11 Views of the DG

Contents

Page

Introduction

11.1. The DG sent us two main submissions and a number of supplementary ones. We also held three hearings with him and colleagues from OFREG. The DG's views on the four major issues in this inquiry are detailed elsewhere in this report (see Chapters 7, 8 and 9). In this chapter we summarize his views on other matters, primarily describing the background and approach to the present price control review.

Terms of reference

11.2. In response to the formal questions in the terms of reference the DG told us that he believed that both he and NIE were in agreement that continuation without modification, or disapplication, of the specified licence restrictions would operate against the public interest. This was because there would be, as a result, a continuing real increase in prices for which there was no underlying economic justification.

The background to the reference

11.3. The DG told us that he considered it important to set the reference in context. He expressed surprise that a reference should have proved necessary, noting that the matters before us were fairly commonplace issues that might be regarded as being largely settled in Great Britain. The RECs had all accepted the price controls set by their regulator. More recently, NGG, whose Chairman was also NIE's Chairman, had accepted a price control which it had previously described as being much more draconian than any that had gone before, including the DG's proposals for NIE. Whilst it was usual for electricity companies to object to the harshness of the regulator's proposals initially, once accepted the proposals became merely tough and challenging. There was thus a question as to why NIE had not accepted the DG's proposals. The fact that, in the DG's view, NIE was a fast-improving company with the clear potential to become first class only served to emphasize that question.

11.4. Setting the reference in context the DG addressed four topics: Northern Ireland's energy problems; other notable aspects of the Northern Ireland context; the DG's overall approach to regulating NIE, in particular the perception that NIE might be subject to greater regulatory risk than the RECs; and the DG's approach to the present price controls.

Northern Ireland's energy problems

11.5. Examination of the problems inherent in Northern Ireland's energy situation led, said the DG, to a key conclusion. This was that his overall approach, far from requiring NIE to solve the problems on its own, protected NIE and enabled it to appear in a better light.

11.6. The DG compared the Northern Ireland energy background before and after the privatization of NIE. He considered that the restructured Northern Ireland electricity industry had proved to be, in practice, rigidly uncompetitive and had locked the price of electricity in the province into an ever upward trend (see Chapter 3.).

11.7. To tackle this, the DG said that he had adopted a three-pronged approach based on reducing generation costs, improving energy efficiency and formulating a new price control for NIE's monopoly T&D Business and its other regulated businesses.[1]

11.8. The DG pointed out that the new price controls for NIE would only effect a once-off reduction in the proportion of final electricity prices attributable to NIE. The problem of prices rising in Northern Ireland while those in Great Britain, by contrast, continued to fall (see Chapter 3) could be tackled only by reducing energy costs and improving energy efficiency as well as controlling the charges made by NIE.

11.9. The DG's approach to Northern Ireland's unique energy problems was therefore a comprehensive one. NIE was not being asked to solve these problems entirely at its own expense. Rather, it was being asked to make no more than an appropriate contribution. Moreover, the other elements included in the DG's approach protected NIE from public pressure to produce the complete solution on its own. At the same time NIE stood to benefit from the DG's creation of new business opportunities, for example in relation to energy efficiency promotion and the so-called green tariff (see paragraph 9.158).

Other aspects of the Northern Ireland context

11.10. The DG pointed out that exposure of public utilities in Northern Ireland to privatization was extremely limited. The water industry there was still in the public sector; there was as yet no gas industry in the province (see paragraph 3.10); and British Telecommunications plc was based on the mainland. Electricity regulation in Northern Ireland was itself three or four years behind that in Great Britain.

11.11. The DG also commented that there was universal hostility to electricity privatization in Northern Ireland, where all the political parties had been opposed to it. The combination of high prices, job losses and enormous profits had also understandably drawn a hostile public reaction. This was very adequately expressed in the local press after publication of the DG's price control proposals. For example, one editorial, while crediting the DG for his efforts, concluded that there was no escaping the impression that, for the consumer, electricity privatization had been a failure. The DG considered it a key part of his job to make privatization work.

11.12. The DG also drew attention to the uniqueness of Northern Ireland's electricity supply industry within the UK, in that it had developed in isolation from other electricity networks: the interconnector with the transmission system in the Republic of Ireland had been inoperable between 1975 and 1995 and there had never been any interconnection with the network in Great Britain. The industry was also isolated in other particular respects. For example, it shared no boundary with any other UK electricity company. As a consequence, electrical engineers stayed with NIE as their careers progressed; further, they were almost all locally born. Nor was there any experience of competing with other PESs for customers. Thus there was no

---

[1]The DG published a consultation document, *Consumer Choice, Competition & Prices* in January 1996, followed by *Consumer Choice, Competition & Prices: The Next Steps-A Progress Report* in July 1996. These papers address, in particular, generation costs and the empowerment of consumers through energy efficiency and other measures. A consultation document on the price control review of NIE was published by OFREG in October 1995, followed by publication of the DG's proposals in July 1996: see, respectively, *Price Control Review for Northern Ireland Electricity plc-A Consultation Document* and *Price Control Reviews for Northern Ireland Electricity plc-The DG's Proposals*.

shared experience of evolving from a public sector company to a privatized utility subject to regulation in the public interest. NIE had therefore made a less complete cultural journey than other PESs. The DG considered this a key factor in understanding the present situation and said, by way of illustration, that at one stage during the review (December 1995) NIE had told him that it saw no need for any P_0 drop whatsoever.

Regulating NIE

11.13. The third topic addressed by the DG was his overall approach to regulating NIE. As a former head of the DED energy division he said that he had particularly noted a catastrophic price divergence between electricity prices in Northern Ireland and Great Britain, and the unwillingness of anyone in the industry in Northern Ireland to accept any responsibility for that situation-all parts of the industry appeared to feel doomed fatalistically to accept ever larger profits. As DG he had therefore sought to stimulate debate and dialogue, particularly with NIE, bearing in mind his statutory powers and the nature of the PPAs (see paragraph 3.26). He sought to establish a shared agenda with NIE, in the sense of a common purpose in relation to such matters as customer service, competition, generation costs and numerous other issues on which OFREG and NIE were still working very closely together, for example CHP, the green tariff, energy efficiency and possible diversification into gas supply.

11.14. Although NIE's core business of electricity distribution was the same as that of the RECs, there were, said the DG, important differences which made NIE unlike the RECs (see paragraph 3.15). The DG's discussions with NIE involved removal of the shackles from which NIE suffered by comparison with the RECs. This would help to make NIE into a first class company. It was the DG's view that, perhaps, one year further on, progress might have been sufficient to avert the present MMC inquiry. A cost-cutting agreement reached between Nigen and NIE in November 1996 (related to the rescheduled closure of Belfast West) illustrated how far NIE had come to appreciate its potential role as an agent of change in the Northern Ireland electricity industry. Yet such a deal could have been signed four years previously: nothing objectively had changed since then apart from NIE's realization of its ability to act in such a constructive way.

11.15. As to regulatory risk, the DGES in Great Britain regulated 14 companies. This necessarily involved an element of averaging, as a result of which some companies would be seen to do better than others. Where, on the other hand, a regulator was responsible for a single company, as in Northern Ireland, the regulatory regime should be customized to fit that company and that market. Hence there should be less regulatory risk where there was one regulator for one company-provided that neither regulator nor company chose to behave in such a way as to make the regime unstable. The DG emphasized that he was totally persuaded of the need for regulatory stability and had tried hard to achieve shared expectations with NIE as to the operation of the regulatory regime. If regulatory instability arose from a company's actions, and affected market perceptions of that company, it would be unfair to expect customers to pay the penalty. Where the company's directors created the instability, the shareholders should bear the consequences.

The current price control review

11.16. The DG said that, in addressing the question of what would be the most appropriate form for a price control review of NIE's businesses, he considered it essential to be able to demonstrate that his approach to the process was both legally defensible, in the light of his statutory duties and responsibilities, and methodologically justifiable. Several factors came into play:

(a) The DG was appointed under Northern Ireland legislation to a post created solely to regulate the Northern Ireland electricity supply industry and in respect of a price-controlled electricity company operating only in Northern Ireland. The duties of the DG were defined in Articles 4 and 6 of the Electricity Order and were limited to Northern Ireland. This indicated that the DG would be unwise simply to adopt a process previously used in Great Britain without taking account of factors specific to Northern Ireland.

(b) Whilst in practical terms the results of OFFER's distribution reviews could be fitted to NIE, this would effectively be applying the REC price control as a direct read-across to Northern Ireland. This would be inappropriate as in effect it would be abrogating to the DGES the duty to undertake a price control

review of NIE and if this had been intended then the legislative and operational basis of regulation in Northern Ireland would have been different.

(c) Since investors in NIE would inevitably look to the RECs for comparisons, the results of any price control review of NIE would need to be at least checked, and to some extent informed, by a bench-marking exercise against the Great Britain companies.

(d) It was clear to investors that the majority of NIE's profits would come from the T&D Business, which in general terms was similar to the business of the RECs (and of NGG which had been owned by the RECs when NIE was privatized) in that it undertook the same activity of transporting electricity from producer to consumer. The regulatory systems were also similar, both Directors General being under the same obligation to ensure that licensed activities could be financed, and the ultimate arbiter for both being the MMC. This suggested that it was reasonable for investors to expect consistency in the broad thrust of regulation. In any case, the final stage of the price control review was for a regulator to step back and look at the result as a whole, regardless of how it was built up, and consider whether the proposals were correct. The answer would reflect the obligation to see that licensed activities could be financed.

(e) On the other hand, the various structural, operational and financial differences between NIE and the RECs were such as to preclude exact comparisons.

11.17. Taking these factors into account, the DG had decided that the most appropriate form of price control review was to undertake a detailed bottom-up evaluation of NIE's cost base but then to check and compare the results against the Great Britain companies (including, where appropriate, NGG) in order to ensure that the results did not prejudice NIE's ability to raise money to finance its activities.

11.18. The DG commented that there was no inherent contradiction in this approach. Some of the costs which NIE faced, for example the cost of capital and equipment, were set in competitive national and international markets. Others were set by the Northern Ireland market-for example, property prices and labour costs-or by local specific features such as overhead wire length or customer density.

11.19. Given the DG's responsibility to ensure the licence-holder's ability to finance its activities, it was useful to look at NIE from the point of view of a potential investor. The market for investment opportunities was at least national (UK), in practice European and, to a now significant extent, world-wide. Investors rarely ventured unguided into this territory and sought familiar touchstones in the course of their decision-making process. For potential investors in NIE or other electricity companies in the UK it was therefore reasonable to assume that they would, while taking due cognizance of differences between NIE and the RECs, be looking broadly to compare the risks and rewards of investing in NIE as opposed to, say, one of the RECs. To this extent, when looking at asset valuation and cost of capital for NIE, the DG needed to take into account that NIE was perceived by the investment community as being one of a type rather than the only one of its kind. On this basis he had explicitly compared NIE with the rest of the electricity supply industry in the UK in terms of asset valuation and cost of capital.

11.20. On the other hand, NIE also faced a set of costs determined locally. The DG did not accept that this worked entirely to NIE's disadvantage: there were a number of `Northern Ireland factors' which acted to reduce the cost of operating in Northern Ireland compared with elsewhere. For example, despite a generous Government-funded compensation scheme property prices in Northern Ireland, and therefore rentals, had been depressed by the events of the last 25 years. To that extent NIE had faced broadly lower property costs than the RECs. It was also the case (although perhaps less strongly) that, because of high unemployment, the regional labour market in Northern Ireland, particularly as it affected NIE, had experienced lower wages than the rest of the UK. Additionally, customers in Northern Ireland had until recently had lower expectations and a much lower propensity to complain about bad service; consequently customer relations and customer service had appeared more important for the RECs than for NIE. Northern Ireland customers also appeared historically less prone to get into debt and hence NIE had less of a problem with bad debt than the RECs.[1]

---

[1]Other positive `Northern Ireland factors' mentioned by the DG included compactness and accessibility of the network and a more temperate climate compared with South Wales and the north of Scotland. The DG also argued that his general view that Northern Ireland cost factors were not all adverse was validated by the gas tariffs recently published by Phoenix Natural Gas, which matched prices in Great Britain despite the requirement for significant investment in new infrastructure in Northern Ireland.

11.21. Because of these differences, the DG explained, he considered that to apply bench-marking uncritically was likely to provide NIE with an inappropriate set of allowable cost bases and hence efficiency factors which would be different from those facing the RECs. Apart from the deleterious effect that this would have on incentives to management efficiency, it would inevitably feed into investment perceptions of the company and affect NIE's ability to finance its activities. The DG said that he had, however, used bench-marking critically, both to inform the bottom-up process and in respect of areas where national and international experience was of greater value, that is asset valuation and cost of capital. On this basis the DG decided that the bottom-up approach to assessing the costs of NIE's businesses for price control purposes was significantly more appropriate than attempting to compare a younger (in privatization terms) and in other respects different company with the relatively more mature RECs and NGG in Great Britain.

11.22. For the reasons described above, the DG believed that his approach to the price control process was the only one that was both logically and methodologically defensible.

11.23. The DG said that he saw the substance of his review as falling in the mainstream of the evolving orthodoxy of incentive utility regulation. That orthodoxy meant that, in setting the price control, forecasts must be based on allowing an efficient business to earn the minimum rate of return necessary in the long run, consistent with being able to finance new capital expenditure. The regulatory principles of RPI-X were, in fact, quite easy. What was difficult was the application of those principles. The weakness of RPI-X was the gaming incentive it gave the regulated company in its dealings with the regulator. This required the regulator to exercise knowledge and judgment in applying the regulatory principles.

11.24. The DG considered, however, that his price control review differed from those of the DGES in three important respects. First, he had the benefit of hindsight: whereas the DGES had been necessarily fairly tentative in the first price control reviews in Great Britain, it was now clear what good cash generators the RECs-and likewise NIE-were. Secondly, the DG's approach, being company-specific, was based neither on regression analyses nor on averages. Thirdly, said the DG, he reviewed all the regulated businesses of NIE at once; this increased the impact of the exercise and, as a consequence, entailed obtaining confirmation from market analysts that the outcome of the DG's approach was workable and credible.

Objectives

11.25. The DG explained that he had set three objectives for his price control proposals: to correct the upward pressure on prices arising from what he saw as the shortcomings of the original price control; to incentivize NIE to perform up to the industry standard in the core of its regulated businesses which were similar to the RECs; and to incentivize NIE to develop competitively in the areas of new business opportunity emerging in the Northern Ireland energy market.

11.26. On the first of these objectives, the DG said that the period since privatization had been marked by three principal features:

(a) The unit cost of producing and distributing electricity had fallen by around 6 per cent in nominal terms between 1991/92 and 1995/96, a fall of 15 per cent in real terms.

(b) The average price for electricity which Northern Ireland customers had to pay had risen by 8 per cent in nominal terms between 1992/93 and 1995/96 and was projected to rise by a further 3 per cent between 1995/96 and 1996/97. This gave a total projected rise of 11 per cent in nominal terms over the current price control period, or a rise of 2 per cent in real terms. However, this rise in prices would have been much greater had it not been for mitigating factors such as the release of £15 million from a total fund of £60 million specifically provided by the Government to provide consumers in Northern Ireland with an equivalent benefit to that received by Great Britain customers on the early abolition of the nuclear levy. In the absence of these factors, electricity prices would have risen by 19 per cent in nominal terms (see Chapter 3).

(c) Falling prices in Great Britain combined with rising prices in Northern Ireland had resulted in a growing price gap. For example, Northern Ireland domestic electricity prices had risen from 5 per cent above the Great Britain average in 1992/93 to 24 per cent above by 1996/97.

11.27. These features had combined to give the companies in the Northern Ireland electricity industry high and growing profits. In 1995/96 around one-third of the electricity price paid was attributable to pre-tax profits in the industry. It was clear, said the DG, that the record since privatization was one of some efficiency gains, falling costs and rising revenue under the initial NIE price controls and the PPAs. To date, all the benefits arising from this had flowed to shareholders. Over the period 1992/93 to 1995/96, the electricity supply industry in Northern Ireland had earned around £570 million in pre-tax profits.

11.28. The DG considered it important to distinguish between NIE's and the generators' contribution to this situation. He looked at this from two aspects, the first being NIE's contribution to the price increase in Northern Ireland since privatization. Between 1992/93 and 1996/97 NIE's T&D and Supply Businesses would contribute an estimated three percentage points of the total projected price rise of 11 per cent. However, this understated the underlying contribution because of the mitigating factors referred to above. In the absence of these, the underlying contribution would be seven percentage points out of a total of 19 per cent. This was particularly striking given that NIE's T&D and Supply Businesses currently accounted for only 40 per cent of total cost. Further, generation costs reflected the full pass-through of fuel costs, which had increased throughout the period.

11.29. The second aspect that the DG looked at was NIE's share of profits earned by the industry. He told us that NIE currently earned around 60 per cent of the pre-tax profits made by the industry, and that about 20 per cent of the price of electricity was profit for NIE. NIE had made efficiency savings on its operating cost base equivalent to only 1.8 per cent a year in real terms since privatization although pre-tax profit had grown by 66 per cent. Hence only 18 per cent of the increase in NIE's profits was attributable to the efficiency gains which the company had made since privatization and the remaining 82 per cent was accounted for by the terms of the initial price controls.

11.30. The DG commented that NIE's profit from its three main regulated businesses was largely determined by two factors, namely the initial price controls and the ability of the company to make efficiency gains since 1 April 1992. Both of these factors were reflected in NIE's strong financial performance, with the company experiencing much faster growth in its profits than in turnover. For example, between 1992/93 and 1995/96, growth in pre-tax profit of 66 per cent (55 per cent in real terms) greatly exceeded the increase of 16 per cent (8 per cent in real terms) in turnover. This rise in profitability was reflected in a pre-tax return on capital employed which rose from 15.2 per cent in 1992/93 to 25 per cent in 1995/96. NIE had also financed its activities without any long-term debt, in spite of a share buy-back in 1995 costing it some £100 million. Indeed NIE's gearing had remained less than 0.1 per cent of net assets, the lowest of any PES.

11.31. Whilst the initial price controls had, in the DG's view, been the main factor pushing up profits, the company had also-albeit to a lesser extent than the electricity industry in Great Britain-become more cost-efficient. Operating costs, net of generator power purchase payments and renewable energy costs, had remained fairly stable and, after allowance for inflation, this implied a real cost saving of 5 per cent between 1992/93 and 1995/96, or real efficiency savings of 1.8 per cent a year. This was somewhat disappointing against the trend elsewhere and clearly indicated that NIE's financial performance did not reflect unforeseen efficiency gains. The DG noted that improvements in cost efficiency at the individual business level were more apparent for the T&D Business than the Supply Business.

11.32. Summing up, the DG said that the shortcomings of the initial price controls were evident from the rate of increase in NIE's profits, as well as from the rising level of electricity prices. In addition, the report of the NIAO on the privatization of the industry[1] provided supporting evidence. Above all, it was now apparent from recent sight of some of the assumptions on the basis of which NIE was privatized (earlier access to which had not been available to the DG) that NIE's profits were higher than had been assumed, notwithstanding what the DG believed were lower efficiency gains than the industry average.

---

[1] *The Privatisation of Northern Ireland Electricity*-Report by the Comptroller and Auditor General for Northern Ireland, October 1994.

The DG's proposals

11.33. The detailed views of the DG on the appropriate levels of capital expenditure and operating expenditure to allow NIE in the next regulatory period are described elsewhere in this report (see Chapters 7 and 8 respectively), as are the DG's arguments in support of his determination of the appropriate RAB and cost of capital for NIE's T&D and Supply Businesses (Chapter 9). Details of the procedures followed by the DG in carrying out his review, and of the proposals themselves, are presented in Chapter 4.

11.34. Commenting on his proposals, the DG stated that the T&D review resulted in proposals for a P_0 fall of 30 per cent and an X factor of -2 per cent. The most similar businesses with which a comparison might be made were the distribution and transmission businesses in Great Britain. The P_0 drop of 30 per cent compared with initial P_0 cuts of between 11 and 17 per cent proposed for the RECs' distribution businesses in August 1994, and a second once-off cut in the second year of the price control, following the reopening of the review, of between 10 and 13 per cent. Taken together, these P_0 cuts were similar in size to the cut proposed for NIE's T&D Business. The X factor of -2 per cent was the same, said the DG, as the X factors currently applying to the Scottish distribution businesses, and was more favourable to the company than the -3 per cent applying to the RECs' distribution businesses; for the Scottish transmission businesses the current price controls contained X factors of -1 per cent, while for NGG the X factor was -3 per cent until April 1997, when it would become -4.

11.35. The DG's proposals for NIE's Supply Business entailed a P_0 drop in 1997/98 over 1996/97, measured in 1996/97 prices, of 43.9 per cent, with an X factor of -1.5 per cent. The DG noted, however, that the Supply Business was forecasting an over-recovery of up to £5 million in the current price control period which would be given back to customers in the new price control period, thereby increasing the actual P_0 drop. The X factor of -1.5 per cent compared with X factors of -2 per cent applying to the supply price controls in Great Britain. The DG commented that, because the supply price controls for the RECs were revised at the same time as a change in the scope of the controls, it was not possible to compare the P_0 cuts.

11.36. The DG explained that the Supply price control had been adapted to achieve what competition would do if the Supply Business were to be exposed to full competition. The control reflected the particular conditions which existed in the Northern Ireland energy market and was designed to enable NIE to prepare itself for the move away from its *de facto* monopoly position in the supply of electricity to under 1 MW customers to one in which it would have to compete in a more fragmented and complex market for energy goods and services. The Supply price control was also designed to protect the interests of customers both by bringing about this change in the market and by regulating prices during the transitional period. It was, said the DG, in anticipation of the potential emergence of effective competition in the Northern Ireland electricity market that he had proposed to shorten the duration of the control to four years.

11.37. The DG said that he had decided to discharge his duties with regard to energy efficiency and the environment as part of the Supply price control review. Accordingly his proposals offered NIE new and unique incentives, including an additional administrative allowance of 0.352p per kWh to encourage the sale of `green' electricity. The price control assumed sales of 5 GWh of green electricity in the first year, rising by 5 GWh a year thereafter. However, the potential existed for NIE to exceed this total, thereby earning additional income whilst stimulating demand for green units.

11.38. The DG also told us that he and NIE had been discussing a scheme by which NIE could create a market in energy efficiency goods and services and recover its costs from customers through their electricity bills. The same opportunity would be available to second-tier suppliers. Any profits earned by NIE under this `negawatt' scheme would be unregulated income which NIE could keep. The Supply Business price control included an allowance of £1 per customer to enable NIE to establish a market for energy-efficient goods and services.

Impact of the DG's proposals

11.39. The DG reiterated his view that incentive utility regulation was not an exact science. He considered that this was perhaps most dramatically shown by the outcome of the first distribution price control in England and Wales which had had to be tightened up because the outcome was shown to be at variance with the underlying realities of the market-place and the true strength of the companies. A major problem, he believed, was the asymmetry of information between the regulator and the regulated company. A further factor was the nature of the exercise: determining the reasonable distribution of efficiency gains between shareholders and customers involved the regulators in judgments which were value-based. All these factors meant that regulators could not just sum together all the components of their review and base their proposals uncritically on the emerging solution. They had a duty to look at the result in the round and see whether it looked reasonable in the wider context of the full range of their duties and in fairness to all those affected by the outcome. In his review, the DG was satisfied-after having listened to NIE and subsequently made a number of adjustments in its favour-that the sum of the parts produced an outcome which was acceptable from the customer's perspective while satisfying shareholders' reasonable expectations. In order to confirm this view, at the conclusion of his review he had engaged stockbrokers to assess the impact of his proposals on NIE's market valuation during the next price control period. Their advice clearly justified the outcome (see Chapter 9).

11.40. The DG was in no doubt that a P_0 drop of £70 million in total for NIE's T&D and Supply Businesses was entirely justified. NIE had made efficiency gains but the initial price controls were extremely light and accounted for most of NIE's increase in profits. The DG saw no reason to give more to NIE on grounds of efficiency improvements made by the company, and did not accept that his proposals failed to honour promises made at the time of privatization. The prospectus was quite clear in indicating to shareholders that, although they were likely to do well for five years, thereafter NIE faced a different regulatory approach. There was no indication of long-term high dividend growth discernible within the prospectus.

11.41. The DG expressed confidence that NIE had the potential to become the type of creative and forward-looking company which Northern Ireland needed. It was unfortunate that the initial price controls of the company were so unchallenging. However, that did not mean that it would be in the interest either of NIE or of Northern Ireland as a whole for NIE to have another four or five years of easily earned excess profits primarily from running a monopoly business for a totally captive market. The DG said that he was optimistic that Northern Ireland's energy problems could be overcome, but a fresh start was required. Although he was surprised that an MMC reference had proved necessary, the opportunity should now be seized to make such a fresh beginning.