10 Views of NIE

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Introduction

10.1. NIE sent us an initial main submission and numerous supplementary submissions. We also held three hearings with the company. NIE's views on the major issues in this inquiry are detailed elsewhere in this report (see Chapters 7, 8 and 9). In this chapter we summarize NIE's more general views on the present price control review, in particular its criticisms of the proposals published by the DG and its views on aspects of the public interest.

Terms of reference

10.2. In response to the formal questions in the terms of reference, NIE said that it believed the process of incentive regulation encouraged it to improve its efficiency. It thought the benefits of improvements made during each regulatory period should all rest with the company, in some cases continuing to do so into the following regulatory period. In its view, however, the strength of incentive regulation was that it drove the company to deliver benefits which ultimately went back to the customer.

The DG's proposals

10.3. NIE told us that publication of the DG's proposals represented the culmination of a lengthy review in which NIE had fully co-operated. Nevertheless the DG's proposals effectively rejected many of the submissions and much of the evidence which NIE had contributed to the review. Whilst accepting the DG's proposals for the PPB, NIE had rejected those for the T&D and Supply Businesses. NIE said that the rejected proposals would:

(a) reduce NIE's aggregate revenues in 1997/98 by £68 million compared with 1996/97;

(b) result in further reductions in NIE's revenues in real terms through the application of the prescribed X factors during the next price control period; and

(c) reduce the average domestic customer's bill by £55 in 1997/98, rising to £63 in real terms at the end of the new period.

10.4. NIE argued that, even allowing for the substantial efficiency gains assumed by NIE, the DG's proposals for its T&D and Supply Businesses would provide it with insufficient revenue from its regulated activities to finance those activities. In 1997/98 its profits would fall by over 50 per cent compared with 1996/97; on the assumption that the current dividend was maintained, HCA dividend cover would be halved in 1997/98, falling to 0.7 times by 2001/02. CCA dividend cover would fall to 0.5 times by 2001/02. Gearing would rise to just under 100 per cent and interest cover would fall to 2.5 times by 2001/02, thereby potentially triggering an event of default under NIE's borrowing arrangements. NIE's financial condition by 2002 would be such as to necessitate a significant increase in electricity prices to provide it with sufficient funds to finance its regulated activities.

10.5. NIE considered that the source of the problem lay in a series of errors in OFREG's conduct of the review and its conclusions. In particular:

(a) The DG had based his conclusions on certain factual errors and unreasonable assumptions.

(b) In conducting a `bottom-up' formulation of the proposed price controls the DG had failed properly to quantify NIE's requirements for capital and operating expenditure and an appropriate return to investors during the period under review. In assessing the appropriate return to investors the DG had failed properly to value the relevant businesses and had applied an inadequate rate of return to the values at which he had arrived.

(c) The DG proposed to `claw back' 50 per cent of NIE's capital expenditure underspend from 1993/94 and 1994/95 (see paragraph 7.22).

(d) Having formulated proposals based on his bottom-up approach, the DG failed to pay due regard to comparisons with prices charged by comparable companies.

NIE's composite proposal

10.6. NIE told us that during the review it came to realize that there was no prospect of persuading the DG of the merits of its case. Whilst it remained confident of those merits, it was aware of the uncertainty and cost which would be occasioned by an MMC inquiry, and the consequent likely fall in its share price. It also recognized that electricity prices in Northern Ireland were higher than those of the closest Great Britain comparators and that every effort must be made to achieve further price reductions. In the hope of averting an MMC inquiry it had therefore offered the DG a composite proposal, allowing for a revenue reduction of £45 million in 1997/98, with the application of an X factor of -3 and a P_0 reduction of 20 per cent for the T&D Business, and an X factor of -1.5 and P_0 reduction of 32 per cent for the Supply Business (see Chapter 9). This would have resulted in a fall in the average annual domestic bill, in 1996/97 prices, of £35 in 1997/98 rising to some £50 in 2001/02.

10.7. NIE stated that it recognized that its composite proposal would leave it unable to finance its regulated activities out of its regulated revenues. The shortfall would need to be made good in part out of shareholder value, reduced customer standards and price increases for customers in the third price control period.

10.8. Clearly, said NIE, directors of a public company could not take such a decision lightly. Their principal duty was to maximize long-term profitability, and hence shareholder value, from regulated and unregulated activities. But the directors had taken account of the public interest objective of limiting prices paid by customers as far as possible and of the role of NIE as a corporate citizen in contributing to the interests of Northern Ireland and the development of industry through inward investment.

10.9. NIE commented that there was a severe risk that adoption of the composite proposal would leave NIE unable to meet the legitimate expectations of customers as to standards of service during the next five years. NIE's proposal had resulted from a fine balancing of the need to maintain its financial viability against the desire to offer further price cuts. If implemented it would have stretched NIE's finances to the limit of what the directors could contemplate. It would also still have necessitated a significant increase in prices in 2002, though to a lesser degree than would be required under the DG's proposals.

10.10. NIE made it clear that, whilst it had hoped that its composite proposal would meet the DG's immediate concerns, it did not consider that the proposal would meet the public interest objectives which the MMC were required to take into account. NIE therefore did not wish to commend that proposal to the MMC.

Points at issue

The DG's methodology

10.11. NIE argued that the DG had conducted his price control review without adequately disclosing to NIE his underlying methodology. Nor had the DG addressed the question of what allowance was required for NIE to improve its standard of service during the next five years, having regard to levels considered to be appropriate in Great Britain. This contrasted sharply with the approach of OFFER, and the MMC in their report on SHE, which allowed for significant improvements in quality of supply.

Factual errors and unreasonable assumptions

10.12. NIE further argued that the DG's proposals incorporated a series of factual errors and unreasonable assumptions relating to its projected operating expenditure (see Chapter 8). It said that the combined effect of these factors would be to require immediate `cliff face' reductions in operating costs in 1997/98 which would be unattainable even over a period of years.

Quantification of allowable expenditure

10.13. NIE said that it was by no means clear why the DG had made severe reductions to NIE's projections in calculating allowable capital and operating expenditure. However, some features of the DG's approach were manifestly wrong, in particular his failure to take account of the magnitude of the efficiency savings achieved by NIE during the first regulatory period; his 50 per cent clawback of capital expenditure underspend (see paragraph 10.5*(c)*); his failure to define the level of service which he expected NIE to achieve in the next five years; and his review of codes of practice and standards of performance only after having made his proposals, thus taking no account of the prospects of additional costs to NIE which future performance requirements would entail.

Valuation of separate businesses

10.14. NIE argued that the DG's valuation of its T&D Business in his proposals ignored the importance of the CCA valuation implicit in the initial price controls (see paragraphs 9.80 to 9.82). The DG's approach therefore substantially understated the opening (April 1997) value of pre-flotation assets. This would represent a misappropriation of part of the underlying asset value which investors paid for at privatization.

Return to investors

10.15. NIE believed that, in addition to undervaluing the T&D Business, the DG's proposals made an inadequate allowance for a return to investors by applying a rate of return of 7 per cent which failed properly to reflect the risks associated with NIE's activities in the Northern Ireland context (see Chapter 9).

10.16. In addition the 0.5 per cent return on turnover (adjusted to discount the relatively high generation costs in Northern Ireland) which the DG proposed to allow on the Supply Business was inadequate. The figure was derived directly from the MMC's report on SHE and took no account of material differences such as the fact that NIE enjoyed no statutory monopoly over supply and would be exposed to effective supply competition (see paragraphs 9.161 to 9.164). In NIE's view it was also wrong for the DG to adjust the Supply Business turnover by discounting NIE's electricity purchase costs since, by way of example, both the scale of NIE's exposure to bad debts and its working capital requirements were directly related to the total price NIE paid for electricity.

Regulatory principles

10.17. NIE maintained that the DG's proposals relied to a large extent on the appropriation of shareholder value to allow NIE to finance its activities in the period under review. In effect the DG had decided that NIE's performance during the initial price control period was sufficiently successful to allow it to draw on shareholders' resources to fund price cuts in the next five years.

10.18. This approach was fundamentally contrary to the principles of RPI-X incentive-based regulation. Such a system of regulation set price controls for a fixed period during which the regulated company might, by achieving efficiencies beyond those contemplated by the controls, earn extra profits for shareholders. The entitlement to retain those profits provided the incentive to achieve efficiencies. If, in the next price control period, shareholder value was appropriated to fund price cuts, the incentive was significantly diminished. The new price controls should be forward-looking and should set prices at a level which allowed the company during the forthcoming period to raise sufficient revenues to finance its activities, without drawing on its past performance, its balance sheet strength or its unregulated earnings to make up any shortfall in regulated revenues. Efficiencies attained during one price control period should, however, benefit customers during the next price control period through being reflected in the allowable revenues for that period.

10.19. It was clear, said NIE, that the DG's proposals breached these principles: the DG explicitly stated that he proposed to disallow certain capital expenditure on the basis that NIE could use funds raised in the first price control period but not spent. This meant, in effect, that NIE was being penalized for its efficiency in meeting its obligations without spending all of its capital expenditure budget in the first price control period.

10.20. It also seemed clear to NIE that the DG's proposals, when taken together with the generation component of customers' electricity bills, would result in final prices broadly equivalent to those charged in the most closely comparable regions of Great Britain. Given the higher generation costs in Northern Ireland, and because T&D costs would also tend to be higher than in Great Britain, NIE's shareholders would therefore effectively be required to subsidize the cost of transmitting, distributing and supplying electricity.

10.21. NIE considered that the DG should not, in principle, expect NIE's shareholders to bear the cost of that subsidy. But even if, in principle, such a subsidy were permissible, the amount of the subsidy implicit in the DG's proposals vastly exceeded what NIE could afford to bear without jeopardizing its ability to finance its functions, undermining incentives to efficiency and adding to regulatory uncertainty. The proposals would therefore be contrary to the long-term interests of customers.

Checking the results of the bottom-up approach

10.22. For all of these reasons NIE considered that the DG's proposals would, if implemented, allow NIE insufficient revenue to finance its functions. NIE believed that the scale of the DG's error was well illustrated by comparing the result of his proposals with the prices permitted to be charged by the three most closely comparable RECs (see Chapter 3). Such a comparison also reinforced the point that, if generation costs in

Northern Ireland could be reduced to Great Britain levels, customer prices would be well below those of the comparators.

10.23. In addition there were other external factors that suggested that the DG's proposals for NIE were far too stringent. NIE believed that the proposed price cuts went beyond anything expected by City analysts, as reflected in the 13 per cent initial reduction in NIE's share price after the DG's announcement of his proposals.

Protection of the public interest

10.24. NIE considered a number of issues to be of special importance in our inquiry, given the public interest considerations required to be taken into account under the electricity legislation, in particular Articles 4 and 6 of the Electricity Order, and also given what it saw as the special circumstances of its case. These were:

- the revenues required to finance its regulated activities;
- the standards of customer service to be attained by NIE;
- the proper treatment of past efficiency gains to maintain incentives to future efficiency;
- the question of tariff sustainability;
- the promotion of competition in supply;
- future policy on connection charges;
- the form and structure of future price controls; and
- the need to avoid increasing regulatory uncertainty.

Costs of financing NIE's activities

10.25. The revenues NIE believed necessary for it to finance its T&D and Supply Businesses, and NIE's projections of its costs, are detailed elsewhere in this report (see Chapter 9). However, in assessing the public interest NIE said it was important to bear in mind that, for a number of reasons beyond NIE's control, the costs it incurred in fulfilling its regulated functions were relatively high. These cost factors had always been present in Northern Ireland and had always militated against the achievement of price comparability with Great Britain.

10.26. The principal factor by far contributing to the relatively high end-price of electricity in Northern Ireland was the cost of generation. Under the terms of its price controls NIE effectively passed through to customers the bulk of its electricity purchase costs and these represented some 60 per cent of the overall average customer's final bill. Other contributory factors related directly to the T&D and Supply Businesses and included, for example, the small size and isolation of NIE, the sparsity of its customer base and the local climate and geography (see Appendix 8.3). NIE submitted that all of these factors should be reflected in NIE's allowed revenues.

10.27. NIE also submitted that the MMC should take account of the following considerations in examining end-price effects:

(a) The interests of industrial and commercial customers, for whom NIE's component of the final bill represented only some 20 per cent, would be better served by allowing NIE to improve its quality of service rather than by reducing NIE's component of the end price. There was no reason to think that this would discourage further inward investment. Indeed such improvement might be essential to enable Northern Ireland to attract such investment, particularly given the findings of the Coopers & Lybrand report on this subject (see paragraph 3.8).

(b) For domestic customers expenditure on electricity represented only 2.7 per cent of average household expenditure. Whilst customers would clearly welcome the biggest possible price reductions, the prices implied by NIE's proposals were clearly affordable.

(c) There was no overriding public interest in bringing Northern Ireland end-prices down to Great Britain levels if that could be achieved only in a way that conflicted with the duties imposed by Articles 4 and 6 of the Electricity Order.

Standards of service

10.28. NIE drew attention to substantial improvements in its quality of service (see Chapter 6). It said that, although the DG's proposals were not explicit as to the levels of service to be attained in the next price control period, it was clear from the stringency of the proposals that the DG must have envisaged a decline in service, at least relative to PESs in Great Britain. This did not reflect customers' expectations, nor was it consistent with the DG's, as was shown by the comparisons of NIE's performance with the Great Britain PESs published in the DG's Customer Service Report for 1995/96.

10.29. NIE described its proposals to improve the quality of supply, reliability and customer service. First, as regards network performance, it said that, on the basic measure of CML per connected customer, NIE's average performance over the last five years was the poorest of all the PESs. Moreover, other PESs were expected to improve their absolute levels of performance over the next few years. NIE would therefore drop even further behind other UK companies unless it was permitted to raise enough revenues substantially to improve its performance. This would undermine the wider public policy objective of encouraging inward investment in Northern Ireland, where accelerated economic growth was needed to address the problems of high local unemployment, high rates of population growth and low GDP per capita. To encourage inward investment NIE must be able to show that its network performance could offer continuous and stable electricity supplies.

Investment in safety and the environment

10.30. NIE said it was clear that more onerous legal requirements in respect of safety and environmental standards would come into force in the next five years, entailing higher costs for NIE. In addition, individual customers, consumer groups and environmental groups were demanding ever higher standards, thereby reinforcing the need for NIE to reflect these concerns in its capital investment programme.

Repairs and maintenance expenditure

10.31. NIE stated that system performance also required adequate expenditure on R&M. Without this, it argued, system deterioration would lead ultimately to an increase in repair times and a need for further capital investment in the next price control period. In addition, R&M expenditure had major implications for safety. NIE's estimates of its requirements for R&M expenditure reflected the need to ensure improved levels of system performance and necessary standards of safety (see Chapter 8).

Other aspects of quality of service

10.32. NIE pointed out that the DG had not yet concluded a review of the Guaranteed and Overall Standards. It said that these standards had a significant impact on operating costs and submitted that any change in the standards should be reflected in the price controls.

10.33. As to other elements of customer service, such as the availability of a range of payment methods, information and direct access to NIE staff, NIE told us that customers would require at least the maintenance of existing standards. The public interest therefore required that NIE should be permitted to raise the revenues needed to meet these standards.

Proper treatment of past efficiency gains

10.34. As explained above, one of the reasons why NIE ultimately felt obliged to reject the DG's proposals was his intended treatment of past efficiency gains (see paragraph 10.18). NIE believed that the DG's proposals disregarded the fundamental principles of incentive-based regulation. In order to maintain incentives to further efficiency, the MMC, in NIE's view, should allow NIE's shareholders to benefit to the full extent of the efficiencies attained during the first price control period.

10.35. In principle, said NIE, this had two consequences: first, that there should be no clawback of past efficiency gains, and secondly, that where such gains were achieved towards the end of the first price control period, not all of the future benefit of that recurring saving should be passed on immediately and in full to customers at the beginning of the next period. While NIE maintained that the first principle should not be compromised it said that, in the present circumstances, it would be content with an arrangement which would allow the entire future benefit of all recurring efficiency savings to be passed immediately to customers (as well as identified future efficiencies). NIE submitted that this position should be taken into consideration when assessing the reasonableness of its own proposals.

Tariff sustainability

10.36. In the context of its view that NIE's weakened financial condition and the poor state of its network would necessitate substantially increased prices in the third price control period (see paragraph 10.4), NIE submitted that such an erratic pricing pattern would operate against the public interest and be contrary to the Government's policy objectives at privatization that prices should, over time, move to cost-reflective levels. NIE took the view that sustainable, cost-reflective tariffs were necessary to ensure that it could finance its activities without unnecessary increases in the cost of capital; that competition could develop without distortion and/or restriction; and that customers could make appropriate investment decisions without being misled by artificially low tariffs in the short term.

Competition in supply

10.37. NIE considered that the conditions for effective competition in supply throughout the market would exist very soon and that it was entitled to a return which reflected the resulting risks. NIE also considered it important to take account of the need to stimulate further competition in supply. Since new competitors would enter the market only if they were confident that they could significantly undercut NIE's supply margin, the public interest would best be served by allowing NIE to earn a return on its Supply Business turnover of at least 1 per cent.

10.38. In addition, NIE was concerned that its Supply Business should not be subjected to a competitive disadvantage through having to recover costs in its supply prices which were properly attributable to the T&D Business. In its view the DG's proposed allocation of costs was inappropriate (see Chapter 8).

Connection charges

10.39. NIE believed that any new price controls for the T&D Business should deal with connection charges in a manner which ensured that, over time, the total cost of connections could be recovered through the sum of connection and Use of System charges, and that those charges became more cost-reflective (see paragraphs 7.81 to 7.84). It argued that this would serve the public interest by providing appropriate signals to consumers, reducing cross-subsidy among customers and facilitating competition in connections.

Form and structure of the price controls

10.40. In NIE's view, public interest considerations required that the form and structure of new price controls should not be such as to distort competition and/or reduce incentives for NIE to achieve further efficiencies. While NIE accepted the scope and duration of the DG's proposed price controls, it therefore had reservations about the tightening of the losses term in the T&D price control (see paragraph 4.33) and about the inclusion of an energy efficiency factor in the Supply price control rather than the T&D price control (see paragraph 4.40).

Regulatory uncertainty

10.41. Finally, NIE stated that a principal objective on its part in seeking the present inquiry was to reduce the regulatory risk to which NIE was exposed by establishing clear regulatory guidelines to be pursued by the DG in fixing new price controls for the second regulatory period, in monitoring performance against such controls and in conducting future price reviews. Unless regulatory risk could be reduced, it said, NIE's cost of capital would increase.

10.42. To that end, NIE hoped that the MMC would be able both to propose suitable price controls for NIE's second regulatory period and to offer guidance on the wider regulatory context within which future price controls should be set. In particular, NIE expressed a wish for the MMC's report to contain clear conclusions and recommendations on the following points:

(a) a precise identification of the adverse effect which would result from a failure to modify the price controls, not only specifying that the unmodified control would operate against the public interest by allowing NIE to raise too much or too little revenue, as appropriate, but also identifying the adverse effect by reference to the quantum of the excess or shortfall. Further, NIE wished the report to include draft licence modifications to remedy any adverse effects;

(b) a clear specification of the circumstances, if any, in which `clawback' in a later regulatory period of any underspend against projected capital expenditure would be justified, allowing NIE to conduct its business during the forthcoming regulatory period on the basis of a proper understanding of the principles by which it would be judged when the DG came to set future price controls;

(c) an acknowledgement that price controls of the `RPI-X' form should continue to operate for a predetermined period, providing NIE with an incentive to achieve efficiencies during that period, and that (subject to the points made in sub-paragraphs *(e)*, *(g)*, *(h)* and *(k)* below) earlier intervention to reset the price controls would therefore be inappropriate;

(d) a recognition that, if the DG proposed to adopt new or revised performance standards for NIE during the forthcoming regulatory period, they should be set on a basis consistent with the output/performance measures used or assumed by the MMC in fixing NIE's allowable revenues;

(e) a statement of the MMC's assumptions as to connection charges and what consequential changes would need to be made to the T&D price control if NIE's basis for fixing connection charges were to be changed; in particular to ensure that, through the T&D price control and connection charges taken in aggregate, NIE would recover all reasonably incurred connection costs, and to make clear that adverse effects would be likely to ensue if connection charges were not substantially cost-reflective as customers would seek connections which added to overall costs;

(f) a statement as to whether the proposed Supply price control was based on the assumption that the additional Supply Business costs associated with Powercard customers were to be recovered via the control or by way of charges for excluded services;

(g) a specification of the extent to which the proposed price controls were intended to fund activities associated with the establishment of a WETS, and the circumstances in which the price controls should be modified to allow recovery of additional WETS-related costs;

(h) if appropriate, details as to how the proposed price controls should be adjusted to allow for a change in NIE's rates bill, including a recommendation that the new rates bill for each year of the forthcoming regulatory period should be calculated taking account of the new rate poundage, the new rateable values and expected growth in network assets, with the proposed P_0 figures in each price control then being adjusted to the extent necessary to ensure full recovery of the relevant increase in rates via the price control over the regulatory period;

(*i*) an acknowledgement that, in preparing its regulatory accounts, NIE should be permitted to adopt the same principles of cost allocation as those used in setting the price controls;

(*j*) a recognition that the MMC's valuation of investors' initial investment should be used in fixing a regulatory asset value for use in future price reviews; and

(*k*) if appropriate, a clear mechanism, capable of being triggered by NIE, to be included within the licence document, to enable the Supply price control to be adjusted before the next scheduled review should effective supply competition develop.

Effects of NIE's proposals

10.43. As stated above (see paragraphs 10.1 and 10.25), NIE submitted details as to the revenues it considered necessary to cover the costs of its T&D and Supply Businesses and remunerate investors appropriately for their participation in those businesses. It also made proposals as to how those revenues should be raised through new price controls.

10.44. In conclusion, NIE told us that its proposals took due account of the relevant public interest considerations. In particular, their effect would be to:

(*a*) ensure that NIE could finance its regulated activities during the second price control period without requiring future customers to pay higher prices in the following period. Thus NIE's proposals were calculated to allow sustainable tariffs in the longer term;

(*b*) allow NIE to attain improvements in network performance and customer service so as to ensure that all reasonable demands for electricity would be met and customers' interests protected;

(*c*) contribute to the attainment of wider public interest objectives in the promotion of inward investment in Northern Ireland and the resulting economic benefits;

(*d*) take account of the financial effect on customers who were being asked to pay no more than affordable prices to improve network performance, to contribute to the growth of the Northern Ireland economy and to guard against price increases in the longer term;

(*e*) observe the principle that prices should be cost-reflective so as to promote the development of undistorted competition in supply, in connections and in other areas; and

(*f*) promote greater regulatory certainty so as to form a basis for a successful relationship with the DG in the future and greater confidence among investors as to NIE's long-term prospects.