

12 Views of third parties

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Government departments and agencies

Department of Economic Development

12.1. The DED submitted written evidence and attended a hearing.

12.2. The DED is the Government department responsible for, among other things, energy matters in Northern Ireland.

12.3. The DED explained that the Government's energy strategy for Northern Ireland, of particular relevance to the electricity supply industry, was set out in its paper published in March 1992 entitled *Energy for the 90's and beyond*. This set out the following four strategic energy objectives:

- (a) energy efficiency and the clean production and use of energy;
- (b) lower costs and the protection of consumer interests;
- (c) diversification of supply; and
- (d) security of supply.

These objectives took account of an earlier White Paper on the privatization of NIE, published in March 1991, which set out the following related objectives for the electricity supply industry:

- to introduce, wherever possible, forms of competition which would result in the lowest possible prices for consumers;
- to regulate the industry in a way which would protect consumers' interests and maintain security and safety of supply without being unduly intrusive;
- to diversify further the Northern Ireland economy through the introduction of enterprising new participants into the power sector; and
- to promote participation by employees of NIE and by electricity consumers in Northern Ireland in the ownership of the industry.

12.4. The DED told us that, in restructuring the industry, the Government sought to realize potential efficiency gains through privatization and the progressive introduction of competition. It also sought to minimize the disadvantages in Northern Ireland of oil dependency, isolation and the small size of the system by introducing both gas and electricity interconnection with Great Britain.

12.5. The DED emphasized that the Government now had no role in determining the price of electricity, except in so far as other policies such as environmental, regulatory or fiscal policies might have an impact on the costs of the industry. The DG now monitored price controls and dealt with price discrimination and cross-subsidy and other economic and financial aspects of the regulatory regime. The DED believed that the most

effective contribution it could make now and in the future to reduce energy bills was through the encouragement of competition and efficiency in the use of energy.

12.6. Finally, the DED pointed out that the Government had earmarked a total of £60 million over three years beginning in 1996/97 to ensure that electricity consumers in Northern Ireland shared in the benefits which their counterparts in Great Britain would enjoy as a result of the early abolition of the nuclear levy. The initial tranche of £15 million in 1996/97 was allocated to reduce the proposed April 1996 tariff increases by an average of 3 per cent so that they were below the current rate of inflation. The DED was now considering, in consultation with OFREG and NIE, how the balance of £45 million should be allocated. Whilst no definite decisions had yet been reached on the allocation, there were obvious attractions to the DED and OFREG in finding a mechanism which would provide maximum benefit to consumers over the next control period.

The Energy Saving Trust Ltd

12.7. The Energy Saving Trust told us that it was set up by the Government and energy companies in 1992 to carry out energy efficiency programmes in the UK. The Secretary of State for Northern Ireland became a member of the Trust in 1994 and NIE joined in 1995. The Trust had had a representative in Northern Ireland since March 1996 and also ran two local energy advice centres in the province as well as a small business loan scheme to promote energy efficiency.

12.8. The Trust explained that it had been working closely with NIE on a number of energy efficiency programmes and had been encouraged by the effort and enthusiasm which NIE had put into these programmes. The Trust welcomed the introduction of the £1 per customer a year allowance that the next price control would give. This allowance would break new ground in Northern Ireland. The Trust was therefore extremely concerned that no provision had apparently been made for an independent evaluation of how this money would be spent.

12.9. The Trust added that it had worked alongside OFFER and electricity suppliers in Great Britain since the £1 per customer allowance was introduced there. It therefore had a great deal of experience in setting up and evaluating such a scheme.

12.10. The Trust believed that OFREG, like OFFER in Great Britain, was unlikely to have the in-house experience to evaluate whether customers' money from the allowance was used cost-effectively. By evaluating how each scheme was set up in Great Britain, the Trust had been able to ensure the cost-effectiveness of energy efficiency measures with an average cost of saving electricity of 1.7p per kWh, a great deal less than the cost of the purchase price of electricity to the PESs.

12.11. The Trust recognized OFREG's intention to promote energy efficiency in the Northern Ireland market. In Great Britain an energy efficiency standards of performance programme had been designed to give the PESs an incentive to find the most competitive way of carrying out these programmes. This had ensured that the energy efficiency market was operating fairly and there was no inducement for the price of energy efficiency measures to increase. The Trust was therefore concerned that OFREG did not appear to be giving a similar incentive to NIE. This might result in the cost of energy efficiency rising, thereby preventing an effective competitive market operating for energy efficiency. Also, in Great Britain the Trust had found that there had been an element of competition between the PESs to offer their customers the best value for their £1 allowance. PESs competed to offer the lowest pence per kWh for the cost of saving electricity and to offer the highest return for each £1 invested in energy efficiency measures. The Trust was therefore concerned about how OFREG would instil a similar competitive element into the Northern Ireland market which, given its unique circumstances, with only one energy supplier, could not be compared with the market on the mainland.

Government Purchasing Agency

12.12. The Government Purchasing Agency (GPA) told us that it had direct responsibility for all procurement undertaken by Northern Ireland's six central Government departments and the Northern Ireland Office. It also had an increasing role in other public purchasing undertaken by local authorities and non-departmental public bodies such as education boards. Consequently, it had a twofold interest in the future arrangements for electricity tariffing in Northern Ireland:

- (a) First, for the benefits of large users of electricity, for example Northern Ireland departments, it wished to maximize value for money in its procurement of energy. Major energy efficiency programmes were being undertaken but users also wanted to see some direct financial benefit by movement, on the part of NIE, towards price parity with consumers in the rest of the UK. The UK's Public Supply Contracts Regulations 1995, which implemented EC Directives, required most large bodies to purchase their electricity by way of open competition. However, the GPA had long been concerned about the very limited opportunity for such competition in Northern Ireland and about its consequent impact on Government energy bills. It therefore welcomed any investigation the MMC might make into NIE's proposals for future tariffing in respect of public sector users.
- (b) Secondly, with responsibility for the annual procurement of £275 million of goods and services for the public sector in Northern Ireland, the GPA was committed to promoting competition among all its suppliers. It recognized that the competitiveness of local companies was adversely effected by the relatively high cost of electricity supplied to industry in the province. This burden of extra energy costs had a double adverse impact on the Northern Ireland economy. First, due to higher local production costs consumers, Government bodies in Northern Ireland and therefore the taxpayer generally paid more for their goods and services than did their counterparts in Great Britain. Secondly, this adverse price differential was compounded by the fact that Northern Ireland companies were handicapped in their competition for contracts outside the province with a consequent negative impact on their overall efficiency.

Health and Social Services Executive

12.13. The Health and Social Services Executive (HSSE) drew attention to the disparity in electricity costs to Health and Social Services in Northern Ireland compared with Great Britain. These costs were currently some 20 to 25 per cent higher in Northern Ireland and diverted valuable resources away from direct patient care. The HSSE said that in principle it welcomed the DG's price control proposals which would free resources for patient care.

Industrial Development Board for Northern Ireland

12.14. The Industrial Development Board for Northern Ireland (IDB), an arm of the DED, explained that its key role was to stimulate employment opportunities in the manufacturing and tradeable services sectors in Northern Ireland by attracting new inward investment and helping existing industry to develop through improving its international competitiveness. Electricity prices for the industrial sector were clearly a significant issue for companies considering investment in Northern Ireland and it was important to companies' overall competitiveness that these costs were kept as low as practicable. This issue had already been touched upon by the DED in its evidence to the MMC (see paragraphs 12.1 to 12.6) and the IDB fully supported these views.

Northern Ireland Economic Council

12.15. The Northern Ireland Economic Council (NIEC) explained that it had a longstanding interest in electricity prices in Northern Ireland. A persistent concern had been high prices relative to the rest of the UK and the Republic of Ireland. For example, a 1995 Northern Ireland Affairs Committee¹ report had found that Northern Ireland electricity prices were the highest in the UK. Furthermore, there were indications that the price differential between electricity prices in Northern Ireland and Great Britain would increase in the future.

12.16. Such high relative prices acted as a serious obstacle to furthering economic development. If such activity was to be significantly increased in Northern Ireland, as the NIEC believed it should be, it was imperative that the competitiveness of industry was not impaired by relatively high energy costs. The attention

¹*Electricity Prices in Northern Ireland, Vol I, HC 1994-95, November 1995.*

that the issue had received over the past year or more showed the wide range of concern that existed, but the fact that the issue had yet to be resolved highlighted the difficulties involved.

12.17. The NIEC was therefore pleased that the reference to the MMC concerned the degree to which electricity prices were expected to fall. Even if the alternative price regime suggested by NIE were accepted, prices would still fall, although not to the same extent as that proposed by the DG. Commenting on the merits of the DG's arguments, based on his July 1996 paper *Price Control Review for Northern Ireland Electricity plc*, was neither an easy nor a straightforward task. Nevertheless, the NIEC believed every effort should be made to ensure that charges were minimized and it was not convinced that NIE had effectively rebutted the case made by the DG, particularly when one looked at the transmission charges once the cost of generation had been extracted.

12.18. The NIEC added that, where possible, bench-marking against the most efficient comparable system should be used to estimate the potential savings available. To the extent that there was genuine uncertainty over the size of any efficiency gains, thought should be given to sharing the gains-over some base amount-between the consumer and the shareholder, taking full account of the gains which had benefited shareholders since privatization. At present, for example, both the DG and NIE envisaged charges falling by at least 22 per cent in 1997/98.

Northern Ireland Forum for Political Dialogue

12.19. The Northern Ireland Forum for Political Dialogue explained that it was an elected body representing a wide cross-section of political opinion, formed under the Northern Ireland (Entry into Negotiations) Act 1996, to discuss issues for the promotion of dialogue and understanding in Northern Ireland. The Forum had debated a number of matters of current interest including matters affecting the Northern Ireland economy. Most delegates considered that the high cost of electricity seriously affected the energy situation in Northern Ireland and acted as a deterrent to inward investment. The dire consequences to the economy of expensive industrial energy, to say nothing of the plight of domestic consumers, indicated that an examination was needed as to how such expensive generating contracts came about when the Northern Ireland electricity industry was privatized. The Forum therefore welcomed the MMC's inquiry.

Northern Ireland Housing Executive

12.20. The Northern Ireland Housing Executive told us that it was designated under the Home Energy Conservation Act 1995 as the Home Energy Conservation Authority for Northern Ireland. The overall aim of the Act was to ensure that affordable warmth could be provided for all sectors of the population in a way that would reduce emissions of greenhouse gases and conserve national resources.

12.21. The Executive had recently submitted a report to the Minister identifying the energy conservation measures it considered practicable, cost-effective and likely to result in a significant improvement in the energy efficiency of residential accommodation in Northern Ireland.

12.22. This report had shown that the percentage spent on fuel for all households in Northern Ireland was 6.6 per cent, but for low-income households that figure was 10 to 13 per cent. The percentage spent on fuel in Northern Ireland was greater than that spent on fuel in Great Britain. Of the Executive's own tenants, 75 per cent were in receipt of housing benefit. Therefore the Executive supported any measures which would reduce fuel costs in Northern Ireland. In addition, electricity was the main form of heating in homes occupied by pensioners and the disabled. These householders tended to have lower incomes and they spent more time in their homes. The Executive also recognized, however, that NIE, as a private company, had responsibilities to its shareholders and it acknowledged that NIE had been involved in energy efficiency measures and was committed to further initiatives.

Roads Service

12.23. Roads Service, an agency within the Department of the Environment (Northern Ireland), said that it was very concerned at the overall level of charges it paid for electricity for street lighting and traffic signs. The annual cost in Northern Ireland was in excess of £6 million. Roads Service complained that it was unable to obtain competitive quotes for electricity because of the structure of the Northern Ireland market and it therefore relied on regulation to protect the interests of the taxpayer who bore the cost of electricity for street lighting.

12.24. The agency pointed out that before the electricity market was opened to competition in Great Britain it was able to compare NIE's annual charges for electricity for standard street lights with those of the 12 RECs. In 1994/95, the last year this was possible, NIE's charge was 11 per cent higher than the average charge in England and Wales. Since then NIE had imposed price increases of 6 per cent in 1995 and 2.6 per cent in 1996. Charges for energy for street lighting had fallen dramatically in England and Wales in that period. Though it was no longer possible to compare prices in the way done previously, the agency understood that average consumer bills in Northern Ireland were over 20 per cent higher than in Great Britain and it suspected the difference was even greater for street lighting.

12.25. Roads Service added that in 1995/96 NIE had introduced a standing charge for each point of connection of street lighting equipment to its network. This was to recover the cost of maintaining the services cable from the mains to the point of supply to each item of equipment directly connected to it. The charge was set at £3.68 but had since been increased to £4.72, an increase of 28 per cent. Against this scenario a fall in energy costs, however small, would be most welcome.

Water Service

12.26. Water Service, an agency within the Department of the Environment (Northern Ireland), said that it welcomed the DG's proposals since they would have resulted in a substantial reduction, in excess of 10 per cent, in its total electricity bill. Such a reduction in electricity cost would relieve funding pressure by:

- (a) offsetting increases in electricity costs brought about by use of more sophisticated plant and equipment required to meet more stringent drinking water quality and sewage effluent standards; and
- (b) mitigating future metered industrial user charges.

Electricity generators and suppliers

British Gas plc

12.27. British Gas said that it was interested in the inquiry from a number of perspectives:

- (a) it was a major investor in energy utilities in Northern Ireland and, in particular, a major supplier of electricity to NIE via the Ballylumford power station;
- (b) it had just started to develop a gas utility in the Greater Belfast area; and
- (c) in the context of all its regulated activities in the UK, it had a wide interest in regulatory developments.

12.28. British Gas supported the principle of incentive regulation which should benefit both customers and shareholders. The interests of customers were best served by establishing a stable set of regulatory principles to encourage efficient long-term investment and operating decisions. British Gas also welcomed the downward trend in electricity prices, reflecting improved efficiency, which would benefit the economy and, consequently, the growth of its activities in Northern Ireland. There were concerns in the province about the differential between electricity prices in Northern Ireland and average prices in Great Britain. Efforts to reduce this differential were welcome. However, British Gas drew attention to a number of concerns it had about the current proposals:

- (a) Lower electricity prices would be achieved more easily if competition existed in the supply of electricity. Whilst the supply market to large users (consuming over 1 MW) was open to competition there had been little activity to date, mainly because there was currently no spare capacity available in the province. Active competition in the supply of electricity would help to achieve the objective of lowering electricity prices. The prospect of competition in the supply market might increase if the MMC ensured that barriers to entry were removed.
- (b) The DG's proposals would reduce electricity prices substantially. Whilst lower prices were welcome, the MMC should examine whether the resultant prices would be below the economic level and might result in an artificial boost in demand for electricity in a manner which might not be sustainable in the longer term and which might be at the expense of other competing fuels.
- (c) In view of the large initial reductions proposed, care should be taken to ensure that these would not have an adverse impact on the cost of capital in NIE, which might distort Northern Ireland's energy market and hamper the development of a utility infrastructure in the province in the long term.

Coolkeeragh Power Limited

12.29. Coolkeeragh Power Limited explained that, as a power generator, all of its dealings with NIE concerned power procurement, an area not under present investigation. It had no expertise in the areas of transmission, distribution and supply charges and therefore declined the invitation to comment on these matters.

Meekatharra (NI) Limited

12.30. Meekatharra (NI) Limited (Meekatharra) explained that though it was not at present a supplier of electricity to the Northern Ireland system, it hoped to tender for future contracts for additional electricity generation.

12.31. Meekatharra had been campaigning for some years for a thoroughgoing review of the Northern Ireland electricity industry. It was disappointed that the DG had asked the MMC to consider only NIE's T&D costs, which severely limited the matters which ought to be considered. Nevertheless, Meekatharra supported the DG's view, implicit in the referral, that NIE was making excessive profits from its T&D operations, accounting for some 80 per cent of its operating profit. NIE's justification of higher prices was not borne out by its expenditure on capital investment. The Northern Ireland consumer was being disadvantaged in the long term by NIE's failure to make the promised capital expenditure from funds which it had already collected from consumers via higher tariffs, which were justifiable only if they were used for investment purposes.

12.32. Meekatharra's main concern was whether consideration of the Scottish interconnector came within the scope of the MMC's inquiry. It was unclear whether NIE regarded the interconnector as a transmission line or a generator. If it was a transmission line then its existence and cost ought to be a matter for consideration by the MMC. For its own part, Meekatharra saw the interconnector not as a transmission line but as a new generator which would be foisted on Northern Ireland:

- (a) without an open and competitive tender, conducted in accordance with objective, transparent and non-discriminatory criteria;
- (b) in breach of NIE's evidence to Parliament in 1991 promising an open tender for new generation in February 1992;
- (c) perpetuating a monopoly which was inconsistent with EC Treaty obligations on competition;
- (d) without having a 'system of open and competitive markets' (Article 129(b)ii EC Treaty); and
- (e) ignoring aspects of European legislation which required energy policy to take full account of the quantitative and qualitative effects on employment and socio-economic issues.

12.33. Meekatharra argued that these matters could be dealt with in greater detail if the MMC were to rule that the interconnector, as a transmission line, was a matter for consideration in the present inquiry.

Nigen Limited

12.34. Nigen told us that it operated two power stations in Northern Ireland and sold generation to NIE under the terms of PPAs. As the element of electricity bills reflecting the costs of the purchase of electricity generation was unaffected by the DG's proposals covered by the terms of reference, Nigen preferred not to make any representations to the MMC.

Northern Electric plc

12.35. Northern emphasized that any judgment made by the MMC should reflect the following principles of regulation:

- (a) Customers should pay the correct price for the product or service they received. That price was the price which a, hypothetical, efficient competitor setting up to provide the same or substantially the same service would have to charge to cover its costs. Any other price would distort the market for those services or for alternatives to those services and lead to the misallocation of resources in the economy. In Northern Ireland, alternatives to electricity usage included the emerging gas industry and energy efficiency. If electricity was priced to recover costs below the level which a hypothetical new entrant would have to charge there would be a misallocation of resources between gas and electricity.
- (b) Returns to shareholders should be adequate to reward long-term investment in the business.
- (c) Income entitlement must be sufficient to cover the operating costs incurred by an efficient operator providing those services. This income must be sufficient to provide the service standards deemed appropriate for customers, and allowance might also have to be made for the introduction of any additional systems and services necessary for the opening up of competition. Whilst Northern was aware that there was no franchise for electricity supply in Northern Ireland, there was, however, at the present time, no opportunity for competitors to enter the Northern Ireland domestic market on the basis of load profiles, which would occur in Great Britain in 1998.
- (d) Incentives to operate efficiently must be preserved. Proper incentives would not coexist with a regime in which the DG made retrospective judgments on the retention of the cash flow benefit arising from capital spending which turned out to be lower than assumed at the initial setting of the price control.

Scottish Hydro-Electric plc

12.36. SHE commented on issues in the DG's proposals relating to asset valuation and to underspend in capital expenditure.

12.37. First, it stressed that an important principle of the regulatory review process for network businesses was that a consistent approach to asset valuation was adopted over time. Expectations of reward for investment would be severely disrupted where the underlying approach to asset valuation for individual companies changed from one review period to the next. This was particularly relevant where a company was planning and funding investment in long-lived assets. The circumstances of the inquiry into NIE's price controls might allow the MMC to clarify the effect on the public interest of regulatory policy in this area.

12.38. Secondly, the price control proposals for NIE's T&D Business explicitly made a cash flow adjustment to the calculation of allowable revenue for the future price control period, so that some of the capital expenditure allowed for in the previous control, but not actually undertaken by NIE, was not refinanced. SHE was concerned that, without careful statement of the principles on which such adjustments should be made in future price control calculations, the incentives on companies to look for efficiencies in capital expenditure could be undermined.

12.39. SHE added that, in its view, different considerations applied to load-related and non-load-related capital expenditure. Non-load-related expenditure was geared towards the refurbishment and improvement of existing networks. Measures of the target output could usually be made for this expenditure: for example, a reduction in CML. It should be possible, therefore, to assess the extent to which the target output was being met, and to reward a company for achieving such targets at a lower cost than forecast by allowing it to keep the underspend. This preserved the incentive for the company to search for the most efficient way to achieve particular targets that were meaningful to customers. The opportunity for a company to affect the total level of load-related capital expenditure was more limited than for non-load-related expenditure, since factors outwith a company's control would affect the overall requirements. Nonetheless, some efficiencies might also be achievable in this category of expenditure and, where these could be demonstrated, they should be treated in the same way as non-load-related efficiencies.

12.40. SHE concluded that the inquiry into NIE's price controls presented an opportunity for the MMC to establish principles for dealing with underspend of capital expenditure during a price review period. Whilst it supported the transparency of an explicit correction being made to the cash flow calculations for the future price control period, it hoped that the MMC would take into account the beneficial effects of reducing regulatory uncertainty in this area and of preserving incentives on companies to look for efficiencies in network investment.

Scottish Power plc

12.41. ScottishPower provided written evidence and attended a hearing.

12.42. ScottishPower explained that it was now a multi-utility group. As well as undertaking generation, transmission, distribution and supply of electricity it also had interests in gas supply, telecommunications and the provision of water and sewerage services. It supplied electricity to customers in southern and central Scotland and, through its subsidiary Manweb, in Merseyside and North Wales. It sold electricity via the interconnector to England and Wales and planned to sell electricity to NIE via an interconnector between Scotland and Northern Ireland.

12.43. ScottishPower considered that the DG's proposals were flawed because they either undermined incentives to efficiency or, in some cases, they amounted to a retrospective clawback of revenue. As a result, they would have adverse implications for costs and quality of service to customers in the future. ScottishPower focused its comments on three particular areas of concern:

(a) The treatment of capital expenditure

The DG's proposals for the revised price control for NIE's T&D Business incorporated a deduction in respect of a shortfall between actual T&D capital expenditure and levels assumed when the existing price control was set. Specifically it was proposed that 50 per cent of the financing costs of investment not spent was to be deducted from allowed revenue in the next price control period. It was noteworthy that the DG did not suggest that the underspend was linked to adverse effects on quality of supply to customers in Northern Ireland. On the contrary, he said that 'network performance statistics suggested that the NIE distribution system performance over a range of indicators was in line with the performance achieved by similar distribution systems in Great Britain'. This position on underspend contrasted with that taken by the DGEs in his recent proposals for NGG's price control. Whilst noting a significant capital expenditure underspend against the assumptions used in the previous review of NGG, the DGEs nevertheless concluded that clawback was inappropriate given the need to maintain incentives for efficiencies in capital spending. In ScottishPower's view, the DG's proposals for clawback would undermine efficiency incentives to the detriment of customers in the long run, and were in conflict with the accepted principles of forward-looking medium-term price control. ScottishPower's other main concern in this area was the lack of detail provided by the DG to explain the very substantial revisions made to NIE's capital expenditure forecasts. For example, the proposals included a reduction of almost one-half applied to NIE's projection of gross load-related distribution system expenditure. Despite this reduction, the DG had assumed a higher level of customer contributions than NIE. Very little explanation of this apparent anomaly was given.

(b) Asset valuation

The DG had proposed an opening value for NIE's T&D Business based on NIE's market value at the close of the first day of trading. (This IMV was allocated pro rata according to the CCA asset values for each business and then, for the T&D Business, was rolled forward by net additions to its assets up to April 1997.) ScottishPower's main concern in this area was the lack of any allowance for a rise in NIE's market value at flotation. There were at least two ways in which such an uplift might be justified: (i) capital gains due to a reduction in perceived risks following flotation, and (ii) capital gains due to reasonable expectations of dividend growth at flotation. This principle had been recognized by other regulators. Secondly, ScottishPower was concerned about the methodology for allocating market values between businesses according to CCA asset values. It seemed appropriate that the methodology should take account of the differential risks and volatility of profits as between Supply and T&D. NIE's prospectus drew attention to this difference, which should in turn impact on the valuation methodology by allocating a relatively low figure to the Supply Business.

(c) Allowed Supply Business revenue

The DG's proposals allowed the Supply Business a profit margin of 0.5 per cent of turnover, the latter being adjusted downwards by 20 per cent of generation costs to reflect the differential between generation costs in Northern Ireland and Great Britain. The justification for the downwards adjustment to turnover was unclear. ScottishPower noted, however, that the allowed price components of the Supply Business gross margin, that is the fixed term and the variable customer- and unit-driven terms, were significantly lower than those currently in operation in Great Britain. Such a restrictive price control was not only likely to be detrimental to the quality of service provided by NIE but was also likely to create a significant barrier to competitive new entry to the Northern Ireland electricity market.

In addition to these three main concerns, ScottishPower said that it would also like to comment on the benefits to the Northern Ireland system which would flow from the proposed interconnector with Scotland. ScottishPower believed that the link would be beneficial to Northern Ireland consumers for several reasons:

- (i) It would allow NIE access to sources of diverse and lower-cost generation than might otherwise be available in Northern Ireland and would maintain downward pressure on energy supply prices in Northern Ireland.
- (ii) It would provide NIE with a controllable and reliable source of standby and reserve generation which would afford it a long-term and more effective and economical means of controlling frequency excursions in its system, with consequent benefits to its quality of supply and generation planning margins.
- (iii) The link could be accommodated into the NIE system with only minimal alterations or extensions to its transmission network, and would represent a most cost-effective infrastructure investment to provide NIE's customers with an alternative source of supply.

Local authorities

Antrim Borough Council

12.44. Antrim Borough Council supported the DG's proposals.

Ards Borough Council

12.45. Ards Borough Council expressed the following concerns:

- (a) there was no effective competition in Northern Ireland for NIE;
- (b) NIE's price increases had exceeded the rate of inflation since privatization;
- (c) despite the view expressed by NIE that it could not afford the price reduction outlined by the DG, its share price suggested that it had the confidence of the market as being a profitable company;
- (d) salary increases for NIE's senior management were surprisingly high given the fact that it felt unable to make substantial decreases in charges to customers; and
- (e) the number of reminders of payment due had now been reduced from two to one.

The Council concluded by saying that since the DG was fully conversant with this matter, his case must be persuasive.

Armagh City and District Council

12.46. Armagh City and District Council supported the DG's proposals for NIE's T&D and Supply charges.

Ballymena Borough Council

12.47. Ballymena Borough Council said that it would be concerned if electricity generating costs were not regulated and investigated and that NIE was forced to operate efficiently regardless. The Council supported the fairest deal possible for the consumer that was consistent with the need for job security and investment in the electricity network. The Council supported the idea of an interconnector from Scotland to Northern Ireland but had reservations about imposing NFFO obligations (to protect the environment) which would or might destroy fish stocks as a result of the use of hydro turbines.

Belfast City Council

12.48. Belfast City Council welcomed the DG's proposals. It considered that the review would result in a reduction in costs to consumers and it supported the development of energy efficiency measures to improve the environment and stimulate job creation. It also endorsed the intention of the DG to pursue with vigour the issue of generation cost reduction.

Carrickfergus Borough Council

12.49. Carrickfergus Borough Council said that it welcomed the DG's price control review proposals. It felt that these represented a realistic and objective assessment of economies which NIE might be expected to achieve, and which might in turn be passed on to the customer. The Council commended the DG on his deliberate stance of avoiding controls which would prevent NIE from operating in an entrepreneurial and commercial manner.

12.50. The Council, however, suggested changes to the DG's proposals in two areas:

- (a) it would welcome the inclusion of a factor specifically to cover the cost of an accelerated policy of undergrounding; and
- (b) it suggested a more gradual phasing in of controls so that any reductions in manpower levels could be achieved by natural wastage rather than compulsory or voluntary redundancy.

The Council added that it was disappointed that the DG was unable to reach agreement with NIE in respect of his proposals for the T&D and Supply Businesses.

Craigavon Borough Council

12.51. Craigavon Borough Council gave its full support to the DG's proposed pricing formulae. The Council had been concerned for some time about the disparity in electricity prices between Northern Ireland and Great Britain, which particularly affected the competitiveness of Northern Ireland industry. The Council considered that NIE had given undue cognizance to the profits of its shareholders at the expense of customer needs.

Down District Council

12.52. Down District Council said that it was concerned at the price which business and industry had to pay for electricity in Northern Ireland and felt that this was an obstacle to economic recovery. Whilst being mindful of the price that NIE had to pay to the generators, the Council welcomed and supported any reduction in charges to the Northern Ireland consumer.

Larne Borough Council

12.53. Larne Borough Council was anxious to ensure that any settlement reached would enable NIE to continue to upgrade its infrastructure. The Council believed that prior to privatization, NIE suffered from a lack of investment that was needed to upgrade its facilities. It contended that this needed to be redressed and that NIE should be able to realize a profit margin which would permit realistic reinvestment. The Council was also concerned that the charges made by the generators were unrealistic and did not reflect recent efficiency gains. Negotiations were needed with the generators to ensure that the cost of electricity to NIE fully reflected these efficiency gains.

Lisburn Borough Council

12.54. Lisburn Borough Council expressed concern at what it considered restrictive practices now in place resulting from contracts signed by NIE with electricity generating companies, running up to 2010. Such arrangements were causing inordinately high electricity prices for both domestic and commercial users in the province.

Newry and Mourne District Council

12.55. Newry and Mourne District Council said that it fully concurred with the views expressed by Newry Chamber of Commerce (see paragraph 12.75).

Omagh District Council

12.56. Omagh District Council had been concerned for some time at the discrepancy in the level of electricity charges between Northern Ireland and Great Britain. It understood that to a large extent this was due to higher generating costs and the lack of competition between the generating companies in Northern Ireland. It welcomed a recent press announcement that an agreement had been reached between NIE and Nigen to extend the life of Belfast West power station, thereby leading to a 3 per cent reduction in electricity bills. The Council emphasized that it would support any efforts which created opportunities to reduce the cost of electricity generation and supply costs to customers, though it emphasized that it would not wish to see system performance and customer service standards being compromised in the process.

Strabane District Council

12.57. Strabane District Council said that it supported the DG in his efforts to negotiate with NIE to reduce the price of electricity to domestic and business users in the province. The Council firmly believed these reductions would help promote its drive to encourage economic development and assist Northern Ireland manufacturers to compete on a level playing field with their competitors in the rest of the UK. The proposed reduction of £40 off the average household bill would be a tremendous boost to the large number of deprived families living on the breadline. Reductions of this kind were, however, unlikely to happen unless NIE's contracts with the major power stations were renegotiated.

12.58. In conclusion, the Council said it regretted that NIE could not reach agreement with the DG and it urged the MMC to enforce his findings. It stressed the importance of price stability of energy supplies, particularly to the rural areas of Northern Ireland which had no other energy options.

Trade and consumer associations

Action Group on Northern Ireland Energy Issues

12.59. The Action Group submitted written evidence and attended a hearing.

12.60. The Action Group, whose members comprise 42 major industrial and commercial energy users in Northern Ireland (see Appendix 12.1 for a list of members), expressed concern about the level of electricity prices in Northern Ireland and the 20 to 30 per cent differential between these prices and prices in Great Britain. It welcomed any measures which might reduce the cost of electricity to industry.

12.61. The Action Group said that its understanding of the DG's proposals was that large industrial users would see a reduction of around 6 per cent of their total electricity bills. Electricity bills consisted of two charges, one due to generation costs and the other due to NIE's costs. For large industrial users around 82 per cent of the bill was related to generation costs and 18 per cent to NIE's costs. The initial effect of the proposals to reduce NIE's charges would result in generation costs accounting for 88 per cent of the bill and NIE's costs for 12 per cent. However, the proposals, which included NIE's costs rising at around 2 per cent below the level of inflation, taken together with generation costs which increased each year by the rate of inflation would result in generation costs becoming an increasingly large percentage of the total electricity bill.

12.62. The Action Group pointed out that it had consistently put forward the view that the PPAs were highly significant in the widening differential between electricity costs in Northern Ireland and Great Britain. Until a process was developed to introduce competitive aspects into the generation of electricity in Northern Ireland large industrial users would continue to be increasingly disadvantaged in the price they paid for electricity. Whilst the DG's proposals were welcomed by its members, the group also required assurances that the level of service presently given by NIE to industry and the reliability of supplies would not be reduced in any way if the proposals were implemented.

12.63. The Action Group added that quality of supply appeared not to have improved noticeably since privatization. Despite the high prices and NIE's increasing profits, the quality of service was worse than that provided by most of the other UK RECs. The Action Group accepted that the size of the electrical system in Northern Ireland and its comparative isolation left it more vulnerable and subject to disruption, mainly from the weather. It therefore welcomed the greater stability that would come from connection to supply from the Republic of Ireland, and to the rest of the UK via the Scottish interconnector. This might also benefit customers by opening the Northern Ireland market up to competition from other suppliers. At present, second-tier suppliers had shown little interest in entering a Northern Ireland market which was dominated by NIE and where customers were severely limited in other choices of power.

Association of Electricity Producers

12.64. The Association of Electricity Producers, whose membership includes most UK electricity generating companies, asked for the following points to be noted:

- (a) The approach to trading in Northern Ireland was a Bulk Supply Tariff approach, which left very little scope for competitive suppliers to differentiate their products. A competitive market was less likely to flourish in such an environment than in a more open one such as existed in England and Wales.
- (b) The regulatory regime should promote transparency and discourage cross-subsidies between businesses. This implied the need for a clear separation between competitive and non-competitive supply markets. Without such safeguards competitive markets in supply were unlikely to develop.
- (c) Where data pertaining to competitors were held by the different parts of the integrated business, such information should be ring-fenced to protect the commercial interests of competing businesses.
- (d) Non-discriminatory access to the system was essential if competition was to flourish. In this regard the inquiry should reflect on the failings of the Energy Act 1983.

General Consumer Council for Northern Ireland

12.65. The General Consumer Council for Northern Ireland (GCC) submitted written views and attended a hearing.

12.66. The GCC stressed that it was important that the MMC were fully aware of the particular circumstances prevailing in Northern Ireland. Its research had shown that, whilst household income in Northern Ireland was only 88 per cent of the UK average, consumers had to spend 20 per cent more each week on fuel, light and power. Also, breaking down household energy spending according to income groups revealed that the lowest income group had to spend 11 per cent of its total weekly expenditure on fuel, light and power, with the highest income group spending only 4 per cent. For these reasons, the GCC argued that electricity prices had taken on an added significance in Northern Ireland and had a greater impact on the standard of living and on economic prosperity generally than in the rest of the UK.

12.67. The GCC explained that historically Northern Ireland electricity tariffs had been around the highest in the UK. Various reasons had been put forward to explain this, some pre-dated privatization while others could be attributed to circumstances arising at the time of privatization and since. In its 1989 report¹ the Council had drawn attention to a number of structural and other characteristics of the Northern Ireland electricity supply industry which impacted adversely on prices:

- (a) the small scale of the Northern Ireland system and the fact that, at the time, it was isolated from the national and European grids; and
- (b) its over-dependence on oil as a generating fuel.

In addition the Council had drawn attention to the fact that the industry compared unfavourably with the electricity supply industry in the rest of the UK based on established and accepted indicators of performance. The Council had concluded that these differences were indicative of operational inefficiencies and diseconomies of scale within the Northern Ireland system. Furthermore, as these were reflected in industry costs and recovered in electricity prices, they represented an added charge to Northern Ireland consumers.

12.68. In the years immediately prior to privatization and since then, domestic tariffs in Northern Ireland had risen sharply, at a much faster rate than in the rest of the UK. In 1991/92, the last year of the publicly-owned NIE, the Northern Ireland domestic tariff was around 3 per cent higher than the UK average. By 1995/96 the difference was 18 per cent and predictions were that the gap would widen even further in the next few years to perhaps 26 to 27 per cent. The GCC put forward a number of explanations for the divergence:

¹*Privatizing electricity in Northern Ireland-the consumer perspective.*

- (a) the first round of regulatory price controls imposed at the time of privatization in 1992 were extremely generous; in particular, they seriously underestimated the scope and the potential within the Northern Ireland electricity supply industry for substantial operating and efficiency savings;
- (b) those savings and efficiency gains were in fact subsequently achieved but, while industry profits rose handsomely as a result, there was no passing on of these benefits to consumers; and
- (c) a further major factor was the adverse effect of the long-term generation contracts entered into at the time of privatization.

The GCC pointed out that since privatization profits of NIE had risen sharply. The company's latest (1995/96) £107 million profit based on a 'supply' turnover of around £250 million when excluding generating costs represented an operating profit to turnover ratio of 43 per cent. In other words, for every £1 paid to NIE by consumers NIE made around 43p profit. This had to be seen in the context of a company which was trading in a relatively risk-free environment with a virtual monopoly on supply. The GCC said that while it recognized that the industry should be profitable, and it had no objection to a reasonable return on investment and a reasonable return to shareholders, where a company enjoyed a virtual monopoly of supply there was an added obligation to ensure that this situation was not exploited. NIE had earned substantial profits at the expense of electricity consumers who had not benefited to the extent that might reasonably have been expected. What had taken place was an inequitable distribution of the benefits of privatization and a failure to achieve a proper balance between the interests of consumers and shareholders.

12.69. The Council argued that because of NIE's failure to strike a proper balance, price controls for the next period should aim to reduce electricity prices in real terms and should contain a deliberate bias in favour of consumers, to compensate for the higher prices they had had to pay during the first regulatory period when price controls were too lax.

12.70. In conclusion, the Council said that it supported the DG's price control proposals which, in its view, were fully justified in the interests of consumers and did not impose an unrealistic or unfair burden on NIE.

NEA Northern Ireland

12.71. NEA Northern Ireland (NEA NI) explained that it formed part of a national charity which tackled heating and insulation problems of people on low income through improvements in energy efficiency. Working in partnership with central and local government, fuel utilities, housing providers, consumer and voluntary organizations, it aimed to alleviate fuel poverty and campaigned for greater investment in energy efficiency to help the poor and vulnerable. It had developed and maintained close links with both OFREG and NIE.

12.72. NEA NI welcomed the fact that in recent years NIE had invested in a number of energy efficiency programmes, including initiatives targeted at low-income households and disadvantaged communities. Similarly, it welcomed OFREG's commitment to address the price burden faced by consumers in Northern Ireland. Electricity prices had been under scrutiny for some time, due to the large price differentials compared with Great Britain and the substantial increase in NIE's profits since privatization. This price differential placed an unfair disadvantage on consumers in Northern Ireland and put low-income consumers particularly at risk. NEA NI listed a number of statistics to reflect this contention and to underline the impact of high electricity prices:

- (a) During 1995/96, 183 customers were disconnected for non-payment of electricity charges. This equated to a disconnection rate of 38 per 100,000 domestic customers, compared with an average figure of three for Great Britain.
- (b) In March 1995, a total of 71,103 customers paid for electricity through prepayment meters, with 12,991 using the prepayment meter to pay arrears. This figure had now risen to approximately 90,000.

- (c) Households in Northern Ireland had an average weekly expenditure on fuel, light and power of £15.56, compared with a UK average of £12.95.
- (d) Low-income households spent 11 per cent of average weekly income on fuel, light and power, proportionally almost three times more than the highest income group (4 per cent).
- (e) In September 1996, a total of 7,848 households were using the direct payment scheme, Fuel Direct, to pay for electricity. This reflected 1.35 per cent of all households, which was the highest level in the UK.

12.73. NEA NI added, however, that it recognized the importance of a quality service from NIE and noted that the current level of customer complaints concerning NIE compared favourably with those made to other RECs in Great Britain. Electricity pricing in Northern Ireland had to strike a balance between a fair and just reduction for consumers, who had borne the brunt of high prices for too long, and the provision of a quality service which allowed for security of supply and special services to those who were disadvantaged or vulnerable, including those living in rural communities.

12.74. Electricity consumers in Northern Ireland hoped that the DG's price review would produce downward pressure on prices, with an estimated saving of £40 off the average domestic fuel bill. This reduction would provide considerable relief to those domestic customers having difficulties in meeting current fuel bills. NEA NI also welcomed the proposed introduction of a green tariff and a customer levy of £1 per customer for investment in energy efficiency. NEA NI therefore supported the tightening of the price control formula, at a level which would give NIE a longer lead time to achieve efficiencies, but which would nevertheless be rigorous in passing benefits on to consumers.

Newry Chamber of Commerce

12.75. Newry Chamber of Commerce asked for the following points to be noted:

- (a) NIE appeared not to relate its pricing to regions of Great Britain.
- (b) Price increases across the board penalized high-volume industrial consumers. A sectoral spread should be considered.
- (c) NIE price increases were not in line with RPI or inflationary trends.
- (d) Price increases failed to afford customers a discount option based on usage or past usage history.
- (e) Price increases encouraged retailers and industrialists to look more closely at alternative forms of power, possibly causing a loss of revenue to NIE. This could result in future price increases to regain volume.
- (f) The price increases had resulted in a swift move to the use of gas for heating and power. Not all changes had been in accordance with full health and safety provisions. NIE might have caused consumers to place their own and other lives at risk to reduce their energy costs.
- (g) The question of whether a full Republic of Ireland and Northern Ireland electricity grid would bring cost savings and added value to the consumers needed consideration.
- (h) Increases in electricity prices and NIE's market value might attract the interests of a predator.

Northern Ireland Consumer Committee for Electricity

12.76. The Northern Ireland Consumer Committee for Electricity (NICCE) submitted written evidence and attended a hearing.

12.77. The NICCE told us that it was set up in 1992 to provide consumer representation for the privatized electricity industry. Since its inception, it had been concerned about Northern Ireland's electricity prices, which had not fallen in line with those in Great Britain. The Government's three-year financial package to alleviate the problem had stabilized the price differential with Great Britain to about 23 per cent in 1996/97.

12.78. The NICCE thought there were a number of reasons for the price divergence with Great Britain. The two main reasons were the long-term generation contracts entered into at privatization and the relatively generous privatization price control given to NIE. The Committee's view had always been that, whilst attempts to tackle generation prices would not be easy, NIE's prices would be controlled by the 1997 regulatory review which would bring as much relief as possible from the hardship caused by high prices.

12.79. The NICCE's response to the DG's consultation paper in spring 1996 made its view clear. NIE was making too much profit, and was bolstering shareholder values at the expense of customers. This was underlined by its financial result for 1995/96 which showed that it had made £107 million profit on a turnover (once generation costs were excluded) of £220 million. Apart from the extremely high profit levels, the NICCE was particularly concerned at the failure of NIE's T&D Business to invest the money it said was required at privatization, despite collecting the costs from customers, and at NIE's poor customer service record, with complaints to OFREG increasing substantially in the last 12 months.

12.80. Clearly a firm but fair regulatory review was required. The DG's proposals for a 12 per cent cut in prices would still allow NIE to make substantial profits, which would increase further if it made efficiency savings, and a reasonable return on capital. The NICCE argued that the DG could have been even tougher as such profit levels were more than sufficient for a low-risk monopoly utility company. In particular, more of the past capital expenditure underspend, financed by consumers, should have been offset against requirements in the next regulatory period, and operating costs, particularly in the T&D Business, should have been further reduced.

12.81. The NICCE agreed with the House of Commons Northern Ireland Affairs Committee, whose report¹ into the Northern Ireland electricity industry concluded that 'the lion's share of the efficiency gains made since privatization should be returned to customers'. Furthermore, the NICCE felt that the DG had been over-generous to the company in a number of areas:

- (a) by allowing a higher rate of return than other regulators;
- (b) by clawing back only half the capital expenditure underspend, despite NIE's admission that this was largely due to its own inefficiency;
- (c) by allowing capital expenditure for some projects which might be unnecessary (for example, work related to the proposed closure of Coolkeeragh power station); and
- (d) by allowing NIE's Retail Business to charge the Supply Business rent for the floor space occupied by account desks in the 34 retail shops.

The NICCE therefore said that it viewed the DG's proposals as the minimum acceptable, and said that it would have been happier with an even tougher review. Any significant move away from the level of price reduction proposed by the DG would not be acceptable to customers or the NICCE.

12.82. The NICCE had noted NIE's arguments against the DG's proposals. It did not accept these arguments. In particular, it believed it was inappropriate for NIE to make direct comparisons with the RECs in Great Britain. The Northern Ireland electricity industry was structured in a different way, with a different regulator and with different problems (primarily high prices). Furthermore, NIE's initial price control settlement was more generous (particularly in T&D) than that received by the RECs. Despite these fundamental differences, NIE seemed to be arguing that the DG should follow directly the precedent set by his Great Britain counterpart. The NICCE was confident that the DG would deliver a price control which was appropriate for the local circumstances and fair to local people. Taking NIE's specific arguments one by one the NICCE said:

¹*Electricity Prices in Northern Ireland, Vol I, HC 1994-95, November 1995.*

- (a) It did not accept that the proposed revenue reductions were unsustainable. NIE was being asked to accept a 34 per cent drop, which was in line with what some RECs received (taking into account the multiple distribution reviews).
- (b) Asset valuation was a complex issue and details were best left to experts. However, the NICCE accepted the general principle that the appropriate value to use was that at which shareholders bought at privatization, allowing for subsequent investment. It was unfair to expect customers to provide a rate of return for NIE on the increase in the value of existing assets since privatization. Shareholders had done well out of the first price control, and there was no reason why they should not do well out of the new proposals.
- (c) It was grossly misleading for NIE to claim that quality of service would suffer. NIE had argued successfully at privatization for additional funds with which to upgrade the network-and then had not spent them. Despite this apparent under-investment, network performance was no worse than would be expected in a comparable REC, and it was fully in line with the electricity supply regulations. The DG's proposals would allow NIE to invest substantially more per year than it had done since 1992.
- (d) It rejected NIE's assertion that the cost projections were unrealistic. Whilst it was true that NIE had made substantial efficiency gains since privatization, it remained much less efficient than the Great Britain RECs across a range of measures, including core staff per 1,000 customers and staff per GWh distributed. NIE had a significant opportunity to offset the impact of the review via cost reduction.

12.83. The NICCE concluded that the fundamental problem was NIE's belief that the price control review was simply about identifying the efficiency savings made since the last price control, and agreeing the proportions in which they should be shared between customers and shareholders. In the NICCE's view, the DG's job was to mimic the effect of the competition that was not there, and the only way this could be done was by looking at the realistic costs of running NIE's regulated businesses, making reasonable assumptions about efficiency savings, and then deciding an appropriate rate of return for a low-risk business. By refusing to accept the DG's proposals, NIE had undermined its credibility and had indicated to the Northern Ireland population that it was seeking to continue the current position whereby it maximized its profit at the expense of its customers who had no choice.

Northern Ireland Electricity Joint Trade Unions' Committee

12.84. The Northern Ireland Electricity Joint Trade Unions' Committee provided a written submission and attended a hearing. The Committee comprises the following trade unions which are all recognized by NIE:

- the Amalgamated Union of Electrical and Engineering Workers;
- the General and Municipal Boilermakers Union;
- the Engineers' and Managers' Association; and
- the Transport and General Workers' Union.

The Committee pointed out that whilst the regulatory review had a wide impact and influence throughout the province, input to the review had been limited to NIE and the DG. Public involvement had been limited to press statements from the two parties which unfortunately gave the perception of a damaging breakdown in relations between them. The Committee would have welcomed a greater openness between the parties and the opportunity to comment on various consultation papers commissioned by the parties but said that it was denied access to them.

12.85. The Committee understood that the DG's aim was to have electricity prices within Northern Ireland at or around the same level as electricity prices generally throughout the rest of the UK. The Committee considered this an unachievable objective in the short and medium term (if at all). If direct competition to NIE was available, price would still not, for a number of reasons, reach the levels applying in other parts of the UK. To that end, OFREG was going beyond its purpose of being a 'surrogate' for competition, and was entering into the arena of public policy.

12.86. The Committee explained that one of the main reasons for the divergence in pricing was that NIE distributed a product created by three other companies: Coolkeeragh Power, Nigen and Premier Power. These three generating companies were set up as a result of Government policy, and at their inception were awarded contracts relating to electricity production, which included requirements on NIE to take electricity from them at specified prices. These contracts were still operative and would remain so for the duration of the review period and set the basis for about 80 per cent of the price of electricity paid by the individual consumer. NIE was prevented from finding alternative supplies at a lower price. These circumstances did not apply in any other area of the UK.

12.87. Another reason for the price difference was that distribution charges applied by RECs in the remainder of the UK varied, and were influenced by a number of factors, in particular population density. In NIE's case, the ratio of circuit distance to output points was the highest in the UK. This alone should be recognized as a factor which would produce a higher charge. Similarly, unit consumption per outlet was lower than other UK companies, giving a lower income over which to provide for the distribution charge.

12.88. The Committee noted that the DG's proposed method of regulation appeared to be unchanged, in that the system of price control of RPI-X through the review period had been retained, albeit with an enforced direct price reduction at the start of the period. It thought this method of calculation failed to reflect public concerns. Public perception was that, generally, electricity prices were high because electricity companies' profits were too high, and that their directors' rewards were also too high. This method of regulation could not deal with that perception. Even if NIE were able to match the average level of UK electricity charges, public concern would continue if profits and directors' rewards remained at the current level. Another concern was the impact of 'step-change' levels of regulated income-in this case 30 per cent in one year-and the need to look for an improved method of dealing with the profits derived from efficiency gains.

12.89. The Committee was concerned that if this method of regulation by price control only was retained, whatever the outcome of the review, the level of price reduction would have to be met substantially by reductions in NIE's staffing levels and/or lowering of staff's terms and conditions of employment. Significant efforts would be made to maintain the absolute level of profit and high shareholder dividends because of stock market considerations. The Committee considered that the existing price control mechanism did not deal adequately with public concerns. Changes needed to be applied widely over all RECs and not singly on one company. The present method of regulation impacted disproportionately upon staff interests.

12.90. The Committee added that since privatization NIE had reduced its staff numbers by about 30 per cent, the majority of whom had worked within the regulated businesses. NIE and its staff were committed to working to improve productivity and service levels to customers. The financial impact of the DG's proposals would reduce revenue initially by about £68 million. Given the limited range of immediately controllable costs available to NIE, and that staff costs were a significant part of controllable costs, the Committee said that it was understandably concerned about staff reductions and the effect these might have on staff morale and the quality of customer service.

12.91. The Committee accepted that the public would no doubt wish to see electricity prices lowered. However, what was not clear was whether, if asked, the public would place security of supply as a higher priority than lower electricity charges. Significant efforts were being made by various agencies within the province to attract inward investment. The price of electricity was one of many differential prices applying in Northern Ireland compared with other parts of the UK or Europe. An inward investor and major electricity user would want a level of security of supply no less than that provided elsewhere in the UK or Europe. Any reductions in staffing levels would adversely affect security of supply, particularly to the western half of the province.

Northern Ireland Textiles and Apparel Association Ltd

12.92. Northern Ireland Textiles and Apparel Association Ltd (NITA) said that it represented the majority of textile and clothing companies in the province. The industry was the largest manufacturing sector in the province, accounting for 25 per cent of all manufacturing jobs and 17 per cent of NIE's industrial revenue. Businesses within the industry continued to face strong competitive pressures from overseas suppliers and had to be conscious of costs, no matter from what source they emanated. Energy costs in apparel manufacturing

were less significant than in textile companies where they represented on average 6.5 per cent of their total conversion costs expressed as a factor of their direct labour costs.

12.93. Given the fact that Northern Ireland energy prices were currently about 23 per cent more than Great Britain prices, and that on current trends the gap seemed likely to widen further, it was not surprising that this issue remained a priority for member companies. The fact that NIE's prices were held down in 1996 by the Government's £15 million Nuclear Privatization Compensation package, and that a further £45 million was promised, was a welcome intervention, but could not be seen as solving the fundamental problem of uncompetitive energy prices.

12.94. The NITA encouraged its members to adopt best practices across the business spectrum, including the conservation of energy. It had worked closely with the DED in this regard and was currently involved with an energy efficiency pilot project involving five member companies. The intention was to disseminate its findings across the entire textiles sector. The NITA stressed the importance, however, of manufacturing industry having a secure and efficient electricity supply system, and of due care and attention being given to customer services. To achieve this NIE obviously had to look to future investment in its network both to facilitate economic growth and reliability of the system.

12.95. In conclusion, the NITA thought the DG's proposals were complex but appeared to have the desired effect of cutting NIE's bills to consumers, by some 12.5 per cent for domestic customers and 6 per cent for larger industrial users. Given NIE increased efficiency and profits, the proposed action did not appear unreasonable and in principle the NITA supported the DG's recommendations which, if successful, would represent a step in the right direction in reducing costs.

Major customers

Blue Circle Cement

12.96. Blue Circle Cement, a division of Blue Circle Industries Plc, expressed concern at the price of electricity in Northern Ireland, particularly in comparison with the competitive rates it obtained in Great Britain. It believed transmission charges were only the tip of the iceberg and said that it would welcome an investigation into generation contracts, which accounted for 80 per cent of the price for large users. Blue Circle also hoped that the MMC inquiry might help to remove the excessive differential between electricity prices in Northern Ireland and those in Great Britain and the Republic of Ireland. Nevertheless, while it understood that NIE had offered to reduce its charges, and hopefully this offer could be improved upon, it stressed the importance that, as a continuous process manufacturer, it should continue to receive an efficient and reliable supply of electricity.

Calor Gas Northern Ireland Limited

12.97. Calor Gas Northern Ireland Limited told us that as a major user of electricity it was concerned about the high cost of electricity in Northern Ireland compared with the rest of the UK. Northern Ireland was one of the poorest and most isolated regions in the UK in terms of GDP and levels of unemployment and the only substantial area of the EU lacking direct links to the major markets of Europe. Electricity costs were making local companies less and less competitive and this was one of the most detrimental factors weighing against Northern Ireland in competing to attract new industries to the region, as well as preserving present jobs.

12.98. Calor Gas argued that privatization of the electricity industry by the Government had been badly handled and that it was accepted that the industry had been sold off at an unrealistic price. Electricity generators had received a virtual licence to print money at the consumers' expense. It was not the buyers' fault that power stations had been run so inefficiently that when new managements took over they were able to make huge profits, some of them on guaranteed contracts until well into the next century. Privatization meant nothing to the consumer if it failed to lead to greater competition and lower prices.

12.99. Calor Gas regretted that the MMC had not been asked to consider the costs of the purchase of electricity. Generation costs accounted for up to 80 per cent of its bills. However, transmission, distribution

and supply charges, within the MMC's remit, also appeared to be excessive. NIE blamed the power stations for its higher charges but NIE's profit figures spoke for themselves.

Eastern Health and Social Services Board

12.100. The Eastern Health and Social Services Board said that, as a major commissioner of health and social care in Northern Ireland, it welcomed any initiative which might help to reduce its electricity bill, which was a significant part of its overhead expenditure.

Euroclean Centre

12.101. Euroclean Centre (Euroclean) explained that its dry cleaning and laundry business, located in a shopping centre complex, was dependent on electricity as its sole source of light, heat and power. Alternative sources of energy such as gas and oil were ruled out due to fire risk and health and safety regulations. Euroclean's research had indicated that net savings of approximately 33 per cent in energy costs would be possible if alternative sources of power were available. Euroclean complained that the jobs of its own employees and its opportunity for expansion were threatened by the unacceptably high cost of electricity, a major component of its costs. This scenario was undoubtedly repeated for many other undertakings, both large and small, throughout the province.

12.102. Euroclean urged the MMC to recommend a significant reduction in business and domestic electricity tariffs in Northern Ireland. Whilst it was aware that special features applied to the NIE cost structure which were not present in the rest of the UK, it stressed that electricity was of such fundamental importance to business activity generally that energy costs must be controlled and reduced to a more acceptable level, if many firms were to survive and remain competitive.

Harland and Wolff Holdings plc

12.103. Harland and Wolff Holdings plc, a member of the Action Group on Northern Ireland Energy Issues, wrote in support of the Action Group (see paragraphs 12.59 to 12.63) and submitted further views. It complained that currently Northern Ireland non-domestic users paid some 27 per cent more than mainland UK users and that the differential was rising. The high cost of electricity was a major component in its overhead cost structure and had to be reflected in its overall product cost.

Hughes Christensen Company

12.104. Hughes Christensen Company (Hughes Christensen) welcomed the DG's review. It explained that it had been based in Belfast since 1954 and had operated with considerable success in a highly competitive industry, exporting oil and gas drilling products to over 60 countries. Significant operating efficiencies were needed to enable the company to continue to compete effectively in the industry. In recent years Hughes Christensen had been placed at a disadvantage because of the spiralling cost of electricity supplied by NIE. Electricity costs ranked second to labour costs in terms of the overall cost of conversion and equated to some 5 per cent of total costs.

12.105. Hughes Christensen pointed out that electricity costs per unit consumed had risen in overall terms by 19 per cent since and including 1994 and Use of System charges had increased by 7 per cent in the past year alone, far exceeding any generous calculation for inflation. This was particularly hard to swallow considering NIE's public announcement of significant operational efficiencies since privatization. In addition to a curtailment of the upward spiral in the cost of electricity, the charging mechanism itself needed clarifying. The distinction between Bulk Supply Tariff and Use of System was unclear. In the past year when a 1 to 2 per cent reduction in the Bulk Supply Tariff was announced NIE also announced a 7 per cent increase in the Use of System tariff, bringing a net increase in overall cost of electricity of 2 per cent. NIE defended its position by arguing that it had a right to adjust the Use of System tariff charge and it had merely exercised this right as the opportunity presented itself.

12.106. The picture since 1994 had been further muddled by the significant changes to the charging mechanisms. Whilst some elements of the change appeared beneficial, the overall increase in cost suggested a less than wholesome reasoning. Users in the above 1 MW category had always been subject to incremental charges in the winter months. These charges had increased in recent years. Hughes Christensen argued that its business was not seasonal and it should therefore not have to bear any incremental costs in any case or incur additional charges. As it was, operating in Northern Ireland placed it at a 26.5 per cent disadvantage in electricity costs per unit when compared with its sister company operating out of Aberdeen, and an apparent 13 per cent disadvantage in electricity costs compared with a similar manufacturing company operating in England and supplied by East Midlands Electricity plc.

Iceland Frozen Foods plc

12.107. Iceland Frozen Foods plc (Iceland) told us that it was rapidly developing its business portfolio in Northern Ireland and would shortly have 21 stores in the region. It was extremely conscious of its overheads and was keen to keep these to a minimum. It was, therefore, dismayed to find that its electricity costs in Northern Ireland were considerably above those of all its other UK operations and complained that, in the absence of real competition in the province, it had little recourse. Iceland had regularly communicated with NIE in an attempt to achieve more realistic costs but it was continually told by NIE that its prices were tied to fixed generation costs and could not be reduced. Iceland added, however, that in its latest (1997) round of price negotiations NIE appeared to have adopted a more flexible approach to its pricing structure and Iceland was hopeful that cost savings might be achieved.

Moy Park Ltd

12.108. Moy Park Ltd (Moy Park), a member of the Action Group for Northern Ireland Energy Issues (see paragraphs 12.59 to 12.63), made the following points:

- (a) Electricity prices in Northern Ireland were much too high, 20 to 40 per cent more than elsewhere in the UK or in Europe. These price levels placed Moy Park under a severe disadvantage in a highly competitive section of the market-place.
- (b) Pressure should be applied on NIE for a price review to reduce price differentials with the rest of the UK. However, Moy Park understood that the costs under review only reflected 40 per cent of the total unit cost of electricity and that the DG's proposals would only reduce the differential by up to 6 per cent.
- (c) The major pricing problem was that other elements made up 60 per cent of unit costs, namely generation contracts. These needed to be addressed urgently.
- (d) Access to the use of the Scottish interconnector should also be considered. Moy Park understood that use of the interconnector was to be under NIE's control for some considerable time to come and that the cost of the connector would be passed on in full to consumers as additional increases in unit costs. This would again increase unit costs unfairly to the region.
- (e) Any changes requiring generators to comply with environmental legislation would immediately be passed on to end-users in increased costs. Moy Park would not be able in turn to recover the costs of compliance with such legislation from its customers and it believed this should be the same for generators.

12.109. In conclusion, Moy Park said that whilst it accepted that some of these issues might not be included in the present MMC inquiry, it believed they should nevertheless be aired. If nothing major was done soon it would have an adverse effect on all businesses in Northern Ireland, both existing and any which might be attracted to the area.

North Eastern Education and Library Board

12.110. The North Eastern Education and Library Board supported the DG's proposals and thought these would enable it to make savings on its electricity bills.

Sean Quinn Group Ltd

12.111. Sean Quinn Group Ltd (Sean Quinn), a member of the Action Group on Northern Ireland Energy Issues (see paragraphs 12.59 to 12.63), complained that since August 1993 its electricity charges had increased by 21 per cent, which seriously affected the competitiveness of its business. Sean Quinn stressed the need for an immediate reduction in electricity charges generally in Northern Ireland and considered it of the utmost importance to the competitiveness of businesses in the province that there should be a strict control over such increases. It noted, however, that some 79 per cent of its final electricity charges from NIE appeared to be attributable to charges from the four independent generators and recommended that the MMC should investigate these charges and, in particular, assess how their capital investment proposals ultimately affected large users and the inordinately high price increases they had to bear as a result.

Short Brothers plc

12.112. Short Brothers plc, a member of the Action Group for Northern Ireland Energy Issues (see paragraphs 12.59 to 12.63), asked for the following issues to be considered:

- (a) Recognition that the present review only covered a relatively small portion (approximately 18 per cent) of the total unit cost of electricity. The DG's proposals for a 30 to 40 per cent reduction in NIE's T&D and Supply costs, albeit welcome, would not significantly reduce the cost of electricity to major users in the province.
- (b) Any decrease in NIE's T&D and Supply costs should not be accompanied by a proportionate reduction in export tariffs for CHP. Current export tariffs offered by NIE should be increased to reflect the percentage differential between import and export unit costs currently applicable in Great Britain.
- (c) NIE's connection charges to industry should be reviewed as a composite part of the investigation.
- (d) Top-up and standby rates for CHP users in the province should be examined and aligned with similar rates in Great Britain.
- (e) Third party access to the T&D network should be allowed for wheeling CHP-generated electricity between sites owned by the same organization in the province.

Springvale EPS Limited

12.113. Springvale EPS Limited (Springvale), also a member of the Action Group for Northern Ireland Energy Issues (see paragraphs 12.59 to 12.63), pointed out that at present NIE's charges to industry averaged about 25 per cent above average Great Britain prices and that, if present trends continued, they could be 50 per cent higher by the year 2000. Springvale commended the DG for his detailed and serious study and noted his recommendations. Springvale was not in a position to judge the validity of NIE's objections but hoped that the DG's proposals could be implemented without hindering the efforts made by NIE since privatization to reduce its costs and improve its efficiency. Springvale added, however, that it was well aware of the much larger element of cost determined by the charges which the generators were permitted to make under their long-term contracts. It was vitally important for the future of manufacturing in Northern Ireland that some way could be found to reduce these charges.

Tennants Textile Colours Limited

12.114. Tennants Textile Colours Limited (Tennants) told us that, as it used over 1 MW of electricity a year, the price of electricity was a major cost element. Tennants complained that electricity costs were unrealistically high in Northern Ireland and the consequences of this for industry in the province were profound. Manufacturers like Tennants were put at a very substantial cost disadvantage in an extremely competitive market, both in Great Britain and internationally, as a result of punitive electricity costs. The privatization of electricity in the province had resulted in some of the elements within the total electricity bill being set at unrealistic levels. One element that fell within the terms of reference was NIE's T&D charges, which had been set very high. A realistic pricing structure which did not favour NIE was essential as NIE had enjoyed quite remarkable profits at the expense of users. A structure which could also be easily policed would be a very positive step to stabilizing industry within the province.

Ulster Television plc

12.115. Ulster Television plc said that it would welcome a reduction in its transmission and distribution costs which it understood represented 20 per cent of its electricity bill. However, it stressed that reliability of supply was even more important. Consequently, it recognized the need for reinvestment in the network and believed it essential that the review ensured that sufficient funds would be available to achieve this across the whole of Northern Ireland.

Ulster Weavers

12.116. Ulster Weavers said that whilst it had little to complain of in relation to supply voltage stability and service, it was at a significant cost disadvantage in relation to energy and electricity costs with respect to its Great Britain competitors. This added a further burden to Northern Ireland manufacturers in addition to the costs associated with their remoteness from major British and European markets. Ulster Weavers said that it would welcome competition in the Northern Ireland electricity market with the opportunity to purchase power from Scotland, England or the Republic of Ireland.

Others

12.117. Dr Michael Pollitt of the Department of Applied Economics, University of Cambridge, submitted a recent paper¹ he had completed on the restructuring and privatization of the electricity supply industry in Northern Ireland. Dr Pollitt's paper concluded that the net gains from NIE's privatization were equivalent to a permanent cost reduction of 6 per cent a year, consumers paid 4 per cent higher prices, whilst the Government could expect to gain around £1.4 billion in asset sales and higher tax revenue.

12.118. Three small shareholders in NIE jointly complained that their point of view had been ignored, or at least under-represented, in the past. They emphasized that the recent dramatic fall in NIE's share price and the stock market's view of the company's prospects indicated the damaging effect of the DG's proposals, particularly in the areas of future returns on investment, customer service and employment. They argued that small shareholders in NIE were interested in the long-term stability of the company and would not be well served by the DG's harsh proposals. They therefore urged the MMC to moderate the proposals in the interests of all parties concerned in the process.

D J MORRIS (*Chairman*)

J BEATSON

A T CLOTHIER

¹*The Restructuring and Privatisation of the Electricity Supply Industry in Northern Ireland-Will it be Worth it?* Michael G Pollitt, DAE Working Papers Amalgamated, Series No 9701 (revised 28 February 1997).

D J JENKINS

J A M KENNERLEY

R J MUNSON

P A BOYS (*Secretary*)

26 March 1997