

8 The operational efficiency of NIE

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Introduction

8.1. This chapter examines NIE's operational efficiency. For T&D, this examination is on the basis of its cash operating expenditure (that is, operating costs other than depreciation). For the Supply Business, as the price control is based on a return on turnover rather than capital employed, the examination is in terms of total operating expenditure (including depreciation).

8.2. The chapter first considers operating expenditure during the current price review period, and then compares the DG's allowed operating expenditure for the next period-which was based largely on the report by his accountancy advisers, PKF-with NIE's projections. Finally, it considers the evidence presented to us on bench-marking NIE's operational efficiency against that of electricity companies in Great Britain.

NIE's historical operating expenditure

8.3. A summary of NIE's historical financial performance is given in Chapter 5. A detailed analysis of its operating expenditure is shown for the T&D Business in Table 8.1 and for the Supply Business in Table 8.2. These tables exclude regulated charges from other businesses that are passed through to customers. In the case of Supply, these are very substantial (£462.4 million in 1995/96) since they represent the cost of purchasing electricity from PPB and payments to T&D for Use of System.

TABLE 8.1 Operating expenditure of the T&D Business, 1992/93 to 1995/96

	<i>£ million</i>			
	<i>1992/93</i>	<i>1993/94</i>	<i>1994/95</i>	<i>1995/96</i>
Engineering and administrative staff*	17.5	17.0	16.0	15.0
Rates	4.0	4.0	4.3	4.5
R&M	16.4	14.9	14.4	15.0
Wayleaves	1.5	1.4	2.0	2.1
Profit centre charges	3.7	5.4	12.5	12.7
Business services	13.8	10.1	6.8	6.5
Corporate costs	3.9	4.2	4.0	4.8
Inter-business transfers	0.2	0.4	0.1	0.3
Other HCA costs	11.1	11.0	9.0	8.0
Interconnector adjustment	-	1.6	-	-
Exceptional items	<u>9.0</u>	<u>7.6</u>	<u>8.5</u>	<u>0.0</u>
HCA cash costs	81.1	77.6	77.6	68.9
MWCA	(0.9)	0.2	(1.6)	0.5
Cost of sales adjustment (CoSA)	<u>0.2</u>	<u>0.1</u>	<u>0.4</u>	<u>0.4</u>
CCA cash costs	80.4	77.9	76.4	69.8
Excluded services	<u>5.9</u>	<u>6.1</u>	<u>5.4</u>	<u>3.8</u>
Total	<u>86.3</u>	<u>84.0</u>	<u>81.8</u>	<u>73.6</u>

Source: NIE.

*Includes industrial staff engaged in meter reading.

TABLE 8.2 Operating expenditure of the Supply Business, 1992/93 to 1995/96

	<i>£ million</i>			
	<i>1992/93</i>	<i>1993/94</i>	<i>1994/95</i>	<i>1995/96</i>
Payroll (including directors)	7.6	6.6	5.4	5.4
Third party revenue collection	2.4	2.7	3.1	2.4
Bad debt provisions	1.4	1.4	1.8	1.6
Profit centre charges	2.2	2.3	2.8	2.6
Business services	1.5	1.7	1.3	1.4
Corporate costs	0.5	1.2	0.7	1.2
Inter-business transfers	4.0	4.5	4.4	3.7
Other costs	2.5	2.2	2.4	2.5
Exceptional items	<u>1.7</u>	<u>1.6</u>	<u>0.9</u>	<u>1.0</u>
HCA cash costs	23.8	24.2	22.8	22.0
MWCA	<u>3.9</u>	<u>(2.1)</u>	<u>5.7</u>	<u>(3.1)</u>
CCA cash costs	27.7	22.1	28.5	18.9
Depreciation	<u>0.1</u>	<u>0.1</u>	<u>0.0</u>	<u>0.0</u>
Total operating costs	<u>27.8</u>	<u>22.2</u>	<u>28.5</u>	<u>18.9</u>
Excluded services	<u>0.5</u>	<u>0.9</u>	<u>1.2</u>	<u>1.4</u>
Total	<u>28.3</u>	<u>23.1</u>	<u>29.7</u>	<u>20.3</u>

Source: NIE.

8.4. Table 8.1 shows that T&D costs have fallen steadily in nominal terms throughout the period. An important element in this has been the fall in payroll, which affected several of the constituent cost elements shown in the table, including R&M and business services as well as engineering and administrative staff. However, these reductions have been partly offset by increased profit centre charges, as T&D's demand for profit centre services has increased and more activities have been set up as profit centres (see paragraph 8.49), and by increased corporate costs. Table 8.2 shows that Supply HCA costs have reduced somewhat in

recent years, with a fall in payroll being partly offset by an increase in other costs, but that CCA adjustments (MWCA) have fluctuated.

8.5. The overall cost of electricity has, however, increased significantly, largely as a result of the PPB's increased cost of purchasing electricity, a cost which is passed on to the Supply Business.

CSC194 transfers

8.6. Prior to the privatization of the RECs, an Area Board working group had produced a set of principles known as CSC194 for the allocation of costs between separate businesses. Since privatization, this agreed basis has continued in use by the RECs. Historically, NIE has not employed the CSC194 cost allocation approach but for the purpose of its submission to the DG and to bring, as it thought, its allocations more into line with the RECs, it employed a transfer of costs from Supply to T&D which it believed was in accordance with CSC194 principles. For 1994/95, NIE assumed the following transfers:

	<i>£m</i>
Energy and marketing publicity	3.5
Processing and meter reading for billing and sales	2.1
Customer records (50 per cent of costs)	0.4
Administration of customer standard system	<u>0.1</u>
Total	<u>6.1</u>

8.7. These were incorporated in the appropriate cost headings. In its BEQ response, NIE included a further £0.2 million of costs relating to accommodation for energy marketing staff as a CSC194 transfer, but it told us that this should have been deducted from T&D revenues rather than added to its costs. We treated these costs as an excluded service for T&D (see paragraph 8.10) but an allowed cost for Supply.

8.8. As indicated in paragraph 8.74, the DG was not minded to allow such a large transfer, which he did not believe would be fair to potential competing suppliers, for the coming price control period. In its August 1996 corporate plan NIE reduced CSC194 transfers to £1.8 million in line with its understanding of the DG's position. For the sake of clarity, we have dealt with CSC194 transfer costs separately throughout this chapter. The tables show figures before CSC194 transfers and the total is then adjusted as appropriate. The historical tables above also show figures before any CSC194 transfers.

Excluded services

8.9. Under the terms of NIE's licence, certain of T&D's activities are excluded from the price control. These fall into two categories: costs of work for other NIE businesses (inter-business transfers) and chargeable work for external customers. In the presentation of its costs NIE treated external work as a separate item but its inter-business transfers were included under the appropriate headings. These included staff costs (the employment costs of personnel providing services to other business units); R&M (the repair and maintenance of prepayment metering devices by T&D staff for the benefit of the Supply Business); and other operating costs (the provision of accommodation by T&D for Supply Business personnel in regional offices).

8.10. In 1994/95 excluded services amounted to £5.4 million, of which £3.2 million was inter-business services and £2.2 million rechargeable items. The £3.2 million of inter-business transfer comprised:

	<i>£m</i>
Work on the Moyle and Tandragee interconnectors	1.6
Prepayment meter maintenance	0.2
Supply accommodation costs	0.2
Staff costs	<u>1.2</u>
Total	<u>3.2</u>

8.11. The allocation of costs between these headings caused some confusion between NIE and PKF (see paragraphs 8.60 to 8.64). For the sake of clarity we have presented all tables with excluded inter-business transfers deducted from the appropriate costs category.

NIE's projected operating expenditure

8.12. NIE originally submitted its projected operating expenditure to the DG in its response to the BEQ dated 2 October 1995. It was on the basis of this document and a series of meetings with NIE that PKF prepared its report.

8.13. At the time of the BEQ, however, NIE had just embarked on a major programme of change as described in Appendix 8.1. The key elements were a major reorganization; a business process re-engineering (BPR) initiative; an enabling agreement allowing the introduction of changes to pay systems and structures, flexible working/multi-skilling and flexible working hours; a corporate skills audit; and activity-based costing and management. At the time of the BEQ the scale of the likely benefits from this programme was unclear.

8.14. During the course of discussions with the DG over the proposed price control, NIE produced a corporate plan in August 1996-which it told us was specifically for the purpose of avoiding an MMC reference-taking into account the effects of the likely benefits from the change programme, which at this stage were becoming much clearer. The corporate plan, with subsequent amendments, was the main basis for NIE's submission to us although the DG did not have sight of it because NIE said that, in the circumstances, it saw no benefit in submitting it to him. In general, where we refer to NIE's plans or projections, we are referring to the corporate plan, although BEQ figures are also given for comparison where appropriate.

8.15. NIE's future projections of operating expenditure with, for comparison, the 1995/96 actuals and 1996/97 estimated out-turn, all at constant 1996/97 prices, are shown in Table 8.3 for T&D and Table 8.4 for Supply. We have adjusted NIE's figures to reflect the out-turn inflation rate in the 12 months to October 1996 (2.67 per cent against NIE's original assumption of 3.2 per cent) and excluded services have been deducted. The total for the five years of the price control is some £10 million lower than NIE's initial submission (see Table 9.28) as a result of the lower out-turn inflation rate and subsequent amendments to the corporate plan.

TABLE 8.3 NIE's actual and projected operating expenditure for T&D by category at 1996/97 prices

	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01	2001/02
							<i>£ million</i>
Engineering and administrative staff	15.4	[
Rates	4.6						
R&M	15.4						
Wayleaves	2.2						
Profit centre charges	13.0						
Business services	6.7						
Corporate costs	5.0						
Inter-business transfers	0.3						
Other HCA costs	8.2						
Exceptional items	<u>0.0</u>						
HCA cash costs	70.8						
MWCA	0.5						
CoSA	<u>0.4</u>						
CCA cash costs	71.7						
Add CSC194 transfers	<u>1.8</u>						
]						
Total	73.5	75.5	74.6	75.5	70.9	70.1	71.2

Figures omitted. See note on page iv.

Source: NIE, adjusted for out-turn inflation by MMC.

TABLE 8.4 NIE's actual and projected operating expenditure for Supply by category at 1996/97 prices

	<i>£ million</i>						
	<i>1995/96</i>	<i>1996/97</i>	<i>1997/98</i>	<i>1998/99</i>	<i>1999/2000</i>	<i>2000/01</i>	<i>2001/02</i>
Payroll (including directors)	5.6	[
Third party revenue collection	2.5						
Bad debt provisions	1.6						
Profit centre charges	2.9						
Business services	1.4						
Corporate costs	1.2						
Inter-business transfers	3.9						
Other costs	2.6						
Exceptional items	<u>1.0</u>						
HCA cash costs	22.6						
MWCA	(3.2)						
Gearing adjustment	<u>0.0</u>						
CCA cash costs	19.4						
Depreciation	<u>0.0</u>						
Total operating costs	19.4						
Less CSC194 transfers	<u>(1.8)</u>						
Total	17.6	21.1	19.7	19.6	19.2	19.3	19.2]
Costs allocated to < 1MW market	17.4	20.9	19.5	19.4	19.0	19.1	19.0

Source: NIE, adjusted for out-turn inflation by MMC.

8.16. The cash costs of T&D, before exceptional items, were expected by NIE to remain broadly constant during the period as increasing profit centre charges and R&M offset the falling payroll. For the Supply Business, costs were projected to fall slightly, as a result of lower corporate costs and inter-business transfers (principally the reduction of payments to the Retail Business for the collection of revenue) partly offset by higher costs of third party revenue collection.

The DG's allowed operating expenditure

T&D

8.17. In determining the amount which NIE would need to recover to meet an efficient level of operating costs, the DG engaged PKF to analyse NIE's actual operating costs in 1994/95 and its projections for the price control period as shown in the BEQ.

8.18. PKF derived what it believed to be an efficient cash operating cost for 1994/95 by carrying out a series of steps. First, it removed all CSC194 transfers (see paragraph 8.6). Secondly, it removed excluded services. Thirdly, it subtracted those costs which it regarded as not being allowable under the price control. Finally, it identified certain efficiency savings which it considered could be made from 1994/95 onwards and covering the new price control period. These changes are summarized in Table 8.5. It should be noted that NIE disagreed with PKF's categorization of CSC194 transfers and excluded costs. Further details of these matters and of the changes made to individual cost categories are described in greater detail below, beginning at paragraph 8.28.

TABLE 8.5 PKF adjustments to the 1994/95 cost base-T&D

£ million, 1994/95 prices

	<i>1994/95 actual</i>	<i>Deduction of CSC194 costs</i>	<i>Excluded services</i>	<i>Disallowed costs</i>	<i>Efficiency adjustments</i>	<i>Base costs for 1994/95</i>
Engineering and administrative staff	19.1	(1.9)	-	-	(0.2)	17.0
Rates	4.3	-	-	-	-	4.3
R&M	16.2	-	-	(3.3)	-	12.9
Wayleaves	2.0	-	-	(0.2)	-	1.8
Profit centre charges	15.0	(2.4)	-	-	(2.5)	10.1
Business services	7.2	(1.1)	-	-	-	6.1
Corporate costs	4.0	-	-	-	-	4.0
Inter-business transfers	0.4	-	-	-	-	0.4
Rechargeable items	2.2	-	(2.2)	-	-	0.0
Other HCA costs	10.0	(0.9)	(3.2)	(2.7)	-	3.2
Exceptional items*	8.5	-	-	(9.6)	-	(1.1)
HCA cash costs	89.0	(6.3)	(5.4)	(15.8)	(2.7)	58.8
MWCA	(1.6)	-	-	-	-	(1.6)
CoSA	0.4	-	-	-	-	0.4
CCA cash costs	87.8	(6.3)	(5.4)	(15.8)	(2.7)	57.6
CSC194 transfers	(6.3)	6.3	-	-	-	0.0
Total	81.5	0.0	(5.4)	(15.8)	(2.7)	57.6

Source: MMC, based on PKF report.

*The BEQ showed exceptional items of £9.6 million but NIE told us that £1.1 million represented T&D's share of corporate VSS costs and was not included in T&D's accounts. See also paragraph 8.68.

8.19. Having identified what it considered to be an efficient level of operating costs for 1994/95, PKF projected these costs forward to the end of the price control period in two different ways. For some cost categories, particularly those containing salary costs (R&M, profit centres and some elements of business services), the costs were projected forward at a rate of 1.5 per cent below the rate of inflation. However, for other costs, it adjusted the figures supplied by NIE year by year. PKF's projections are given in Table 8.6 at 1994/95 price levels. Further details of PKF's methodology are given below beginning at paragraph 8.28. The DG accepted PKF's recommendations with one exception: he allowed NIE an additional £1 million a year (in 1994/95 prices) on wayleaves. He then added the level of CSC194 transfers he believed appropriate and increased the allowed operating expenditure by 5.33 per cent in line with anticipated increases in the RPI between October 1994 and October 1996 (which, under the terms of the licence, are taken as the RPI level for 1994/95 and 1996/97 respectively). Details of the DG's allowed operating expenditure for T&D are shown in Table 8.7, except that we have adjusted all the figures in line with the actual increase in RPI from October 1994 to October 1996, which was 5.92 per cent.

TABLE 8.6 PKF's projection of NIE's efficient operating costs for T&D

£ million, 1994/95 prices

	<i>1994/95</i>	<i>1995/96</i>	<i>1996/97</i>	<i>1997/98</i>	<i>1998/99</i>	<i>1999/2000</i>	<i>2000/01</i>	<i>2001/02</i>
Engineering and administrative staff	17.0	15.7	15.3	14.8	14.4	14.1	13.7	13.3
Rates	4.3	4.2	4.0	3.9	3.7	3.6	3.5	3.4
R&M	12.9	12.8	12.5	12.4	12.2	12.0	11.8	11.6
Wayleaves	1.8	1.7	1.7	1.6	1.6	1.5	1.5	1.4
Profit centre charges	10.1	9.9	9.8	9.7	9.5	9.3	9.1	9.1
Business services	6.1	6.1	5.7	5.8	5.8	5.7	5.5	5.5
Corporate costs	4.0	2.7	2.9	3.2	3.4	3.4	3.2	3.3
Inter-business transfers	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Other HCA costs	3.2	5.4	5.1	5.0	5.1	4.9	5.5	4.6
Exceptional items	(1.1)	(0.5)	1.0	0.9	0.8	0.8	0.7	0.7
HCA cash costs	58.8	58.4	58.5	57.5	57.0	55.7	55.0	53.4
MWCA	(1.6)	0.0	0.0	0.0	0.0	0.0	0.2	0.2
CoSA	0.4	0.3	0.2	0.2	0.2	0.2	0.2	0.2
CCA cash costs	57.6	58.6	58.7	57.7	57.2	55.9	55.3	53.8

Source: MMC analysis based on PKF report.

TABLE 8.7 The DG's projection of NIE's efficient T&D operating costs

£ million, 1996/97 prices

	1997/98	1998/99	1999/2000	2000/01	2001/02
Engineering and administrative staff	15.7	15.2	14.9	14.5	14.1
Rates	4.1	4.0	3.8	3.7	3.6
R&M	13.1	12.9	12.7	12.5	12.3
Wayleaves	2.8	2.7	2.7	2.6	2.6
Profit centre costs	10.2	10.1	9.9	9.7	9.7
Business services	6.1	6.2	6.1	5.9	5.8
Corporate charges	3.3	3.6	3.6	3.4	3.5
Inter-business transfers	0.5	0.6	0.5	0.5	0.5
Other HCA costs	5.3	5.4	5.2	5.9	4.9
Exceptional items	<u>1.0</u>	<u>0.8</u>	<u>0.8</u>	<u>0.8</u>	<u>0.7</u>
HCA cash costs	62.0	61.4	60.1	59.3	57.7
MWCA	0.0	0.0	0.0	0.2	0.2
CoSA	<u>0.2</u>	<u>0.2</u>	<u>0.2</u>	<u>0.2</u>	<u>0.2</u>
CCA cash costs	62.2	61.6	60.3	59.7	58.0
Add CSC194 costs	<u>1.5</u>	<u>1.5</u>	<u>1.5</u>	<u>1.5</u>	<u>1.5</u>
DG's proposal for cash operating costs	63.7	63.1	61.8	61.1	59.5

Source: MMC, based on PKF report and DG's proposals.

8.20. One qualification concerned the impending revaluation of rateable values in Northern Ireland, which comes into effect on 1 April 1997. Since this was outside the control of NIE and there was no right of appeal, the DG agreed that an adjustment in the price control would be made once the effect was known.

Supply

8.21. The DG and PKF followed a similar procedure to that described above for T&D to arrive at the level of operating costs for the Supply Business which the DG concluded could properly be recovered under the price control in the under 1 MW market.

8.22. PKF sought to derive an efficient cash operating cost for 1994/95 in the same way as for T&D. That is, it added back CSC194 transfers, subtracted those costs which it regarded as not being allowable under the price control and identified certain efficiency savings that it felt could be made from the beginning of the new price control period. Unlike the case of T&D, however, the DG was not of the same opinion as PKF on certain questions of costs which would be disallowed. Table 8.8 shows the PKF adjustments to the base year, after modification by the DG. As for T&D, NIE did not agree with PKF's categorization of CSC194 transfers. Further details of individual categories are given commencing at paragraph 8.77.

TABLE 8.8 PKF's adjustments to the 1994/95 cost base (as amended by the DG)-Supply

£ million, 1994/95 prices

	<i>1994/95 actual</i>	<i>Addition of CSC194 transfers</i>	<i>Excluded services</i>	<i>Disallowed costs</i>	<i>Efficiency adjustments</i>	<i>Base costs for 1994/95</i>
Payroll (including directors)	3.5	1.9	-	-	(0.8)	4.6
Third party revenue collection	3.1	-	-	(0.8)	-	2.3
Bad debt provisions	1.8	-	-	(0.3)	-	1.5
Profit centre charges	0.3	2.4	-	-	(0.5)	2.2
Business services	0.7	1.1	-	-	-	1.8
Corporate costs	0.9	-	-	-	-	0.9
Inter-business transfers	5.0	-	(1.2)	(2.8)	-	1.0
Other costs	1.5	0.9	-	(0.3)	-	2.1
Exceptional items	<u>0.9</u>	<u>-</u>	<u>-</u>	<u>(0.9)</u>	<u>-</u>	<u>0.0</u>
HCA cash costs	17.7	6.3	(1.2)	(5.1)	(1.3)	16.4
MWCA	5.7	-	-	(4.7)	-	1.0
Gearing adjustment	<u>0.0</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>0.0</u>
CCA cash costs	23.4	6.3	(1.2)	(9.8)	(1.3)	17.4

Source: MMC analysis of PKF report, and the DG.

8.23. Having identified what it believed to be an efficient level of operating costs for 1994/95, PKF projected these costs forward to the end of the price control period, as for T&D, in two ways: some costs were projected forward from the base year, and some were derived by adjusting the figures supplied by NIE year by year. PKF's projections, taking into account the DG's amendments, are shown in Table 8.9 at 1994/95 levels. Further details of PKF's methodology are given below beginning at paragraph 8.77.

TABLE 8.9 PKF's projections of NIE's efficient operating costs for Supply, as amended by the DG

£ million, 1994/95 prices

	<i>1994/95</i>	<i>1995/96</i>	<i>1996/97</i>	<i>1997/98</i>	<i>1998/99</i>	<i>1999/2000</i>	<i>2000/01</i>	<i>2001/02</i>
Payroll (including directors)	4.6	4.8	4.9	4.8	4.8	4.7	4.6	4.6
Third party revenue collection	2.3	3.0	3.0	3.0	3.0	2.9	2.8	2.9
Bad debt provisions	1.5	1.5	1.4	1.4	1.3	1.3	1.3	1.3
Profit centre charges	2.2	2.2	2.1	2.1	2.0	2.0	2.0	1.9
Business services	1.8	1.8	1.9	1.8	1.7	1.8	1.7	1.7
Corporate costs	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Inter-business transfers	1.0	1.0	1.0	0.9	0.9	0.9	0.9	0.9
Other costs	2.1	2.1	2.2	2.3	2.3	2.3	2.4	2.5
Exceptional items	<u>0.0</u>	<u>(0.4)</u>	<u>(0.2)</u>	<u>0.1</u>	<u>0.1</u>	<u>0.1</u>	<u>0.1</u>	<u>0.0</u>
Total HCA costs	16.4	17.0	17.0	17.3	17.1	17.1	16.8	16.7
MWCA	1.0	0.9	0.8	0.9	1.0	0.9	1.0	0.9
Gearing adjustment	<u>0.0</u>	<u>0.0</u>	<u>0.2</u>	<u>0.1</u>	<u>0.2</u>	<u>0.2</u>	<u>0.2</u>	<u>0.2</u>
Total CCA costs	17.4	17.8	18.0	18.3	18.2	18.2	18.0	17.8

Source: MMC based on PKF report and DG's proposals.

8.24. The DG then increased the allowed operating expenditure in line with anticipated increases in the RPI between October 1994 and October 1996, made an allowance for depreciation and allocated a proportion of these costs to the below 1 MW market. Based on information supplied by NIE in respect of 1994/95, the DG took this proportion to be 99.33 per cent. Details of the DG's allowed operating expenditure for Supply are shown in Table 8.10, where we have again adjusted all the figures in line with the actual increase in RPI between October 1994 and October 1996 (5.92 per cent).

TABLE 8.10 The DG's projections of NIE's efficient Supply operating costs

	<i>£ million, 1996/97 prices</i>				
	<i>1997/98</i>	<i>1998/99</i>	<i>1999/2000</i>	<i>2000/01</i>	<i>2001/02*</i>
Payroll (including directors)	5.1	5.1	5.0	4.9	4.8
Third party revenue collection	3.2	3.2	3.3	3.2	3.1
Bad debt provisions	1.4	1.4	1.4	1.4	1.4
Profit centre charges	2.2	2.2	2.1	2.1	2.0
Business services	1.9	1.8	1.9	1.8	1.8
Corporate costs	1.0	0.9	0.9	0.9	0.9
Inter-business transfers	1.0	1.0	0.9	0.9	0.9
Other costs	2.4	2.4	2.4	2.5	2.7
Exceptional items	<u>0.1</u>	<u>0.1</u>	<u>0.1</u>	<u>0.1</u>	<u>0.0</u>
Total HCA costs	18.3	18.1	18.1	17.8	17.7
MWCA	1.0	1.0	1.0	1.0	1.0
Gearing adjustment	<u>0.1</u>	<u>0.2</u>	<u>0.2</u>	<u>0.2</u>	<u>0.2</u>
Total CCA costs	19.4	19.3	19.3	19.0	18.9
Depreciation	†	†	†	†	†
Total operating costs	19.4	19.3	19.3	19.0	18.9
Less CSC194 costs	<u>(1.4)</u>	<u>(1.4)</u>	<u>(1.4)</u>	<u>(1.4)</u>	<u>(1.4)</u>
Total	18.0	18.0	17.9	17.8	17.6
DG's proposal for total operating costs allocated to < 1MW market	17.9	17.8	17.7	17.5	17.4

Source: MMC, based on PKF report and DG's proposals.

*The DG's proposals, published in July 1996, assumed a four-year price control. The DG supplied us with information to extend the proposals for a further year.

†Less than 0.05.

Comparisons between NIE's and the DG's proposals for T&D

8.25. The DG's proposals are compared with NIE's corporate plan and the BEQ response in Table 8.11—all figures are in out-turn 1996/97 prices.

TABLE 8.11 Operating expenditure for the T&D Business: comparison of five-year totals

	<i>£ million, 1996/97 prices</i>			
	<i>NIE BEQ</i>	<i>NIE corporate plan</i>	<i>DG's proposals</i>	<i>Variance of DG's proposal v NIE's corporate plan</i>
Engineering and administrative staff	[
Rates				
R&M				
Wayleaves				
Profit centre charges				
Business services				
Corporate costs				
Inter-business transfers				
Other HCA costs				
Exceptional items				
HCA cash costs				
MWCA				
CoSA				
CCA cash costs				
Add CSC194 costs				
Total	469.2	362.3	309.2	(53.1)]

Figures omitted. See note on page iv.

Source: MMC analysis of information from NIE and the DG.

8.26. Overall, it can be seen that the difference between the DG and NIE's corporate plan amounted to £53 million over the five years. The major items of disagreement were in profit centre charges (almost half the total difference), R&M and other HCA costs. Some of the differences in individual categories resulted from the fact that the DG's figures assumed that, with the exception of rechargeable items, all excluded services were deducted from 'other HCA costs', whereas NIE gave us a detailed breakdown of the categories from which excluded services should be deducted. If these adjustments were made to the DG's figures, they would have reduced his projected staff costs by £2.4 million and R&M costs by £1 million while increasing HCA costs by £3.4 million.

8.27. The individual cost categories are now considered in turn.

Engineering and administrative staff costs

8.28. In the BEQ, staff costs were included in the categories of engineering and administrative staff costs, R&M and other costs. A significant proportion of staff costs (37 per cent in 1994/95) were capitalized.

8.29. For the base year, PKF found that sickness absence was high, at about 5 per cent. It considered there was scope for an immediate reduction to 3.5 per cent, saving 26 posts within T&D. On this basis, it reduced the costs of engineering and administrative staff by £0.2 million.

8.30. In rolling the base year forward, PKF did not deal directly with salary levels, but instead calculated the ratio of the total salary staff costs for engineering and administration (including industrial staff employed on meter reading) to the total number of all employees. It noted that this ratio (which is influenced by the changing proportion of engineering and administrative staff to the total, as well as changing wage rates) was rising at a rate of 1.5 per cent a year in real terms. It considered that this ratio was excessive and suggested that it should instead be projected to rise at a rate of 1.5 per cent below inflation.

8.31. In terms of staff numbers PKF deducted 1.5 per cent each year to reflect reduced sickness absence but made no further changes to projected manpower costs, effectively accepting NIE's BEQ manpower plan in terms of numbers (although the numbers PKF quoted as NIE's plan were not identical to those given by NIE). PKF also accepted NIE's proposed level of VSS payments but did not make an additional allowance for VSS payments for the reduction in staff numbers attributable to lower sickness absence since it believed that this could be achieved before the start of the new period. The DG told us during the course of the inquiry that he felt, with the benefit of additional information he had received since setting the price control, that these had been lenient targets and that greater reductions in manpower costs were possible. He said, first, that wage levels within NIE were high, which gave greater scope to reduce incremental drift than PKF had assumed, and secondly, that there was scope for further reductions in manpower numbers, as evidenced by the achievements of the RECs and, indeed, by NIE's corporate plan. He also now felt that allowing full VSS payments was generous, since it made no allowance for natural wastage nor for reducing the value of the severance package, as NIE was planning to do from 1 April 1997.

8.32. [

Details omitted. See note on page iv.

] However, NIE argued that it was not possible to look at manpower in isolation, since manpower reductions could only be achieved through additional IT expenditure and VSS payments.

TABLE 8.12 **Projected year-end staff numbers (FTE)-T&D including civil projects (before CSC194 transfers)**

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01	2001/02
BEQ (NIE)	1,729	1,588	[
PKF	1,668	1,560						
NIE corporate plan								
Variance, corporate plan to DG]

Figures omitted. See note on page iv.

Source: NIE, PKF.

8.33. However, as emerges from Table 8.11, NIE's projected engineering and administration staff costs were not substantially less than the DG's: if the different allocations of excluded cost are taken into account the gap was only £1.9 million over five years. [

Details omitted. See note on page iv.

] NIE told us that it saw the corporate plan projection as a very challenging target.

8.34. [

Details omitted. See note on page iv.

]

8.35. We carried out further analysis of NIE's manpower planning procedures and productivity, details of which are set out in Appendix 8.2. We noted that NIE had made considerable changes to its terms and conditions of service which would ultimately bring significant benefits. We confirmed PKF's view on the high historic sickness absence levels. We noted that NIE's overall remuneration package was significantly better than appropriate Northern Ireland comparators, largely due to better pensions and holidays. Salaries were higher than the REC average (despite the fact that Northern Ireland earnings were lower on average than Great Britain). However, recent pay settlements were not out of line with the RECs. [

Details omitted. See note on page iv.

]

8.36. In terms of staff numbers, we noted that the vast majority of those leaving NIE in 1994/95 took advantage of the VSS scheme, but 22 people left for reasons other than VSS. In 1995/96 the figure was 32 and for 1996/97 the figure to January 1997 was 27. Recruitment over the same period averaged 25 a year, but NIE told us that it was not at present recruiting. The sum allowed for VSS in the corporate plan for T&D provided for all leavers (taking account of a one-year lag between the provision and the payment). An assumption of continued natural wastage would have given a lower projection for VSS costs.

Rates

8.37. A series of negotiations has taken place between NIE and the rating authorities with a view to a reassessment of rateable values (the first since 1976) to take effect from April 1997. In the BEQ, NIE projected that rates would rise steeply. PKF said that it would expect NIE to take action to mitigate any increase in rates and eliminated the increase completely. However, the DG subsequently agreed to review the price control when the outcome of the rate revaluation was known.

8.38. NIE's corporate plan also eliminated any increases in rates pending completion of the review, except that rates were held constant in real terms at 1995/96 levels rather than constant in nominal terms at 1994/95 levels, resulting in the difference in Table 8.11.

Repairs and maintenance

8.39. R&M is one of the areas where PKF determined an appropriate base level of expenditure and then projected it forward without reference to the BEQ. The base level was determined by taking the actual R&M expenditure incurred in 1994/95 of £16.2 million and subtracting from it:

	<i>£m</i>
A deferred maintenance provision	1.0
A stock obsolescence provision	0.2
Non-recurring maintenance	0.5
Work on the Moyle & Tandragee interconnectors	1.6

This left £12.9 million as the base figure. PKF noted that actual R&M costs had fallen in the period up to 1994/95, with no suggestion by NIE, PKF said, of inadequate maintenance; that there appeared to be some double counting of costs; and that it had been informed that the cost of materials had fallen in a number of areas.

8.40. PKF also considered that the rate of maintenance might be unnecessarily high relative to the value of the network. It took an appropriate rate of maintenance to be 2 per cent of the asset base, a figure given to it by OFFER and based, OFFER had told it, on an MMC report.¹ However, it was not clear which valuation of the asset base was to be used. The DG took net modern equivalent asset value (MEAV) and deduced that NIE was inefficient. NIE took gross MEAV and argued that it was efficient. We were unable to establish from OFFER or OFREG which valuation was adopted when the bench-mark was used in the industry. Nor was OFREG readily able to provide us with comparative statistics on this measure for other PESs.

8.41. PKF also questioned whether NIE had the resources to carry out the programme as envisaged. However, it acknowledged that it had not reviewed the technical criteria put forward by NIE in support of an increase in R&M costs.

8.42. On the basis of the above, and taking account of reductions in real labour costs in a similar way to that described in paragraph 8.30, PKF suggested that R&M expenditure should be allowed to increase by 1.5 per cent below the rate of inflation throughout the period.

8.43. NIE agreed that work on the interconnectors should be disallowed, and also said that work on the installation of prepayment meters (£0.2 million) was an excluded service, but disagreed with the other exclusions. It argued that the base year chosen by PKF was atypical because of the need to divert resources to the capital expenditure programme and away from R&M (see Table 8.1 for the historic trend). In recognition of this, NIE had made the deferred maintenance provision of £1 million. It also argued that the level of faults and interruptions recorded in 1994/95 was lower than normal, resulting in lower repair costs than normal. NIE argued that an element of stock obsolescence was inevitable, and therefore an allowable cost. It told us that historic stock write-offs had been:

	<i>£</i>
1992/93	79,000
1993/94	511,000
1994/95	-
1995/96	146,000

giving an average over recent years of £184,000. It added that the non-recurring expenditure in 1994/95 had been on anti-climbing guards and would not be repeated, but there would be other non-recurring items in future years.

8.44. NIE told us that it had developed its figures from a bottom-up approach. There was a comprehensive maintenance plan covering virtually every item of plant in the system. Annual maintenance costs were

¹This was apparently a reference to the MMC report on *Yorkshire Electricity Board*, HMSO, Cmnd 9014, September 1983.

calculated for each type of plant and summed to give an overall maintenance budget. The total was then reduced by efficiency improvements of 3 per cent to allow for the capital plant replacement cycle.

8.45. Table 8.13 shows NIE's proposed R&M costs together with the estimated growth of the system in terms of circuit km, compared with the DG's proposed price control. In summary NIE projected that its R&M expenditure would grow in real terms in proportion to increases in circuit length, whereas the DG assumed that R&M expenditure would fall by 13 per cent in real terms over the period from a starting point which was 18 per cent lower.

TABLE 8.13 **Comparison of projected R&M costs**

	1997/98	1998/99	1999/2000	2000/01	2001/02	Total
Total R&M cost (£m, 1996/97 prices):						
NIE's proposal	[
DG's proposal						
Variance						
Projected circuit length (km)						<i>Figures omitted. See note on page iv.</i>
R&M cost (£/km):						
NIE's proposal						
DG's proposal]

Source: NIE and the PKF report.

8.46. NIE's views on the effect that cuts in R&M expenditure would have on system performance are set out in paragraph 6.26.

Wayleaves

8.47. PKF accepted that wayleaves were, in the short term, an uncontrollable cost but argued that the proposed increases did not appear to relate to the specific economic circumstances of NIE. For the base year PKF eliminated a provision of £0.5 million in respect of back payments but allowed £0.3 million for future settlements. Thereafter it eliminated the increase in wayleaves in an analogous manner to rates. The DG disagreed with PKF and allowed an additional £1 million in each year, although this still did not go as far as the company had indicated it needed.

8.48. NIE told us that rates of payment were negotiated nationally between the Estates and Wayleaves Committee of the electricity industry and the National Farmers' Union/Country Landowners Association and that recent agreements meant that wayleaves would continue to rise. NIE said that abandoning national procedures would create serious problems, without necessarily reducing wayleave costs.

Profit centre charges

8.49. Profit centres cover activities which NIE believed would be better run separately from the core business; this separation would lead, it thought, to greater commercial awareness and greater accountability for costs and quality of service. The largest, the Information Systems Department (ISD), had been a profit centre since before privatization, as had telecommunications and the training centre. Transport and the Culcavy central warehouse profit centre had been set up more recently. Civil engineering was a profit centre within T&D, with costs and revenue netted off for accounting purposes.

8.50. Unlike T&D charges, profit centre charges are unregulated but they represent a significant proportion of T&D's costs. They were, in aggregate, the largest single item of difference between the DG's and NIE's proposals. Details of projected profit centre charges and the differences between the parties are given in Table 8.14.

TABLE 8.14 Profit centre charges

£ million, 1996/97 prices

	1997/98	1998/99	1999/2000	2000/01	2001/02	Total
<i>NIE projection</i>						
ISD	[
Transport						
Training						
Telecommunications						
Warehousing						
Civil						
Total]
DG's proposal	<u>10.2</u>	<u>10.1</u>	<u>9.9</u>	<u>9.7</u>	<u>9.7</u>	<u>49.5</u>
Variance	[]

Figures omitted. See note on page iv.

Figures omitted. See note on page iv.

Source: NIE and the PKF report.

8.51. PKF argued that contracts with profit centres had not been market tested, that historical and proposed increases in profit centre charges were excessive and that charges included a commercial return which would not arise if an internal resource were used. Based on a Government report¹ and NIE's overall operating margin, PKF concluded that profit centre charges could be reduced by 20 per cent immediately and by 1.5 per cent in real terms a year thereafter.

8.52. NIE said that the increases in expenditure on ISD and telecommunications were necessary to implement the BPR programme and achieve the planned productivity gains and improvement in network service and customer performance. It said that the increases in charges were in large part due to the depreciation of new assets. On efficiency, NIE argued that reliance on comparison with Government departments was inappropriate since NIE had already made dramatic gains in productivity since privatization and could not be expected to make such large savings again in the second regulatory period. NIE also said that the costs of civil engineering had been overlooked by PKF (the DG stated that this was not the case). It said that the DG's proposal would result in a negative return on the assets employed in profit centres and would inhibit further investment.

8.53. NIE told us that the training centre had been market tested in that it supplied training courses and facilities to third parties at the same prices as charged to internal businesses; and that transport, ISD and telecommunications charges had been bench-marked against external providers and found to compare favourably.

Business services

8.54. Business services relate to certain overheads required by all NIE's separate businesses and which are, therefore, provided centrally in order to achieve economies of scale. PKF examined in detail only the largest activities, relating to employment and purchasing, which amounted to about 60 per cent of the total.

8.55. PKF took the view that the costs of the Human Resources department could be reduced proportionately to employee numbers and that both employment and purchasing costs should be restricted to increases in staff costs of 1.5 per cent below the rate of inflation (see paragraph 8.30). PKF also excluded additional operating costs during the period relating to pre-vocational training and child-care allowances.

8.56. NIE said that the additional cost savings assumed in its corporate plan were greater than those envisaged by PKF, although consistency required that account be taken of the additional VSS costs.

¹*Government Opportunities*, June 1995. Published for Her Majesty's Government by Business Information Publications Ltd.

Corporate costs

8.57. Corporate costs represent those costs incurred by NIE in the corporate control and strategic management of the business. They include the costs of the Board and Company Secretary; group financial control; treasury and taxation; and shareholder services.

8.58. PKF disallowed the expenditure on shareholder services and related costs (such as provision for extraordinary general meetings and shareholder circulars) as not being appropriately borne by customers. It also disallowed expenditure on a proposed environmental management system and on external environmental and safety audits.

8.59. As with business services, NIE's corporate plan assumed greater savings in corporate costs than assumed by PKF. However, NIE noted that some of the costs disallowed by PKF related to NIE's position as a plc and would normally be passed on to customers, even in a competitive market.

Inter-business transfers and excluded services

8.60. There were considerable differences between PKF and NIE in the use of the terms inter-business transfers, rechargeable items and excluded services.

8.61. PKF did not give a detailed breakdown of these items and told us that this was because it had not been provided with evidence to support the substantial projected increase in costs. Accordingly, having deducted the CSC194 transfers, PKF restricted increases in inter-business transfers from the base year to 1.5 per cent below the rate of inflation (although an arithmetic error meant that NIE was allowed £1 million more than intended for 2000/01).

8.62. PKF also disallowed all costs associated with services not covered by the price control (excluded services), a total of £5.4 million in 1994/95, but did not give a breakdown of which services were under this heading.

8.63. NIE said that it had used the definition of excluded services proposed by the DG but believed this had led to confusion between internal recharges (inter-business transfers, principally from the Retail Business), which were covered by CSC194 transfers, and excluded services. The latter included both external recharges (costs incurred in providing services to third parties) and non-regulated work for other NIE businesses. NIE told us that the only inter-business transfer which was added subsequent to its submission to the DG related to payments to the Interconnector Business to allow the latter to recover its investment in the ESB standby link. We were told that negotiations were taking place between the parties on this matter.

8.64. NIE argued that, in the base year, all the excluded service costs were already accounted for elsewhere, and that PKF had therefore deducted certain of the items twice (work on the interconnectors, prepayment meter maintenance and accommodation costs). Our analysis suggested that NIE was correct on this matter. However, PKF did not simply roll the base year figures forward for most of these categories, so the double counting had not affected the DG's proposals. When NIE had had the opportunity to examine the PKF report in detail (which it was given in December 1996, at our request) it largely concurred with this view.

Other operating expenditure

8.65. Other operating expenditure includes such items as rent, insurance, transport, electricity for own consumption, bad debt provisions and miscellaneous items. The last amounted to just over half the total in 1994/95.

8.66. PKF, in determining the base year adjustments, subtracted from other HCA costs £2.5 million for provisions relating to self-insurance and other charges on the grounds that they should be self-financing.

8.67. In projecting forward other HCA costs, PKF adjusted the BEQ figures by disallowing several items of expenditure. It disallowed expenditure on the implementation and maintenance of a risk-assessment programme and on a safe working environment programme because the actual cost and timing of the projects was subject to some uncertainty, particularly given that management was currently ensuring that there was a safe environment. It suggested that research and development expenditure amounting to £1 million over the five-year control period should be eliminated on the grounds that it should be matched to income or efficiency improvements when the projects come to fruition. It also disallowed expenditure on energy efficiency; meter recertification costs; compliance with the Construction (Design and Management) Regulations 1994/95 and the Streetworks (NI) Order 1995. PKF also took into account annual savings proposed by NIE on insurance (£0.5 million) and non-recurring interconnector work (£0.5 million).

8.68. NIE said that the total amount of provisions eliminated by PKF was £12.1 million, comprising, so NIE thought, £9.6 million of VSS payments and £2.5 million of insurance provisions. However, NIE said that the true figure for VSS payments was £8.5 million, the difference of £1.1 million representing T&D's share of corporate VSS provisions which were in the BEQ but not included in T&D's accounts (see Table 8.5). In effect, therefore, PKF had deducted £3.6 million of other provisions comprising, NIE said, an insurance charge of £1.8 million, the deferred maintenance provision of £1 million referred to in paragraph 8.43, the wayleaves provision of £0.5 million referred to in paragraph 8.47 and £0.3 million other provisions. NIE argued strongly that the exclusion of all these provisions from the base year was mistaken.

8.69. Specifically, NIE argued that disallowing insurance costs in the base year was incorrect. If it did not self-insure, the costs would simply appear as higher premiums paid for external insurance. It provided information showing that, over the period 1992 to 1995, applications of provisions had been:

	<i>£m</i>
1992	1.3
1993	1.0
1994	1.1
1995	1.0

giving an average annual application of £1.1 million. Provisions rose by £1.1 million over the same period.

8.70. The deferred maintenance and wayleaves provisions, NIE argued, had been subtracted under the appropriate cost headings and therefore had been double counted. Our analysis suggested that NIE was correct in asserting that PKF had deducted these costs twice. However, as PKF did not roll forward the category of other HCA costs from the base year, the double counting had no impact on the proposed price control under this heading. Once it had seen the full PKF report, NIE concurred with these views.

8.71. NIE also argued that, even with efficient debt management, it could not be expected to be immune from the risk of customers defaulting on payments for connection charges, or charges arising from alterations or damage to NIE equipment, and that the bad debt provision should therefore be allowed.

8.72. As far as the future projections were concerned, NIE argued that all the items disallowed by PKF were essential expenditure which should be borne by customers. NIE told us that it had a statutory obligation to implement and maintain an effective risk-assessment programme together with a safe working environment. NIE estimated the cost of this as £1.5 million over the price control period.

8.73. NIE considered that, since research and development expenditure covered specific projects which could be expected to bring benefits to customers or the environment, but not to reduce costs or generate increased income within the price control period, the expenditure should be allowed.

CSC194 transfers

8.74. The DG, in his proposed price control, was not prepared to allow the full CSC194 transfers identified by NIE in its BEQ response. Instead, he was prepared to allow the transfer of approximately half of computer recharges associated with processing meter readings, annual subscription costs to the Electricity Association and half of customer records costs. However, in allowing these transfers he applied the PKF proposed reduction of 20 per cent to the CSC194 computer recharge and then restricted increases in these charges to 1.5 per cent below the rate of inflation. The CSC194 transfers included in the proposed Supply price control did not match exactly those included for T&D.

8.75. NIE reluctantly agreed to the DG's proposals in respect of which categories of costs to transfer but disagreed with the PKF efficiency gains.

Comparisons between NIE's and the DG's proposals for Supply

8.76. The difference between the DG's proposals and NIE's corporate plan and BEQ response are shown in Table 8.15. This shows that the main differences between the parties related to the profit centre charges and inter-business transfers. Indeed, these two items amounted to more than the total difference between the two parties.

TABLE 8.15 **Operating expenditure for the Supply Business: comparison of five-year totals**

£ million, 1996/97 prices

	<i>NIE BEQ</i>	<i>NIE corporate plan</i>	<i>DG's proposals</i>	<i>Variance of DG's proposal v NIE's corporate plan</i>
Payroll (including directors)	[
Third party revenue collection				
Bad debt provisions				
Profit centre charges				
Business services				
Corporate costs				
Inter-business transfers				
Other costs				
Exceptional items				
HCA cash costs				
MWCA				
Gearing adjustment				
CCA cash costs				
Depreciation				
Total operating costs				
Less CSC194 costs				
Total	95.5	96.9	88.9	(8.0)
Costs allocated to < 1MW market	94.5	95.9	88.3	(7.6)

Source: MMC analysis.

Payroll

8.77. PKF took a rather stricter view on manpower costs for Supply than it did for T&D. In addition to reducing sickness absence to 3.5 per cent (in this case, from 6.8 per cent) and restricting wage rate increases to [*] per cent below the rate of inflation, PKF assumed savings of an additional [*] staff as a result of rationalization and an additional [*] staff in the base year declining to zero over the period of the price control as a result of bringing forward planned improvements in productivity.

*Figures omitted. See note on page iv.

8.78. NIE's corporate plan goes considerably further than the BEQ, reaching a total lower than PKF but at a phased rate of reduction, as shown in Table 8.16. However, NIE regarded PKF's assumptions on reductions in average salaries as unrealistic. It also argued that the greater reduction in manpower numbers would require greater VSS payments.

TABLE 8.16 **Projected year-end staff numbers-Supply (before CSC194 transfers)**

	1995	1996	1997	1998	1999	2000	2001	2002
BEQ	232	222	[
DG	181	194						
NIE corporate plan								
Variance]

*Figures omitted.
See note on page iv.*

Source: PKF, NIE.

Third party revenue collection

8.79. Third party costs of revenue collection comprise five main elements:

- a Stamp Saver scheme (phased out during autumn 1994) under which customers purchased saving stamps at post offices and used them to pay their electricity bills;
- an EasySaver scheme, introduced to replace the Stamp Saver scheme, under which retailers (primarily the Post Office) collect payments on behalf of NIE;
- Powercards, which are effectively prepayment cards;
- the costs of a contract with Securicor to collect cash from retail shops; and
- bank charges incurred by NIE on direct debits.

8.80. In its report, PKF treated third party collection costs related to Powercards as an excluded service and disallowed them. It also, in the base year, disallowed the difference between the costs of the Stamp Saver scheme and the introduction of the Easy Saver scheme (a net disallowance of £0.8 million). For the remaining items PKF assumed that the number of people and hence level of payments would not increase from the 1994/95 level and that the cost per payment to the Post Office would be held constant, with no pass-through for inflation.

8.81. However, the DG took a different view and included Powercard collection costs within Supply's operating cost base. He also allowed for projected increases in the number of customers and payments across all budget payment schemes. In the final proposals, therefore, there was little difference between the DG's figure and that proposed by NIE in its corporate plan.

Bad debts

8.82. In establishing the base year figure, PKF reduced the level of bad debt provision raised at 31 March 1995 by £0.3 million, an increase which it did not believe was required in future years. However, thereafter it did not amend NIE's bad debt provisions, noting that NIE's average level of bad debt write-offs was 0.33 per cent, compared with 0.56 per cent for Great Britain electricity companies.

Profit centre charges

8.83. PKF treated profit centre charges to the Supply Business in the same way as for T&D (see paragraph 8.51).

8.84. NIE argued against the restriction on profit centre charges, again for similar reasons to those applying to T&D (see paragraphs 8.52 and 8.53).

Business services and corporate costs

8.85. PKF argued that the costs of business services and corporate costs for Supply were increasing at a higher rate than for T&D. Consequently, PKF restricted the increases in these charges to 1.5 per cent below the rate of inflation.

8.86. NIE told us that PKF had been confused as to where excluded services lay and had effectively allowed NIE greater revenue than required. In addition the NIE corporate plan showed further reductions in costs from the BEQ.

Inter-business transfers

8.87. Inter-business transfers covered two main items of cost. First, there were charges from T&D for the installation of Powercard meters (a charge which both parties agreed was excluded); and secondly, a charge from the Retail Business for the provision of customer services and cash collection. PKF discussed the principle of whether the Retail charges should be borne by Supply at all, on the grounds that payment of bills brought customers into the shops and hence acted as a marketing activity for Retail. However, having given the matter further consideration, PKF did not make any adjustment other than to deduct the excluded services mentioned above.

8.88. The DG, however, took a different line and in his final proposals reduced the rental charge from the Retail Business for cash collection and customer service to a level he regarded as being an efficient allowance of about £1 million a year against the BEQ figure of about £2.4 million.

8.89. In its corporate plan NIE recognized that more cost-effective methods of receiving bill payments would need to be developed. It envisaged, however, that the level of Retail charges assumed by the DG would be reached over three years to allow a gradual changeover to the new arrangements for dealing with customers.

Other operating costs

8.90. Other operating costs included postage, the licence fee, travel and subsistence, community care and other miscellaneous items.

8.91. PKF disallowed expenditure relating to a WETS on the grounds that its introduction was uncertain. It also disallowed increases in telephone costs to reflect the increased use of '0345' numbers and certain sundry items such as staff discounts. PKF originally disallowed depreciation but the DG added back £20,000 a year in his final proposals.

8.92. NIE argued that increased telephone costs for remote customer contact would be inevitable if it were to be in a position to reduce its Retail charges. NIE also noted that expenditure on WETS (projected to rise to £0.3 million a year) was not allowed. It said that the allowable cost base would need to be adjusted if the costs arising from any new trading arrangements differed significantly from those assumed in the price control for the Supply Business.

Monetary working capital adjustment and gearing

8.93. PKF discussed both these items in its report and decided to allow them in full. However, NIE's projected MWCA and gearing costs were higher in the corporate plan than they had been in the BEQ.

Comparators and bench-marking

8.94. Bench-marking is possible for a wide variety of NIE's activities-in particular for quality of service, capital expenditure and operating expenditure. The choice of which organizations might be considered as appropriate comparators depends upon which of these aspects is being considered: organizations which are of no value as a comparator in one area may be a very valuable comparator in another. As far as NIE's T&D and Supply Businesses are concerned, the most obvious comparators are the transmission, distribution and supply companies elsewhere in the UK. These are the 12 RECs in England and Wales, the two Scottish integrated electricity companies and NGG. It may also be possible to consider overseas electricity companies, although no evidence of this kind was presented to us by any party during the course of the inquiry.

8.95. How useful another organization is for bench-marking depends on how similar its activities are, in the field under consideration, to those of the company in question.

8.96. In the case of NIE, there are significant differences between the structure of the privatized electricity supply industry in Northern Ireland and the structures in England and Wales and in Scotland. In particular, the RECs' only regulated activities are distribution and supply, while NIE is also responsible for transmission and the Scottish companies are fully integrated. There are also differences in the contractual and trading arrangements as between Northern Ireland and Great Britain.

8.97. There is no pool for the wholesale trading of electricity in Northern Ireland and NIE must purchase its electricity under long-term contracts from generators-principally the four power stations which were privatized separately. A further complication is that, in the last two years, the majority of the RECs have been taken over by other companies, including water companies, US utilities and, in the case of Manweb, an integrated electricity company (ScottishPower). This raises the question as to whether these integrated companies can achieve synergies not currently available to NIE, which might affect comparability.

8.98. Whilst these differences in structure make comparisons more difficult, there is no reason in principle why the various aspects of NIE's activities cannot be meaningfully compared with similar activities in the rest of the UK provided that care is taken to ensure that all costs are correctly allocated to the proper activities and appropriate econometric or other techniques are used.

8.99. There are also differences between the operating environments of NIE and its counterparts in Great Britain. As far as NIE's Distribution and Supply Businesses are concerned it serves a much smaller population, with a much lower population density (and hence with greater line length per customer) and with lower per capita consumption figures than the Great Britain companies. Both the DG and NIE submitted evidence on the extent to which differences in operating environment might affect comparisons between NIE and the Great Britain companies. This is summarized in Appendix 8.3.

8.100. Clearly, differences in operating conditions will affect operating expenditure, but it may be possible to develop econometric or other models which allow for differences in operating conditions and enable underlying differences in efficiency to be identified. The DG believed it feasible and valuable to bench-mark NIE's activities against other companies, and PKF commissioned LE to carry out a bench-marking analysis of the efficiency of NIE as a cross-check on the validity of the bottom-up analysis carried out by PKF. This work is summarized in Appendix 8.4. While he did not base his proposed price controls on LE's report, the DG said that LE's analysis had shown that econometric and other techniques could be used to make comparisons across companies (that is, any differences in operating environment which could not be incorporated in the econometric or mathematical models were not sufficient to have a statistically significant impact on predicted costs). He also said that the result of LE's analysis supported PKF's conclusions on the level of efficiency gains that were available to NIE.

8.101. NIE on the other hand generally regarded such comparisons as unhelpful because of the differences in operating environment but had nevertheless commissioned NERA to compare its operational efficiency with that of Great Britain companies. This analysis is also summarized in Appendix 8.4.

8.102. We noted that, despite having available the same range of econometric and mathematical techniques and despite using virtually identical data, LE and NERA reached very different conclusions on NIE's relative efficiency. There were several differences in the detail of their analyses which might have accounted for this. First, in terms of approach, LE found econometric analysis unsatisfactory and preferred to use data envelopment analysis¹ (DEA). They developed both short-run and long-run models. NERA relied on finding an intuitively plausible econometric model and only using DEA as a check on the econometric analysis. Secondly, LE assumed constant returns to scale. NERA preferred variable returns to scale. NERA's freely estimated model indicated very large economies of scale but its preferred model constrained economies of scale (on the basis of other work it had done) to more modest, but still significant, levels. Thirdly, LE and NERA differed on which were the most significant factors affecting costs. For example, LE's preferred model used number of customers, total length of circuit and aggregate transformer capacity. NERA argued that GWh distributed, length of overhead circuit and number of transformers were more appropriate variables.

¹DEA is a technique for comparing the overall productivity of companies. It uses linear programming to establish an efficiency frontier which is defined by the most efficient producers in the sample. Companies that form the efficiency frontier use the minimum quantity of inputs to produce the same quantity of outputs as other, similar firms. The relative efficiency of each firm is then determined by its position in relation to the efficiency frontier. A disadvantage of the technique is that companies which are dissimilar, that is use a different combination of inputs, may be located on the frontier as there are no other similar companies with which they can be compared.