

## NORTHERN IRELAND ELECTRICITY RP5 PRICE CONTROL REFERENCE

### UR PAPER ON CAPEX

#### Introduction

1. This paper introduces and summarises the issues arising on this RP5 price control reference in relation to NIE T&D's capital expenditure ('capex'). First, it sets out the factual background to the capex requests made by NIE T&D for this price control period, and the overall approach that we consider appropriate to take in light of that factual background. Second, it sets out in detail the structure of the capex mechanism that we proposed in the FD and recommend to the Commission in this inquiry. Third, it explains the position that we take in respect of quantum of capex within that structure. Finally, this paper concludes with some observations about the future of capex regulation in Northern Ireland.

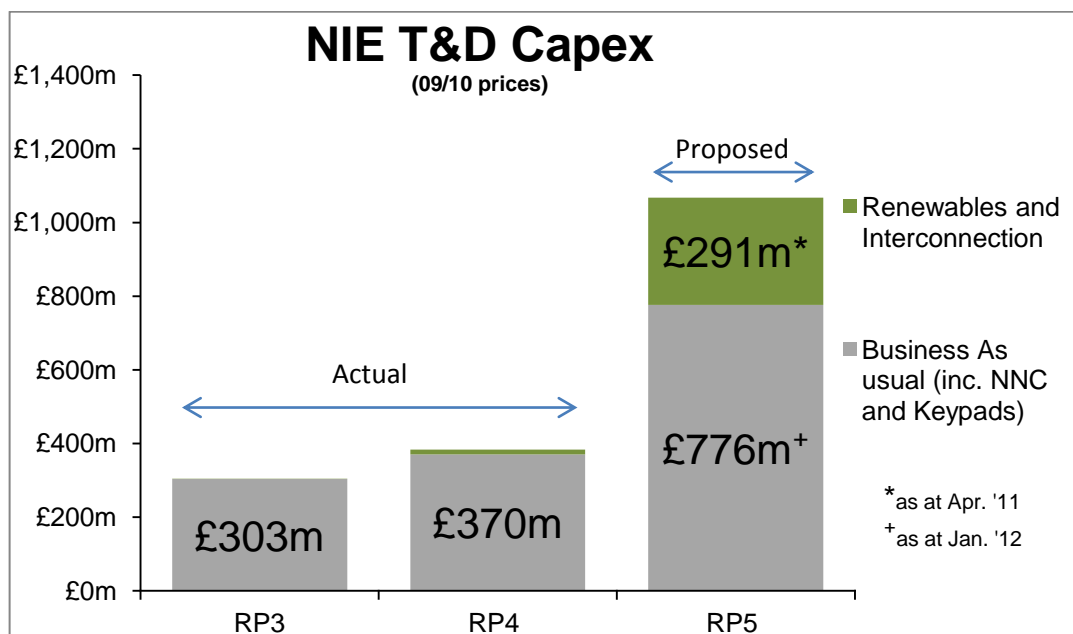
#### Factual background and general approach

2. The capex issues raised in this inquiry are by any measure extraordinary. NIE T&D proposed that customers in Northern Ireland should pay for a capex programme the scale of which has never been seen before. As shown in the figure below, it has requested more than twice the amount of "business as usual" capex that it accepted in RP4 (2007 – 2012)<sup>1</sup>, which in turn was substantially more than what was actually invested during RP3 (2002 – 2007).

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<sup>1</sup> NIE T&D has predicted it will spend the full allowance within their submission

**Chart 1: NIE T&D Actual Capex RP3, RP4 and proposed Capex for RP5**



3. The sheer scale of the capex programme proposed by NIE T&D demands that particularly close attention should be paid to the capex issues in this inquiry. The factual background to those requests gives yet further cause for concern:
- As NIE T&D itself noted, most of the current Northern Ireland transmission and distribution network was originally built during the 1950s, 1960s and 1970s<sup>2</sup>.
  - Contrary to NIE T&D's suggestion, however, the fact that parts of the network are more than 40 years old does not imply that they need replacing. In that regard, we note that Ofgem's DPCR5 asset replacement modelling has shown that electricity network assets have a useful life that extends well beyond that age.<sup>3</sup>
  - The suggestion that large parts of the network need to be replaced because of their old age is also undermined by the performance of the network in recent times. In particular, customer minutes lost (CML) levels have been substantially below NIE T&D's targets throughout the past decade. Moreover, even those

<sup>2</sup> NIE T&D, *Transmission and Distribution Price Control for RP5 BPQ: T&D Network Capital Investment Requirements for RP5*, p3.- Documents can be provided if requested.

<sup>3</sup> [Ofgem DPCR5](#): Electricity Distribution Price Control Review Methodology and Initial Results Paper – Appendix 7 Asset Replacement Modelling Implied Lives.

modest levels of CML have been caused in large part by planned work on the network rather than by faults.<sup>4</sup>

- (d) In addition to this NIE T&D has not made any payments to customers required under the Guaranteed Standards Regulations relating to poor network performance.
- (e) It is also important to take account of recent trends in demand for electricity in Northern Ireland. In particular, as a result of the recession, aggregate demand has fallen since 2008. Using Annual Demand (Sent-Out generation) from the SONI Website peak demand has fallen by 4%<sup>5</sup>. In the All-Island Generation Capacity Statement the average cold spell temperature correction peak demand in 2011/12 was 2% lower than it was in 2007/08<sup>6</sup>. Although there are certainly *parts* of the network that come under load strain at times, it is not the case that there has been an across the board increase in demand that might call for an across the board capacity upgrade. Moreover, it must be borne in mind that a fall in overall demand implies an increase in price per KW/h for any given level of aggregate revenue required by NIE T&D. That would compound the price impact of NIE T&D's capex proposals.
4. Those aspects of the factual background cast doubt on NIE T&D's claim that a massive increase in business as usual and load related capital investment is required during this price control period.
5. Of even greater concern, however, is the lack of transparency and accountability in NIE T&D's capex submission and accounting practices. The Commission will note that we have wider concerns about NIE T&D's transparency and accountability as well (in particular as to NIE T&D's approach to capitalisation practices, which is addressed in a separate paper). For present purposes, however, what is relevant is that NIE T&D:
- (a) Does not appear to keep adequate records of which assets it replaces in respect of fault repair, despite claiming this as "betterment" of the network.<sup>7</sup> That has

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<sup>4</sup> [DD](#) p 57, Figure 9.1.

<sup>5</sup> <http://www.soni.ltd.uk/InformationCentre/Publications/> (search term = demand)

<sup>6</sup> See [http://www.eirgrid.com/media/All-Island\\_GCS\\_2013-2022.pdf](http://www.eirgrid.com/media/All-Island_GCS_2013-2022.pdf), p 17, which shows demand on an average cold spell temperature correction basis.

<sup>7</sup> [Ofgem RIGS](#) define the majority of fault repair costs as opex and therefore do not require the GB DNOs to update their asset registers with the detail of changes made, however NIE T&D

several undesirable implications for regulation and customers. First, it makes it impossible for us (or, now, the Commission) to evaluate the efficiency of that expenditure. Second, it means that NIE T&D is unable to state the true age or condition of its assets. Given that over the most recent price control 10% of NIE T&D's capex was spent on post fault repair it must be the case that it has either extended the life of or replaced a substantial proportion of its network. But because it does not keep adequate records of the work that it does, this "betterment" is not reflected in its request for RP5 Capex.

- (b) Has asked customers to pay substantial sums of money on capex projects without a robust, evidence based demonstration of necessity. As explained in more detail below and in more detailed documents that we are in the process of finalising, NIE T&D failed to provide basic evidence to support a substantial number of the capex projects that it proposed for this price control period. To give just one example, NIE T&D requested funding for network reinforcement in the Granville area. Normally a project of this type would be justified based on the total power passing through equipment at any one time. In this area the domestic demand for electricity is highest at times when the industrial demands are lower than their peak. NIE T&D attempted to justify this project based on the sum of the domestic and industrial peak demands, even though they do not happen at the same time. We asked NIE T&D for a load duration curve to demonstrate the actual combined loading on the equipment. NIE T&D failed to provide that information and could not demonstrate the extent of any overload.
- (c) Has not updated its planning standards since privatisation. Those standards set out the criteria against which NIE T&D decides whether to replace or upgrade parts of the network. Whereas the standards in GB have been updated several times since privatisation to reflect the changing technology and increase in embedded generation, NIE T&D continues to use its out of date standards. Accordingly, even to the extent that NIE T&D does have an adequate evidence base to consider whether work needs to be done, it does not have up to date criteria against which to analyse that evidence. By way of illustration, NIE T&D requested funding for reinforcement work in the Limavady area on the basis that it was justified under its current planning standards. However, those standards

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claims that this work extends the life of its network and therefore should be reflected in the formal records to avoid double counting in its asset management plans. The record keeping should be consistent with the cost categorisation.

do not take into account the contribution made by small scale generation embedded within the supply zone. That omission results in significantly higher forecasted flows into the area, and would therefore result in investment that would not be considered necessary under more appropriate standards, such as those which operate in GB.

6. Notwithstanding the matters set out above, it is obvious that some capex will be required during RP5. It is also clear that there is a substantial degree of uncertainty about exactly how much capex will be required. This places the Commission in a very difficult position. On the one hand, essential capital expenditure must take place, and customers should be required pay for it. On the other hand, the Commission has to find a way to protect customers from inefficient investment, and to ensure that customers only pay for capital investments that are actually made.
7. When considering how to respond to that difficult position, it is important to bear in mind what is to be expected of a modern and competent utility in this field. We consider that excellence in asset management is the critical enabler for success in a any network utility enterprise like NIE T&D. Asset management is what ensures that the enterprise can make the right interventions on the right assets at the right time and do so in the right way so as to minimise disruption to the performance of the network and to secure that performance over time.
8. As the Commission will no doubt be aware, in other sectors, network utilities have developed comprehensive asset management processes that produce robust risk based forecasts of the optimum interventions (both opex and capex) to secure the continuing serviceability of their networks and to deal with changing demands. Those processes should include robust and continuous benchmarking (both metric and process) so that robust forecasts can be made of the likely costs. It is clear to us, however, as explained above, that NIE T&D's approach to its network falls well short of this standard of excellence in asset management.
9. In the FD, we proposed to deal with that shortfall and the difficult trade-off set out above by establishing a three fund structured approach to necessary capital expenditure, coupled with a requirement that NIE T&D should address its asset management process shortfall well before decisions are needed for the RP6 period. The three fund structure and our proposal for increased reporting and accountability is explained in detail below.

10. Although we continue to believe that the approach proposed in our FD is a reasonable solution to what is a very difficult problem, we would also welcome any other approaches that the Commission considers would better incentivise NIE T&D to improve its asset management performance. One option in particular that we think is worth investigating is whether NIE T&D's capex for RP5 should be capped at the levels of actual expenditure in RP4 while maintaining the obligation on NIE T&D to maintain the serviceability of its network. The advantage of that approach would be that it would make clear to NIE T&D that the only way to obtain approval for greater capex in RP6 would be to provide clear evidence on improvements to its asset management performance to the level at which it can justify the need to spend more on the network. Such an approach could be combined with a mechanism for approving additional capex required to adapt to major changes that occur in the period (similar to our proposal for Fund 3, discussed below).

### **The structure of the proposed capex mechanism**

#### Overview

11. Our proposed approach to funding NIE T&D's capex requirements over the course of RP5 is to divide those requirements into three categories, each of which is financed by a separate fund using distinct mechanisms and risk allocations reflecting the degree of control that NIE T&D has over the activities covered by the three funds and the degree of certainty as to their costs. That approach largely reflects the request that NIE T&D made in its BPQ submission. As is explained in detail below, this approach would protect customers, ensure that necessary capex work can take place and substantially reduce the systematic risk that NIE T&D would otherwise face in its capex activities.

#### Fund 1

12. Fund 1 is designed to cover capex activities that are largely within NIE T&D's control.<sup>8</sup> It consists of two components, each of which is governed by a different mechanism, as explained below.

#### *Output measurable capex in Fund 1*

13. First, Fund 1 includes planned asset replacement and refurbishment work. Some elements of this part of Fund 1 are specific, named projects, such as the replacement

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<sup>8</sup> Fund 1 is described in [FD](#) §§5.33-5.62.

of the Kells 110kV substation. Others are more general, such as the replacement of a proportion of the 11kV overhead lines. In neither case should NIE T&D have any difficulties identifying the volumes of assets that it actually replaces or refurbishes within that category. Accordingly, NIE T&D will only be permitted to increase its RAB in respect of assets that it can actually show it has replaced or refurbished. Moreover, we propose that customers should be protected by overall pound sterling caps for transmission and distribution on the amount of this kind of work that NIE T&D can claim during the period reflecting benchmarking of asset management practice in GB (as discussed below). Subject to these caps, however, volume risk is allocated to customers, in that the amount by which the RAB increases will vary with the volume of asset replacement that NIE T&D does. Moreover, NIE T&D has full flexibility as to how it allocates and prioritises the volumes of work that it does within that cap. Thus, it can decide to defer replacing one part of the network and instead replace more of another part than it had originally planned, so long as it does not exceed the overall cap. We do not consider that the residual volume risk represented by the cap imposes any material systematic risk on NIE T&D because the cap has been set conservatively (as explained below) and in any event planned asset replacement/refurbishment work would not be likely to be highly correlated with the market.

14. We propose, however, that unit cost risk for this category of work should be shared between customers and NIE T&D such that NIE T&D retains the benefit or penalty for a five year period. That is necessary to encourage efficiency in respect of what is a highly controllable and predictable aspect of its business. In other words, if NIE T&D spends more than the predetermined allowed unit cost for a particular piece of work, it will pay a penalty for that inefficiency for a period of five years. Equally, however, to the extent that NIE T&D spends less than the pre-determined allowed unit cost, it will be rewarded for that efficiency for a period of five years. We also propose that NIE T&D's statutory obligation to develop and maintain an efficient system should be reflected in an efficient spend clause in its price control, so that only efficient spend on capex is added to its RAB.<sup>9</sup>
15. To give effect to that risk allocation, we propose the establishment of an independent reporter (as discussed in our paper on that topic). The reporter will audit the actual volumes of asset replacement work done on an annual basis, together with the unit costs for that work. We will then adjust the RAB and calculate the efficiency rewards or

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<sup>9</sup> [FD §5.43](#).

penalties to be applied in RP6 as appropriate. The efficiency payments will run for five years from the year in RP5 in which the efficiency arose. Thus, for example, if NIE T&D achieves a unit cost saving in respect of a particular asset replacement in year 2 of RP5, it will be rewarded for that efficiency in years 2 - 5 of RP5 and year 1 of RP6.

16. NIE T&D objects to the establishment of a reporter. According to NIE T&D, its introduction amounts to "*micro-management*".<sup>10</sup> We disagree. It is essential that we should receive robust and credible information to allow us to discharge our statutory duties and to provide market participants with sufficient information to form an opinion on the value provided by NIE T&D and help inform any commercial decisions that those participants are making within their business. It should also be noted that Ofgem collates substantially more information via its RIGs than we propose to collect. Ofgem uses an examiner to verify and audit this data. In particular, Ofgem requires DNOs to report costs and volumes for asset replacement and refurbishment disaggregated to a much lower level than we propose to require.<sup>11</sup> We only propose to seek the bare minimum necessary to enable us to verify that customers are obtaining value for the capex that they are funding. For that reason we consider the level of reporting proposed in RP5 to be essential.

#### *Input driven capex in Fund 1*

17. As noted in paragraph 5(a) above, there is a substantial amount of capex that NIE T&D says that it needs to spend but for which NIE T&D says it cannot identify any outputs (i.e. assets replaced or refurbished). We consider that to be an unacceptable state of affairs for a public utility in the 21st Century. We understand that Ofgem treats more of these items of expenditure as opex than NIE T&D does, reflecting the fact that in large part they do not provide a justified long term economic benefit.<sup>12</sup> Nevertheless, we also consider that the items of work that are said to fall into this category need to be funded through one channel or another. They are:

- (a) fault and emergency work (£17 million);
- (b) additional costs associated with replacing assets in storm conditions (£0.5 million);

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<sup>10</sup> [NIE Response](#) to the [DD](#) Ch 11 §3.4.

<sup>11</sup> RIGs v3 worksheet CV3.

<sup>12</sup> See Ofgem's formal definitions of capital spend in its [RIGs v 3 Appendix 2](#)



- (c) reactive work (£11.5 million);
  - (d) capitalised overheads (£15.8 million);
  - (e) public realm work (£0.85 million);
  - (f) additional overheads associated with the new roads and street works legislation (£4.4 million);
  - (g) real price effects (£0.6 million); and
  - (h) the implementation of the Electricity Safety Quality & Continuity Regulations (Northern Ireland) 2012 ("ESQCR") (£1.25 million).<sup>13</sup>
18. In respect of these items, we proposed in the FD the allocation of a fixed sum of money that NIE T&D is allowed without needing to account for what it achieves by spending it. That is, NIE T&D's RAB will increase by the allowed sum irrespective of whether NIE T&D spends it. That approach provides an incentive for NIE T&D to shift this spending to capex falling within the output measured portion of Fund 1, because doing so (within the cap for those output measured items) would bring about a further increase in RAB. The trade off for customers is that such a shift would bring greater transparency in capex spending which will enable a more satisfactory approach to be taken to Fund 1 expenditure in future price controls. To that end, we proposed that NIE T&D should report on an annual basis on the *amount* that it spends on this input driven portion of Fund 1, so that we can monitor its development and draw lessons for the future.
19. We consider that this is an aspect of our capex proposal that warrants careful investigation by the Commission. In particular, a downside of our proposal is the risk of double (or even triple) funding some items of work. In particular, the "betterment" aspect of the work involved in items a, c and e above is (as noted above) to some extent duplicative of the output measurable items in Fund 1 discussed above. Moreover, as noted in our paper on opex, our opex benchmarking exercise implicitly assumed that some fault costs would be accounted for as opex (consistently with the approach taken by GB DNOs). Our opex proposal therefore already provides an allowance for some fault cost works. As noted above, our Fund 1 capex proposal also

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<sup>13</sup> [FD §5.46](#).

gives NIE T&D the flexibility to account for those works under the output measurable elements of Fund 1. If NIE T&D takes up that option, it will have effectively been funded three times for that work (once in opex, a second in the output measurable element of Fund 1 and a third in the allowance for input driven items in Fund 1). While we believe the incentives and transparency benefits of this approach warranted the risk of over-payment, there is accordingly a need for the Commission to investigate whether those elements of our proposal could be improved.

## Fund 2

20. Fund 2 is intended to cover work that is less predictable than Fund 1 and is largely in respect of work that is necessary because of changes in customers' needs, such as increases in demand in particular local areas that call for an increase in capacity.<sup>14</sup> It consists of three categories, each of which is dealt with differently: (i) specific load related projects; (ii) metering; and (iii) connections. Each is explained in turn below.

### *Specific load related projects*

21. The main element of Fund 2 is funding for specific projects required because of an increase in demand in local areas. In the FD, we took an evidence based approach to these projects, assessing each proposal against NIE T&D's current planning standards that set out the criteria for evaluating such proposals. As explained in more detail in the quantum section below and in the more detailed documents that we are in the process of finalising, the result of that process was that some projects were accepted whereas others were not because NIE T&D did not produce the evidence required to justify them.
22. In light of the inherent uncertainty in respect of demand for electricity in Northern Ireland, however, we do not propose that those conclusions should be set in stone for the duration of the price control period. On the contrary, we propose an annual reporting system in which NIE T&D can present evidence to the reporter to justify the projects that it considers necessary for the following year, effectively replicating the process that we have already engaged in for the first year. The reporter will consider the evidence and make a recommendation to us, and we will then issue an updated allowance for that year in light of those recommendations. For the avoidance of doubt, we expect that that approval process should take place in accordance with the new

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<sup>14</sup> Fund 2 is explained in [FD](#) §§5.63-5.90.

standards that NIE T&D has already been instructed to prepare.<sup>15</sup> In that annual reporting process, NIE T&D will also be required to report on the Fund 2 capex that it has spent during the previous year.

23. That process allows us to de-risk this category of capex almost entirely. Because NIE T&D can obtain pre-approval for its projects, it faces essentially no volume risk. The only way in which NIE T&D could be exposed to volume would be if it undertook projects without first obtaining our approval. Even then, those projects would be approved on an ex-post basis if they met the thresholds for necessity set out in NIE T&D's planning standards approved by us and in force at the time. For these projects the Reporter would be carrying out a checking role. The risk that NIE T&D would choose to undertake a project without approval and without an evidence base to justify it under its own standards cannot be described as systematic.
24. As with Fund 1, we propose that unit cost risk should be shared, with NIE T&D retaining any benefit or penalty in respect of Fund 2 projects for a five year period. Although there is uncertainty at this stage as to *whether* these projects will actually be *necessary*, there is no real uncertainty as to their unit cost because they are essentially the same activities as those covered by Fund 1 (i.e. installing network infrastructure). As with Fund 1, therefore, NIE T&D will be rewarded/penalised for unit cost efficiency/inefficiency as the case may be in accordance with the findings of the annual reporting process.

### *Metering*

25. In addition to the specific projects element of Fund 2, we propose that Fund 2 should also include an allowance for metering activities, including complying with NIE T&D's obligations to certify existing meters and to replace faulty meters. We propose that for the period before the introduction of smart metering these activities should be funded in the following way: (i) the unit cost risk is shared in the same way as Fund 1 (NIE T&D retains unit cost efficiency for five years); and (ii) NIE T&D is paid for the volumes of work that it actually does. The reason that these activities are included in Fund 2 is that at this stage it remains uncertain as to when smart metering will be introduced. At that stage, which is likely to be during the course of RP5, NIE T&D will no longer need to perform these functions and so will not incur further costs. We propose that smart

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<sup>15</sup> [FD §5.74](#)

metering costs should be dealt with and incentivised as part of Fund 3 (as discussed below).

### *Connections*

26. The final element of our proposal for Fund 2 is an allowance for connections costs. Since 1 October 2012, customers in Northern Ireland have been required to pay the full cost of any new connections. For that reason, going forward, NIE T&D will not need any allowance in its price controls for connections applied for after that date. Until October 2012, however, certain customers were only required to pay 60% of the cost of new connections directly, with the remainder being funded from the generality of customers. Because a significant volume of new connections requested prior to October 2012 still need to be made, however, NIE T&D requires an allowance for its 40% share of those costs in RP5 as well. We propose to allow for those costs on a pass-through basis (subject to an efficient spend condition analogous to that proposed in respect of Fund 1 discussed above),<sup>16</sup> but limited to the two years to 1 October 2014 so that NIE T&D has an incentive to complete them promptly and draw a line under that historic approach to funding some particular types of connections.<sup>17</sup>

### Fund 3

27. Finally, Fund 3 is intended to cover large projects for which there is even greater uncertainty than in Fund 2, both as to timing and cost.<sup>18</sup> This covers, in particular, smart metering and investments in the network required to accommodate the expansion of renewable energy that is anticipated to take place in order to satisfy EU renewable energy targets. The operation of this fund is straightforward: there are no allowances at this stage, but NIE T&D has complete freedom to present proposals for projects at any stage in RP5 and they will be approved to the extent that they are necessary and efficient. This approach insulates NIE T&D from essentially all of the (substantial) risk associated with these projects.
28. This Fund also facilitates innovation by allowing NIE T&D to act on innovative ideas at any stage in the price control period, rather than needing to have them fully developed and justified at the outset.

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<sup>16</sup> [FD §5.75](#).

<sup>17</sup> [FD §8.13](#).

<sup>18</sup> Fund 3 is explained in [FD §§5.91-5.110](#).

29. Overall the mechanism of this Fund allows us to incentivise desirable outcomes for each project. In some cases customers' best interests will be served by NIE T&D delivering the project in a timely manner, in other cases their interests will lie in the project being delivered at lowest cost.

### **The quantum of capex**

30. The sections above have explained the structure of our proposed mechanism for dealing with NIE T&D's capex proposals for RP5. This section explains the costs that we propose NIE T&D should be allowed, as well as the volumes of work that should be allowed.

### Costs

31. In the FD, we proposed that capex should be based on NIE T&D's proposed costs, subject to an efficiency adjustment reflecting the results of our cost benchmarking exercise. Our benchmarking of capex suggested that NIE T&D's direct costs compared favourably with those of its peers in GB, but that its indirect costs were substantially out of line. The capex benchmark for asset replacement projects indicated indirect cost inefficiencies greater than 20%. Ultimately we proposed an efficiency adjustment of 10% to those indirect costs. Although that was substantially less than the adjustment that the capex benchmarking exercise suggested was appropriate, it was in line with the indirect opex inefficiency identified by our opex benchmarking exercise (as to which, see our paper on opex). We consider that to be appropriate because the opex exercise was more robust (because it had a larger sample size) and because it is desirable that the efficiency incentive for indirect costs should be consistent across opex and capex.
32. No ongoing productivity challenge was introduced within the FD for capex and the Commission may wish to consider further whether this is appropriate.
33. We anticipate that the Commission will conduct its own further benchmarking exercise as part of this inquiry. We are ready to assist in that process and would suggest that the most up to date results should be used to adjust the Funds 1 and 2 quantum levels at the end of the inquiry.

Volumes

34. Our approach to volume allowances in the FD necessarily varied between the categories of expenditure in Funds 1 and 2, reflecting the different nature of the projects involved. Its approach was as follows:

- (a) In respect of the general asset replacement and refurbishment activities in the output measurable part of Fund 1, we took a benchmarking approach, modelling asset replacement requirements based on data for asset replacement in GB.<sup>19</sup> As with the cost benchmarking exercise, the Commission may want to conduct its own modelling of the need for asset replacement. In that regard, it should be noted that any benchmarking of NIE T&D's network against the GB networks is likely to be biased in favour of a finding that replacement is necessary because, as explained above, NIE T&D's data on the actual age of its assets is biased upwards by virtue of the fact that it has not updated its asset register in respect of the unplanned capitalised replacement and refurbishment work that it has done on the network over the years. Our asset replacement modelling in the FD did not take account of the fact that NIE T&D consider these activities to be "betterment" of the network, but it may be that the Commission will be able to do so in its modelling. Furthermore, it would be desirable for the Commission to investigate the treatment of tree cutting within this category. NIE T&D treats a substantial proportion of its tree cutting costs as asset refurbishment capex (see the capitalisation practices paper for more detail). It is worth noting that NIE T&D has changed its practices in relation to capitalisation of tree cutting substantially over the regulatory periods. The current practice results in substantial costs being added to NIE T&D's RAB and subject to a return over 40 years. NIE T&D has said that trees generally need to be cut again within three to five years, in order to comply with NIE T&D's safety standards. Our approach has been, for the sake of simplicity, not to separate out tree cutting from other elements of NIE T&D's asset base. But we can also see the attraction of treating items like tree cutting differently (for example, depreciating them over 3-5 years), and the Commission may well come to a different conclusion on that issue.
- (b) In respect of the specific named projects in Funds 1 and 2, we examined the evidence presented by NIE T&D and determined whether it was sufficient to justify each project in turn. In many cases NIE T&D was unable to produce the

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<sup>19</sup> The results of that analysis can be provided on request.

necessary evidence, notwithstanding the numerous requests that we made and the several workshops at which we repeated our concerns. Given that these were all projects that NIE T&D had concluded were necessary and demanded that customers should fund, we find that position very troubling. It reinforces the need for the annual reporting mechanism set out above. We are in the process of finalising a single document summarising our reasons for the conclusions that we reached in respect of each project for ease of reference by the Commission and will provide that document as soon as it is ready.

- (c) In respect of the "input driven items" in Fund 1, we proposed that NIE T&D should be given an allowance based on its historic run-rate for those items, adjusted for the 10% indirect cost inefficiency referred to above.<sup>20</sup>

- 35. The total allowances for Funds 1 and 2 that NIE T&D requested and that we proposed should be allowed are as follows:

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<sup>20</sup> [FD §5.56](#).

**Table 1: Fund 1 and Fund 2 RP5 Capex Summary.**

Fund	Spend area	NIE T&D submission		UR's final determination	
		Transmission	Distribution	Transmission	Distribution
1	Asset replacement (output measurable)	£119.0m	£357.3m	£85.3m	£157.6m
1	Input driven items			£7.1	£44.8m
1	<b>Sub-total</b>	<b>£119.0m</b>	<b>£357.3m</b>	<b>£92.4m</b>	<b>£202.4m</b>
		<b>£376.3m</b>		<b>£294.8m</b>	
2	Load related capex Network IT; network performance; non-network IT	£60.1m	£142.8m	£11.6m	£31.3m
2	Metering	£0.0m	£37.5m	£0.0m	£20.5m
	Connections	£0.0m	£59.3m	£0.0m	£37.3m
2	<b>Sub-total</b>	<b>£60.1m</b>	<b>£239.6m</b>	<b>£11.6m</b>	<b>£89.1m</b>
		<b>£299.7m</b>		<b>£100.7m</b>	
<b>Total</b>		<b>£179.1m</b>	<b>£596.9m</b>	<b>£104.0m</b>	<b>£291.5m</b>
		<b>£776.0m</b>		<b>£395.5m</b>	

## Conclusion

36. As will be apparent from the above, we consider that the approach to capex allowances proposed in the FD is a pragmatic solution to what is a difficult problem made even more difficult by NIE T&D's lack of accountability and transparency in this critical area of its business. After 20 years since privatisation it should not be unreasonable for a regulator to expect to be able to regulate capex by setting incentives for the achievement of outcomes that matter to customers (such as health and load indexes, customer minutes lost, etc) rather than needing to set allowances and unit costs for particular pieces of infrastructure. On that approach, the regulated entity could demonstrate the need for substantial new capex without difficulty and the regulator could approve it, confident that the money would actually be spent, and would be spent efficiently and on projects that are actually required. But that is not the world of NIE T&D.
37. For that reason, our proposal for this inquiry is that, at a minimum, the Commission should adopt the same approach to capex as set out in the FD, updated for the results of any further benchmarking, modelling, or project analysis that it conducts, but that (at a minimum) a very clear message should be given to NIE T&D as to the level of



sophistication and effectiveness that will be required of its asset management practices in the future. Effective asset management requires a company to record all that is needed to understand performance issues and decide on the right interventions. In our view, a very substantial improvement is required over RP5 as the essential precondition for effective regulation. This improvement is also required for NIE T&D to meet acceptable asset management standards and reduce any future gap in understanding of capex requirements for the network. Without this we will be unable to move to simpler forms of regulation in the future.