

RP7 - NIE Networks Price Control 2025-2031

Final Determination Annex H
Rate of Return Adjustment Mechanism
30 October 2024



About the Utility Regulator

The Utility Regulator is the independent non-ministerial government department responsible for regulating Northern Ireland's electricity, gas, water and sewerage industries, to promote the short and long-term interests of consumers.

We are not a policy-making department of government, but we make sure that the energy and water utility industries in Northern Ireland are regulated and developed within ministerial policy as set out in our statutory duties.

We are governed by a Board of Directors and are accountable to the Northern Ireland Assembly through financial and annual reporting obligations.

We are based at Queens House in the centre of Belfast. The Chief Executive and two Executive Directors lead teams in each of the main functional areas in the organisation: CEO Office; Price Controls; Networks and Energy Futures; and Markets and Consumer Protection. The staff team includes economists, engineers, accountants, utility specialists, legal advisors and administration professionals.



Abstract

This annex provides the Utility Regulator's approach to the rate of return adjustment mechanism.

Audience

Likely to be of interest to regulated companies, consumers, other regulatory bodies, government and other statutory bodies.

Consumer impact

The overall consumer impact of RP7 is set out in the main final determination report.

An adjusted rate of return will change the amount earned for rate of return within the price control and this will feed into tariffs during the RP7 period and as an end of period adjustment.

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1. Rate of Return Adjustment Mechanism

Key Changes from the Draft Determination

- 1.1 Tables have been updated to reflect final determination values.
- 1.2 The method of true-up has been updated to apply in two stages.

Overview

- 1.3 In Chapter 13 of the RP7 Final Determination we explain why we think it will be appropriate for us to make an ex-post adjustment to the RP7 allowed rate of return.

Risk free rate

- 1.4 Our calculation of the risk-free rate uses three different input indices and requires forecasts of both RPI and CPIH inflation. Rather than strive to replicate this computation on a continual basis, we propose to focus the adjustment mechanism on change in the value of index on which we place most weight - i.e., the yield on 20-year index-linked gilts. The value of this index, as published on the Bank of England's website, will retrospectively adjust the calculation of the risk-free rate in each year of the RP7 period by an amount that is equal to the difference between the annual average out-turn value of the index and the value at our cutoff date for data of August 2024 of 1.12%.

Debt

- 1.5 Our intention is that the adjustment mechanism will operate as follows. Table 1.1 reproduces the Chapter 13 'baseline' estimates of NIE Networks cost of debt. The 'Current market rate' is to be regarded as a holding assumption that applies until the business enters new borrowing(s) either to refinance existing debts or to fund new investment. All other inputs into the calculations are fixed allowances.

Average nominal cost of debt			
		Current market rate	5.76%
Average interest costs	5.79%	Forward rate adjustment	zero
Transaction costs	0.15%	Transaction costs	0.15%
Embedded debt	5.94%	Cost of new debt	5.91%
30:70 weighted average			
Weighted average cost of debt = 5.92%			

Table 1.1 – RP7 cost of debt calculation.

1.6 Throughout RP7, the current market rate will be updated with a replacement figure based on estimate(s) of the prevailing market interest rates for BBB rated corporate borrowers at the point(s) in time when the company raises new debt. The replacement figure(s) will be obtained as follows:

- a) data source – bond market prices/yields contained within the Markit iBoxx database; and
- b) index family – iBoxx £ non-financials BBB index; and
- c) tenor – this family of indices contains separate series for tenors of bond of 1-3, 3-5, 5-7, 7-10, 10-15 and 15+ years, as well as other more aggregated data. The reported yield from the series¹ that most closely matches the tenor of the debt that NIE raises. For example, if the company raises debt with a tenor of 12 years, reference will be made to the 10-15 years series. If the company raises debt with a tenor of 6 years, reference will be made to the 5-7 years series; and
- d) averaging – the reading will be for the average reported yield on the relevant series over the whole of the calendar month in which NIE carried out its financing exercise; and
- e) sharing – the sharing mechanism has been removed during RP7 period and NIE Networks incentive is limited to out-performance against the iBoxx benchmark.

Inflation

1.7 Actual annual inflation for October in each year will replace the period average forecast of 1.88% used when setting the initial RP7 Rate of Return. October is the reference point for inflation used within the NIE Networks licence.

¹ using iBoxx rules

Method of true-up

- 1.8 Annex I sets out the computations in greater detail and includes an illustration of how updated values would impact the final rate of return for RP7.
- 1.9 The adjusted rate of return will be considered in two stages -
 - a) the first stage as part of the tariff setting process during the RP7 period (in period). Movements in Risk free rate and Debt will be monitored, updated, and considered during the annual tariff approval process. This will avoid any build-up of under or over recoveries (K correction factor) due to these items feeding into the RP8 period.
 - b) The second stage will be considered at the end of RP7 (end of period). Movements in inflation will be monitored and updated but not considered until RP7 is complete. Instead of feeding into RP7 tariffs, the adjustment will be made via an adjustment to the closing value of RP7 asset base. This will feed into tariffs during the RP8 period.
- 1.10 The asset base adjustment will be derived by comparing the entitlement for the RP7 period (excluding any interest on K factor) between two RP7 models populated with RP7 outturn values. One model will contain the adjusted rate of return following the inclusion of Risk Free Rate and Debt and the second with the final annual rates of return including inflation as calculated in Annex I.
- 1.11 Using annual rates of return for the inflation adjustment ensures inflation within the rate of return matches indexation of regulated asset bases as the profile may vary from year to year.
- 1.12 Adjustments will then be applied to the opening 40 year asset base and depreciation profiles at the start of RP8, prior to other licence calculations such as indexation taking place. The adjustment will be depreciated on a straight line basis.