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Competition Commission
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Dear Mr Jackson,

Thank you for your letter dated 3rd May 2013, inviting a submission on the issue of Northern Ireland Electricity Limited's (NIE) price determination, which was referred to the Competition Commission (CC) by the Northern Ireland Authority for Utility Regulation (UR) on 30th April 2013.

Please note that while your letter was addressed to the Company Secretary of ESB Networks Ltd, this response is from ESB, which is the parent company of NIE and a number of other legally separate companies, including NIE and ESB Networks Ltd. ESB Networks Ltd is the licensed operator of the electricity distribution system in the Republic of Ireland and is legally distinct from NIE.

As owner of NIE, ESB does not seek, nor is it permitted, as a consequence of NIE's licence conditions, to get involved in the day to day operations of NIE. Consequently our considerations are focussed on the related matters of corporate governance and shareholder value as opposed to commenting on the details of the determination with regard to the specific investment or operational activities which NIE might undertake. At the most fundamental level, ESB's concern is to ensure that NIE can discharge its statutory and licence duties within an acceptable regulatory environment.

You will no doubt have noted ESB's submission to the UR on the NIE Price Control Draft Determination of 19 April 2012 and our general discontent with the thrust of the Draft Determination and its departure from established regulatory norms. We would refer the Competition Commission to the views of Professor Stephen Littlechild that were submitted then in conjunction with the ESB response (and are attached along with ESB's response to the UR with this letter as attachments 2 and



3 for your convenience). Following the publication of the Final Determination our opinion did not change and we have since engaged Professor Littlechild again to comment further on the Final Determination particularly in relation to the UR's approach to the price control, its proposed treatment of pension costs, its proposed treatment of Capex and its proposed use of a Reporter. Professor Littlechild's further views accompany this submission as attachment 1.

ESB acquired NIE Ltd on 21st December 2010. The acquisition was based on a reasonable expectation that a transparent, predictable and measured regulatory system would reward efficient investment and operation and that in time synergies between the Network operations in the Republic of Ireland and those in Northern Ireland would be released to the benefit of both sets of customers. ESB seeks an appropriate return on its investments on a par with the risk undertaken and in line with those of peer organisations operating in comparable industries and jurisdictions facing similar risks. It is, therefore, with great concern that we note Professor Littlechild's comments on the regulatory process as directed by the UR in Northern Ireland and in particular the opportunistic rather than principled nature of this process. We completely agree with these views. This creates significant regulatory uncertainty which is not in the interest of ESB as an investor in Northern Ireland but more importantly it is not in the interest of electricity customers or indeed customers of other regulated entities in Northern Ireland. Such uncertainty will inevitably result in higher funding costs and higher prices to customers.

ESB remains committed to long term investment in the Northern Ireland electricity system. However, to do so requires regulatory structures which are supportive of this investment. It is noteworthy that 29 months on from the acquisition, the UR has still not finalised the NIE licence to reflect the acquisition, a further indication that the Northern Ireland regulatory system is failing to address the reasonable requirements of industry participants.

It remains the common objective of ESB and NIE to meet the needs of customers, in both the short and long terms, by providing for necessary and efficiently incurred infrastructure development, and adequate resources for the continued safe, secure and efficient operation of the network, within a framework that allows for appropriate remuneration of efficient investment consistent with established regulatory practice. The interests of customers should be safeguarded in short and long timescales by providing a balance of measures to incentivise and reward good performance and innovation. It is our view, supported by the observations of Professor Littlechild, that the package of measures determined by the UR simply does not achieve this balance.



The scale of investment facing electricity sectors across western Europe and indeed the globe in the drive to decarbonise our economies is unprecedented. The UR's final determination, for all the detailed reasons set out by NIE in its Statement of Case, and for the process and structural reasons identified by Professor Littlechild in the attached paper, is clearly deficient and should be rejected. Accordingly we urge the CC to determine this price control on the basis of ensuring adequate incentives and rewards are allowed to companies for the investments and risks they undertake which safeguard the needs of existing and future customers.

Yours sincerely,

Peter O'Shea

Head of Regulation and Strategy, ESB

Further Views on the Utility Regulator's Approach to NIE's Transmission and Distribution Price Control RP5

Stephen Littlechild*

31 May 2013

EXECUTIVE SUMMARY

1. Last year, ESB, the owner of NIE, asked me to assess the approach of the Utility Regulator (UR) to pensions costs, previous capital expenditure and the regulatory process generally, as exhibited in the ongoing RP5 price control review of NIE T&D up to the point of the UR's *Draft Determination* of April 2012. My *Report* dated 16 July 2012 (henceforth *Previous Report*) was submitted to the UR's consultation process.
2. Following the UR's *Final Determination* of October 2012, ESB has asked me for further views on the UR's approach to price controls, especially the philosophy behind the UR's approach, its treatment of pensions costs and capital expenditure, and its proposed use of a Reporter.

The UR's approach to price controls

3. UK price controls, and their treatment of capital expenditure, have evolved in the light of experience. The "traditional approach" became increasingly time-consuming and resource-intensive. Ofgem moved towards greater discretion for companies coupled with greater use of incentives. Ofwat became increasingly focused on monitoring and second-guessing the companies, but this was recognised as problematic, and it has now moved towards less intrusive monitoring and greater use of incentives, more comparable to Ofgem.
4. The UR's approach in RP4 reflected a similar thinking as in Ofgem's approach. In contrast, the UR's approach in RP5 reflected a reversion not merely back to the "traditional approach" but beyond that, to a focus on monitoring and second-guessing capital expenditure, including the use of a Reporter, that is more intrusive even than Ofwat's earlier approach.

The UR's treatment of pension costs

5. The UR's treatment of pension costs in its *Draft Determination* was ad hoc, not systematically consistent with either Ofgem's approach or its own previous approach. It left the impression that the UR was acting on an opportunistic rather than principled basis. The UR's *Final Determination* reverses its previous position on key issues such as valuation date, the eligibility of Powerteam pension costs and the recognition of special pension contributions made by the company. The continued erratic treatment of pension costs reinforces the impression of an opportunistic rather than principled approach.

* Emeritus Professor, University of Birmingham; Fellow, Judge Business School, Cambridge; and Member, Competition Commission. This paper reflects the author's personal views and does not purport to represent the views of any organisation with which the author is associated.

6. The UR's approach to pensions is of a piece with its approach to RP5 as a whole, which my *Previous Report* found did not measure up to the Values that the UR set itself. Transparency had been impaired by the lack of real two-way engagement. Consistency was problematic with respect to previous UR policy on pensions deficit, capital expenditure, engagement with the company, the setting of the opex allowance and GB regulation. Proportionality was called into question by the volume of UR information requests and by the likely regulatory costs of its proposed approach to capex. The UR failed to develop adequate workplans and timetables, and repeatedly failed to meet its timelines.
7. Since the *Draft Determination*, in addition to the continued inconsistency on pensions costs, there has been a further overrun of the price control process, which the UR has failed to acknowledge and address. The UR also took over five months to refer NIE to the Competition Commission, compared with the UK regulatory norm of two to five weeks.

The UR's treatment of capital expenditure

8. The UR proposes to cut 50% of the capital expenditure in NIE's business plan and 21% of the operating cost. This is significantly greater than Ofgem's proposed cuts for a typical distribution network operator in the last two price controls in GB (1% of capex and 9% of opex in 2004, 15% of capex and 1% of opex in 2009). It is greater than even the most severe cut (16% of capex and 27% of opex) that Ofgem proposed. Moreover, Ofgem's most severe cut was for the least efficient network in GB, whereas NIE is ranked comparable with the most efficient networks in GB. I acknowledge the UR's point that the allowances claimed by NIE showed a greater increase on the actual spend in the previous five years than was the case for the GB networks.
9. The substantial divergence between NIE's view and the UR's view may in significant part be attributable to the UR, whose performance in RP5, as noted, has not been up to the general standard of UK regulation. Also, the UR's consultants made no site visits to understand NIE's capital expenditure programme, whereas Ofgem's 2004 price control process involved three site visits per network. It seems that the UR was not as informed about NIE's capex programme as Ofgem was in GB.
10. The UR's proposed rules for allowing and monitoring capital expenditure in its Funds 1 and 2 are exhausting and restrictive. They would be time-consuming and resource-intensive. They would create friction between company and regulator, and blur responsibilities, rather than assist in identifying the most appropriate investment programme for customers. They would depend upon prompt feedback from the UR, but the UR's record in RP5 does not suggest that it would be capable of discharging the responsibilities that its own proposals would put upon it. I do not believe that GB privatisation could have been sold to the City on the basis of such a regulatory approach, and it would be surprising if it were in the interests of Northern Ireland to create a climate that deterred investment in fundamental utilities.

The UR's proposal to introduce a Reporter

11. The UR proposes to introduce a Reporter to act as auditor, certifier and commentator on the company's regulatory submissions. Although Ofwat has now discontinued the use of Reporters, the UR says that the benefits of

Reporters at Ofwat have been realized over a number of years so that they are no longer needed.

12. This is not what Ofwat itself said. It made no reference to any benefit of Reporters. It pointed out the costly and unsatisfactory consequences of the weight it had previously placed on data collection and monitoring, including the use of Reporters. In deciding to discontinue Reporters, Ofwat proposed that the companies themselves take accountability for their systems and assurance processes. In effect, the approach involving Reporters had become a problem rather than a solution.
13. Ofwat's present view and revised approach is consistent with the conclusions and recommendations of the 2011 Gray *Review of Ofwat*. Gray found that the data collection and monitoring regime, including Reporters, had become excessively burdensome and undermining of companies' responsibility for their business plans.
14. The Water Industry Commission for Scotland (WICS) has recently discontinued its use of a Reporter, for similar reasons.
15. The decision of the Office of Rail Regulation (ORR) to use Reporters, in about 2000, was informed by a perception that Ofwat's Reporter model was generally successful. That perception has now been superseded by Ofwat's more recent experience and revised policy. A 2011 Public Accounts Committee report expressed concern that the arrangements for Independent Reporters were "creating at worst a potential conflict of interest and at best too cosy a relationship between various players".

Summary and Conclusions

16. The UR's RP5 price control philosophy is not consistent with its philosophy in RP4 or with the present direction of GB regulation generally: indeed, it is heading in the reverse direction. The UR's stance on pensions costs has been erratic. Its regulatory process has not met its stated Values of Transparency, Consistency and Proportionality. Its assessment of NIE's capex business plan is out of line with Ofgem's assessments, and has not been informed by any site visits. Its proposed approach to monitoring capital expenditure involves much greater emphasis on data collection and checking, including the use of Reporters. This reflects, but goes further than, an approach that Ofwat once took. Ofwat has since abandoned that approach because it was excessively burdensome and undermining of responsibilities. In short, RP5 reflects an approach that has been tried, and found wanting. RP5 is not the future, it's the past, and a past that didn't work well.

TERMS OF REFERENCE

1. Last year, ESB, the owner of NIE, asked me, as a former GB electricity regulator, to assess certain aspects of the present approach taken by the Northern Ireland Utility Regulator (UR) to the then ongoing review (known as RP5) of NIE's Transmission and Distribution Price Control. The specified aspects were the treatment of pensions costs and the approach to previous capital expenditure, both as set out in the UR's *Draft Determination* of 19 April 2012, and the UR's regulatory process generally during RP5. NIE submitted my report, entitled *The Utility Regulator's Approach to NIE's Transmission and Distribution Price Control RP5*, 16 July 2012 (henceforth my *Previous Report*), to the UR's consultation process.
2. The UR published its *Final Determination* on 23 October 2012. NIE rejected it on 22 November 2012. ESB has now asked me to assess the philosophy behind the UR's approach to price controls, to look again at the UR's revised treatment of pension costs and its approach to capital expenditure as set out in the *Final Determination*, and to comment on the UR's proposed use of a Reporter.
3. Part One of this report sets the UR's approach in RP5 in the context of price controls and their evolution in the US and UK. Part Two comments on the UR's revised treatment of pension costs. Part Three examines the UR's approach to capital expenditure. Part Four evaluates the UR's proposed use of a Reporter in the light of the experiences of other UK regulators that have used Reporters, including Ofwat, the Water Industry Commission for Scotland (WICS) and the Office of Rail Regulation (ORR). A brief final section summarises the conclusions of this report.

PART ONE THE UR'S APPROACH TO PRICE CONTROLS

1. The UR's explanation of its approach to price controls

4. The UR's *Draft Determination* explained why its approach to setting price controls had changed in RP4 and how it proposed to take a further different approach in RP5. It focused in particular on the treatment of operating costs (opex) and capital expenditure (capex). In my *Previous Report* (p 16) I summarised the UR's explanation as follows.

In its RP4 proposals, the UR summarised what it called "the traditional approach" to setting the opex allowance.

"The work typically involved an examination of the company's operating cost base, benchmarking it against the cost bases of other electricity network companies both nationally and internationally, and undertaking a very detailed item by item analysis of individual expenditure categories."
(p 5)

The UR commented that this method was "time-consuming and resource-intensive, and differences in the way that companies report their costs adds to the difficulty in ensuring that efficiency comparisons are made on a like-for-like basis". The UR also explained the problem of capex underspend in the traditional approach to the capex allowance. These concerns led the UR to take a different approach in RP4.

"In a move away from the traditional methods applied to a price control a number of new approaches to incentive mechanisms were introduced for RP4. These included a 'rolling' Opex mechanism and setting Capex using actual rather than forecast expenditure. An evaluation of these mechanisms will be required to assess the appropriateness of continuing with them in RP5." (RP5 Strategy Paper p 2)

In its RP5 Draft Determination, the UR moves into reverse. "For RP5 we are minded to return to a traditional RPI-X type price control, with allowances designed to incentivise NIE T&D to control its operating and capital costs." (para 4.14 p 15) The rolling opex mechanism is replaced by a five year lag mechanism, as used in GB, and the ex post capex mechanism is replaced by an ex ante capex allowance with provision for a Reporter.

5. I then expressed two concerns about the UR's changed approach in RP5.

It is understandable that a regulator should review the operation of the various components of a price control, and where appropriate propose changes on a going-forward basis. Two aspects of the present proposal are of some concern, however. First, in proposing a return to the "traditional approach" to opex, the UR makes no reference to the shortcomings that it had previously identified in the RP4 process, that were sufficiently serious to cause it to abandon that approach. Second, there is no acknowledgement or exploration of the additional regulatory burden – that might be expected to have similar shortcomings - associated with the proposed ex ante capex allowance and Reporter system. In consequence, whether this increased regulatory involvement can be fairly described as "a traditional RPI-X type price control" or an "allowance designed to incentivise NIE" is questionable.

6. Various different methods for setting price controls have been developed over the years, each trying, in the light of experience, to improve upon previous methods. A brief sketch of some recent developments in price controls will provide a helpful context for assessing the UR's RP5 approach. I start with US experience, which informed the design of utility price controls in the UK.

2. US approaches to price control

7. All price controls – and for that matter all profit and rate of return controls – that last more than a short time need to provide for assessing and remunerating operating costs and capital expenditure (capex). The controls should ensure that regulated companies are adequately remunerated for providing the services that customers want. They should also ensure that expenditure is incurred efficiently, and is not charged to customers at an excessive profit.
8. The traditional US approach is for a regulated company to be allowed to set rates that provide a reasonable return on an approved regulatory asset base (RAB). As and when it carries out capital expenditure, the company may apply to bring the new asset into the RAB. It has to demonstrate that the asset is “used and useful” and that the construction cost was reasonable. This ex post assessment process was designed to protect both customers and companies and their investors. Companies would have the incentive to incur only reasonable costs for fear of excess costs being disallowed, and they would have the reassurance that their reasonable costs would be remunerated, while customers would be assured that each new investment had been approved by the regulator.
9. During the 1960s and 1970s various criticisms were made. The legalistic process was time-consuming, costly and uncertain. Economists argued that, if the allowed rate of return were greater than the company's cost of capital, there would be an incentive to engage in excessive capital expenditure (gold plating). And unless the regulator could prove inefficiency, the company would in effect simply pass-through its actual operating costs (opex) on a cost-plus basis. Moreover, since the regulator could step in at any time to reset rates equal to cost, the incentive to reduce that cost was limited or non-existent.
10. Later research on the US regulated sector suggested that the concerns about excessive capex and opex might not have always been justified. Indeed, especially after some nuclear construction costs were disallowed, it was feared that regulated companies were discouraged from new investment by the risks of ex post disallowance by the regulator. Methods therefore began to be developed for providing ex ante regulatory assessment and assurance about new investment. Companies and customers also began to bypass the most costly, risky and time-consuming aspects of the regulatory process by negotiating settlements to propose to the regulators, which were increasingly encouraged and accepted.

3. The “traditional” approach to UK price controls

11. The earlier concerns about US rate of return regulation influenced the design of price controls for the newly privatised utilities in Great Britain in the 1980s. A major aim in the UK was to improve the efficiency of the previously nationalised industries. It was accepted that “the regulator knows best” was not a

plausible assumption. Hence the concept of a five year RPI-X price cap, set on the basis of expected efficient costs, which gave the regulated company a five year incentive to find the best ways of reducing operating and capital costs, and to respond to changing circumstances, provided that an acceptable quality of service continued to be provided. This is what the UR has called the “traditional” approach to setting UK price controls. It was widely used in privatising the GB utilities, and in particular was inherited and implemented by Ofgem and Ofwat.

12. The RPI-X price caps proved effective. Significant efficiencies were indeed obtained in operating and capital costs, in all the privatised industries, and indeed continue to be obtained. RPI-X price controls were continued in most sectors, with various modifications.
13. Nonetheless, at least two concerns arose as to the treatment of capital expenditure (capex). First, as in the US, the setting of the price control involved a costly and confrontational process whereby the companies and their consultants were pitted against the regulator and its consultants in order to try to identify an appropriate capex programme and efficient levels of cost (for example, by benchmarking). Second, if a price control had been set on the basis of an estimated efficient level of capex, but in the event the company did not incur all of that capex, customers asked whether it was right that the customer should have paid for capex that was not actually incurred? Regulators ensured that, if the planned capex did not get built, it did not go into the RAB for the subsequent price controls, so customers would not continue to pay for it. Nonetheless, the concern persisted.

4. Evolving UK regulatory approaches

14. UK regulators responded to these concerns in various ways. Ofwat took a relatively hands-on approach, with a clearer specification of what investment was approved and intended to be implemented and when, with ongoing monitoring and reporting including the use of Reporters. This approach may have been influenced by the very significant level of investment that water companies were required to make in order to meet environmental obligations. Over time, the approach became more and more detailed. The ORR moved in a similar direction, also using Reporters, reflecting among other things a concern about the competence of Railtrack and the lack of information about that company’s system.
15. In contrast, Ofgem moved towards a more extensive system of incentives to address these concerns. Inter alia, it developed the concept of menu regulation that provided incentives on each company i) to propose a level of capex that was consistent with the regulator’s proposed level, and ii) to ensure that actual expenditure was consistent with the level that the company proposed.
16. Experience with these two systems has informed the latest round of price control processes. Ofgem has found its menu regulation approach satisfactory and has continued it. It has also evolved the RPI-X approach into the concept of RIIO (Revenues = Incentives + Innovation + Outputs) which puts emphasis on the outputs delivered rather than on the inputs (including capex) used to deliver them. Companies are thereby given greater freedom to manage.
17. In parallel, Ofgem has begun to develop a concept of customer engagement that encourages the companies to talk to their customers and customer

representatives to ascertain what services they want, to explain and discuss the capex and costs involved, to build these customer preferences into each company's business plan and to inform the regulatory stance on it. During the course of the forthcoming price control periods one might expect that the customers and their representatives will be monitoring each company's performance and in particular the implementation of the actual capex programme, and that the company will be explaining the reasons for any deviation from its earlier business plan.

18. Significantly, Ofwat too has now moved in a similar direction as Ofgem. Following critical independent assessments of its approach (eg David Gray's *Review*) Ofwat has moved away from a process of detailed assessment and second guessing of the companies' business plans, and detailed monitoring of implementation. It no longer mandates frequent regulatory reporting and the use of Reporters. Ofwat too now uses menu regulation as an incentive to companies, with the emphasis on outputs rather than inputs. And it too is requiring a process of customer engagement to inform the development and assessment of company business plans.
19. The Scottish water regulator WICS has moved furthest and fastest in this same direction. It has created a Customer Forum that is now actively engaged with Scottish Water in the price control process.
20. The ORR has continued to use a detailed benchmarking and monitoring approach, including the use of Reporters. This has been criticised, however, as explained later.

5. The UR's RP4 and RP5 approaches in context

21. The developments in price control approaches outlined above show that the UR's approach in RP4 reflected a similar experience and philosophy as at Ofgem and, later, at Ofwat, albeit to a more limited extent than at these two regulatory bodies. In particular, the UR in RP4 recognised the difficulties of forecasting capex spend, and the costly and confrontational process of debating the efficient capex programme, and began to develop incentives as a better way to deal with the problems experienced.
22. The UR's approach in RP5 reverses that development.. But as explained below, it also introduces a more complex treatment of capex involving separation into three Funds, each with detailed rules concerning its use. Common to these rules are more detailed assessment (sometimes described as second-guessing the company's management), real-time monitoring and the use of a Reporter.
23. Thus, the UR's approach in RP5 is a move in the opposite direction to present trends in GB. But it is not simply a reversal to "the traditional approach" used by GB regulators. It is a more detailed, prescriptive and interventionist approach. In that respect it seems to go beyond the approach that Ofwat used before recognising the difficulties and disadvantages that this involved. These points are developed further in the context of capital expenditure and the use of Reporters. But the more general question is why the UR is now moving in the opposite direction to GB regulators, and proposing to adopt measures that they are increasingly discontinuing because of their unsatisfactory consequences?

PART TWO THE UR'S TREATMENT OF PENSION COSTS

6. The UR's treatment of pension costs in its *Draft Determination*

24. My *Previous Report* summarised and commented on the UR's treatment of pension costs in RP5. Briefly, the UR's *Draft Determination* declined to use the latest available date of valuation of the pension deficit, contrary to Ofgem's practice. (*Previous Report*, section 1) It decided upon a longer (15 year) period to recover the deficit than the pension trustees had decided upon, consistent with Ofgem's practice although the basis for Ofgem's decision (rising electricity prices) did not apply to the UR's *Draft Determination*. It argued that NIE should not recover the share of pension deficit attributed to Powerteam because the latter was a separate legal entity. It revisited a series of the UR's own past regulatory decisions in deciding which pension-related costs should be allowable.
25. I found that "neither the objective of providing a stable environment to encourage investment, nor consistency with previous UR decisions, nor 'consistency with recent GB regulatory practice', would support the UR's present proposal to reduce NIE's allowed revenue by calculating the impact on the pension deficit of NIE's actions over the last three price control periods and retrospectively adjusting for that". (*Previous Report* para 41)
26. I concluded that "The UR's pensions proposals leave the impression that the UR is acting on an opportunistic rather than principled basis, seeking any justification for a short-term price reduction." (*Previous Report*, para 42 p 9)

7. The UR's treatment of pension costs in its *Final Determination*

27. In its *Final Determination* the UR now reverses its previous decision on valuation date, and proposes to use a more recent one – but not the most recent one, which exhibits a greater deficit and which is promised to be considered later. The UR maintains the 15 year recovery period. It reverses its decision on Powerteam. It reverses its decision on revisiting previous regulatory decisions – except for costs arising from early retirements, which reduce NIE's pension-related revenue by £41m. It now provides no adjustment for special contributions made by the company, which it had previously held to justify £65m revenue for the company.
28. The presentation of this last element is disingenuous. By way of explanation for its decision, the UR says "In its response to the draft determination, NIE T&D noted that it "did not seek to recover the value of special contributions paid". (*Final Determination* para 7.48, p 68) However, this is only part of what NIE said, and the UR's excerpt is taken out of the context of NIE's sentence as a whole. NIE said

7.2 The method adopted by the Utility Regulator to calculate the value of the special contributions is different from NIE's calculations. The figure NIE submitted was £51.3 million although, in line with its principled approach to pensions costs and NIE's submission as to the inappropriateness of retrospective adjustments, NIE did not seek to recover the value of the special contributions in excess of the early retirement costs borne by the shareholder. (*NIE Response to the UR's Draft Determination*, p 169)

29. What NIE was evidently saying is that it did not seek to recover the value of the special contribution *conditional upon* a principled approach being taken to the recovery of pensions costs, such as the one NIE itself set out, which included the inappropriateness of retrospective adjustments. This was not a carte blanche renunciation of a claim for special contributions to be taken into account, regardless of whether the UR adopted a principled approach or not.
30. Unfortunately, the UR's revised treatment of pensions costs in its *Final Determination* is as erratic as in its *Draft Determination*. It reinforces the impression that the UR is taking an opportunistic and arbitrary approach rather than a principled approach, seeking any justification to avoid conceding a short-term price increase to customers.

8. The continued inadequacy of the UR's regulatory process

31. The UR's opportunistic approach to pensions is unfortunately of a piece with its approach to RP5 as a whole. As I explained in my *Previous Report*, the UR's approach does not measure up to the Values that the UR set itself. I found that Transparency had been significantly impaired by the lack of real two-way engagement on the part of the UR. Consistency of the UR's approach was problematic with respect to previous UR policy on pensions deficit, capital expenditure, the nature of engagement, the setting of the opex allowance and GB regulation. Proportionality was called into question by the volume of UR information requests and by the likely regulatory costs of its proposed approach to capex. The UR failed to develop adequate workplans and timetables, repeatedly failed to meet its timelines, and failed to address the implications of the overrun of its price control process beyond the term of the previous price control.
32. The UR has responded to my *Previous Report*. (*Final Determination*, Appendix F consultation Responses, pp 27-35). However, nothing there causes me to change the views I expressed. Indeed, the UR's conduct since the *Draft Determination* adds to this dismal record. I have already noted its dramatic and apparently opportunistic inconsistency on pensions costs as between the *Draft* and *Final Determination*. In addition, there has been a further overrun of the price control process, and the UR has failed to acknowledge and address the implications of this.
33. To explain, in October 2011 the UR summarily extended by six months the previous RP4 price control which was due to expire at the end of March 2012. It did so without a public consultation process or a licence modification process, despite the fact that the RP4 price control contained specific provisions relating to the period up to 31 March 2012 only. In August 2012 the UR further extended the RP4 price control to 31 December 2012, again without further consultation. But since 1 January 2013 NIE has been left in limbo from a price control perspective.
34. Presumably there is scope to try to true-up everything when the next price control is put in place. Meanwhile NIE has no proper framework within which to run its business, and not least make plans for capital expenditure. Amongst other things, procurement processes and contract renewals have been delayed because of ongoing uncertainty, which in turn creates the prospect of

bottlenecks in getting materials and contractors in place. It rather looks as if the UR is leaving somewhat of a mess for the Competition Commission to sort out.

35. In part, this problem has arisen because the UR did not deal in a timely way with NIE's decision not to accept the UR's *Final Determination*. NIE gave notice of its rejection on 20 November 2012. The UR's formal referral of NIE to the Competition Commission was not issued until 30 April 2013, more than five months later. This stands in contrast with the UR's reference of Phoenix Gas to the Competition Commission: that company's licence required a reference to be made within seven weeks, which at the time of issuing the licence was evidently considered a reasonable maximum time.
36. The time taken by the UR to refer NIE stands in even starker contrast with Ofwat's 2010 reference of Bristol Water within 19 days of it rejecting Ofwat's final determination, and with the UR's own 1996 reference of NIE in 19 days. Prompt referrals after rejection of a price control proposal – within about two to five weeks - have long been the norm in the GB utility sector, as the following list shows.

South West Water determination 28 July 1994, rejection August 1994, reference 29 September 1994

Portsmouth Water determination 28 July 1994, rejection August 1994, reference 29 September 1994

Scottish Hydro Electricity proposal September 1994, rejection 27 October 1994, reference 14 November 1994

British Gas proposal August 1996, rejection October 1996, reference 14 October 1996

Northern Ireland Electricity proposal 31 July 1996, rejection 30 August 1996, reference 18 September 1996

Mid-Kent Water determination 25 November 1999, rejection January 2000, reference 7 February 2000

Sutton and East Surrey Water determination 25 November 1999, rejection December 1999, reference 7 February 2000

37. During the five months leading up to its Competition Commission reference, the UR gave no public indication of its thinking or of the reasons for delay. Given this remarkable and inconsiderate lack of urgency, one can only surmise that the UR had failed to prepare for the possibility of the company rejecting its *Final Determination*, and did not have an adequate case ready to file with the Competition Commission.

PART THREE THE UR'S TREATMENT OF CAPITAL EXPENDITURE

9. Contrast between the UR's RP5 approach and that of Ofgem in GB

38. I am asked to consider the UR's treatment of capital expenditure – what might be called future capital expenditure to distinguish it from the previous capital expenditure considered briefly in my *Previous Report*. There are two aspects to examine. First, in sections 9 to 11, I consider the approach that the UR used in the RP5 price control process for assessing the amount of capital expenditure that would be appropriate during the forthcoming price control period, and contrast it with the approach used by Ofgem. Then, in sections 12 and 13, I consider the approach that the UR proposes to use to monitor and vet the NIE's actual capital expenditure during the course of that period.
39. For reasons explained in my *Previous Report*, the UR's RP5 process of attempting to define appropriate capex and set this element of the price control proved as time-consuming and resource intensive as the UR had previously (in setting the RP4 price control) said was to be expected. The UR's 300 questions, 45 spreadsheets and over 450 follow-up questions (*Previous Report* para 107, p 22) are just an illustration. The RP5 process was also more confrontational and unsatisfactory than modern price control processes in the GB electricity sector.
40. The treatment of capex proposals in particular highlights the contrast between the UR and Ofgem in GB. In its *Draft Determination*, the UR proposed to cut NIE's business plan capex (Funds 1 and 2) by about 60% and its opex by about 25%. I commented that "these are more severe cuts than other UK regulators would normally consider reasonable" (*Previous Report* para 110, p 23)
41. The UR's *Final Determination* increased NIE's proposed capex and opex allowances but it still proposed to cut NIE's business plan capex by about 50% (Table 5.5) and its opex by about 21% (Table 6.4). My earlier comment still applies: these are more severe cut than other UK regulators would normally consider reasonable. The following paragraphs document and quantify this claim.
42. In its November 2004 *Final Proposals*, Ofgem's consultants PB Power formed a view of base case capex that was in aggregate about 10% less than the adjusted base case forecasts of the distribution network operators (DNOs). (Table 7.5 p 84) Ofgem's total allowance including a sliding scale mechanism was in aggregate 3% less than the DNOs' forecast, and Ofgem's total allowance including Quality of Service allowances was in aggregate only 1% less. Ofgem's aggregate cut for opex was 9% off the DNOs' business plans.
43. Five years later, in its December 2009 *Final Proposals*, Ofgem's final proposal was for an aggregate cut of 15% in network investment and 1% in opex, compared to the DNO business plans. (Table 3.2 p 35)
44. For four transmission companies (three electric, one gas), Ofgem's *Final Proposals* of December 2006 proposed an aggregate cut of 18% in capex and 7% in opex. (Table 2.3 p 9) In December 2012 Ofgem's *Final Proposal* for National Grid Electricity Transmission was a capex cut of 8% and an opex cut of 15%. (Table 3.2 p 26) In April 2012 Ofgem had already accepted the business plans of Scottish Power and Scottish Hydro.
45. There are of course differences from one company to another (see below). But the above figures suggest that what might be thought of as a "typical" regulatory

adjustment to a GB electricity distribution network company's business plan might be about 1% off capex and 9% off opex, or about 15% off capex and 1% off opex. For transmission the figures are a little higher, at 18% and 7% off, or 8% and 15% off, and arguably 0% and 0% off for two transmission companies. It is apparent that the UR's proposed 50% off capex and 21% off opex is quite out of line with regulatory practice in the GB electricity sector.

46. Perhaps not surprisingly, given its radically different inputs, the outcome of the UR's proposed RP5 price control is also out of line with Ofgem's recent DNO price controls. In 2005 the UR explained that the RP4 outcome for NIE was similar to Ofgem's 2004 proposals for comparable GB network companies because NIE faced the same issues. However, in 2012 there is now a striking contrast between the proposals of the two regulators. For the three GB distribution companies that the UR previously described as most comparable to NIE, Ofgem considered in 2009 that it was necessary to implement a price *increase* totalling about 34% over five years. (*Previous Report*, para 113 and fn 5, p 23) In contrast, the UR's *Draft Determination* for RP5 proposed a real price *reduction* totalling about 16% over five years.¹
47. The various modifications in the UR's *Final Determination* no longer enabled the UR to propose a price reduction. It now envisaged that "network charges should remain relatively flat over RP5". (Executive Summary para 16.4) Nevertheless, relatively flat network charges are still way out of line with Ofgem's proposals for a 34% price increase for comparable GB DNOs.

10. Comparison with exceptional Ofgem cases

48. It might be said that the GB figures given above are simply aggregates, that there were differences between the 14 DNOs, and that in some cases the regulator proposed cuts significantly above the average level. This is true: but how high were the highest cuts?
49. In both 2004 and 2009 Ofgem's proposed cuts were rather minimal for many DNOs, and in some cases Ofgem proposed higher rather than lower opex allowances. Nonetheless one company does stand out at the other end of the spectrum: EdF, which owned three DNOs (known as LPN, SPN and EPN).
50. In 2004, Ofgem consultant PB Power's view on capex was lower than EdF's view by 26%, 10% and 18% for the three networks, respectively. Excluding the Quality of Service allowance, Ofgem's capex allowances were lower by 16%, 3% and 10%, respectively. Including the Quality of Service allowance, Ofgem's capex allowances were lower by 16%, 2% and 6%, respectively. Ofgem's opex cuts were 27%, 24% and 18%, respectively. EdF was again an outlier in 2009. Ofgem proposed capex cuts of 21%, 20% and 20% for these three EdF networks, coupled with opex cut of 3%, 2% and 9% respectively.
51. Thus, out of 28 DNOs in Ofgem's experience over the last two price controls, the most severe example is EdF's LPN network in 2004, with a capex cut of 16% coupled with an opex cut of 27%. The next most serious example is EdF's EPN network in 2009, with a capex cut of 20% and an opex cut of 9%. It is

¹ Here and in the *Final Determination* I have used the UR's figure excluding network expansion for renewables and interconnection because this is the relevant basis for comparison with the GB distribution networks. In GB the network costs of renewables and interconnection fall to the transmission networks.

nonetheless apparent that the UR's presently proposed capex cut of 50% and opex cut of 21% for NIE is more severe than even the most severe of Ofgem's cuts.

52. Another significant factor needs to be taken into account too. Ofgem's 2004 benchmarking analyses show EdF's three networks, especially LPN, as the least efficient in the whole GB sector, in terms of both opex and total cost. (eg *Final Proposals* Figs 7.1 – 7.3) It is therefore not at all surprising that EdF's networks, and LPN in particular, should be assessed significantly more severely than other networks in GB.
53. I understand that NIE has provided evidence of its benchmarking against the 15 UK Distribution Network Operators (DNOs). It ranks 2nd on allowed revenues, 4th on indirect costs, 1st on repairs and maintenance costs and better than benchmark on 83% of cost lines. The UR cites its consultants CEPA as identifying some room for improvement in indirect costs, but grants that "benchmarking by SKM [also the UR's consultants] has shown that the direct costs associated with NIE T&D's capex plan are efficient". (*Final Determination* para 5.54 p 33)
54. Thus, even on the UR's appraisal, NIE is running a network that ranks with the best of the GB electricity networks, whereas on Ofgem's appraisal EdF's networks ranked with the worst. Understandably, Ofgem considered it appropriate to propose significant cuts in the EdF DNOs' estimates of capex and opex, but only minimal cuts in the capex and opex plans of the best-performing DNOs. Is there any reason to suppose that NIE as a network company comparable to the best in GB would propose less reasonable capex and opex plans than its GB comparators? Or any objective justification for the UR to impose more severe cuts on NIE's business plans than Ofgem imposed on the plans of even the worst-performing GB network?

11. Response to the UR on cuts to NIE capex and opex

55. In responding to my previous comments, the UR says "The statement about 'cuts to NIE T&D's proposed opex and capex' does not consider the substantial increased allowances sought by NIE T&D and lack of supporting detailed information provided in NIE T&D's original submission. This is not consistent with other regulated companies' submissions."²
56. It is not clear who are the "other regulated companies", and I am not able to assess the amount of supporting detailed information provided in any of these submissions. However, there are reasons to believe that the increased allowances sought in NIE T&D's original submission were not inconsistent with the submissions of electricity companies in GB.
57. NIE engaged Parsons Brinkerhoff (PB), technical consultant to Ofgem during the DPCR5 review, "to provide assistance with the preparation of its capex submission so that it was developed in a manner consistent with the processes and techniques adopted in current GB regulatory practice". (NIE, *T&D RP5 Price Control, Statement of Case to the Competition Commission*, Chapter 5, para 2.23, p 70)
58. I have compared the increased allowances sought. NIE T&D reportedly sought increases of 107% in capex and 22% in opex compared to the actual spend in the

² *Final Determination*, 23 October 2012, Appendix F, Consultation Responses, p 29

previous five year period.³ For the 14 GB DNOs, the average increases sought in 2009 compared to the previous five year period were 48% in capex (range 29% to 77%) and 16% in opex (range 9% to 24%).⁴ The figure of 107% for NIE T&D is thus beyond the range of what the GB DNOs sought for capex increases, and the figure of 22% is above the average but just within the range for what the GB DNOs sought for opex increases.

59. However, NIE's T&D business includes transmission as well as distribution. National Grid Electricity Transmission (NGET)'s proposed increase in capex seems to have been about 177% above Ofgem's allowance in the previous control,⁵ and its proposed increase in controllable opex about 38% above Ofgem's previous allowance.⁶ So NIE's proposed increases are significantly lower than NGET's proposed increases, for both capex and opex.
60. A more thorough comparison would need to take account of factors specific to Northern Ireland (for example, the higher proportion of overhead circuits), and the fact that lumpy projects will show up in a smaller network but will be smoothed over time in a larger network. In addition, NIE's distribution network is responsible for a number of operating costs and associated cost increases that in GB are borne by Elexon, MRASCo and suppliers. These factors and the above calculations suggest that, when transmission and supply activities are taken into account as well as distribution, NIE T&D's proposed increases in capex and opex allowances are not in fact inconsistent with the broad range of submissions of GB companies.

12. The UR's approach to capex regulation

61. If NIE is not out of line with best company practice in GB in terms of efficiency, an alternative possible explanation for the UR's remarkably severe proposed cuts in capex and opex is that the UR is out of line with best regulatory practice in GB. As summarised above, my *Previous Report* provided reasons to believe that this was the case. The UR's performance during the RP5 price control process was seriously lacking with respect to Transparency, Consistency and Proportionality. The UR also failed to manage the timetable of the price control process. I have shown above that this dismal performance continued after the *Draft Determination*, up to and indeed after the *Final Determination*. The UR's approach does not reflect good UK regulatory practice and is simply not on a par with that of other UK regulators.
62. The UR has in fact provided some further insight into its thinking and practice on capex regulation. In explaining why it increased NIE's capex allowance from the *Draft* to the *Final Determination*, the UR says that this was because NIE provided further information.

³ *RP5 Draft Determination*, Table 9.1 p 58 and Table 10.1 p 91

⁴ Ofgem, *DPCR5 Final Proposals* 2009, Table 3.2

⁵ Total capex proposal £13, 255.6m for 8 years averaging £1657m per year (Ofgem, *Final Proposal for NGET*, December 2012), compared to Ofgem's allowance of £2997 for 5 years averaging £599m per year. (Ofgem, *TPRC Final Proposals*, December 2006 Table 3.3).

⁶ Controllable opex proposal £1980m for 8 years averaging £247.5m per year (National Grid, *Business Plan Overview* p 32), compared to Ofgem's allowance of £782.4m for 5 years averaging £156.48m per year (Ofgem, *Final Proposals*, December 2006). I do not presently have access to NGET's actual spend on opex and capex during those years.

We would like to emphasise that at all times throughout this capital assessment process we have accepted the factual accuracy of all of the data that NIE T&D provided to us. Our consultants do not consider it typical for a third party to undertake site visits as it is of limited value in validating data. The factual information that NIE T&D provided in its initial submission was insufficient to support its capex claim. NIE T&D has provided significantly more data since our draft determination. The money approved in our final determination is largely as a result of the additional evidence that NIE T&D provided concerning the condition of the network assets and NIE T&D's asset management strategies. (*Final Determination* para 5.16 pp 26-7)

63. However, this paints a rather worrying picture of a "Computer Says No" approach to regulation. It simply looks to tick boxes on information provided by the company, rejects proposed investments if all the boxes are not ticked, looks only to minimise short-term price by minimising capex, and does not try to understand the situation on the ground and the implications for quality of service to customers if investment does not go ahead.
64. The UR's comment about site visits is revealing and particularly worrying. Whether or not site visits are of limited value in validating data, this is surely not the only reason for making them. Are they not important in assisting the consultant (and hence the regulator) to understand the context and reasons for the proposals, to appreciate the challenges faced by the company and its thinking in addressing them, to assess the quality of the staff working on the capex projects, to form some first hand view of the appropriate nature of the capex programme beyond what can be conveyed in written answer to a question? And, at the same time, do such visits not convey to the company the nature of any concerns that the consultant or the regulator might have, issues on which they might appreciate further information, and so on? The information, understanding and trust that can be developed in such an on-site process goes beyond what can be conveyed in a series of written answers to written questions, however many such questions are posed. In rejecting site visits, the UR has rejected all these potential insights and other benefits.

13. Ofgem's contrasting approach to capex regulation

65. The UR's arm's-length approach stands in stark contrast to the interactive approach of Ofgem. Consider, for example, how Ofgem's *Final Proposals* summarised its DNO price control process in November 2004 (and a comparably open approach still applies today)

Project Update

1.5 Since the publication of the September 2004 Update document, a committee of the Gas and Electricity Markets Authority has met with each of the DNO management teams at a senior level to discuss the outstanding issues on the review. For each management team, this was the third such meeting during the course of the review, reflecting Ofgem's commitment to transparency and access. In addition, Ofgem has met each company management at least once. In Ofgem's view, all of the company management teams have had ample opportunity to make their case.

1.6 In addition, since the September Update:

◆ an Ofgem-DNO legal issues working group has met on three occasions to discuss drafts of the licence modification proposals that will give effect to the price controls and the regulatory instructions and guidance documents that will support reporting against, monitoring and subsequent review of the licence conditions;

- ◆ an Ofgem-DNO-NGT incentives working group has met twice to discuss the development of the incentives framework;
- ◆ an Ofgem-DNO cost assessment working group has also met to discuss outstanding cost and financial issues; ... (p 2)

Ch 7 Assessing Costs

7.2 Over the past year, Ofgem has devoted substantial resources to assessing the companies' historical and forecast costs. The cost assessment work began with the specification of detailed information requests, in consultation with the companies. The completed business plans were initially submitted in stages – historical information in September 2003 and forecasts in December 2003 and January 2004, but a number of resubmissions were necessary. Ofgem and its consultants have visited each group on a number of occasions, including 2-3 day visits in October/November 2003 and February 2004, and one day visits in March (Ernst & Young) and in April/May. Subsequent to initial proposals, Ofgem met with each DNO management team on a number of occasions to discuss aspects of the cost assessment. (p 64)

Capital expenditure

7.50. ...Ofgem has, with the assistance of the engineering consultants PB Power, reviewed the proposals put forward by each of the DNOs to ensure that the allowances set are appropriate and represent fair value for customers.

7.51. To assist in this process Ofgem commissioned PB Power to review both the proposals submitted by the DNOs and also their capital expenditure during the current price control period. The approach, described in detail in the *Initial Proposals* paper, has involved a review of the proposals submitted by the companies together with the development of models for both load-related and non-load related expenditure to allow an assessment of the DNOs' requirements on a consistent basis. *The process has involved three main visits to each of the DNOs and extensive subsequent discussions.* (p 80, italics added)

66. The UR has not published SKM's consultancy report in RP5, whereas NIE was shown Mott McDonald's report in RP4. It is not known what consultants SKM were asked to look at, how comprehensive was their remit, how they carried out their work, what their conclusions were, or how they arrived at their conclusions. In contrast, Ofgem was keen to publish the capital expenditure reports by its consultants PB Power.

The reports are being published to provide greater transparency into the reasons for Ofgem's final proposals and, in particular, to allow interested parties to understand the type of analysis and assessment that contributed to the development of capital expenditure allowances, which were an important component of the overall proposals. It is also envisaged that publishing these reports should provide background information that may be useful to those interested in future price control reviews. (Ofgem, *Electricity Distribution Price Control Review – PB Power Reports on Capital Expenditure*, 20 January 2005)

67. The PB Power reports themselves were substantial documents: one for each DNO, each report of between 67 and 92 pages in length. There is no question but that, by the end of this highly interactive price control process, Ofgem and its consultants had a thorough understanding of the capex plans of each of the DNOs. It seems inconceivable that the UR's hands-off process, with its refusal to make site visits, would have enabled its consultants SKM to reach a comparable understanding of NIE's capex plan, and hence communicate such understanding to the UR itself.

68. In summary, the UR's 50% cut in NIE's capex plan and 21% in its opex plan are more severe than any cut proposed by Ofgem. One cannot explain this on the grounds that NIE is less efficient than the least efficient GB DNO: on the contrary there is evidence that NIE is among the most efficient. The more plausible explanation is that the UR's price control process was simply not up to the standard of Ofgem's, in terms of resources, management or attitude. In particular, the UR's approach to assessing capex did not enable its consultants fully to understand and advise it on NIE's capital expenditure proposals.

14. The UR's proposed new approach to monitoring and controlling capex

69. Under the "traditional price control" to which the UR referred in RP4, the regulator would base the allowed price control revenue on an assumption about total capex during the five year period. The process of setting such controls could be time-consuming and resource-intensive, but once they were set the company had five years to manage the business without detailed regulatory involvement or approvals. Towards the end of that period, in discussing the allowed capex for the next five year period, the company would be asked to comment on its actual capex expenditure in relation to its earlier proposals.

70. Contrast this with the requirements now proposed by the UR in RP5. It proposes to categorise expenditure into three Funds. For Fund 1, comprising asset replacement and other work assumed to be under NIE's control, the UR proposes the following obligations and conditions:

- NIE takes the unit cost and volume risk (para 5.36)
- customers are protected by five specified provisions and obligations, but in addition the UR "requires NIE to demonstrate that it has efficiently incurred costs associated with installing assets" (para 5.37)
- NIE can increase or decrease the volume of units in each classification, but not the costs associated with those units (para 5.39)
- NIE is to make annual reporting "to provide a detailed explanation of the variance between the actual outturn and the plan" (para 5.41)
- the risk of asset failure is placed with NIE (para 5.42)
- the initial allowance is primarily based on the asset replacement modelling the SKM (rather than NIE) undertook (para 5.42)
- "an efficient spend clause will be added to NIE's licence to reflect the statutory obligation on the company to develop and maintain an efficient, coordinated and economic system" (para 5.43)
- "The Reporter will verify the asset replacement work each year and sign off the actual spend that is added to the RAB" (para 5.43)
- at the end of RP5 the UR will undertake a final reconciliation to calculate the residual efficiency payments that NIE can claim during RP6 (para 5.44)
- "NIE will be required to report its progress on asset renewal and the 'input driven' items each year. This will be primarily through the capex database, although a narrative report will also be required" (para 5.58)
- "The information to be provided on an annual basis for each programme includes average unit costs, actual spend and number of units installed, expected spend and number of units to be installed

before the end of RP5, and the reasons for any change from the original programme” (para 5.59)

- “This information will be verified by the Reporter, who will also comment on the implications of any changes to the Programme. The unit costs will be assessed and any efficiency identified.” (para 5.60)
- The Reporter’s formal report will be provided to NIE each year. “This will allow the company to incorporate any feedback into its plans for the remainder of the price control” (para 5.61)

71. A parallel set of obligations and conditions is proposed for Fund 2, comprising those investments undertaken in response to changes in demand. Among the additional obligations on NIE here are

- to undertake a comprehensive review of current planning standards and fully document its current prudent investment criteria (para 5.69)
- to review current operating and planning standards within the first year of RP5, and to consult on the assumptions it intends to apply when assessing network capacity. Any projects that do not meet this standard will not be classed as efficient. (para 5.71)
- to document its prudent investment strategy and have it approved – presumably by the UR? – to allow it to be considered when deciding to proceed with investment (para 5.72)
- “the Reporter will assess the projects that NIE undertakes. The Reporter will also audit NIE’s decision making process, to ensure that projects the company intends to initiate during the following year are necessary and efficient” (para 5.73)
- actual spend on connections will be subject to an obligation to invest efficiently (para 5.75)
- NIE is required “to provide a statement describing how it interprets the updated planning standards and prudent investment strategy” (para 5.78)
- Annual scrutiny by the Reporter [see above] (para 5.82)
- “In addition to the reporting for Fund 1 programmes, we require information about the reasons for investment for each Fund 2 project. This will include existing loading on the assets, including the number of hours above the rated capacity under normal operation; expected changes in demand over the coming years; and a description of how the planning standards and prudent investment strategy have been applied in each case.” (para 5.83)
- “Where we request it, this information will be verified by the Reporter, who will also comment on the implications of any changes to the programme. The unit costs will be assessed and any efficiency identified.” (para 5.85)
- As with Fund 1, NIE will be allowed (expected?) to incorporate into its plans any feedback from the Reporter’s annual review (para 5.86)
- Additional investment due to increases in demand will be logged up at the end of RP5, and projects that cannot be demonstrated to be required will be logged down. “This is facilitated by the additional annual reporting and scrutiny by the Reporter of the need for and efficiency of the investment” (para 5.87)
- NIE will only be able to add necessary and efficiently incurred spend onto the RAB as assessed by the Reporter.” (para 5.88)

- “At the end of RP5 the final reconciliation will determine the combined efficiencies (positive or negative) identified each year into revenue adjustments to be applied during RP6. The output of the annual Reporter’s reviews will identify the projects to be logged up or down.” (para 5.89)
72. One can understand the UR’s concern to ensure that capital expenditure is efficiently incurred. But are 26 such exhausting and restrictive obligations an effective and proportional way of achieving that end? The proposal is not just a “belt and braces” approach: it is a “belt, braces, string round the waist, trussed up in a sack, tethered to a post and nailed to the floor just to be on the safe side” approach.

15. Implications of the UR’s proposed approach to capex monitoring

73. Consider some of the implications of the UR’s proposed approach. Even with the best will in the world, the onerous reporting obligations would be time-consuming and costly to implement – both for NIE and for the UR. NIE is given flexibility in certain respects (volumes) but not others (costs). The restrictions on NIE would increase its costs and its risks by limiting its flexibility. NIE would be held to a plan proposed before the beginning of the period that cannot reasonably be expected to remain unchanged for five years. Variations from that plan, and a significant part of NIE’s allowed revenue, would be dependent on the views of the Reporter and the UR. Their function would be to appraise and second guess NIE’s judgements. NIE’s dependence on their assessment of its actions, and interpretation of the efficient expenditure obligation, would further increase NIE’s risk.
74. The UR’s proposed approach is not simply a problem for NIE. It is almost designed to create friction between the company, the Reporter and the regulator. This is not conducive to implementing and continually modifying the investment programme in the way that is most conducive to discovering and meeting the ever-evolving needs of customers, and meeting safety obligations, in a constantly changing market. It will also put pressure on the parties to deal with these stresses in ways that reduce transparency and accountability and have been criticised elsewhere. (See the discussion below of the role of Reporters in the water and rail sectors.)
75. The process would create additional ambiguity about responsibility for the outcome. Is NIE still responsible for keeping the lights on? Or, because the UR has so limited the funds available to NIE, and taken upon itself the task of approving or disapproving NIE’s actions in so many respects, has the UR effectively taken that responsibility upon itself? And where does the Reporter stand in all this?
76. Of course, the effectiveness and viability of a proposed set of arrangements depends not only upon the formal wording of those arrangements but also upon the way in which they are interpreted and implemented. With trust and goodwill, parties can make a variety of different arrangements work well. What then might be said of the prospects for interpreting and operating the arrangements proposed in RP5?
77. The best guide to how the UR is likely to interpret and operate the proposed arrangements is surely the performance of the UR during the process of appraising capex and setting the price control arrangements in the first place.

78. Consider the proposed approach to capex. The UR's proposals put great emphasis on the need for NIE to provide detailed explanations before the UR can approve the charging of them to Funds 1 and 2 – and for that matter Fund 3 too. Is this not the same kind of process as the UR has just put NIE through in determining the sizes of Funds 1 and 2? Has this recent process not been characterised by repeated, time-consuming and costly questioning, resistance, uncertainty, grudging acceptance and eventual stand-off? Would not NIE – and customers – be subject to precisely the same costs and risks when the time came to implement the arrangements that the UR proposes for the future?
79. In connection with reporting on Fund 2, the UR says:

Annual scrutiny by the Reporter is essential to reduce risk for both customers and NIE T&D under this fund. NIE T&D will take the risk that the Reporter agrees that the company's investments are necessary and efficient. We will mitigate this risk by approving the assumptions, standards and processes that are used to assess the need for investment. The Reporter's assessment will be based on these standards. This will be an annual process, timed so that it is co-ordinated with NIE T&D's submission of the annual capex reporting and database. Prompt feedback from us will allow NIE T&D to take corrective action in a timely manner and will reduce risk associated with an efficiency review at the end of the price control. (para 5.82 pp. 39-40)

80. The approach thus depends upon "prompt feedback from the UR". Unfortunately, experience to date suggests that neither "prompt" nor "feedback" are words that can be associated with the UR's processes in RP5. Put simply, the UR's record in RP5 does not suggest that it would be capable of discharging the capex monitoring responsibilities that its own proposals would put upon it.
81. Although the UR refers to returning to a traditional RPI-X control, the present RP5 proposals could not be more different from the traditional RPI-X control introduced at the time of privatisation. My discussions with merchant banks and investors before, during and after GB electricity privatisation suggest to me that most investors would not have considered buying shares in a company regulated on the basis of such restrictive, intrusive and risky conditions as proposed in RP5, and that privatisation could not have been sold to the City if such regulation had been contemplated at that time. It would be surprising if it were in the interests of Northern Ireland to create a climate that deterred investment in fundamental utilities.

PART FOUR THE UR's PROPOSED USE OF A REPORTER

16. The UR's reasoning about Reporter

82. The UR proposes to introduce a Reporter into the electricity network price control process. Its functions would be “to act as an auditor, certifier and commentator on aspects of the regulatory submissions that a company is required to make”. (*Final Determination* para 17.3 p 119)
83. The UR had previously examined the pros and cons of such an approach, and indicated its intention to establish a Reporter, in its *Network price controls: Proposals for a Cross-Utility approach, A Consultation*, September 2011. The main driver was “a greater need to tackle asymmetry of information between the regulator and regulated company”. (para 6.1) The UR notes that Ofwat introduced and developed the use of the Independent Reporter, and that the same approach has been used by the Water Industry Commission for Scotland (WICS). It then sets out nine Pros and nine Cons and concludes that, on balance, there are many advantages in extending the concept to gas and electricity.

8.5 The pros and cons of a Reporter based on our experience in water are summarised below.

Pros

- Reporters provide a technical audit function providing challenge to the company and assurance for the regulator.
- Reporters can complement the skill sets of regulators, providing current technical knowledge that a regulator may not wish to maintain.
- Reporters develop a broad understanding of the company over time and over a range of issues which improve the ability to challenge new proposals.
- Reporters can act as the conscience of the company moderating the submissions the company makes to the regulator.
- Reporters can prevent gradual creep in company submissions. Ongoing low level scrutiny encourages companies to become self policing.
- Reporters bring a practical approach to the development of new processes (for example —forward looking risk based asset maintenance) separating practical solutions from hype.
- Reporters provide commentary as well as assurance, giving regulators a broader insight into company submissions.
- Reporters challenge on the basis of experience and knowledge as well as process.
- Reporters become embedded in the company as part of the normal process of assurance which can be less intrusive and less disruptive than the introduction of advisers by the regulator on individual submissions.

Cons

- Reporters introduce a significant additional cost. Typically, costs to consumers are £230k per annum per company.
- Despite the requirement for independence, Reporters may still be seen as being on the side of the regulator. This can impact on the behaviour of the company and reduce openness. In an attempt to prevent this and maintain a relationship there is a danger that the Reporter may tend to caution in their views.
- The assurance to the regulator is dependent on the opinion and skills of the individual Reporter. It is difficult for the regulator to assess this in a one-to-one regulatory environment.
- The close and long-term working relationship between Reporter and company risks the Reporter being “captured” by the company. The Reporter engages closely with the company and less so with the regulator. As a result, the company can influence the development of the audit and the report while the regulator must define the audit blind and receives the report as a completed opinion.

- Reporters comment in terms of reasonableness. Reasonableness is an ill-defined and broad spectrum test which leaves much to individual opinion. To say something is unreasonable requires strong evidence. There may therefore be a tendency, which favours the company, towards a conclusion that a submission is reasonable unless it can be proven otherwise.
- The need to provide a balanced view can result in a report listing comments and identifying weaknesses without a definitive answer on which a regulator may rely.
- Reporters must manage the commercial, professional and personal pressures which can undermine true independence.
- Reporters audit a wide scope of work on a sample basis. It is questionable whether the level of sample audit carried out by a Reporter is representative, limiting the effect of any conclusion.
- In one-to-one regulation the independent professional status of the reporter may lead other stakeholders to give the company and regulator opinion equal weight and see the reporter as the final arbiter.

8.6 A comparison of the pros and cons above suggests that the use of a Reporter is not a panacea. In particular we are aware of the difficulties of using a reporter where there is only a single company. The issue of assessing a Reporter's views where there is only one company being regulated should not be under-estimated. The need always to ensure that the regulator is the final arbiter is also important. On balance however the Utility Regulator considers that there are many advantages to using a Reporter and is proposing to apply the concept to gas and electricity.

17. Comments on the UR's Pros and Cons

84. The UR's list of Pros can perhaps be summarised in terms of two main benefits that a Reporter can provide to the regulator: greater assurance that information provided is accurate and reliable (whether provided directly or by influencing the company in that direction), and a source of technical advice to the Regulator. Certainly a regulator faced with asymmetric information needs both assurance and advice.
85. However, it seems to me that the UR's perceived vulnerability to asymmetric information, and its consequent need for further assurance and advice, are not independent of the approach that the UR itself has adopted in PR5. Specifically, the UR has put greater focus (than in PR4 and than most GB regulators) on revisiting and reassessing previous regulatory decisions, and on checking and challenging the statements and judgements of the regulated company. Its proposed future approach is much more data-intensive and requires more regulatory judgement on an ongoing basis. And at the same time, as shown earlier, the UR's technical consultants have played a significantly less involved role than have Ofgem's consultants.
86. In consequence, if the UR were to adopt a regulatory approach comparable to the one that it adopted in PR4, or to the ones being developed by GB regulators such as Ofgem and Ofwat, including comparable use of its own technical consultants, then it would be less vulnerable to asymmetric information and have less need for the assurance and advice that a Reporter might provide. Put another way, it is because the UR in PR5 is moving in an opposite direction to that of other regulators that it feels a need to introduce a Reporter at a time when these other regulators are discontinuing the role of Reporter.
87. As regards the Cons that the UR identifies, I would make three points. First, the costs of a Reporter are not only the monetary costs of the Reporter's office. There is also a cost in terms of additional delay and uncertainty in the regulatory process while the Reporter is informed and forms or conveys its views to the

regulator. More generally, the use of a Reporter seems to be an inherent feature of the capex monitoring and approval scheme that the UR is now proposing, and I have indicated in Part Three above my reservations about the burdensome, undermining and counterproductive nature of that approach.

88. Second, those in the utility sector with whom I have discussed the use of Reporters reinforce a point that the UR itself makes. The value of a Reporter to the regulator is very much dependent on the opinion and skills of the individual Reporter. This in turn reinforces the case for using the regulator's own technical consultant instead of a Reporter, at least for the provision of advice.
89. Third is a point not explicitly made in the UR's list of Cons. There is now evidence that, rather than a Reporter challenging and stimulating the companies to take more responsibility for providing better data, the companies have tended to leave this to the Reporter, thereby reducing their own sense of responsibility for the data. This emerges in the history of Ofwat's involvement with Reporters, to which I now turn.

18. Ofwat's policy and experience on the use of Reporters

90. In explaining its decision to introduce a Reporter, the UR said that other regulators had found it helpful to use a Reporter. A response to the UR's consultation challenged this. It was said that "Ofgem had considered a Reporter function and did not anticipate recommending the introduction at this stage; and Ofwat have previously used the Reporter approach and had found it to be of no benefit" (*Final Determination* para 17.10)
91. As regards Ofwat, the UR answered as follows:

OFWAT are no longer requiring a Reporter on the basis that a Reporter has been in place for a number of years and reasons for introducing the Reporter have been addressed over the years, including the establishment of a sustainable working relationship together with appropriate and complete information being received from the regulated company. The benefits of a Reporter have been realized over the years to the point now that the function is no longer necessary. It is our objective to get to a similar position with the regulated company in the medium to long term.

(*Final Determination* Appendix E p 5, responding to NIE response ch 2 p 21 para 4.11)

92. But this is not what Ofwat itself said in the consultation document where it proposed to discontinue the use of Reporters. Ofwat made no reference at all to any benefits having been obtained from the use of Reporters. One might have expected some such reference, to previous benefits at least, but there was none. Ofwat did not indicate that the working relationship had improved so that Reporters were no longer necessary, much less did it credit Reporters with having brought about this improved situation. On the contrary, it explained the disadvantages that its previous approach had entailed, and said that there was a better way forward. Specifically, it said the following:

Protecting customers against failures is central to our role. In the past, in fulfilling our duties, we have placed considerable weight on data collection and monitoring as a way of ensuring the companies complied with their regulatory obligations ("regulatory compliance"). But this approach does not

necessarily get the best results for customers. It is costly in terms of regulatory resources and can mean the companies respond to the regulator rather than to their customers. Nor does it incentivise better performance.

This document sets out two significant shifts in the way we approach regulatory compliance. These changes are fundamental to the delivery of our strategy – sustainable water – and they underpin our revised approach to regulation generally. They are also in line with the recommendations set out in the review of Ofwat and consumer representation in the water sector (the ‘Gray review’).

The first change is to the current system of regulatory reporting. This would move Ofwat away from detailed regulatory monitoring of compliance. This change puts the companies firmly in charge of managing their risks, and redefines our role as holding them to account for the results, not the processes they adopt to ensure compliance.

Second, we propose that Ofwat itself adopts a risk – based framework. This will not only include a systematic assessment of risk and opportunity but will also allow us to focus the allocation of our own resources. This will demonstrate that we intend to conserve resources and target our efforts, so we have the capability to act swiftly and decisively where there is a real risk to outcomes for water consumers. And the companies and we would be freed from regulatory burden where there are no material risks to consumers.

(Ofwat, *Regulatory compliance – a proportionate and targeted approach A consultation*, 5 Oct 2011, p 1)

93. In summarising the key messages of its proposal, Ofwat said

- Protecting customers against failure is central to our role. But the approach we have used in the past – which relied heavily on data collection and monitoring – has become onerous and burdensome over time and does not necessarily get the best results for customers.
- We want a new approach where companies are responsible for managing their risks and our role is to hold them to account for their delivery to their customers.
- As part of this, we will no longer require the companies to submit June returns or to employ independent reporters. Instead, we are proposing that they take accountability for their systems and assurance processes to enable their Boards to sign off a compliance statement. We expect the companies to alert us to any potential risk to meeting a legal or regulatory obligation at an early stage. (p 5)

94. It would thus seem that Ofwat’s view is that its regulatory reporting system, including its use of Reporters, was no longer the *solution* to a problem, if indeed it ever had been, but had now become *a problem in itself*.

19. The Gray Report: Review of Ofwat

95. Ofwat noted that its proposals were in line with the Gray review and report on Ofwat. (David Gray, *Review of Ofwat and consumer representation in the water sector*, Defra, 2011) Amongst other things, Gray found the following:

One of the most consistent messages in responses to the call for evidence was that the burden imposed by Ofwat's approach to regulation was disproportionate and damaging. Most of the companies' responses referred to the scale of the annual reporting requirements (the June Returns) and the information required for the five-yearly price review (PR). However, the impression given of a detailed and intrusive approach to regulation applied more generally across Ofwat's activities. Many of the companies provided examples of the costs they incur in connection with the price review process and the June Returns. They also drew attention to the increasing burden since privatisation. Some examples are given below. As well as the scale of the formal submissions to Ofwat, companies pointed to several related issues which worsen the impact of those reporting requirements:

- the impact on management time from having to sign off the accuracy of data at board level;
 - the requirement to have all data checked and confirmed by outside parties (known as "reporters");
 - the extent of follow-up questions from Ofwat; and
 - uncertainty over how some of the data was used or whether it is used at all.
- (*Gray Review* p 25)

Some respondents identified an underlying lack of trust between Ofwat and the companies and a resulting adversarial approach to regulation. They felt this led to intrusive and detailed reporting requirements and unnecessary complexity. (*Gray Review* p 25)

96. The *Gray Review* gave several examples of the costs that companies had to incur as a result of this approach. Ofwat's estimate of its own cost is significant but the industry body Water UK gave a much higher estimate of the costs that are imposed on the companies.

Ofwat reports that the cost of the reporter function (paid for by companies) is the equivalent of £1.5 million a year and about £6 million in a price review year.

Water UK stated that "Companies estimate they spent approximately £100 million in additional costs and directly employed additional labour equivalent to over 500 employee-years in order to comply with the regulatory requirements of PR09".

(*Gray Review* p 25)

97. The *Gray Review* also identified a consequence that it deemed "much more important than the direct cost to consumers".

The cycle of data provision seems to have become self-reinforcing. The more Ofwat demands, the more the companies want to provide, in order to ensure Ofwat accepts their business plans. The resulting highly detailed specification of the business plan leads to a lack of flexibility in implementation as the

companies are concerned about Ofwat penalising them for diverging from it. So, rather than assessing an appropriate amount of money required for the company to meet a reasonable assessment of its obligations, the price review process effectively leads to a very detailed specification of a business plan that then becomes very inflexible. The end-result is a loss of “ownership” of business plans by companies. This impact on the way companies behave is potentially much more important than the direct cost to consumers of the data and reporting requirements. (*Gray Review* p 27)

98. The *Gray Review* concluded as follows

We found a clear consensus that the burden imposed on the companies by the regulatory regime is excessive and needs to be reduced. This is important in its own right but the problem goes further than just the scale and cost of the regime. We saw considerable evidence to suggest that Ofwat goes too far into the detail of company business plans and that, as a result, the companies are very Ofwat-focussed and very cautious and conservative in their approach. Rectifying this will require a substantial change of approach by both Ofwat and the companies it regulates. There is also some evidence that the system of incentives applied by Ofwat may be too focussed on penalties and compliance as opposed to positive incentives for desired changes of behaviour. (*Gray Review* p 6)

99. Thus, there is a clear message coming from experience of regulation of the water sector in England and Wales: Ofwat’s approach to regulation – especially its reporting requirements and use of Reporters – had become disproportionate and damaging, excessively burdensome, distorting, and undermining of accountability for actions and responsibility for future plans.

20. The use of a Reporter by the Water Industry Commission for Scotland

100. What about regulation of the water sector in Scotland? The UR’s consultation paper noted that the same approach – use of an Independent Reporter – had been adopted by WICS in Scotland. What is WICS’ view?

101. Two years ago, the Chief Executive of WICS explained its policy thinking as follows. (*I³ and the need for change*, Alan Sutherland’s Blog, WICS, 9 February 2011) WICS’ initial approach was to focus on benchmarking in order to challenge Scottish Water to improve its performance to match the performance of the leading companies in England and Wales, a challenge to which it had responded well. WICS could no longer rely on benchmarking comparisons: the gaps were too small to draw definitive conclusions. There was now greater priority in ensuring that customers understand and are willing to pay for improvements in water quality. Also, a reduction in WICS’ own budget meant focusing on customers’ priorities. These changes raised a question over the extent of information that WICS collected.

102. WICS therefore encouraged the formation of a Customer Forum, and decided to reduce its information collection by more than 90%, but in doing so it needed to understand better what Scottish Water wanted to tell it.

“We are moving to the Cold War End Game – a case of trust but verify. This explains our change to the role of the Reporter. Here we seek to replace an engineering review of regulatory information with

targeted scrutiny of issues that Scottish Water, the Customer Forum or the Commission [WICS] consider could be useful.”

103. Accordingly, in 2011 WICS discontinued use of a Reporter and replaced it with an Industry Assessor that could examine any aspect of Scottish Water’s performance, or indeed advise any of the parties on issues they deemed important. So, in the Scottish water sector too, the regulator no longer considers a Reporter necessary or appropriate.

21. Ofgem’s allegedly onerous reporting arrangements

104. As noted above, one response to the UR’s consultation said that “Ofgem had considered a Reporter function and did not anticipate recommending the introduction at this stage”. However, in one of its opening submissions to the CC, the UR says that “the reporting arrangements that we have proposed for the price control are much less onerous than those which Ofgem have imposed for some time”. (*UR paper on the reporter*, NIE RP5 Price Control Reference, UR-8, April 2013, para 12) The UR explains this as follows.

- a. Ofgem sets out and manages its reporting requirements in substantial detail – for instance, no fewer than twelve conditions of the GB electricity distribution licence (standard licence conditions 44 – 50A2) are devoted to the recording, reporting and monitoring of information associated with the price control conditions. Those conditions prescribe detailed requirements in relation to the recording and reporting of information on network outputs, performance, standards measured against the targets for incentive schemes, costs and revenues. Each information requirement is subject to its own set of Regulatory Instructions and Guidance (RIGs) with which each DNO is required to comply. The RIGs provide Ofgem with the power to specify, in a subsidiary document, detailed further obligations as to: the objectives to be achieved in information reporting; the manner, form and frequency of reporting; the precise definition of terms and standards; the standards of accuracy to which information must be estimated, measured and reported; commentary and supporting information to be provided with reported data; and so on. Each set of RIGs may be modified by Ofgem, after consultation, to change the recording and reporting standards during the price control period.
- b. The RIGs collectively amount to several hundred pages of detailed requirements, reporting workbooks and spreadsheets; the glossary of terms alone runs to hundreds of pages. The licence conditions require the DNOs to co-operate with an Ofgem appointed ‘Examiner’ whose role is to scrutinise and report on their systems, processes and procedures, the quality and accuracy of information collected under them, and their compliance with the RIGs.
- c. Provisions relating the recording and reporting by National Grid in relation to its electricity transmission system are no less extensive. (paras 13 – 15)

105. There is important background to this particular set of licence conditions. As I understand it, a number of the DNOs became concerned that inconsistent measurement and reporting as between the different DNOs were allowing some of them to hide their inefficiency and/or poor performance. The DNOs themselves drove this uniform reporting process. It was developed by a process

of constructive engagement and buy-in from the companies, with a view to reducing squabbles over data at subsequent controls, and associated risk.

106. The detailed specification of uniform reporting requirements, with the appointment of someone to assess these, is not the same as installing a Reporter in the regulated company with advisory functions that go well beyond checking that information provided is consistent with a uniform template. The main objection to a Reporter is not that more detailed information will have to be filed. Rather, the concerns include that the existence of the Reporter within the company will add to cost, delay and uncertainty, reduce the company's own sense of responsibility for providing accurate information, be a cause of friction between the parties, and provide less reliable advice to the regulator than its own technical consultants could provide. Also, Gray, Ofwat and WICS all concluded that not so much data needed to be collected because it was costly, hence a Reporter was an unnecessary and undesirable cost. Although Ofgem may have detailed specifications for certain kinds of data provision, these have largely been agreed with the companies, and in other respects Ofgem has already taken steps to reduce the burden of the price control process.

22. The Office of Rail Regulation's experience with Reporters

107. One other UK regulator that has used Reporters in a major way is the Office of Rail Regulation (ORR). The relevant history is briefly as follows.
108. During the 1990s there were increasingly severe criticisms of the information system and reporting arrangements at Railtrack and ORR, and also the poor performance of Railtrack. (See for example National Audit Office, *Ensuring that Railtrack maintain and renew the railway network*, 12 April 2000.)
109. In a consultation starting in 1999, ORR proposed to appoint Reporters in order to address these issues. As part of its argument, ORR referred to the practice and experience of Ofwat.

12.19 Over the past 10 years, OFWAT has developed a system of reporters. Reporters are employed to provide an independent assessment of the robustness of company information submissions and the assumptions underlying them. The reporter model has generally been seen as successful in the water industry in improving the accuracy and consistency of data received by OFWAT. (ORR, *Periodic review of Railtrack's access charges: provisional conclusions on the incentive framework*, April 2000)

110. Licence provisions to provide for Reporters were put in place in 2001. ORR has appointed a series of Reporters, most recently four Reporters for the price control period beginning 2009.
111. The problems were not solved, however. A further NAO report in 2011, followed by a PAC Report in 2011, were again critical of Network Rail (the successor to Railtrack) and the ORR. This now included significant criticism of the use of Reporters.

6. We are concerned there may be duplication between the organisations involved in reviewing Network Rail's efficiency and that the relationships between them may be too cosy. The Department for Transport, the Regulator, 'Independent Reporters', Network Rail itself and other funders all have roles in reviewing Network Rail's efficiency. Independent Reporters are appointed

jointly by Network Rail and the Regulator but may also perform other work for Network Rail, creating at worst a potential conflict of interest and at best too cosy a relationship between various players. There is a lack of clarity about who is being held to account and who is commissioning work. The Regulator should strengthen arrangements to guarantee the independence of its Reporters, and should work with the Department and other funders to agree a protocol to ensure that work to assess and review Network Rail's efficiency is not duplicated. (Public Accounts Committee, House of Commons Committee of Public Accounts, *Office of Rail Regulation: Regulating Network Rail's efficiency*, Forty-first Report of Session 2010–12 4 July 2011 pp 5-7)

112. Note first that there has been significant criticism throughout of the performance of Railtrack, later Network Rail. The ORR's introduction of Reporters was intended in large part to address this. In contrast, there is evidence that NIE has performed well. As noted above, under present management it has benchmarked with the leading UK electricity distribution networks and the UR accepts that its direct capex costs are efficient. So whether or not Reporters were appropriate to address the problems of the GB rail sector, those problems do not characterise NIE's T&D business in Northern Ireland.
113. The ORR's decision to implement a system of Reporters was informed by a view that Ofwat's reporter model "has generally been seen as successful". That was in 2000. A decade later, the serious weaknesses of that model have become apparent, as acknowledged by Ofwat itself, as set out above.
114. In the rail sector too, the Reporter model is evidently now considered to be problematic. In the PAC's view just cited, it is characterised by "at worst a potential conflict of interest and at best too cosy a relationship between various players". There is also "a lack of clarity about who is being held to account and who is commissioning work". How the ORR can "strengthen arrangements" and what effect this will have remain to be seen.

23. What do Reporters report on?

115. Meanwhile, the Reporter model is still in operation for Network Rail's present price control period. What information and assurances is it providing? Here are three examples from one of the latest reports of one of these Reporters. (Ove Arup, *Network Rail and Office of Rail Regulation, Part A Independent Reporter, Mandate AO/031: Review of 2012 Annual Return*, Issue 9 October 2012)

p. 2 Review of Last Year's Recommendations

No 2011.AR.1 Recommendation to Network Rail: Proof read final version of Annual Return prior to publication

July 2012 Progress: Arup have reviewed the final draft which picked up a number of typographical and grammatical errors and also identified some missing data.

p. 12 Conclusions

The audit was undertaken to assess the accuracy of data and commentary presented in Network Rail's Annual Return 2012. Our conclusions are summarised below:

... Proof reading the final draft seems to have been successful in improving the quality of the text and report format. Therefore, we suggest a repeat of the proof reading arrangements made for the Annual Return 2012.

p. 6 Review of 2011/12 Annual Return

Report Section: Drainage renewals

Data consistent with annual return 2012? Minor Discrepancy

Observations/Comments: Table 4.31 Error in totalling. Volume of catchpits⁷ cleaned out for E&W should be 72,838 (vs 72,837 reported in the Annual Return)

116. Without a detailed examination of this and other reports it cannot be claimed that the above three examples are typical of the contributions of the Reporters. But the report just cited certainly contains more examples like the above. For example, further automation instead of manual copying is recommended to help minimise typographical errors (p 2), in one table the unit (Yards) was missing and there were grammatical errors in the text (p 4), a typographical error reported 2.52 as 2.51 (p 5), some values for Preventative and Replace were interchanged (p 6), “a few erroneous exam dates [were] recorded in NR’s database” but “the results in the table below are not noticeably affected by these minor discrepancies” (p 7), the number of employees screened in relation to noise at work was incorrectly reported as 2871 instead of 2870 and the figure for employer’s liability claims in the draft annual return should have been 474 instead of 471 (p 8).
117. We can all sleep more soundly knowing that the Reporter has proof-read Network Rail’s Annual Return and picked up some grammatical errors. We can appreciate the novel suggestion that Network Rail should in future proof-read its own Return in order to improve the quality of the text. And we should celebrate the discovery that Network Rail actually cleaned out one more catchpit than the 72,837 that it counted. But is this really what is needed to ensure the cost-effective provision of electricity network services in Northern Ireland?

⁷ “A catch-pit is, essentially, an empty chamber with an inlet pipe and an outlet pipe set at a level above the floor of the pit. Any sediment carried by the system settles out whilst in the catch pit, from where it can be periodically pumped out or removed.” www.pavingexpert.com

SUMMARY AND CONCLUDING REMARKS

118. The philosophy of the UR's approach to price control in RP5 is inconsistent with the way that price controls are evolving in the GB electricity and water sectors. In the light of experience, these regulators are moving away from "command and control" approaches and towards greater use of incentives and involvement with customers. The UR's approach in RP4 was a small step in that direction but the approach in RP5 is a reversal of approach, that goes beyond a reversion to the "traditional approach" to price controls.
119. My *Previous Report* found that the UR's treatment of pension costs was inconsistent with previous UR decisions and with recent GB practice. It left the impression that the UR was acting on an opportunistic basis. The UR's *Final Determination* reverses a number of the UR's previous decisions, and reinforces the impression that the UR is taking an opportunistic and arbitrary approach.
120. The UR's erratic approach to pensions is of a piece with its approach to RP5 as a whole. My *Previous Report* found that the UR's approach did not measure up to the Values of Transparency, Consistency and Proportionality that it had set itself. It had also failed to develop and meet a price control timetable and failed to address the implications of the process over-running. That approach has continued since the *Draft Determination*, including the UR's reversals on pensions costs, its five month delay in referring NIE to the Competition Commission and its failure properly to extend NIE's price control.
121. The UR proposed to cut the capex in NIE's business plan by 50% and the opex by 21%. This is a much more severe cut than Ofgem proposed for the typical electricity distribution company in its 2004 and 2009 price controls. It is also more severe than the treatment of EdF's distribution networks, which were the networks treated most severely. But whereas EdF's networks were the least efficient in GB, NIE is reportedly comparable to the most efficient networks.
122. The UR's consultants did not make site visits to help understand the issues associated with NIE's capex programme, and their report to UR was not published. In contrast, Ofgem's 2004 consultants made three main visits to each of the DNOs and Ofgem published its consultants' reports to provide greater transparency and understanding. A lack of understanding on the UR's part, and an inadequate price control review process, rather than an inappropriate business plan on NIE's part, is likely to explain the exceptionally severe cuts that the UR has proposed.
123. The UR has proposed a long list of exhausting and restrictive obligations with respect to the implementation of future capital expenditure. They would be costly, time-consuming and uncertain to implement, and would increase friction between company and regulator. They would depend on prompt feedback by the UR, but the UR's record does not suggest it would be capable of providing this.
124. The UR proposes to appoint a Reporter, noting that other GB regulators have found this helpful. However, Ofwat has now concluded that detailed monitoring of compliance, including the use of Reporters, has become onerous and burdensome, and does not necessarily get the best results for customers. The *Gray Review* made a similar criticism. Ofwat has now discontinued the use of Reporters, as has WICS. The Public Accounts Committee has criticised some aspects of the Reporter model used by the Office of Rail Regulation. A brief examination of some of the Reporters' work raises the question whether this is

really what is needed to ensure the cost-effective provision of electricity network services in Northern Ireland.

125. To summarise, the UR's RP5 price control philosophy is not consistent with that in RP4 or with the present direction of GB regulation generally: indeed, it is heading in the reverse direction. The UR's stance on pensions costs has been erratic. Its regulatory process has not met its stated Values of Transparency, Consistency and Proportionality. Its assessment of NIE's capex business plan is out of line with Ofgem's assessments, and has not been informed by site visits. Its proposed approach to monitoring capital expenditure involves much greater emphasis on data collection and checking including the use of Reporters. This reflects an approach that Ofwat once took. Ofwat has since abandoned that approach because it was excessively burdensome and undermining of responsibilities. In short, RP5 reflects an approach that has been tried, and found wanting. RP5 is not the future, it's the past, and a past that didn't work well.



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7/18/2012

COMMENT ON UTILITY REGULATOR'S DRAFT DETERMINATION ON NIE TRANSMISSION AND DISTRIBUTION PRICE CONTROL

Dear Kevin,

ESB has reviewed the Utility Regulator's Draft Determination on the proposed price control for NIE and, as owner of NIE, offers the following observations.

Background

By acquiring NIE and promising to undertake significant capital expenditure, ESB made a firm commitment to Northern Ireland's electricity customers. This decision was predicated on a belief that Northern Ireland was an investor friendly location with a modern well developed regulatory apparatus. In particular, ESB had an expectation that fair and timely regulatory judgements would be rendered, honouring past agreements, giving due regard to precedent, and delivered in an open and transparent manner.

From that background, we are very unhappy at the general thrust of the Draft Determination, its stark departure from established regulatory norms in mature jurisdictions and by the specific proposals in respect of certain major cost elements.

We have experience of regulatory processes in Ireland and internationally, and in particular with the long-established practice in Great Britain. Consistency over time, giving rise to reasonable predictability of outcomes and credibility of the governing regime, is one of the bedrocks of good regulatory practice, and is especially important in the energy industry which has long lead times and investment cycles.

External Assessment

There are a number of important respects in which the approach adopted by the Utility Regulator is so much at variance with established regulatory practice that we engaged Prof. Stephen Littlechild, former head of OFFER, and now an eminent international consultant on regulatory matters (as well as adviser to Ofgem, among other regulatory authorities), to

review the Draft Determination. We wished to establish whether or not, by reference to what an investor in a regulated industry in the UK may reasonably expect, the proposals set out in the Draft Determination are consistent with good regulatory practice in respect of the matters concerned.

You will find Prof. Littlechild's views attached to this letter of response. His analysis and his emphatic conclusions demonstrate that the approach of the Utility Regulator in relation to the Draft Determination has been deficient and unsatisfactory.

Major Individual Issues

Considering first the individual cost issues on which specific proposals are made, the main points on which the Draft Determination proposes to depart materially from what might reasonably be expected are in relation to:-

- (a) the insufficient level of capital expenditure envisaged;
- (b) the review and retrospective adjustment of the allowable pension deficit repair costs;
- (c) the stated intention to make retrospective adjustments pending an investigation into capitalisation policies;
- (d) the proposal to introduce "*contestability*" in respect of much of NIE Powerteam's activities, and the proposal concerning recoverability of NIE Powerteam's employee pension costs;
- (e) return on investment.

(a) Capital Expenditure

The Draft Determination proposes to strike out large blocks and categories of capital expenditure which in NIE's judgement are necessary in order that the network can meet the needs of customers and to enable NIE to satisfy its statutory and licence obligations. This is a matter of fundamental concern to ESB as Ultimate Controller of NIE and as investor in that company. ESB in acquiring NIE gave undertakings in relation to investment in the network and to the welfare of customers in Northern Ireland. ESB must take the most serious view of proposals which grossly underfund the investment required to ensure a safe, secure, reliable network in Northern Ireland.

(b) Pensions

In relation to pension deficit repair costs, the Draft Determination envisages reviewing actions taken as far back as fifteen years ago, under price controls that by any normal reckoning are closed and final. Regulated entities have a reasonable expectation that decisions and practices of this vintage, long since settled, will not be reopened. The proposals here, which would entail reviewing matters in the knowledge of the Utility Regulator for many years and already retrospectively reviewed by it, would have the effect of dismantling all expectation of regulatory stability, and are contrary to the uniform practice in this respect in Great Britain and elsewhere. In effect the principle behind the Utility Regulator's proposals would require that each future price control would need to consider the current financial impact of each of those retrospective decisions and "true up" or "true down" the liability on the regulated utility arising from those historic decisions.

This would explicitly design a structural instability into the price control process with all the consequences that such instability would entail. A statement by the Utility Regulator that this is a “one off” adjustment does not and will not ease those concerns. The Utility Regulator will wish to take note of Prof. Littlechild’s observations on the pension issue, as on the other issues raised in this response.

(c) Capitalisation Policy

ESB is extremely concerned about the way in which the issue of the internal capitalisation policies of NIE and the OPEX allowance has been approached. This approach has the potential to adversely affect the reputation of NIE and the wider ESB Group. On the headline point, ESB accepts that it is right to review the performance of NIE at the end of a price control period. It is wrong, however, to seek to retrospectively change the basis of the RP4 price control. The capitalisation issue was addressed explicitly and in a considered way in the RP4 process, when the UR determined that the issue should be approached at a high level on the basis of fundamental principles, and drew its conclusions accordingly. I refer to the UR’s papers of December 2005 and September 2006 which state very clearly a preference for a high-level approach rather than a “traditional” approach for reasons stated by UR to include a wish to be “collaborative”, and to avoid “expensive and expansive work”. While I accept that the Utility Regulator is entitled to adopt a more detailed approach to RP5, it would be improper now, and inconsistent with minimal standards of regulatory certainty, to re-open the RP3/RP4 determinations in the manner proposed.

(d) NIE Powerteam

A proposal that NIE be required to put substantial transmission and distribution work out to tender, rather than be entitled to deploy NIE Powerteam for that work, misunderstands the position of NIE Powerteam as a core part of NIE’s business. NIE Powerteam was established, with NIE employees but as an entity legally separate from NIE, as a management initiative to provide focus and priority to a distinct set of activities. The Utility Regulator acknowledges (and implicitly endorses) the current arrangements with NIE Powerteam in various provisions of NIE’s licence, including those which implement the RP4 price control. The essential point is that NIE Powerteam’s activities are of their nature inherently part of the network provider’s activities. This is borne out by the fact that 1,000 of NIE’s 1,200 employees are assigned to NIE Powerteam. The UR’s proposal appears to be predicated on the mistaken assumption that NIE Powerteam is a simple service provider. This is clearly not the case. As regards the pension rights of employees of NIE Powerteam, these are identical to those of NIE and the associated costs should be recoverable from customers in the same way as those associated with NIE employees.

(e) Return on Investment

The various proposals set out in the Draft Determination would, as well as underfunding the amount needed by NIE to satisfy its statutory and licence obligations, have the effect of allowing NIE insufficient revenue to provide ESB as investor with a reasonable return on its investment. Under the Utility Regulator’s “minded to” position on WACC and taking account of the inadequate provisions for pensions, OPEX and incentives, NIE’s return on equity during RP5 would be less than 2%. The effective return would be lowered further taking into consideration the Utility Regulator’s proposed underfunding in respect of capex. There is no rational reason why the Utility Regulator should expect NIE’s investors to bear at least as much risk as investors in GB DNOs, but for a massively lower return. On the contrary, when regulatory risk, relative scale of operation, and peripheral location are factored in to the consideration, an argument for a higher return is compelling.

I want to respond to a specific comment at paragraph 16.7 in the Utility Regulator's draft proposals. In response to the NIE statement that NIE will need to compete for funding with the other 15 UK DNOs, the UR stated that:

The primary determinant of NIE T&D's ability to obtain and maintain investors confidence is whether the returns that NIE T&D can offer investors sits no lower than NIE T&D's cost of capital. If we were to follow NIE T&D's proposal, electricity customers in NI could incur higher charges than necessary. In practice, the equity investor in NIE T&D is currently ESB and it is not obvious that NIE T&D is "competing" with the other DNOs for ESB's equity investment.

Emphasis added

This response misses the point completely. NIE will require access to capital markets to raise funding necessary for its future investment programme and will need to compete with other DNOs for this purpose. A comment that NIE is not competing with other DNOs for ESB's equity investment is entirely irrelevant. These matters are of fundamental and profound importance to all and demand much greater consideration by the Utility Regulator. This is evidenced by the public comments of Fitch Ratings which were independently offered, are objectively based and indicate a clear negative sentiment should the Utility Regulator's proposals be maintained in their current form.

It is clear that a decision to proceed on the basis envisaged in the Draft Determination could not fail to have serious consequences as regards ESB's investment and perspective in Northern Ireland.

Bankability of NIE

Related to the question of return on equity is that of NIE's capacity to fund the investments necessary to maintain and develop the networks.

The overall effect of the proposals set out in the Draft Determination would be to deprive NIE of the revenue appropriate to its functions and which is available, by efficient and innovative operation within a mature regulatory framework, to DNOs in Great Britain. An inevitable consequence would be a decline in NIE's creditworthiness and therefore in its capacity to raise efficiently the finance necessary for its activities. The Utility Regulator will be aware that the T&D licence requires NIE to maintain an investment-grade rating.

The financeability of NIE's business would be adversely affected by the heightened regulatory risk that is introduced by the Draft Determination. Ratings agencies and investors place heavy reliance on the stability and predictability of the regulatory regime and implementation of the proposals in the Draft Determination would significantly undermine confidence in the regulatory model. The proposals as presented would also severely affect the financial position of the company and would hamper NIE's ability to access the capital markets. The recent commentary from Fitch provides evidence that the Draft Determination introduces significant concerns for investors with regard to the regulatory model and with regard to NIE's ability to maintain its investment grade credit rating and ability to raise finance in the market. To forestall this outcome, ESB expects that the Utility Regulator will recognise the need to make substantial revisions across the whole range of proposals set out in the Draft Determination.

Conclusion on the Proposals

The upshot of the proposals set out in the Draft Determination would be a price control which would not in the best interests of NI customers, and to damage materially the earning capacity and financial position of NIE, on a basis that is not consistent with GB regulatory practice, involves overturning established principles of good regulation, and is not justified by arguments presented in the Draft Determination itself and is not supported by evidence.

Regulatory Process

There is also the matter, upstream of the particular proposals in the Draft Determination as published, of the general approach taken to the process of developing this document, involving considerations of consultation, timeliness and timetables, the quality of the Utility Regulator's engagement with NIE, and ultimately the depth of the Utility Regulator's understanding of the T&D business.

It appears to ESB that there has been a serious lack of consultation and dialogue by the Utility Regulator with NIE in connection with RP5. In the normal course of a well-run regulatory process there would have been extensive two-way engagement, involving site visits, face-to-face meetings between consultants and access to consultants' reports. This would have led to the progressive development on both sides of a thorough understanding of the imperatives which should guide the process. This bilateral process ought to have occurred prior to the publication of a document setting out proposals to make material changes in the way regulation is conducted and the entitlements of a regulated entity are established.

Conclusion on the Draft Determination and Process

ESB has experience of working in many countries throughout the world and we are very surprised and disappointed by what appears to us to be the unilateral and inconsistent approach taken so far by the Utility Regulator in relation to RP5.

ESB understands that NIE remains committed to co-operate to the fullest extent with the Utility Regulator, and to make available its detailed knowledge and expertise in a meaningful two-way engagement. The common objective of ESB, NIE, and the Utility Regulator must be to meet the needs of customers, in the short and long terms, by providing for comprehensive infrastructure development, and tightly-controlled expenditure in the delivery of that infrastructure, within a framework that allows for meaningful remuneration of investment consistently with mature regulatory practice.

Yours sincerely,

Peter O'Shea
Head of Regulation and Strategy

/ Attachment

**The Utility Regulator's Approach
to NIE's Transmission and Distribution Price Control RP5**

**Stephen Littlechild
16 July 2012**

Executive Summary

1. ESB has asked me to assess the UR's approach to pensions costs, previous capital expenditure and the regulatory process generally, as exhibited in the ongoing RP5 price control review of NIE T&D.

Pensions Costs

2. The UR accepts NIE's ongoing pension cost of £10.5m. But whereas NIE suggests a pension deficit repair cost of £66.7m, the UR proposes to reduce this to £11.8m. Its reasons are a) it declines to base the allowance on the latest estimate of the pension deficit, b) it argues that NIE T&D customers should not have to cover that part of the deficit attributable to NIE Powerteam, c) it prefers to spread the deficit over 15 years rather than the 11 years determined by the NIE T&D pension trustees, and d) it has gone back over the past three price control periods to recalculate what in its view NIE was required to contribute to or take from the pension pot.
3. In my view none of the UR's arguments is persuasive. a) At a time of uncertainty it is prudent to have regard to the latest estimate of the pension deficit, as Ofgem did in GB. b) The accepted obligation on customers to meet NIE's pension deficit costs should include Powerteam pension costs whether or not Powerteam is regarded as a separate entity. c) Ofgem's decision to spread deficit costs over 15 years is understandable in the GB context where Ofgem was proposing significant increases in tariffs, but less persuasive in Northern Ireland where the UR is proposing a significant reduction in T&D charges. d) The UR's RP4 pensions policy followed GB precedent in making limited adjustments for earlier years; Ofgem has not subsequently sought to reopen these issues, and there is no obvious case for the UR to do so in RP5.

Previous capital expenditure

4. The UR claims to have identified a change in capitalisation policy by NIE, has initiated an investigation into NIE T&D's accounts in order to restate the regulatory accounts for previous years, and if appropriate intends to adjust the RAB for certain previous years.
5. I am advised that NIE does not accept the UR's assertions about its capitalisation practice. I am not in a position to assess the arguments on this issue. I find it surprising that the UR has not sought to clarify and resolve this issue beforehand, rather than maximising regulatory uncertainty by including an unresolved allegation in the Draft Determination.

Assessing regulatory process

6. I have assessed the UR's regulatory process in RP5 against the five Values that the UR has set itself. The most relevant are Transparency, Consistency and Proportionality.

Transparency

7. Transparency has been significantly impaired by the lack of real two-way engagement on the part of the UR, not least in the lack of planning of information flows during RP5 and the lack of discussion of the kinds of price control elements that the UR has had in mind. This leaves the impression that the UR has not been willing to understand the full implications of the policy that it now proposes.

Consistency

8. Consistency of the UR's approach has been problematic in four respects. Its treatment of the pensions deficit and previous capital expenditure suggest an unwillingness to accept the implications of the UR's own previous price control decisions. The UR's change from active engagement to non-engagement is encapsulated in the view that "The manner in which previous price controls were carried out should not have a bearing on future price controls." The UR's return to the "traditional approach" to opex in RP5 makes no reference to the shortcomings that the UR had previously identified in the RP4 process, that were sufficiently serious to cause it to abandon that approach. The UR has been evasive, perhaps dissembling, on the question whether its presently proposed approach is generally consistent with GB regulation.

Proportionality

9. Proportionality is called into question by the volume of UR information requests from NIE during RP5, which were not well planned and discussed in advance, and by the likely regulatory costs of its proposed approach to capex. The UR is less sensitive to its own costs of regulation, and to the burden of regulation on the company and hence on consumers, than are GB regulators. This is the case even though the per capita cost of energy regulation by the UR is about six times that by Ofgem in GB.
10. Delivering price control determinations is said to be the UR's bread and butter work, and a priority. However, the UR has failed to develop adequate price control workplans and timetables, has repeatedly failed to meet the timelines that it has suggested, and has unfairly blamed NIE for the slippage. The UR decided to roll over the previous price control RP4 for six months without consultation or licence modification, which is out of line with good regulatory practice. UR has indicated that capex should continue at RP4 levels but nothing has been proposed or agreed with respect to other price control determinants beyond 1 October 2012. This leaves NIE unable to make informed investment and operating plans.

Contrasting price controls

11. The Draft Determination cuts NIE's proposed opex by about 25% and its proposed capex (Funds 1 and 2) by about 60%. These are more severe cuts than other UK regulators would normally consider reasonable.
12. The Draft Determination proposes a lower cost of capital than Ofgem has used. A ratings agency has commented that the Draft Determination "provides for more challenging financing assumptions than Fitch Ratings would normally expect for a UK regulator. ... the proposals raise concerns that the financial profile of NIE could deteriorate over the next five years. ... Fitch is not convinced that the draft determination actually provides for adequate capital market access for a business in a growth phase. It appears that UReg may interpret its financing duty materially different to other UK regulators." (FitchRatings Comment, May 2012)
13. Outcomes, too, are different. The UR now proposes a price *reduction* of about 16% over 5 years whereas Ofgem considers that an average price *increase* of about 30% is necessary. This is in contrast with the last price control, where the UR was at pains to explain why the RP4 outcome for NIE was similar to that for the most comparable GB network companies because NIE faced the same issues as they did. Does NIE no longer face the same issues? Why should the situation suddenly have changed so radically?
14. There is another explanation. Recent reviews of Ofgem and ORR regulatory processes emphasise the importance of full engagement with the company and of good project management with detailed and realistic timetables. The UR process in RP5 does not bear comparison with best practice UK regulation. In several respects the UR's conduct has fallen short of its own stated Values of Transparency, Consistency and Proportionality. I am afraid it suggests that the remarkable price reductions proposed in the Draft Determination are too good to be true; that they have been achieved, not by following the principles of good regulation, but by flouting them.

The implications for customers

15. This has direct implications for prices and customers. If a regulator is not transparent because it is unwilling to engage, if it does not act consistently with its previous price control commitments and due regulatory process, if its information requests and proposed price control arrangements put a disproportionate burden on the regulated company, and if it fails to develop and implement realistic work plans, then the company that it regulates will be unable to invest and operate in a way that best meets the needs of its customers. The company's operating costs will be needlessly increased and its flexibility and responsiveness reduced. There will be a reluctance to invest. Regulatory uncertainty, inconsistency and lack of proportionality will impact adversely on the company's cost of capital – in NIE's case, as it competes for debt in the funding market against other utility companies whose regulators are more transparent, consistent and proportionate. Higher operating costs and cost of capital mean higher prices for customers.

The Utility Regulator's Approach to NIE's Transmission and Distribution Price Control RP5

Stephen Littlechild¹
16 July 2012

16. ESB, the owner of NIE, has asked me, as a former GB electricity regulator, to assess certain aspects of the present approach taken by the Northern Ireland Utility Regulator (UR) to the ongoing review (known as RP5) of NIE's Transmission and Distribution Price Control. The specified aspects are the treatment of pensions costs and the approach to previous capital expenditure, both as set out in the UR's Draft Determination of 19 April 2012, and the UR's regulatory process generally during RP5.

1. The UR's approach to pensions costs

17. NIE has proposed an allowance of £77.2m (in 2009/10 prices) to cover pensions costs during the RP5 price control period. This comprises £10.5m ongoing pension costs plus £66.7m deficit repair cost. The UR's RP5 Draft Determination of May 2012 accepts the argument for £10.5m ongoing costs but allows only £24.3m in deficit repair costs. Further, it argues that the deficit is higher than it need have been as a result of various NIE actions in the past. To correct for this it proposes a reduction of £12.5m in the total amount allowed. UR's proposal is thus for a net pensions allowance of £10.5m + 24.3m - £12.5m = £22.3m in RP5.

18. The UR summarises NIE's calculation as follows.

10.2 NIE T&D's submission was based on an actuarial assessment of the contributions required to fund ongoing costs and on a total pension scheme deficit of £150 million which took account of changes in funding position since the last formal valuation date (31 March 2011). They proposed that the deficit should be recovered over 11 years. NIE T&D assumed that consumers would fund the entire pension scheme deficit. (RP5 Summary p 25)

¹ Stephen Littlechild was appointed Professor of Commerce at the University of Birmingham in 1975, and is now Emeritus Professor there. From 1983 to 1989 he served on the Monopolies and Mergers Commission. In 1983, at the time of the first UK utility privatisation, he advised the UK Government on regulation of British Telecom's profitability. He proposed the RPI-X price cap that was subsequently adopted, and used also for the privatisation of all the other UK utilities, including NIE. Variants of that approach have increasingly been adopted worldwide. From 1989 to 1998 Professor Littlechild was the first Director General of Electricity Supply in Britain, head of the Office of Electricity Regulation (OFFER). Since 1998 he has been a consultant on privatisation, regulation and competition in electricity and the utility sector generally. He has advised governments, regulatory bodies, international agencies and regulated companies around the world. He has also been actively involved in research and debate on regulatory issues and has published extensively on these matters. From 2006 to 2011 he was a member of the UK Postal Regulatory Commission (Postcomm). He is presently a Fellow at Judge Business School, University of Cambridge.

19. In contrast, the UR made the following assumptions.

10.5 We reviewed the most recent actuarial valuation report, dated 31 March 2011 for the NIE Pension Scheme which reports a total deficit of £87.6 million. ... we propose that 79% of the NIE Pension Scheme deficit at the formal valuation date can be allocated to NIE T&D. This equates to £69.2 million (79% x £87.6 million). In addition to this, we propose that the deficit be recovered over a period of fifteen years in line with recent GB regulatory precedent. During RP5, we therefore propose that an amount of £24.3 million can be recovered. (RP5 Summary p 26)

1.1 The date of valuation

20. The UR proposes to use the £87.6m deficit existing at the formal valuation date (31 March 2011), whereas NIE proposes an updated version to take account of market changes (adverse investment conditions) experienced since the valuation date. The figure of £150m is the deficit amount that was agreed in a recovery plan between NIE and the pension scheme trustees. The UR asserts that it “makes sense” to use the formal valuation, but gives no reason for this preference other than citing the NIE actuaries’ formal note accompanying their update, that “*The information...is designed to give a broad picture of the direction of funding changes since the last actuarial valuation but does not have the same level of reliability as, and therefore does not replace the need for, formal actuarial valuations*”. (RP5 Draft Determination para 11.26 p 116)

21. I understand that the UR requested NIE to bring forward its formal valuation from March 2012 to March 2011. If RP5 had proceeded according to the original timetable, this would have provided a formal valuation 12 months before the beginning of the new price control. With the present slippage in the price control review, whereby the final price control proposal is now said to be due “before the end of the year” (2012), it seems as though the new price control may not be in place until March 2013. This means that the formal valuation in March 2011 will be about 24 months out of date.

22. In setting its latest distribution price control, Ofgem took a different view. Its final proposals in December 2009, for new controls to be implemented in March 2010, were based on actuarial valuations provided by the companies as of 30 September 2009. In other words, these valuations were only 6 months away from the initiation of the price controls. Ofgem explained

“5.11. We consider that in times of significant movements in financial markets and uncertain economic conditions, that the latest valuation provides the most appropriate estimate of the level of deficit. ... We ... have used the September valuations provided to us by the DNOs, even where some companies have had a full triennial valuation at 31 March 2009, since there have been material changes in estimated deficits subsequent to those valuations. (Ofgem, Final proposals – allowed revenues and financial issues, 7 December 2009 p 34)

23. There are still uncertain economic conditions, and a valuation of £150m surely represents a material change in estimated deficit compared to the March 2011

valuation of £87.6m. Since the UR has committed to accounting for any subsequent change in valuation at the next price control review (RP6), it is not clear why it would be preferable to ignore the latest available information on the material change in estimated pensions deficit.

1.2 The deficit recovery period

24. NIE proposed that the deficit be recovered over 11 years, this being the period agreed with pension trustees in January 2012. The UR notes that NIE T&D is a monopoly network provider and that consumers should bear the costs of unavoidable deficit costs. It then says “All of this represents a significantly strong covenant for trustees, and provides justification for a longer deficit recovery period.” (para 11.39, p 119) Actually, although it suggests that a longer deficit recovery period is feasible, it provides no justification for a longer period.

25. The UR notes recent regulatory precedent varying from 10 to 15 years, then proposes that the allowed pensions deficit be recovered over 15 years “in line with recent GB regulatory precedent”. Ofgem considered carefully what period to choose, and opted for 15 years for two main reasons.

5.7. The impact on business and domestic consumers in DPCR5 of moving to a shorter period would be substantial.... Spreading the funding of repair payments over 15 years lowers the burden on existing customers. It also allows more time for the uncertainty to reduce about whether the deficits will diminish as the economy recovers. This will reduce the risk that consumers fund the deficits at a faster rate than is necessary during the deepest recession of the last seventy years. (Ofgem, Final proposals – allowed revenues and financial issues, 7 December 2009 p 35)

26. Whether there is more or less uncertainty about the economy now than there was in December 2009 is debateable. However, from the regulatory perspective, there is a significant difference between the situations of the GB consumers then and the Northern Ireland consumers now. Ofgem was proposing a new price control that would *increase* electricity distribution charges by an average of 5.6% per year in real terms – an increase of about 30 % by the end of five years. (The precise rate of price change varied by distribution company, and in the highest case amounted to an increase of 11.1% per year, getting on for 70% over 5 years.) In contrast, the UR is proposing a new price control that would *reduce* NIE T&D charges by over 3% per year in real terms – a reduction of about 16% over 5 years for domestic customers.

27. Reducing prices is tempting for regulators – in the short term. Customers would always prefer lower prices to higher ones. But that is not really the choice that they – and the regulator on their behalf – actually face. With respect to both the pension deficit valuation date and the pension deficit recovery period, the question is whether the regulator is justified in reducing the burden on today’s customers at the expense of a greater burden (by virtue of the interest payable) on tomorrow’s customers. If network prices have to rise significantly anyway, the case for deferral may be stronger. But if network

prices are falling, or remaining broadly constant, the case for putting off the pain and storing it up for later is much less obvious. The UR's Draft Determination does not address this issue.

28. I understand that NIE does not believe that the UR's proposed price reductions are sustainable. NIE's own proposal would imply a tariff increase of some 20% over 5 years. On that basis, and for consistency with Ofgem's GB regulation, NIE is prepared to accept a 15 year deficit recovery period. But if the UR maintains that tariffs should fall instead of rise, and rejects consistency with Ofgem's GB regulation on other issues, it is not clear what justification the UR has for extending the deficit repair period.

1.3 The treatment of Powerteam

29. The UR argues that NIE Powerteam Ltd is a separate legal entity from NIE T&D. On that basis, the UR says that the price control should not recover the share of pension deficit attributed to Powerteam. NIE, in contrast, explains that Powerteam employees are exclusively engaged on NIE-related activities. NIE should therefore be able to recover the share of pension deficit costs allocated to Powerteam.

30. The UR says

“Powerteam effectively operates as a department of T&D. NIE T&D uses Powerteam for the majority of its subcontracted labour work on the network. Powerteam provides network services including metering, meter reading, overhead lines, customer operations and plant/technical support to NIE T&D, as well as providing other support functions under managed service contracts.” (Draft Determination, para 2.21 p 7)

31. Some of the GB networks have from time to time contracted out activities such as meter-reading or IT. One might assume from the UR's discussion and proposal that NIE and Powerteam operate in a similar way that. In fact, that is not the case: I understand that Powerteam employs about 1000 of NIE's 1300 staff. It is not a peripheral activity, it is the core of NIE's staff. The two organisations operate in an integrated way. As UR's description continues

“Given the organisational structure, a number of business functions are shared across T&D and Powerteam. Examples include: telecoms, IT, corporate service allocations, finance, technical, facilities management, HR and business improvement.”

32. The UR acknowledged the current Powerteam arrangements in the RP4 price control through the inclusion of a specific profit-sharing term in NIE's regulatory formula (viz. 50/50 sharing between NIE and customers). This is strong evidence that the UR endorsed the Powerteam model. There was no suggestion that this arrangement would remove or shift the obligation to fund the pension deficit. Similarly, if the Powerteam arrangement were to be discontinued, as the UR now suggests, the UR has not suggested that NIE customers should no longer cover NIE's full pension deficit.

33. In principle, there seem to be two regulatory options. If Powerteam is regarded as essentially the same entity as NIE, then NIE's price control should include the recovery of Powerteam's share of the pension deficit costs. But if,

hypothetically, Powerteam were regarded as a separate entity from NIE, then the charges for Powerteam's services to NIE should include a contribution to cover Powerteam's share of pension deficit costs. Either way, the accepted obligation on customers of NIE to pay the pension deficit costs should include whatever share of the pension deficit costs might be deemed associated with Powerteam.

1.4 Adjusting for past actions

34. The UR argues that consumers should pay only once for costs which were either efficiently incurred or legally unavoidable. To ensure this, it says that it is necessary to carry out a historic analysis, to identify actions that were either inefficient or legally avoidable, and then to assess the impact of these actions on the present deficit. The UR identifies four types of action that have impacted on the deficit, viz: special contributions (+£77.5m), actual contributions less price control allowances (+£30.9m), benefit improvements (-£86.0m) and early retirements (-£61.9m), net total -£39.5m. This is equivalent to -£36.7m in 2009/10 prices, of which NIE's 91% share would be £33.4m. Paid back to consumers over 15 years this would be -£12.5m during RP5.

35. The UR's aim that customers should pay only once for costs is a valid consideration. But it is not the only one. In its recent statement *Principles For Economic Regulation* (BIS April 2011), discussed further below, the Government says

- the framework for economic regulation should provide a stable and objective environment enabling all those affected to anticipate the context for future decisions and to make long term investment decisions with confidence
- the framework of economic regulation should not unreasonably unravel past decisions...

36. The deficit-related actions that the UR has identified date back to price control periods RP4, RP3 and RP2, almost 15 years in some cases. Furthermore, the UR itself has previously addressed these issues. In its PR4 price control proposal of December 2005 the UR made an explicit adjustment relating to pension costs.

NIE has argued that pensions should be allowed on the same rolling basis proposed for controllable costs. The Authority accepts that most of the company's pensions costs should be allowed on this basis. However, following precedent set in the price control for the GB Distribution Network Operators (DNOs), the Authority considers that 30% of the pension costs relating to early retirement deficiency costs should be disallowed. This is an amount of c£225k per annum and will be deducted from the rolling Opex calculation. (p 6)

37. The pensions-related actions now identified by the UR were all ascertainable shortly after the time they occurred, at least in general terms. When it set the RP4 price control, the UR must be presumed to have considered the situation and decided, like Ofgem, that it would make an explicit adjustment only for those items related to early retirement payments. For the UR now to reopen

these issues and to take a different approach is surely to “unreasonably unravel past decisions”.

38. It might be argued that NIE took certain actions subsequent to the UR’s RP4 decision in December 2005. The Draft Determination suggests that NIE might have made further contributions during RP4. But these would contribute to reducing the pension deficit rather than to increasing it.
39. In proposing to reduce the pension deficit over 15 years, the UR argues that this is “consistent with recent GB regulatory practice.” But are the other elements of its pension proposals equally consistent with recent GB regulatory practice?
40. Ofgem has considered pensions issues carefully, in numerous consultations. Having done so, it has made no calculations over the last three price control periods, and made no corresponding adjustment to the allowable pension deficits. On the contrary, Ofgem has emphasised that customers will pay such pension deficits as exist at the end of March 2010, apart from the aforementioned adjustment for early retirement pensions. For Ofgem, the main issue has been how best to ensure that pension costs are minimised on a forward-looking basis.
41. In sum, neither the objective of providing a stable environment to encourage investment, nor consistency with previous UR decisions, nor “consistency with recent GB regulatory practice”, would support the UR’s present proposal to reduce NIE’s allowed revenue by calculating the impact on the pension deficit of NIE’s actions over the last three price control periods and retrospectively adjusting for that.
42. The UR’s pensions proposals leave the impression that the UR is acting on an opportunistic rather than principled basis, seeking any justification for a short-term price reduction.

2. The UR’s approach to previous capital expenditure

43. In setting the RP4 control, the UR adopted a new approach to the treatment of capex and controllable opex. Controllable opex was based on a five year rolling mechanism, while the RAB was updated to reflect actual capex on an ongoing basis.
44. In evaluating experience to date, the UR notes that during RP3 NIE’s controllable opex fell from £53.5m in year 1 to £29.1m in year 5. In its RP5 Draft Determination the UR says there was a step change of 23% between year 3 (£44m) and year 4 (£33.9m). It says that, in year 4 of RP3, NIE made changes to its capitalisation practice, so as to increase the proportion of expenditure that is characterised as capex rather than opex. The UR says that this was not made known when it set the control. Had the UR known of this, it might have adjusted the RP4 controllable opex allowance accordingly. Accordingly, the UR initiated an investigation into NIE T&D’s accounts. UR’s intention is to restate the regulatory accounts for the period from 2005/6 onwards, to assess the extent of any double payment that consumers may have

made during RP3 and RP4, and if appropriate to adjust the RAB for the relevant years of RP3 and RP4. The UR's recent press release (9 July 2012) says that an interim report suggests that there has been a material double payment by customers.

45. Whether it is reasonable to describe the £10.1m fall in opex from year 3 to year 4 of RP3 as a "step change" is debatable, given that there were varying but substantial reductions from each year to the next during that period, totalling £24.4m in four steps. The phrase suggests that there was something suspicious about a significant cost reduction from year 3 to 4. However, a regulator would not find such a pattern of operating cost reduction surprising. A company engaged in debate with its regulator about the scope for future cost reductions is unlikely to announce a major cost reduction as it goes into those negotiations. Such a company would find it better to make the cost reductions after the next control is agreed. Indeed, so familiar is this practice that Ofgem introduced a price control modification precisely to address this issue, which the UR now proposes to adopt, whereby a company is allowed to keep opex savings for a fixed period of five years, regardless of when they are made.
46. I am advised that NIE does not accept the UR's assertions about its capitalisation practice. I am not in a position to assess the arguments on this issue. But I do find it surprising that the UR should make this rather serious allegation about NIE's conduct in its Draft Determination, rather than seek to resolve it beforehand. The alleged change in capitalisation policy is said to have taken place in about December 2005, during RP3. That was over six years ago. If the UR had not identified this issue during the course of RP4, it would have done so at an early stage during the course of the RP5 review, once it had received answers to the questions it put to NIE. Why was the UR's present concern not discussed with NIE immediately, with the aim of resolving it before a public statement on the price control? Quite apart from the aspersion cast on the company and the implications for the adequacy of regulatory supervision and the regulatory relationship, the present approach has surely maximised the extent of regulatory uncertainty on this issue, which will have adverse implications for the cost of capital and hence for prices to customers.

3. The UR's regulatory process during RP5

47. Against what criteria should one evaluate the UR's regulatory process? The UR's website, under the heading "About Us: Who we are", sets out the Values to which it aspires. First among these is "**Be a best practice regulator: transparent, consistent, proportional, accountable and targeted**". These are the five Principles of Regulation initially defined by the Better Regulation Task Force in 1997. They have subsequently been made applicable to, or been adopted by, other UK utility regulators. They have also been used by other UK utility regulators as the benchmark against which to assess their own regulatory process.²

² E.g. *Independent PR08 Programme Evaluation, Report to the ORR Board, 5 August 2009*, s 3.6.

48. The present Government has recently stressed the importance of a sound regulatory framework in its *Principles For Economic Regulation* (BIS April 2011). These principles are “intended to articulate the factors that are key to the high level design of the frameworks for economic regulation, not to guide detailed application of regulators’ judgement in carrying out their functions”. Nevertheless, they are consistent with and enhance the Five Principles, and provide some further insight into the meaning and importance of these principles.
49. The aim of the present section is to assess how far the UR’s regulatory process in RP5 is consistent with its five Values. In the limited time available, I have not sought to assess every UR regulatory action against every regulatory Value. Rather, I have examined a number of aspects of the UR’s process that at first sight do not appear to be fully consistent with some of these Values.

4. Targeted

50. The Value that regulation should be **targeted** is principally addressed to the question whether particular activities should be regulated in detail or subject to competition. It is generally accepted that T&D networks have limited prospects for competition, and require regulation. I therefore do not explore this Value here, other than to note that, within the area of T&D regulation, there is a question whether the proposed regulatory approach is well targeted on the areas of concern. This can be dealt with under the Value of proportionality.

5. Accountable

51. The Value that regulation should be **accountable** is discussed in a section headed “Reinforcing accountability”, where the BIS Principles say:

31. Effective accountability of a regulatory framework therefore depends on transparency, a requirement to explain decision making, exposure to scrutiny and the right to challenge decisions.

32. Open and committed consultation about proposals plays an important role in strengthening transparency. It ensures that all parties can see and understand the logic and direction of travel of a regulator’s deliberations.

33. At the same time, publication of the reasons for regulatory decisions after the event provide clarity about their basis and rationale to help guide assessments of whether they were appropriate and proportionate judgements.

52. Since the RP5 process is not yet complete, it is premature to assess whether the UR will fully explain “the reasons for regulatory decisions after the event”. It is fair to say that the RP5 Draft Determination of April 2012 does indeed explain its reasoning so far. Similarly, “exposure to scrutiny and the right to challenge decisions” are not presently at issue. Of more immediate concern is the first point cited above. “Effective accountability of a regulatory framework depends on transparency”.

6. Transparent

53. This discussion of accountability reinforces the importance of the first of the regulatory Values: **transparency**. Is the UR's consultation process such as to strengthen transparency? Is it ensuring "that all parties can see and understand the logic and direction of travel" of the UR's deliberations?
54. The UR's main published documents in RP5 have been the Strategy Paper of July 2010, the Update of May 2011 and the Draft Determination of April 2012. These do not seem particularly problematic from a transparency perspective. They set out and explain the main aspects of the UR's thinking. Of more concern is the regulatory process *between* the publication of these documents. The critical question here is the extent of real engagement.
55. Documents issued by the UR (e.g. Draft Determination paras 9.43, 9.47), and the published minutes of its Board meetings, make reference to meetings and engagement with NIE. In contrast, NIE has told the UR that there has been little or no real engagement on the price control during this period.

To date, the flow of information has been very much one-way - from NIE to the UR. Apart from the information provided in the Strategy Paper Update (which in the main was limited to confirmation of separate price controls, five year duration, and continuation of RPI-X and post tax WACC) and an initial assessment of capex (which revealed a very low figure for RP5 capex which is not at all credible) the UR has provided very little insight into how its thinking is developing.

As you know from our earlier representations, by this stage in the process NIE would have preferred to have had more meaningful two-way interaction in the form of discussion and debate with senior UR staff and your consultants on the emerging positions the UR is minded to adopt across the various workstreams in formulating its Draft Determination. This would have been more in keeping with previous UR reviews of NIE's price controls and Ofgem's reviews of the Distribution Network Operator (DNO) price controls in GB, where in each case there was substantive two-way dialogue at an earlier stage. (Letter J O'Mahoney to S Lynch 16 Feb 2012)

56. The UR responded as follows.

The Utility Regulator disagrees with NIE that the flow of information has been very much oneway. The Utility Regulator has required time to gather information and understand NIE's submission. NIE will have ample opportunity during the consultation period to express its views and the Utility Regulator will be happy to fully engage with NIE during consultation period. It should be noted that the interaction between the Utility Regulator and NIE for this price control is not a negotiation. The manner in which previous price controls were carried out should not have a bearing on future price controls. (Letter T Wishart to J O'Mahoney 22 March 2012)

57. The UR's practice stands in contrast to practice in GB, which has evolved over time but has always incorporated a significantly greater extent of mutual discussion than exhibited during RP5. For example, in the GB energy sector, it would be normal for Ofgem and the companies to discuss the design and timetabling of the price control review, the design of the initial Business Plan

Questionnaires in the light of data availability and the time and costs involved, and the work and findings of consultants advising the regulator on opex and capex. It would be standard practice for these consultants to visit the companies, to try to understand the reasons for the companies' own plans and to test out their own thoughts on the companies' engineers and management. There would also be at least one meeting between the top regulatory team and each company before the publication of any Draft Determination, at which ideas and arguments would be exchanged. This makes it possible for each company to understand and explore the development of the regulator's thinking on the price control.

58. My understanding is that very little such engagement happened in RP5, and to the extent that it did happen it was largely ignored by the UR. For example, the UR discussed the original form of the data tables with NIE in May 2010. The UR said that the format of the questionnaire would be similar to the information reported internally within NIE. The company reviewed and responded to the UR's draft questionnaire in June 2010, in anticipation of the formal questionnaire being issued later that month.
59. At a meeting on 2 July 2010 the UR indicated that the questionnaire was unlikely to be issued before the end of October. When, in October, the UR issued a second draft questionnaire seeking comments from NIE, it asked for them within one week. But the scope of the questionnaire had changed substantially from the first draft. Historical information on operating costs was requested for RP3 that had never been requested before, and when the official questionnaire was issued in late October 2010 it was accompanied by a substantial number of questions the detail of which had not been discussed with NIE. The BPQ and questionnaire were much more detailed than in any previous price control review. NIE have said that the UR indicated that this would limit the number of follow-up information requests, but that turned out not to be the case.
60. Another example of the lack of real engagement is the UR's approach to the collection of data about NIE Powerteam. At the initial meeting in May 2010, the UR had discussed Powerteam and were to give consideration to whether a separate questionnaire would be required. It was only in October 2010 that NIE was made aware of the requirement to complete a questionnaire for Powerteam. The first draft BPQ provided for Powerteam was essentially the same as for NIE T&D except for the company name change, even though the businesses are quite different. NIE had to redraft the Powerteam BPQ to make it relevant.
61. The lack of engagement may have contributed to the UR being unsympathetic and unrealistic in terms of timescales for responses to their demands for information. For example, the UR failed to realise that it is not straightforward for NIE to respond to data requests for RP2 and RP3 when staff have moved on and the information is not readily available. A number of UR information requests after the BPQ were marked urgent, requiring a response the next day or within the next two days. Yet, as I suggest below, the price control process as a whole lacked any coherent timetable. NIE's perception is also that the UR have some relatively inexperienced staff, who are not well coordinated, do not

have a good understanding of the information they receive and do not pay particular attention to detail.

62. I am astonished that the UR's engineering consultants did not even deem it necessary or appropriate to make site-visits to the company's network and premises. Thus, not only is it difficult for the company "to see and understand the logic of the UR's direction of travel", there must also be a question as to whether the UR has taken every available opportunity fully to inform itself about the relevant circumstances of the company that it regulates. More generally, although the UR has asked many questions and obtained much information, the lack of real two-way engagement up to the issue of the Draft Determination increases the chances that the UR may not have understood fully the information that the company has provided, or the circumstances in which it is to be applied, or the implications of particular directions of travel.
63. In correspondence and elsewhere, the UR repeatedly affirmed that there would be an opportunity for full engagement with the company during the consultation period on the Draft Determination. However, given that NIE has not been consulted on the UR's thinking hitherto, its priority at this late stage is to prepare its response to the Draft Determination. Moreover, there must be a question whether a regulator can be as open-minded to information, discussion and argument after it has publicly committed to a Draft Determination as it can be before that.
64. The lack of engagement during RP5, by the UR and its consultants, leaves the impression that the UR has demanded information from NIE but not sought to get or understand NIE's views. It is understandable that a regulator should seek to take a tough line with a regulated company. But in doing so the UR does not seem to have been willing to try to understand the full picture. It seems to have avoided information, views or consequences that are inconvenient for the line that it wishes to take.

7. Consistent

65. As regards the regulatory Value of **consistency**, under the sub-heading "Coherent, adaptable but stable regulation", the BIS document says

25. Efficient investment is an important part of promoting the long-term interests of consumers. It is important that the regulatory frameworks avoid adding undue uncertainty to the business environment.

26. To a large extent this is achieved by building a stable and transparent regulatory environment with a long track record of consistent regulatory decision making. A history of rational regulatory decisions, which can be objectively justified, creates an expectation that a narrow set of outcomes will follow a given set of circumstances. This in turn will help both investors and consumers to predict regulatory decisions. On the other hand, piecemeal, ad hoc or unanticipated changes in policy or regulatory responsibilities are likely to erode investor confidence and increase the cost of capital.

66. In discussing predictability, the document says

- the framework for economic regulation should provide a stable and objective environment enabling all those affected to anticipate the context for future decisions and to make long term investment decisions with confidence
- the framework of economic regulation should not unreasonably unravel past decisions, and should allow efficient and necessary investments to receive a reasonable return, subject to the normal risks inherent in markets

67. It is to be expected that a regulator will seek to evaluate previous policy and practice, to make adjustments where appropriate, and to explore innovations. Nonetheless, at least four aspects of consistency – or inconsistency – in the RP5 process and Draft Determination are potentially concerning.

7.1 Respect for previous UR policy

68. It has already been noted that the UR’s proposed policy on pensions and on previous capital expenditure in the RAB suggest an unwillingness to accept the UR’s previous policy on these issues. A change of direction going forwards is understandable, but to recalculate previous price control entitlements as if different regulatory rules had been in operation is another matter. The proposed policies do not seem consistent with the principle that “the framework of economic regulation should not unreasonably unravel past decisions”.

7.2 Consistency of regulatory process

69. There has also been an explicit change in the UR’s regulatory approach. The UR’s RP4 proposals explained the reasons for the UR’s approach at that time.

Following difficult negotiations between Ofreg and NIE the second price control for the T&D business was eventually settled following the 1996 referral to the Monopolies and Mergers Commission. The third price control (RP3) was agreed between the regulator and the company but not without hard negotiations and extensive and expensive work agendas for both parties. It was felt by both parties that a satisfactory outcome could be reached for the price control for the fourth regulatory period (RP4) by adopting a collaborative approach. (p 3)

70. In contrast, when NIE expressed its concern about the lack of real engagement during the RP5 process, as discussed above, the UR rather bluntly responded, “The manner in which previous price controls were carried out should not have a bearing on future price controls.” (T Wishart letter to J O’Mahoney 22 March 2012) It is difficult to reconcile this stance with the UR’s Value of consistency. There appears to be no recognition of the problematic history that caused the UR to take the approach it did in RP4, or of the potential disadvantage of instigating a return to such a problematic relationship in future.

7.3 Consistency with traditional price control approach

71. In its RP4 proposals, the UR summarised what it called “the traditional approach” to setting the opex allowance.

“The work typically involved an examination of the company’s operating cost base, benchmarking it against the cost bases of other electricity network companies both nationally and internationally, and undertaking a very detailed item by item analysis of individual expenditure categories.” (p 5)

72. The UR commented that this method was “time-consuming and resource-intensive, and differences in the way that companies report their costs adds to the difficulty in ensuring that efficiency comparisons are made on a like-for-like basis”. The UR also explained the problem of capex underspend in the traditional approach to the capex allowance. These concerns led the UR to take a different approach in RP4.

“In a move away from the traditional methods applied to a price control a number of new approaches to incentive mechanisms were introduced for RP4. These included a ‘rolling’ Opex mechanism and setting Capex using actual rather than forecast expenditure. An evaluation of these mechanisms will be required to assess the appropriateness of continuing with them in RP5.” (RP5 Strategy Paper p 2)

73. In its RP5 Draft Determination, the UR moves into reverse. “For RP5 we are minded to return to a traditional RPI-X type price control, with allowances designed to incentivise NIE T&D to control its operating and capital costs.” (para 4.14 p 15) The rolling opex mechanism is replaced by a five year lag mechanism, as used in GB, and the ex post capex mechanism is replaced by an ex ante capex allowance with provision for a Reporter.

74. It is understandable that a regulator should review the operation of the various components of a price control, and where appropriate propose changes on a going-forward basis. Two aspects of the present proposal are of some concern, however. First, in proposing a return to the “traditional approach” to opex, the UR makes no reference to the shortcomings that it had previously identified in the RP4 process, that were sufficiently serious to cause it to abandon that approach. Second, there is no acknowledgement or exploration of the additional regulatory burden – that might be expected to have similar shortcomings - associated with the proposed ex ante capex allowance and Reporter system. In consequence, whether this increased regulatory involvement can be fairly described as “a traditional RPI-X type price control” or an “allowance designed to incentivise NIE” is questionable. The regulatory burden is examined further below.

7.4 Consistency with GB regulation

75. Previous UR documents have identified consistency with regulatory policy in GB as an important consideration. Indeed, GB inputs have at times been critical inputs in setting the NIE control. For example, “For RP3, the Utility Regulator made extensive use of comparisons with Great Britain’s distribution

network operators and historical savings in setting the baseline revenue and efficiency targets.” (UR Strategy Paper p 12)

76. NIE has stressed to the UR the importance of this issue for its own business, because of the implications for investor confidence, cost of capital and ultimately prices to customers.

“As set out in our response to the UR’s consultation on a cross–utility approach to network price controls, it is most important that the regulatory framework within which NIE operates maintains a clear and stated alignment with GB regulatory precedent. This means having an approach consistent with that applied by Ofgem to the GB DNOs. Given Ofgem’s influence on most of the UK electricity industry, maintaining a link to GB precedent and current approach is crucially important to support investor confidence in the electricity industry in NI.” (J O’Mahoney letter to S Lynch 16 Feb 2012)

77. The UR responded by saying “Alignment with GB: The Utility Regulator can confirm that the price control follows the philosophy of the Zeus consultation.” (T Wishart letter to J O’Mahoney 22 March 2012)

78. This is a somewhat troublesome response, not simply because it illustrates a reluctance to engage, as discussed above. It also epitomises a classic “Sir Humphrey” technique: answering a question slightly different to the one that was actually posed, in such a way as to appear to give a reassuring answer, when in fact this is not the case. The “philosophy of the Zeus consultation” refers to the UR’s proposal for a cross-utility approach to network price controls within Northern Ireland. While the relevant discussion document did indeed make reference to the GB approach, it did not propose “a clear and stated alignment with GB regulatory precedent”. It is evident from numerous aspects of the present paper that the UR’s proposed approach is explicitly *not* aligned with GB regulatory precedent in many critical respects.

79. Accordingly, a more honest and constructive response to NIE’s letter would have been to acknowledge NIE’s concern and to identify and invite discussion of those aspects on which the proposed price control approach might be said to differ from GB precedent, and the reasons for the UR taking its chosen approach. In the absence of such a response, there necessarily remains some doubt to whether, or to what extent, the UR proposals are in fact aligned with GB precedent, and a residual suspicion of the UR’s regulatory consistency. In consequence, investors will be uncertain how far they should factor some additional risk element into the cost of capital in Northern Ireland.

8. Proportional

80. Under the subheading “Effective and proportionate regulation”, the BIS document says

40. Economic regulation, as with most forms of regulation, imposes costs on regulated companies. These costs derive from the regulatory cost the regulators impose on their sectors and the administrative cost of running the regulatory institutions. Costs in these sectors tend to be passed through to end

consumers. It is important that they are proportionate and outweighed by the benefits achieved for consumers.

8.1 Regulatory burden

81. NIE has drawn attention to the burden imposed by the RP5 price control review process. Examples include answering almost 300 questions and populating some 45 spreadsheets in response to the Business Plan Questionnaire (BPQ), providing 15 BPQ support papers and 43 strategy papers, answering 150 follow-up questions on opex and related issues plus over 300 follow-up questions on capex. (Letter of J O'Mahoney to S Lynch 16 Feb 2012) In addition, many of the follow-up questions went back to previous price control periods, even back to privatisation, which were particularly time-consuming to answer.
82. The UR's Draft Determination notes that it received narratives, spreadsheets and databases for a dozen different activities of NIE T&D and also NIE Powerteam. It also says "Although we did not request them, we were pleased to receive supporting papers" relating to some 16 issues. (para 4.21) Lest it be thought that NIE brought additional and unnecessary work upon itself in respect of these support papers, note that they were all on matters integral to a modern price control, provided by consultants well experienced in providing similar material to and for regulators in GB.
83. The proposals in the UR's Draft Determination are also likely to increase the costs of implementing and monitoring the price control. For example, the proposed approach to capex (para 9.82 et seq) will require the UR to specify in some detail what capex is to be delivered (Fund 1), and to approve subsequent proposals related to renewable generation (Fund 3), which will require cost-benefit analyses. A Reporter is required to verify actual volumes delivered and actual costs incurred, to report on asset management practices and the development of asset health indices, and (for Fund 2) to verify the need for the work that is undertaken and whether or not the costs have been incurred efficiently.

8.2 Regulatory costs

84. The costs imposed by the UR's questions and proposals have been and will be substantial. As the BIS document recognises, over the long term these costs will be passed on to customers.
85. Are the costs imposed by the UR nonetheless proportionate? All regulators argue that the cost of their offices is relatively small per customer, and is therefore worth incurring. But the leading UK regulators have shown considerable sensitivity to this burden, and have sought to reduce it. Statements by Ofgem³ and Ofwat⁴ illustrate this. Such awareness is not apparent in the UR's recent price control statements.

³ For example, Ofgem has said "We also recognised that the requirement for a single historical data request during a price control placed too heavy a burden on the DNOs to produce data that their systems were not developed to provide." (Ofgem, Electricity Distribution Price Control Review, Methodology and Initial Results, 8 May 2009, para 1.12 p 6)

86. The BIS document continues

41. As organisations, regulators should be efficient and well run, maximising the benefit they can deliver with their available budgets. As regulators, their interventions and tools should deliver desired outcomes in the least burdensome way, based on the established best practice for designing regulation. This means imposing requirements only where necessary, considering alternatives to regulation and minimising the risk of unintended consequences.

87. What is the evidence on the costs of the UR relative to regulatory costs elsewhere in the UK? Consider the evidence provided by the accounts of each regulatory body for the year ended March 2011. Ofgem's annual cost recovered in licence fees is £31m. Divided by the 60.4m population of GB this amounts to 51p per head of population. The annual cost of Ofwat plus WICS in Scotland is £17.9m + £3.9m = £21.8m, or 36p per head. The total cost of energy plus water regulation in GB is therefore about 87p per capita. In Northern Ireland, the annual cost of UR is £7m. Divided by the population of 1.8m this is about £3.89 per head. In other words, the per capita cost of regulation by UR is about four and a half times the comparable cost of regulation in GB.
88. UR's accounts show the breakdown in cost by sector. Water regulation costs £1.6m, an annual cost of 89p per head. This is more than double Ofwat's annual cost (32p) but less than 20% higher than the cost of water regulation in Scotland (75p).
89. The higher cost of regulation by UR derives mainly from the energy sector. There, the annual cost is £3.7m for electricity + £1.7m for gas, an average of £3.00 per head. Energy regulation by the UR thus costs about six times per capita what Ofgem costs in GB.
90. This calls into question whether the UR is acting proportionately in devoting so many resources to energy regulation, and whether it is designing its regulatory approach in such a way as to work within, and to make best use of, the resources that it has available.

⁴ For example, Ofwat has said "The way we set and monitor outputs has become increasingly complex and data intensive for us, the companies, and other regulators and stakeholders. This was confirmed in 'Lessons from our approach to setting price limits (PR09)', a report we published in December 2010. This document detailed concerns from stakeholders that the price review process had become increasingly burdensome and complex and – as a result – less transparent. ...As the complexity has grown, so the risk of unintended or undesirable consequences and conflicting outputs has increased. ... Setting detailed outputs also tends to fuel detailed monitoring – with the danger that real issues are lost in detail. In turn, this monitoring tends to feed even more detailed outputs at the following price reviews, as adjustments are made in the light of experience." (Ofwat, Future price limits – a consultation on the framework, 22 Nov 2011, s 3.2 p 20)

8.3 Timely regulatory decisions

91. In its discussion of proportionate regulation, the BIS document says

43. As well as being cost-effective, regulatory decisions need to be made in a timely manner. Infrastructure investments have long lead times. Delays to key decisions can cause uncertainty and raise the costs to industry or leave consumers unprotected.

92. In its draft Forward Work Plan of October 2010, the UR said of the RP5 price control review:

This will require intensive work over the next two years scrutinising investment plans, financing and operating costs and establishing appropriate price controls. We see this as a priority project and we will divert resources from other projects if this becomes necessary. (p 12)

In his Foreword to the UR's 2010-11 Annual Report, the Chairman said "We continue to focus on our bread and butter work such as delivering price control determinations." What then is UR's record with respect to the timing of delivery of RP5?

93. The RP4 price control was due to expire on 31 March 2012, with the next control due to begin in April 2012. The UR issued a timeline to NIE on 4 February 2010. This showed the BPQ issueing in May 2010, and the Final Determination issueing in November 2011. However, the BPQ did not issue until October 2010. The UR issued a new timeline to NIE indicating that the Final Determination would slip to March 2012.

94. The UR's Strategy Paper in July 2010 said that the next consultation phase would be in Q4 2010. No consultation materialised at that time.

95. On 6 October 2011 the UR announced a 6 months extension of RP4. It said that "a Draft Determination will be issued this winter", there would be consultation on it from December 2011 to March 2012, a Final Determination would be published in August 2012 and the licence modification process would take place from August to September 2012. However, no Draft Determination was forthcoming in winter 2011. It was not issued until April 2012.

96. The Draft Determination said that RP5 would now be implemented from 1 October 2012, and reaffirmed that the previous price control RP4 would be extended from 1 April to 30 Sept 2012. It now said "This has been necessary because of delays in receiving the full RP5 submission from NIE T&D. As a result we needed more time to complete a robust assessment ..." (Summary para 3.2) It said that the final price control would be published by the end of the year. This seems to imply that RP5 will not be implemented until 2013. There was no explanation or discussion of the implications of this further delay.

97. NIE acknowledges that parts of the BPQ information were provided two weeks late, on 14 February 2011; that the capex databases were not completed

until early April; and that the BPQ data split between T&D was not provided until 11 March 2011. However, it says there is no reason why this should have delayed the price control process. The capex databases were essentially a summary of more detailed information already provided. As regards the T&D split, the whole of the Draft Determination except the impact on tariffs is on a combined basis, for which data was provided in February.

98. The UR has also been late with a number of other recent price controls. The minutes of the UR Board meeting of December 2011 record the Board's concern at the delay in the overall price control process for Power NI.
99. The UR's timetable and plans for RP5 have turned out not to be realistic. They have been changed belatedly, with little or no notice to, or discussion with, the company whose revenues and investment are at stake, and whose participation should be an integral part of the regulatory process. It is implausible, and ungracious, for the Draft Determination to blame a regulatory delay of six months - perhaps more realistically a year - on a few weeks' delay by NIE in responding to a few elements of the BPQ. The UR was already five months late in issuing the BPQ.

8.4 The present situation

100. Are things any better now and looking forward? There is as yet no acknowledgement that the UR's last published timetable has gone awry. The UR has provided no timetable for the future.
101. Nor has the UR provided any explanation whether NIE is presently subject to the RP4 price control that was supposed to expire at the end of March 2012, or presently without a valid price control at all. NIE expressed its concern on this score to the UR.

The UR's decision to roll over the RP4 price control was taken without consultation and without licence modifications. The approach is out of line with Ofgem's practice in extending price controls. As you know we have legal advice that licence modifications are required. (Letter J O'Mahoney to S Lynch, 16 Feb 2012)

102. In response, the UR noted NIE's comments and said
- "In order to facilitate the Utility Regulator's response to NIE's concerns the Utility Regulator requests that NIE provides details of the legal advice it has highlighted." (Letter T Wishart to J O'Mahoney, 22 March 2012)
103. But surely, whether a major regulated entity does or does not have a valid price control for a period of at least six months is a matter that goes beyond "a response to NIE's concerns"? On such a fundamental issue it is surprising that the UR had not taken its own legal advice long ago, and taken action accordingly.
104. The lack of clarity on price control is becoming increasingly serious. The Draft Determination (para 4.18) stated that "RP4 will be extended from 1 April 2012 to 30 September 2012". However, no formal licence modifications

have been implemented in this regard. I understand that the UR has indicated that, until the RP5 control is implemented, capex should continue at RP4 levels. However, nothing has been proposed by the UR or agreed with NIE in relation to opex, pensions, incentives or allowed returns beyond 1 October 2012. That is less than 3 months away. Consequently, NIE is unable to make informed investment and operating plans for its business. How can this be in the interests of customers?

105. The UR's failure to set and meet realistic targets continues. For example, the UR initiated its investigation into changes in capitalisation practice on 20 February 2012. It said that "The UR expects to resolve this investigation in a timely manner." Informally, a senior UR official indicated to NIE that the investigation should only take about two weeks. However, the Draft Determination in April 2012 announcing the investigation said that it would be completed during the three month consultation period – that is, by 19 July 2012, five months after it was initiated. Then on 9 July the UR announced that "the process of information gathering is taking longer than the consultant auditors first anticipated". There is no revised date for publishing the final report of the investigation, other than that it will allow time for responses to be considered before the Final Determination of RP5 – the date of which is itself no longer specified other than "by the end of the year".

8.5 The UR's capability – a proportional approach?

106. This lack of forward workplans, and the series of significant and largely unexplained delays, plus a lack of attention and sensitivity to the fundamentals of an important utility business, is not a very impressive record of how a regulatory body deals in a timely manner with what it describes as its "bread and butter work", as a "priority project to which it will if necessary divert other resources". The basic practicalities of running and regulating a utility business that serves a population of nearly two million people seem to have been overlooked.
107. This in turn raises many questions. Has the UR, in this price control review, bitten off more than it can chew? Were its 300 questions, 45 spreadsheets and over 450 follow-up questions more than it could digest? Had it properly thought through the implications of the approach it decided to take? Why did it fail to learn the same lessons about over-complexity and simplification as the other UK utility regulators? Why does it seem to have forgotten the lessons that it had learned earlier? Is it now more concerned with politics and presentation and the short term, with trying to deliver a price control that is seen to be tough on a privatised utility? Has it been insufficiently concerned with the practicalities of regulation and with the longer term implications of its attitude for future investment? Has it, in sum, fallen short on one of its key Values, and lost some sense of proportion?
108. The UR's poor record on delivering the present price control review does not bode well for its ability to implement the significantly more intensive regulatory role that it envisages as a result of the price control itself. The Draft Determination proposes a significantly more active role for the UR than in the past, particularly with respect to specifying and approving the capex

programme. The UR will also have to monitor and respond to the considerable information to be provided by the Reporter. With this increased degree of regulatory involvement, there must be a question whether the UR has the quantity and quality of resources to discharge its proposed responsibilities in a constructive and timely manner.

9. Contrasting price controls

109. The UR's proposals on pensions costs and previous capex, and its regulatory process generally, should be viewed in the context of the rest of the price control as a whole. Consider the main components of its building block approach.
110. The UR proposes to cut NIE's business plan opex by about 25% and its business plan capex (Funds 1 and 2) by about 60%. These are more severe cuts than other UK regulators would normally consider reasonable.
111. The UR proposes a lower cost of capital than Ofgem has used. A ratings agency has commented as follows.
"the Draft Determination ... provides for more challenging financing assumptions than Fitch Ratings would normally expect for a UK regulator. ... the proposals raise concerns that the financial profile of NIE could deteriorate over the next five years. ... Fitch is not convinced that the draft determination actually provides for adequate capital market access for a business in a growth phase. It appears that UReg may interpret its financing duty materially different to other UK regulators." (FitchRatings Comment, May 2012)
112. These observations, taken with my findings above, confirm my view that there is a significant difference between how the UR is now approaching RP5 and how Ofgem and other UK utility regulators approach a price control review in GB – and, for that matter, how the UR itself previously approached RP4.
113. Not surprisingly, outcomes, too, are different. The UR now proposes a price *reduction* of about 16% over 5 years whereas Ofgem considers that an average price *increase* of about 30% is necessary. This outcome is in contrast with that in RP4, where the UR was at pains to explain why the outcome for NIE was similar to that for the most comparable GB network companies because NIE faced the same issues.⁵ Does NIE no longer face the same issues? Why should the situation suddenly have changed so radically?

⁵ "The capped revenue in the first year of RP4 is a 2.8% real increase on the level of regulated revenue today. Increases in revenue entitlement were a feature of the last distribution review in GB (where for example, regulated revenues for Scottish Hydro, Swalec and Sweb, the three companies most comparable to NIE in terms of their scale and network characteristics, increased by over 4% in real terms on average). Ofgem explained that the increases were necessary because of 'the need for increased investment, combined with additional tax and pension costs facing companies'. NIE faces those same issues." (UR Proposals Paper 14 December 2005, p 19) In the latest Ofgem review, the average annual price increase of the same three GB companies described as most comparable to NIE is 6%, slightly higher than the average increase of 5.6% for all GB companies.

114. It is of course possible that other UK regulators are out of step with the UR. Perhaps the UR has found a new and better way to regulate and set prices for the benefit of customers. However, an examination of recent reviews of the price control processes of two other UK regulators suggests a different explanation.
115. Ofgem invited the views of its stakeholders on its recent price control review process. In general there was strong support. Foremost among the specific areas of good practice were full engagement with the distribution network operators and with the Authority, and strong project management that was vital to timely delivery.⁶ One lesson learned was the need for even more time and engagement devoted to “bringing the network companies with us”.⁷
116. The Office of Rail Regulation commissioned an independent review of its recent price control review process. As noted above, it evaluated the process against the five principles of good regulation. There, too, there was strong support for the price control process from stakeholders. There, too, openness, engagement and effective project management were key elements.⁸ The ORR was particularly diligent with respect to setting a detailed and realistic timetable well in advance, and keeping to it.⁹
117. How different has been the UR process in RP5 as detailed above! It does not bear comparison with best practice UK regulation. Sad to say, in

⁶ “A committed and accessible DPCR5 team: External stakeholders, including DNOs welcomed the effort the DPCR5 team made to ensure they were available to discuss aspects of the price control. Also, the effort the price control team demonstrated in working to deadlines to ensure delivery provided external parties confidence that the programme was running to schedule....

An informed and engaged Committee of the Authority: The DNOs welcomed the time spent with the Committee of the Authority to present their views. They appreciated the opportunity to have direct access to the decision makers and found the Committee members engaged and well briefed.

Strong project management: We had a stand alone and well qualified project management team. This was vital to the timely delivery of the project, provided a focal point for the team and made sure there was sufficient time for us to produce well written documents. ...

Well structured external engagement: DNOs and other external stakeholders found the process of workshops between consultation documents useful in order to inform and provide early exposure to our thinking. DNOs also welcomed the time spent in bilateral meetings with senior members of the team and working groups established to help develop proposals.” Ofgem, *Electricity Distribution Price Control – Review of process*, 9 July 2010.

⁷ “*Bringing the network companies with us:* The DPCR5 process demonstrated that we need to build in time to ensure the network companies (and other stakeholders) understand fully where our thinking or approach to key issues has changed, and the implications of these changes.”

⁸ “1.1 The 2008 Periodic Review (PR08) followed current practice for UK regulators. It passed without disorder or confusion on the part of ORR, Network Rail and most stakeholders. ORR managed the programme well. There was strong leadership and effective project management of what was an immensely complex task. ...

1.2 The process was open, inclusive and undertaken without visible rancour....

1.3 Stakeholders generally felt this was a process in which they were actively encouraged to participate with most taking the opportunity to do so” (*Independent PR08 Programme Evaluation, Report to the ORR Board*, 5 August 2009, p 5)

⁹ “3.8.2 It published its initial consultation paper in August 2005, nearly four years before the new funding arrangements would be implemented. This early start was appropriate ...

3.8.17 Section 4 set out ORR’s proposed timetable for the review. The description was detailed, and in the event ORR met the timetable it had set out.” [This four-year-ahead timetable specified two dozen milestone actions over the Preparation phase and Formal review phase, each specified by month and year.]

several respects it is an example of how not to regulate. In these respects the UR's conduct has fallen short of its own stated Values of Transparency, Consistency and Proportionality. And I am afraid it suggests that the remarkable price reductions proposed in the Draft Determination are too good to be true; that they have been achieved, not by following the principles of good regulation, but by flouting them.

10. The implications for customers

118. Inadequacies of regulatory process are not simply a matter between regulator and regulated company. They have consequences for prices and customers. If a regulator is not transparent because it is unwilling to engage, if it does not act consistently with its previous price control commitments and due regulatory process, if its information requests and proposed price control arrangements put a disproportionate burden on the regulated company, and if it fails to develop and implement realistic work plans, then the company that it regulates will be unable to invest and operate in a way that best meets the needs of its customers. The company's operating costs will be needlessly increased and its flexibility and responsiveness reduced. There will be a reluctance to invest. Regulatory uncertainty, inconsistency and lack of proportionality will impact adversely on the company's cost of capital – in NIE's case, as it competes for debt in the funding market against other utility companies whose regulators are more transparent, consistent and proportionate. Higher operating costs and higher cost of capital mean higher prices for customers.