submitted a specific request under the Dt mechanism during the course of RP4. We considered that request and granted it in part. The statutory framework does not provide for any appeal process from such decisions, but NIE T&D could, of course, have sought judicial review of it. NIE T&D chose not to do so. It follows that our decision was final. The Commission will note the irony that NIE T&D should contend that elements of RP4 should be reopened in the absence of any special circumstances while at the same time NIE T&D vociferously opposes any review of RP4 in respect of NIE T&D's change in capitalisation practices which led to customers paying twice for the same items of expenditure (which is a special circumstance). The Commission need not investigate this issue on this inquiry. In relation to the third issue NIE T&D's position is even less meritorious. NIE T&D asks the Commission to review our legal interpretation of a particular provision of NIE T&D's RP4 price control. Again, that is a matter that NIE T&D could have but chose not to raise by way of judicial review. The Commission has no jurisdiction to rule on the legal interpretation of NIE T&D's RP4 price control and should not entertain this request at all.

22. Ch 13 (NIE Powerteam): This chapter is not relevant to the Commission's inquiry. As the Commission will by now appreciate, NIE Powerteam is the legal entity through which NIE T&D carries out much of its regulated activities. It is not presently a subsidiary of NIE T&D but the two entities share the same owner. Contrary to the suggestion in NIE T&D's SoC, we are not proposing to restrict NIE T&D's use of NIE Powerteam in any way. Naturally we will require that NIE T&D's overall costs (including those of NIE Powerteam) should be efficient. How NIE T&D goes about achieving that, however, is its business.
23. Ch 14 (Reporter): NIE T&D objects to our proposal to establish a Reporter. NIE T&D's criticisms of that proposal, however, largely amount to criticisms of our capex proposals that the Reporter is required to assist with implementing. Beyond those criticisms, all that NIE T&D can say is that the Reporter will be expensive and that his/her role will give rise as to confusion as to responsibility for decision making. In that regard, NIE T&D refers to its recent experience with what it refers to as a "Reporter" in

respect of the implementation of the Enduring Solution IT project. But that did not involve a Reporter at all - rather it was a third party consultant that we appointed to scrutinise NIE T&D's implementation of that project on our behalf. In any event, we consider that our consultant's work was extremely valuable. But NIE T&D's criticisms of that experience only go to emphasise the importance of our proposal that the Reporter should be appointed by (and selected by) NIE T&D rather than us (subject to our approval) so that it has a more constructive relationship with the Reporter than it tends to have with our third party consultants.

24. Ch 15 (WACC): In respect of the allowance for cost of capital, NIE T&D essentially repeats the submissions from its response to the DD. It ignores our introductory submissions on this inquiry (UR-7) and the broader range of issues that we have asked the Commission to investigate. As explained in those submissions, NIE T&D's position that it should be paid more than its actual cost of debt and more than its actual cost of equity is fundamentally flawed. These points are explored further below. In fact, NIE T&D's latest submissions provide yet more data in support of the view that we expressed in our introductory submissions that NIE T&D's true cost of capital is likely to be substantially lower than we allowed for in the FD. In light of these new data, we reiterate our request that the CC should consider this issue afresh and award NIE T&D a lower cost of capital than the 4.55% that we proposed in the FD.
25. Ch 16 (Impact on tariffs): In this chapter, NIE T&D sets out the tariff impact of the proposals made in its SoC. As the Commission will see, they are very substantial and front-loaded (so that NIE T&D's presentation of "average annual increases" paints a misleading picture). In addition, it bears emphasising that they do not include the impact of the further substantial capex that is likely to be approved under Fund 3 (renewables and other large and uncertain programmes) during the course of RP5. We will provide a reconciliation of NIE T&D's estimated tariff impacts to those set out in our FD in due course.
26. Ch 17 (Financeability): NIE T&D's submissions on its financeability add nothing to its submissions on the other topics set out above. It argues that if it is right about the amount that it will need to spend on opex and capex, then the FD allowed revenues will create financial difficulties. This should not come as a surprise and does nothing to address the matters of principle that we identified in our introductory submission (UR-7). In addition, NIE T&D makes some criticisms of the details of our modelling. We

have already asked NIE T&D to provide us with its "corrected" version of our model so that we can comment on those points in more detail.

### **Further submissions on points of principle raised in Statement of Case**

#### Overview

27. As summarised out above, NIE T&D's submissions in its SoC are fundamentally flawed in many important respects. In this section of our response, we focus in more detail on points of particular importance arising out of those submissions under the headings of opex, capex, pensions, capitalisation practices and cost of capital.

#### Opex

28. As noted above, the most important issue in respect of opex is the extent to which NIE T&D is efficient. We urge the Commission to investigate this issue for itself given its centrality to this reference.
29. As explained in our initial submissions (UR-3), the benchmarking exercise that we conducted focussed exclusively on indirect opex costs (i.e. controllable opex costs other than network repairs and maintenance) because we could not establish robust benchmarking of NIE T&D's direct opex. We concluded that NIE T&D's indirect costs were 10-13% inefficient compared with the bottom of the upper quartile of GB DNOs. That translated into a 7% adjustment to total controllable opex (conservatively opting for the lower end of the inefficiency estimate), which we allowed NIE T&D to catch up over two years.
30. Although the rights and wrongs of this analysis will not necessarily be germane to the Commission's inquiry if the Commission now conducts its own analysis, we note that NIE T&D have raised four objections to that analysis: (i) that our construction of NIE T&D's baseline costs overstated NIE T&D's costs of "market opening"; (ii) that we included in the benchmarking exercises costs that we disallowed in the opex allowance; (iii) that we failed to take account of the impact of the sparsity of NIE T&D's network on its opex; and (iv) that we overstated the extent to which NIE T&D benefits from lower regional wages than the GB DNOs to which we compared it. It may assist the Commission in its own work to understand our response to each of these criticisms, as set out below.

31. In respect of the overstatement of market opening costs, NIE T&D claims that instead of including market opening costs of £500k for NIE T&D, we should have included only £130k, reflecting the narrower range of market opening activities that GB DNOs engage in.<sup>8</sup> Our figure of £500k was already significantly narrowed from the full extent of market opening costs actually incurred by NIE T&D, and we considered it to be conservative. NIE T&D has failed to produce a detailed breakdown of its relevant costs to demonstrate that our figure is inappropriate.
  
32. In respect of the inclusion of disallowed items in the benchmarking, NIE T&D contends that we included certain costs in the benchmarking exercise (in particular, 50% of NIE Powerteam's profit margin on the "services" it provides to NIE T&D when working on its behalf<sup>9</sup>) but excluded them from NIE T&D's allowances. According to NIE T&D, that gave rise to double-counting. That is incorrect - our benchmarking analysis was entirely consistent with our approach to allowances. In respect of NIE Powerteam's profit margin, the 50% was included in both the benchmarking and the allowance. In any event the 7% efficiency adjustment was applied to NIE T&D's baseline costs after the subtraction of the excluded items, so there was no double-counting.
  
33. As to the sparsity of NIE T&D's network, in our view there is no evidential basis for the proposition that NIE T&D's indirect opex costs are adversely affected by network sparsity compared with GB DNOs. We note that the only GB DNO to be given a sparsity adjustment by Ofgem in DPCR5 was SSE Hydro, which faces sparsity issues of an entirely different order from those that NIE T&D faces given that SSE Hydro services the islands and Highlands of Scotland. Moreover, network sparsity primarily affects network related opex. But our benchmarking exercise related only to indirect opex, meaning opex other than network repairs and maintenance.
  
34. As to the regional wage adjustment, NIE T&D contends that we based our analysis on an excessively high level set of occupational codes. We disagree. As explained in our introductory paper on this topic (UR-3 §13), the disaggregated data on which NIE T&D relies is based on sample sizes that are too small to be robust.

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<sup>8</sup> Ch 7 §2.6.

<sup>9</sup> The other 50% was returned to customers under the RP4 mechanism, which is why only 50% was included.

35. NIE T&D also disputes our allowance for an additional 1% productivity improvement.<sup>10</sup> A paper from First Economics<sup>11</sup> that we are submitting alongside this document explains the rationale for this ‘frontier shift’ in more detail. We note that First Economics has identified that in principle the 1% per annum should have been applied in all years after the base year (2009/10) and not just from the start of RP5. NIE T&D has claimed that it has achieved improvements in its direct cost efficiencies over these years, which relate to opex as well as capex.
36. The First Economics paper also explains that the RPE allowance performs a similar function to the ongoing productivity allowance – i.e. it captures the extent to which a firm at the industry efficiency frontier would see its costs change over time. As such, a great deal of NIE T&D’s submission on RPEs is misdirected. Rather than focus on its own costs – past and future – NIE T&D should have been concerned with estimating the RPEs for a frontier firm. It cannot therefore legitimately claim monies from customers to pay for above-market pay increases between 2010/11 and 2012/13, nor can it atypically deem vast quantities of its workforce to be ‘specialist labour’, commanding premium pay increases.

### Capex

37. As explained in our introductory submissions on capex (UR-4), we have proposed a three fund capex mechanism as follows:
- (a) Fund 1 (Asset Replacement): NIE T&D is paid for the volumes of asset replacement that it delivers, subject to an overall pound sterling cap (largely based on the volumes of asset replacement requirements predicted by our asset replacement modelling exercise and the NIE T&D’s unit costs). There is a 5 year efficiency incentive in relation to NIE T&D’s performance against pre-determined unit cost targets. As a result: (i) unit cost risk is shared between customers and NIE T&D, with NIE T&D retaining any benefit/penalty for the five years after the expenditure is incurred; (ii) volume risk is allocated to customers (subject to the pound sterling cap); and (iii) NIE T&D has full flexibility as to which volumes of assets it replaces within the pound sterling cap.

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<sup>10</sup> Ch 7 section 3.

<sup>11</sup> UR-28 Frontier shift - RPEs and ongoing productivity growth

- (b) Fund 2 (Load related): NIE T&D is given a baseline allowance for projects that it has already justified with evidence. There is a 5 year unit cost efficiency mechanism as with Fund 1. NIE T&D will also be allowed to submit new evidence for further ex ante approval of further projects throughout RP5. As a result: (i) unit cost risk is shared in the same way as in Fund 1; (ii) volume risk is allocated to customers; and (iii) all projects must be specifically justified by NIE T&D and approved by us (ideally in advance) in order for the associated capex to be added to the RAB.
  - (c) Fund 3 (Renewables and other large, uncertain projects): These projects will be assessed on a case-by-case basis.
38. Although the parties are in agreement as to Fund 3, NIE T&D objects to our proposed content of Fund 1 and our proposed structure and content of Fund 2.
39. As noted above, our proposal is that the Fund 1 incentive structure should apply to all asset replacement work. That is because the need for asset replacement is driven by (i) general deterioration of asset quality over time; and (ii) adverse events such as storms or other causes of faults. Across a network of a reasonable size, and over a reasonable period of time, it is possible to predict roughly the volume of such work that will need to be done through standard asset replacement benchmarking analysis. Obviously it will not be possible to identify in advance exactly which assets will need to be replaced (especially in relation to emergency and fault work) but it should be possible to make reasonably accurate predictions of the overall volume. Similarly, because this is largely work that NIE T&D does on a regular basis (or is at least similar to such work), it should in almost all cases be possible to produce good estimates of unit costs.
40. NIE T&D disagrees, contending that only a very small number of very high volume rolling asset replacement programmes are amenable to being remunerated on this basis.<sup>12</sup> But in making that case, NIE T&D sets out to criticise a straw man rather than the model that we have actually proposed. In particular, NIE T&D claims that our approach to Fund 1 requires it to commit in advance to a five year programme of works, without the flexibility to adjust the volumes of asset replacement work that it does between particular types of asset replacement.<sup>13</sup> That is incorrect. As we

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<sup>12</sup> Ch 4 §4.3.

<sup>13</sup> See in particular Ch 4 §§2.4 second bullet and 4.4 fourth bullet.

explained in our introductory paper on this topic (UR-4 §13), we have proposed that within Fund 1 NIE T&D should have full flexibility to reallocate volumes between the projects that make up Fund 1, subject only to a requirement that it should not exceed the overall cap for Fund 1, which is expressed in pounds sterling.

41. NIE T&D's claim that our proposal does not allow it the flexibility to shift spending between asset replacement programmes (Fund 1) and load related asset upgrading (Fund 2) is also flawed.<sup>14</sup> If, for example, NIE T&D discovers that demand for use of a particular asset that was scheduled for replacement increases unexpectedly such that the asset should really be upgraded rather than replaced on a like-for-like basis, it can apply for ex-ante approval of that upgrade through our Fund 2 mechanism. Indeed, doing so would operate in NIE T&D's favour because the overall cap for Fund 1 would remain unchanged, whereas it would have obtained new funding for the project within Fund 2. Flexibility in the other direction is much less likely to be an issue given (i) the small number of load related projects that we have approved for Fund 2 at this stage (c. £42m in total across transmission and distribution); and (ii) the clear evidence that those load related upgrades will actually need to take place within RP5. Our Fund 1 allows for the necessary volume of assets to be replaced during RP5.
  
42. More generally, NIE T&D contends that it should be incentivised to defer capex.<sup>15</sup> We do not consider the deferral of asset replacement work to be an "efficiency" that should be incentivised – the benefit of doing so is largely theoretical and the potential detriment significant. In relation to electricity transmission and distribution networks, the scope for genuinely efficient deferral or avoidance of asset replacement work is marginal and any "smart solutions" can be covered by our Fund 3 proposal. In contrast, the risk of gaming if NIE T&D were incentivised to defer asset replacement capex would be great. In particular, it would have an incentive to persuade us (or now the Commission) that excessive volumes of assets need to be replaced in RP5 and then to claim the excess as an efficiency. It could then seek an allowance for the deferred replacement in the following price control period.
  
43. In relation to unit costs, we find it surprising that NIE T&D should say that it cannot estimate with confidence the cost of asset replacement work so that our proposed unit cost risk sharing mechanism is too challenging for it.<sup>16</sup> It should be recalled that our

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<sup>14</sup> Ch 4 §4.4 fifth bullet.

<sup>15</sup> Ch 4 §4.16.

<sup>16</sup> Ch 4 §4.4 second bullet.

proposal is symmetric with respect to unit cost risk: NIE T&D retains the upside of any efficiency and the downside of any inefficiency. Furthermore, it only retains those upsides and bears those downsides for five years. NIE T&D's understanding of its own cost base should not be so poor that such an allocation for asset replacement work could be considered overly challenging. We do note, however, NIE T&D's specific complaint in relation to the Ballylumford switchboard project.<sup>17</sup> While we consider NIE T&D's inability to estimate its costs to be unsatisfactory, on this occasion we are content for that particular project to be shifted to Fund 3 as proposed by NIE T&D.

44. While we will reserve our detailed submissions on the other individual projects within Fund 1 at this stage, one other project within that Fund calls for special attention: the 15 year project to upgrade the size of conductors on the 11kv distribution network that NIE T&D said would cost £127m in the first five years alone.<sup>18</sup> This project is not motivated by any concern about the deterioration of the condition of the relevant assets, or by any projections of increased strain from demand. Rather, it is motivated by NIE T&D's concern about a risk that has always been there since the assets were first installed, and that would continue even after the project has completed: the risk of ice or snow forming on conductors and giving rise to a "birdcage" effect that can ultimately cause the poles to break.<sup>19</sup> Although NIE T&D is right to note that this risk is greater for small conductors than for large ones, it can affect conductors of any size and indeed it has in recent times affected conductors that are much larger than the 50mm ones that NIE T&D proposes to install on the 11kv network.
  
45. As the Commission will appreciate, this is an issue that calls for a very careful cost benefit analysis of a range of options. The starting point has to be consumer demand: the critical question being what customers are willing to pay now to reduce (but not eliminate) the seriously negative outcomes that would result from what is already a relatively low probability event. A range of options should be considered, bearing in mind that different increases in size would have different impacts on the probability of the event occurring. It would also be necessary to ask customers to compare the risk of unplanned outages in future (which is the adverse outcome that the project aims to avoid) with the certainty of substantial planned outages now as NIE T&D replaces the entirety of the 11kv network over a 15 year period.

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<sup>17</sup> Ch 4 §4.5.

<sup>18</sup> Ch 5 §§4.56-4.67.

<sup>19</sup> Ch 5 §4.56.

46. NIE T&D claims that an analysis of this kind is inappropriate given the degree of harm involved in the low probability event occurring.<sup>20</sup> In particular, it has carried out no work to assess customers' views of the costs and benefits referred to above. But the complexity of the issues is all the more reason why a robust analysis is necessary. Without such an analysis, customers will be required to pay enormous sums based on nothing more than NIE T&D's view of their preferences.
47. Rather than carry out such an exercise, NIE T&D proposes that it should embark on a £35m pilot study during RP5 to produce a better estimate of the project costs. Even if one were to ignore the facts that (i) at 28% of the estimated total project cost that is an extremely large "pilot" study; and (ii) such an exercise would be of no use at all to the decision making process in relation to the project as a whole if not accompanied by an estimate of benefits, that proposal is clearly inappropriate. NIE T&D will already be replacing substantial parts of the 11kv network during the course of RP5 through projects that we have approved.<sup>21</sup> It should not therefore need a separate pilot project (let alone one of this scale) to determine the costs of replacing conductors on the network.
48. We draw attention to this project at this stage not only because it is substantial in its own right and obviously inappropriate, but also because it illustrates the dangers in relation to NIE T&D's proposals for Fund 2. In particular, NIE T&D argues that it should be given an *ex ante* allowance for Fund 2, and that it would then "*bear a set proportion of under-spend or over-spend relative to*" that allowance.<sup>22</sup> There would be no requirement for NIE T&D to demonstrate what, if anything, it has produced for customers with those sums. In respect of projects that NIE T&D now claims (without evidence) will be required in RP5 due to asset age or projected increases in demand, NIE T&D would be free to defer that capex to the following period (where they could be incorporated into NIE T&D's capex proposal for that price control). It could then treat the resultant "*savings*" as "*efficiencies*" for which it should be rewarded, or to spend them on other projects of dubious worth, whereupon they would be added to the RAB for the full 40 year period of depreciation. The relevance of the 11kV resilience project described above in that regard is that it illustrates the type of projects that NIE T&D would undertake with customers' money if left to its own devices and shielded from regulatory scrutiny.

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<sup>20</sup> Ch 5 §4.63.

<sup>21</sup> See projects D8 – 11kV Overhead Lines and D37 – 11kV Load Related.

<sup>22</sup> Ch 4 §4.20 second bullet.

49. As with asset replacement work, we do not consider it to be appropriate to incentivise capex deferral in respect of the load related projects covered by our Fund 2. NIE T&D's planning and operational standards do not currently allow it to substitute non-network solutions for network upgrades as a means of addressing load growth. In any event, as noted above, we have only allowed a small number of load related projects so far, and those projects clearly need to be completed soon, because they concern assets that are already operating outside the standards that NIE T&D is required to meet.
50. Notwithstanding those concerns, however, NIE T&D contends that its proposals accord with well established and traditional RPI-X economic regulation.<sup>23</sup> That contention is not supported by any references to primary regulatory material. It is also completely without foundation. In relation to major capital projects there is no longer any meaningful concept of "standard" or "traditional" economic regulation which is applicable in all cases: different regulators have at different times taken quite different approaches to dealing with the range of challenges that arise in relation to incentivising and remunerating capex. But we are not aware of any approaches currently taken in the United Kingdom that bear any resemblance to NIE T&D's proposal in their capacity to give rise to regulatory gaming. In particular, NIE T&D's proposal that it should be given an allowance without any requirement to identify outputs or outcomes or for *ex-post* adjustment is, to our knowledge, without parallel.
51. In contrast, our approach to the structure of Fund 2 creates appropriate incentives to ensure value for customers while also shielding NIE T&D from risk. NIE T&D seeks to portray our proposal as one of *ex post* logging up and logging down according to arbitrary processes.<sup>24</sup> That is incorrect. Our proposal is (as noted above) that each year NIE T&D can propose load related projects for the following year and produce a business case based on accurate, up to date data to support those proposals. That way, customers only pay for work that actually needs to happen and that actually does happen, and NIE T&D is not left stranded having done work that remains unfunded. NIE T&D retains the option to do load related work without first obtaining an approval, but if it chooses to do that it has undertaken the risk of its own volition.

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<sup>23</sup> Ch 4 §§4.19 and 6.6.

<sup>24</sup> Ch 4 §§4.11-4.12.

52. As to the specific projects that we have allowed in Funds 1 and 2 and the allowances that we have made in respect of them (after accounting for efficiencies), we will submit a detailed response to NIE T&D's criticisms in due course.

### Pensions

53. As noted above, NIE T&D's submissions on pensions raise two issues in addition to those identified in our introductory paper on this topic (UR-5). We respond to these points below, but we would also ask that the Commission gives equal attention to the other matters that we have raised and which NIE T&D has not directly commented on in its SoC.
54. NIE T&D's concerns with our FD proposals focus on (i) the treatment of £24m of pension contributions that NIE T&D made in RP4 in excess of the RP4 price control allowance, which, it claims we have "stranded"; and (ii) whether £71.4m of special contributions that NIE T&D made in 2005 and 2007 can be offset against the portion of the deficit due to early retirements for which we propose NIE T&D should be held responsible. Those issues are considered in turn below.
55. During RP4, pension contributions (and opex more broadly) were remunerated under a rolling mechanism. That meant that the allowance for a particular year in RP4 was the outturn expenditure for corresponding year in RP3. From that figure, we also made an adjustment to ensure that NIE T&D took responsibility for a 30% share of its early retirement deficit costs. As it happens, during RP4, NIE T&D paid contributions that exceeded its price control allowance by £24m. NIE T&D argues that if the rolling mechanism were to have continued into RP5, it would have recovered that excess contribution in this price control period.<sup>25</sup> NIE T&D also argues that if our new pension principle that, from RP5 onwards, NIE T&D should be allowed to recover any deficit repair costs that it cannot avoid, had applied during RP4, it would have recovered those excess contributions.<sup>26</sup> In fact, however, neither of those "if" conditions are satisfied. There was no basis on which NIE T&D could properly have expected that the rolling approach from RP4 would continue into RP5. The RP4 regulatory framework was fixed for a five-year period only with the clear intention that there would be a full scale periodic review ahead of RP5. As part of the RP5 review, all parties are agreed that opex and pensions should no longer be dealt with on a rolling basis. That change

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<sup>25</sup> Ch 10 §4.8.

<sup>26</sup> Ch 10 §4.9.

in approach brings considerable benefits for NIE T&D: its RP5 allowance for opex plus pensions would be lower than we have proposed in our FD if we were simply to set RP5 allowances in line with actual expenditure five years previously. As to our new pension principle, the quote that NIE T&D refers to in this regard makes clear that it only applies "*for RP5 ... going forward*".<sup>27</sup>

- 56. NIE T&D claims that, at the time, it thought it benefited from protection under the rolling mechanism which it anticipated would continue.<sup>28</sup> Needless to say, NIE T&D's subjective beliefs in this regard are not capable of providing any basis for reopening the RP4 price control (even if they were actually and genuinely held at the time). NIE T&D contends in the context of the capitalisation practices issue that "new" or "implied" rules cannot be invoked to change the price control treatment of events that happened in previous periods.<sup>29</sup> Yet that is exactly what it is asking the Commission to do here, and (unlike our proposal in relation to capitalisation practices) it makes that request in the absence of any special circumstances to justify the deviation from the usual approach.
  
- 57. In any event, we do not accept that NIE T&D could genuinely have believed during RP4 that we had committed to continuing the rolling approach to pensions contributions through RP5. NIE T&D has not produced any contemporaneous documentary evidence to support that proposition. On the contrary, the only contemporaneous evidence supports the exact opposite view, that NIE T&D knew it was "*carrying the risk that the actual level of contributions payable during RP4 ... will be higher*".<sup>30</sup> If it were the case that NIE T&D had a clear understanding that we had promised to continue the rolling approach into future price control periods, one would expect to see that documented in NIE T&D's records. In any event, however, even if such documents did exist they could not overcome the fatal flaw in NIE T&D's case identified above, which is that we never actually made any such promise, let alone incorporated it into a document that NIE T&D could say gives rise to a "rule" that can be relied on to reopen the treatment of past expenses.

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<sup>27</sup> Ch 10 §4.9.

<sup>28</sup> Ch 10 §4.11.

<sup>29</sup> Ch 11 §§4.37-4.40. For the avoidance of doubt, as explained below, it is not correct that our proposal in relation to capitalisation practices involves the retrospective application of any rules.

<sup>30</sup> Annex 10.11.

58. A similar evidential vacuum surrounds the second issue. That issue relates to the 30% of early retirement deficit costs that we proposed in the FD (and that NIE T&D accepts) that NIE T&D should bear. Although NIE T&D accepts it should bear that cost, it claims to have already paid it with two special shareholder contributions made in 2005 and 2007.<sup>31</sup> This is an opportunistic and retrospective hypothecation of contributions that were made for reasons that had no direct link to early retirement liabilities:
- (a) the 2005 payment was not mentioned by NIE T&D when it accepted in 2006 at the start of RP4 that it bore responsibility for 30% of early retirement costs. Accordingly, no adjustment was made for the 2005 contribution when we calculated NIE's RP4 pension cost allowance. It is not credible now to decide in 2013 that this was an omission and that the 2005 contribution and the RP4 early retirement are a double count; and
  - (b) the 2007 payment was made in the context of and motivated by the acquisition of Viridian Group (then NIE T&D's parent company) by Arcapita Bank. It had nothing to do with early retirement costs.<sup>32</sup>
59. NIE T&D is unsurprisingly unable to refer to any contemporaneous evidence to support the proposition that those payments did relate to the early retirement deficit costs. Indeed, NIE T&D has chosen not to provide the Commission with any of its internal (or other) documents explaining what the purpose of those payments was.
60. In any event, NIE T&D's special contributions could only be relevant as part of a comprehensive historical analysis of all of the decisions taken by NIE T&D over time that have affected the deficit in one way or another. In such an analysis, NIE T&D's special contributions would feature on one side of the ledger, while its decisions to take "contribution holidays" or to increase pension benefits would appear on the other, along with a fair estimate of NIE T&D's share of early retirement deficit costs. We undertook such an analysis in our DD, which produced the result that on balance, NIE T&D's decisions had exacerbated the deficit to a substantial degree. NIE T&D objected to that approach on the basis that it was retrospective. In light of NIE T&D's objections, we decided to take a more conservative approach and only adjust for early retirement deficit costs in the same percentage as Ofgem does and as we had in RP4 and to

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<sup>31</sup> Ch 10 section 5.

<sup>32</sup> See attached UR-29 - Confidential Letter – Electricinvest Acquisitions Ltd October 2006, a letter dated 31 October 2006 from Electricinvest Acquisitions Ltd to the Trustees of the Viridian Group Pension Scheme which proposed that second payment.

ignore all other decisions that affect the deficit. But NIE T&D cannot have it both ways. NIE T&D's proposal on this inquiry amounts to cherry-picking and should not be entertained.

61. In our view, the key issue in this inquiry is quite different from the issues that NIE T&D has raised: it is the question of whether it is fair to customers to ask them to bear 70% of early retirement costs. We noted in our introductory submissions (UR-5 §18) that NIE T&D enjoyed closer to 50% of the benefits of those early retirements and that it should also take a 50% share of costs. The only argument that we have identified against that approach is the weight of Ofgem's and our previous regulatory precedent. We would welcome the Commission's view, however, as to whether, given that our approach in RP4 was not based on a thorough analysis of the issue or set in stone as a final response to it, it would be better to set the RP5 price control on a sounder analytical basis.

#### Capitalisation practices

62. NIE T&D's submissions on the capitalisation practices issue take matters no further than where they were in NIE T&D's response to our DD on this issue. At this stage, we would urge the Commission to take careful note of what NIE T&D's submissions do not dispute:
  - (a) NIE T&D do not dispute that it was agreed at the start of RP4 that expenditure should be paid for through opex allowances or capex allowances but not both.<sup>33</sup> Because opex was remunerated on an allowance basis and capex on a pass-through basis, that required continuity in respect of NIE T&D's approach to capitalisation;
  - (b) NIE T&D does not dispute that at during RP3 it changed its approach to capitalisation.<sup>34</sup> While NIE T&D may quibble about fine accounting distinctions between practices and estimates, there is no doubt that a change took place.

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<sup>33</sup> See supporting document UR-22 The "Composite Proposal" submission from NIE T&D dated 4 March 2005 in which NIE T&D made precisely that proposal.

<sup>34</sup> NIE T&D's Response to the Utility Regulator's Draft Determination in respect of an investigation into NIE T&D's capitalisation practice, 27 September 2012, §1.11.

- (c) NIE T&D does not dispute that the result of its change in approach was that, at least to some extent, expenditure that had previously been classified as opex started to be classified as capex, with no change in the underlying activity.<sup>35</sup>
  - (d) NIE T&D does not dispute that the effect of that change in classification was that in addition to obtaining its opex allowance outperformance, the newly capitalised expenditure would be added to its RAB with the result that customers pay for it over the following 40 years.<sup>36</sup>
63. NIE T&D does not dispute those core facts because they are indisputable. In our submission, they are the only facts that matter to the question of principle as to whether an adjustment to NIE T&D's RAB ought to be made. It cannot be right that a change in approach to the accounting treatment of work should result in customers being required to pay twice for the same item of work.
64. NIE T&D's objections to that approach of principle all ring hollow:
- (a) NIE T&D claims that its conduct did not breach any licence conditions.<sup>37</sup> We do not necessarily accept that that is the case. However, even if it were, it would not assist NIE T&D in relation to this issue. This is not an enforcement procedure for breach of licence. This is a price control review. The question for present purposes is on what RAB should NIE T&D be allowed a return. The Commission in *Phoenix Gas* rightly concluded that downwards adjustments could be made to the RAB without there having been any breach of accounting standards or licence conditions.<sup>38</sup> Double-counting is sufficient to justify such an adjustment.
  - (b) NIE T&D claims that the principles on which our proposed adjustment relies were not reflected in any express licence conditions. It claims that we are seeking to impose "new rules" retrospectively.<sup>39</sup> That is incorrect. We are not trying to impose anything retrospectively. Rather, we are trying to prevent customers from

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<sup>35</sup> 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.

<sup>36</sup> See Ch 11 §6.1 fifth bullet, which only contends that it is artificial to draw a link between the two payments that NIE T&D indisputably receives.

<sup>37</sup> Ch 11 §§4.3-4.5.

<sup>38</sup> *Phoenix Gas* §§5.89-5.103.

<sup>39</sup> Ch 11 §§4.38-4.40.

paying again in RP5 (and RP6 etc) for work for which they have already paid. In any event, as we said in our introductory paper on this topic, the basic principle that customers should either pay for a particular piece of work through opex or capex but not both was one that NIE T&D proposed and we accepted in setting the RP4 framework (UR-6 §19). There is nothing new about it.

- (c) NIE T&D's claims that our "delay" in investigating this issue somehow precludes the Commission from considering it now.<sup>40</sup> But our investigation only related to opex outperformance during RP4, and it is entirely appropriate that a look back to the previous price period should take place in the context of the price setting process for the following period. In any event, all of the relevant events occurred in the very recent past and NIE T&D has not identified any prejudice arising from any delay that could have any bearing on the question of whether it is appropriate now for the Commission to investigate.
  - (d) NIE T&D also claims that our approach will undermine investor confidence.<sup>41</sup> That submission lacks all credibility in light of (i) the modest scale of the adjustment proposed; (ii) the fact that it only relates to opex outperformance in the immediately preceding price control period; and (iii) the context that it is only reducing the RAB in respect of expenditure for which NIE T&D has already been fully paid through the opex mechanism.
65. Once it has been decided that, as a matter of principle, an adjustment should be made, the only remaining question is how large that adjustment should be. In that regard, the Commission already has the report which supports our calculation of the extent of double-counting in the FD. NIE T&D relies on a report by its consultants, KPMG, criticising that calculation. Again, however, it is instructive to note carefully the terms in which those criticisms are made. KPMG does not disprove that c. £35m of opex was inappropriately reclassified as capex. Rather, KPMG complains that we have not excluded the various alternative explanations for the data and evidence from which we reached our conclusions. NIE T&D apparently remains unwilling, however, to produce positive evidence to show that its opex outperformance reflected genuine efficiencies, or to demonstrate actual changes in behaviour that explain the increases in capitalisation rates to which we refer.

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<sup>40</sup> Ch 11 §5.28 first to fourth bullets.

<sup>41</sup> Ch 11 §5.28 penultimate and final bullets.

66. Given that NIE T&D has reproduced its KPMG report with its SoC, we hereby produce, for completeness, our consultants' (SKM) response to that report<sup>42</sup>. But as the Commission will have seen from our initial submissions on this topic there are a range of other, more comprehensive (without necessarily being more time consuming) approaches that could also be taken to quantifying the required adjustment and we look forward to discussing those with the Commission in due course.

#### Cost of Capital

67. NIE T&D's submissions on cost of capital do not advance its case beyond the stage of its response to our DD in any material respect. NIE T&D has not addressed many of the questions that we asked of the Commission in our introductory submissions on this topic (UR-7). In particular, it has no answer to the criticism that it is asking customers to pay it an allowance in respect of capital costs that is based on an estimate of cost of debt that is greater than NIE T&D's actual cost of debt and an estimate of cost of equity that is greater than NIE T&D's actual cost of equity. There is no justification whatsoever for taking such an approach.
68. On the contrary, as we explained in our introductory submissions, NIE T&D will be able to finance itself in the capital markets so long as the Commission allows NIE T&D to earn a return in line with its cost of capital. NIE T&D's ability to access capital markets does not depend on the rates of return that other companies may currently be earning. For that reason, the returns on offer in, for example, Ofgem's DPCR5/RIIO-T1/RIIO-ED1 reviews should not have any determinative impact on the returns that the Commission should build into NIE T&D's RP5 price control.
69. The Commission will recall that we have highlighted in our introductory submission some respects in which the Commission will need to consider whether our FD proposal was too generous to NIE T&D (or at least that it is too generous now, in light of more up to date data). NIE T&D's SoC provides new evidence to support a lower cost of capital.
70. First, we note that NIE T&D argues that a central estimate of the cost of the new debt that it will need to take on in RP5 is 6% nominal.<sup>43</sup> This is substantially lower than the

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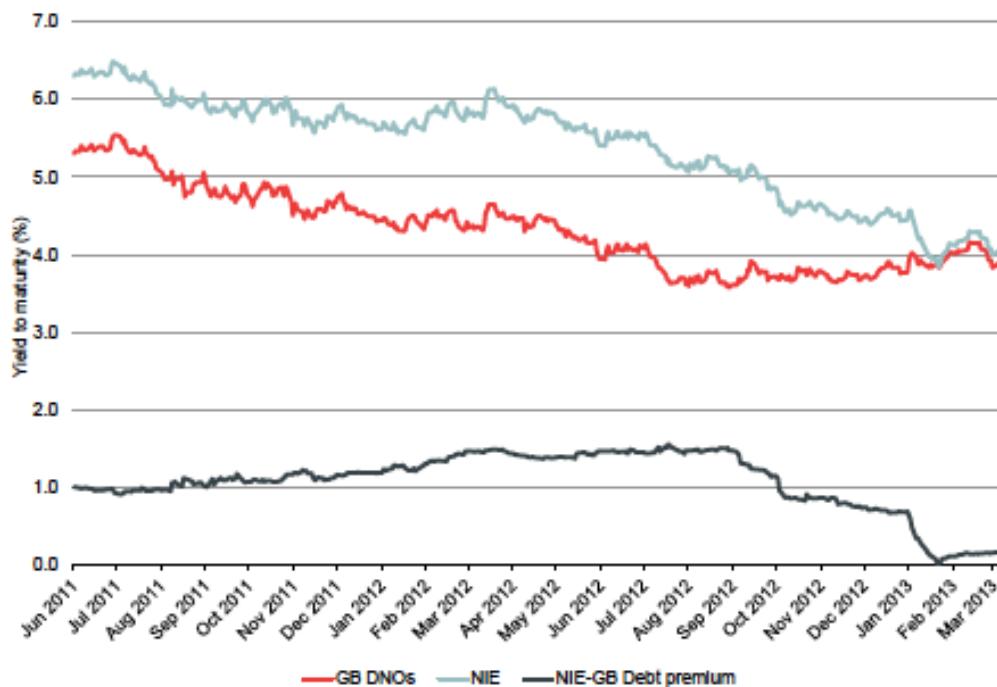
<sup>42</sup> UR-30 SKM response to KPMG report

<sup>43</sup> Ch 17 §4.9.

6.5% that we provided for in our FD and reinforces our concern that the allowance that we proposed is excessive in relation to NIE T&D's cost of new borrowing.

71. Second, the Commission may recall that we raised the issue of whether the interest rates that NIE T&D is paying on its existing debt might have been inflated by its parent company ESB's weaker financial position (and therefore whether it might be appropriate to shield customers from being required to pay for those inflated rates). The following chart from the SoC emphasises that this will issue requires careful scrutiny:

**Figure 15.1: Yield to maturity of NIE and comparator GB DNO bonds**



Source: NIE T&D's SoC p 340.

72. The chart confirms that NIE T&D paid a substantial premium relative to GB companies when it issued £400m of new debt in 2011. This premium persisted in the secondary market until late 2012/early 2013 when it disappeared completely. We do not think that it is a coincidence that the disappearance of the premium followed moves by ESB to strengthen its financial position. The relevant timeline is as follows:
  - (a) in September 2012, ESB successfully issued a €600m 5-year bond with a coupon of 6.25%;

- (b) in November 2012, ESB successfully issued a €500m 7-year bond with a coupon of 4.375% in an offering that was 12 times over-subscribed. ESB explained at the time that the long tenor and the lower interest rate reflected “improving market sentiment towards ESB and Irish bonds generally”;
  - (c) in January 2013, Fitch revised ESB’s credit rating from BBB+ (Negative Outlook) to BBB+ (Stable Outlook);
  - (d) at the same time, Fitch also revised NIE T&D’s credit rating from BBB+ (Negative Outlook) to BBB+ (Stable Outlook) in recognition of its ties to ESB.;
  - (e) in February 2013 S&P followed suit and revised ESB’s credit rating from BBB+ (Negative Outlook) to BBB+ (Stable Outlook);
  - (f) at the same time it too revised NIE T&D’s credit rating from BBB+ (Negative Outlook) to BBB+ (Stable Outlook) in recognition of its ties to ESB.
73. In light of this recent experience, it would be of considerable concern ask that the Commission consider whether any premium that NIE T&D was forced to pay in 2011 by virtue of its ownership structure should be passed on to customers in RP5.
74. For completeness, we note that NIE T&D’s submissions in relation to the existence of a Northern Ireland premium are without theoretical foundation and are not supported by evidence. In that regard, we refer to our submissions on that topic in our introductory paper (UR-7 §21).

### **Summary of points for further investigation**

75. Because NIE T&D has largely ignored these points in its SoC, we take this opportunity to remind the Commission of its power and duty to consider whether aspects of our FD proposal should be changed in customers’ favour. In particular, we have asked the Commission to consider the following important points:
- (a) The efficiency of NIE T&D’s direct (i.e. network repairs and maintenance) opex costs (given that we were only able to benchmark its indirect costs);<sup>44</sup>

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<sup>44</sup> UR-3 §7.

- (b) The effect of NIE T&D's capitalisation practices on its base year opex and the benchmarking of its opex efficiency (note that we will shortly provide our own analysis of this point to assist the Commission);<sup>45</sup>
- (c) Whether NIE T&D should be required to operate at the opex efficiency frontier rather than only to meet the bottom of the upper quartile of efficiency, and/or whether NIE T&D should be expected to improve its opex efficiency in a shorter period than the two years that we proposed;<sup>46</sup>
- (d) Whether the 1% ongoing efficiency adjustment should be applied in the years between the benchmark year for the opex allowance and the start of RP5 (i.e. 2010/11 and 2011/12) in addition to the years of RP5 itself;<sup>47</sup>
- (e) The extent to which there are decrements to opex that offset NIE T&D's claimed increments;<sup>48</sup>
- (f) Whether some degree of incentivisation would be more appropriate than 100% pass through for at least some categories of "uncontrollable" opex;<sup>49</sup>
- (g) Whether our proposal for "input driven capex" in Fund 1 could be improved to reduce the risk of double-counting;<sup>50</sup>
- (h) Benchmarking of capex efficiency;<sup>51</sup>
- (i) Whether an ongoing productivity challenge should be adopted for capex;<sup>52</sup>
- (j) Whether some degree of incentivisation should be introduced for pension deficit reduction;<sup>53</sup>

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<sup>45</sup> UR-3 §9.

<sup>46</sup> UR-3 §§11-12.

<sup>47</sup> See §35 above.

<sup>48</sup> See §15 above.

<sup>49</sup> UR-3 §§21-23.

<sup>50</sup> UR-4 §19.

<sup>51</sup> UR-4 §33.

<sup>52</sup> UR-4 §32.

<sup>53</sup> UR-5 §17.

- (k) Whether NIE T&D should bear more than 30% of the cost of pension liabilities arising from early retirements;<sup>54</sup>
- (l) Whether the extent of NIE T&D's reclassification of opex to capex was greater than documented in our report;<sup>55</sup>
- (m) Whether a lower amount should be allowed to cover NIE T&D's cost of debt in light of the impact that its parent company's credit rating had on the premium at which it issued debt in 2011 and more recent decreases in interest rates generally;<sup>56</sup>
- (n) Whether the risk free rate and/or the equity risk premium might be lower than we estimated;<sup>57</sup>
- (o) Whether NIE T&D's beta might be lower than we estimated in light of more recent market data;<sup>58</sup>
- (p) Whether the overall structure of the price control reduces systematic risk for NIE T&D in such a way as to warrant a further reduction from our estimate of its beta;<sup>59</sup>
- (q) Whether the formula we used to calculate the allowed return requires adjustment;<sup>60</sup>
- (r) Whether the recently announced reductions in corporation tax rates have any implications for NIE T&D's allowances in the RP5 price control; and
- (s) Whether the appraisal of NIE T&D's financeability should take into account its failure to protect itself from the nominal-real mismatch phenomenon by failing to

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<sup>54</sup> UR-5 §18.

<sup>55</sup> UR-6 §13.

<sup>56</sup> UR-7 §§11-12.

<sup>57</sup> UR-7 §16.

<sup>58</sup> UR-7 §18.

<sup>59</sup> UR-7 §19.

<sup>60</sup> UR-7 §31.

issue index-linked debt and whether its financeability has been affected by avoidable shareholder distributions that have inflated its gearing level.<sup>61</sup>

## **Conclusion**

76. As explained above, NIE T&D's SoC betrays its inconsistent and inappropriate approach to economic regulation in general and to the conduct of this inquiry in particular. NIE T&D's proposals would result in customers paying more for less. That is unacceptable.
77. In contrast, we urge the Commission to devise a price control package for NIE T&D that:
  - (a) Encourages accountability and transparency in all of NIE T&D's operations;
  - (b) Provides sufficient allowance for its efficient opex costs, and no more;
  - (c) Provides an allowance for capex that adequately addresses the issues of (i) the extent to which capex programmes are actually needed during RP5; (ii) what NIE T&D should be required to deliver in exchange for its allowance; (iii) uncertainty as to the extent to which some types of capex will be required during RP5; and (iv) how to incentivise NIE T&D to be efficient in relation to capex;
  - (d) Provides a fair allocation of pension deficit costs, and in particular requires NIE T&D to pay for a fair share of the liabilities arising from early retirements that reflects the share of the benefits from those retirements that NIE T&D enjoyed;
  - (e) Protects customers from the requirement to pay again in RP5 and beyond for work in respect of which NIE T&D has already been paid during RP4;
  - (f) Provides for NIE T&D to earn a return on capital that reflects its actual cost of capital; and
  - (g) Ensures that NIE T&D can efficiently finance its activities over RP5.

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<sup>61</sup> UR-7 §43.

**Appendix 1**

| <b>Reference</b> | <b>Suite of supporting papers to the reference</b>   |
|------------------|--|
| 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            | Full 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> |
| UR-25            | NIAUR Asset Replacement Modelling - Updated Report April 13 Complete   |
| <b>Reference</b> | <b>Suite of supporting papers to the supplementary submission</b>  |
| UR-26            | Supplementary submission to the Competition Commission following NIE T&D's Statement of Case   |
| UR-27            | Appendix E – Comments on NIE TD response to RP5 draft determination  |
| UR-28            | Frontier shift: RPEs and Ongoing Productivity Growth   |
| UR-29            | Confidential Letter – Electricinvest Acquisitions Ltd October 2006   |
| UR-30            | SKM response to KPMG report  |