

Northern Ireland Electricity Limited

Transmission and Distribution  
RP5 Price Control

**Supplementary Submission  
to the  
Competition Commission**

10 June 2013





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## 1. INTRODUCTION

- 1.1 This submission supplements NIE's Statement of Case (SoC) provided by NIE on 10 May 2013. It contains NIE's response to the supplementary submission made by the UR on 24 May 2013 (UR-26) as well as commenting further<sup>1</sup> on the UR's opening submission dated 30 April 2013 (UR-2 to UR-24).

### Opening comments

- 1.2 NIE is disappointed by the UR's approach to the present investigation generally and by its submissions. Its most recent submission, UR-26, contains three related but distinct faults:

- it is wrong on numerous points of substance, compounding similar errors in its opening submission;
- it continues to reveal a disregard for the failure of process which has emerged in the UR's handling of the matter; and
- it continues to deploy derogatory language, much aimed at NIE's integrity, without bases or proper justification.

In short, UR-26 confirms a serious failure of regulation.

- 1.3 As a consequence, NIE is placed in a difficult position. We recognise that the present submission is itself a response to a supplementary submission, a stage at which one might reasonably expect a narrowing down of the points of contention. Unfortunately, the nature of the UR's response severely limits the extent to which that is the case here.

- 1.4 If the CC is to make progress in these circumstances, NIE submits that it should disregard the UR's pejorative language and superficial analysis and focus instead on the substantive issues in the detail necessary for the CC to have a full understanding of them. We believe and welcome this to be the CC's approach in all such past cases.

- 1.5 However, it is essential that we first deal with some important process points, as they constitute very important background to some of the main substantive disputes.

### Relevance of the RP5 price control review and Final Determination

- 1.6 First, the UR tries to ignore the fact that it has spent three years conducting its RP5 price control review, culminating in a formal Final Determination (FD). It now

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<sup>1</sup> NIE provided its initial comments on the UR's opening submission in the covering letter that accompanied the SoC.

criticises NIE for framing its case as a response to the FD, and seeks to distance itself from positions adopted in the FD. For example, at UR-26, paragraph 9(a), the UR appears to take issue with NIE's case that the rolling opex and pensions allowances of RP4 should be replaced with newly-determined opex and pensions allowances. But the FD itself decided that there should be a new assessment of NIE's opex allowance and a new approach to the recovery of pensions costs. NIE agrees with the UR. The only issues are as to whether the UR's allowances are sufficient. While it is true that the CC may now wish to revisit the UR's assessment of the approach to be taken, it is unhelpful for the UR to pretend that it has not previously endorsed large parts of NIE's case.

- 1.7 More generally, the UR also wishes to eat its cake and have it in discussing the relevance of its RP5 price control review. On the one hand, it asks the CC to accept that NIE has proved so incompetent and unreliable in evidencing its capex and opex requirements that the only solution is a novel system of approvals of NIE's capex projects on a case by case basis supplemented by a Reporter. On the other hand, it does not wish the CC to review the conduct of the RP5 price control review in any detail. Such an approach is inconsistent: the CC cannot fairly accept the UR's assessment of NIE's conduct and performance unless it examines for itself how both NIE and the UR conducted themselves in respect of the RP5 price control review. NIE submits that a detailed examination would show that NIE approached the matter on a professional basis, and acted in good faith in attempting to co-operate with the UR in reaching a fair RP5 price control. Conversely, the UR's conduct fell well short of best regulatory practice. Indeed, NIE trusts that NIE's approach to the present CC investigation will confirm its submission that it approaches the matter in good faith, with a view to establishing a fair price control.

#### **Deficiencies in the UR's performance**

- 1.8 Deficiencies in the UR's approach are also apparent in its response to the present CC investigation. As the UR well knows, the CC must work to a tight timetable. Yet the UR has failed to provide its full response to NIE's SoC on time, and intends to drip feed more material to the CC after the due date for its response. The UR complains that it has had only 2 weeks to respond to NIE's SoC, while NIE had some six months to prepare its SoC. That outcome is entirely of the UR's making, since it delayed for some six months in making its reference to the CC, with resulting detriments to NIE and its customers. NIE's SoC should not have been a surprise to the UR, since it reflected many of the criticisms of the UR's work which NIE had set out in full in its response to the UR's draft determinations. NIE will look to the CC to ensure that NIE is not prejudiced by the UR's shortcomings in the context of the present investigation.
- 1.9 The UR seeks to distract attention not just from the procedural aspects of the RP5 price control review, but also from the substantive analysis underlying the FD. It

argues that, since the CC is to investigate the matter afresh, it does not matter whether the UR's analysis is defective. NIE disagrees. It is critical that the CC should review the UR's analysis, since much of the prejudicial criticism of NIE advanced by the UR is said to be supported by its substantive analysis. Moreover, it is only by reviewing the UR's performance to date that the CC can properly assess whether the UR has the expertise and resources to carry out the substantial responsibilities contemplated by the RP5 price control.

### **UR's failure to discharge its regulatory functions**

- 1.10 Most notably, the UR says it is unable to use the evidence available from NIE and from its own consultants to derive an adequate forecast of NIE's basic capex requirements<sup>2</sup>. (It is also now inviting the CC to look afresh at the whole of NIE's opex allowance.) The UR has therefore failed to complete to its own satisfaction some of the most fundamental elements of its work in setting an RPI-X price control. Instead, its proposals effectively envisage that, for much of NIE's capex requirements, NIE should approach the UR each year with the specification of its proposed individual capex projects and should then obtain ex ante approval for the projects and the price at which they are to be carried out. NIE submits that the UR's performance to date shows that there is no prospect of its being able to process NIE's applications for approval in a timely, fair or efficient manner.
- 1.11 In practice, therefore, NIE would have no option but to press on with necessary projects (many of them required to meet statutory obligations, including health and safety obligations) and to seek ex post approval for each of them individually. NIE would, at that point, effectively be held captive: the UR could withhold approval, or approve a project only at a lower cost than NIE could achieve, leaving NIE unable to recover any revenues for it, or any revenues beyond what the UR assessed, ex post, to be the efficient cost. If NIE delivered a project at an exceptionally efficient price, it is most unlikely that the UR would allow NIE to recover more than the actual cost of the project. Thus, the three fund mechanism becomes a one way bet, which NIE can only lose.
- 1.12 NIE's conviction that the UR is incapable of operating the three fund capex proposals fairly or efficiently is borne out by its experience to date. The UR's failure to determine an ex ante capex allowance is entirely attributable to its own failure to do its job properly, based on full evidence provided by NIE. Similarly, whatever the substantive merits of the unresolved points outstanding from RP4, there can be no doubt that the UR has failed to determine a number of NIE's requests under the  $D_t$  term of the RP4 price control. Moreover, the UR's failure to adopt proper modifications to deal with the extension of the RP4 price control, its

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<sup>2</sup> For this purpose, basic capex excludes the capex associated with unpredictable and very significant investments in the transmission infrastructure (mainly to facilitate connection of new renewable generating plant) which are contemplated to be covered by Fund 3.

delay in making the present reference to the CC, and its present distancing of itself from its own FD, provide no basis for confidence that the UR will in future make fair, timely and efficient decisions and then stick to them.

- 1.13 It is also notable that the UR fails to recognise that NIE has no adequate remedy if the UR fails to make timely and good quality decisions as to the approval of particular Fund 2 and Fund 3 projects. The UR suggests (in the context of its discussion of the unresolved issues from RP4) that NIE could apply for judicial review of the UR's decision/lack of decision. But that is fanciful. Judicial review is timely, costly and does not provide a full review on the merits. Investors will lose confidence in a regulatory regime which requires NIE routinely to look to judicial review to "appeal" against decisions as to the revenues to be allowed for individual projects. The regulatory system functions much better where the regulator proposes a fully specified price control and the company then has the option of rejecting it, and subjecting its case to a full merits appraisal by the CC. This is the approach adopted in all GB regulatory regimes. The UR seeks to avoid that.
- 1.14 In this situation, NIE now looks to the CC to decide for itself what capex allowance NIE needs to finance its activities for RP5, and to settle on an appropriately framed price control to provide NIE with appropriate incentives to manage its capex budget efficiently. NIE is confident that it can provide the CC with all the information it will need to do that job rigorously and thereby to promote the interests of NIE's customers.

### **Misleading presentation of the issues**

- 1.15 The UR's submission is also misleading in its misrepresentation of NIE's case, and of the extent to which facts are or are not in dispute. We would therefore urge the CC to read NIE's case with care, so as to avoid being misled by the UR as to what NIE is saying. The UR's presentation of the issues relating to the RAB adjustment is particularly misleading in suggesting that many of the underlying facts are agreed, when it is clear from NIE's SoC that that is not so. The UR also uses prejudicial language to denigrate NIE's case without good cause. For example, the UR seeks to dismiss NIE's capex assessments as a mere "desk top" exercise. Such a description ignores the expertise of NIE's engineers, the rigour of the process underlying the preparation of NIE's capex plans and, crucially, the fact that NIE's assessment was not merely conducted from behind a desk, but entailed a detailed review of the physical condition of NIE's network. The UR knows full well that its own review of NIE's work entailed no examination of any of NIE's network assets.

### Cherry picking

- 1.16 UR-26<sup>3</sup> contains various allegations of "cherry-picking" and "gaming" by NIE – in essence, allegations that NIE has adopted an inconsistent approach to various matters in order to secure advantage. NIE rejects these allegations in their entirety. NIE's approach is a principled one and what are alleged to be inconsistencies in approach are in fact nothing of the kind.
- 1.17 For example, the first instance of cherry picking alleged by the UR is in relation to opex and pensions<sup>4</sup>. The UR complains that, on the one hand, NIE has suggested an end to the rolling allowance approach to opex and pensions adopted in RP4 while, on the other hand, contending that because the rolling allowance approach would have ensured that NIE would recover all its pensions costs, albeit with a 5-year time lag, it should be entitled to an adjustment in RP5 to reflect the £24 million in pension deficit repair costs that NIE paid during RP4 in excess of the allowance for that period.
- 1.18 This is not a case of cherry picking. The UR recognises that NIE's pension deficit repair costs are essentially uncontrollable. More than 97% of the NIE final salary scheme members have protected rights under legislation established at privatisation which, as a matter of law, NIE is legally obliged to pay for. That is why the UR's 'pension principles', as set out in the FD, provide for customers, rather than NIE's shareholders, to bear these costs. (The fact that the FD pension deficit allowance does not accord with this principle merely underlines the inconsistency in the UR's approach.)
- 1.19 The rolling pension allowance adopted in RP4 similarly recognised that customers would pay the full costs of NIE's pension deficit repair costs, albeit that to the extent that actual costs in any year of a particular price control period exceeded the allowance for that period, NIE would need to wait until the equivalent year of the next price control period (i.e. 5 years) to recover those additional costs. That was unquestionably an essential feature of the rolling allowance approach.
- 1.20 In light of the foregoing, it will be readily apparent that any decision to move away from the rolling mechanism in RP5 must be accompanied by a 'true up' in respect of any pension deficit repair costs incurred during RP4 in excess of the allowance for that period in order to avoid NIE shareholders having to bear substantial costs that would otherwise fall to customers both under a continuation of the rolling allowance mechanism and under the UR's proposals for RP5. Seeking a true up is not therefore a case of cherry picking: it is a direct and necessary consequence of the switch from one approach to another in respect of the recovery of pensions costs. The UR's decision in its FD not to allow a true up was opportunistic and

<sup>3</sup> See paragraph 9 of UR-26.

<sup>4</sup> See subparagraph (a) of paragraph 9 of UR-26. That subparagraph refers to opex and pensions although in fact the allegations of cherry picking relate exclusively to pensions.

inconsistent with a principled approach to the recovery of uncontrollable pension costs.

- 1.21 Nor is this approach inconsistent with the adoption of a different approach for RP5 to the recovery of controllable opex costs: the UR accepted in its Final Determination that, for RP5, it would be preferable to base NIE's controllable opex allowance on a bottom up assessment of NIE's opex costs. However, that bottom up assessment reflected opex savings achieved during RP4, with the result that opex costs forecast for RP5 are lower than they would otherwise have been. Thus, the key benefit of the rolling opex allowance – that cost savings achieved in period 1 should be reflected in prices charged to customers in period 2 – is achieved.
- 1.22 The other instances of cherry picking alleged by the UR are equally misleading. Rather than address them in this Introduction, which would give them a prominence which they do not deserve, they are addressed in Section 3 below (or in the Annexes referred to therein), which contains NIE's response to points raised by the UR in relation to the SoC on a chapter-by-chapter basis.

## **2. NIE'S APPROACH TO THE RP5 PRICE CONTROL REVIEW**

- 2.1 In view of the UR's latest submission, NIE believes that it will assist the Commission to have a fuller understanding of NIE's motivations and objectives at the commencement of the RP5 price control review in 2010. These objectives remain the same today, and are worth re-stating to provide some context.
- 2.2 It was well understood at the time that the RP5 process would be quite different to the RP4 process and would be an opportunity to re-appraise the methods of cost assessment and incentive design that had been in place till then. The UR issued its Strategy Document in July 2010 which highlighted the key issues to be faced at the RP5 review, and also issued a paper on alternative financing structures (in December 2010) and a cross-utility consultation (in September 2011). Over the same period, NIE was also thinking carefully about the type of price control regime that it felt would best serve the interests of all stakeholders, and it articulated that position in response to the various consultations and in its RP5 submissions. This position was well summarised in the following extract from its response to the cross-utility consultation<sup>5</sup>:

*"In forming its regulatory policy we believe that it is most important for the UR to maintain a clear and stated alignment with GB regulatory precedent, which in the case of NIE means an approach consistent with that applied by Ofgem to the GB Distribution Network Operators (DNOs). Given*

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<sup>5</sup> NIE's Response to UR's consultation document, *Network Price Controls: Proposals for a Cross-Utility Approach to Network Price Controls*, 23 November 2011.

*Ofgem's influence on most of the UK electricity industry, we believe that maintaining a link to GB precedent and current approach is crucially important to support investor confidence in NIE. Specifically, we believe that NIE must be able to compete on a level-playing field with GB DNOs for both equity and debt funds. Consistency with this GB precedent is, in our view, far more important than consistency across the different network price controls overseen by the UR.*

*Ofgem undertakes lengthy and detailed consultations to which numerous stakeholders respond. Ofgem's approach is consequently subjected to significant scrutiny and challenge and is well understood by stakeholders, in particular the investor community. Given the existence of this highly relevant and well tested precedent, a NI specific cross-utility approach risks increasing complexity unnecessarily, thereby reducing transparency. It also creates the risk that investors and ratings agents perceive that there is increased regulatory risk in NI, arising from departures from existing, well-understood regulatory precedent. The most relevant benchmarks for NIE are the GB DNOs and the UR should pursue an approach to regulation that is consistent with the Ofgem regulatory model."*

2.3 NIE continues to take this view.

2.4 NIE realised that it would need to engage effectively with UR in order to achieve its objective and, crucially, to demonstrate its own commitment to aligning itself to the GB style of regulation that went beyond simply arguing for a particular regulatory instrument. To this end, it engaged with the UR in four key areas:

*NIE's approach to developing its RP5 business plan anticipated Ofgem's use of 'well justified business plans (WJBP)' as a cornerstone of future RIIO reviews*

- Although Ofgem had not at that time finalised its guidance on what would constitute a WJBP, the criteria were becoming increasingly clear in a range of Ofgem working papers and it was against these criteria that NIE developed its plan over the winter of 2010/11. NIE provided a comprehensive response to all of the areas requested in the BPQ, including providing a range of material in the form of BPQ support papers and capex strategy papers. The result was, in our view, a business plan that bears favourable comparison to the DNOs' plans submitted at DPCR5 in terms of its clarity, transparency, degree of evidencing and focus. We would acknowledge that in the intervening period RIIO has now been applied in GB to the electricity transmission operators, the gas transmission operator, and the gas distribution operators, and is currently being applied to the electricity distribution operators so there is a great deal of new learning NIE would benefit from that will be useful in developing future plans.

*NIE led the work to benchmark its efficiency against the GB DNOs using Ofgem's models*

- Benchmarking has been a key feature of Ofgem's reviews, so an important demonstration of our commitment to align with GB precedent was to take the lead in undertaking the cost mapping necessary to ensure like-for-like comparisons and then estimate the models that Ofgem ran at DPCR5 on a 15-DNO<sup>6</sup> sample. This work formed the basis of the UR's own assessments.

*NIE developed a methodology for evaluating the WACC*

- Our framework for setting the WACC, articulated in Chapter 15 (WACC) of our SoC (and in a variety of submissions made throughout the price control process), started from the Ofgem approach, adjusted for NI-specific factors, and any changes to market data that would be significant enough to justify moving away from the Ofgem parameters.

*NIE developed a set of well-defined proposals covering the use of incentives across core areas of cost and output performance that drew heavily on GB practice*

2.5 NIE's proposals extend to:

- Investment incentives, including the development of the three pot model intended to provide the UR with comfort (pending the development of health and load indices as described below) that it could better monitor NIE's performance in delivering important elements of its capex plan, while maintaining NIE's operational flexibility and its incentive to seek efficiencies and to innovate.
- Performance incentives, primarily covering customer interruptions and customer minutes lost with a proposed calibration in line with GB norms, and a strengthening of existing incentives for revenue protection which represents a significant and controllable aspect of the cost of network losses borne by customers. We also took the lead in attempting to develop the incentives framework further by suggesting initial ideas for new incentives in RP5 to improve customer service and facilitate greater connection of renewable generation (to which the UR has not responded), as well as proposing to work with the UR to develop workable incentives for RP6 to improve network losses.

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<sup>6</sup> i.e. the 14 GB DNOs and NIE

- Secondary deliverables, to put in place work with the UR that would lead to the development of Health and Load indices over the course of RP5 such that they could be tested and ready for use at RP6.

2.6 NIE also understood that in certain cases the UR would be wary of applying GB precedent too closely. Consequently, in some areas, NIE moderated its proposals to account for this. For example, NIE's three pots approach to regulating investment was an attempt to devise a sensible framework that would meet the UR's concerns with the traditional RPI-X approach of setting an ex ante allowance, with the operator exposed to upside and downside risk of expenditure relative to the allowance.

2.7 In summary, the whole thrust of NIE's approach was to propose a closer alignment of the regulatory framework with that applied by Ofgem, taking account of NI-specific factors where relevant and justified, and recognising the need for a transition period in certain cases to allow both NIE and the UR to gain experience in the operation of certain mechanisms before they became fully operational. It is fundamental to the situation that the CC, the UR and NIE now find themselves in that, most regrettably, the UR did not, over a period of three years, substantively engage with NIE on these important matters during the RP5 price control review, and it is disappointing that the UR now seeks to characterise NIE's attempt to set out an internally consistent incentive-based regulatory model in disparaging terms. Indeed, given that a regulatory framework comprises not only the formal rules adopted by the regulator, but also the conduct and culture of the regulator and its staff, the UR's submissions to the CC further reinforce NIE's view that it would be beneficial for the UR to align its overall practices more closely to Ofgem's. What would be particularly unacceptable in NIE's view, would be to pass effective control of detailed month-by-month capex decisions to the UR.

### **3. NIE'S RESPONSE TO UR'S POSITION ON THE SOC**

3.1 In this Section 3, we set out in overview NIE's position in response to certain general points arising from UR-26, as well as the UR's opening submission. In doing so, we adopt the same chapter numbers and headings used in our SoC and adopted by the UR.

3.2 A response to more detailed points raised by the UR in its submissions is provided in a series of Annexes to which reference is made below. In many cases, we cross-refer to our SoC and in the interests of brevity do not in this submission seek to repeat points that are already well made therein.

## Chapter 4 (Capex Structure)

3.3 The UR commences its opening submissions on capex by highlighting the step change in the level of capex requested by NIE for RP5, relative to RP3 and RP4. The reasons for NIE's substantially increased capex requirements are addressed below under the heading Chapter 5 (Capex Quantum). This section is concerned with the UR's proposal for a 'three fund' capex mechanism – a proposal which NIE considers to be unworkable, as explained below.

3.4 It is useful to recall that it was NIE that originally proposed a three "pot" capex mechanism, the structure of which (i.e. an ex ante allowance with RPI-X style incentives) is consistent with Ofgem precedent as evident from DPCR5. NIE's objective was to devise a sensible framework that would meet head on the potential concern that, with a simple ex ante allowance, NIE might enjoy excessive freedom to under-spend or mis-spend the allowance. NIE therefore proposed that the capex allowance be structured as three separate pots, each of which would be subject to different rules and incentive arrangements, depending on the extent to which the cost and specification of the works concerned were predictable and controllable by NIE:

- Pot 1 was to provide an allowance for high volume, commoditised work (e.g. rolling programmes of overhead line refurbishment) where both the volume and unit cost of the work could be predicted with reasonable accuracy. This would have accounted for approximately 27% of NIE's core capex.

NIE considered that this work is sufficiently predictable that NIE was content to propose that a revenue allowance be fixed at the outset of RP5 based on (a) a forecast of the total units to be delivered and (b) the target unit costs. The pot would have been subject to rules by which, while NIE had the scope to substitute volumes between different programmes during RP5, its revenue entitlement would have been adjusted pro rata on the basis of delivered volumes (subject to not exceeding the total revenue allowance fixed at the outset); but if realised unit costs exceeded or fell short of the target unit costs, NIE would have borne the additional cost, or benefited from the saving, subject to cap and collar arrangements proposed as part of NIE's proposed capex incentives.

- Pot 2 was to provide an allowance for other projects that are, at the outset of RP5, less certain, or that will be triggered by events that are less controllable by NIE. NIE proposed a traditional ex ante allowance for such work (which would have accounted for approximately 63% of NIE's core capex) based on an assessment of NIE's expenditure requirements necessary to meet its statutory and licence obligations, and performance improvement targets set as part of the RP5 price control.

It was envisaged that NIE would be free to deploy these funds for whatever projects it judged to be best suited to fulfil its statutory and licence obligations, in light of changing needs. The overall size of pot 2 and the range of work to be covered would have allowed for NIE to take advantage of "swings and roundabouts" by applying cost savings on some projects to meet either cost increases on others or new requirements.

NIE would have been adequately constrained (from inefficient deployment of the funds, or from under-investment) by: (i) the comprehensive coverage of its statutory and licence obligations, which impose tight standards in terms of network quality and capacity; (ii) the fact that, although load growth might not emerge precisely in accordance with NIE's plan, overall load growth is sufficiently predictable for an overall ex ante allowance to be set at an appropriate level for the RP5 period as a whole; and (iii) any significant deviations from the overall revenue allowance would trigger adjustments under NIE's proposed cap and collar arrangements.

- Pot 3 was to provide for large, discrete projects (including renewables and interconnection projects) where there is material uncertainty over the time and extent of expenditure at present.

NIE proposed that such projects should be approved individually subsequent to the RP5 price control review as requirements become clearer during the course of RP5.

- 3.5 NIE envisaged that the UR should monitor NIE's performance by reference to the rules applying to each of the three pots on a continuous basis, with detailed annual reporting.
- 3.6 In parallel with its proposal for the 'three pot' capex mechanism, NIE committed to working collaboratively with the UR to develop network load and health indices to supplement regulatory reporting with a RPI-X regulatory framework. This was intended to provide visibility of output performance in line with developing Ofgem precedent.
- 3.7 The UR's proposals for a three fund mechanism differ significantly from NIE's proposals, at least in respect of Funds 1 and 2.
- Fund 1 is much wider in scope than NIE's Pot 1. It would cover all asset replacement activity, accounting for 81% of NIE's core capex, and not just high volume, commoditised work. It would include, not only the predictable replacement of large volumes of commodity-type assets, but also:
    - a number of complex, high value projects, each of which is unique and has a cost that no distribution or transmission network operator could

reasonably be expected to predict<sup>7</sup> with accuracy for a price control submission; and

- o 'input driven' expenditure (e.g. capex associated with repairing storm damage), notwithstanding that these costs are uncertain and largely outside NIE's control.

The UR has proposed that these works be subject to individual target costings set at the outset of RP5. The overall revenue allowance for Fund 1 would be the aggregate of (a) the individual unit costings x volumes for commodity-type assets; (b) the individual costings for other unique projects; and (c) the allowance for 'input driven' expenditure. NIE would be entitled to keep the benefit of any cost savings achieved relative to the target costs, but would bear the burden of any cost overruns.

The UR proposes that it would be open to NIE to flex the mix of activities within Fund 1 (by doing more of one type of asset replacement/project and less of another). If NIE did flex the mix of work in this way, the UR would check what NIE had achieved (number of assets replaced/number of specified projects) at the end of RP5 and allow only the revenues associated with those activities.

Whilst this may superficially appear to provide NIE with a large degree of flexibility, in practice it is risky and unworkable. The main reasons are as follows:

- (i) The additional projects which the UR intends to include within Fund 1 (beyond routine asset replacement) are individually unique, and cannot be accurately costed, at an individual level, at the outset of RP5. There is a real risk that, if NIE "beats" the target cost for any particular project, the UR will seek to reopen its assessment of the target cost (e.g. arguing that the target cost was, with hindsight, manifestly excessive). Conversely, there is no real prospect that the UR will be willing to compensate NIE for any inevitable cost overruns; and
- (ii) There is every reason to believe that NIE will need to amend the specification of projects during RP5, or devise new projects to meet new needs, and as a result, these projects will not have an ex ante

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<sup>7</sup> This would require the RP5 programme to be fully defined at the outset, with each project designed and costed, and ready for construction. However, this would be inefficient, resulting in projects being designed well ahead of need, based on a forecast of requirements. To achieve this degree of accuracy, NIE would have had to fully design the RP5 programme of works during the early part of RP4 (in order to populate the RP5 BPQ), meaning projects would be defined up to 7 years ahead of construction.

target cost (which is a necessary feature of the UR's ex post efficiency assessment process). In practice, therefore, NIE will end up having to undertake large parts of its asset replacement activity in the hope of obtaining an ex post approval. The prospect of getting any credit for delivering works at a super-efficient cost is, in reality, nil, but the prospect of suffering a disallowance of costs judged to be inefficient is very significant.

In short, the UR's proposals to extend the Fund 1 mechanism to include substantially more, and more complex, elements of NIE's overall asset replacement programme render the fund unworkable and asymmetrically risky for NIE. The fund rules would severely restrict NIE's freedom<sup>8</sup> to manage asset replacement activities in light of changing circumstances over the 5 year period, and would expose NIE's shareholders to the risk of non-recovery/under-recovery of the efficiently incurred costs of any asset replacement activities which management judge it necessary to undertake.

- The UR's proposed Fund 2 would provide a single ex ante allowance for, among other things, a number of unique load-related projects planned by NIE. For these projects, individual cost allowances would be fixed at the outset of RP5. Again, NIE would be entitled to retain the benefit of any cost savings in implementing agreed projects, and would bear the burden of any cost overruns.

The Fund 2 proposals exhibit several of the same difficulties as are identified above in respect of Fund 1. As with 'one off' asset replacement projects in Fund 1, the Fund 2 load-related projects are unique, and cannot realistically be individually costed with a high degree of accuracy at the beginning of RP5. Many such projects require planning permissions, which may limit how the project can be carried out. Detailed engineering plans may need to be developed to meet planning and other constraints identified during RP5, with the prospect of significant variations from initial costings.

It would also be open to NIE to propose new Fund 2 projects to the UR during RP5 and, subject to obtaining approval for them at a project-specific target cost, to add them to the revenue allowance. However, NIE has no confidence that the UR will issue approval decisions in a timely, fair or efficient manner. In practice, NIE would be obliged to proceed with projects before obtaining approval, and would be subject to an ex post assessment which would subject NIE to substantial asymmetric risk. If NIE

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<sup>8</sup> It is also to be noted that, under EU rules, the UR is obliged to provide separately ring-fenced allowances for transmission and for distribution activities. This necessarily limits NIE's freedom to switch expenditure from one activity to another across the T and D boundary.

commences work on such projects without having first obtained the UR's approval, it bears the risk that the UR will withhold funding if it:

- disagrees with the need for the project; or
- determines that costs have not been efficiently incurred.

3.8 From NIE's perspective, four key issues emerge from the UR's proposed capex mechanism for Funds 1 and 2, as described below.

*Asymmetric forecasting risk*

3.9 First, NIE is expected to take the risk that the costs of individual projects exceed estimates made at the outset of RP5. This is the case not just in relation to high volume, commoditised work for which average unit costs can be predicted with a degree of accuracy allowing cost risk to be diversified. It extends also to complex projects the costs of which cannot reasonably be predicted with the requisite degree of accuracy at this stage. NIE is expected to accept very substantial and asymmetric forecast error risk that it can do little to control. This risk can be managed within an overall fund comprising numerous individual projects, but is intolerable where each project is subject to a specific ex post review process.

*Ex post review risk*

3.10 Second, NIE is expected to take the risk that the UR's proposed ex-post assessment of efficiency will be carried out objectively and fairly. Changes from the initial plan are inevitable in response to changing circumstances and NIE will bear the uncertainty of the UR's ex-post assessment of the reasons for the variation.

3.11 The situation is exacerbated by the fact that none of the processes and criteria for the UR's ex post efficiency assessment have been set out in detail by the UR. The failure to do so has significant implications for transparency and regulatory certainty. In the absence of a clear set of ex ante rules to guide its operational decisions, NIE expects that the UR's assessment will be subjective, and rely unduly on hindsight, to the ultimate detriment of NIE.

3.12 Various different scenarios can be envisaged. The following table provides some non-exhaustive examples:

Scenario	Risks
NIE delivers an agreed project at less than the allowed cost.	The UR may rely on hindsight to decide that the target cost should have been lower, and may preclude NIE from retaining the benefit of cost savings.
NIE delivers a substitute project, to attain the same result as an agreed project, and does so at a lower price than the allowed cost of the agreed project.	The UR treats the delivered project as a non-approved project and sets, ex post, an allowed cost equal to the outturn cost. NIE gets no reward for devising a better cheaper alternative to the originally agreed project
NIE delivers an agreed project at a higher cost than the allowed revenue.	NIE is required to bear the cost of the overspend.
Due to changing circumstances, NIE is able to defer into RP6 one project and substitute this with a different project, to meet a different need which has emerged as urgent during RP5.	NIE will lose the revenue allowance associated with the deferred project, and may not obtain an appropriate revenue allowance for the new project. This example illustrates how the Fund 2 structure limits NIE's freedom to manage its overall budget flexibly to meet overall need.

### Logging up risk

3.13 Third, so far as relates to the undertaking of projects which do not form part of the initial Fund 2 allowance (the so-called logging up mechanism), NIE has no up-front certainty as to its revenue allowance for such projects, but is expected to trust the UR to provide revenues as and when projects need to be carried out. For the reasons given above, NIE can have no confidence that the UR will approve funding on an ex ante basis. In particular:

- The UR has a very poor record of responding in a timely manner to funding requests made under approval arrangements incorporated within an existing price control.
- If NIE disagrees with the UR's decision on an approval request, or the UR fails to make a decision in a timely manner or at all, NIE's only recourse is to judicial review. But this is not an effective remedy because it is costly, slow and does not provide an appeal on the merits.

Instead, for the logging up process to be workable, NIE would need clear and transparent rules to be adopted, at the outset, as to the process to be adopted, and the substantive criteria to be applied, in respect of the grant of approvals. But, given the multiplicity of situations to be addressed, NIE has no confidence that such rules could be adequately specified, or their implementation ensured, to protect NIE against the real risks identified above.

*Interference with management's freedom to manage the T&D Business*

- 3.14 Fourth, NIE is legally responsible for ensuring that its network can meet all reasonable demands for electricity and that mandatory health and safety standards are met. The company, or individual directors, may be criminally liable if certain standards are not met. In some cases, NIE's management have to move quickly to address urgent network risks. Often, it will require the exercise of judgment to decide what needs to be done. It is only right that those who bear legal responsibility for that judgment should be free to exercise their judgment. Yet the UR's proposed three fund structure creates a situation where the UR will wish to decide – by giving or withholding approval – whether particular projects should proceed. If it refuses approval, NIE may have to abandon projects which it judges necessary, as they will not be financeable. This is an entirely inappropriate allocation of functions between NIE and the UR.
- 3.15 The significance of this problem is all the greater in light of the substantial increase in capex which NIE expects to undertake during RP5, as discussed in paragraphs 3.19 ff. below.
- 3.16 So far as relates to Fund 3, NIE accepts that there is no practical alternative but to provide for these projects to be subject to ex ante approval, with a specific revenue allowance per project. But, for the Fund 3 arrangements to be workable, NIE will need clear and workable rules for the giving of approvals, and a clearly specified understanding as to the scope for a later reopening of matters which have been so approved.

*Proposed solution*

- 3.17 The better course therefore is for the UR (and now the CC) to adopt NIE's three pot structure. This would entail<sup>9</sup>:
- Setting a separate ex ante allowance for pot 1 capex (routine, predictable asset replacement, with target unit costs for each asset type), including a simple mechanism for the revenue allowance to be adjusted if NIE delivered lower volumes, or flexed expenditure between different asset types.
  - Setting a single ex ante allowance for other capex (largely, the residue of the UR's Fund 1 and all of the UR's Fund 2), based on the CC's best estimate of NIE's revenue needs. NIE would be free to manage the expenditure of this capex allowance, subject to the constraints imposed by legal/regulatory standards; the rigour of the ex ante assessment of need; enhanced regulatory reporting during RP5; and NIE's proposed cap and collar arrangements.

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<sup>9</sup> Full details of the changes proposed by NIE in the scope of the UR's fund are set out in Chapter 4 (RP5 Capex – Structure) of the SoC.

- Adopting a Fund 3 mechanism substantially similar to the UR's Fund 3 mechanism, but with clear procedural rules and substantive criteria to be applied in giving project specific approvals.

So far as relates to Fund 2, such arrangements would more closely accord with the statutory scheme for setting price controls which envisages effective protections for NIE against abuse of regulatory power by providing NIE with the option of rejecting the UR's proposals and thereby triggering a merits-based assessment of the issues by the CC. The UR's proposals for Fund 2 effectively bypass those protections by providing NIE with no scope for a merits-based appeal in respect of approval decisions required during RP5. Overall, NIE's proposals also provide sufficient assurance that NIE will be constrained from under- or mis-spending its capex allowances, to the detriment of customers.

In contrast, the UR's proposals would be unworkable, would introduce additional costs and delays in the implementation of projects, would be unfair to NIE, and would undermine investor confidence, all to the ultimate detriment of customers. There would be a very damaging blurring of responsibilities between the UR and NIE's management, between the UR and the Reporter, and between the Reporter and NIE's management. The UR's submissions do not address these concerns at all.

#### UR's response to NIE's SoC

- 3.18 UR-26 contains<sup>10</sup> various further allegations and derogatory comments directed at NIE's case in relation to the structure of the RP5 capex arrangements. These matters are addressed in full in Annex 1 (RP5 Capex – Structure) to this submission. It is sufficient to note in this Overview that NIE rejects the UR's criticisms in their entirety.

#### **Chapter 5 (Capex Quantum)**

- 3.19 The UR's opening submission on capex (in particular UR-4) focussed heavily on "*the sheer scale of the capex programme*" proposed by NIE, noting that:

*"The capex issues raised in this inquiry are by any measure extraordinary. NIE T&D proposed that customers in Northern Ireland should pay for a capex programme the scale of which has never been seen before."*

- 3.20 While the UR uses the language of hyperbole, it is correct to identify that the level of capex requested for RP5 represents a step change over capex levels in RP3 and RP4, and that there will be an inevitable impact on tariffs.

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<sup>10</sup> See in particular paragraphs 9 and 37 to 52 of UR-26.

3.21 However, the UR's presentation of the issue is misleading and alarmist. The UR fails to acknowledge certain key facts:

- Its own position has shifted over time (both after the publication of the Draft Determination and, again, after publication of the FD). The UR and the UR's consultants, SKM, now acknowledge (UR-25) that NIE's assessment of the volumes of capex activity to be undertaken, as modelled in the network model, are substantially correct. The model covers all asset replacement activity, but does not cover other capex activity (e.g. to meet new legal requirements, reactive investments, network automation, etc).
- While the UR does not accept NIE's case on the volume of transformers and reactors to be replaced during RP5<sup>11</sup>, its rejection of NIE's case may simply reflect the UR's failure to examine all the evidence provided by NIE as to the extent of deterioration of its transformers and reactors, and the UR's undue reliance on an age-based assessment.

Accordingly, the UR accepts – in substance – that there will need to be a step change in NIE's capex activities, and should not now be expressing surprise or alarm at that fact.

3.22 However, despite the sizeable shift in the UR's position, there remain key areas of disagreement between the UR and NIE:

- As noted above, the UR continues to under-estimate the extent to which NIE will need to replace transformers, reactors and re-engineer the distribution overhead network during RP5;
- The UR continues to disallow altogether expenditure in respect of certain key elements of NIE's business plan – most notably expenditure for unique programmes (e.g. 11kV network resilience, compliance with ESQCR legislation<sup>12</sup>, network performance and flood protection, as documented in SoC Table 5.7<sup>13</sup>); and
- The UR has underestimated the costs of undertaking required capex activity. This underestimate arises from three mistakes by the UR:
  - the UR's application of an unjustified (in)efficiency discount;
  - the mis-estimate of RPEs; and

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<sup>11</sup> The SKM report UR-25 also reduces by approximately half NIE's proposals for overhead line reengineering.

<sup>12</sup> Electricity, Safety, Quality and Continuity Regulations.

<sup>13</sup> SoC, page 82.

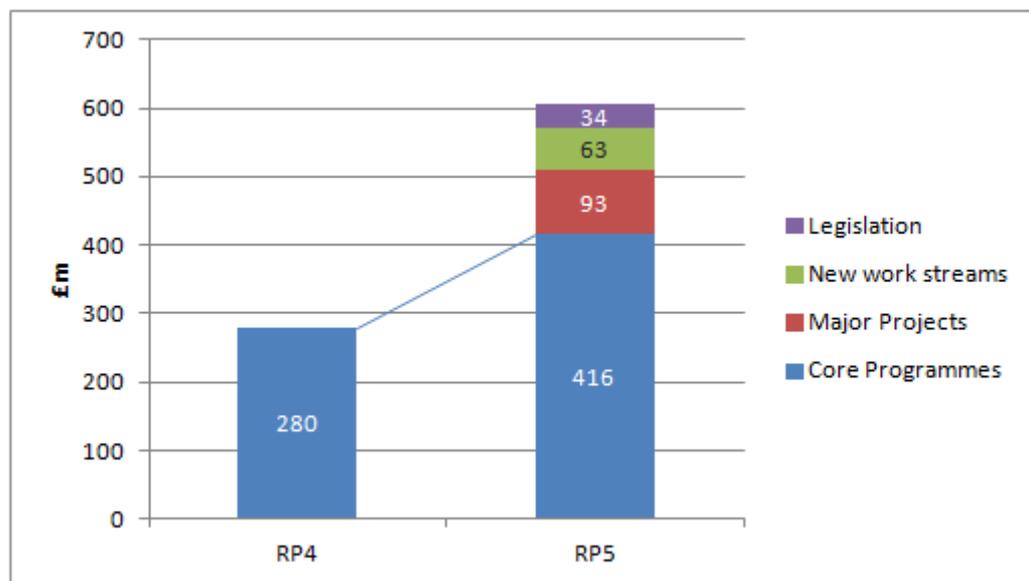
- specific areas of disallowance which are not justified (as documented in SoC Table 5.3<sup>14</sup>).

As a result, the total allowances for both Funds 1 and 2 are inadequate to cover the works which those funds contemplate to be undertaken.

3.23 Against this background, we now turn to analyse in more detail the composition of NIE's capex requirements, and to reply to the points raised in the UR's submissions.

3.24 The increase in NIE's capex requirement for RP5 relative to the allowance for RP4 is illustrated by the figure below:

**Capex – NIE proposals for RP5 relative to RP4**



3.25 However, there are clear reasons for the increased volumes, as set out in the SoC<sup>15</sup>. These include:

- NIE must commence asset replacement programmes on several additional asset classes (e.g. 33kV overhead line tower refurbishment and cable replacement) which are only now falling due for replacement in RP5. Maintaining them in service would present unacceptable risks;
- There are a small number of complex high value projects (e.g. two transmission voltage support schemes) required in RP5 which have not been required in previous price control periods.

<sup>14</sup> SoC, page 73

<sup>15</sup> See Chapter 5 (RP5 Capex – Quantum), paragraph 2.6 to 2.12.

- Increased volumes of asset replacement work are required for assets which, some 40+ years on from rural electrification in NI, have been shown to have deteriorated through age. The need for asset replacement is exacerbated by the relatively modest asset replacement rate in previous price control periods.
- In addition, new legislation, primarily the Electricity Safety Quality and Continuity Regulations (ESQCR) and Road and Streetworks legislation place new specific statutory requirements on NIE in terms of compliance.
- The need to invest in the 11kV network to reduce the risk of widespread and prolonged loss of supply resulting from ice accretion on small cross-section conductor overhead lines.

(For completeness, we would also mention that any expenditure to cater for renewable projects would be in addition to these amounts.)

- 3.26 In essence, the position in NI is, in these respects, no different to the position in GB. In its Final Proposals for DPCR5, Ofgem commented<sup>16</sup> on the large increases in expenditure forecast by the DNOs relative to DPCR4 for reasons similar to those identified above.
- 3.27 While the UR now accepts the step change in capex volumes, it still persists in claiming, as it does in UR-26<sup>17</sup>, that NIE has "*failed to justify for large swathes of its planned capital programme*". This is incorrect. NIE's original BPQ submission and the accompanying 43 capex strategy papers and responses to substantial follow up inquiries justify its capital programme in considerable detail<sup>18</sup>.
- 3.28 Moreover, as noted in paragraph 3.21 above, the UR's statement in UR-26 is at odds with the fact that the UR and its consultants, SKM, now appear to accept that NIE's asset replacement volumes as per their modelling are generally substantiated. (In this regard, NIE does not understand the UR's reference in paragraph 13 of UR-26 to NIE's failure "*to reflect adequately the changes in circumstances that have occurred since it prepared its original submission*". The only relevant changes to NIE's case relate to its proposals for the 11 kV pilot refurbishment programme, and to its assessment of RPEs. Otherwise, the only change has been to the UR's (and SKM's) assessment of whether various capex volumes are now justified.)

<sup>16</sup> See paragraph 3.21 of Ofgem's 'Final Proposals – Allowed Revenue Cost Assessment' (146/09) document to be found at: [http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/DPCR5/Documents1/FP\\_3\\_Cost%20Assessment%20with%20SS%20comments.pdf](http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/DPCR5/Documents1/FP_3_Cost%20Assessment%20with%20SS%20comments.pdf).

<sup>17</sup> UR-26, paragraph 13.

<sup>18</sup> A detailed description of process adopted to prepare NIE's BPQ submission is contained in paragraphs 2.13 to 2.25 of the Chapter 5 to the SoC.

- 3.29 In NIE's opinion, the UR would have been quicker to accept that NIE's capex volumes are justified – and would be more likely to accept NIE's position on the few areas of outstanding disagreement – had the UR engaged appropriately with NIE from the outset of the RP5 review process. The UR's review process leading up to the publication of the draft determination was characterised by a lack of transparency and meaningful two-way engagement. The UR's technical advisers did not undertake any site visits, nor any systematic appraisal of NIE's network, nor any audit of NIE's engineering appraisals, as part of their assessment, despite offers by NIE to arrange visits and meetings. Consequently, the UR missed a valuable opportunity for its technical advisers to better understand the context and the reasons for NIE's proposals, to appreciate the challenges facing the company and to form a first-hand view of the appropriate nature of the capex programme, and to factor that into their advice to the UR.
- 3.30 One of the key outstanding areas of disagreement on capex volumes relates to the need for the 11kV resilience programme (see paragraphs 44 to 46 of UR-26). A response to the UR's criticisms is contained in Annex 2 (RP5 Capex – Quantum) to this submission. For the purposes of this Overview, NIE notes that the need for the 11kV resilience programme will be a matter addressed during the CC's site visit to NI scheduled for 13 / 14 June.

### **Chapter 6 (Opex)**

- 3.31 The UR's allowance for controllable opex of £182.2 million leaves NIE with a shortfall of £53.7 million. The UR notes that most of this shortfall (£29.8 million) reflects the combined effects of different assumptions about efficiency and real price effects – items that are addressed below under the heading Chapter 7 (Efficiency). The UR further notes that the remaining points relate to items of new opex. This is not strictly correct as there is also a shortfall against baseline opex which is currently being offset by the incorrect inclusion, by the UR, of the IAS 19 current service pension charge in the base year costs. Although as the UR state the remaining contributory factors to the controllable opex shortfall are individually less material, they collectively add up to £23.9 million.
- 3.32 (The UR fails even to comment on the separate £7.6 million shortfall that arises in respect of non-network capex, which was also addressed in Chapter 6 of NIE's SoC. The UR therefore understates the extent of its disagreement with NIE in respect of matters falling under this head.)
- 3.33 Of the remaining contributory factors to the controllable opex shortfall, key among these relates to the Enduring Solution IT system. The UR has determined an allowance of £21.4 million to operate and maintain the Enduring Solution (ES) processes and systems. This falls 26% or £7.5 million short of what is required over the RP5 period.

- 3.34 NIE successfully implemented the ES system in May 2012 at a total cost of £37.6 million. It was driven by the need to meet legislative and regulatory requirements for a fully competitive retail electricity market. The project also delivered full separation of the customer billing processes and legacy IT systems previously shared between NIE (the network operator) and Power NI (the retail Supplier). It was a well-managed project, delivered by a Systems Integrator following a competitive procurement exercise. The ES system has been supporting the NI retail market effectively for the past 12 months.
- 3.35 The ES system has created a step-change in NIE's operating costs. It replaced low spec, static applications providing minimal functionality with complex, functionally rich applications requiring significantly more support effort. There has been a 12-fold increase in daily messages processed by the system, 90 additional systems interfaces and a five-fold increase in bills issued. It has delivered unconstrained switching, whereby approximately 838,000 retail customers can freely move between electricity suppliers, introduced improved functionality for customers, ensured data integrity for the wholesale and retail markets and enabled harmonisation between the markets in NI and RoI.
- 3.36 NIE is responsible for managing all the NI retail market processes and data, whilst in GB responsibilities for these functions are spread across many different industry participants including meter data collectors, data aggregators, suppliers and meter installers. Therefore, solely to meet the needs created by the NI retail market, the ES system is necessarily complex and differs significantly from solutions in place within GB.
- 3.37 The NIE support costs are based upon a detailed review of activities and they have been validated in the period since go-live. Support is being provided at an annual cost of 13% of the original implementation cost. External benchmarks, including reports from Gartner submitted as part of NIE's SoC demonstrate that organisations would expect to pay 25% to 30% of implementation cost for on-going operations.
- 3.38 The fact that the ES services are being provided in a low cost manner is reflective of NIE's overall low IT cost base, which was established following a competitive outsourced managed service procurement exercise in 2009.
- 3.39 NIE responds to the UR's criticisms of the way NIE developed its submission for an allowance in respect of the maintenance and operation of the ES system in Annex 3 (RP5 Opex – Enduring Solution). NIE responds to other points raised by the UR in relation to opex in Annex 4 (RP5 Opex – Other).
- 3.40 As regards the remaining contributory factors to the shortfall in the opex allowance, reference should be made to Chapter 6 (RP5 Opex) of the SoC.

## Chapter 7 (Efficiency)

### Benchmarking

- 3.41 NIE has led the way on benchmarking work for RP5, with extensive benchmarking carried out by Frontier Economics. In particular, the work undertaken on cost mapping by Frontier and NIE jointly has enabled direct comparisons with the fourteen GB DNOs, and demonstrated that NIE is a leading performer within the overall class of UK DNOs (as outlined in Chapter 7 of NIE's SoC). Frontier's benchmarking work in respect of indirect costs has been shared in full with the UR, and reviewed at each stage by its consultants, CEPA.
- 3.42 In respect of indirect costs and opex more widely, the UR has relied on work undertaken by CEPA. Frontier considers that there are material flaws in CEPA's analysis which cause the UR significantly to understate NIE's efficiency. Whilst the results of CEPA's analysis have been made public, NIE has not had any access to the underlying data or the analysis that has driven the results and their work has not been peer reviewed. This lack of transparency exacerbates NIE's concern that the UR's position stems from what appears to be poorly justified and partial assumptions, which give rise to material adjustments to the quantum of NIE's costs that have been benchmarked.
- 3.43 (NIE has similar concerns over the transparency of the UR's recent benchmarking of capex, which again has not presently been made available for peer review.)
- 3.44 In summary, NIE's approach was proactive, open, responsive to feedback, and made use of an authoritative database that included recent data. In contrast, the UR's approach has been reactive, closed, unresponsive to feedback and based on data that ended in 2008/09.
- 3.45 NIE has presented compelling and robust evidence to demonstrate that it is efficient in its operations, and that the UR's proposed inefficiency discounts are therefore unjustified. NIE's more detailed response to benchmarking issues raised in the UR's supplementary submission (UR-26) is contained in Annex 5 (Benchmarking).

### On-going productivity and RPEs

- 3.46 The UR misrepresents NIE's position in respect of on-going efficiency (UR-26, paragraph 16). It is not the case that NIE 'considers that there is no more room left for it to improve on opex efficiency such that it considers that an on-going efficiency target is inappropriate'. As set out in its SoC Case (Chapter 7 Section 3), NIE acknowledges that future savings are possible, but cautions that they are likely to be small in scale and incrementally driven when compared to past savings.

3.47 NIE maintains, as also suggested by First Economics, that the on-going productivity target should be considered jointly with the level of RPEs. NIE maintains that it expects to face significant positive RPEs in RP5 (SoC, Chapter 8), contrary to the UR's view that RPEs will be negative. NIE considers that there is strong evidence to demonstrate that the effect of RPEs will exceed future productivity savings. This is evident from the recent regulatory settlements summarised by First Economics (in UR-28) and also emerges as a trend in the draft business plans presently made available by the GB DNOs as part of the RIIO-ED1 review. In its initial and supplementary submissions the UR has failed to address the substantive points raised by NIE in respect of RPEs, in particular in respect of labour costs.

3.48 In respect of labour RPEs for 2010/11, 2011/12 and 2012/13, the UR suggests that NIE's pay settlements are 'above market'<sup>19</sup> and should not be considered in estimating RPEs. It instead recommends that the cost inflation of an efficient company should be considered, although it is not clear whether, by this, the UR commends the use of the analysis it used in its FD. The UR's analysis in the FD reveals that in the wider economy there were reductions in real wages over the three years in question. This is not in dispute. However, as NIE set out in its SoC, it is not appropriate to make use of this data when calculating RPEs for NIE since:

- it is irrelevant to NIE, since the circumstances which NIE faced meant that it was unable to benefit from the reductions in real labour costs observed in the wider economy over this period;
- NIE's experience and practice is entirely consistent with wider experience in the energy and utilities sector, in particular the electricity networks and renewables sector; and
- NIE's labour costs remain at or below relevant salary efficiency benchmarks for the NI marketplace and the UK DNO sector and advanced manufacturing sector for comparative roles.

3.49 NIE has over many years exercised tight control over its labour costs. The level of each of NIE's pay settlements has demonstrably been both necessary and efficient. NIE's pay strategy is based on external benchmarking against market rates combined with annual pay awards that have been linked with RPI. Any above-RPI pay awards have been based on efficiency/productivity improvements which have helped the company up-skill its workforce and reduce employee numbers from 3,000 at privatisation to approximately 1,300 today (comparing the T&D business on a like-for-like basis).

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<sup>19</sup> UR-26, paragraph 17.

- 3.50 Over the past three years, despite NIE agreeing the RPI-linked pay settlements outlined above, the number of its staff leaving to take up employment with other companies across the UK and beyond has trebled due to significant increased demand for specialist skills and active headhunting activity. NIE has also experienced increased discontentment in its workforce regarding recognition and reward. In its most recent employee survey only 37% of employees were satisfied with recognition & reward in the company (10% lower than the benchmark for similar companies).
- 3.51 The UR also questions the ‘vast’ proportion of NIE’s workforce that is considered to be specialist in nature<sup>20</sup>. NIE considers that the UR has significantly underestimated the proportion of the workforce that should be regarded as specialist, rather than general. NIE considers that there are three reasons for this, which are that the UR:
- has taken no account of the operating model that NIE has found it necessary to adopt in order to address efficiently the challenges of serving a sparsely populated region;
  - has not properly evaluated the up-skilling model adopted by NIE to achieve the reduction in labour from 3,000 to 1,300 through not replacing leavers over many years and up-skilling the employees that remain especially in the administration and craft roles; and
  - has not assessed whether it is reasonable to consider that a recruit from the general labour market would be an adequate substitute for an existing member of NIE’s skilled workforce should they leave.
- 3.52 The UR has failed to address any of these points in its submissions so far, which is symptomatic of its failure to engage with the realities of the situation.
- 3.53 NIE’s detailed response to the issues raised on on-going productivity and RPEs in the UR’s supplementary submission (UR-26 and UR-28) is outlined in Annex 6 (Productivity and RPEs).

### **Chapter 8 (RPEs)**

- 3.54 The UR’s submissions in relation to RPEs are addressed in summary above and in detail in Annex 6 (Productivity and RPEs).

### **Chapter 9 (Incentives and Innovation)**

- 3.55 The UR’s response to NIE’s SoC does nothing to change NIE’s view that the UR has proposed only limited, often asymmetric, incentive arrangements for RP5

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<sup>20</sup> UR-26, paragraph 36.

which do not encourage innovation and create only weak incentives for cost efficiency; and furthermore, are inconsistent with recent GB regulatory trends (e.g. Ofgem's DPCR5 and RIIO-T1, as well as development of RIIO-ED1).

- 3.56 In contrast, NIE's proposals would be more effective in stimulating the delivery of efficiency and performance, and would fairly reward NIE for what it achieves, consistent with best practice in incentive-based regulation.
- 3.57 NIE's more detailed response to the points raised by the UR can be found in Annex 7 (Incentives and Innovation).

### **Chapter 10 (Pensions)**

- 3.58 The UR raises two points with respect to pensions in paragraph 19 of UR-26.
- 3.59 Both these points need to be understood within a context where the UR has accepted that NIE's pensions costs are uncontrollable: the bulk of final salary scheme members are already retired, and some 97% of the scheme's final salary members are Protected Persons within relevant pensions legislation, so that NIE is precluded from reducing their pension benefits, even on a forward looking basis.
- 3.60 The first issue raised by the UR relates to alleged cherry-picking between (on the one hand) the decision to abandon the rolling approach to pension contribution allowances adopted in RP4 and (on the other hand) NIE's contention that because the rolling allowance approach would have ensured that NIE would recover all its costs, albeit with a 5-year time lag, it should be entitled to an adjustment in RP5 to reflect the £24 million in pension deficit repair costs that NIE paid during RP4 in excess of the allowance for that period. NIE has already addressed and dispensed with this allegation of cherry picking in the Introduction.
- 3.61 The UR's second point relates to NIE's alleged attempt to "rewrite history" by hypothecating the special contributions made in 2005 and 2007 to the payment of early retirement liabilities where (according to the UR) no such link exists.
- 3.62 As regards this allegation, the special contributions were made in July 2005 and March 2007 on the occasion of the disposal of Sx3 and the acquisition of Viridian by Arcapita respectively. The July 2005 contribution was made after NIE submitted its RP4 proposals (4 March 2005). The March 2007 contribution was made after the RP4 price control was agreed (in December 2006).
- 3.63 The purpose of the £50 million special contribution paid in 2007 was to eliminate the £44 million deficit identified in the 31 March 2006 valuation, irrespective of the origin of that deficit. This much is clear from the Electricinvest Acquisitions letter provided in UR-29. It was successful in this objective: as at 31 March 2007, the scheme had a surplus of £18.6m following the special contribution of £50m. There

is no basis for the UR (or the CC) to conclude that this special contribution should not be attributed to ERDCs incurred before that date.

- 3.64 NIE's more detailed response to the points raised by the UR can be found in Annex 8 (Pensions).

### **Chapter 11 (RAB adjustment)**

- 3.65 The UR alleges that NIE's capitalisation of particular costs will have the effect of charging customers twice for the same activities, on the basis that particular activities were intended to be covered by NIE's opex allowance, but will, by being added to the RAB, be recovered over 40 years via a depreciation charge and a return on the capitalised investment. We refer to this alleged effect as "double counting". The allegation relates to the last two years of RP3 and the whole of RP4.

- 3.66 NIE denies that it has double-counted expenditure in this way. In summary, our arguments relate to both:

- the way in which the RP3 and RP4 price controls were set; and
- the particular facts relating to the expenditures in issue.

- 3.67 On the first point:

- the idea of double counting as described above incorporates an assumption that particular items of expenditure (e.g. costs of particular kinds of tree-cutting, costs of particular kinds of R&M activity) were intended to be covered out of the opex allowance. This is generally true where the opex allowance is set (as for RP5) on the basis of base year forecasts, with efficiency adjustments for future years. One can look at the underlying forecasts and see that particular heads of expenditure were expected to be treated as opex. But, in RP3 and RP4, this method was not used. The RP3 price control was set on the basis of a total revenue allowance, which was then split into capex and opex without reference to any detailed underlying opex forecasts, and RP4 was explicitly designed to avoid the need for any bottom up forecast of opex costs: instead, the outturn opex for RP3 was used directly to set the allowable opex for the equivalent year of RP4. There were therefore no specific activities which underlay the opex allowances for RP3 or RP4. In short, in the absence of an explicit business plan to form the basis for the opex allowances, with specific hypothecation of the opex allowance towards specific activities, a test of double-counting cannot be applied in a meaningful way;

- it is, of course, appropriate to ask whether the overall methodology for the RP4 price control implicitly relied on an assumption that the opex allowances would cover the same classes of activity as had been treated as opex during the equivalent years of RP3. If such an assumption did underlie RP4 (and NIE does not accept that it did) then one would expect the UR, in adopting the rolling opex mechanism for RP4, to have satisfied itself that the proposed opex allowance was appropriate, based on all the information available to it. That would have included information as to any changes to NIE's proposed mix of activities for RP4 which were in prospect, and were made known to the UR, when the RP4 price control was set. If the UR was aware of changes to NIE's proposed mix of activities in setting the RP4 price control, and hence of the potential effect of such changes on NIE's future opex and capex spends, then the UR had the opportunity to propose adjustments to the RP4 opex allowance at the outset. To the extent that it chose not to do so, it should not be allowed to make retrospective adjustments now to reflect such factors.

3.68 In proposing adjustments to NIE's opening RAB for RP5, the UR appears to proceed on a quite different basis, namely that NIE's opex allowances for RP3 and RP4 were intended to be hypothecated to expenditures on particular activities. But, even if that were so (which NIE does not accept), it does not follow that any deviation from an ex ante expectation, and a shift from opex to capex expenditure, should result in an adjustment to NIE's RAB. It would be necessary to determine why such a shift had occurred, whether it was consistent with the overall "swings and roundabouts" operation of RPI-X price controls (whereby a revenue allowance justified by particular expenditures may be efficiently deployed in a different way, in light of new efficiency opportunities and new demands) and whether consumers have, nonetheless, secured a fair share of overall efficiency savings. The UR has not examined these matters at all.

3.69 So far as relates to the particular adjustments proposed by the UR:

- The UR was aware, in setting the RP4 price control, that NIE planned to adopt new refurbishment strategies which would entail more capitalised tree-cutting costs (and, by implication, lower reactive opex tree-cutting costs). It set the RP4 price control on that basis, and should not now seek to re-open it;
- NIE's total overhead costs were reduced significantly between RP3 and RP4, and some 82% of the benefit of such reductions will accrue to customers. By focusing only on the percentage of overheads that are capitalised, the UR has failed to consider whether NIE's accounting treatment of overhead costs is legitimate and has operated fairly as between shareholders and customers;

- NIE's opex R&M costs were reduced significantly between RP3 and RP4. This reflects a variety of different factors, including enhanced operational efficiencies, the installation of new assets which obviate the need for maintenance of older assets, and the better recognition of R&M costs which form part of capex works. The benefit of that reduction in opex R&M costs has accrued in part to NIE's shareholders, and will also accrue in part to NIE's customers, through the setting of a new more demanding opex allowance for RP5. This is consistent with the overall workings of RPI-X price controls.
- In addition, the UR's calculations of the amounts alleged to have been wrongly capitalised are fundamentally unsound.

3.70 These matters are discussed further in Annex 9 (RAB Adjustment), which also incorporates a further short report from KPMG, in response to the additional report provided by the UR's consultants, SKM (UR-30). The KPMG report confirms that nothing in UR-30 causes KMPG to alter its original report.

3.71 However, it is also important to address the UR's misleading presentation of NIE's case. For the record, we would emphasise that, contrary to what the UR says (UR-26, paragraph 62)

- NIE does not accept the UR's portrayal of the RP4 price control: the treatment of controllable opex in the RP4 price control was designed to ensure that, so long as the rolling opex mechanism continued, NIE would recover in any given period only the outturn opex achieved in a corresponding earlier period, and that any reduction in opex in one period through the undertaking of additional capex would be reflected in a lower opex allowance for the corresponding later period. The updating of the RAB by reference to actual capex would mean that any capex underspend, relative to a capex budget, would secure no advantage to NIE. But that was the extent of any "agreement".
- NIE has set out in its SoC the principles underlying its accounting treatment of particular costs. The UR's assertion that NIE changed "its approach to capitalisation" is imprecise, and does not accurately reflect the facts.

3.72 In short, the facts which the UR presents as undisputed are not, in any meaningful sense, agreed, and do not support the conclusions which the UR seeks to derive from them.

### **Chapter 12 (Unresolved issues from RP4)**

3.73 The RP5 price control should take account of any over- or under- recovery of revenue entitlement in RP4. The three unresolved issues that arose under the

RP4 price control which gave rise to an under-recovery need to be considered as part of this inquiry, despite the UR's view to the contrary.

- 3.74 NIE's more detailed response to the points raised by the UR can be found in Annex 10 (Unresolved issues from RP4).

### **Chapter 13 (NIE Powerteam)**

- 3.75 It appears from paragraph 22 of UR-26 that the UR has abandoned its case with respect to the need for compulsory competitive tendering of services currently provided by NIE Powerteam. However, since it has not expressly acknowledged nor explained its change in approach, NIE submits that the CC should ask the UR to confirm its position.
- 3.76 In particular, the UR should be asked to confirm that, for the purpose of the RP6 price control review, it will not take the continuation of the NIE Powerteam arrangements (as restructured to comply with the European Commission's IME3 decision) as necessarily inconsistent with delivering best value to customers. NIE is understandably concerned to ensure that the UR will not in future use any ambiguity with respect to its position on NIE Powerteam unjustifiably to penalise NIE for alleged inefficiencies.
- 3.77 Further points in relation to NIE Powerteam are made in Annex 11 (NIE Powerteam).

### **Chapter 14 (Reporter)**

- 3.78 The UR's response to the SoC does nothing to change NIE's view that the proposed Reporter is unnecessary, particularly as a significant part of the role falls away if the Competition Commission adopts the conventional approach to regulating capex.
- 3.79 Appointing a Reporter is no substitute for the adoption of clear rules and reporting requirements, where that is what is needed.
- 3.80 NIE notes and supports the additional objections to the proposed Reporter raised by Professor Stephen Littlechild in his paper in support of ESB's submission to the CC.
- 3.81 NIE's more detailed response to the points raised by the UR can be found in Annex 12 (Reporter).

## Chapter 15 (WACC)

3.82 In respect of the UR's discussion of the cost of capital in both UR-7<sup>21</sup> and UR-26<sup>22</sup>, NIE does not accept the characterisation of its position by the UR, rejects the arguments put forward, and does not accept that there is a reasonable basis for a number of allegedly factual assertions that are made by the UR. Specifically:

- the UR criticises NIE's approach to estimating the cost of capital, but NIE considers that its approach (i.e. starting from the Ofgem approach, adjusted for NI-specific factors, and any changes to market data that would be significant enough to justify moving away from Ofgem's parameters), which it has adopted consistently throughout the RP5 process, has been and is fair, reasonable and in line with standard regulatory practice;
- the UR encourages the use of short run estimates in assessing the cost of capital in a number of places, but NIE considers that such an approach would be inappropriate since;
  - it would risk locking in either a very low or very high cost of capital that may not persist over the regulatory period, thereby increasing the risks borne by NIE relative to other utilities; and
  - it would be a material departure from standard practice;
- NIE rejects the assertion that there is no premium on its bonds relative to GB peers, something that the UR itself has recognised in recent regulatory decisions and which is evident in market data ;
- NIE rejects the assertion that any premium on its debts might arise as a consequence of its ownership by ESB, a proposition that cannot be sustained as it fails to explain:
  - Why there was a premium on NIE's short-dated bond before NIE was purchased by ESB;
  - Why there was a premium on NIE's short-dated bond even before the Irish debt crisis led to spikes in the yields on Irish government debt;
  - Why there is a similar premium observed on the bond issued by Phoenix Natural Gas, which has no links to ESB; and

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<sup>21</sup> E.g. paragraph 28.

<sup>22</sup> E.g. paragraph 24.

- Why, as noted above, the SEM Committee<sup>23</sup>, which includes three representatives from the UR, decided to take account of a “risk premium” that reflects “spread differentials between NIE and UK utility bonds” in its decision paper on new entrant costs if it believes that this spread only arises as a consequence of ESB’s ownership of NIE and therefore does not apply more generally;
  - NIE considers that the yield premium on its bonds relative to GB also implies that an equity risk premium relative to GB is justified and required. In this respect NIE notes the similar conclusions of a paper by Professor Ian Cooper, which has been submitted to the CC by Phoenix Natural Gas Limited, where the link between debt premia and equity premia is analysed in detail;
  - the level of gearing proposed by the UR in its Final Determination (50%) is suboptimal, out of line with wider regulatory practice and inconsistent with the advice of its own expert advisor; and
  - contrary to the UR’s assertion, NIE’s systematic risk is not reduced by the regulatory arrangements proposed in the Final Determination, instead NIE considers that the UR’s proposals, particularly with respect to capex, would increase significantly the risks it bears in both an absolute sense and relative to the GB DNOs.
- 3.83 NIE’s more detailed response to the points raised by the UR can be found in Annex 13 (WACC and Financeability).

### **Chapter 16 (Impact on tariffs)**

- 3.84 NIE's response to the UR's comments on the impact on tariffs is provided in Annex 14 (Impact on tariffs).

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<sup>23</sup> The SEM Committee is the decision making authority on all matters related to the Single Electricity Market. It consists of three UR representatives, three Commission for Energy Regulation (CER) representatives, an independent member and a deputy independent member.

**Chapter 17 (Financeability)**

- 3.85 As set out in detail in NIE's SoC, in respect of financeability NIE rejects the UR's assessment which is based on modelling errors, flawed assumptions over future costs and fails to recognise the effect of unjustified disallowances. The UR has also failed to take account of the real and perceived increase in regulatory risk that would arise from its Final Determination, which we expect would act as a further drag on NIE's credit rating. Furthermore, the UR fails to consider the implications of the exceptionally low returns to the equity investor resulting from the Final Determination. None of the points raised by the UR in its opening submission and UR-26 have led NIE to revise its view in this regard.
- 3.86 NIE considers that the financeability concerns arising from the Final Determination should be addressed by ensuring that core cost allowances and the allowed rate of return are set at appropriate levels and that unjustified disallowances in other areas (e.g. with respect to pensions and the proposed capitalisation adjustment) are reversed.
- 3.87 NIE's more detailed response to the points raised by the UR can be found in Annex 13 (WACC and Financeability).



## ANNEX 1

### RP5 CAPEX - STRUCTURE

#### 1. INTRODUCTION

1.1 This Annex relates to the UR's proposals in respect of the structure of the RP5 capex allowance. In this regard, and as set out in our SoC<sup>1</sup>, NIE's main concerns are with the UR's proposals for Funds 1 and 2, in particular:

- the inclusion of all asset replacement within Fund 1;
- the inclusion of the Ballylumford switchboard project within Fund 1;
- the inclusion of "input driven" expenditure within Fund 1; and
- the structure of Fund 2

1.2 NIE welcomes that the UR now<sup>2</sup> agrees that the Ballylumford Switchboard project should be included in Fund 3, as proposed by NIE. Otherwise, the UR's reply does not address NIE's fundamental concerns with its proposed structure of the RP5 capex allowances, which NIE submits is unworkable and inappropriate.

1.3 The changes to the FD position that are necessary to implement NIE's proposals are summarised below.

#### **Fund 1**

1.4 Fund 1 should be limited only to those investments for which NIE can predict, at this point in time, the need to replace set volumes of certain types of assets; and the likely efficient cost per unit. These properties relate only to those clearly identifiable asset replacement work programmes (rolling programmes) which NIE categorised under its Fund 1 proposal. In contrast, the other elements of asset replacement expenditure that the UR proposes to include in Fund 1 do not have these properties of predictability and are therefore unsuitable for inclusion under Fund 1, and should be transferred to Fund 2.

#### **Fund 2**

1.5 A conventional RPI-X approach should be applied for Fund 2. Having carved out Fund 1 and Fund 3 to cater for specifically identified investments, NIE proposed that an ex ante allowance be set for Fund 2 to allow it to cater for remaining

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<sup>1</sup> NIE SoC, Chapter 4.

<sup>2</sup> UR-26, paragraph 43.

obligations, allied with strong incentives to encourage efficiencies through innovative approaches and productivity gains. Under this proposal, NIE would bear a set proportion<sup>3</sup> of under-spend or over-spend relative to the ex ante allowance, with exposure of NIE and customers being “capped” and “collared” at +/-1.5% of regulated revenues<sup>4</sup>.

### **Fund 3**

- 1.6 NIE has fewer concerns with the UR’s proposals in relation to the approval of major projects. However, the FD does not fully detail how the approval process will operate in practice. The Ballylumford Switchboard project should be included in Fund 3 and Smart Networks included in Fund 2. The UR now agrees that the Ballylumford Switchboard project should be included in Fund 3, as proposed by NIE.

## **2. COMMENTS ON UR-26**

- 2.1 This Section 2 contains NIE’s response to UR-26 in relation to RP5 capex structure. Section 3 below provides further<sup>5</sup> comments on UR-4 (the UR’s opening submission on capex).

### **NIE proposal is consistent with Ofgem precedent**

- 2.2 The UR characterises<sup>6</sup> NIE’s position on capex structure (and other aspects of the price control) as being designed to incentivise “*regulatory gaming on a large scale*”. NIE rebuts strongly this suggestion which is without foundation. Furthermore, the UR implies<sup>7</sup> that NIE’s proposals are somehow remarkable. To be clear, the structure of NIE’s proposals for capex is consistent with Ofgem precedent as evident from DPCR5<sup>8</sup>, and the benefits which that affords customers in GB. There is no objective reason why this should not also be applied in NI.

### **NIE is committed to supporting enhanced regulatory reporting**

- 2.3 The UR states<sup>9</sup> that NIE says it “*must not be required to account for how, or even if, it has actually spent that capex allowance*”. This is incorrect and misrepresents NIE’s position, as set out in our SoC. NIE has asked the UR to define its reporting requirements which NIE will then facilitate. Furthermore, NIE has committed to

<sup>3</sup> NIE has proposed an incentive rate of 30%.

<sup>4</sup> NIE BPQ04, section 3.

<sup>5</sup> NIE provided its initial comments on the UR’s opening submission in the covering letter that accompanied the SoC.

<sup>6</sup> UR-26, paragraph 9.

<sup>7</sup> UR-26, paragraph 9 (b) and paragraph 50.

<sup>8</sup> NIE SoC, Chapter 4, paragraph 2.4.

<sup>9</sup> UR-26, paragraph 9.

working collaboratively with the UR to develop network load and health indices to supplementary regulatory reporting within a RPI-X regulatory framework<sup>10</sup>.

### **UR's proposal is unworkable and inappropriate**

- 2.4 The UR describes<sup>11</sup> its proposed three fund capex mechanism and seeks to address the reasons advanced by NIE as to why this mechanism is unworkable and inappropriate. In summary, those reasons are:
- Cost estimates: it is not possible to prescribe individual investment requirements precisely at the outset of RP5;
  - Ex-post assessment: NIE will bear the uncertainty of the UR's ex post assessment of variations from the initial plan;
  - Flexibility: ring-fencing substantially limits NIE's flexibility to manage changing requirements; and
  - Incentives: the proposed approach diminishes NIE's incentives to innovate to achieve efficiencies.

### **Cost Estimates**

- 2.5 In its SoC, NIE set out why the Fund 1 arrangements cannot be made to work for all asset replacement investments in the manner proposed by the UR. The UR has not addressed this significant concern within its response – and seeks only simplistically to dismiss it as a failure on NIE's part, rather than recognise it as a limitation faced by all electricity network operators and modify its proposals accordingly. The UR seems content to simply place the risk on NIE for the issues that will arise as a consequence of poorly designed capex arrangements.
- 2.6 The incentive properties of Fund 1 work with reference to outturn variations between actual and target costs for individual projects. This approach would work well if Fund 1 were limited to high volume, commoditised work (e.g. rolling programmes of overhead line refurbishment) where both the volume and unit cost of the work could be predicted with reasonable accuracy. However, the UR has proposed applying this arrangement to all asset replacement investments. NIE is firmly of the view that only a limited portion of the investment programme is sufficiently predictable for such a scheme to operate reliably in practice. This is because the remaining projects are not simple commodities the cost of which can be defined reliably by a simple metric that applies a standard unit cost to a variable volume of activity. Rather, these projects are more complex and are not sufficiently defined in either scope or cost at the point of the price control review to

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<sup>10</sup> NIE SoC, Chapter 4, paragraph 2.5.

<sup>11</sup> UR-26, paragraphs 37ff.

be capable of providing robust target costs capable of being incentivised in the manner proposed by the UR. While the UR expresses surprise at this<sup>12</sup>, NIE has<sup>13</sup> already described the reasons why the costs of these projects are not sufficiently robust to be defined ex ante, but will become so as each project is subject to detailed appraisal, design and costing as RP5 progresses. Neither is this unique to NIE; therefore it is disingenuous for the UR to present<sup>14</sup> this normal feature of investment planning as a failure of NIE to understand “its own cost base” or being “unsatisfactory”.

- 2.7 Conversely, if the UR’s expectations were capable of being met in practice, presumably other regulators would have identified the benefits that the UR attributes to this form of capex regulation. However, this is not the case. Ofgem (among others) set allowances to cater for investment requirements in aggregate, rather than set incentives based on target costs for each individual project as proposed by the UR. The former (conventional) approach allows sufficient flexibility for the company to manage a range of uncertain outcomes over the course of the price review period and preserves the beneficial RPI-X incentive properties.

#### **Ex post assessment**

- 2.8 In its response, the UR does not address NIE’s continuing concerns that the UR proposes an ex post assessment of the reasons for the inevitable variations from the initial plan, without prescribing the details of the process that will apply.
- 2.9 As set out above, the UR’s proposal is by design, based on the flawed assumption that the investment programme can be reliably prescribed at the outset of RP5 and that efficiency can then be assessed by a simple comparison of outturn against plan. Furthermore, while the UR relies on a high-level and idealistic description of the concepts that it considers should apply, the details of how the ex post review process would be applied in practice have not been prescribed by the UR. This significantly increases uncertainty for NIE. In particular, it is not clear what criteria will be applied by the UR in assessing whether the inevitable variations from plan are efficient or otherwise.
- 2.10 Therefore, while NIE has highlighted legitimate concerns that the structure is unworkable in practice, the UR has yet to provide any significant detail to explain how it proposes to address those concerns. Nor is there any indication that the UR has even considered these limitations, or indeed whether it proposes to set out these detailed arrangements as part of this review to provide on an ex ante basis, an acceptable level of transparency of the regulatory process it proposes should be followed. Otherwise, NIE is faced with the prospect of the UR’s ex post assessment process being developed retrospectively or arbitrarily, which runs

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<sup>12</sup> UR-26, paragraph 43.

<sup>13</sup> NIE SoC, Chapter 4, paragraph 4.4.

<sup>14</sup> UR-26, paragraph 43.

counter to regulatory best practice. Meanwhile, NIE would<sup>15</sup> bear the risk that the UR's conceptual arrangements cannot ultimately be made to work in practice, in a manner that properly recognises that variations from the initial plan were efficiently incurred.

### **Flexibility**

- 2.11 NIE submits that the ring-fencing of allowances substantially limits NIE's flexibility to manage changing requirements. This is a consequence of both the fund structure itself, and the granular definition of the initial plan which effectively provides allowances for individual investments in the form of target costs.

#### Fund structure

- 2.12 The UR has proposed dividing capex allowances across six primary funds (three each covering transmission and distribution investments) with further ring-fencing of allowances within each of these funds e.g. for "input driven items", connections, metering etc. This significant fragmentation of allowances inherently limits flexibility, for example, in managing investments that straddle the boundaries between the different funds. Furthermore, as set out in our SoC<sup>16</sup>, this also limits NIE's ability to diversify the risk of under-provision in the event that unanticipated asset replacement requirements were to emerge. While the UR makes reference<sup>17</sup> to this point and describes it as "flawed", the example it gives does not in fact address the issue at all; that under the UR's proposal NIE would be denied the flexibility to diversify uncertainties in asset replacement requirements with uncertainties in load-related requirements<sup>18</sup>.

#### Target costs

- 2.13 The UR states<sup>19</sup> that within Fund 1, NIE 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." NIE agrees that this approach can work for high volume asset replacement investments that NIE agrees are suitable for Fund 1. However in practice, uncertainty around the target costs for the wider scope of asset replacement investments proposed by the UR has the effect of limiting flexibility, as now explained.
- 2.14 The UR proposes to prescribe target costs for such individual investments at the outset of RP5, without providing NIE with a detailed understanding of how

<sup>15</sup> It should be noted that NIE is currently bearing this risk in respect of investment decisions that have been made in good faith since 1 January 2013.

<sup>16</sup> NIE SoC, Chapter 4, paragraph 4.4, fifth bullet.

<sup>17</sup> UR-26, paragraph 41.

<sup>18</sup> Which is possible under NIE's proposal for Fund 2.

<sup>19</sup> UR-26, paragraph 40.

subsequent changes will be considered by the UR once the required scope of works becomes clear. This uncertainty would have the combined effect of limiting NIE's flexibility to change from the initial plan, either in terms of changing the scope of projects that have been "agreed" within the initial plan, or substituting new projects because of changes in priorities in light of better information.

- 2.15 Such uncertainties are illustrated by comments such as those made by the UR on NIE having the flexibility to depart from the initial plan which the UR characterises<sup>20</sup> as running the risk that NIE will spend on "*projects of dubious worth*". The 11kV network resilience project is presented by the UR as a relevant example, which the UR concludes<sup>21</sup> as being "*clearly inappropriate*" without any objective engineering evidence or criteria having been presented by the UR to support its own conclusion, or to forewarn NIE that such investments will be assessed subsequently against particular regulatory requirements. In practice, this appears to contradict the UR's claim that NIE has full flexibility in reprioritising asset replacement investments.
- 2.16 With respect to load-related investments, the UR refers to its proposed logging up and logging down of Fund 2 allowances and states<sup>22</sup> that the "*structure of Fund 2 creates appropriate incentives to ensure value for customers while also shielding NIE T&D from risk*". NIE does not agree. Such a process would leave NIE dependant on regulatory approvals of individual engineering requirements necessary for NIE to discharge its statutory and licence obligations. This is addressed further in Section 3 below<sup>23</sup>.

#### Incentives

- 2.17 The UR states<sup>24</sup> "*NIE T&D contends that it should be incentivised to defer capex*" and furthermore, considers that the "*risk of gaming ... would be great*" were NIE provided with an incentive to defer asset replacement. This is an incorrect and unfortunate characterisation of NIE's position.
- 2.18 NIE submits that it should have the flexibility to change its capex plans in response to changing needs and priorities, which in some cases may involve the deferral of projects where this can be done efficiently and compliant with the company's statutory and licence obligations. This is a normal feature of RPI-X regulation. In contrast, the UR's proposed approach would diminish NIE's incentives to innovate to achieve such efficiencies.

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<sup>20</sup> UR-26, paragraph 48.

<sup>21</sup> UR-26, paragraph 47.

<sup>22</sup> UR-26, paragraph 51.

<sup>23</sup> In response to UR-4, paragraph 16.

<sup>24</sup> UR-26, paragraph 42.

- 2.19 Moreover NIE submits that it is efficient and reflective of best practice in asset management, to continue to assess the condition and risk posed by individual assets throughout the regulatory period and where appropriate defer their replacement.
- 2.20 NIE would be adequately constrained from inefficient deployment of funds, or from under-investment by:
- the comprehensive coverage of its statutory and licence obligations, which impose tight standards in terms of network safety, quality and capacity;
  - the fact that, although load growth might not emerge precisely in accordance with NIE's plan, overall load growth is sufficiently predictable for an overall ex ante allowance to be set at an appropriate level for the RP5 period as a whole; and
  - any significant deviations from the overall revenue allowance would trigger adjustments under NIE's proposed cap and collar arrangements.
- 2.21 Neither<sup>25</sup> does the UR “*consider it to be appropriate to incentivise capex deferral in respect of the load related projects covered by our Fund 2*”. As with asset replacement, NIE submits that it is also in customers' interests to seek to delay as far as possible load-related investments by increasing network utilisation as far as possible consistent with statutory and licence obligations.
- 2.22 Furthermore, the UR suggests that incentives to minimise load-related investment are not required because it considers NIE has not the scope to influence investment requirements, and in any case, the issue is addressed by its proposed logging up / logging down process for Fund 2. NIE does not agree: it is generally recognised that innovation in network development<sup>26</sup> is necessary to address the challenges in meeting government targets for sustainability. However, the UR's proposed “logging” process would diminish NIE's incentive to innovate<sup>27</sup> by providing no means of rewarding innovation to come up with a “smart solution” that would avoid, limit or delay the extent of network development necessary to cater for increased electrical demand. While the UR makes reference elsewhere<sup>28</sup> to its proposal to fund “smart solutions” through Fund 3 this is in fact a moot point. It does not address the fundamental point of NIE's SoC<sup>29</sup> as to what real incentive NIE has to pursue “smart solutions” in the first place – if there are no incentives to defer capex to counter the inherent uncertainties of pursuing innovative solutions

<sup>25</sup> UR-26, paragraph 49.

<sup>26</sup> NIE BPQ: RP5 Capital Investment Paper (RP5, F7).

<sup>27</sup> Such as increasing network utilisation through innovative active network management or pursuing a greater understanding of the scope to applying dynamic ratings to transformers or overhead lines.

<sup>28</sup> UR-26, paragraph 42.

<sup>29</sup> NIE SoC, Chapter 4, paragraph 4.11.

and moreover, there are significant regulatory risks were NIE to depart from the initial plan.

### 3. FURTHER COMMENTS ON UR-4

- 3.1 This Section 3 provides further comments on UR-4 (the UR's opening submission paper on capex) in relation to capex structure. It supplements comments already made by NIE in the cover letter that accompanied the SoC.
- 3.2 Paragraph 11 of UR-4 states that the UR's proposed three fund capex structure "*largely reflects the request that NIE T&D made in its BPQ submission*". That is not the case: as set out in NIE's SoC<sup>30</sup> and in the Overview to this supplementary submission, the UR's proposals for Funds 1 and 2 are in fact significantly different to the arrangements proposed by NIE and give rise to serious concerns.
- 3.3 Furthermore, paragraph 11 characterises the UR's proposals as being beneficial to customers and reducing risk for NIE. NIE does not agree. As set out in NIE's SoC, the UR's proposals will significantly increase regulatory risk for NIE and substantially diminish incentives to innovate to the ultimate detriment of customers.

#### Fund 1

- 3.4 Paragraph 12 of UR-4 states that "*Fund 1 is designed to cover capex activities that are largely within NIE T&D's control*". That is not the case. The UR has designed Fund 1 simply to cover all asset replacement expenditure, as acknowledged subsequently by the UR in UR-26<sup>31</sup>. In contrast, NIE's proposal for Fund 1 had been carefully designed to cover a much smaller subset of asset replacement reflecting the extent to which their cost and specification are predictable, controllable and measurable by NIE.
- 3.5 Paragraph 14 refers to "*unit cost risk*" and describes it as a "*highly controllable and predictable aspect of its business*". NIE does not agree that all asset replacement expenditure requirements for RP5 are sufficiently predictable at the outset of RP5 to enable the UR's proposed mechanism to work in practice. It is of significant concern to NIE that the UR proposes to define now what are effectively ex ante and individual "unit cost" allowances for complex projects that are not well defined at the outset of RP5 and will only become clear as these projects are subject to detailed design as RP5 progresses. These concerns are set out in more detail in NIE's SoC<sup>32</sup>.

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<sup>30</sup> Chapter 4, paragraph 4.1.

<sup>31</sup> UR-26. Paragraph 37.

<sup>32</sup> NIE SoC, Chapter 4, paragraph 4.4.

- 3.6 Paragraph 16 of UR-4 refers to the UR's proposed establishment of a Reporter. The UR refutes NIE's suggestion that the introduction of a Reporter amounts to "micro-management" by suggesting that the Reporter is simply part of the regulatory reporting structure. NIE submits that the UR's position fails to recognise that in the absence of detailed definition of how the capex structure will operate, that the Reporter will inevitably become part of the day to day operation of the business as guidance as to the regulatory position will need to be sought by NIE in an attempt to limit regulatory risk. This raises the prospect of rules being developed retrospectively, significant delays and uncertainties in routine operations and ultimately, blurring of responsibilities between NIE and the Reporter/UR for decisions that are best left for the company to manage.
- 3.7 Moreover, the UR appears to make a virtue out of not adopting RIGs to define reporting requirements in the manner adopted by Ofgem. For the avoidance of doubt, NIE would welcome clear rules on capex reporting being established ex ante. In fact we consider this to be essential in order to ensure NIE has absolute clarity on the UR's information requirements and to ensure that systems and processes can be established to allow these requirements to be serviced efficiently, predictably and routinely.
- 3.8 Paragraph 17 of UR-4 refers to what the UR terms "*input driven capex*" needs for which it states NIE "*cannot identify any outputs*" and concludes "*that to be an unacceptable state of affairs for a public utility in the 21<sup>st</sup> Century*". This criticism is entirely unwarranted. Allowance is sought for unplanned capex requirements such as assets replaced following faults or otherwise reactively in response to currently unanticipated events. Therefore by definition, the assets that will eventually be replaced are currently uncertain and can not be identified ex ante. While the extent and nature of requirements is currently uncertain, experience indicates a level of allowance is necessary to cater for unplanned expenditure in RP5.
- 3.9 Moreover, other categories of cost referred to in paragraph 17 do not in themselves deliver additional outputs but are in fact additional costs that indirectly impact on the total cost of delivering already identified projects and programmes, for example, capitalised overheads, real price effects and additional costs to meet new legislative requirements.
- 3.10 Paragraph 19 of UR-4 includes a suggestion by the UR that its own approach runs the risk of "*double (or even triple) funding some items of work*". However, in practice the margin of forecasting error is trivial if not non-existent, and by the UR raising this suggestion in isolation provides an inaccurate representation of the risk presented to NIE by the UR's proposals.
- 3.11 Taking fault and emergency expenditure as an example, it could be assumed that the UR's benchmarking and subsequent allowances, will have separately taken account of the historic level of opex and capex spend on fault repair. Therefore it is

unclear where there is scope for double counting. Furthermore, the UR refers to scope for overlap between the capex allowances for replacement of assets following faults, and the capex allowances for replacement of similar assets under planned work. While this is theoretically possible, in practice any scope for overlap is minimal and is much less material than the other uncertainties that mitigate against reliably prescribing investment requirements on an ex ante basis without sufficient flexibility to cater for variations from initial assumptions that inevitably will occur.

- 3.12 For example, a much more significant and material risk is that the UR's minimal allowance (£0.5 million) for replacing assets following storm damage to the network is wholly inadequate, based on experience. Yet this risk passes without comment by the UR. The capex arrangements (structure and quantum) should recognise the natural uncertainties in forecasting capex requirements and provide flexible and balanced arrangements based on central-case assumptions.

## **Fund 2**

- 3.13 The UR's proposal for Fund 2 entails a very substantial departure from the RPI-X framework proposed by NIE, as well as from Ofgem precedent.
- 3.14 In paragraph 22 of UR-4, the UR appears to justify the need for its Fund 2 proposals "*in light of the inherent uncertainty in respect of demand for electricity in Northern Ireland*". While recognising fully that there is inherent uncertainty in setting ex ante capex allowances, NIE does not accept that the fundamental considerations (including forecasting load-related investments) are any more uncertain in NI than they are elsewhere e.g. in GB, as dealt with by Ofgem. It is therefore unclear why the UR considers a need to introduce a bespoke and unproven solution in NI with all the attendant disadvantages and risks that NIE has described in its SoC.
- 3.15 In paragraphs 22 and 23 of UR-4, the UR describes its process by which proposed load-related investments would first be reviewed by the Reporter and then approved by the UR to "*de-risk this category of capex almost entirely*". NIE does not agree that the use of a Reporter will bring such de-risking.
- 3.16 On the contrary, this proposal introduces both the Reporter and UR in the operational decisions of the business, blurring responsibilities and leaves NIE dependant on regulatory approvals for individual operational requirements that are ultimately necessary to meet its statutory and licence obligations. For example, what recourse would NIE have if the UR were to disagree with its engineering judgement that investment was justified to address a safety risk (as it has done in UR-4 in respect of the Limavady reinforcement<sup>33</sup>) and was unable to comply with

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<sup>33</sup> UR-4, paragraph 5.

its statutory duties as a result? These concerns are fundamental to the role of an economic regulator in setting parameters for a regulated utility to discharge its statutory and licence obligations.

- 3.17 In paragraph 24 of UR-4, the UR refers to “*unit costs risks*”. As with Fund 1 investments, NIE has significant concerns that target costs are being set for individual investments ex ante, rather than providing an overall allowance to meet investment requirements in aggregate.
- 3.18 In paragraph 25, the UR states that Fund 2 includes an allowance for metering activities “*including complying with NIE T&D’s obligations to certify existing meters*”. This is not the case. The allowance proposed by the UR provides only for limited certification activity. In its SoC<sup>34</sup>, NIE requests the Commission to increase the allowance by £17 million to meet its legal obligations in respect of meter certification.
- 3.19 Also in paragraph 25, the UR provides further details on the process it envisages for incentivising metering work. This proposal appears to be new and is indicative of NIE’s concern that details of the UR’s proposed capex arrangements would continue to develop incrementally as RP5 progresses.

### **Fund 3**

- 3.20 Paragraph 28 of UR-4 refers to the UR’s proposed inclusion of innovation (smart grid) initiatives under Fund 3. NIE does not agree that Fund 3 is appropriate for this purpose and proposes<sup>35</sup> that ex ante funding should be allowed within Fund 2.

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<sup>34</sup> NIE SoC, Chapter 5, paragraph 5.20.

<sup>35</sup> NIE SoC, Chapter 4, paragraph 5.6.



## ANNEX 2

### RP5 CAPEX - QUANTUM

#### 1. INTRODUCTION

- 1.1 This Annex 2 contains NIE's response to UR-4 (UR's opening submission on capex) and UR-26 in relation to capex quantum.

#### 2. OVERALL COMMENTS ON PROCESS

- 2.1 NIE agrees with the UR<sup>1</sup> that the CC has limited time and should not be "burdened" with process issues. To state however that process issues are "irrelevant" to the issues under consideration, and further, that "the outcome of the inquiry should not *turn on the robustness or otherwise of the analytical work*"<sup>2</sup> is extraordinary. NIE has uncovered a range of significant errors, misinterpretations, and internal inconsistencies in UR's analysis, outlined in this document and in our SoC and which undermine the conclusions drawn by the UR, and hence much of the basis for its FD and subsequent submissions to CC.
- 2.2 It is also unhelpful that the UR has not responded fully to the SoC in accordance with the inquiry schedule. The UR states<sup>3</sup> that it has not been possible to prepare a detailed response to the SoC in the two weeks allowed. This ignores the point that the basic case laid out in the SoC largely reiterates the case made in NIE's original BPQ submission and its voluminous supporting evidence, which the UR has now had for well over two years.
- 2.3 In a number of areas covered in UR-4 and UR-26, the UR's stated positions indicate either a lack of understanding of NIE's case, or a misrepresentation of it. In the following sections we highlight the most serious examples of this.

#### 3. THE OVERALL LEVEL OF CAPEX REQUESTED BY NIE

- 3.1 NIE is well aware that the level of capex requested for RP5 is a step change over capex levels in RP3 and RP4, and that there will be an inevitable impact on tariffs.

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<sup>1</sup> UR-26, paragraph 5.

<sup>2</sup> UR-26 paragraph 7.

<sup>3</sup> UR-26 paragraph 1.

However, there are clear reasons for the increased volumes, as laid out in the SoC<sup>4</sup>. These include:

- NIE must commence asset replacement programmes on several asset classes which are only now falling due for replacement in RP5. Maintaining them in service would present unacceptable risks.
- There are a small number of complex high value projects (e.g. two transmission voltage support schemes) required in RP5 which have not been required in previous price control periods.
- Increased volumes of asset replacement work are required for assets which, some 40+ years on from rural electrification in NI, have been shown to have deteriorated through age. The need for asset replacement is exacerbated by the relatively modest asset replacement rate in previous price control periods.
- New legislation, primarily the Electricity Safety Quality and Continuity Regulations (ESQCR) and Road and Streetworks legislation place new specific statutory requirements on NIE in terms of compliance.
- The need to invest in the 11kV network to reduce the risk of widespread and prolonged loss of supply resulting from ice accretion on small cross-section conductor overhead lines.

(For completeness, we would also mention that any expenditure to cater for renewable projects would be in addition to these amounts.)

- 3.2 In essence, the position in NI is, in these respects, no different to the position in GB. In its Final Proposals for DPCR5, Ofgem commented<sup>5</sup> on the large increases in expenditure forecasted by the DNOs relative to DPCR4 for reasons similar to those identified above.
- 3.3 The UR chooses to ignore these underlying realities, and instead presents dramatic statements such as “...a capex programme the scale of which has never been seen before”<sup>6</sup>. The UR states further<sup>7</sup> that NIE has “failed to justify for large swathes of its planned capital programme”. This is incorrect; NIE’s original BPQ

<sup>4</sup> SoC Chapter 5, paragraphs 2.6 to 2.12.

<sup>5</sup> See paragraph 3.21 of Ofgem's 'Final Proposals – Allowed Revenue Cost Assessment' (146/09) document to be found at: [http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR5/Documents1/FP\\_3\\_Cost%20Assessment%20with%20SS%20comments.pdf](http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR5/Documents1/FP_3_Cost%20Assessment%20with%20SS%20comments.pdf).

<sup>6</sup> UR-4, paragraph 2.

<sup>7</sup> UR-26, paragraph 13.

submission and the accompanying 43 capex strategy papers and responses to substantial follow up inquiries justify its capital programme in considerable detail<sup>8</sup>.

- 3.4 Ironically, and demonstrating considerable inconsistency, the UR's position is also at odds with the fact that its own position has shifted over time (both after publication of the draft determination and, again, after publication of the FD). The UR and UR's consultants, SKM, now acknowledge (UR-25) that NIE's assessment of the volumes of capex activity to be undertaken, as modelled in the network model, are substantially correct. The model covers all asset replacement activity, but does not cover other capex activity (e.g. to meet new legal requirements, reactive investments, network automation, etc). While the UR does not accept<sup>9</sup> NIE's case on the volume of transformers and reactors to be replaced during RP5, its rejection of NIE's case may simply reflect the UR's failure to examine all the evidence provided by NIE as to the extent of deterioration of its transformers and reactors, and the UR's undue reliance on an age-based assessment.
- 3.5 Accordingly, the UR accepts – in substance – that there will need to be a step change in NIE's capex activities, and should not now be expressing surprise or alarm at that fact.
- 3.6 However, despite the sizeable shift in the UR's position, there remain key areas of disagreement between the UR and NIE:
- As noted above, the UR continues to under-estimate the extent to which NIE will need to replace transformers, reactors and re-engineer the distribution overhead network during RP5;
  - The UR continues to disallow altogether expenditure in respect of certain key elements of NIE's business plan – most notably expenditure for unique programmes (e.g. 11kV network resilience, compliance with ESQCR legislation<sup>10</sup>, network performance and flood protection, as documented in SoC Table 5.7<sup>11</sup>); and
  - The UR has underestimated the costs of undertaking required capex activity. This underestimate arises from:
    - the UR's application of an unjustified (in)efficiency discount;
    - the mis-estimate of RPEs; and

<sup>8</sup> A detailed description of process adopted to prepare NIE's BPQ submission is contained in paragraphs 2.13 to 2.25 of Chapter 5 of the SoC.

<sup>9</sup> The SKM report UR-25 also reduces by approximately half NIE's proposals for overhead line re-engineering.

<sup>10</sup> Electricity, Safety, Quality and Continuity Regulations.

<sup>11</sup> SoC page 82.

- specific areas of disallowance which are not justified (as documented in SoC Table 5.3<sup>12</sup>).

As a result, the total allowances for both Funds 1 and 2 are inadequate to cover the works which those funds contemplate to be undertaken.

#### 4. UNDERSTANDING INVESTMENT REQUIREMENTS

- 4.1 The UR characterises its task<sup>13</sup> in setting a capex allowance for NIE as being significantly challenging. While that may be the case, the challenge should be no more difficult than in the case of GB DNOs where the established practice is for Ofgem and its consultants to work closely with the DNOs to understand investment requirements in detail. This did not happen in the RP5 process, giving rise to many issues as detailed below.
- 4.2 Some comments by the UR show a fundamental misunderstanding of investment assessment techniques. For example<sup>14</sup>, the UR considers that through standard asset replacement benchmarking it should be possible to make reasonably accurate predictions of the overall volumes. This is not the case and regulators implicitly accept that this is so by virtue of the fact that, as far as we are aware, no allowance is ever granted by a regulator where the model predicts a higher volume of assets than a utility has requested. There are many reasons why a model will generate different volumes of asset replacement than requested by a utility which are unrelated to efficiency or risk appetite. At best, an asset replacement model can be used only to predict asset replacement liabilities over a longer term than a price review period. For price review purposes, the model can only be used to focus discussions on the condition and associated risks of particular asset categories. This is how modelling has been used in recent years by Ofgem.
- 4.3 The model used by the UR (or its consultants) to benchmark asset replacement volumes, has not been made available to NIE, however the outputs from the modelling were presented in the UR's consultants' updated report dated 29th April 2013<sup>15</sup> which also included for the first time the benchmarking carried out in August 2012. Neither have details of other capex benchmarking such as overhead line expenditure been made available, despite requests by NIE. The UR stated that some of the data used for benchmarking purposes was confidential.

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<sup>12</sup> SoC page 73.

<sup>13</sup> UR-4, paragraph 6.

<sup>14</sup> UR-26, paragraph 39.

<sup>15</sup> Northern Ireland Authority for Utility Regulation – Updated report on Asset Replacement Projects and Modelling 29<sup>th</sup> April 2013 – prepared by SKM.

- 4.4 The UR further suggests<sup>16</sup> that NIE is lacking in estimating skills. Accurate estimates of site specific projects requiring civil works and with a range of plant and equipment to be supplied and installed can only be formed once design has progressed from the conceptual design phase (desktop study) through the detailed design and programming stage, and in some cases only after the tender enquiry stage has been completed. In its Annual Cost Report for financial year 2005/06, Ofgem noted<sup>17</sup> the difficulties that DNOs have not only in estimating costs, but in predicting the scope and timing of investments:

*"For a majority of DNOs there is a significant degree of scheme churn (i.e. different schemes from those set out in forecasts prepared during the last price review – [DPCR3]) even at this early stage in the regulatory period [DPCR4]. In some cases system reinforcement and asset replacement schemes have been deferred until after the end of DPCR5 whilst new schemes for the current period have been introduced. Scheme phasing, and forecast costs have also varied significantly from earlier predictions."*

- 4.5 The UR states<sup>18</sup> that NIE has been lacking in providing evidence for specific projects in the proposed Funds 1 and 2:

*"In respect of the specific named projects in Funds 1 and 2, we examined the evidence presented by NIE T&D and determined whether it was sufficient to justify each project in turn. In many cases NIE T&D was unable to produce the necessary evidence, notwithstanding the numerous requests that we made and the several workshops at which we repeated our concerns. ..."*

- 4.6 NIE recalls one such engagement in January 2012 over a three week period in which the UR tabled more than 300 questions. This workshop was arranged after NIE highlighted to the UR its concerns about the lack of engagement. The questions raised by the UR were aimed at populating a highly granular database rather than to generate genuine discussion on assessment methodology and findings. All questions were fully answered as confirmed by the UR's representative at the time. Later in the review process, post the draft determination, NIE met with the UR and its consultants SKM, mainly on load-related issues and again all data requests were addressed.
- 4.7 NIE raised concerns with the UR about the use of the capex database and the adoption of this type of methodology for the initial assessment of projects. For example, for the initial assessment, high marks could only be obtained in the methodology if projects had progressed through the advanced stages of

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<sup>16</sup> UR-26, paragraph 39.

<sup>17</sup> Ofgem Ref - 18/07 paragraph 2.27.

<sup>18</sup> UR-4, paragraph 34(b).

development which is clearly inappropriate for projects that will not be initiated until well into RP5.

- 4.8 This approach later appeared to have been abandoned by the UR.

## 5. ASSET AGE AND ASSET REPLACEMENT

5.1 In UR-4<sup>19</sup> the UR states that NIE has suggested that parts of the network that are more than 40 years old implies they need replacing. NIE has never suggested this, and does not replace assets on the basis of age. As has been explained to the UR, assets are only replaced based on condition assessment, when the risks associated with their retention on the network are unmanageable and unacceptable.

5.2 Despite the increased level of asset replacement expenditure proposed by NIE in RP5, assets will still only be replaced at the rate of 0.6% of the value<sup>20</sup> of the asset base per annum. Since this expenditure will be focused on those assets over 40 years old, (approximately 45% of the asset base is between 45 and 80 years old), these older assets will be replaced at the rate of 1.3% per annum. At the end of RP5, over 93% of the older assets on the network will still be in service at ages well beyond those of the mean lives of assets determined by Ofgem during DPCR5.

## 6. NETWORK PERFORMANCE AND ASSET REPLACEMENT

6.1 The UR continues to hold the position<sup>21</sup> that, since network performance in terms of Customer Minutes Lost (CML) and Customer Interruptions (CI) is good, the case for asset replacement is undermined. NIE has explained to the UR that network performance as measured by CML and CI is very largely dependent on the performance of the extensive 11kV rural overhead line network which supplies large numbers of rural customers. The lower voltage network supplies smaller numbers of customers and few customers are affected by a fault whereas the higher voltage networks (above 11kV) have redundancy that is immediately available without manual intervention so that customers would not normally lose supply as a result of a fault. CML is thus a useful indicator of the average condition

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<sup>19</sup> UR-4 paragraph 3(b).

<sup>20</sup> Modern Equivalent Asset Valuation (MEAV).

<sup>21</sup> UR-4 paragraph 3(c).

of the 11kV overhead line network<sup>22</sup> but not for overhead line networks at other voltages.

- 6.2 Neither is CML a good indicator of the need for investment in plant assets, which is the primary driver of increased asset replacement requirements for RP5. This is because the intent is to replace the asset prior to failure to prevent safety issues arising in the event of failure. It would be irresponsible to wait for an increase in plant failures before planning an increase in investment. Rather, in line with industry best practice, the best indicator of future investment requirements is having detailed information on the physical condition of plant assets, which we can demonstrate to the Commission.
- 6.3 The UR further references the fact<sup>23</sup> that NIE has not made any payments to customers required under the Guaranteed Standards Regulations, as evidence of good network performance. Again, this is erroneous. The relevant Guaranteed Standard relates to the timely restoration of customers' supplies following a network fault i.e. it is a measure of NIE's operational response to network faults, not a measure of asset condition or risk.

## 7. LOAD RELATED EXPENDITURE

- 7.1 The UR states<sup>24</sup> that aggregate demand has fallen since 2008; while it concedes that "*there are parts of the network that come under load strain at times*", it further states this does not call for "*across the board capacity upgrade*". Firstly, the UR is incorrect in its assertion on aggregate demand, since this has actually increased over the period. Secondly, load-related investment is driven by demand growth on heavily loaded substations and not an aggregate demand increase. NIE has proposed no such across the board capacity upgrade, and the UR has presented no supporting evidence for its statement. NIE only invests after it is clear that the network at a specific point is overloaded or is about to become overloaded, and does not invest speculatively against a demand forecast or to generate spare capacity across the network as implied by the UR's comment. This would be clear from even a cursory reading of the relevant capex strategy papers.
- 7.2 The UR further accuses NIE of failing to provide basic evidence to support a "substantial number" of load-related capex projects. It cites a specific reinforcement project (Granville), and its view that NIE attempted to justify the expenditure on the basis of adding domestic and industrial peak demands (which occur at different times). The UR seems to misunderstand the detailed information

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<sup>22</sup> The number of CMLs in any year also depends on the weather, i.e. the number of storms and, in particular, whether those storms are classified as exceptional events.

<sup>23</sup> UR-4, paragraph 3(d).

<sup>24</sup> UR-4, paragraph 3(e).

provided by NIE on this proposal. NIE has demonstrated to the UR that the peak demand at Granville (as recorded and not determined by calculation) was already at 138% of firm capacity and over-firm for a significant period of the year<sup>25</sup>. The network constraint arises due to statutory voltage limits rather than thermal considerations. It is not known how the UR formed the impression that peak demand had been calculated from the addition of the peak demands of sub groups of customers. Requests were received from the UR for specific loading information, including for the Dungannon-Granville system, which was provided as requested. However, at a very late stage, the UR asked NIE for load duration curves for all primary substations and NIE explained that several man months of work would be required to fulfil that request but that if data was required for specific named substations, NIE would oblige. In the event, no further requests for additional information were made.

- 7.3 Regarding network planning standards, the UR states<sup>26</sup> that since standards have not been updated since privatisation, it does not have up to date criteria against which to measure load-related investments. By way of illustration it posits that a proposed reinforcement in the Limavady area would not be required due to the offsetting effect of embedded small scale generation, if assessed using more recently updated GB planning standards. It is theoretically correct that a review of network planning standards could result in a revision to assumptions made when forecasting the effects of embedded generation. However, NIE had explained<sup>27</sup> to the UR that the Limavady reinforcement involved replacement of a section of small cross section 33kV overhead line which was already operating at the limits of its capacity. It was therefore proposed to replace this section of line with a larger cross section conductor to maintain compliance with licence standards.
- 7.4 It is difficult to understand why the UR could consider that a review of network planning standards (which are concerned with the consideration of contingencies) would relieve actual recorded overloads on this network. Indeed, due to the safety and network reliability risks associated with recorded overloading, the undersized conductor has recently been replaced.

## 8. EXCELLENCE IN ASSET MANAGEMENT

- 8.1 The UR comments<sup>28</sup> that:

*"... excellence in asset management is the critical enabler for success in any network utility enterprise like NIE T&D".*

<sup>25</sup> UR Final determination, Distribution Capex Appendix, project 31.

<sup>26</sup> UR-4 paragraph 3(c).

<sup>27</sup> UR Final determination, Distribution Capex Appendix, project 35.

<sup>28</sup> UR-4, paragraphs 7 and 8.

NIE concurs with this view and has provided evidence to the UR that it paid due attention to ensuring that its practices were up to date. Indeed the UR's consultants SKM concluded that NIE's risk assessment processes were sound.

8.2 The UR further states that:

*“NIE T&D's approach to its network falls well short of this standard of excellence in asset management”.*

8.3 NIE has had a gap analysis carried out to determine what development of its asset management processes is required to enable it to gain PAS 55 accreditation, which is the recognised asset management standard in the industry. This analysis confirms that NIE's processes are sound and, of the twenty-four assessment categories, NIE's maturity essentially met or exceeded the level required in all but three areas. NIE has already addressed these areas and is also reinforcing other aspects of its asset management practices. The current expectation is that certification will be achieved by the end of 2013.

8.4 NIE has documented the development of asset management techniques since the mid-1990s to the present day in its report 'NIE's Journey Towards Excellence in Asset Management' which is provided at Appendix 2A.1. That report refers to a letter from NIE's PAS 55 consultant, Asset Management Consulting Limited, a copy of which is provided at Appendix 2A.2.

8.5 The UR makes specific criticisms of NIE around lack of transparency and accountability in its capex submissions; no adequate records of asset replacement during fault repair, despite claiming this as betterment of the network; and inability to state the true age or condition of assets. In fact, all plant replacements carried out under fault repairs are fully detailed in the relevant asset register. With respect to distribution overhead line assets, NIE's processes are also consistent with standard electricity utility practice by recording ages and location of overhead line poles. Therefore, while recognising that assessing the efficiency of reactive asset replacement is challenging, it is no more so for NIE than it is for the GB DNOs.

8.6 In addition, NIE's RP5 capex submissions take full account of “betterment” obtained from fault repairs since overhead line components replaced under fault conditions do not then need to be replaced when the line is subsequently refurbished. In the case of cables, NIE is only commencing proactive cable replacement programmes during RP5 and any piecemeal replacement of cable sections after a fault will be taken into consideration in the programmes.

8.7 Regarding asset replacement benchmarking, the UR states<sup>29</sup> that:

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<sup>29</sup> UR-4, paragraph 34a.

*"As with the cost benchmarking exercise, the Commission may want to conduct its own modelling of the need for asset replacement. In that regard, it should be noted that any benchmarking of NIE T&D's network against the GB networks is likely to be biased in favour of a finding that replacement is necessary because, as explained above, NIE T&D's data on the actual age of its assets is biased upwards by virtue of the fact that it has not updated its asset register in respect of the unplanned capitalised replacement and refurbishment work that it has done on the network over the years."*

- 8.8 NIE refutes the suggestion that assets may be younger than stated and PB, based on its experience as technical consultant to Ofgem during both DPCR4 and DPCR5, considers that the accuracy of NIE's asset records would compare very well with the DNOs. It should be noted that the annual regulatory reporting templates used by Ofgem allowed for data cleansing volumes to be identified in its asset reporting submissions<sup>30</sup> recognising that some DNO data may be inaccurate. All primary and secondary plant items are detailed accurately in the asset register including those replaced under fault conditions. Some minor secondary plant items such as the older cut outs and meters may have an assumed installation date the same as that of the associated supply cable which is considered to be a reasonable assumption.
- 8.9 Overhead and underground circuits are recorded on a GIS system and a data cleansing exercise was carried out when the paper records were digitised.

## **9. 11KV RESILIENCE**

- 9.1 Unfortunately, the UR remains unconvinced in relation to a major area of network risk – regarding resilience of the rural 11kV network to major weather events. NIE's proposals are fully supported by the Ulster Farmers' Union, who represent large numbers of rural customers who would suffer most from prolonged outages.
- 9.2 Of particular concern are the UR's comments on NIE's request for finance for a pilot project. While NIE has explicitly dealt with the probability of network failure associated with conductors of different sizes in its report submitted to the UR, the UR's points on conductor size seem to ignore the fact that NIE has considered this in its submission. The UR considers that options have not been considered and yet the UR itself suggested an option which NIE followed up and documented in its report in addition to the other options considered.

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<sup>30</sup> Column m of sheet 5.3 of R.RP 2009/10.

- 9.3 Equally concerning is the comment that NIE has carried out no work to assess customers' views of the costs and benefits. NIE discussed the issue with the UR at an early stage and as a result of that discussion, it was agreed that NIE would carry out its investigation, document its findings and that this document would be used as the basis of a joint consultation document. This will be quite clear from the report already submitted with the SoC even to the point that the issues which NIE considered should be consulted upon were listed.
- 9.4 Several other comments are somewhat odd. The UR states<sup>31</sup> that NIE is not motivated by concern about deterioration of assets, and that the risk has always been there and will continue to be after the project is completed. NIE's motivation is manifestly driven by asset condition. As regards risk, just because the risk "has always been there" is no reason to ignore it. Furthermore, the UR's assertion that the risk will remain after the project will be completed is incorrect. The risk would be substantially reduced over the course of RP5 and the two successive regulatory periods.

## 10. OUTPUT MEASURES

- 10.1 In its UR-4 conclusion<sup>32</sup>, the UR states:

*"After 20 years since privatisation it should not be unreasonable for a regulator to expect to be able to regulate capex by setting incentives for the achievement of outcomes that matter to customers (such as health and load indexes, customer minutes lost, etc) rather than needing to set allowances and unit costs for particular pieces of infrastructure. On that approach, the regulated entity could demonstrate the need for substantial new capex without difficulty and the regulator could approve it, confident that the money would actually be spent, and would be spent efficiently and on projects that are actually required. But that is not the world of NIE T&D."*

- 10.2 NIE is committed to working with the UR to develop secondary network measures, such as load and health indices, to supplement its regulatory reporting, within an overall RPI-X regulatory framework. This would be consistent with the approach adopted by Ofgem, but recognises that the development of metrics for such secondary network outputs is a complex and substantial task. Indeed, even though work commenced much earlier in GB, the development of appropriate metrics for GB DNOs still remains "work in progress". In this regard, it should be noted that NIE has already, for a number of years, been reporting to the UR in

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<sup>31</sup> UR-26, paragraph 44.

<sup>32</sup> UR-4, paragraph 36.

respect of the primary network metrics established by Ofgem for GB DNOs post-DPCR5. CML, the distribution network primary output, and energy not supplied (ENS), the transmission network primary output, have been reported to the UR since RP2 and hence have been, and are available to the UR.

- 10.3 In its submission, NIE tabled details of assets that require replacement during RP5 and in several cases, RP6. This in fact confirms the assets classified as Health Indices (HI) 5 (i.e. 'need to replace') at the beginning of RP5 and at the end of RP5 so again this data is available. Further work is required to establish the mid-grade HIs, 2, 3 and 4 both at the start and end of the period. With respect to Load Indices (LIs), NIE has provided substantial information to the UR for both current and forecast LIs. The other secondary network outputs agreed between Ofgem and the DNOs, fault rates, have also been available for a number of years.
- 10.4 Since the output measures have sensitivities and limitations, NIE considered that the UR should engage with NIE in the development of these in NI so that it would understand the sensitivities and limitations but the UR did not take up this offer.
- 10.5 It should be noted that the UR has neglected to engage with NIE on the development of output measures. The MMC concluded in its 1997 report that;

*"We would emphasize that the above process of reasoning has been for the purpose of determining the amounts to be included in setting the price control, not to prescribe an investment programme. We can only make our best estimates based on the information and techniques currently available. It is for NIE to decide on the level and pattern of capital expenditure over the next five years, taking account of developments in technology and best practice, which are most appropriate to achieve the objectives set between itself and the regulator. In this context we would urge the DG to seek to reach agreement with NIE on the appropriate target outputs, for example in terms of a reduction in CML, which the company should seek to achieve over the period of the price control, taking account of the views we have expressed). ..."*

- 10.6 NIE reminded the UR of this observation by the MMC during the course of the price review for RP3 in its 'Response to WS Atkins Draft Report on Factual Findings on Capital Expenditure W86E May 2001' particularly in respect of 'not prescribing an investment plan'.
- 10.7 It is further noted that Ofgem, in its 2004 work plan, stated that it intended to focus on outputs and during the course of DPCR4, it engaged extensively with the DNOs (with assistance of PB) to develop appropriate output measures. Ofgem understood and accepted the output limitations and sensitivities when they were agreed for DPCR5 at the end of 2015. These limitations and sensitivities meant

that Ofgem adopted the output measures quite tentatively and with some reservations.

10.8 However, the UR did not engage with NIE on outputs at any time since RP3 regarding the development or availability of outputs measures even to the extent of not forewarning NIE that it might expect output measures to be available for the RP5 price review. Instead the UR simply requested that they be submitted with the BPQ.

10.9 The UR further states<sup>33</sup>:

*"It should also be noted that Ofgem collates substantially more information via its RIGs than we propose to collect. Ofgem uses an examiner to verify and audit this data."*

10.10 While it is true that Ofgem may appoint an examiner, the duties carried out fall far short of those proposed by the UR for a Reporter. The RIGs<sup>34</sup> note in 1.15:

*"In accordance with SLC 46.8 the licensee must permit a person nominated by the Authority to examine the systems, processes and procedures for measuring the specified information, the specified information collected by the licensee and the extent to which the systems, process and procedures and the specified information complies with the RIGs."*

## **11. OTHER APPROACHES TO SETTING CAPEX**

11.1 In another demonstration of lack of confidence in its own FD, the UR suggests<sup>35</sup> that CC could consider other approaches to uncertainty of capex required e.g. cap at RP4 levels, maintaining serviceability, but with a mechanism to provide extra capex if major changes occur in the period. As outlined above and in the SoC, RP4 levels of capex would be grossly inadequate, and "maintaining serviceability" would be an impossibility. As regards "major changes in the period", the changes from RP4 capex drivers are already known, and have been evidenced in detail.

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<sup>33</sup> UR-4, paragraph 16.

<sup>34</sup> Ofgem doc 36a/12 - Electricity Distribution Price Control Cost, Volume and Revenue Reporting - Regulatory Instructions and Guidance: Version 3.

<sup>35</sup> UR-4, paragraph 10.



## ANNEX 3

### RP5 OPEX – ENDURING SOLUTION

#### 1. INTRODUCTION

- 1.1 The UR has determined an allowance of £21.4m to operate and maintain the Enduring Solution (ES) processes and systems. This falls 26% or £7.5 million short of what is required over the RP5 period. In its SoC, NIE has set out in detail why it believes this disallowance is unjustified.
- 1.2 In response to UR criticisms<sup>1</sup> of the way in which NIE developed its ES submission, Section 2 of this Annex summarises why NIE's updated submission in respect of ES opex should be allowed in full.
- 1.3 Sections 3 and 4 respectively comment on two reports prepared by Gemserv (the UR's representative on the ES project) which the UR says formed the basis of its FD allowance. These reports were provided in the UR's opening submission as UR-17<sup>2</sup> and UR-18<sup>3</sup>. This is the first opportunity that NIE has had to review and comment on either report.

#### 2. NIE'S CASE IN SUMMARY

- 2.1 NIE successfully implemented the Enduring Solution (ES) system in May 2012 at a total cost of £37.6 million. It was driven by the need to meet legislative and regulatory requirements for a fully competitive retail electricity market. The project also delivered full separation of the customer billing processes and legacy IT systems previously shared between NIE (the network operator) and Power NI (the retail Supplier). It was a well-managed project, delivered by a Systems Integrator following a competitive procurement exercise. The Enduring Solution system has been supporting the NI retail market effectively for the past 12 months.
- 2.2 The ES system has created a step-change in NIE's operating costs. It replaced low cost, static applications providing minimal functionality with complex, functionally rich applications requiring significantly more support effort. There has been a 12 fold increase in daily messages processed by the system, 90 additional systems interfaces and a 5 fold increase in bills issued.

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<sup>1</sup> UR-3, paragraph 18.

<sup>2</sup> Gemserv update report on changes to the Enduring Solution ICT and employee costs.

<sup>3</sup> Gemserv Report on NIEs revised RP5 Opex proposals for Enduring Solution ICT.

- 2.3 NIE is responsible for managing all of the NI retail market processes and data, whilst in GB responsibilities for these functions are spread across many different industry participants including meter data collectors, data aggregators, suppliers and meter installers. Therefore, solely to meet the needs created by the NI retail market, the Enduring Solution system is necessarily complex and differs significantly from solutions in place within GB.
- 2.4 The acquisition of NIE by ESB created the opportunity for the ES to be delivered using a tried and tested technology (SAP IS-U) which provides significant functionality to support the operation of distribution network organisations and which has the potential to deliver future benefits to NI customers.
- 2.5 The NIE support costs are based upon a detailed review of activities and they have been validated in the period since go-live. Support is being provided at an annual cost of 13% of the original implementation cost. External benchmarks, including reports from Gartner submitted as part of NIE's SoC<sup>4</sup> demonstrate that organisations would expect to pay 25% - 30% of implementation cost for on-going operations.
- 2.6 The fact that the ES services are being provided in a low cost manner is reflective of NIE's low overall IT cost base, which was established following a competitive outsourced managed service procurement exercise in 2009.
- 2.7 The UR has made much of the fact that the ES support and maintenance services were not separately tendered and therefore value for money cannot be established. NIE's position is that the managed service contract was competitively tendered and that the incorporation of the ES services within the existing managed service was agreed by the UR's representative who sat on the Project Board.
- 2.8 In paragraph 18 of UR-3, the UR makes reference to the unsatisfactory way in which the ES submission was developed. As explained below, it was the UR's approach to the setting of the ES opex allowance that was unsatisfactory.
- 2.9 Given the complexity of the ES project (the largest IT project ever undertaken by NIE<sup>5</sup>) and the timing of the regulatory review process it was not possible to arrive at a fully informed position with respect to operating costs at the time of the original BPQ submission. NIE highlighted at that stage that the submission would be updated when the project reached a more advanced stage. The UR's lack of open

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<sup>4</sup> SoC Chapter 6, paragraphs 5.57 and 5.58.

<sup>5</sup> "The ES project delivered complex IT solutions for 2 organisations (NIE and PowerNI) in a very tight timescale. The challenges of the project including data migration issues, market harmonisation and the large number of stakeholders involved meant that it was one of the most complex IT implementations I have observed over many years in quality assurance roles." Richard Barton, Deloitte Partner and Utility Industry Expert.

and detailed engagement over the subsequent months significantly impacted its ability to properly understand the data provided by NIE.

- 2.10 NIE submits that it was unreasonable to expect it to present a fully detailed and evidenced submission of opex costs at an early stage of an extremely complex IT and business change programme. However, whatever the difficulties experienced in arriving at a final submission, these operating costs are being incurred efficiently as demonstrated by the IT market benchmark information referred to above and therefore should be fully recoverable.
- 2.11 To date, the UR has failed to demonstrate the basis upon which it considers these costs to be inefficient. The detailed rationale used and the benchmarking underpinning the disallowance has not been shared with NIE (see Section 3 below).

### **3. NIE'S COMMENTS ON UR-17**

- 3.1 In its opening submission, the UR provided two Gemserv reports (UR-17 and UR-18) which the UR says<sup>6</sup> formed the basis of its ES opex allowance.
- 3.2 This Section 3 comments on the first of these reports entitled 'Gemserv's update report on changes to the Enduring Solution ICT and employee costs' dated 6 July 2012 (UR-17).
- 3.3 NIE notes that neither of the two Gemserv reports were shared with NIE prior to its inclusion in the UR's opening submission to the CC.

#### **Section 1 of UR-17**

- 3.4 At the beginning of Section 1, UR-17 lists a number of prior reports provided to the UR in connection with Enduring Solution and other NIE IT submissions.
- 3.5 None of the reports listed here have been provided to NIE or, it would appear, to the CC. The main rationale for the RP5 allowances is described in these reports. (UR-17 and UR-18 describe only subsequent changes to these allowances.) Therefore, NIE has had no opportunity to review the basis for disallowance and would invite the CC to request this material from the UR. In NIE's submission, it is important that it has the opportunity both to review this material in detail and to make representations to the CC on the accuracy and completeness of the reports.
- 3.6 Section 1 describes the scope of the report. It includes on page 5, 3<sup>rd</sup> last bullet, "*Review of stranded employee costs caused by the termination of existing market*

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<sup>6</sup> UR-3, paragraph 18.

*opening DT terms that were not included in the NIE submissions and ignored in the original reports”*

- 3.7 The statement is incorrect in so far as it suggests that relevant items were not included in NIE's BPQ submission. That submission separately identified existing resources, each of whom were recruited for previous phases of market opening following receipt of regulatory approval. Therefore, these resources were included in the NIE submission. Moreover, in Section 5 paragraph 2, the UR's representative appears to contradict the statement in Section 1 by stating that *“the NIE submission built on the existing market opening DT terms and took a marginal, rather than absolute, approach to new resourcing.”*

### **Section 2 of UR-17**

- 3.8 Section 2 of the report deals with the Joint TIBCO Market Messaging Hub.
- 3.9 NIE would highlight that the UR's representative has assumed principles with respect to cost sharing between NIE and ESBN which were not confirmed to NIE by the UR until April 2013, despite NIE's repeated requests for clarity on the matter. This delay in obtaining clarification on cost sharing principles is in line with the generally unsatisfactory way in which engagement around cost recovery was progressed both in advance of and following the Enduring Solution implementation<sup>7</sup>.

### **Section 3 of UR-17**

- 3.10 In Section 3.2 (Legacy system ICT cost reductions), within the *Gemserv's Opinion* paragraphs the UR's representative states that the cost reduction information:

*“...was inadequately presented in the subsequent submission ...”.*

- 3.11 The cost reduction information was clearly labelled in the summary table included in the NIE submission 'Legacy reduction recognised in the BPQ'. The narrative accompanying the table was also clear on this matter and stated as follows:

*“The following items are currently costed within NIE's business as usual ICT costs and will disappear following ES go-live. A number of these reductions in RP5 have already been factored into NIE's BPQ submission (mainframe hosting, QBS BPO staff and BAU Software licences).*

*The additional reductions shown here are due to the representation of the ES opex information as a bottom-up costing rather than a differencing calculation. On the basis of this analysis, an additional £1.86m of*

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<sup>7</sup> SoC Chapter 6, paragraph 5.61.

*reductions over the 5-year period would be removed from the existing BPQ submission.”*

- 3.12 The UR’s representative ultimately accepted NIE’s position with respect to the relevant cost reductions. However, NIE submits that the reference to ‘inadequately presented’ represents an unfounded criticism of the NIE submission.
- 3.13 In Section 3.4, within the *Gemserv’s Conclusions* paragraph, the UR’s representative states:

*“On the basis that this allowance will cover all the requirements detailed above and will only exclude major system changes driven by the UR (such as Smart Metering) it is recommended that the allowance is approved. It is recommended that no further allowance should be agreed during the RP5 without NIE providing substantive evidence that these RP5 allowances are inadequate to cover them.”*

- 3.14 For clarity, NIE would highlight to the CC that the ES Submission provided on 6 July 2012 contained the following note with respect to this allowance:

*“In the event that the market requires significantly more development for a major change, it is NIE’s assumption that this would be undertaken as a project and cost recovery approved separately via an individual business case. Equally, this allowance would not cover a significant system upgrade.”*

- 3.15 A major system upgrade will not be ‘driven by the UR’ but will be a requirement during the normal course of an IT system’s lifecycle. The allowance described here would not cover this type of project and NIE expects that such costs would be separately recoverable during RP5<sup>8</sup>.

#### **Section 4 of UR-17**

- 3.16 In Section 4, within the *Gemserv’s review of NIE’s submitted cost table* paragraphs, the UR’s representative states:

*“The transitional costs for legacy OULPS Data Aggregation system are the direct result of a project change request and as a consequence should be considered a project related, not transitional cost.”*

- 3.17 Project costs are the capital costs associated with the initial implementation of the Enduring Solution systems and processes. Recovery of these costs were discussed separately with the UR and are outside the scope of the RP5 price control. Transitional costs are NIE operating costs incurred in the period

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<sup>8</sup> SoC Chapter 6, paragraphs 5.60 to 5.62.

immediately post go-live. The costs referred to here are the operating costs associated with a legacy application which needs to be maintained for 13 months post ES go-live (to support Data Aggregation activities). It is therefore unclear why the UR's representative believes that this should be capitalised as part of the ES project costs. These are actual opex costs incurred by NIE since May 2012.

- 3.18 In Section 4, within the *Gemserv's review of NIE's submitted cost table* paragraphs, the UR's representative states:

*"The NIE table indicates support for an additional service manager and hypercare manager. This is addition to the Wipro transitional (or hypercare) manager. It is Gemserv's opinion that this is more than adequate to supplement a homogeneous BAU service management team and has removed the costs for the service manager from the revised table below."*

- 3.19 NIE's ES Transition Costs submission paper dated 29 June 2012 set out the following rationale for the Service Manager:

*"A Temporary Service Manager, full time for 3 months and 50% for the subsequent 3 months, is required to deal with the increased level of service management for a number of months from go-live. During this early phase of operation a specific warranty defect management process will be in operation, KPIs will require proof of measurability, and SLAs will need to be monitored in greater detail, to confirm that they are deliverable, given the performance of the solution. Given the need to manage the warranty position and the additional SLA activity, there will be an overhead in operating the measurement system which will drive the invoicing for the actual effort required to support the new applications during the first 6 months of operation and thereby seek to minimise costs."*

- 3.20 NIE did demand a significant degree of oversight in the period post go-live to allow validation of the support resourcing and system performance. The addition of this resource was a prudent measure to manage the increased risk to market operations associated with the early days of operation and the costs should be recoverable as reasonable and efficiently incurred (a daily rate of £314/day).

- 3.21 In Section 4, within the *Gemserv's review of NIE's submitted cost table* paragraphs, the UR's representative states:

*"Gemserv is also confused by the need for Northgate to impose a service introduction charge of £57k. The project budget accounted for a large sum of money to train Northgate staff and ensure readiness to support the Enduring Solution services at go live. Gemserv concludes, if applicable, this is a project cost and not suitable for cost recovery as a transitional cost and has removed the amount from the table on the next page."*

- 3.22 NIE's ES Transition Costs submission paper set out the following rationale for the Service Introduction costs:

*“Under the terms of our existing agreement with Northgate certain aspects of the introduction of new services to the existing managed service are chargeable. Service introduction charges do not contain efforts of staff already covered within the managed service. Activities covered by this charge include:*

- 1. Financial modelling;*
- 2. Commercial and legal activities;*
- 3. Managed service process change activities; and*
- 4. Other general service introduction activities such as acceptance and readiness reviews and reporting.”*

- 3.23 These are actual opex costs incurred by NIE in line with the terms of the existing managed service agreement and they should be fully recoverable.

#### **Section 5 of UR-17**

- 3.24 Section 5 paragraph 2 states that:

*“it was possible to review the existing resource and provide an opinion of what additional resource was required post Enduring Solution delivery.”*

- 3.25 NIE's view is that any assessment of the need for additional resource needs to be based on a robust analysis, rather than opinion. This is a critically important factor in determining what levels of costs, efficiently incurred by NIE, are reasonable and therefore recoverable.

- 3.26 The opinion of the UR's representative was flawed because it failed to provide any robust analysis to support that opinion. In contrast, NIE's submission was based on a detailed resource model<sup>9</sup>, developed specifically to assess the number of additional resources required. This model and its outcomes were rigorously challenged by senior managers before the submission was finalised. NIE's objective was to seek cost recovery for the minimum number of resources required.

- 3.27 During project discussions with the UR's representative, no challenge was made as to the accuracy of the model or its underlying assumptions. However, this did not prevent an unsubstantiated opinion from being formed. The Gemserv opinion is that NIE should be entitled to recover costs for 9 of the 14 additional FTE's proposed. We would invite the CC to investigate how this opinion was formed and

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<sup>9</sup> SoC, Appendix 6.7.

on what basis. NIE submits that in the absence of a robust analysis supporting Gemserv's opinion, there are strong grounds to prefer NIE's reasoned submission as to its requirement for additional resources.

- 3.28 In Section 5, within the *DSC call centre staff* paragraphs the UR's representative states:

*"Gemserv does not believe that NIE, as a distribution business, has the role or responsibility to advise electricity customers on competitive market activities. Any telephone callers should therefore be referred to relevant organisations or websites. On this basis we cannot recommend the continuation of the DT funding for 3 FTEs."*

- 3.29 NIE is not comparable with a typical GB DNO, given its role as common services provider to the NI market. NIE's services extend to include meter reading, meter changes and data aggregation, activities all undertaken by suppliers in the GB market. Therefore it is reasonable to expect a volume of customer enquiries relating to these services that would be addressed by suppliers in the GB market. Previously, because of NIE's unique market obligations, three FTE's had been approved by the UR to deal with customer queries relating to the electricity market. NIE requested a continuation of these three FTE's to deal with such queries. The UR's representative's opinion is flawed as it is based upon experience of the GB market.

### **Section 6 of UR-17**

- 3.30 In Section 6, the third paragraph states:

*"The period of the RP5 price control is assumed to be 5 years and all the schedules in this report have been built on that premise. The period when the interim Dt Terms need to apply are between the 21<sup>st</sup> May and the 30<sup>th</sup> September 2012. This period is 133 days, 36.5% of one year or 7.25% over the 5 years. Therefore Gemserv has used these percentages to extrapolate the straight line (BAU) costs from the tables in other sections of this report."*

- 3.31 This is a flawed approach to extrapolating costs during the RP4 extension period as the ES costs in many cases reduce towards the end of the RP5 period and using an average over 5 years will not produce an adequate allowance in the higher cost early days of operation. This calculation is explicitly referenced in Section 6.1 of UR-17 where it is being used to calculate the RP4 Business As Usual opex allowance.

#### **4. NIE'S COMMENTS ON UR-18**

- 4.1 This Section 4 comments on UR-18, being the second of the two Gemserv which the UR says<sup>10</sup> formed the basis of its ES opex allowance. This second report is entitled 'Report on NIE's revised RP5 opex proposals for Enduring Solution ICT' and is dated 25 September 2012.
- 4.2 NIE reiterates that this report was not shared with NIE prior to its inclusion in the UR's opening submission to the CC.

##### **Section 2 of UR-18**

- 4.3 At the beginning of Section 2, the UR's representative states that:

*“Since the RP5 ‘IT and Telecoms BPQ 14’ support paper dated 11th February 2011 was submitted to the UR, NIE have made many more submissions in different formats revising their predicted costs for the five year price control period. This has made objective analysis complex and time consuming.”*

- 4.4 To clarify the position in the light of this comment, NIE has made three main submissions to the UR in relation to ES operating costs as summarised in the table below:

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<sup>10</sup> UR-3, paragraph 18.

Submission	Project Stage	Submission Amount	Qualification included in the submission
BPQ February 2011	Design Phase	£22.5m	<p>‘There is a significant degree of uncertainty involved in planning opex costs well in advance of completion of the ES design. While the submission includes known additional costs (SAP licences, hardware maintenance) and known savings (mainframe costs, Oracle licences) there are a number of areas where final information will not be available for some time.’</p> <p><i>IT Resource Costs</i> ‘These projections have been based upon very early discussions with Northgate and Wipro. The change to the managed service costs resulting from ES will not be fully understood until much later in the project and therefore, the degree of confidence in these figures is low.’</p> <p><i>BPO Resource Costs</i> ‘The change to the BPO managed service costs resulting from ES will not be fully understood until much later in the project and therefore, the degree of confidence in these figures is low.’</p>
November 2011 forecast	System Integrator Testing	£29.5m	<p><i>Outsourced Support Costs</i> ‘The figures in this paper represent NIE’s present best view of the minimum level of ICT and Business Process Outsourcing (BPO) support services required in the light of the information currently available to us. The figures are based on certain assumptions and will require further review if circumstances outturn differently post Go Live. The current position has been developed in advance of any user testing of the new applications. NIE expects that further information may emerge during the later stages of testing which may impact the proposed resourcing – either to increase or decrease the requirement.’</p> <p><i>NIE Manpower Cost</i> ‘The figures in this revised submission represent NIE’s present best view of the minimum level of additional resources required in the light of the information currently available to us. The figures are based on certain assumptions and will require further review if circumstances outturn differently post Go Live.’</p> <p>In the interim, the User Acceptance Testing (UAT) stage of the project which is scheduled to run from November 2011 to February 2012 will provide a better insight into the workings of the new arrangements and identify any further refinement of the additional resource requirement above the minimum requirements described in this submission. However, it is only with the benefit of operational experience that NIE will be in a position of certainty regarding any need for further resources above the minimum</p>

Submission	Project Stage	Submission Amount	Qualification included in the submission
			levels described in this submission.'
July 2012 forecast	2 months post go-live	£29.4m	<p data-bbox="808 336 1128 363"><i>Outsourced Support Costs</i></p> <p data-bbox="808 368 2067 488">This paper sets out an updated submission of the Enduring Solution 'steady state' IT support costs, based on a more informed position emerging from the later test stages of project delivery and the early weeks of live operation. The information in the paper represents NIE's best view of support requirements and costs at this point.'</p> <p data-bbox="808 523 2067 735">'Due to the complexity of the new arrangements and the relatively limited experience of this suite of applications in the production environment, NIE plans to adopt an iterative approach in conjunction with the Managed Service Provider in determining the most cost effective on-going resource needs through the use of an agreed 'activity based' model and proposes that the regulatory allowances might be considered on this basis. This approach suggests that an initial view of the RP5 allowance would be agreed in August / September 2012, with an agreed checkpoint after 12 months of live operation, at which point the allowance could be adjusted.'</p>

- 4.5 At the beginning of Section 2 the UR's representative refers to "*Gemserv's report on the impact of the Enduring Solution on NIE's costs dated 28th November 2011*".
- 4.6 This Gemserv report has not been provided to NIE or (presumably) to the CC. NIE expects that the November report contains information about the 'benchmarking' exercise undertaken to determine reasonable operating costs for NIE's SAP IS-U solution. As this benchmarking exercise has been used to disallow 45% of NIE's SAP IS-U support costs over the RP5 period, NIE believe that this information is central to the UR's case. In NIE's submission, it is important that it has the opportunity both to review this material in detail and to make representations to the CC on the accuracy and completeness of the reports.

### **Section 5 of UR-18**

- 4.7 In paragraph 5.1.1 the UR's representative states that:

*"Gemserv carried out some rudimentary benchmarking exercise with a System Integrator and a major user ..."*

- 4.8 NIE has not been provided with any information relating to the Gemserv benchmarking study. As it is cited as the reason for a 45% disallowance of NIE's SAP IS-U support costs, it is a cause for concern that this crucial exercise has been described as 'rudimentary'. Given the complexity of the ES solutions, the use of benchmarking information to validate support costs is of limited value as each implementation is very different. High-level reviews of other implementations of the same technology (SAP IS-U) have identified a wide variance in support resources. In fact, as set out in NIE's SoC, a range of external best practice information indicates that the proposed SAP IS-U operating costs are extremely competitive <sup>1</sup>.

- 4.9 In paragraph 5.1.1 the UR's representative states that:

*"We also assumed that a lower cost offshore support team would be used with the percentage of offshore resources being increased over the five year period"*

- 4.10 The ES solutions are business critical applications, essential for the effective operation of the retail electricity market in NI. As such, and to avoid unnecessary risk to the market, NIE do not believe that significant offshoring of the support services is appropriate, particularly in the early days of operation.

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<sup>1</sup> SoC Chapter 6 paragraphs 5.57 to 5.58.

- 4.11 In paragraph 5.1.1, the UR's representative comments upon the increase in SAP IS-U support resources between the November 2011 and July 2012 NIE submissions (21 fulltime equivalents (FTEs) in November to 28.2 FTEs in July).
- 4.12 The rationale for this increase in numbers was set out in some detail in the NIE July 2012 submission<sup>2</sup>. However, the UR's representative makes no comment on this analysis, relying instead upon his 'rudimentary' benchmarking information to determine an appropriate support resourcing.
- 4.13 In paragraph 5.1.1, the UR's representative states that:
- “The new cost line for Wipro was not in the November 2011 submission and represents the majority of increased costs in the NIE July submission. The cost of £4,237k, based on the NIE information, represents approximately 47 man years and, assuming 220 days are worked per annum, provides an average daily cost of £420. For an offshore model this seems expensive based on 2009/10 prices and is substantially more than the Gemserv benchmarking carried out last year where the base year costs were calculated to be around £300 per day for a 60:40 onshore/offshore split. The Wipro team seem to be used as an extended, and nearly permanent, transitional support team. Gemserv can only conclude that the main underlying reason for this is NIE have had to negotiate with both organisations<sup>3</sup> who have collectively, for different reasons, found themselves in strong negotiating position that could be described as predatory.”*
- 4.14 The rationale for the ES support model and associated resourcing was set out in detail in NIE's July 2012 submission. The steady state support arrangements are between NIE and Capita (previously known as NMS) only. Capita have chosen to subcontract some services to Wipro and, for clarity, these subcontract costs were shown separately in the NIE submission. The scope and scale of the ES systems required Capita to recruit additional resources and a number of new resources have been in place since summer 2011. Rather than recruiting new permanent staff in every instance, Northgate have chosen to leverage the experience of Wipro employees previously involved in the project by engaging Wipro as a subcontractor to assist in some key areas where specific skills are more difficult (and costly) to obtain.
- 4.15 This approach provides a contractual framework to gain access to additional offshore resources as required for future development projects. However, NIE does not believe that significant offshoring of the support services is appropriate, particularly in the early days of operation, therefore 50% of the steady state Wipro

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<sup>2</sup> P 120706 ES ICT steady state submission.

<sup>3</sup> NMS and Wipro.

resources are operating onshore. The average daily rate for the Wipro team (onshore and offshore) is £380.

4.16 In paragraph 5.1.1, in relation to SAP Activities, the UR's representative states that:

*"Although the latest NIE submission indicates a reduction in costs, their revised estimate is still approximately £500k higher than the Gemserv recommendation. No changes to our July 2012 recommendations are proposed".*

4.17 The SAP Activities referred to represent the costs associated with the Capita Business Process Outsourcing (BPO) resources required to operate processes associated with the SAP IS-U application<sup>4</sup>. In its July 2012 submission, NIE sets out the rationale for the proposed costs. The UR's representative provides no rationale for the allowed amount in either their July 2012 report (UR-17) or their September 2012 report (UR-18). NIE can only assume that a full review of this cost category is provided in the Gemserv Report dated 28th November 2011, which has not been provided to NIE (nor, presumably, to the CC).

4.18 In paragraph 5.1.5, in relation to Software Licence charges, the UR's representative states that:

*"Although Gemserv is again surprised about this elementary error in the NIE November 2011 submission, we can only conclude the revision is justified and have included the additional sum of £303.5k (SAP £107.5k (Item 4) and other software £196k (item 5)) in the updated conclusions table."*

4.19 NIE would note that the July 2012 submission set out the rationale for the change in licence costs which emerged following detailed review of the end users required to access the new applications and of the infrastructure remaining following decommissioning. The NIE November 2011<sup>5</sup> submission did not include an 'elementary error' but was based upon the best information available at that stage.

4.20 In paragraph 5.1.6, in relation to Legacy Reductions, the UR's representative states that:

*"A separate table in the NIE July submission reduces the allowance for legacy reductions by £224k from £4,551k to £4,327k. This is further complicated by the NIE tables adjusting the amount recognised in the BPQ by an additional £217k and a reduction of £441k under 'Additional reductions' (those not included in the BPQ). Again it is surprising that some of these known costs continued to change. There is insufficient*

<sup>4</sup> SoC Chapter 6 paragraphs 5.98 to 5.106.

<sup>5</sup> P 111116 ES ICT BPO Bottom up costing Final.

*information to provide an opinion and Gemserv would suggest that no adjustments are made to Gemserv's July 2012 recommendations that agree with the NIE submission (P120618), dated the 18th June 2012 (Item 6)."*

- 4.21 NIE would note that the July 2012 submission set out the rationale for the change in Legacy Reductions and further explanation was provided to the UR on 12 September 2012 in response to a written question. No further information was requested by Gemserv. But despite this, the UR's representative recommended that the NIE revised submission be ignored on the basis of 'insufficient information' and this recommendation was adopted in the FD. The legacy reductions set out in the July 2012 submission have been reflected in NIE's business as usual IT and Telecoms charges since May 2012<sup>6</sup>.

### **Section 6 of UR-18**

- 4.22 In Section 6 (Conclusions) the UR's representative states that:

*"The UR was made aware of the additional and profound risks that such a change at this late stage would impose on the project and, to safeguard the customers' interests, several additional conditions were inserted in the approval letter sent to NIE."*

- 4.23 NIE made the decision to switch to SAP because it was a better solution for the NI retail market<sup>7</sup>. At the time of the switch, NIE gave assurances to the UR that the project would be managed effectively and no additional risk would result for the NI customers. The project was delivered successfully on time and to budget and has been supporting the market effectively since go-live. The UR did impose several conditions in the approval letter but the approval letter did not include any instruction to NIE that the change to SAP must result in a change to the procurement strategy with regard to on-going operational support and the need to retender the existing services.

- 4.24 In Section 6 (Conclusions) the UR's representative states that:

*"This would lead Gemserv to the supposition that NIE would have never signed the existing managed services contract if SAP was then their preferred solution. Previously, the SAP ISU systems had been discarded at two separate points before and during the open procurement process. It can only be concluded that ESB instigated the change and the Viridian Group obliged as part of the sale agreement."*

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<sup>6</sup> SoC Chapter 6, paragraphs 5.118 to 5.124.

<sup>7</sup> SoC Chapter 6 paragraphs 5.17 to 5.27.

- 4.25 The introduction of a new technology suite to an on-going managed service contract is common practice. For example, in 2006 the UR agreed to NIE extending the then existing managed service to incorporate support for the new Oracle product introduced to support Industrial and Commercial market processes. The Managed Service provider did not have experience in supporting the application but a programme of skills transfer was undertaken during the project and support of the new solution handed over through a change control process. The on-going operational costs were fully recovered by NIE<sup>8</sup>.
- 4.26 A SAP IS-U solution was considered during the ES procurement but was rejected due to the quality of the bid and NIE's confidence in the bidder's ability to deliver successfully within the required timescales rather than any concern about the product set, which is widely acknowledged to be more suitable for a DNO than the equivalent Oracle product. The acquisition of NIE by the ESB Group created the opportunity to access ESB Intellectual Property Rights in their SAP solution, as well as its experience and resources, which allowed NIE to implement a superior SAP solution within the expected timescales. At the time of the acquisition, the SAP-based solution employed by ESB had been successfully supporting a similar market with high volumes of switching for a number of years, which gave NIE confidence of the ability of a SAP-based solution effectively to support the demands of the NI market going forward<sup>9</sup>.
- 4.27 In Section 6 (Conclusions) the UR's representative states that:
- “Although the Enduring Solution project was tendered in accordance with OJEU rules, NMS effectively became a nominated subcontractor. The Systems Integrator bidders had to negotiate with NMS who must have found themselves in a strong and potentially predatory position. The Systems Integrator contract imposed onerous conditions on the successful bidder to train NMS staff who were also accounted for as part of the contract cost.”*
- 4.28 The Managed Service provider was requested not to bid for the ES delivery contract due to the advantage this would give them over other bidders. A Principles document was developed which set out how the Managed Service Provider would engage with all bidders on an equal footing. Beyond the core services associated with existing applications (data extraction and modifications) the bidders were free to utilise the Managed Service Provider as much or as little as they wished to ensure the competitiveness of their bids. In the event, the successful SI further utilised the Managed Service Provider beyond the core services. This suggests that the SI considered that the Managed Service Provider could deliver these services in a more cost effective manner than the SI. This

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<sup>8</sup> SoC Chapter 6 paragraphs 5.42.

<sup>9</sup> SoC Chapter 6 paragraphs 5.22.

would not support the notion of a 'predatory position'. The reference to 'onerous conditions' to train staff is an emotive term which in this context has no substance. The introduction of a new technology suite to an on-going managed service contract or to an in-house IT support team is common practice and always involves a managed programme of skills transfer.

4.29 In Section 6 (Conclusions) the UR's representative states that:

*"Gemserv understands that over 50% of the customised functionality is still based on the original ESNB developed code and the operational experience of ESNB should have provided a strong base to understand the NIE operational requirements for the cloned system."*

4.30 The System Integrator has confirmed that only 30% of the NIE SAP IS-U implementation reused code developed by ESNB. This relatively small reuse was due to the differences in legislation, market rules and business processes in place in NI and ROI. Support for the ESNB system is provided by an in-house IT Services team.

4.31 NIE were aware of the scale of SAP IS-U support resources required to support the ESB solution but it was unclear how that would be impacted by our differing system and differing support arrangements. Therefore we used the lower early estimates of support resourcing discussed with the Managed Service Provider to support the pre go-live submissions (with the appropriate caveats around uncertainty). As part of their governance role, ESB IT Services reviewed the final support resource plan and confirmed that in their view, this was appropriate to support the system as implemented. As the UR has based its allowance on a rudimentary benchmarking process, it is doubtful that an earlier, more informed view would have resulted in a different outcome in relation to allowances.

4.32 In Section 6 (Conclusions) the UR's representative states that:

*"Since the RP5 BPQ was produced, NIE have produced many variant submissions relating to the ES systems operational costs and many items have been proven to be incorrect and have needed substantive Regulatory resources to analysis and identify issues with these submissions. The latest submission submitted in July fundamentally changed many of the costs and also called for a further review of operation costs during the second year of operation. This does not seem to align with the requirements of a five year price control and is tantamount to a cost plus request."*

4.33 The UR has been extremely critical of the process whereby NIE developed and presented ES operating cost submissions. The UR's reluctance to engage fully with NIE throughout this process and undertake detailed assessment in the more

complex areas of the support arrangements has exacerbated the difficulty experienced in understanding NIE's approach and data. There was, we believe, an expectation within the UR, that this was a simplistic matter which could be resolved at a superficial level. In view of the complexity of the ES system, any such expectation was ill-informed and misplaced.

4.34 In Section 6 (Conclusions) the UR's representative states that:

*“During the summer of 2011, during the discussion on ITC Opex costs, the UR reminded NIE of their obligation to procure efficiently using a competitive selection processes. NIE indicated that the five year managed services contract met this condition and they had no intention of embarking on a further competitive procurement. The UR received a letter in August 2011 confirming this stance. NIE have also stated on more than one occasion that their managed services contractor has the necessary skills to fully support the SAP ISU systems.”*

4.35 The approach to the provision of ES support services was set out in the ES Procurement Strategy and approved by the Project Board, including the UR's representative. Following the switch to a SAP-based solution, the UR produced a set of conditions associated with their approval to proceed: there was no condition requiring a change in procurement strategy. The UR introduced the idea of re-procurement only when it was too late for the project to complete such an exercise in advance of go-live. The many reasons why re-procurement at that stage was ill-advised were set out in detail in NIE's August 2011 letter. No response to this letter has ever been received from the UR. NIE are confident that the approach adopted towards provision of ES support delivers and will continue to deliver low cost IT services to NIE, thereby benefiting NI customers<sup>10</sup>.

4.36 In Section 6 (Conclusions) the UR's representative states that:

*“Early in 2012 it became apparent that inadequate arrangements were in place for post Go Live support. The UR's non-voting member of the Enduring Solution project board indicated the UR's concern on several occasions at project board meetings and the project board recognised this as a risk to the successful handover to an operational support team. It would seem that eventually NIE realised that NMS would not, in isolation, be able to support the new arrangements and started to enter into negotiations with Wipro (the Systems Integrator) to provide SAP ISU support alongside NMS. It is not clear to Gemserv how negotiations at this late stage could result in an efficient and competitive procurement.”*

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<sup>10</sup> SoC Chapter 6 paragraphs 5.40 to 5.47.

- 4.37 As the project entered the user acceptance phase the ES Project Board sought regular updates on the status of the Managed Service Readiness. While the earlier updates identified that the planned activities were running behind schedule due to other project demands there was never any question that the post go-live arrangements were a significant cause for concern or would in any way impact the go-live. A review of the 2012 Project Board Minutes (which were full and signed off as accurate at each subsequent meeting) has identified two meetings where questions were asked by the UR's representative about Managed Service readiness but no concerns were recorded. Detailed progress updates were provided to Project Board at the meetings of 18 April and 25 April prior to the cut-over decision but no questions or concerns were raised by the UR's representative.
- 4.38 NIE did not enter into negotiations with Wipro to provide SAP IS-U support alongside NMS. NMS chose, for perfectly sound commercial reasons, to subcontract certain support activities to Wipro to leverage project experience and to acquire scarce resources. Under the terms of the tendered Systems Integrator contract, NIE retained some transitional Wipro resources for the bedding in period immediately post go-live but these resources were released as quickly as possible. A period of post go-live support from a Systems Integrator is a normal part of any implementation project<sup>11</sup>.
- 4.39 The UR had previously raised this issue with NIE and we responded by explaining the contractual position (in presentation and in writing). It is therefore difficult to understand how this perception remains.
- 4.40 In Section 6 (Conclusions) the UR's representative states that:
- “Gemserv believes it is reasonable to expect organisations such as NIE to procure expert resources efficiently and competitively. In the absence of a competitive tender process that tests the market, it is not possible to confirm the NIE ICT operational proposals are based on efficient and competitive cost and there is much evidence to support a conclusion that operational costs could be much lower than are presently projected.”*
- 4.41 NIE has outsourced its IT services following a competitive procurement exercise which established very low IT operating costs. The ES services are being delivered within this framework, as envisaged when the Managed Service was tendered and when the ES Systems Integrator contract was tendered. NIE has seen no evidence to support a conclusion that the costs are being incurred inefficiently. In fact, IT market benchmarks would suggest that the services are

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<sup>11</sup> SoC Chapter 6 paragraphs 5.48.

being delivered in an extremely low cost manner. We look forward to the CC's review of the UR's evidence, which has so far not been provided for NIE's review<sup>12</sup>.

4.42 In Section 6 (Conclusions) the UR's representative comments:

*"As requested by the UR, Gemserv's advice assumes a well considered competitively procured service and has used this information in the opinions and recommendations provided to date. We realise that this has to be somewhat subjective and accept there is always room for error in providing assurance advice in such complex situations. However, we believe the recommended costs in this report are achievable and could be further reduced in the long term by effective procurement processes and good expert management."*

4.43 Without access to withheld information, NIE cannot comment on whether this 'subjective' review has any basis. In our view, this is an extraordinary concluding remark to a report which appears to be the main basis for a significant disallowance of NIE's IT operating costs.

#### **Section 8 of UR-18**

4.44 In Section 8, within the NIE ES Employee Requirements paragraphs, the UR's representative comments as follows:

*"However, we would refer the UR to the three FTE's that are subject to market opening DT Terms but not relevant to the Enduring Solution. NIE have indicated that these FTE's are providing metering operations services that are not part of Gemserv's remit and are therefore unable to support a case for continued cost recovery. NIE have indicated these FTE's have a continuing role and seek cost recovery. This request has been ignored in this and previous Gemserv reports."*

4.45 NIE is unclear as to the three FTEs referred to by the UR's representative. NIE identified two FTEs engaged in metering operations, recruited following UR approval for the NI2007 project. As stated in NIE's submissions the costs of these employees need to be funded separately if not provided for under the market opening heading<sup>13</sup>.

#### **Section 9 of UR-18**

4.46 In Section 9, paragraph 9.3 (Transitional Costs and D<sub>t</sub> term) the UR's representative comments:

<sup>12</sup> SoC Chapter 6 paragraphs 5.40 to 5.47.

<sup>13</sup> SoC Chapter 6 paragraphs 5.115.

*“Based on the updated review of the NIE July 2012 submission, and the recommendations in Section 7 of this report, Gemserv has proposed an allowance of £17,959.54 for the Enduring Solution ITC Opex over the five year period of the RP5 price control. Gemserv understands the new market systems became operational on the 21st May 2012 and the BAU costs are not funded under the RP4 price control, or the original DT Terms that lapsed on the 20th May 2012; therefore an appropriate allowance needs to be made in a post Go Live Enduring Solution DT term. As the period between 21st May 2012 and 30th September 2012 represents 12.21% of the five year control period, it is suggested that an allowance of £2,193.31k (12.21% of £17,959.54k) is approved if the UR agrees to all Gemserv’s recommendations in Section 7.”*

4.47 The UR is using the ES operating cost allowances calculated for RP5 to set allowances for the RP4 extension period. NIE is exposed to £1.5 million of under recovery against actual costs incurred during the RP4 extension period. Once the CC determines allowances for RP5, NIE expects the UR to revise the RP4 allowances accordingly.

4.48 In paragraph 9.3 of the Transitional Costs and D<sub>t</sub> term section of the report the UR’s representative comments:

*“However, as mentioned earlier in this report, NIE did not plan well for post Go Live operational resources and this also has to be taken into account.”*

4.49 NIE refutes this suggestion completely. The ES project went live on schedule and has been operating successfully since that point. A review of the Project Board Minutes provides a summary of the approach taken to managing the post go-live arrangements and demonstrates that no substantive issues were raised.



## ANNEX 4

### RP5 OPEX – OTHER

#### 1. INTRODUCTION

1.1 This Annex provides NIE's comments on aspects of UR-3 (the UR's opening submission on opex). In this regard:

- Paragraphs 1 to 3 deal with introductory matters that do not warrant a response from NIE;
- Paragraphs 4 to 13 are concerned with efficiency benchmarking, which is addressed in Annex 5 (Benchmarking) to this supplementary submission
- Paragraph 17 is concerned with real price effects, which are addressed in Annex 6 (Productivity and RPEs); and
- Paragraph 18 is concerned with the Enduring Solution IT system, which is addressed in Annex 3.

The comments in this Section are therefore restricted to relevant matters raised in the remainder of UR-3.

#### 2. PARAGRAPH 15 OF UR-3

2.1 In paragraph 15 of UR-3, the UR states that:

*“NIE sought an allowance for £7.4m of workforce renewal in the course of RP5. We rejected that claim in its entirety”.*

2.2 NIE sought an allowance of £4.9 million for workforce renewal in the course of RP5 which was the incremental cost over and above the estimated £2.5 million already included as workforce renewal costs during the course of RP4.

2.3 The UR further states that:

*“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”.*

2.4 NIE does not argue for increased labour costs within the workforce renewal allowance. The workforce renewal allowance is specifically and solely for

recruitment, training and up-skilling costs as a result of retirees, other leavers and increased capex.

2.5 NIE does however seek an allowance to increase labour costs in line with the pay determined for specialist skills throughout the sector. This argument is set out in Chapter 8 (Real Price Effects) of our SoC<sup>1</sup>.

2.6 The UR further states:

*“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.”*

2.7 NIE made that suggestion not in relation to workforce renewal (addressed in Chapter 6 (RP5 Opex) of the SoC) but in paragraph 3.8 of Chapter 8 (Real Price Effects) of the SoC. In that paragraph, NIE states *“over the past 3 years, despite NIE agreeing the generally above RPI pay settlements outlined above, the number of people leaving to take up employment across the UK and beyond has trebled”*. Since the SoC was finalised we have now the figures for the last 12 months and have concluded that in the past 12 months alone the figure has doubled.

2.8 The UR further states:

*“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.”*

2.9 Approximately 45% of the workforce renewal allowance that NIE is requesting is in relation to replacing increasing numbers of retirees and other leavers throughout RP5 and is not directly related to an increase in capex. Furthermore, even according to the UR's projection for capex in RP5 there will be a significant increase in capex relative to RP4. Therefore, a large proportion of the projected workforce renewal allowance will be required irrespective of the agreed level of capex in RP5.

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<sup>1</sup> See pages 211 to 234.

### 3. PARAGRAPH 16 OF UR-3

3.1 Paragraph 16 of UR-3 relates to the opex allowance for the renewables baseline.

3.2 The UR states, in relation to the costs associated with the preliminary development phases of the renewable energy transmission projects, that 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*

3.3 Table 6.41<sup>2</sup> of NIE’s SoC contrasts NIE’s Forecast costs for the renewable baseline with the FD allowance. This indicates that the total shortfall of £2.5 million associated with the renewables baseline arises in the following cost areas:

Cost area	£m
Salaries	0.1
Wholesale market impact	0.5
Allocation of managed service & supply chain	1.9
Total Shortfall	2.5

3.4 This highlights the main area of dispute relates to the allocation of managed service and supply chain overheads. The shortfall against salary costs is only £0.1 million. The UR is therefore not correct to state that the salary levels of relevant staff are the main issue that arises in relation to the renewables baseline.

3.5 In any event, NIE’s submission for salary costs was based on the current cost of the highly experienced staff actually working on renewable projects.

### 4. PARAGRAPHS 21 TO 23 OF UR-3

4.1 Paragraph 21 to 23 of UR-3 are concerned with uncontrollable opex. In paragraph 21, the UR states that the:

*“issues for the Commission to investigate in this inquiry are:*

*(i) to what extent these items really are outside of NIE’s control and should therefore be included in this category; and*

<sup>2</sup> See page 164 of the SoC.

- (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.”*

4.2 The UR refers to rates, wayleaves and licence fees as either fully within NIE’s control and therefore should not be included within the uncontrollable cost category or, as controllable to some extent and whether an alternative risk allocation should be introduced. Rates, wayleaves and licence fees are dealt with separately below.

4.3 In Table 3 of UR-3, the UR sets out the amounts which it says NIE expects to spend on uncontrollable opex in RP5, showing a total of figure of £107.3 million. The figure £107.3 million reflects NIE’s original BPQ submission in February 2011. That figure was updated by NIE for the purposes of both (a) its response to the UR’s draft determination and (b) the SoC to reflect its latest assessment of its uncontrollable opex requirement. The up to date figure is now £95.3 million, as detailed in the table below.

	<b>NIE BPQ</b>	<b>NIE Adjustments</b>	<b>NIE Forecast</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>
Rates	69.0	0.0	69.0
Wayleaves	21.2	0.0	21.2
Licence Fees	5.7	(2.1) <sup>3</sup>	3.6
Injurious Affection	11.4	(11.4) <sup>4</sup>	0.0
Reporter	<u>0.0</u>	<u>1.5</u> <sup>5</sup>	<u>1.5</u>
<b>Total</b>	<b>107.3</b>	<b>(12.0)</b>	<b>95.3</b>

### **Rates**

4.4 In paragraph 23(a) of UR-3, the UR states:

*“It does have some control (at least in the long run) over the rates it pays for its other buildings, 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.”*

<sup>3</sup> Adjustment to reflect licence fee costs included within the UR’s draft determination and FD.

<sup>4</sup> Adjustment to exclude costs on the basis that such costs if incurred will be treated on a pass through basis.

<sup>5</sup> Adjustment to reflect proposal by the UR to introduce a reporter.

- 4.5 NIE refers the CC to NIE's response to the UR's draft determination in July 2012, in which NIE explained (at paragraphs 6.6 to 6.8 of Chapter 6):

"6.6 *The calculation of NIE's rates liability is set out in the Valuation (Electricity) Order (Northern Ireland) 2003 (2003 Order). The Net Annual Valuation (NAV) is calculated in accordance with a formula based on the growth in transmission circuit length and distribution MVA transformer capacity.*

6.7 *The UR has suggested that rates are semi-controllable because NIE has a choice over the location of its buildings/offices. However this reasoning is wrong. NIE's rates are based on the formula set out in the 2003 Order. Land and Property Services calculate the NAV based on circuit length and transformer capacity. This NAV is then apportioned over various district councils in NI and regional and district rates are then applied to determine the overall rating liability.*

6.8 *The NI Finance Minister has announced that a NI ratings revaluation will take place in April 2015. This timing would align with the next revaluation of nondomestic properties in the rest of the UK. The effect which this revaluation will have on NIE is unknown."*

- 4.6 NIE's rates are fixed by a statutory formula over which NIE has no control. For that reason, it is appropriate that these costs are funded on a pass-through basis.

### **Wayleaves**

- 4.7 Paragraph 23(b) of UR-3 states that:

*"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. But that is just the choice that NIE T&D has made (no doubt reflecting the fact that it has no incentive to 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."*

- 4.8 NIE refers the CC to NIE's response to the UR's draft determination in July 2012 in which NIE explained (at paragraphs 6.12 to 6.14):

"6.12 *A wayleave permits NIE to install electric lines and associated equipment on, over or under private land and to have access to that*

*land. The landowner is compensated in the form of wayleave payments. If a landowner withholds consent NIE is able to apply to DETI for a 'necessary wayleave', but this is a lengthy process which adds cost.*

6.13 *NIE does not negotiate wayleave payments on a case-by-case basis with individual landowners. Rather, NIE's rates are based on Scottish Power's wayleave rates which are in line with the rates recommended by the Electricity Networks Association (ENA) which acts on behalf of the UK electricity network companies. The ENA uses rates reviewed in accordance with detailed studies carried out by the Agricultural Development Advisory Service (ADAS) to calculate, revise and recommend wayleave payment rates. NIE updates the farmers' unions annually with the recommended wayleave payment rates.*

6.14 *This approach has significant benefits in ensuring that landowners and their representatives are satisfied that the payment being made by NIE is fair and non-discriminatory and that any challenge to those rates is unlikely to be successful. This in turn enables NIE to process a high volume of agreements with individual landowners on a consistent basis and reduces the need to apply for necessary wayleaves thus avoiding the associated costs. Any disparity between NIE rates and Scottish Power and similarly ENA/ADAS rates could result in landowners seeking to challenge the payment offered by NIE in the Lands Tribunal of Northern Ireland. If such challenges were successful it could be expected that NIE would be required to negotiate specific rates for individual landowners on a case by case basis. The additional administration and resource burden that this would place on NIE would be significant. For these reasons it is considered that NIE wayleaves payments must be in line with those set by Scottish Power and ENA/ADAS and should not be the subject of individual negotiation with landowners."*

4.9 The current processes for paying wayleaves are therefore efficient. The UR's proposal that NIE might negotiate lower wayleave rates in NI would significantly increase the cost of administration and it is extremely unlikely that lower rates could be agreed.

4.10 Wayleaves are therefore an uncontrollable cost and should be treated as a pass-through cost.

### **Injurious Affection**

4.11 Paragraph 23(d) of UR-3 states that:

*“So far no such claims against NIE T&D have proceeded to judgement. 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’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.”*

4.12 NIE refers the CC to 7.8 and 7.9 of NIE’s SoC, in which NIE explains

*"7.8 NIE is currently in receipt of a number of claims for injurious affection and the Lands Tribunal of Northern Ireland is currently considering the legal and valuation issues associated with a number of these claims. The outcome of this process is uncertain. While precedent exists in GB, there is no precedent for the payment of such claims in Northern Ireland.*

*7.9 It follows that the costs associated with injurious affection that NIE will incur in the next few years are so unpredictable as to be unsuitable for ex ante regulation. A different approach may be possible in later regulatory periods once the scale of these costs becomes known."*



## **ANNEX 5**

### **BENCHMARKING**

#### **1. INTRODUCTION**

1.1 As will have been clear from NIE's SoC (Chapter 7), NIE has material concerns over the benchmarking that has been used to support the UR's FD. The UR has not adequately addressed NIE's concerns in its supplementary submission to the CC (UR-26) following NIE's SoC. After providing some context to the benchmarking exercises that have been undertaken, NIE summarises its concerns over:

- the UR's benchmarking of R&M and total opex.
- the UR's benchmarking of indirect costs; and
- the new points raised by UR for further investigation

#### **2. CONTEXT**

2.1 Part of the difficulty in responding to the points the UR has raised in its submission in respect of its benchmarking of indirect costs is that there is a lack of clarity around exactly what analysis CEPA has undertaken on behalf of the UR.

2.2 NIE started the engagement with the UR on benchmarking by submitting a report written by Frontier Economics in February 2011. This was reviewed by CEPA, the UR's consultants, and an updated version of the Frontier report was submitted in June 2011. These Frontier reports were based on a dataset that was drawn from Ofgem's DPCR5 Financial Model (for the DNOs), and NIE's costs mapped to the DNO cost classifications for 2009/10 (and also 2007/08 and 2008/09 for R&M). Frontier's analysis of indirect costs was updated to include 2010/11 data (from Ofgem's annual cost report) in August 2012.

2.3 As well as commenting on Frontier's work, CEPA undertook its own analysis in October 2011 (made available to NIE as an annex to the draft determination in April 2012) and October 2012 (in support of the FD, although no updated CEPA report has been made available to NIE) on a private database that only extends as far as 2008/09. Whilst the results of the analysis have been made public, NIE has not had access to much of the underlying data or analysis that has driven the results.

- 2.4 In summary, NIE's approach was proactive, open, responsive to feedback, and made use of an authoritative database and the most recently published reports. In contrast, the UR's approach has been reactive, closed, largely unresponsive to feedback and based primarily on data that ended in 2008/09. This lack of transparency exacerbates NIE's concern that the UR's position stems from what appears to be poorly justified and partial assumptions, which give rise to material adjustments to the quantum of NIE's costs that have been benchmarked.
- 2.5 NIE has similar concerns over the transparency of the UR's recent benchmarking of capex, which again has not presently been made available for peer review.
- 2.6 NIE notes that the UR intends to submit a further benchmarking report to the CC in due course. NIE would welcome further analysis and will review closely whatever material the UR submits. As noted in the Overview to this supplementary submission, NIE is concerned that the UR has been unable to submit these reports within the timelines laid down by the CC.
- 2.7 As the UR notes, the CC might choose to undertake its own analysis of NIE's efficiency in the course of its investigation. NIE would be happy to support that exercise and will provide the fullest possible cooperation, as it has done hitherto throughout the course of RP5. Notwithstanding this, NIE wishes to make the observations set out below on certain points raised by the UR in its Initial and Supplementary Submissions.

### **3. BENCHMARKING R&M AND TOTAL OPEX**

- 3.1 Frontier's benchmarking assessed the efficiency of both direct (R&M) and indirect opex. The UR has taken the view that it has been unable to benchmark R&M reliably, and consequently that it has similarly been unable to benchmark total opex (see for example paragraph 29 of UR-26). The primary argument put forward in CEPA's report<sup>1</sup> for the UR is that the disaggregated cost drivers necessary to undertake this benchmarking do not exist. This argument is repeated by the UR in its Initial Submission (UR-3, paragraph 7), along with wider criticism of NIE's 'lack of transparency and accountability'.
- 3.2 In respect of the question of whether it is possible to benchmark R&M and total opex, NIE is not persuaded by the arguments presented by the UR and CEPA. First, it is reasonable to suppose that R&M will be driven to a large extent by the volume of network assets. This overarching driver of R&M can clearly be captured well by simple scale variables of the type that are readily available, especially if the sample is long enough to be satisfied that any year-to-year volatility in R&M costs

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<sup>1</sup> "NIAUR-Opex evaluation: Efficiency assessment of NIE's operating expenditure", CEPA, October 2011.

can be assessed and addressed. Frontier's analysis against scale variables (the CSV) suggests that NIE's performance on R&M was consistently sector leading in each of the three years analysed and given the consistency of this result there is no reason to suppose it derives from year-to-year volatility.

- 3.3 Second, recent work by Frontier Economics at the RIIO-GD1 review showed that the weighted average of the disaggregated cost drivers (of the sort that CEPA asserts are necessary) used by Ofgem was very highly correlated with simple measures of scale such as MEAV, throughput, customer numbers and network length. This result provides further confirmation that these costs can be benchmarked with a suitable level of robustness using simple scale variables.
- 3.4 Third, it is now increasingly understood that such high levels of disaggregation create arbitrary cost boundaries that could create measurement error or distort behaviour.
- 3.5 The effect of the UR's conclusion on the feasibility of benchmarking R&M and total opex is that it ignores the results of analysis that would suggest that NIE is efficient. As noted, Frontier's analysis of R&M costs on more aggregated cost drivers would place NIE in the upper quartile, and CEPA's analysis of total opex for the UR would place NIE just 0.2% away from the upper quartile, notwithstanding the continued presence of other material flaws in CEPA's work noted by NIE in its SoC (Chapter 7, Section 2).
- 3.6 Lastly on the specific question of the availability of data to support analysis of tree cutting, NIE recognises that in GB, 'Spans cleared' is a measure that Ofgem developed with the DNOs to measure and record tree cutting outputs. The fact NIE 'was unable to produce' the same data is down to the fact that NIE has never previously been required to provide any specific tree cutting outputs to UR and owing to this the data was not collected. Had UR signalled in a timely manner that data on spans cleared was considered necessary to support its analysis at RP5 then NIE would have ensured its availability. Should that data be required in future then NIE will put in place processes and systems to ensure it is captured so far as is possible on a comparable basis.

#### **4. BENCHMARKING OF INDIRECT COSTS**

- 4.1 The UR has determined to apply an inefficiency discount of 7% for controllable opex, on the basis of its benchmarking of NIE's indirect costs. As noted in NIE's SoC, there are a number of material flaws in the UR's analysis of indirects which cause the UR to significantly understate NIE's efficiency. NIE's most significant concerns are summarised below, responding to points raised in UR-26.

### **Market opening costs**

- 4.2 There is a disagreement between the UR and NIE in respect of the quantum of NIE's market opening costs that should be included in the benchmarking analysis (see UR-26, paragraph 31).
- 4.3 In GB, the DNOs are responsible for the provision of just one service to support the operation of the competitive retail market, i.e. to maintain a database of metering points (the Metering Point Administration Service). In contrast, NIE is responsible for providing all retail market support services in NI. For benchmarking purposes it is necessary to estimate the quantum of cost incurred by NIE in support of the retail market that would be comparable with that of the GB DNOs, a task made difficult by the significant difference in role of NIE relative to the GB DNOs, and the more fundamental differences in wider market arrangements between BETTA and the SEM.
- 4.4 CEPA and the UR have included an estimate of £500,000 for these costs in its most recent benchmarking. This significantly exceeds NIE's own estimate of £125,000 in 2009/10 and £185,000 in 2010/11. No evidence has been provided in support of the UR's estimate. Should the UR or the CC make fresh information available NIE will consider it in full and give it appropriate weight.

### **Consistency of costs in the benchmarking and baseline opex**

- 4.5 The UR has noted NIE's concerns over the consistency of the costs included in its benchmarking study and the costs included in the opex baseline to which the resulting efficiency discount is applied. NIE is not persuaded by the UR's assertion (in UR-26 paragraph 32) that its approach is entirely internally consistent, but a review of the data to which NIE has hitherto been denied access should resolve this issue definitively.

### **Sparsity**

- 4.6 NIE's approach to benchmarking has been to exclude all regional factors. This does not mean that they are unimportant or irrelevant, but reflects the fact that efficiency assessments can have a tendency to get bogged down in sterile debates about company-specific factors, rather than focus on whether there is clear evidence of efficiency or inefficiency on the basis of a range of evidence. NIE's approach has built on Ofgem's modelling framework, which was also to ignore regional factors unless there were compelling reasons for some adjustment that could not be expected to even out in the round.
- 4.7 NIE raised the issue of sparsity because the UR has chosen to introduce one regional factor (i.e. regional wages), but ignore others (e.g. sparsity). It is this

cherry-picking of potentially relevant company-specific factors that NIE's original approach was intended to avoid.

- 4.8 Now that the UR has questioned whether sparsity is relevant (UR-26, paragraph 33), it is worth noting that there are good reasons to expect it to drive costs. First, indirect costs are incurred in supporting NIE's direct costs. If sparsity increases the size of NIE's network and the size of its field operations (such as R&M) it is likely that a larger "back office" will be required to serve those field operations. While certain indirect costs are largely fixed in nature – so it is reasonable to suppose that sparsity will affect indirect costs to a lesser degree than direct costs – NIE does not accept that it doesn't affect costs at all. Second, recent analysis by Frontier for Ofgem shows a role for density in totex regressions, highlighting that serving a sparsely populated region does give rise to higher cost, although the extent to which the strength of the effect drives direct or indirect costs was not assessed.
- 4.9 In summary, NIE would urge the CC to consider regional effects in the round. NIE's view was that on balance regional effects were not necessary to include in the model.

### **Regional wages**

- 4.10 As set out in detail in NIE's SoC, there has hitherto been a disagreement as to the best method of estimating the quantum of any difference in regional wages (see also UR-26, paragraph 34). The UR made use of high level, 2 digit Standard Occupational Classification codes (SoCs). NIE considers this approach to be flawed, as the high-level codes cover types of labour that are wholly irrelevant to NIE and its business. NIE has proposed that, if a regional wage adjustment is to be undertaken, then it should be based on more detailed 4 digit SoCs, where it is possible to identify the specific types of labour that comprise NIE's workforce. Analysis of the data for these 4 digit codes reveals that the UR's method appears to materially overstate the effect of regional wage differences, to NIE's disadvantage.
- 4.11 It is helpful that in its Initial Submission (UR-3, paragraph 13) the UR agrees with NIE that "in principle disaggregation is of course desirable as a way to improve the validity of the comparison". That this is common ground is clearly welcome. However, the UR remains concerned over the "reduction in sample size, which tends to increase the volatility of the data" and consequently still regards its flawed, high level approach to be superior.
- 4.12 In respect of the sampling error associated with the use of 4 digit SoC codes, the UR's concerns are overstated. This follows because:

- it is the common approach of both NIE and the UR that any adjustment should be derived from a weighted average of SoCs; and
  - it is the common approach of both NIE and the UR to base that adjustment on an average of several years (e.g. CEPA used the period 2006-2010 inclusive).
- 4.13 One consequence of this averaging over a number of years and across a number of SoCs is to reduce materially the sampling error associated with the resulting weighted average value. Hence, NIE's view is that the UR has not made the case for the use of high-level, 2 digit codes.
- 4.14 Finally, NIE observes that, while the UR has hitherto objected to the use of 4 digit SoC data in support of indirect benchmarking on the grounds that it is unreliable, it had no similar objection to using 4 digit SoC data in supporting its salary benchmarking. The inconsistency in the UR's position between these two areas is clear.

### **Connections**

- 4.15 While it appears to be agreed that a connections adjustment to NIE's cost base is needed in order to ensure a like-for-like comparison with the GB DNOs, the UR has called into question the estimate that NIE has provided (UR-3, paragraph 8). The UR considers that this number is high compared to its "anecdotal evidence". No further detail has been provided to support the UR's concern.
- 4.16 NIE's estimate of the share of connections was based on a bottom up analysis of time sheet data and FTEs that support connections, an approach which NIE considers to be entirely reasonable.
- 4.17 Full detail of the analysis undertaken by NIE was passed to the UR and its consultants during CEPA's peer review of Frontier's benchmarking report. The basis of NIE's estimate has therefore been known to the UR for approaching two years and has not hitherto been questioned.
- 4.18 The UR's concern appears to be based entirely on a high level comparison against its "anecdotal evidence". However, there is one obvious reason why NIE's connections activity might appear large relative to that of GB DNOs, which is that at present the connections activity is not contestable in NI, whereas it is in GB. In GB, according to the latest Ofgem report<sup>2</sup>, the incumbent GB DNO provides 77.3% of metered connections<sup>3</sup> made in GB, whereas NIE will provide 100% in its service

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<sup>2</sup> Electricity Distribution Annual Report for 2010-11, Ofgem 30 March 2012. See for example Table 6.1 on page 44.

<sup>3</sup> NIE notes that the incumbent DNO delivers 97.6% of unmetered connections in 2010-11. However, most unmetered connections are small scale LV connections (a less attractive market for

region. Notwithstanding any other difference that might be relevant, this is likely to explain why NIE's number, on casual inspection, appears "high".

### **Effect of NIE's capitalisation policy**

- 4.19 The UR indicates (in UR-26, paragraph 75(b)) that the CC should investigate the effect of NIE's capitalisation policies on base year opex and the opex benchmarking. The UR also raised the issue of capitalisation in its Initial Submission (UR-7, paragraph 9), where it suggested that NIE had not provided information (the nature of which is not specified) in time for it to be taken into account in its benchmarking.
- 4.20 The UR's concern highlights a fundamental misunderstanding of the cost mapping work that was undertaken by Frontier and NIE. As set out in the SoC the cost mapping work seeks to replicate the Ofgem accounting rules in respect of whether costs are "direct" or "indirect". The cost mapping work considers only the underlying nature of the activity that gives rise to any cost and Ofgem's treatment. It takes no account of how any given cost might be treated by NIE for statutory or regulatory accounting purposes. NIE's capitalisation practices are therefore rendered irrelevant by the cost mapping and play no role in determining the extent of NIE's indirect costs.
- 4.21 The detail of the cost mapping was shared in full with the UR and its consultants (CEPA) and Frontier met the UR's consultants to explain all elements and ensure it was properly understood and peer reviewed. The UR should therefore have been well aware that there is no scope for capitalisation policies to have affected either NIE's or the UR's benchmarking of opex.

## **5. APPLICATION OF ANY INEFFICIENCY FACTOR**

- 5.1 The UR also raises two further points for discussion in relation to the application of a cost reduction target (UR 26, paragraph 75c) whether NIE should:
- be required to operate at the opex efficiency frontier rather than only to meet the upper quartile of efficiency; and
  - be expected to improve its opex efficiency in a shorter period than the two years proposed by the UR in its FD.
- 5.2 Notwithstanding that Frontier's benchmarking shows NIE to be efficient such that no catch-up is required, these points are addressed below. For the avoidance of

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competition) and based on Ofgem data this segment is likely to make up no more than 13% of the connections market by value.

doubt, however, NIE considers that as an upper quartile company, an efficiency adjustment is unnecessary and the discussion is largely irrelevant.

### Scope of catch-up

- 5.3 It is common practice to set the catch-up target at a lower level than would be implied by the frontier level of performance as revealed in a benchmarking study in order to account for noise and the inevitable imperfection in cost drivers. Ofgem acknowledged in DPCR5 that its benchmarking results and the quality of its underlying data for the GB DNOs did not justify setting allowances at the frontier.

*“For each cost category we have had to decide whether we set the benchmark level at the frontier (i.e. the level of the most efficient company), the upper quartile (the top 25 per cent companies), the upper third (the top 33 per cent of companies) or at the average level. In general our approach is to use the upper quartile. We do not consider that our benchmarking results or the quality of the underlying data justify setting allowances according to the frontier, and to do so would discredit our work.”<sup>4</sup>*

- 5.4 Consequently, at DPCR5, Ofgem defined the upper quartile as the benchmark for indirect costs, and the upper third (or the top 33 per cent) as the benchmark for network operating costs, due to the perceived greater variability in that data.
- 5.5 In Ofgem’s most recent price-control, RIIO-GD1, Ofgem not only defined the upper quartile of the GDN’s costs as the benchmark, but also required the GDNs to close only 75% of the gap.
- 5.6 “We defined efficient costs equal to the upper quartile (UQ) GDNs costs rather than the frontier allowing for other factors that may influence the companies costs. We also assumed that GDNs would close only 75 per cent of the assessed gap between their forecasts and the UQ.”<sup>5</sup>
- 5.7 In the CC’s own assessment of the Bristol Water case, it determined a catch-up rate of 60% of the frontier firm to be appropriate. “The main justification for having the 60 per cent catch-up rate over a five-year period is that there is noise in Ofwat’s efficiency estimates”.<sup>6</sup>
- 5.8 This review of recent regulatory precedent reveals that it is common practice to set the benchmark at least as low as the upper quartile. This would be appropriate in the light of the significant uncertainties associated with the UR’s benchmarking analysis.

<sup>4</sup> “Electricity Distribution Price Control Review Final Proposals – Allowed Revenue – Cost Assessment”, Ofgem, December 2009, paragraph 1.49.

<sup>5</sup> “RIIO-GD1 Final Proposals – Supporting Document– Cost Efficiency”, Ofgem, December 2012, paragraph 1.10.

<sup>6</sup> The CC (2010), ‘Bristol Water plc Price Limits Determination’, September. Paragraph 67.

**Timing of catch-up**

- 5.9 The UR has proposed that NIE T&D should be allowed the first two years of RP5, i.e. 2012/13 and 2013/14, to achieve a catch-up of 7%. The UR invites the CC's views on whether NIE T&D should be expected to improve its opex efficiency in a shorter period than the two years proposed. NIE considers a shorter period than the two years to achieve a target at this level to be inappropriate and unachievable. The UR's own assessment in the draft determination<sup>7</sup> suggests that it would be difficult for NIE to achieve the significant level of savings implied by its efficiency adjustment in a single year.
- 5.10 NIE agrees with the UR's view that, should it be required to deliver savings on the scale requested by the UR, the level of saving implied could not be achieved in a single year.
- 5.11 NIE remains confident that an efficiency target will prove to be unnecessary. Should the CC disagree it will be necessary to consider carefully the period over which it is reasonable to require NIE to close any gap.

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<sup>7</sup> Paragraph 10.23.



## ANNEX 6

### PRODUCTIVITY AND RPEs

#### 1. INTRODUCTION

- 1.1 The UR in its supplementary submission to the CC (UR-26 and UR-28) raises certain points in relation to the estimation of on-going productivity and real price effects (RPEs). This Annex sets out NIE's response to the points raised by the UR.

#### 2. ESTIMATION OF ON-GOING PRODUCTIVITY

- 2.1 The UR has raised two main points in relation to on-going productivity:

- first, on the level of the on-going productivity target and its relationship to RPEs; and
- second, on the scope of application of the on-going productivity target in the price control.

- 2.2 NIE's response to each of these is set out below.

##### **On-going productivity and its relationship to RPEs**

- 2.3 In respect of on-going efficiency, the UR misrepresents NIE's position (UR-26, paragraph 16). It is not the case that NIE 'considers that there is no more room left for it to improve on opex efficiency such that it considers that an on-going efficiency target is inappropriate'. In contrast, as set out in its SoC (Chapter 7 Section 3), NIE acknowledges that future savings are possible, but cautions they are likely to be small in scale and incrementally driven when compared to past savings.
- 2.4 In its SoC (Chapter 7) NIE also presented its views on the arguments that the UR has hitherto relied on to support its view that on-going productivity should be assumed at a level of 1%. For the reasons set out there, NIE considers that none of these arguments have merit and, consequently, at present, no justification has been provided to support the UR's assumption that 1% per year on opex is reasonable.
- 2.5 NIE acknowledges that it is standard regulatory practice in GB to impose an on-going productivity target (as documented by First Economics in UR-28) and it anticipates that the CC will wish to do so here. In setting this target, NIE's view is that this should be considered jointly with the level of RPEs, as also suggested by

First Economics. Indeed, this provides a helpful context within which to set out NIE's high level views, pending more detailed investigation of this issue by the CC.

- 2.6 NIE considers that in "steady state" it is reasonable to anticipate that on-going productivity and RPEs will largely cancel out. This follows because as labour becomes more effective over time and creates savings, these will be captured by labour (which will earn its marginal product) and will not be available to be shared between customers and shareholders.
- 2.7 However, it is clear that the electricity network industry has not been in steady state over recent years. Similarly, it seems unreasonable to expect that it will be in steady state going forward.
- 2.8 In the period immediately following privatisation, both in NI and GB, it is widely acknowledged that the DNOs were inefficient and that significant cost reductions were possible. This proved to be the case, and all DNOs, NIE included, made significant cost reductions. Since these cost reductions were achieved largely through the elimination of "slack", there was no need to pay labour more for securing these improvements. Consequently, on-going productivity significantly outstripped RPEs during the initial price control periods following privatisation, leading to significant overall cost reductions.
- 2.9 Circumstances are now very different.
- The great majority, if not all, of the original legacy of inefficiency has been addressed and network operators now begin from a far more efficient base. It follows from this that the rate of on-going productivity is likely to have fallen in recent years and will continue to fall going forward. There is a risk that the future scope for on-going savings might be overstated.
  - Additionally, the policy imperative to decarbonise the economy has given rise to a set of new challenges that are beginning to change the level of demand for electrical network services and in time will change the role of those networks.
    - In order to meet the needs of renewable projects, network operators (including NIE) are engaging in large scale, complex, greenfield construction. Undertaking such work implies a higher level of risk of cost overruns than has previously been the case when the role of the network operator was to simply maintain and replace. NIE must now not only maintain and replace a significant proportion of its ageing network, it must now also expand its network.
    - The large increase in demand for new network is also having a direct effect on input prices, specifically with regard to labour. NIE has

presented a wide range of information on its workforce in its SoC (see in particular Chapter 7 and Chapter 8 which address NIE's Efficiency and Real Price Effects), noting that it will need to be expanded at a time when a significant number of staff will retire and in the face of a marked tightening in the supply of sufficiently skilled labour. NIE is not alone in facing these pressures – they are common to all electrical network operators in GB and consequently NIE expects significant real increases in its labour costs going forward, as reflected in its assessment of RPEs.

2.10 Owing to these factors, NIE considers that future productivity savings will be modest with the threat of cost overruns more pronounced than was the case in the past, while NIE will be asked to manage significant inflationary pressures.

2.11 It will be necessary for the CC to weigh up these risks, as other regulators have done. It is noteworthy that recent regulatory determinations show that RPEs have matched or exceeded on-going efficiency in all but one of the determinations summarised by First Economics (UR-28, see Tables 1 and 2).

2.12 The most relevant sector for comparison with NIE is of course the GB DNOs. Ofgem is currently undertaking its ED1 price control review of these operators, and it has stated that it will apply the same methodology for electricity distribution RPEs and productivity as it applied in the transmission and gas distribution reviews. It has not yet published the results of this analysis, but two of the GB DNOs have published information about their assumptions for RPEs and on-going efficiency for the ED1 period:

- WPD (one of the companies that Ofgem found to be most efficient at DPCR5) is projecting an aggregate uplift of £188 million to its cost base across its four licensees, over the 8-year period to account for Real Price Effects net of productivity<sup>1</sup>. This represents a net uplift to WPD's core cost base of c.2.85% (given its own estimate of a total cost base of approximately £6.6 billion). Underlying this aggregate picture, WPD has stated that its annual productivity assumption is 1%, and its RPE assumptions are based on analysis completed by First Economics. The combined effect of the two is a sizeable uplift to total costs.
- UKPN's analysis is a little less transparent, but it appears to be projecting an aggregate uplift of £210 million to its cost base across its three licensees, over the 8-year period to account for RPEs net of productivity<sup>2</sup>. This represents a net uplift to UKPN's core cost base of approximately 2.8%

<sup>1</sup> See WPD Draft Business Plan, March 2013, page 78 and 123-124.  
<http://www.westernpower.co.uk/docs/Stakeholder-info/WPD-Draft-Business-Plan-2015-2023-Published-online.aspx>

<sup>2</sup> UK Power Networks, 2015 to 2023 Business Plan Update, April 2013, Tables 20-23.

(given its total cost base of approximately £7.3 billion). Underlying this aggregate picture are annual RPEs of 1.2% p.a. for operational activities and 1% p.a. for network investment as estimated by NERA, with a productivity factor that “offsets, in part” the RPE effect, also estimated by NERA.

### **Application of productivity factors in the price control**

2.13 The UR has also raised two points for further discussion in relation to the application of the on-going productivity factor in the price control:

- whether the 1% on-going 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 (UR-26, paragraph 75(d)); and
- whether an on-going productivity adjustment should be made for capex (UR-26, paragraph 75(i)).

2.14 On the first point, NIE acknowledges that it is Ofgem’s practice to apply productivity from the base year. Whether the CC considers it is appropriate to do so here might depend on the nature of its benchmarking and the year(s) analysed and its assessment of the balance of risks as outlined above. On the second of these points, NIE acknowledges that it is Ofgem’s practice to apply a productivity target to capex, but considers that if such a target is to be applied then it should be smaller in scale than that applied to opex, owing to the challenging nature of NIE’s capex programme as outlined above.

## **3. ESTIMATION OF RPES**

3.1 The UR also raised two specific concerns with regard to NIE’s estimation of RPES:

- on NIE’s outturn labour costs and the efficiency of its pay settlements (UR 26 paragraphs 17); and
- on the input weights used in NIE’s estimation of RPES (UR 26 paragraphs 36).

3.2 NIE’s response to each of these is discussed in turn.

### **NIE's outturn labour costs**

3.3 The UR states that:

*“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.”*

3.4 In respect of outturn labour costs and the question raised in regarding the efficiency of NIE's pay settlements, NIE considers that it has demonstrated in its SoC (Chapter 8, Section 3) that its pay settlements:

- closely match those awarded by other electrical network operators when considered over a reasonable period;
- have resulted in outturn salary levels that are efficient; and
- which have helped to deliver an overall level of operational performance that is efficient.

3.5 While the RPEs NIE has experienced are markedly different from those proposed by the UR, NIE considers the level of each of its pay settlements to have been appropriate, necessary and efficient.

3.6 NIE has over many years exercised tight control over its labour costs. NIE's pay strategy is based on external benchmarking against market rates combined with annual pay awards that have been linked with RPI. Any above-RPI pay awards have been based on efficiency/productivity improvements which have helped the company up-skill its workforce and reduce employee numbers from 3,000 at privatisation to approximately 1,300 today (comparing the T&D business on a like-for-like basis).

3.7 Over the past three years, despite NIE agreeing the RPI-linked pay settlements outlined above, the number of staff leaving to take up employment with other companies across the UK and beyond has trebled due to significant increased demand for specialist skills and active headhunting activity. NIE has also experienced increased discontentment in its workforce regarding recognition and reward. In its most recent employee survey only 37% of employees were satisfied

with recognition & reward in the company (10% lower than the benchmark for similar companies).

- 3.8 Given this, NIE considers that it is appropriate for these pay awards to be taken into account when calculating RPEs.

### **Input weights to determine RPEs**

- 3.9 The UR states that:

*“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.”<sup>3</sup>*

- 3.10 The first of the two points raised in this paragraph, with respect to labour costs, is addressed above. In respect of input weights, there are obvious difficulties with adopting First Economics’ prescription that we should analyse the input structure of only some notional, frontier firm, since this would require a real or hypothetical firm with known input structure to be found and analysed. A more practical solution would be to assess the reasonableness of NIE’s input mix, in the light of its service region and its role as combined transmission and distribution operator, and to then use that as a basis for estimating RPEs going forward. NIE considers that it has provided sufficient evidence to support such a review by the CC in its SoC and related submissions. In addition it is NIE’s view that it has demonstrated that it is efficient in its operations and consequently can be considered to be a “frontier firm”, as desired by First Economics.

- 3.11 NIE notes that the UR questions the ‘vast’ proportion of NIE’s workforce that is considered to be specialist in nature. NIE considers that the UR has significantly under-estimated the proportion of the workforce that should be regarded as specialist, rather than general. NIE considers that there are three reasons for this, which are that the UR:

- has taken no account of the operating model that NIE has found it necessary to adopt in order to address efficiently the challenges of serving a sparsely populated region;
- has not properly evaluated the up-skilling model adopted by NIE to achieve the reduction in labour from 3,000 to 1,300 through not replacing leavers over many years and up-skilling the employees that remain especially in the administration and craft roles; and

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<sup>3</sup> UR 26, paragraph 36.

- has not assessed whether it is reasonable to consider that a recruit from the general labour market would be an adequate substitute for an existing member of NIE's skilled workforce should they leave.

3.12 The UR has failed to address any of these points in its submissions so far.



## ANNEX 7

### INCENTIVES AND INNOVATION

#### 1. INTRODUCTION

- 1.1 This Annex responds to the attempts made by the UR in UR-26 to address NIE's concerns with its proposals for Incentives and Innovation.

#### 2. COMMENTS ON UR-26

- 2.1 In paragraph 18 of UR-26 the UR states as follows:

*"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 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. 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. 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."*

- 2.2 The UR does not respond in detail to the deficiencies highlighted by NIE in Chapter 9 of its SoC. Rather the UR relies simply on stating that it considers that its proposals create the right incentives for NIE to act in customers' interests during RP5, without setting out clearly what they consider these "incentives" or "interests" to be. Neither does it address NIE's concern that the UR's proposals are heavily skewed towards penalising NIE for underperformance, coupled with unreasonable allowances, and provide little opportunity for NIE to innovate to provide a better quality of service to customers.
- 2.3 The UR refers to its desire to move to "*a more outcome (in the sense of CML, CI, health and load indices etc) oriented system of economic regulation*" and suggests that they have sought other forms of incentives for RP5 because NIE "*has not developed the requisite metrics*". NIE does not agree: CML and CI metrics have been established in NI for over 20 years. Furthermore, NIE is committed to work with the UR to develop secondary network measures such as health and load indices to supplement its regulatory reporting within an overall RPI-X regulatory framework. While their development may lag a few years behind that in GB, this should not prevent the development of a well-constructed system of incentive-based regulation such as that which has been in place in GB over several recent price control periods.
- 2.4 The UR states that NIE considers the network performance incentives as "*being too challenging*". This misrepresents NIE's position, which is clearly set out in our SoC<sup>1</sup>. NIE's concern is that the UR incorrectly describes<sup>2</sup> its proposal as providing a symmetrical incentive. Furthermore, NIE submits that the UR's calibration of the incentive would in practice provide no meaningful incentive to improve network performance. The UR does not address this concern but simply points out that the calibration safeguards NIE from excessive penalties. This misses the point that the calibration provides no meaningful incentive to improve quality of service to customers.
- 2.5 The UR makes reference elsewhere<sup>3</sup> to its proposal to fund "smart solutions" through Fund 3. However, this does not address the fundamental point raised in NIE's SoC<sup>4</sup> as to what real incentive NIE has to pursue "smart solutions" in the first place. The UR's capex proposals substantially reduce NIE's flexibility or incentive to change its initial capex plan. There is therefore no potential upside for NIE in seeking innovative solutions. Indeed, the UR's proposed ex post review process gives rise to significant downside risk. Innovative solutions have inherently less certain outcomes when compared with conventional investments and, in the event that they were not to turn out as planned, may be deemed by the UR (with the

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<sup>1</sup> NIE SoC, Chapter 9, paragraphs 3.10 to 3.24.

<sup>2</sup> Final Determination, paragraph 9.12.

<sup>3</sup> UR-26, paragraph 42.

<sup>4</sup> NIE SoC, Chapter 4, paragraph 4.11.

benefit of hindsight) to have been inefficient when subjected to ex-post review. NIE would have no reason to innovate and run the risk of cost disallowance in circumstances where, in a best case, it can only hope to recover its costs. This is addressed further in Section 2 of Annex 1.



**ANNEX 8****PENSIONS****1. INTRODUCTION**

- 1.1 This Annex sets out NIE's comments on UR-5 (the UR's opening submission in relation to pension) and UR-26 in relation to pensions.

**2. COMMENTS ON UR-5**

- 2.1 Paragraph 5 of UR-5 states that:

*“Following the dot-com crash in 2000/2001, however, the scheme has been in a constant state of (substantial) deficit.”*

- 2.2 The deficit agreed for funding purposes following the 31 March 2003 valuation was £72.9 million. The deficit fell to £44 million as at 31 March 2006 and the NIE's shareholder agreed to clear this deficit by the payment of a special shareholder contribution of £50 million in March 2007. The annual actuarial report as at 31 March 2007 showed a surplus of £18.6m.

- 2.3 The deficit which has arisen since 31 March 2007 reflects lower than expected investment returns and increases in life expectancy that have affected pension schemes generally.

- 2.4 Paragraph 5 further states:

*“NIE's latest valuation for the purposes of the RP5 review put the deficit at £222.5m as at 31 May 2012.”*

- 2.5 The latest actuarial funding update from Aon Hewitt prepared for the Scheme's trustees shows a deficit of £ 135.5 million as at 16 May 2013. A copy of this updated is provided at Appendix 8A.1.

- 2.6 Paragraphs 6 and 7 of UR-5 state that:

*“In the FD, we allowed the full amount of the on-going pension costs (£10.5m) that had initially been claimed by NIE T&D (i.e. contributions other than those made in respect of the deficit) on the basis that they were broadly in line with market norms.”*

*NIE T&D has since asked for an increase in that allowance from £10.5m to £11.1m over five years. We have not yet had an opportunity to consider the reasonableness of that request but given its size it should not be difficult for it to be reviewed as part of this inquiry."*

2.7 The increase in the on-going cost reflects an increase in the cost of benefit accrual reported in the 31 March 2011 valuation (see paragraph 6.3 of Chapter 10 of the SoC). This valuation became available only after submission by NIE of its BPQ. The UR was made aware of this in NIE's response to the draft determination in July 2012 (see paragraph 2.2 of Chapter 7 of NIE's response to DD).

2.8 Paragraph 17 states that:

*"The allocation of the whole of the deficit to customers, save for a proportion of liabilities associated with early retirement, effectively holds NIE T&D harmless from the emergence of a pension fund deficit for which it is at least in part responsible. We note that in Bristol Water the Commission adopted a different solution, splitting the responsibility for Bristol Water's pension deficit between customers and shareholders on a 90:10 basis."*

2.9 The important difference between Bristol Water and NIE is that more than 97% of the NIE final salary scheme members have protected rights which NIE is legally obliged to pay for. There are effectively no further steps which NIE can take to manage its pension liability (see paragraph 1.5, footnote 3 of Chapter 10 of the SoC)

2.10 The Electricity (Protected Persons) Pension Regulations (NI) 1992 provide statutory protection for past and future pension rights for members of the NIEPS at privatisation. NIE has a legal obligation to ensure that benefits that pensioners and contributors have already earned will be fully protected, and so long as current contributors remain in the industry their benefits will remain unchanged, without requiring any higher employee contributions.

2.11 Paragraph 18 of UR-5 states that:

*"We also consider that it would be valuable for the Commission to give fresh consideration to the question of the appropriate allocation of costs in respect of ERDCs. The 30:70 split was adopted for RP4 on the basis that the 5 years of benefit that a company can take from opex efficiency savings equates to around 30% of the net present value of the perpetual cost saving that the business enjoys under the RPI – X system of regulation. However, in the case of early retirement, because the age profile of NIE T&D's early retirees was approximately 50-60 years, it could be said that the average efficiency saving lasted no more than ten years in total (i.e. before the retiring employee would have left the workforce naturally). It*

*follows that customers might have received no more than 5 years or 50% of the total of the approximately 10 years of benefit arising from NIE T&D's early retirements. In principle, customers should therefore bear no more than 50% of the costs of meeting early retirement liabilities. We did not follow that approach in our FD because we wanted to maintain continuity with the approach that we had taken in RP4. But that is a matter on which the Commission may well come to a different view in this inquiry. "*

- 2.12 It is not necessary for the CC to determine whether the appropriate split is 30:70 or 50:50. In either case, the special contributions made by NIE's shareholder in July 2005 and March 2007 are more than sufficient to meet the share of ERDCs to be borne by NIE.
- 2.13 Of course, if the CC disagrees with NIE in this regard, NIE will wish to make submissions on the appropriate split to be adopted.
- 2.14 Paragraph 21 of UR-5 states that:

*"During the consultation process, NIE T&D indicated that it could accept a period of 15 years, so long as it was allowed to earn its allowed regulatory rate of return on the cost of capital on the excess contributions made by it in meeting its obligation to repair the deficit in the shorter period of 11 years. In other words, NIE T&D asked that its allowances for pension contributions over 15 years should produce the same NPV as its actual contributions over 11 years, using NIE T&D's allowed rate of return as the discount rate. That request differs from the approach we took in the FD, where we used the NIE pension scheme's own discount rate (2.08% real) to produce the profile of contribution allowances over 15 years. We continue to consider that the pension scheme's own discount rate provides the most appropriate basis for profiling allowances. The scheme deficit itself has been calculated using that discount rate. NIE T&D's request is essentially that it should be permitted to transform future cash flows (i.e. the scheme's actual obligations to pay benefits to members in the future) into a present value (i.e. the current scheme deficit) using one (low) discount rate, and then transform that present value back into 15 years of future annual cash flows (i.e. the allowed deficit repair contributions) using another (higher) discount rate. That is inappropriate because it is internally inconsistent and would produce an artificial profit for NIE T&D out of its pension deficit. It would therefore be inappropriate to award NIE T&D its WACC in respect of the contributions that it makes to its pension scheme."*

- 2.15 This issue arises only because the UR is assuming a different deficit repair period than that agreed between the company and the scheme's trustees. NIE's preferred regulatory treatment would be that pensions costs are allowed on the

same basis as agreed with the scheme's trustees since this is straightforward and easier to monitor and control.

2.16 However, if the deficit repair periods are different it is wrong for the UR to assert that NIE would make an artificial profit. NIEPS is a separate legal entity from NIE and the pension scheme discount rate used to discount scheme liabilities is not the same as NIE's cost of capital. To ensure that NIE is economically held whole, any financing costs borne by NIE as a result of making actual contributions in advance of recovering those costs from customers should be recoverable through future price controls and attract the regulatory rate of return which reflects NIE's costs of financing the advance payment.

2.17 Paragraph 22 states that:

*“NIE T&D has also asked that the 15 year period should be set in stone so that there is no risk of the pension deficit as at the next price review (or triennial valuation) being re-spread over a further 15 year period from that date, and so on. Although we do not currently envisage needing to change the 15 year period at future price control reviews, it would be inappropriate to fetter our discretion (and ultimately the Commission's discretion on any reference) to adopt a different approach to different circumstances at a future price control review. “*

2.18 NIE has not asked for the 15 year period to be set in stone. NIE's preference would be for pensions costs to be recoverable over the same period as the deficit repair contributions are actually paid.

2.19 If the price control allows for pensions over a different period than that agreed between the company and the scheme's trustees, then the timing differences between actual contributions and the regulatory allowances introduce unnecessary complexity. As noted in the SoC, NIE is content to accept a longer period provided it is kept whole on an NPV basis. However, NIE's preferred regulatory treatment would be that pensions costs are allowed on the basis agreed with the Trustees on the basis that this is simple and transparent and therefore easier to monitor.

### **3. COMMENTS ON UR-26**

3.1 This Annex deals with pension-related matters raised in UR-26 only to the extent that they are not adequately addressed in Section 2 above or in the Overview to this supplementary submission.

3.2 Paragraph 58 of UR-26 states that:

*“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. 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.”*

- 3.3 It is wrong for the UR to argue that any of the current deficit is attributable to ERDCs incurred in period 1997 to 2003. The fact is the shareholder contributions have more than offset the 30% cost of ERDCs deemed to be attributable to the shareholder. The UR’s proposals to disallow part of the deficit on the basis of early retirement costs would mean that the shareholder was being asked to fund these costs twice.
- 3.4 The special contributions were made in July 2005 and March 2007 on the occasion of the disposal of Sx3 and the acquisition of Viridian by Arcapita respectively. The July 2005 contribution was made after NIE submitted its RP4 proposals (4 March 2005). The March 2007 contribution was made after the RP4 price control was agreed (in December 2006).
- 3.5 The purpose of the £50 million special contribution paid in 2007 was to eliminate the £44 million deficit identified in the 31 March 2006 valuation, irrespective of the origin of that deficit. This much is clear from the Electricinvest Acquisitions letter provided in UR-29. It was successful in this objective: as at 31 March 2007, the scheme had a surplus of £18.6 million following the special contribution of £50 million. There is no basis for the UR (or the CC) to conclude that this special contribution should not be attributed to ERDCs incurred before that date.
- 3.6 The UR attributed a value of £65.5 million to the special contributions in the draft determination (paragraph 11.57). No reason is presented for the UR’s change of approach in the FD. The FD says that “*NIE did not seek to recover the value of special contributions paid*”. However, this quote from NIE’s response is incomplete

and misleading. What NIE actually said in its response was that *“NIE did not seek to recover the value of special contributions paid in excess of the early retirement costs borne by the shareholder.”*

3.7 Paragraph 59 of UR-26 states:

*“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.”*

3.8 It is not NIE's case that the shareholder contributions were hypothecated at the time to NIE's share of the ERDCs. It is sufficient that the contributions had effect to eliminate the deficit in 2007 (and, in the case of the 2007 contribution, were paid with the intention of achieving that objective, whatever the origin of the deficit) and are today sufficient to cover NIE's share of ERDCs.

3.9 For completeness, however, we note that NIE has provided the UR with all correspondence in relation to the special contributions including:-

- in relation to the £25 million special contribution:-
  - press release dated 31 March 2005
  - Return of capital circular dated 6 June 2005
  - Letters from Viridian Group PLC to the Trustees dated 9 June 2005 and 15 July 2005
- in relation to the £50 million special contribution:-
  - Stock Exchange Announcement (6 October 2006)
  - Staff announcement (6 October 2006)
  - Recommended proposal for the acquisition by ElectricInvest Acquisitions of Viridian Group (27 October 2006)
  - Letters dated 31 October 2006 and 12 January 2007 from ElectricInvest Acquisitions to the Trustees
  - Letter dated 18 January 2007 from the Trustees to ElectricInvest Acquisitions.

3.10 All this information is available to CC on request.

## ANNEX 9

### RAB ADJUSTMENT

#### 1. INTRODUCTION

1.1 The UR alleges that NIE's capitalisation of particular costs will have the effect of charging customers twice for the same activities, on the basis that particular activities were intended to be covered by NIE's opex allowance, but will, by being added to the RAB, be recovered over 40 years via a depreciation charge and a return on the capitalised investment. We refer to this alleged effect as "double counting". The allegation relates to the last two years of RP3 and the whole of RP4.

1.2 NIE denies that it has double-counted expenditure in this way. In summary, our arguments relate to both:

- the way in which the RP3 and RP4 price controls were set; and
- the particular facts relating to the expenditures in issue.

1.3 On the first point:

- the idea of double counting, as set out in 1.1 above, incorporates an assumption that particular items of expenditure (e.g. costs of particular kinds of tree-cutting, costs of particular kinds of R&M activity) were intended to be covered out of the opex allowance. This is generally true where the opex allowance is set (as for RP5) on the basis of base year forecasts, with efficiency adjustments for future years. One can look at the underlying forecasts and see that particular heads of expenditure were expected to be treated as opex. But, in RP3 and RP4, this method was not used. The RP3 price control was set on the basis of a total revenue allowance, which was then split into capex and opex without reference to any detailed underlying opex forecasts, and RP4 was explicitly designed to avoid the need for any bottom up forecast of opex costs: instead, the outturn opex for RP3 was used directly to set the allowable opex for the equivalent year of RP4. There were therefore no specific activities which underlay the opex allowances for RP3 or RP4. In short, in the absence of an explicit business plan to form the basis for the opex allowances, with specific hypothecation of the opex allowance towards specific activities, a test of double-counting cannot be applied in a meaningful way;
- it is, of course, appropriate to ask whether the overall methodology for the RP4 price control implicitly relied on an assumption that the opex

allowances would cover the same classes of activity as had been treated as opex during the equivalent years of RP3. If such an assumption did underlie RP4 (and NIE does not accept that it did) then one would expect the UR, in adopting the rolling opex mechanism for RP4, to have satisfied itself that the proposed opex allowance was appropriate, based on all the information available to it. That would have included information as to any changes to NIE's proposed mix of activities for RP4 which were in prospect, and were made known to the UR, when the RP4 price control was set. If the UR was aware of changes to NIE's proposed mix of activities in setting the RP4 price control, and hence of the potential effect of such changes on NIE's future opex and capex spends, then the UR had the opportunity to propose adjustments to the RP4 opex allowance at the outset. To the extent that it chose not to do so, it should not be allowed to make retrospective adjustments now to reflect such factors.

1.4 In proposing adjustments to NIE's opening RAB for RP5, the UR appears to proceed on a quite different basis, namely that NIE's opex allowances for RP3 and RP4 were intended to be hypothecated to expenditures on particular activities. But, even if that were so (which NIE does not accept), it does not follow that any deviation from an ex ante expectation, and a shift from opex to capex expenditure, should result in an adjustment to NIE's RAB. It would be necessary to determine why such a shift had occurred, whether it was consistent with the overall "swings and roundabouts" operation of RPI-X price controls (whereby a revenue allowance justified by particular expenditures may be efficiently deployed in a different way, in light of new efficiency opportunities and new demands) and whether consumers have, nonetheless, secured a fair share of overall efficiency savings. The UR has not examined these matters at all.

1.5 So far as relates to the particular adjustments proposed by the UR:

- The UR was aware, in setting the RP4 price control, that NIE planned to adopt new refurbishment strategies which would entail more capitalised tree-cutting costs (and, by implication, lower reactive opex tree-cutting costs). It set the RP4 price control on that basis, and should not now seek to re-open it;
- NIE's total overhead costs were reduced significantly between RP3 and RP4, and some 82% of the benefit of such reductions will accrue to customers. By focusing only on the percentage of overheads that are capitalised, the UR has failed to consider whether NIE's accounting treatment of overhead costs is legitimate and has operated fairly as between shareholders and customers;
- NIE's opex R&M costs were reduced significantly between RP3 and RP4. This reflects a variety of different factors, including enhanced operational

efficiencies, the installation of new assets which obviate the need for maintenance of older assets, and the better recognition of R&M costs which form part of capex works. The benefit of that reduction in opex R&M costs has accrued in part to NIE's shareholders, and will also accrue in part to NIE's customers, through the setting of a new more demanding opex allowance for RP5. This is consistent with the overall workings of RPI-X price controls.

- In addition, the UR's calculations of the amounts alleged to have been wrongly capitalised are fundamentally unsound.

1.6 In light of these considerations, which are elaborated separately in respect of tree-cutting costs, overheads and R&M costs below, NIE submits that no retrospective adjustment to NIE's RAB is justified.

## **2. TREE-CUTTING COSTS**

2.1 The FD proposes that NIE's RAB be reduced by £11.6 million, on the basis that, during RP4, NIE capitalised a greater proportion of its tree-cutting costs than it had in earlier years.

2.2 The UR makes much of the fact that, in the early years of RP3, NIE capitalised only one third of tree-cutting costs, but in later periods, it capitalised a higher percentage of such costs. This point is irrelevant: NIE never applied a one third/two thirds split as a matter of principle. The one third/two thirds split was the coincidental outcome of the application of appropriate methodologies to decide which tree-cutting costs should be capitalised.

2.3 Under relevant accounting principles, NIE treats as opex the costs of reactive tree-cutting, and it capitalises costs of tree-cutting undertaken as part of a capital project (e.g. overhead line refurbishment).

2.4 During RP4, NIE adopted new refurbishment strategies incorporating tree-cutting which had the effect of reducing the amount of reactive tree-cutting. This led to higher capitalised tree-cutting costs, and lower opex tree-cutting costs. But this reflected a change in NIE's underlying activity, not a change in its accounting practice.

2.5 The UR was aware in advance of the new refurbishment strategies including the tree-cutting which formed part of such strategies, by virtue of its review of NIE's capex plans submitted for RP4, and its own consultants' report (Mott MacDonald, May 2006). The UR did not question the appropriateness of NIE's proposed strategies, and it is inconsistent with the overall ex ante approach to RPI-X price control regulation for it to do so now.

2.6 There is therefore no justification for any retrospective adjustment to NIE's RAB.

### 3. OVERHEADS

3.1 The FD proposed that NIE's RAB be reduced by £8.6 million on the basis that NIE capitalised a larger proportion of overheads than in previous accounting periods. Capitalised overheads relate to costs associated with asset management and planning, procurement and stores, outage management, the installation and commissioning of technical equipment, safety and IT.

3.2 NIE is required by condition 2 of its licences to comply with relevant accounting standards in deciding how much of its overheads to capitalise. Those obligations have effect to require NIE to keep its capitalisation rates under review, with a view to ensuring that an appropriate proportion of overheads are capitalised. In consequence of its review of the appropriateness of its capitalisation rates during RP3, NIE judged it appropriate to capitalise a higher percentage of its relevant overheads in the final two years of RP3 and in RP4 than in previous years.

3.3 NIE's total overheads in respect of the activities referred to in paragraph 3.1 for RP3 were £69.6 million, of which £48.0 million were capitalised, and £21.6 million were treated as opex. NIE's total such overheads for RP4 were £59.5 million, of which £45.1 million were capitalised, and £14.4 million treated as opex. This means that:

- In total, NIE reduced its overheads by £10.1 million from RP3 to RP4 (comprising approximately £2.0 million of savings per year). That is a genuine efficiency saving, regardless of how overhead costs are treated for accounting purposes;
- Those savings amount to a total lifetime saving of approximately £40 million (assuming an approximate WACC of 5%). NIE retained the benefit of £7.2 million of those savings (i.e. the difference between the £21.6 million of opex overheads notionally included in the RP4 allowable opex - on the assumption of a "hypothecated" opex allowance - and the outturn opex overheads of £14.4 million for RP4). Thus, in total, NIE secured for the benefit of shareholders only some 18% of the total savings in overheads.
- In absolute terms, the overheads capitalised in RP4 (£45.1 million, representing 10.2% of NIE's gross capex of £444.4 million) were lower than those capitalised in RP3 (£48.0 million, representing 12.5% of its gross capex of £385 million), and lower than those included in the RP4 capex budget (£48.1 million). The value of overheads that were capitalised in

RP4 is therefore less than the amount budgeted and less than the amount capitalised in RP3.

- 3.4 NIE therefore submits that there is no justification for reducing retrospectively NIE's RAB in respect of capitalised overheads.

#### **4. REPAIRS AND MAINTENANCE**

- 4.1 The FD proposed that NIE's RAB be reduced by £11.5 million on the basis that NIE spent less on R&M than it had in previous years.

- 4.2 The UR's approach ignores two important factors:

- The UR's calculation of the proposed adjustment proceeds on the assumption that R&M activities in one period should replicate those undertaken five years previously. As noted earlier, this assumption played no role in the formulation of the RP4 price control, and from a technical perspective is flawed: in a dynamic network, older assets are replaced with newer ones and systems and processes are constantly changing.
- Customers benefit from such advances, as opex savings are passed on via the setting of lower opex allowances for future regulatory periods, but the company is incentivised to make such advances by being permitted to retain the benefit of opex savings for the duration of the current regulatory period. This feature was built in to the rolling opex mechanism adopted by the UR for RP4, and is also reflected in the UR's assessment of NIE's opex requirements in its Final Determination for RP5.
- During RP4, NIE introduced new methods of recording and analysing its R&M activities, which have allowed it to identify more precisely which elements of its R&M activities fall to be capitalised, according to the capitalisation rules which it has traditionally used. This has resulted in the recognition of more R&M costs as being appropriate for capitalisation. This is itself a form of efficiency improvement, since better recording of past costs can be expected to enable NIE more accurately to cost future opex and capex projects.

- 4.3 NIE submits that amounts capitalised by virtue of these factors should not be regarded as double-counting.

## 5. FUNDAMENTAL FLAWS IN THE UR'S ASSESSMENT OF QUANTUM

- 5.1 If, contrary to NIE's submissions above, the CC were minded to propose a reduction to NIE's RAB to reflect any of the matters discussed above, NIE submits that no reliance should be placed on the UR's analysis for determining the quantum of any adjustment to the RAB.
- 5.2 The UR's analysis in the FD, based on its consultants' report, is grossly simplistic. It assumes, for example, that any reduction in R&M opex that is matched by an increase in capex in an accounting category that is deemed to cover broadly the same kind of work justifies an equivalent RAB adjustment. And when determining the RAB adjustment in respect of capitalised overheads, the UR relies on a simple calculation of the difference between the amount of overheads which would have been capitalised at the "old" percentage rates and the higher amounts capitalised at the "new" rates. No attempt is made to assess or recognise the legitimacy of NIE's re-assessment of the proportion of overheads attributable to capital projects, nor to compare NIE's opex overheads in RP4 with the outturn opex overheads in RP3, nor to examine the extent to which reductions in overheads have been shared between NIE's shareholders and customers.
- 5.3 It is notable that the UR does not commend its analysis to the CC; rather, it invites the CC to conduct its own analysis "to arrive at a more precise quantification" of the effects of what the UR alleges are changes to NIE's accounting practices.
- 5.4 The UR has, however, now produced a supplementary report (UR-30) prepared by its consultants by way of response to KPMG's report. The supplementary report deals only with the proposed R&M adjustment, and does not comment on KPMG's critique of the consultants' original work relating to overheads and tree-cutting costs. The supplementary report was apparently available to the UR in formulating its FD, but it did not disclose the report as part of its reasoning, or otherwise make it available to NIE until providing it as UR-30. NIE has now reviewed the supplementary report and has asked KPMG to comment on it. We attach as Appendix 9A.1 a copy of KPMG's comments, from which it is apparent that nothing in UR-30 causes KPMG to alter its original report.
- 5.5 However, KPMG notes that UR-30 raises various questions as to whether NIE provided complete and accurate information to the UR and its consultants. NIE has also identified certain other factual matters which merit comment. We would comment on these matters as follows:
- In footnote 1 to sections 2.2.5 and 2.2.7.2 to UR-30, SKM states: "*We note that the omission of the mini-pillar capital programme from the capital programmes identified by NIE gives rise to doubt as to whether the full scope of capital programmes into which R&M expenditure has been made available*" and "*Again, we note that the omission of the mini-pillar capital*

*programme from the capital programmes identified by NIE gives rise to the doubt as to whether the full scope of capital programmes into which R&M expenditure is capitalised has been made available".* These comments suggest that NIE may have withheld information from the UR and SKM. NIE rejects this allegation. The full scope of capital programmes was made available to SKM.

- In responding to section 2.2.6.2, SKM refers to two data files "*summary table V9-2.xls*" and "*PG summaries \_ v1-2-xlsx*". These appear to be updated versions of files. Neither of these has been provided to NIE.
- In responding to section 2.3.1, SKM states: "*the practice of reducing Opex by increasing Capex is confirmed by NIE via both the discussions throughout the process and their policy change timeline, numerous examples of which are cited in the report*". This statement is very misleading. NIE has not supported the proposition that it reduced opex by increasing capex as is suggested. NIE's explanation of the facts is as set out in its SoC and in the remainder of this Annex.

5.6 In short, NIE submits that nothing in UR-30 assists the UR in establishing the accuracy of its assessment of the extent (if any) to which NIE has capitalised expenditure which, under any relevant principles, should have been treated as opex. Accordingly, the UR has no proper basis on which to support its proposed adjustment to NIE's RAB.

## **6. WEIGHING ALL THE FACTORS**

6.1 If the CC were to conclude, contrary to NIE's submissions, that there is potentially a case for some adjustment to NIE's RAB to reflect some or all of the matters discussed above, then it would be necessary for the CC to consider, by reference to all its statutory duties, whether a retrospective adjustment is justified and, if so, to what extent. If necessary, NIE would wish to address the CC further at a later stage on the factors which should weigh in such an assessment, but would draw attention at this stage to the following factors:

- the absence of any clear opex forecasts underlying the RP3 and RP4 price controls, and the resulting difficulty in identifying or computing the extent of any double-counting;
- separately, the unreliability of the UR's assessment of the quantum of any double-counting;

- the UR's failure to examine any off-setting items, whereby NIE faced additional opex costs, beyond those which might - on the UR's approach - fairly have been assumed to be covered by the rolling RP4 opex allowance;
- the positive efficiency characteristics of NIE's actions in implementing its overhead line refurbishment programme; its introduction of new more efficient assets with the resulting reduction in opex maintenance costs; its introduction of new methods of analysing costs more accurately; and the enhanced accuracy/transparency of its financial statements;
- the resulting benefits to consumers, in the form of lower opex costs in future, a better more modern network, and better cost data to inform future cost forecasts;
- the fact that the UR could have addressed these matters directly in setting the RP4 price control - e.g. by adopting a bottom up approach to forecasting opex and setting an opex allowance, and by adopting more detailed regulatory accounting guidelines to supplement and/or create exceptions to relevant accounting standards;
- the fact that, during RP4, the UR monitored NIE's annual capex spend (as detailed in NIE's annual capex reports), and could have disallowed capex which it judged to be unnecessary. NIE was not therefore free to add unlimited amounts of capex to its RAB;
- the fact that, during RP4, consumers were adequately protected as to price by NIE's compliance with its obligations under condition 2 of its licences, by the overall effectiveness of the rolling opex mechanism in passing on to consumers the benefit of opex savings achieved during RP3, and by the monitoring of and restraints imposed on NIE's capex spend during RP4; and
- the UR's delay in raising this issue, which should have been clear from NIE's annual regulatory accounting statements from, at latest, 2006/7 (UR-6, paragraph 4). For example, if NIE had known that the UR objected to NIE's capitalisation of tree-cutting costs (a possibility flagged by Mott McDonald in their report to the UR as early as 2006), it would have wished to discuss that with the UR earlier, with a view to agreeing an uplift to NIE's opex allowance since, on the UR's analysis, that would appear to have been justified.

6.2 In the PNGL case, the CC recognised that any ex post adjustment to the RAB should be exceptional, and should be fully justified. For this reason retrospective adjustments in GB regulatory history are extremely rare. This is for good reason: the GB system of RPI-X regulation rests on the fundamental premise that a stable

and transparent regulatory regime provides a sound commercial framework within which utilities can make significant efficiency savings and raise funds on capital markets in the knowledge that key regulatory parameters will not be changed ex post. Arbitrary and unexpected retrospective changes undermine this stability, weaken incentives and increase the cost of raising capital, to the long term detriment of customers. NIE submits that, on the test set out by the CC, there is no compelling case for an adjustment to NIE's RAB.



## ANNEX 10

### UNRESOLVED ISSUES FROM RP4

#### 1. INTRODUCTION

- 1.1 This Annex explains why the UR is not correct in its view that the CC does not need to examine the three unresolved issues that arose under the RP4 price control which caused NIE to under-recover against its full revenue entitlement.

#### 2. NIE'S RESPONSE TO UR-26

- 2.1 In paragraph 21 of UR-26, the UR states as follows:

*"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."*

- 2.2 In Chapter 12 of its SoC, NIE identified three outstanding issues with respect to RP4 which it seeks to ensure are fairly and definitively resolved as part of the RP5 process. These relate to capex efficiency incentive payments, costs associated with on-going support for the Enduring Solution IT system and the interpretation of the capital allowances term in the RP4 price control.
- 2.3 The UR considers that these matters do not require consideration by the CC.
- 2.4 NIE disagrees. It has not been possible to resolve these matters by agreement between the UR and NIE and as a consequence, NIE has under-recovered, relative to its full revenue entitlement, under the RP4 price control. This can be rectified only via the RP5 price control and the amounts in question should therefore be taken into account when setting the correction factor ( $K_i$ ) to be applied in year one of the RP5 price control.
- 2.5 Furthermore, in respect of the Enduring Solution costs, the UR relies on the same reasoning as appears in its FD for RP5 to partially refuse approval of NIE's claim. As regards the capital allowances term, the matter needs to be resolved now so that it is clear what is, for regulatory purposes, the value of the residual pool of capital allowances available to NIE at the opening of RP5 (see paragraph 4.9 of Chapter 12 of the SoC). Whilst NIE could in theory have chosen to seek judicial review of the UR's decisions on both issues, given the strong link between those issues and issues necessarily to be addressed as part of the RP5 price control, NIE sought to have them resolved through the RP5 price review process. If the CC does not now seize itself of the issues, NIE will effectively have been deprived of any opportunity to challenge the UR's decision.

- 2.6 As regards the capital efficiency incentive payments, NIE submitted a paper to the UR (on 23 May 2013) setting out its comments on the draft audit report prepared by the UR's consultants, PKF. PKF have raised a number of issues that they have neither discussed with NIE nor made transparent in their draft report. These include a view that some elements of the process employed by NIE to calculate capex efficiencies are inconsistent with the 2006 Direction. NIE has requested the opportunity to engage directly with PKF on these issues before their report is finalised, but that has yet to happen.
- 2.7 The UR notes that these reported capex efficiencies have not been reflected in a revised capex forecast for RP5 yet they do not balance this observation by acknowledging other movements in cost assumptions that are less favourable. For example, the extension of RP4 and delay in ramping up the level of investment to address an increasing asset age profile is more likely to have increased the overall quantum of expenditure required over the RP5 period which will now run 6 months later than our original assumptions. The Commission should note that NIE has reviewed its original BPQ submission and while there may be some favourable and unfavourable incremental variations in some cost lines due to the passage of time, we consider that in overall terms our BPQ forecast remains representative of capex requirements for RP5.



## ANNEX 11

### NIE POWERTEAM

#### 1. INTRODUCTION

- 1.1 This Annex records how the UR has changed its position regarding the arrangements by which NIE procures services provided by NIE Powerteam.

#### 2. NIE'S RESPONSE TO UR - 26

- 2.1 In paragraph 22 of UR-26, the UR states as follows:

*"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."*

- 2.2 NIE Powerteam is a separate legal entity from NIE but forms an integral part of the NIE organisation. Its exclusive function today is to undertake activities forming part of NIE's T&D Business.
- 2.3 In its draft determination<sup>1</sup> the UR proposed that the current arrangements between NIE and NIE Powerteam should be brought to an end. In its FD the UR withdrew this proposal and set out its expectation that services delivered by NIE Powerteam will be competitively procured and market tested (see paragraph 6.52 of the FD).
- 2.4 In its reply to NIE's SoC the UR states that the matter is not relevant to the Commission's inquiry. It says it is not proposing to restrict NIE's use of NIE Powerteam in any way; and how NIE achieves efficiency in its overall costs (including those of NIE Powerteam) is NIE's business. NIE takes this to mean that mandatory competitive procurement of NIE Powerteam services is no longer on the UR's agenda.
- 2.5 It is for NIE's management to decide how best to organise its business. For the avoidance of doubt, NIE has confirmed that it has no 'in principle' objection to

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<sup>1</sup> Paragraph 8.12

subcontracting its activities where it is appropriate to do so. NIE has subcontracted and continues to subcontract a subset of its activities (generally lower skilled activities such as highway excavation, cable laying and pole erection) which by their nature lend themselves to such treatment. NIE considers that the current balance between outsourcing and in-house service delivery is the right one for cogent strategic reasons relating to: efficiency; NIE's ability to provide a rapid 24/7 emergency response and the need to secure long term access to a multi-skilled resource which provides flexibility in the delivery of work. In this regard, see Sections 5 and 6 of Chapter 13 of the SoC.

- 2.6 NIE is incentivised to manage NIE Powerteam's costs efficiently as part of NIE's own overall costs. The efficiency benchmarking provided within the SoC demonstrates that NIE, operating under the existing internal arrangements with NIE Powerteam, is a leading performer relative to the GB DNOs.
- 2.7 Although it appears that the UR has abandoned its case with respect to the compulsory competitive tendering of services currently provided by NIE Powerteam, since it has not expressly acknowledged nor explained its change of position, NIE submits that the CC should ask the UR to confirm its position.
- 2.8 In particular, the UR should be asked to confirm that, for the purpose of the RP6 price control review, it will not take the continuation of the NIE Powerteam arrangements (as restructured to comply with the European Commission's IME3 decision) as necessarily inconsistent with delivering best value to customers. NIE is understandably concerned to ensure that the UR will not in future use any ambiguity with respect to its position on NIE Powerteam unjustifiably to penalise NIE for alleged inefficiencies.

## ANNEX 12

### REPORTER

#### 1. INTRODUCTION

- 1.1 This Annex responds to the attempts made by the UR in UR-26 and UR-8 to address NIE's objections to the proposal to establish a Reporter.

#### 2. NIE'S RESPONSE TO UR-26

- 2.1 In paragraph 23 of UR-26, the UR responds to NIE's criticisms of its proposal for a Reporter:

*"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."*

- 2.2 Nothing in the UR's response changes NIE's view that the UR's proposal for a Reporter is unnecessary, particularly as a large part of the Reporter's role will fall away if the CC adopts a conventional approach to regulating capex, in line with NIE's submissions. The UR's response plays down NIE's concerns regarding the blurring of roles that would result and it remains unclear as to what assurances could be given that a Reporter would work in a manner that is efficient, timely and fair and that the 'rules' would not be developed on an 'as you go' basis. A Reporter is no substitute for the adoption of clear rules and reporting requirements that should be consulted upon and agreed at the outset of RP5.

- 2.3 Nor is NIE persuaded by the arguments set out in the UR's opening submission on the Reporter (UR-8). NIE's comments on UR-8 are set out in Section 3 below.
- 2.4 NIE notes and supports the additional objections to the proposed Reporter raised by Professor Stephen Littlechild in his paper in support of ESB's submission to the CC.

### 3. NIE'S RESPONSE TO UR-8

- 3.1 In paragraph 3 of UR-8, the UR states that:

*"...we are asking the Commission to evaluate the current levels of transparency and accountability in NIE's T&D activities and to consider whether the public interest requires that more should be done to improve those levels. Our view is that a significant improvement is needed as a matter of urgency."*

- 3.2 NIE takes issue with this assessment of the present situation. As regards transparency, NIE has at all times co-operated fully with the UR to provide full and timely information and is committed to continuing to do so. As regards accountability, NIE already bears a high level of accountability by virtue of its statutory and licence obligations (for example, safety-related obligations) which carry punitive penalties for non-compliance.

- 3.3 In paragraph 5, the UR states that:

*"... the history of our regulation of NIE T&D has been blighted by the asymmetry of information between us and NIE T&D. The most striking illustration of that point is the capitalisation practices issue ..."*

- 3.4 The UR cites capitalisation practices as an example of asymmetry of information. If the UR is troubled by the adequacy of information reported to it and/or the absence of precise rules as to how NIE should classify costs between opex and capex, then the best solution would be for the UR to address these matters via detailed regulatory accounting guidelines (as does Ofgem in GB). Appointing a Reporter is no substitute for the adoption of clear rules and reporting requirements, where that is what is needed.
- 3.5 In paragraph 7, the UR alleges that, in relation to *"fault repairs betterment NIE T&D was unable to provide any record of the improvement to the network that it claims to achieve ...."*
- 3.6 In fact, all plant replacements carried out under fault repairs are fully detailed in the relevant asset register. With respect to distribution overhead line assets, NIE's

processes are also consistent with normal electricity utility practice by recording ages and location of overhead line poles. Therefore, while recognising that assessing the efficiency of reactive asset replacement is challenging, it is no more so for NIE than it is for the GB DNOs.

3.7 In addition, NIE's RP5 capex submissions take full account of "betterment" obtained from fault repairs since overhead line components replaced under fault conditions do not then need to be replaced when the line is subsequently refurbished. In the case of cables, NIE is only commencing proactive cable replacement programmes during RP5 and any piecemeal replacement of cable sections after fault will be taken into consideration in the programmes.

3.8 Paragraph 8 quotes two other examples of the UR's concern:

*" .... NIE T&D's inability to provide records to substantiate monies claimed under the capex efficiency mechanism and NIE T&D's inability to provide a copy of their previous capitalisation practices ..."*

3.9 The reporting process can be improved significantly by clearly defining the requirements at the outset to enable information to be collected and reported routinely and predictably.

3.10 For example, in the case of the capex efficiency mechanism, the information 'gap' was in respect of the granular detail behind one element of efficiency analysis for the base year, 2006/07. That analysis had been used as the basis for five successive annual efficiency reports submitted by NIE to the UR between 2007 and 2012. Furthermore, the UR had already approved the efficiency claims for 2007/08 and 2008/09 which implied approval of the 2006/07 base year analysis on which those annual claims were based.

3.11 Yet despite this extent of reporting and regulatory consideration, it wasn't until February 2013 that the UR requested further information on the 2006/07 analysis, which by that time was no longer available. NIE had no reasonable expectation that the UR would revisit the 2006/07 figures, particularly as annual capex reporting was designed to facilitate routine and regular information flows. Reporting requirements clearly defined in advance, would have avoided this issue arising.

3.12 The UR also cites the unavailability of documentation relating to previous capitalisation procedures. We understand the document to which the UR refers described an internal procedure (for fault and emergency repairs) that was in place pre-2005 i.e. prior to the RP4 price control review. The UR only requested this information in September 2011 (as part of an information request going back almost 12 years, to the start of 2000). Had there been an expectation that NIE

would be required to produce that document as part of the RP5 price control review it could have been archived.

3.13 Paragraph 11 notes that:

*“... the advisory roles and the auditing of the documents produced by NIE T&D could (and would) be carried out by consultants appointed by us in the absence of such a Reporter.”*

3.14 The UR goes on to claim that two benefits of the Reporter are (a) the Reporter would be independent of the UR and NIE T&D and so would foster a greater degree of trust and a more constructive relationship and (b) the Reporter would be embedded within NIE which would greatly enhance its understanding of the business and facilitate the early identification of potential problems.

3.15 Much of the role of the Reporter envisaged by the UR will not be required if the CC adopts the conventional approach to regulating capex. The remainder of the Reporter’s role relates to auditing and validating information. We agree these roles could be carried out by consultants and we would work with the UR towards meeting its requirements for increased reporting in these areas. See paragraphs 2.12 and 2.13 of Chapter 14 of the SoC in this regard.

3.16 The benefits perceived by the UR relating to the independence of a Reporter are clouded by various questions which remain unanswered. Example of such questions (such as the Reporter’s accountability, the right to challenge, redress etc.) are set out in paragraph 15 of the cover letter to NIE’s SoC. The draft licence condition published by the UR with its FD does not address these issues adequately or at all.

3.17 The perceived benefits of embedding a Reporter are not borne out by NIE’s experience of having a Reporter embedded within the Enduring Solution IT project. That experience is described in the paragraph 2.7 of Chapter 14 of the SoC and in Annex 14A.1.

3.18 Paragraph 13 states that the UR’s proposed reporting arrangements are “*much less onerous*” than Ofgem’s. In so doing, the UR seeks to make a virtue of that fact. But NIE would much prefer that the UR set out a clear set of legally certain rules and reporting arrangements that would enable NIE to know where it stands and what it is required to do. NIE would therefore strongly support establishing a NI equivalent to Ofgem’s Regulatory Instructions and Guidance (RIGs).

3.19 Paragraph 19 states:

*“Our proposal to improve the quality of reporting should therefore be understood as a first step towards what is our preferred outcome of ultimately shifting to a more “outcomes” based model of regulation”.*

- 3.20 The UR goes on to say that it will still require very detailed reporting on the outputs. The paragraph concludes with the view that “*NIE T&D has a long way to go before it can claim to provide anywhere near as much detail on the network in NI as GB DNOs provide in relation to their networks*”.
- 3.21 NIE has asked the UR to define at the outset of RP5 its requirements for reporting. NIE is committed to working with the UR to develop secondary network measures, such as load and health indices, to supplement its regulatory reporting, within an overall RPI-X regulatory framework. This would be consistent with the approach adopted by Ofgem, but recognises that the development of metrics for such secondary network outputs is a complex and substantial task. Indeed, even though work commenced much earlier in GB, the development of appropriate metrics for GB DNOs still remains “work in progress”. In this regard, it should be noted that NIE has already, for a number of years, been reporting to the UR in respect of the primary network metrics established by Ofgem for GB DNOs post-DPCR5.
- 3.22 Regrettably, the UR has not recognised the need to specify appropriate output measures at the beginning of RP5, and clearly to define in advance the associated reporting requirements. Furthermore, the UR has missed the opportunity to adopt a strong incentives-based framework for RP5 (as proposed by NIE), which would have provided NIE with strong and balanced incentives to minimise capex costs yet deliver improvements in network performance consistent with proven regulatory precedent in GB. Instead, the UR proposes novel and ill-defined capex arrangements, which leave it uncertain precisely how NIE's performance will be measured and what information NIE will need to provide to the UR to justify its expenditures to the UR's satisfaction.



## ANNEX 13

### WACC AND FINANCEABILITY

#### 1. INTRODUCTION

1.1 In UR-26, the UR restates a number of the points that it raised for the first time in its Initial Submission (UR-7). In this Annex, NIE responds to the UR's points in the following areas:

- The overall approach to setting the cost of debt and equity.
- The effect of ESB's ownership on observed debt premiums.
- Other, more technical matters relating to:
  - short vs. long run estimates;
  - the debt premium and whether the underlying risks might be diversifiable;
  - RORE;
  - Risk profile;
  - Basis of the RPI;
  - Modelling of allowed return;
  - The UR's overall assessment of financeability;
  - Shareholder distributions; and
  - Index-linked debt

1.2 In summary, NIE does not accept how its position has been characterised by the UR, rejects the arguments put forward, and does not accept that there is a reasonable basis for a number of allegedly factual assertions that are made by the UR.

#### 2. OVERALL APPROACH

2.1 In paragraph 67 of UR-26 the UR criticises NIE's position, which it characterises as seeking a cost of debt and a cost of equity that exceed NIE's actual costs in both

cases. The implication of the UR's assertions is that it somehow knows the "true" level of both the cost of debt and the cost of equity. In practice, these forward looking numbers cannot be directly observed and need to be estimated on the basis of a wide range of historic data and other relevant information.

- 2.2 The usual approach to estimating the cost of debt and equity is to observe the historic information that exists for the entity in question (e.g. coupons on existing debt, yields on those bonds in secondary markets, estimates of the equity beta if the entity's shares are traded on an exchange) and to supplement this with information for a set of comparators that undertake similar activities and have a similar risk profile (including not only capital market data but also relevant regulatory precedent). Having collated this information, it is inevitably necessary to exercise some judgement in deciding on a point estimate of the cost of capital.
- 2.3 NIE has adopted the same three-stage approach to estimating the cost of capital throughout the RP5 review process.
- **Stage 1** takes Ofgem's decision at DPCR5 as the basis for the UR's decision at RP5. The Ofgem DPCR5 WACC decision cannot be interpreted in isolation of the rest of the settlement since it sat within a wider framework Ofgem developed for setting allowed returns. As a result, the starting point for RP5 needs to reflect not just the headline WACC allowed by Ofgem, but the actual baked-in returns that DNOs were allowed, which Ofgem's RORE analysis demonstrated are in excess of the baseline WACC.
  - **Stage 2** enables the adjustment of the WACC calculated in stage 1 to take account of relevant NIE-specific factors.
  - **Stage 3** evaluates whether financial market evidence on the WACC has changed significantly since DPCR5, to such an extent that merits a change to the parameters of Ofgem's decision.
- 2.4 NIE considers that its approach is consistent with wider practice in the utility sector.
- 2.5 The relevant factors for the CC to consider in reaching its judgement in this case will include:
- which set of comparators to take account of – NIE has consistently argued that the GB DNOs are the most relevant peer group;
  - whether to be guided primarily by short run or long run metrics drawn from market data – in a number of places (as detailed below) the UR seems to suggest that short run estimates should be given significant weight, a proposal that in our view runs counter to prevailing practice; and

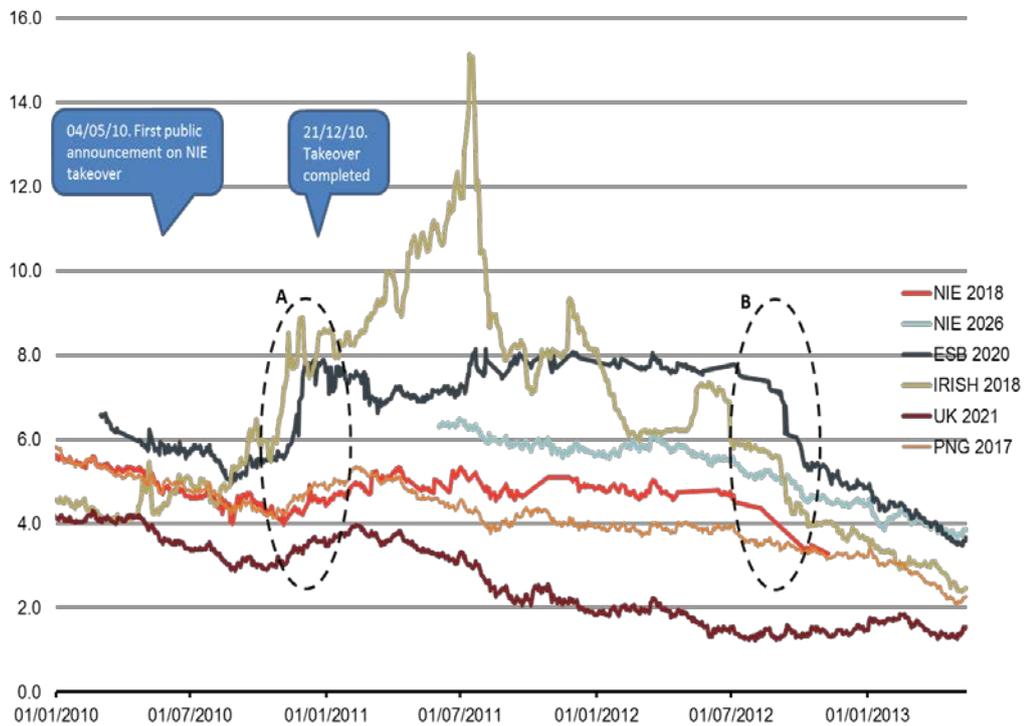
- the extent to which it is appropriate to err on the side of caution – inevitably the deployment of CAPM will give rise to a range of possible values and, given the challenges in estimation, it is necessary to exercise judgement in deciding where in that range to set the required point estimate.

2.6 Given the importance of its decision in respect of the cost of capital to ensuring that the overall price control is financeable, and the importance of maintaining investor confidence, NIE is confident that the CC will take a suitably rounded approach to its estimation and will place an appropriate weight on certain of the UR's unjustified absolute assertions. NIE would also ask that the CC takes account of its general position, which is that the key elements of the regulatory regime – including the cost of capital – are aligned to Ofgem's regulatory approach. This position is discussed further in Section 2 of the Overview to this supplementary submission.

### **3. ESB'S EFFECT ON NIE'S CREDIT QUALITY**

- 3.1 In paragraph 71 to 73 of UR-26, picking up a point raised in paragraph 11 of UR-7, the UR devotes significant attention to the question of whether ESB's ownership of NIE is responsible for the observed premium on NIE debt. It reproduces a figure from NIE's SoC (labelled as Figure 15.1 in UR-26) and produces a variety of quotes from Ratings Agents, to support its view that the main determinant of the premium observed on NIE's debt products relative to GB equivalents is due to the financial weakness of ESB, NIE's parent.
- 3.2 However, the UR's position is difficult to sustain, as can be illustrated by considering NIE's debt premium over a slightly longer period of time.
- 3.3 Figure 1 shows the yield to maturity on NIE's short and long dated bonds over time, alongside ESB, PNG and UK and Irish government bonds. While the yields on NIE's bonds have remained comparatively stable over time, ESB's bond yield saw two large shocks in late 2011 (upwards, A) and late 2012 (downwards, B), during the culmination of Irish debt crisis and its aftermath. As the figure shows, these shocks were not reflected in movements in NIE's bond yields. If ESB's credit quality is an important driver of NIE's ability to raise debt finance, one would expect to see much closer correlation in yields than is in fact the case.

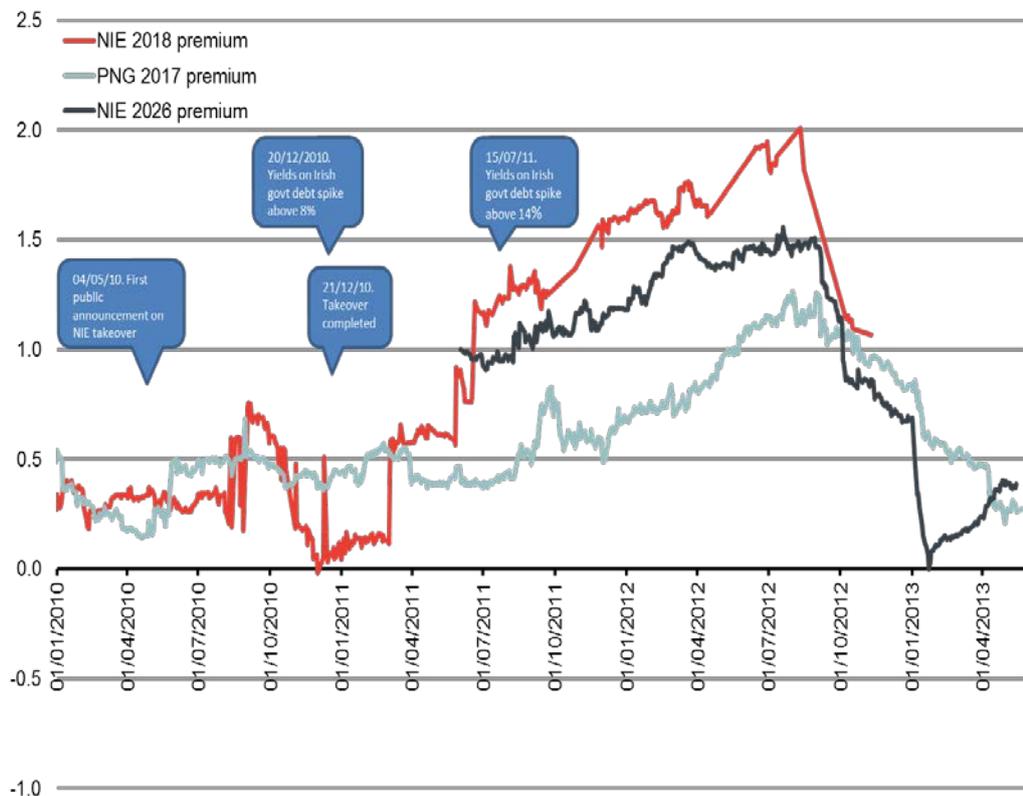
**Figure 1.** Yield to maturity for ESB, NIE, PNG and UK and Irish government bonds (%)



Source: Bloomberg. The year cited refers to the maturity date for each bond.

3.4 To illustrate this point in a different way, Figure 2 shows the spread of NIE’s bonds over baskets of comparable GB utility bonds (with similar tenor and credit rating). The figure reveals that the premium on NIE’s short dated bond was in existence before ESB purchased NIE and also before the Irish debt crisis had led to spikes in the yields on Irish government debt.

**Figure 2.** Premium on the yields of NIE and PNG bonds relative to a basket of GB utilities with similar maturity dates



Source: Bloomberg. The basket of 'peer' GB utility bonds used for calculating the spreads on the short dated bonds (NIE 2018 and PNG 2017) is United Utilities (2018), National Grid Gas (2017), Scottish Power 2017 and Severn Trent Water (2018).

The basket of 'peer' GB utility bonds used for calculating the spread on the long-dated NIE bond (2026) is Eastern Power Networks (2025), London Power Networks (2027), South Eastern Power Networks (2026), Western Power Distribution (2025), Western Power Distribution (2027), SSE (2028), Northern Gas Networks (2027) and United Utilities (2027). This basket is expanded from that used in the SoC which used only the first five listed.

The premium on NIE's short dated bond moves above that of PNG in mid-2011, when NIE's longer-dated bond was first issued (2 June 2011). The issuance of £400 million of new debt is likely to have caused a general reappraisal of NIE owing to the resulting higher level of gearing, while also decreasing liquidity in the short-dated bond, explaining why the short dated bond yield is higher than that of the long dated bond. As discussed below, NIE's gearing is low relative to prevailing levels in the utility sector and has at all times remained below the RP4 gearing threshold of 57.5%.

3.5 NIE considers that there are a number of questions that reveal that the UR's position cannot in fact be sustained. If the observed premium is primarily a consequence of ESB's ownership of NIE, then:

- Why was there a premium on NIE's short-dated bond before NIE was purchased by ESB?

- Why was there a premium on NIE's short-dated bond even before the Irish debt crisis led to spikes in the yields on Irish government debt?
- Why is there a similar premium observed on the bond issued by Phoenix Natural Gas, which has no links to ESB?
- Why has the SEM Committee, which includes three representatives from the UR, decided to take account of a "risk premium" that reflects "spread differentials between NIE and UK utility bonds" in its decision paper on new entrant costs<sup>1</sup> if it believes that this spread only arises as a consequence of ESB's ownership of NIE and therefore does not apply more generally?

3.6 NIE's view is straightforward: provisions contained in its licence with respect to the need to ensure at all times the availability of adequate resources, including financial resources, ensure that NIE is, and should be properly regarded as, a stand-alone entity. This is a position that is supported by the available market data shown above. The premium on NIE debt is therefore not driven by ESB's ownership of NIE.

3.7 Finally, given the evidence of a sustained debt premium (for both NIE and PNG) over recent years, it is NIE's view that the UR's statement in paragraph 74 of UR-26, that in fact there is no such premium, is entirely unsupported. Given the acknowledgement of just such a premium in the recent SEM Committee decision on best new entrant costs highlighted above, it would appear that the UR is seeking to cherry pick the evidence that it is willing to consider from one regulatory decision to the next. NIE also notes that the CC reviewed the issue of a NI premium on debt in the course of its inquiry into Phoenix Natural Gas. It found a differential in bond yields and a widening of that differential from August 2011, which it considered "may be partly due to Northern-Ireland-specific factors including the regulatory regime"<sup>2</sup>.

#### 4. OTHER MATTERS

4.1 In this section we address, albeit briefly, a range of further assertions made by the UR in UR-7 and UR-26.

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<sup>1</sup> "Fixed cost of a Best New Entrant Peaking Plant, Capacity Requirement & Annual Capacity Payment Sum for the Calendar Year 2013 - AIP/SEM/12/078", 2012, CER & UR. A 50 bps uplift was applied to the estimate of the cost of debt (see page 29).

<sup>2</sup> Paragraph 8.109 of the Commission's final report.

### Short versus long run estimates

- 4.2 In UR-7 and UR-26 the UR places great emphasis on spot estimates drawn from recent market data in assessing the cost of capital. For example, in UR-7, the UR argues that both the risk-free rate (paragraph 16) and the equity beta (paragraph 18) should be reassessed given recent market data. In UR-26 the UR focuses on the cost of new debt (paragraph 70).
- 4.3 NIE does not agree with the suggestion of using only very recent market data for assessing the cost of capital. Given volatility in this data over time, such an approach would risk locking in either a very low or very high cost of capital that may not persist over the regulatory period and will not reflect the true cost of capital. Crucially, an overemphasis on short-run point estimates would also be a material departure from standard practice and would expose NIE to a clear and visible additional risk that is not borne by other utilities.
- 4.4 More specifically on the observation that the risk-free rate has fallen, the UR is incorrect in its assertion that this also means that NIE's cost of equity finance has fallen. The UR contends that the decline in gilt rates has been driven by the Bank of England's policy of quantitative easing (QE). Whilst QE has certainly contributed to falling yields, it is also well recognised that a major factor has been the so-called 'flight to safety' where investors have rebalanced their portfolios by liquidating risky investments and shifting these funds towards relatively safe assets, such as UK gilts. This (along with a falling supply of government bonds as a result of QE policies) has driven down gilt rates. As financial stability returns, it is probable that investors will 'unwind' this rebalancing of risk by moving funds back towards riskier assets. This would push up gilt rates. Although it is clearly difficult to say when this will occur, it would be imprudent to assume that a recovery of some kind would not happen over the next five years. A forward-looking assessment of the cost of capital should recognise this.
- 4.5 In addition, it is well understood that a business's true cost of capital is relatively stable over time, even during periods of market volatility. That is precisely because investors can and do move capital between risky assets and safe assets in response to changing market conditions<sup>3</sup>. Therefore long-term estimates of the risk-free rate and the equity risk premium are the most appropriate values to use.
- 4.6 Similarly, a short-run run estimate of beta is not appropriate in assessing the correct beta to apply in assessing the WACC. The UR observes that current

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<sup>3</sup> As market volatility increases, investors demand safer assets, thus pushing the yields on those assets down. Contemporaneously, the premiums demanded by investors to hold risky assets increase. This should be borne out by an increase in the ERP. Indeed there is good evidence that implied risk premiums have increased overall as the risk-free rate has fallen (this can be seen in time series on implied UK and EU risk premia alongside gilt rates). The net effect is that the overall cost of equity has remained relatively stable.

estimates of beta are lower than past values. However, this fails to acknowledge that estimated utility betas (both asset and equity) typically decline during periods of market turbulence since:

- returns on utilities are generally stable over time; and
- consequently during periods of high market volatility, such as recently observed during recent financial crises, the measured correlation between utility returns and market returns usually falls.

4.7 This is likely to be reversed as market volatility returns to more usual levels. Therefore the WACC determination should not lock in temporarily low betas that arise as a consequence of short run volatility, which might not reflect accurately the underlying business risk faced by the companies. A longer-term perspective is more appropriate.

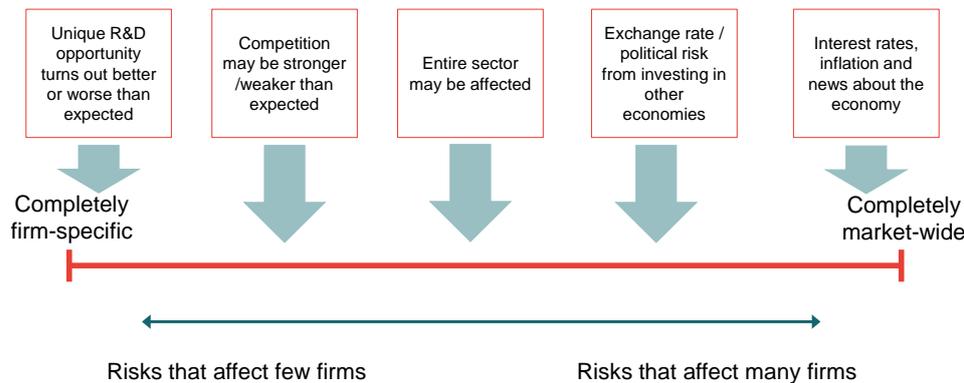
4.8 In summary, in estimating the WACC, the approach taken to determine the beta, risk-free rate and equity risk-premium should use a long-term time horizon. The CC has recognised this principle in past determinations.

#### **Debt premium and diversification of risk**

4.9 In paragraph 21 of UR-7 the UR asserts that should any debt premium exist, then its sources are entirely specific and therefore may be diversified away by equity investors. Consequently, the UR is seeking to argue that if there is a debt premium for NIE, this should not imply that there needs to be a related equity premium.

4.10 In our view, the UR's position is extreme and unsustainable. Some proportion of the debt premium will be driven by risks that are systematic.

4.11 When considering the application of CAPM, it is common to hear practitioners discuss diversifiable and non-diversifiable risks as binary, non-overlapping concepts. A more useful way of thinking about the risks that real businesses face is in terms of points along a spectrum, as represented in Figure 3.

**Figure 3.** Spectrum of risks

Source: Adapted from Damodaran (2001), *Corporate Finance: Theory and Practice*, chapter 6.

- 4.12 Located at the extremes of this spectrum are purely diversifiable risks and purely non-diversifiable risks. However, it is unusual for risks faced by companies to lie at one extreme or the other, and would be even more unusual for all risks to lie at one extreme.
- 4.13 Estimation of the relevant proportion is likely to be challenging, although estimates have been made based on academic research (see for example Guthrie (2012)<sup>4</sup>, which estimated the relevant proportion of systematic risk might be 55%).
- 4.14 For these reasons NIE considers that there is a strong argument for including an equity premium as well as the observed debt premium in calculating NIE's WACC, as set out in NIE's SoC (Chapter 15, paragraphs 3.24 to 3.29).
- 4.15 Finally, the UR's view that any such effect will be captured by the beta is unlikely to be justified, as NIE's beta cannot be directly observed. It can only be estimated indirectly by observing other information, the great majority of which will be derived for and from entities that are not subject to these NI risks. While the CC might choose ultimately to effect an uplift on equity through an uplift to the asset or equity beta, this does not obviate the need to make such an adjustment somewhere in the estimation of the cost of capital.

## RORE

- 4.16 In UR7 (paragraphs 23 to 26), the UR seeks to misrepresent the effect of Ofgem's DPCR5 price control calibration, as implemented through its RORE analysis. NIE is simply asserting that additional returns, over and above those afforded by Ofgem's headline WACC, were made available to the GB DNOs if they were able to meet, not beat, regulatory targets. In order to understand the allowed returns at

<sup>4</sup> "Leverage and Transpower's WACC", Prof Graeme Guthrie, April 4 2012.

DPCR5, it is therefore necessary to understand and take account of the RORE uplift.

- 4.17 The need to understand and take account of RORE is a direct consequence of NIE's three stage approach to estimating WACC (as outlined at paragraph 2.3 above), which NIE has been consistently applied throughout the RP5 price control process. NIE continues to consider that an approach of this kind is appropriate and that its adoption would, over time, lead to an overall reduction in the cost of capital as investors benefit from increased clarity and transparency.
- 4.18 NIE does, however, note that owing to the delays in completing the RP5 review considerable time has now elapsed since it first developed its approach to estimating the cost of capital. In keeping with our over-arching methodological position, NIE considers that it is relevant to also take account of Ofgem's more recent and completed price control reviews for the gas distributors (RIIO-GD1) and the transmission companies (RIIO-T1). NIE has done so in submitting its updated position on the cost of capital in its SoC.

### **Risk profile**

- 4.19 In paragraph 9 of UR-7, the UR sets out its view that owing to the design of elements of its proposed regulatory arrangements NIE's exposure to systematic risk is reduced and that the CC should take this into account in its estimation of beta.
- 4.20 NIE disagrees with the UR's assessment of the effect of its proposals and not accept that there are reasonable grounds to suppose that NIE is lower risk than GB peers.
- 4.21 Moreover, there are also certain elements of the UR's proposed package that NIE considers significantly increase its risk profile, in particular in respect of the regulatory arrangements around capex (as described at length in NIE's SoC, Chapter 4). The regulatory and operational risks that arise from these arrangements are of significant concern to NIE and if the proposed arrangements are implemented are likely to be of similar concern for investors.
- 4.22 NIE also notes the recent statements made by Moody's<sup>5</sup> with regard to the stability and predictability of regulation in NI. The possibility that Moody's might revise downwards its assessment of NI regulation is, again, a significant concern and highlights the wider regulatory risks to which NIE is exposed relative to GB peers that are regulated by Ofgem. This further emphasises the importance of adopting a package of arrangements that more closely resemble those in place in GB and to signal a commitment to maintain those links going forward.

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<sup>5</sup> "New Competition Commission Referral Suggests Regulatory Uncertainty Remains in Northern Ireland", Moody's Investor Service, May 9 2013.

### **Basis of the RPI**

- 4.23 In paragraph 16(b) of UR7, the UR makes reference to “*technical changes that the ONS has made to its measurement of prices*”, which it considers will have shifted the level of RPI. The UR then invites the CC to consider making an adjustment.
- 4.24 So far as NIE is aware, no adjustment to the method of calculating RPI has in fact been made by ONS. Following the completion of a review by the National Statistician, as reported on 10 Jan 2013, it was decided to leave the methodology that underpins the RPI unchanged. Consequently, NIE sees no reason to suppose that an adjustment of some kind is now required to account for a change in the methodology used to derive RPI, since there has been no such change.

### **Modelling of allowed return**

- 4.25 In paragraphs 30 to 32 of UR7 the UR raises what it regards as a technical matter with respect to how allowed return has hitherto been calculated.
- 4.26 NIE notes the issue. NIE sees no reason to depart from the long established practice adopted in previous price controls in respect of the application of the allowed cost of capital in order to calculate allowed revenues. Should the CC wish to adopt a different financial modelling approach, NIE is confident that this would not give rise to a reduction in the overall present value of revenues allowed, i.e. that NIE would not be disadvantaged.

### **The UR’s overall assessment of financeability**

- 4.27 As set out in detail in NIE’s SoC, in respect of financeability NIE rejects the UR’s assessment which is based on modelling errors, flawed assumptions over future costs and fails to recognise the effect of unjustified disallowances. The UR has also failed to take account of the real and perceived increase in regulatory risk that would arise from its FD, which we expect would act as a further drag on NIE’s credit rating. Furthermore, the UR fails to consider the implications of the exceptionally low returns to the equity investor resulting from the FD. None of the points raised by the UR in its initial and supplementary submissions have led NIE to revise its view in this regard.
- 4.28 NIE remains concerned that the UR has had to bring forward £9 million of revenue entitlement from RP6 to achieve the financial metrics required to maintain a strong investment grade credit rating. It is NIE’s view that such an adjustment would not be needed if the proposed price control was appropriately calibrated. It is not clear how the proposed bringing forward of this revenue will affect the RP6 price control.
- 4.29 NIE considers that the financeability concerns arising from the FD should be addressed by ensuring that core cost allowances and the allowed rate of return are

set at appropriate levels and that unjustified disallowances in other areas (e.g. with respect to pensions and the proposed capitalisation adjustment) are reversed.

### **Shareholder distributions**

- 4.30 The UR suggests (UR-7, paragraph 43) that the CC investigates whether NIE's gearing level at the start of RP5 is excessive, by virtue of borrowings made to fund "avoidable shareholder distributions" as occurred in the Bristol Water case. NIE considers such a suggestion to be both unhelpful and unnecessary. NIE has consistently maintained gearing below the RP4 gearing threshold of 57.5% and there is therefore no basis for any finding that NIE has made excessive distributions to shareholders.

### **Index linked debt**

- 4.31 In paragraph 43(b) of UR-7, the UR questions why NIE has not issued any index linked debt. NIE observes that the majority of recent utility bond issues have been of standard, fixed coupon products. Where RPI linked products have been issued, they have tended to be offered by larger and more highly rated entities than NIE (e.g. National Grid) and typically as an addition to a relatively large existing portfolio.
- 4.32 In 2011, following recommendation from its advisors, NIE issued a standard, fixed coupon bond. NIE considers its conduct in this respect to have been prudent, well considered and in line with wider industry practice. NIE anticipates that it may need to raise additional finance during RP5 and will carefully assess how best to structure its offering to ensure it raises this finance efficiently.

**ANNEX 14****IMPACT ON TARIFFS****1. COMMENTS**

1.1 In paragraph 25 of UR-26, the UR states that:

*“In Chapter 16, 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.”*

1.2 This comment is unwarranted. The tariff tables in Chapter 16 are clearly labelled and show the tariff impact for each of the main customer groups for each year of RP5.

1.3 Also the statement that NIE’s analysis does not include “*other large and uncertain programmes*” is factually incorrect. The only expenditure which is excluded from NIE’s analysis is that in relation to renewables and the north south interconnector, the tariff implications of which are explained clearly in paragraphs 5.2 and 5.3 of Chapter 16 of the SoC.

