Utility Regulator
www.uregni.gov.uk

Power NI Supply SPC25 Price Control

Draft Determination

19 December 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; Markets; Consumer Protection and Enforcement. The staff team includes economists, engineers, accountants, utility specialists, legal advisors, and administration professionals.

OUR MISSION

To protect the short and long-term interests of consumers of electricity, gas and water.

OUR VISION

To ensure value and sustainability in energy and water.

OUR VALUES

ACCOUNTABLE
We take ownership of our actions.

TRANSPARENT
Ensuring trust through openness and honesty.

COLLABORATIVE
Connecting and working with others for a shared purpose.

DILIGENT
Working with care and rigour.

RESPECTFUL
Treating everyone with dignity and fairness.

Abstract

This paper sets out the Utility Regulator's (UR) proposals for the next Power NI Supply Price Control which covers a four year period from April 2025 to March 2029.These proposals cover the company's residential electricity supply business. This consultation paper outlines the analysis and rationale for UR's proposed decisions in relation to the main issues within the control, those being its structure and form, scope and coverage of regulated tariffs, duration of control, operating cost levels and allocations, and allowed margin. Its main focus is the determination of Power NI's own costs and the margin necessary to finance its residential supply business.

Audience

Power NI, consumers, consumer representatives, consumer groups, other regulated companies in the energy industry, government, and other bodies with an interest in the energy industry.

Consumer impact

This paper sets out UR's proposals for the Power NI Supply Price Control from April 2025 – March 2029 (also known as SPC25). The Price Control establishes the permitted costs and margin for the duration of the control period which will be taken into account when the maximum regulated tariff for domestic customers is set. We are also introducing a cost sharing mechanism which provides a strong incentive for the company to reduce costs and share both savings increased costs with consumers.

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Executive Summary

This paper sets out the Utility Regulator's (UR's) Draft Determination for the next Power NI Supply Price Control (SPC25), which will regulate the maximum tariff Power NI can charge its domestic electricity consumers during the four-year period from 1 April 2025 to 31 March 2029.

Its focus is the amount of operating and other costs which Power NI can recover to run its business and the margin it can recover to finance its activities. Based on the most recent Power NI tariff review, which covers a 2-year period from December 24, these costs make up 8% of a typical domestic electricity bill.

We broadly agree with the operational and other costs put forward by Power NI and we have proposed a 2% reduction in those costs. We disagree on the amount of margin Power NI should recover to finance its domestic supply business. The company proposed an amount of £33.6m/a (in nominal terms). Our Draft Determination proposes an amount of £15.9m/a (in nominal terms). The marked difference between these amounts is largely due to a difference in our respective views on the basis on which the margin should be determined. Power NI has put forward a margin on the basis of a stand-alone company with the same risk profile as a company operating in a competitive environment. For the reasons set out in this paper, we have concluded that our determination should be based on the individual circumstances of the regulated company, taking account of the facts UR is faced with at the time this decision falls to be made.

Scope and coverage of the Price Control

At present Power NI is subject to a Price Control in the Northern Ireland (NI) domestic electricity supply market. The SPC25 Price Control will continue the regulation of the maximum tariff Power NI can charge domestic consumers for the supply of electricity and will replace existing arrangements for regulated tariffs which come to an end on 31 March 2025. The new SPC25 Price Control will commence on 1 April 2025.

UR has concluded that we should continue to regulate Power NI's domestic tariffs because it still holds a dominant position in the NI domestic supply market. At present, Power NI supplies electricity to 61.1%[1] of domestic consumers and supplies more than 3 times the number of domestic consumers as its nearest competitor.

Duration of the Price Control

In line with our initial thoughts on duration, we propose to set a Price Control for a period of four years from 1 April 2025 to 31 March 2029. This will reduce the

[1] 2024 Q3 QREMM

regulatory burden of shorter Price Controls on both the company and the regulator. It will also allow for a period of stability as the electricity sector develops to support decarbonisation of the economy.

However, setting a Price Control for a longer period than previous controls increases the risk of forecasting errors. To mitigate this risk, we propose to introduce a symmetrical cost sharing mechanism of 35:65. This mechanism will apply to the categories of cost included in our determination of operational costs and other costs and will be calculated annually. Through this mechanism, the company would retain 35% of any savings against the determined cost allowances and would incur 35% of any cost over-run.

Structure and form of the Price Control

Respondents to the approach consultation largely agreed that the existing structure and form remains appropriate. We have maintained much of the structure and form of the current Price Control but also considered amendments where we determined these to be in the interest of consumers. We have proposed introducing a cost sharing mechanisms whereby Power NI will retain 35% of any savings and absorb 35% of any over-run compared to determined costs. We have proposed varying the margin in relation to customer numbers and the market price of energy to protect both Power NI and consumers against changing circumstances outside the control of the company.

Operating expenditure (Opex)

UR has carried out an analysis of Power NI operating costs at each Price Control. Operating costs include expenditure such as salaries, IT costs, bad debt, shared services, and materials and bought in services. We found Power NI's forecast of future costs to be reasonable, proposing minor adjustments to the operational costs of 2%. Table 1 below shows UR's proposals for the Opex amounts for FY25 and for the duration of the SPC25 Price Control in October 2023 prices.

Cost Category	UR PROPOSED COSTS (£m)				
	FY25	FY26	FY27	FY28	FY29
Determined Opex	39.795	40.543	40.802	39.629	39.788
Determined depreciation	0.972	1.163	0.353	0.337	0.317
Determined Opex and depreciation	40.767	41.706	41.155	39.966	40.105

Table 1: UR Proposed OPEX and other costs for FY25-FY29

Operating expenditure allocation

The determination of operating costs and other costs covers the operation of the Power NI domestic and commercial businesses and certain other group activities. The Price Control includes a methodology for allocating these determined costs between the different parts of Power NI's activities so that the determination of domestic tariffs only takes account of costs relevant to the domestic business. In the recent past, the allocation of these determined costs to other parts of the Power NI business has been in the range 22 to 24%. For the SPC25 Price Control, we reviewed the existing methodology and propose to continue the methodology and cost drivers currently used, subject to on-going review.

Margin review

Our proposals include a Draft Determination of a margin which is necessary to allow Power NI to finance its activities. The margin was last subject to a significant review for the 2014-2017 Power NI Price Control when the determined amount was approximately 2.2% of revenue. For this control, Power NI have argued that the current level of margin recovered is no longer appropriate. Based on analysis provided by its consultants (KPMG), Power NI has argued that the margin should be set at £33.6m/a (in nominal terms), equivalent to 4.6% of revenue.

UR has carefully considered Power NI's margin submission and has engaged its own consultants (First Economics) to provide review, analysis and advice on the submission. Based on this, our Draft Determination proposes a margin of £15.9m/a (£14.6m/a in October 2023 prices), equivalent to a margin of approximately 2.2%.

We have proposed changing the structure of the allowed margin so that it will vary in proportion to the number of customers served and the prevailing market price for energy.

Next steps

We have published this Draft Determination for consultation which will close on Monday 3 March at 5pm. Once we have considered the response to this consultation, we plan to publish our Final Determination paper on the Power NI

SPC25 Price Control by the end of April 2025 along with our consultation on any licence modifications. We will publish a final decision on licence modifications at the end of June 2025. The licence modifications will come into effect at the end of August 2025 but will operate from 1 April 2025, subject to the right of Power NI to appeal our final decision on licence modifications to the Competition and Markets Authority (CMA).

1. Introduction

1.1 This paper sets out UR's Draft Determination for the next Power NI Supply Price Control (SPC25), which will regulate the maximum tariff Power NI can charge its domestic electricity consumers during the four-year period from 1 April 2025 to 31 March 2029.

1.2 The purpose of this document is to consult on our proposals for the SPC25 Price Control for Power NI before we make a Final Determination. The closing date for consultation responses is 3 March 2025 and details of how to respond to this consultation are provided in Chapter 6 below. It is our intention to publish our Final Determination in April 2025. At that time, we will publish a further consultation on licence modifications to give effect to our Final Determination before making a final decision on these licence modifications.

1.3 While this consultation deals with all aspects of the Power NI Price Control, its focus is the determination of Power NI's operating costs, other costs and margin. These costs make up about 8% of a typical domestic electricity bill.

Strategic context for SPC25

1.4 In the electricity sector, the principal objective of UR is "to protect the interests of consumers of electricity supplied by authorised suppliers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the generation, transmission, distribution or supply of electricity"[2].

1.5 The electricity supply market in Northern Ireland is now served by nine competing supply companies, of which seven are active in the domestic market. Most of these businesses also supply industrial and commercial (I&C) customers. Power NI developed from the incumbent supplier at the time supply competition was introduced. Because it had a dominant position in an emerging competitive market, UR regulated parts of its supply business and has continued to regulate its domestic supply business.

1.6 There are approximately 847,000 consumers served by the Northern Ireland domestic electricity market and approximately 76,000 in the I&C market. Power NI currently supplies 61.1% of the domestic market and 48.6% of I&C market (by connections).[3]

[2] Article 12(1) of the Energy (Northern Ireland) Order 2003
[3] 2024 Q3 QREMM

1.7 When competition is not sufficiently developed or effective, UR protects consumers by regulation. This applies to the relevant areas of the electricity supply market as it does to other sectors of the energy industry and UR proposals for the Power NI Supply Price Control 2025 (SPC25) must be taken against this backdrop. We have consulted already on the Approach to this Price Control in 2023 and the Final Approach paper was published in March 2024

1.8 Electricity suppliers in Great Britain (GB) and the Republic of Ireland (ROI) are not subject to Price Controls as the markets in these areas are significantly more mature and competitive than the market in Northern Ireland (NI).

1.9 Following a three-year Price Control in 2014, recent Power NI Price Controls (2019-2021, 2021-2023 and 2023-2025) have covered two-year periods and broadly extended the existing regulatory arrangements. The current Price Control comes to an end on 31 March 2025 and the next SPC25 Price Control will apply with effect from 1 April 2025.

Consumer impact

1.10 A large proportion of the tariffs which Power NI can charge (for example, the commodity cost of electricity supplied, and buyout of renewable obligations) are determined when the cost of these elements can be properly assessed. The Price Control sets the mechanisms by which these costs are determined and recovered from consumers and has determined financial values which set the operating costs and margin which Power NI can recover to supply electricity to domestic consumers. As an indication of the immediate impact of these determinations, the proposed value of operating costs and margin determined for the SPC25 Price Control (FY26-FY29) is 8% of a typical domestic bill per annum based on an average consumption of 3,200 kWh. Currently the average annual bill from 1 December 2024 is £989 inclusive of VAT with a unit price of 29.44 p/kWh (ex VAT), 30.91 p/kWh (incl. VAT)[4].

1.11 The primary purpose and effect of this Price Control is to continue to ensure that, in spite of the dominant position of Power NI in the NI domestic electricity supply market (currently serving 61% of customers), the company charges its domestic customers a fair price for electricity while also having sufficient resources to be able to provide a high quality of customer service.

[4] https://www.uregni.gov.uk/files/uregni/documents/2024-11/Briefing%20paper%20for%20Power%20NI%20tariff%20review%20-%20December%202024.pdf

Our statutory duties

1.12 Our principal objective and statutory duties in relation to the exercise of our electricity functions (including setting the Power NI Price Control) are set out fully at Article 12 of the Energy (Northern Ireland) Order 2003 (the Energy Order)[5]. These include objectives which we must aim to achieve, definitions, duties, and a number of matters to which we must have regard. For ease of reference, we summarise the main elements of Article 12 below, but like any summary it is not entirely complete. We therefore refer consultees who are interested to the full text of the Article and associated definitions, as these are what we have relied upon in reaching our Draft Determination.

1.13 Our principal objective in carrying out our electricity functions is to protect the interests of consumers of electricity supplied by authorised suppliers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the generation, transmission, distribution or supply of electricity. Consumers, for this purpose, means both existing and future consumers.

1.14 We must carry out those functions in the manner which we consider is best calculated to further the principal objective, having regard in particular to:

a) The need to secure that all reasonable demands in Northern Ireland or Ireland for electricity are met.

b) The need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under Part II of the Electricity (Northern Ireland) Order 1992 (the Electricity Order) or the Energy Order.

1.15 We must also carry out its functions consistently with a number of other duties which are set out in full at Article 12 of the Energy Order.

1.16 Subject to the duties already mentioned above, we are required to carry out our respective electricity functions in the manner which it considers is best calculated:

a) To promote the efficient use of electricity and efficiency and economy on the part of persons authorised by licences or exemptions to supply, distribute or participate in the transmission of electricity.

b) To protect the public from dangers arising from the generation, transmission, distribution or supply of electricity.

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[5] The Energy (Northern Ireland) Order 2003

c) To secure a diverse, viable and environmentally sustainable long-term energy supply.

d) To promote research into, and the development and use of, new techniques by or on behalf of persons authorised by a licence to generate, supply, distribute or participate in the transmission of electricity.

e) To secure the establishment and maintenance of machinery for promoting the health and safety of persons employed in the generation, transmission, distribution or supply of electricity.

f) To have regard to the effect on the environment of activities connected with the generation, transmission distribution or supply of electricity when carrying out those functions.

1.17 In performing the above duties, we must have regard to the interests of groups of vulnerable consumers in Northern Ireland, comprising the disabled and chronically sick, pensioners, low-income consumers and residents of rural areas.

1.18 In carrying out our electricity functions, we must not discriminate between persons whose activities include generating, supplying, or transmitting electricity.

The electricity sector in Northern Ireland

1.19 Electricity supply companies operate at the commercial interface between the electricity industry and consumers. They:

a) purchase energy from the wholesale market (the all-island Single Electricity Market (SEM)) and incur other wholesale market costs including market operating costs, imperfections charges and generation capacity charges;

b) incur network charges and system service charges which cover the regulated costs of the distribution and transmission network owners and operators, NIE Networks and SONI; and

c) incur their own costs of operating their supply business and capital investment and the cost of financing their activities.

1.20 Supply companies aim to recover their cost, including financing costs / profit from consumers to remain viable.

1.21 At the time of writing there were 7[6] supply companies serving domestic consumers in Northern Ireland. The number and percentage of domestic consumers served by each company are shown in Table 1.1 below.

Supply company	Connections ('000)	Connections (%)
Power NI	517	61.1%
SSE Airtricity	145	17.1%
Budget Energy	107	12.6%
Electric Ireland	39	4.6%
Click Energy	38	4.4%
Go Power	1	<1%
Share Energy	<1	<1%
Totals	847	100%

Table 1.1 Electricity supply companies by domestic connections

1.22 Only Power NI's domestic supply tariffs are currently regulated. All commercial electricity supply and all other domestic supply services operate on a commercial and competitive basis. Because Power NI continues to have a dominate position in the domestic electricity supply sector, we have concluded that it is appropriate to continue to regulate its domestic supply tariff.

1.23 The conclusion of UR's review of the latest change to Power NI's domestic tariff (maximum average price)[7], effective from the 1 December 2024, provides information on the build-up of the Power NI tariff and how it is scrutinised by UR. It included an estimate of the annual average bill from 1 December 2024 of £989 inclusive of VAT[8].

1.24 The structure of the Power NI Price Control allows the company to recover most of its costs based on actual cost basis. This includes wholesale market costs including energy costs; Northern Ireland Renewable Obligation (NIRO) costs; Use of System (network) costs and other system costs such as system support service (SSS) costs and public service obligation (PSO) costs. Only the supplier charge, comprising the Power NI's internal costs and the margin required to finance its activities, is determined through this Price Control. In the latest assessment of Power NI tariff, the supplier charge makes up 8.4% of the total revenue Power NI expects to recover, equivalent to £83 of the annual average bill outlined above.

[6] 2024 Q3 QREMM
[7] Briefing paper for Power NI tariff review - December 2024.pdf
[8] The average annual bill amount was calculated based on the standard domestic tariff (including VAT) and is based on an average annual consumption of 3,200 kWh.

Our approach to the SPC25 Price Control

1.25 We consulted on our Approach to Power NI SPC25 Price Control in November 2023. Having considered the responses to the consultation, we published our approach to the Price Control in March 2024[9]. The key conclusions underpinning our approach were:

a) We would continue to set a Price Control for Power NI's domestic tariff given its continuing dominant position in the domestic supply market.

b) The duration of the Price Control would be increased to four years with a view of reducing the regulatory burden of carrying out short duration Price Controls and provide a period of stability while further consideration is given to initiatives such as smart metering and the implementation of alternative tariff structures which will be part of the delivery of net-zero.

c) The broad structure and form of the Price Control would be maintained including a determination of Power NI's own costs and margin and recovery of other energy costs, market costs and network costs on the basis of actual costs incurred.

d) We would continue to make provision for certain categories of costs defined in the Licence to be passed through to consumers. This would include the addition of a category to cover the implementation of smart metering once the impact it will have on electricity suppliers' reasonable costs is known.

e) The determination of opex would be made for combined domestic and commercial businesses with provision for a method of allocation to distribute determined costs between the domestic and commercial businesses. We proposed introducing a cost sharing mechanism when the actual operating costs incurred were higher or lower than those we determined.

f) We would continue to use CPIH as the general measure of inflation applied during the Price Control to covert allowances determined in October 2023 prices to nominal values for the relevant regulatory year.

1.26 We received a business plan submission from Power NI comprising a presentation and detailed submission on costings which set out the company's assessment of its business costs and financing costs (margin) for the SPC25 Price Control period. The company's submission was supported

[9] Final approach to the Power NI Supply Price Control 2025 published | Utility Regulator

by separate consultant’s reports on the efficiency of the business and the assessment of financing costs.

1.27 Having reviewed these submissions, this Draft Determination sets out our proposals for the design of the SPC25 Price Control and the determined values of business costs and financing costs (margin) for the SPC25 Price Control period. These proposals are published for consultation.

Structure of this Document

1.28 This document is structured in a number of chapters as follows, each addressing different aspects of the Price Control:

Chapter 2 Scope and Coverage: provides detail on the scope and coverage of this Price Control.

Chapter 3 Design of the Price Control: considers the design of the Price Control, focusing on changes to the current arrangements.

Chapter 4 Operating Expenditure (OPEX) and Other Costs: sets out our assessment of the allocation of Power NI's total OPEX between price controlled (domestic) and non-price controlled (I&C) customers.

Chapter 5 Margin Review: sets out the proposed allowed margin necessary to finance the price-controlled part of the Power NI business

Chapter 6 Consultation and Next Steps: sets out the rest of the timetable for this Price Control and how we intend to further engage with stakeholders as we complete this Price Control.

2. Scope and Coverage

2.1 Power NI's current Licence includes a Supply Charge Restriction Condition (Annex 2) which determines the maximum average charge per unit supplied in respect of "regulated premises" as defined within Annex 2 of the Power NI Licence[10].

2.2 "Regulated premises" are defined in the Licence as: *any premises supplied by the Licensee, other than the following: (a) Non-Domestic Premises and (b) other premises as may be agreed by the Authority and the Licensee from time to time.* In effect, the domestic premises served by the company.

2.3 Following consultation on the approach to the SPC25 Price Control, we concluded that Power NI continues to have a dominant position in the supply of electricity to domestic consumers. Therefore, we have decided that it is in the interest of consumers to continue to regulate the maximum average charge per unit supplied in respect of "regulated premises".

2.4 Historically, tariffs charged by Power NI have been regulated because the company had a dominant position in electricity supply in Northern Ireland. At that time, we concluded that the regulation of Power NI's tariffs was in the interest of consumers.

2.5 Initially, all domestic tariffs and some industrial and commercial (I&C) tariffs up to 50MWh per annum were regulated. Further deregulation took place during the 2017 Price Control which removed price regulation from the 0-50MWh I&C market, leaving only domestic customers within the scope of the Price Control.

2.6 When UR removed I&C tariffs from the scope of the regulated Price Control in 2017, the combined market share of Power NI/ Energia[11] in the 0-50 MWh sector of the market was 53% by consumption[12]. Data published in our most recent Quarterly Retail Energy Market Monitoring Report for Q3 2024[13] shows that for Power NI the equivalent market share by consumption is 20.5%. When we consulted on our Approach to the 2017 Power NI Supply Price Control, the company's share of the domestic market was 66% by customer number and 64% by consumption. In the Decision paper for the 2014-2017 Price Control, UR had set a market share level of 50% as the threshold for consulting on the possible removal of a control on Power NI tariffs.

[10] The Northern Ireland Authority for Utility Regulation (uregni.gov.uk)
[11] Power NI is part of the Energia Group.
[12] Approach Consultation (uregni.gov.uk)
[13] 2024 Q3 QREMM

2.7 There are currently 7 companies supplying electricity to domestic consumers in Northern Ireland. Figure 2.1 below shows the domestic electricity market share by supplier at Quarter 3 (July to September) 2024. Power NI remains dominant in the domestic consumer market with a market share of 61.1% by customer number and 60.8% by consumption. Power NI continues to supply more than three times the number of domestic consumers as its nearest competitor, SSE Airtricity (17.1% of customers).

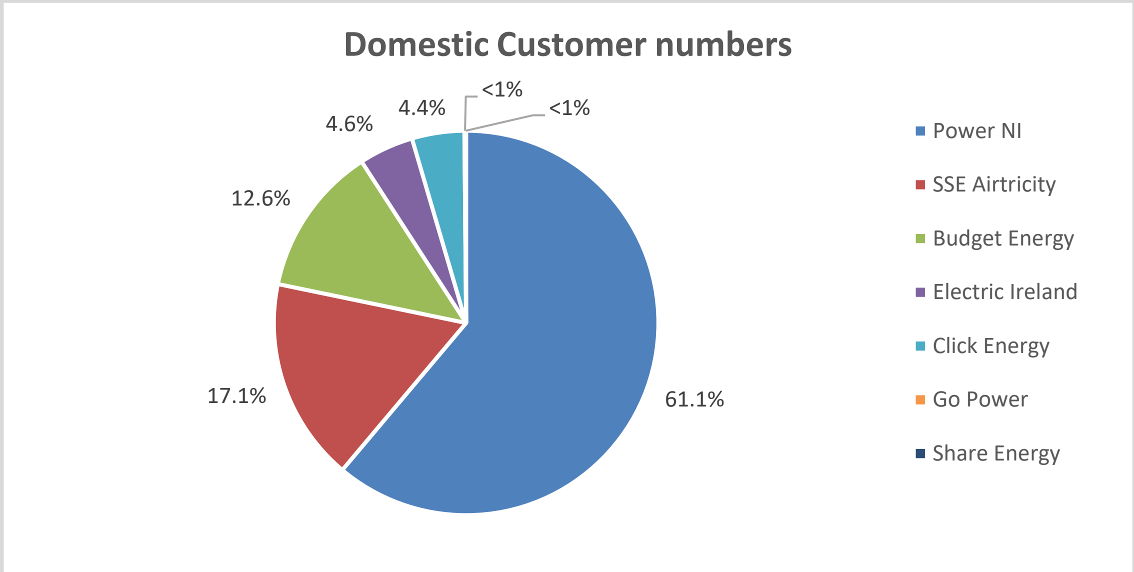

Figure 2.1: Domestic electricity market share (by connections)

2.8 In May 2024, Electric Ireland announced that it was exiting the Northern Ireland domestic market. At that time Electric Ireland had 7.1% of the NI domestic market and this has declined as they facilitate their domestic customers to transition to other suppliers. A further change in the market saw Share Energy entering the market in September 2024 as a new supplier.

2.9 Within the forthcoming Price Control period, Power NI has provided a forecast for its customer numbers, Figure 2.2. It assumed a 4% year-on-year increase from FY25 to FY29 which represents a cumulative 20% increase to the end of the Price Control. This would increase Power NI's market share from 60% to circa 70% of NI domestic electricity customers.

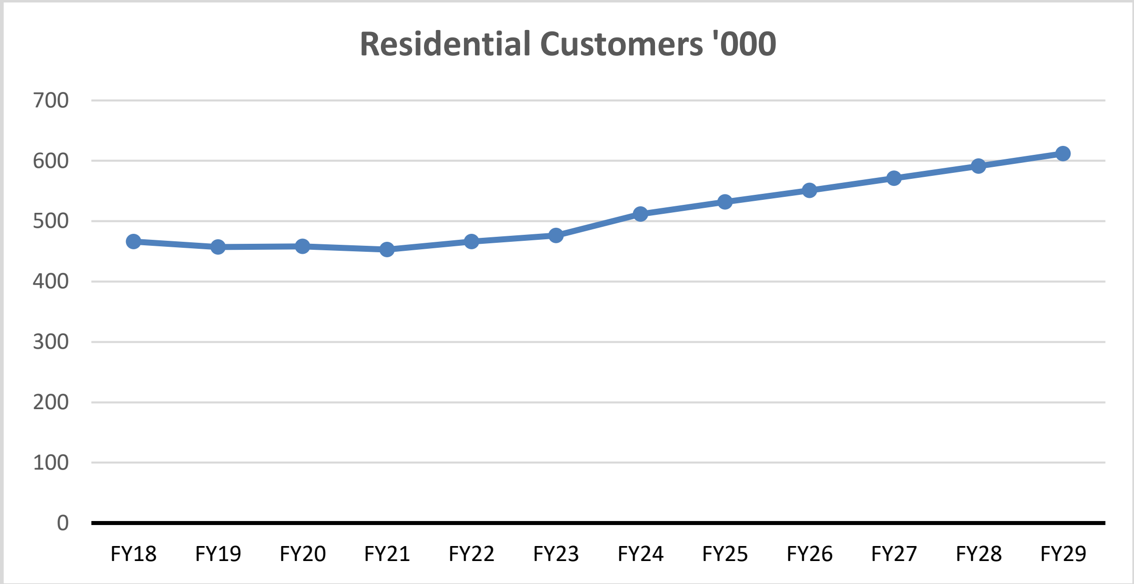

Figure 2.2: Power NI residential customer numbers ('000)

2.10 These forecast figures demonstrate that its market dominance is expected to deepen and become more consolidated during the period of SPC25 and hence there is no reason to think it will be anything other than at least as dominant (if not more so) over the period.

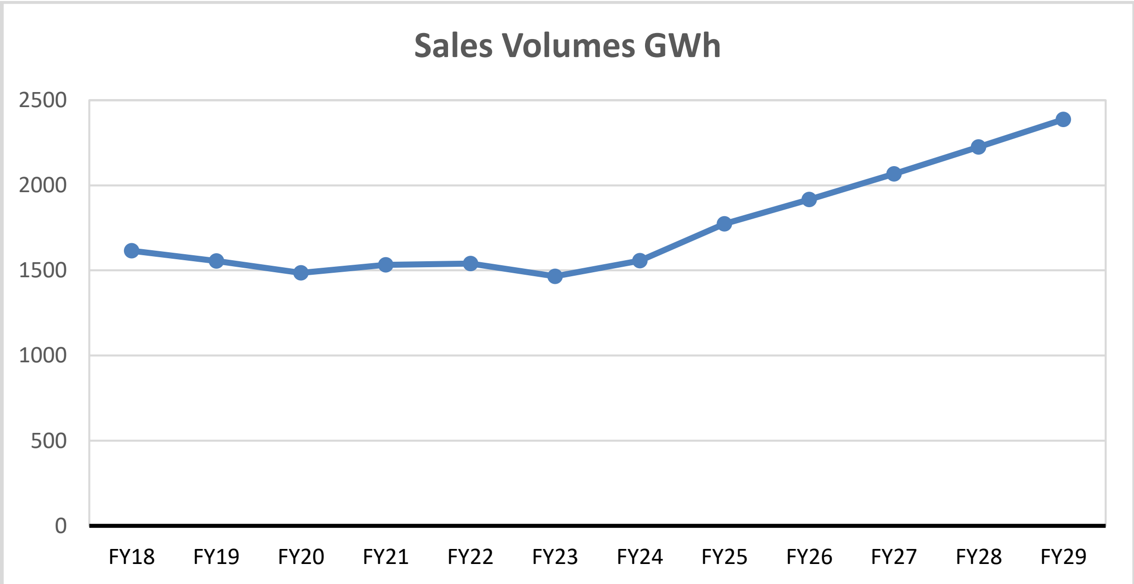

Figure 2.3: Power NI Actual and Forecast Sales Volumes (GWh)

2.11 By comparison, Power NI have has forecast an 8% year on year increase in sales volumes for residential customers over the duration of the Price Control. Power NI's assumption of increased sales volumes (GWh) is based on its premise that consumption will increase due to increased electrification of transport and heat as per the Ten-Year SONI Generation Capacity Statement 2023–2032.

2.12 Given the dominance that Power NI has in the market, it has the ability to act independently of the rest of the market, including on price. The competitive pressures are not sufficient by themselves and not sufficiently effective to constrain it. UR, therefore, needs to step in and set an appropriate Price Control. It is necessary to do this in order to ensure the protection of Power NI's customers.

2.13 A concentration analysis using the Herfindahl-Hirschman Index (HHI) for 2024 Q3 reveals an HHI of 4,226 for the domestic supply market. An HHI above 2,500 confirms a highly concentrated market, showing that Power NI continues to hold a dominant position in the market.

2.14 Table 2.1 shows the change in domestic market concentration over time. After a period when its market share reduced, Power NI has increased market share, and the concentration of the market has increased as a result.

	HHI Index
Q3 2021	3,644
Q3 2022	3,860
Q3 2023	4,006
Q3 2024	4,226

Table 2.1: Herfindahl-Hirschman Index (HHI) for domestic supply market 2021-2023

2.15 In view of the dominant position Power NI continues to hold in the domestic market, we have decided that it is in the interest of consumers to continue to regulate the maximum average charge per unit supplied in respect of "regulated premises". We will review the position at the time of setting SPC29.

3. Design of the Price Control

Introduction

3.1 The structure and form of Power NI's supply Price Control is defined in its supply Licence. The financial mechanisms which determine Power NI's regulated tariffs and the revenue it recovers through those tariffs are set out in Annex 2 of the Licence.

3.2 In this Chapter of our Draft Determination, we consider the design of the next Price Control covering:

a) Duration of the Price Control

b) Adjusting for inflation

c) Maximum allowed unit price of electricity (M_{St})

d) Modification of the S_t term

3.3 A key part of our proposals are the modification of the St term which makes provision for the recovery of Power NI's operating costs, certain other costs and margin. These changes include changes to the determined parameters underpinning the equation for St, modifications on how the St term is modified for customer numbers and margin and a cost sharing mechanisms where actual costs are more than or less than determined costs.

Duration of the Price Control

3.4 Recent Power NI Price Controls including extensions have covered three-year and two-year periods (2014-2017, 2017-2019, 2019-2021, 2021-2023 and 2023-2025). Prior to that, the duration of Power NI Price Controls varied from a one-year to a five-year control.

3.5 The duration of a Price Control is a matter of judgement:

a) If the duration is too short, the incentive for the regulated company to deliver efficiencies is muted and the regulatory burden on both the regulated company and regulator is increased.

b) If the duration is too long, the risk of forecasting errors for both costs and, in the case of a competitive retail market, consumer market share is increased. In addition, it is more likely that a longer duration Price Control could be affected by extreme events such as the recent volatility in commodity prices and inflation before tariffs are reset.

3.6 In our consultation on the approach to this Price Control we noted the there is merit in extending the duration of the Price Control to reduce the regulatory burden of carrying out short duration controls. We proposed extending the Power NI SPC25 Price Control to four years. Extending the duration of the Price Control will also provide a period of stability while further consideration is given to initiatives such as smart metering and the design and implementation of alternative tariff structures which are likely to be part of the delivery of net-zero.

3.7 We are aware that increasing the duration of this Price Control to four years increases the risk of cost forecasting errors and/or the potential to be affected by unforeseen or uncontrollable events. In addition to forecast and unknowable risks it is also appropriate to encourage efficiency across the period of the Price Control. Power NI is continuing to enhance and promote its customer self-service options and is increasing its digitisation of services. This will allow it to make certain efficiencies while at the same time ensuring consumer protection standards are met, particularly with vulnerable customers or those requiring additional and more personal assistance. Taking this into consideration we have evaluated the appropriateness and necessity of a cost sharing mechanism and are minded-to introduce a mechanism which will be applicable annually to the Opex to both protect against unknowns and incentivise efficiency.

Adjusting for inflation

3.8 In the current Licence, key monetary values used to determine the maximum allowed unit price for electricity are stated in October 2023 prices. The Consumer Prices Index including owner occupiers' housing costs (CPIH) was applied as a general measure of inflation to convert these values to nominal values when calculating tariffs. The CPIH index for October is used as the representative value for the relevant regulatory year.

3.9 For SPC25, we will state key monetary licence values used to determine the maximum allowed unit price for electricity in October 2023 prices. We will continue to use CPIH as the general measure of inflation to convert these values to nominal values when calculating tariffs. The CPIH index for October will continue to be applied as the representative value for the relevant regulatory year.

Maximum allowed unit price of electricity (M_{St})

3.10 The structure and form of Power NI's supply Price Control is defined in its supply Licence. The financial mechanisms which determine Power NI's regulated tariffs and the revenue it recovers through those tariffs are set out in Annex 2 of the Licence. At present, Power NI's maximum allowed unit price of electricity (**M_{St}**) for domestic customers is calculated from the formula for **M_{St}** below.

$$M_{St} = G_t + U_t + S_t + K_{St} + J_t + E_t - D_t$$

in any given year ‘t’.

3.11 We do not propose changing the following terms of the **M_{St}** equation:

- The **G_t term** covering costs incurred in the purchase of electricity.
- The **U_t term** covering transmission and distribution network costs.
- The **K_{St} term** covering revenue under or over-recovery in the previous year which can be collected by the business (under-recovery) or given back to consumers (over-recovery).
- The **J_t term** covering the cost of the buy-out from the Northern Ireland Renewables Obligation (NIRO).
- The **D_t term** covering the sharing of any savings of costs between the Licensee and consumers in respect of costs of meeting renewables obligations and other costs specified by UR from time to time.

3.12 These terms allow Power NI to recover a range of energy market costs, networks costs and energy subsidy costs on the basis of actual cost incurred. The costs which fall under these terms make up 91.6% of a typical Power NI bill as of 1 December 2024. A full definition of these terms can be found in the current Power NI Licence[14].

3.13 The focus of this Draft Determination in respect of the maximum allowed unit price for electricity is the modification of the **S_t** and **E_t** terms of the **M_{St}** equation.

3.14 The **S_t** term determines the operating costs, other costs and margin which Power NI can recover through its tariff. Our proposal is to modify the **S_t** term of the Licence as set out in the section below beginning at Paragraph 3.16.

3.15 The operating costs and other costs recovered through the **S_t** term excludes certain pass through costs which are recovered through **E_t** term. Information on the costs recovered through the Et term are described in the section below beginning at Paragraph 3.38 reproduces the definition of the various Et terms in the existing Licence, describes whether these terms will be

[14] The Northern Ireland Authority for Utility Regulation

retained, amended or deleted and identifies new terms covering additional categories of pass through costs.

Modification of the S_t term

3.16 The $\mathbf{S_t}$ term of the Licence determines the operating expenditure (opex), other costs and margin which Power NI can recover through its tariff.

3.17 Detailed information on the determination of operating cost and other cost allowances which underpins the proposed St term can be found in Chapter 4. Detailed information on our assessment of the margin which Power NI should be able to recover to finance its business can be found in Chapter 5.

3.18 The key monetary values in this section are in October 2023 prices. As noted above, CPIH will be applied as a general measure of inflation to determine the maximum allowed unit price for electricity in nominal terms.

The current St term

3.19 The $\mathbf{S_t}$ term is currently defined in the Licence as the allowed charge in pence per unit supplied to supply customers at regulated premises in relevant year t, which is derived from the following formula

$$S_t = \left(\left(P_f + (P_C * C_t) - A_t\right) * Pl_t\right) / Q_{st}$$

Where:

P_f	is a fixed sum determined in the Price Control.
P_c	is a fixed amount per customer determined in the Price Control.
C_t	is the number of supply customers.

The terms above defined the determined costs for the Power NI residential and commercial businesses. These combined business costs are then modified by the term:

At	which is a sum determined from a methodology defined in the Licence, or such other methodology as approved by UR, to reflect the operating costs attributable to the Power NI commercial business and other costs not related to the Northern Ireland domestic consumers (see the section below beginning at Paragraph 3.32.
Pl_t	is the application of CPIH to inflate costs determined in base year prices to nominal terms for the relevant regulatory year.

Q_{st} is the quantity supplied in the relevant year.

3.20 As a result, the **S_t** term was part fixed and part variable relative to customer numbers. In broad terms circa 70% of the St term was fixed and 30% variable in terms of customer numbers. This split was broadly in line with the historical proportions of opex and margin.

Proposed modifications to the St term

3.21 We propose to modify the St term of the Licence so that it is derived from the following equation:

$$S_t = 100 * \left((P_f - A_t) + (P_v * MF_t) \right) * \frac{Pl_t}{(Q_{st})} - CS_t$$

3.22 We propose to:

a) Align the fixed amount (**P_f**) with the determined operational cost and other costs as shown in Table 4.2. These costs remain relatively constant over the four years of the Price Control and show no significant variation with customer numbers. Therefore, we propose to use an average of the determined values which will apply in each of the four years of the Price Control.

b) Restructure the equation to group the **P_f** and **A_t** terms together. While this has no impact on the functioning of the equation, it serves to confirm that the **A_t** term is an adjustment to the operational cost allowances of the Price Control.

c) Amend the variable element of the **S_t** term such that **P_v** becomes the determined value of the margin subject to the application of a Margin Factor (**MF_t**) to reflect changes in the number of customers and the market price of energy relative to that which underpinned our determination of margin. The calculation of the Margin Factor is set out in Chapter 5, beginning at Paragraph 5.60.

d) The deduction of a cost sharing amount (**CS_t**) to reflect a share of any cost saving against the determined S_t amount which is returned to customers.

e) Include an additional factor of 100 to align with the definition of the St term as a value in pence per unit.

3.23 Our proposed determined values for the terms of the St equation are set out below. Monetary values are stated in October 2023 prices.

P_f £40.733m/a, being the average value of the determined operating and other costs as set out in Table 4.2. This includes an allowance for certain lines of depreciation and costs which will be recharged or recovered by Power NI when it uses its systems in other areas of its work. When tariffs are determined, this amount is subject to a deduction for commercial and other use through the $\mathbf{A_t}$ term described below, which has historically run at between 22 and 24% of this determined amount.

P_v £14.6m/a, being the average value of the margin determined in Chapter 5 in October 2023 prices.

PI_t is the application of CPIH to inflate costs determined in base year prices to nominal terms for the relevant regulatory year.

Q_{st} is the quantity supplied in the relevant year.

CS_t is a cost sharing amount as defined immediately below.

Cost sharing amount

3.24 When we set out our approach to the Price Control, we noted that increasing the duration of the Price Control to four years increases the risk of cost forecasting errors. We suggested that one way of mitigating this risk was to introduce a cost sharing mechanisms as part of the overall design of the Price Control.

3.25 In response to our consultation on this issue:

a) CCNI commented that it would expect to see appropriate mechanisms in the Draft Determination to help minimise the risk of forecasting errors and ensure Power NI is encouraged to maximise its efficiency across the period.

b) Power NI noted that cost sharing could be an important risk mitigation factor but would need to understand the mechanics of how such a mechanism would be implemented.

3.26 There is strong regulatory precedent for the use of cost sharing mechanisms to mitigate the risk of forecasting errors over the duration of a Price Control. For example:

a) Our regulation of NIE Networks includes a 50:50 cost sharing mechanism on both capital investment and operating costs.

b) Our regulation of the transmission system operator SONI includes a 25:75 cost sharing mechanism on costs subject to fixed determined allowances.

c) Our regulation of the gas distribution companies includes a cost 35:65 cost risk sharing mechanism on capex investment only.

d) Our regulation of the Gas to the West project included a 35:65 cost sharing mechanism on capital investment.

e) Ofwat and Ofgem also include cost sharing mechanisms in its regulation of the water and energy sectors in GB.

3.27 In view of the risk which can be mitigated by a cost sharing mechanism and regulatory precedent supporting such a mechanism, we have concluded that there is a case for introducing a cost sharing mechanism into the SPC25 Price Control.

3.28 The strength of a cost sharing mechanism is a matter of judgement which must balance the relative financial risk to the regulated company and the effectiveness of the mechanism incentivising the company to reveal lower costs. In determining a proposed cost sharing rate for Power NI, we have:

a) Taken account of the cost sharing rates outline above which range from 50:50 to 25:75, with the company retaining the first part and the second part returned to consumers.

b) That the larger the company, in terms of RAB and portfolio of activities, and therefore its ability to mitigate or absorb cost shocks, the larger the cost share attributed to the company.

3.29 In light of this experience and precedent, we have concluded that an appropriate strength for a cost sharing mechanism in SPC25 would be a 35:65 symmetrical cost share in favour of the customer. For the avoidance of doubt 65% of any savings would be passed back to the customer through the tariff and Power NI would retain 35% of any saving. Equally, in the event of an overspend, Power NI will bear 35% of any additional spending and the customer will bear the remaining 65% of the additional cost through the domestic tariff.

3.30 To give proper effect to the $\mathbf{CS_t}$ term in the proposed equation for **St** at Paragraph 3.24, it is necessary to:

a) Calculate the **CSt** in nominal term.

b) Calculate the adjustment as a positive value where there is a saving in actual cost relative to the allowance.

c) Adjust the saving to take account of the fact that the determined $\mathbf{P_f}$ value and the reported actual costs are for the company’s residential and commercial business combined. In the formula for **St** above includes a deduction from the P_f allowance in respect of commercial business costs. A similar approach must be applied to the actual costs of the combined business.

3.31 We believe that these objectives can be met through the application of the following equation for the CS_t term:

$$CS_t = 65\% * \left(\left(P_f * Pl_t + E_t\right) - AO_t\right) * \left(1 - \frac{A_t}{\left(P_f + E_t/Pl_t\right)}\right)$$

Where:

AO_t is the actual operational cost and other costs in nominal terms incurred by the company which fall within the categories of costs set out in Table 4.2 and the categories of costs which fall into the Et term to the extent that they are not recovered under any other part of the licence or any other licence.

And the terms P_f, Pl_t, E_t and A_t have the meanings ascribed to them above.

Allocation of costs between the residential and commercial businesses (the At term)

3.32 The determination of operational costs and other costs (the P_f term above), covers the costs of Power NI's residential and commercial businesses. To determine the S_t term for the regulated domestic business, it is necessary to deduct an appropriate amount to reflect the operational and other costs of the commercial business. This deduction is the A_t term in the equation for S_t at Paragraph 3.21 above.

3.33 In the current Licence the A_t term is the sum of two separate components defined as follows:

a) £5.696 million or, such other amount as reasonably determined by the Authority using the same methodology used to arrive at the amount of £5.696 million or such other methodology as approved by the Authority; plus

b) £6.59 *(R_t – PN_t)

where:

R_t means the number of persons that are on 30th September in relevant year t registered as a customer on the Licensee's customer billing system, determined in such manner as the Authority shall specify from time to time by notice to the Licensee; and

PN_t means the number of persons that are on 30th September in relevant year t persons in relation to whom the Licensee is the Registered Supplier (as defined in Condition 27 of the Licence), determined in such manner as the Authority shall specify from time to time by notice to the Licensee.

3.34 The monetary value in the first part of the definition is an historical figure which has not been used for some time. Instead, an established methodology has been developed based on detailed activity based costing methodology using four cost drivers: units sold, revenue, number of customers and bills, or, for some costs, combinations of those main drivers. The drivers are applied to a detailed set of sub sets of activity costs within each of the main cost categories for determined operational costs underpinning the **P_f** term.

3.35 To place the At term in context, the most recent allocation of the main drivers between the residential and commercial businesses are summarised in Table 3.1 below. For 2022-23, **A_t** was 22% of the **St** value. Between FY19 and FY23, this percentage ranged from 22% to 24%.

	Total at Sep 2023 '000	Unregulated Sep 2023 '000	Unregulated %
Units	2,153	648	30.11%
Revenues	688,516	177,183	25.73%
Avg. Customers	529	37	6.36%
Bills	1,324	151	11.43%

Table 3.1: Main drivers for apportionment of regulated and deregulated costs

3.36 We propose to continue this methodology for SPC25 beginning from the established **A_t** methodology using the 2023-24 tariff submission updated to reflect the determined values of the Final Determination. We will continue to reserve the option of adopting such other methodology as approved by the Authority to address changes in circumstances.

3.37 The second part of the **A_t** term recognises the possibility that Power NI might wish to use its systems to host consumers which the company is not the Registered Supplier. We propose to maintain the structure of this part of the **A_t** term for SPC25. The company is currently updating its billing systems. Until this work is complete, we will continue to use the value of £6.59 / customer (adjusted for inflation). Once the update is complete and the cost of the new systems are known, we will amend this value to reflect the cost of the new system.

Pass through costs (the E_t term)

3.38 The Licence formula for the maximum allowed unit price of electricity (MSt) includes the **E_t term** covering certain categories of costs defined in the Licence to be passed through to customers.

3.39 As part of this Price Control, we have assessed the scope of these pass-through cost categories and considerer whether they should be retained, amended or deleted for the SPC25 Price Control. We have also considered whether additional categories of pass through costs should be added for the SPC25 Price Control. Our proposals for SPC25 are set out in Table 3.2 below.

Ref	Existing Et term	Proposed revision for SPC25
1	(a) any reasonable costs incurred by the Supply Business in complying with the requirements imposed on the Licensee under legislation and other legal requirements through which Directive 2009/72/EC is implemented, whether before or after the coming into effect of this Annex, as reasonably determined by the Authority, and to the extent not recovered under another part of the Licence or any other licence.	**Retain**
2	(b) any reasonable costs incurred by the Supply Business in complying with the requirements imposed on the Licensee under the arrangements for the Single Electricity Market (being the project described in the Memorandum of Understanding dated 23 August 2004 and made between the Authority and the Commission for Energy Regulation in Dublin), whether before or after the coming into effect of this Annex, as reasonably determined by the Authority, and to the extent not recovered under another part of the Licence or under any other licence.	**Retain**

Ref	Existing Et term	Proposed revision for SPC25
3	(c) any payments made to NIE Ltd in relation to costs of systems implemented for compliance with (i) the requirements imposed under legislation and other legal requirements through which Directive 2009/72/EC is implemented; and (ii) the requirements imposed under the arrangements for the Single Electricity Market (being the project described in the Memorandum of Understanding dated 23 August 2004 and made between the Authority and the Commission for Energy Regulation in Dublin); in both cases including annual depreciation and financing costs and whether before or after the coming into effect of this Annex, as reasonably determined by the Authority, and to the extent not recovered under another part of the Licence or under any other licence.	**Retain**
4	(d) pension deficit costs of: (i) £400,000 per year, or (ii) such other amount, as reasonably determined by the Authority and notified to the Licensee, which amount reflects and is calculated in accordance with: (A) a report submitted by the Licensee to the Authority setting out the results of the most recent triennial actuarial review undertaken by the Licensee, or (B) the regulatory principles, determined by the Authority and notified to the Licensee, as applicable (from the date specified in the Authority's determination) to the allowance of pension deficit costs.	**Amend** We propose to retain the wording of the term but amend the value of £400,000 to £519,000 to reflect the most recent triennial actuarial review undertaken by the Licensee. Subject to clarification from Power NI, we propose to clarify the term to note the specified amount is a nominal amount. We propose to clarify the term to confirm that the recovery of the amount in tariffs is subject to that amount being applied to the relevant pension fund(s).
5	(e) the amounts apportioned or allocated to the Supply Business in respect of the fees paid by the Licensee under Condition 11	**Retain**
6	(f) a reasonable rate of return as reasonably determined by the Authority on the capital represented by the costs incurred by the Supply Business associated with Phase III of the Enduring Solutions Project and an allowance for depreciation of the capital represented by such costs	**Retain**

Ref	Existing Et term	Proposed revision for SPC25
7	(g) any reasonable costs incurred by the Supply Business associated with the European Target Model Project, whether before or after the coming into effect of this Annex, as reasonably determined by the Authority, and to the extent not recovered under another part of the Licence or under any other licence.	**Retain**
8	(h) any reasonable costs incurred by the Supply Business associated with the upgrade of its customer care and billing systems (including software and hardware) implemented as part of the Enduring Solutions Project, whether before or after the coming into effect of this Annex, as reasonably determined by the Authority, and to the extent not recovered under another part of the Licence or under any other licence.	**Retain**
9	(i) any reasonable costs incurred by the Supply Business in complying with any requirement that: (i) is imposed on the Licensee under a legal instrument through which Directive 2012/27/EU is implemented; and (ii) is substantially equivalent, or otherwise corresponds, to any requirement imposed under the Electricity and Gas (Energy Companies Obligation) Order 2012 on any person holding an electricity supply licence granted (or treated as granted) under section 6(1)(d) of the Electricity Act 1989, whether before or after the coming into effect of this Annex, as reasonably determined by the Authority, and to the extent not recovered under another part of the Licence or under any other licence.	**Retain**
10	any reasonable costs incurred (or to be incurred) by the Licensee to comply with any new or modified Conditions of the licence which are made in consequence of the Authority's project described in the document entitled 'Consumer Protection Programme - Final Decisions'.	**Retain**

Ref	Existing Et term	Proposed revision for SPC25
11	k) any reasonable costs associated with IT systems (including support), employment related and Payment Providers + Mailing costs as reasonably determined by the Authority, and to the extent not recovered under another part of the licence or under any other licence.	**<u>Delete</u>** This term was introduced in licence modifications which came into effect on 1 April 2023. It provided for increased costs of IT systems (including support), employment related and Payment Providers + Mailing costs over and above those allowed in the historical St term. These increased costs are now incorporated in the proposed amended St term as described above, making this term redundant.
12	(l) such other amount which reflects and is calculated in accordance with a sharing mechanism, specified from time to time by the Authority, to reflect a reasonable sharing of any savings made in respect of "Payment Providers + Mailing" (should this scenario arise) for which a cost allowance within St has been provided.	**<u>Delete</u>** We propose to introduce a broader cost sharing mechanism which will include Payment Providers + Mailing costs. We propose to incorporate this mechanism as part of the St term as described above, making this term redundant.
13	(m) any reasonable costs incurred (or to be incurred) by the Licensee in administering the provision and delivery of EBSS payments and other associated requirements, as set out in the direction made on 22 December 2022 by the Secretary of State pursuant to section 22 of the Energy Prices Act 2022 (the EBSS AFP NI Direction), as reasonably determined by the Authority and to the extent such costs are not recovered or recoverable under another part of this licence, under any other licence or under any other legal instrument (including, for the avoidance of doubt, the EBSS AFP NI Direction).	**<u>Delete</u>** This term was introduced in licence modifications which came into effect on 1 April 2023. It made provision for the recovery of the costs in administering the provision and delivery of Energy Bill Support Scheme (EBSS) payments and other associated requirements for the Alternative Fuel Payment (AFP). As the term is linked to specific legislation and the provision has already been made for cost recover, we consider the term redundant.
14	Proposed new term making provision for future costs of smart metering.	**<u>Proposed additional term</u>** any reasonable costs incurred (or to be incurred) by the Licensee in implementing smart metering for domestic consumer which is clearly in pursuit of a Ministerial policy decision, as reasonably determined by the Authority and to the extent such costs are not recovered or recoverable under another part of this licence or under any other licence.

Ref	Existing Et term	Proposed revision for SPC25
15	Proposed new term making provision for future costs of the Digital Engine project.	**Proposed additional term** Any reasonable costs incurred (or to be incurred) by the licensee associated with the Digital Engine project, as reasonably determined by the Authority and to the extent such costs are not recovered or recoverable under another part of this licence or under any other licence.

Table 3.2: Proposed amendments to pass through costs (the Et term)

3.40 The additional Et terms included in table 3.2 are:

a) **Smart metering**. The term makes provision for the company to recover smart metering costs once a clear Ministerial policy decision is in place to underpin such costs. We have excluded these costs from the calculation of margin and an additional return on capital will be recovered at the cost of capital determined in Chapter 5.

b) **Digital Engine costs**. This term makes provision for the company to recover Digital Engine costs. At this stage it is assumed that this project is for the development of apps, systems integrations or digital sustainability as the energy transition progresses. However, Power NI will need to furnish UR with a detailed proposal. We have excluded these costs from the calculation of margin and an additional return on capital will be recovered at the cost of capital determined in Chapter 5.

3.41 The company has made provision for the cost of financing a number of Et items) when calculating the working capital requirement which underpinned its margin. We have followed the same approach when determining the margin proposed for SPC25, applying a nominal, pre-tax, cost of equity to calculate contribution to the overall margin. Where a nominal cost of equity has been included in the margin, the cost recovered for capital investment under these terms would be limited to nominal depreciation.

4. Operating Expenditure (OPEX) and Other Costs

4.1 This section of the paper sets out our assessment of Power NI's operating expenditure (OPEX) and proposed allowances and other costs.

4.2 One of the principal areas of analysis in formulating our proposals for this Price Control has been to determine the appropriate level of OPEX which should be allowed for Power NI for the next Price Control period.

4.3 As stated in our Approach document, we initially anticipated that we would have a combined approach which would consist of "top-down" and "bottom-up" analysis. However, given the length of time since the last full Price Control along with inflationary and cost of living shocks in the last few years, it was deemed more appropriate to conduct a fuller line-by-line assessment of all costs within each of the OPEX categories.

4.4 Prior to the submission of costs, UR and Power NI agreed that 2023/24 (FY24) would be the base year for the SPC25 Price Control as it was the nearest full year of actual costs to the start of the new Price Control. All costs referred to in the paper are in 2023/24 prices unless stated otherwise.

4.5 The current Price Control uses CPIH as the general measure of inflation which is applied to inflate determined values from base year prices when calculating the maximum allowed unit price of electricity in tariff year prices. The index for October 2023 is used for the relevant regulatory year. We intend to continue to use CPIH as the general measure of inflation for the SPC25 Price Control.

4.6 Power NI have six categories of operating expenditure/cost provision:

- Salaries
- Materials and Bought in Services (MBIS)
- Outsourced IT and Software Costs (including Printing)
- Agency Costs
- Shared Services and IT Systems
- Bad Debt

4.7 Power NI provided UR with a detailed breakdown of each of the cost categories through a Business Efficiency Questionnaire (BEQ). This BEQ detailed each cost category and contained historical actual costs from FY18 to FY24, latest best estimates (LBE) for the current financial year FY25, and forecast costs for the four years of the SPC25 Price Control from FY26 to FY29.

4.8 UR Price Control team analysed the BEQ and established a query process with Power NI. The Price Control team reviewed each cost category and sought additional evidence and explanation from Power NI as to the quantum of costs and the constituent parts of these costs where they were not evidenced or obvious. UR also engaged internal experts in this area of Price Control to examine the cost submissions made by Power NI with regard to salaries and IT. They examined all the cost areas set out below.

4.9 Power NI are forecasting that their OPEX will increase from FY24. The most significant projected increase is in FY25 which is the last year of the current Price Control and of the two-year OPEX uplift agreement. A number of uplifts in individual OPEX costs have been projected for FY25, with forecast costs then remaining relatively static or in some cases decreasing during the four-year duration of the SPC25 Price Control.

FY25 OPEX Proposals

4.10 Table 4.1 shows Power NI's forecast OPEX costs for FY25 and UR's proposed position on these. Following assessment of Power NI's FY25 forecast costs, UR has made some adjustments to the salaries and outsourced cost categories as outlined below, resulting in a 2.0% reduction of £668k in the Net OPEX for FY25. **The proposed Net OPEX for FY25 with these adjustments is £38.0m.** Changes to forecast costs are highlighted in green text in the table and all costs are in the 23/24 price base.

Cost Category	POWER NI FORECAST £m	UR PROPOSED £m	DIFFERENCE £m
	FY25	**FY25**	**FY25**
Salaries	17.6132	17.218	-0.395
Materials	3.681	3.681	-
Total Bad Debt	1.622	1.622	-
Outsourced IT and Software	7.696	7.423	-0.273
Agents (PPM)	3.750	3.750	-
Shared IT Systems	3.922	3.922	-
Shared Services	0.353	0.353	-
Net OPEX (excl. ROI recharge, pass through and depreciation)	38.637	37.969	**-0.668**

Table 4.1: Power NI forecast and UR proposed OPEX costs for FY25

4.11 **Salaries** - an additional 27.8 average Full Time Equivalents (FTE)[15] have been forecast in FY25. UR has discussed these requests with Power NI and internal UR colleagues and proposes to not allow 7.8 additional FTE. This equates to a reduction of £395k (in 23/24 prices) for FY25. Further information on the reason for these adjustments can be found below.

4.12 **Outsourced IT and Software** - an additional uplift amount of £2.2 million has been requested that includes implementation and licensing costs for cyber security, data governance, software and compliance. UR has discussed these requests with Power NI and proposes to allow costs with one adjustment. This equates to a reduction of £273k (in 23/24 prices) for FY25. Further information on the reason for these adjustments can be found below.

FY26-FY29 Price Control Proposals

4.13 Table 4.2 shows UR's proposed costs for FY25 and for each year of the SPC25 Price Control. Following assessment of Power NI's forecast costs for the Price Control period, UR has made some adjustments to the salaries and outsourced IT and software costs as outlined below. These adjustments largely reflect UR's proposed decisions for FY25 carried forward into the

[15] Full Time Equivalent or FTE is a unit of measurement used to show the number of full-time hours worked by all employees in an organisation. In the UK, a standard work week of 40 hours has an FTE value of 1.0. The number of FTE will often differ from the number of staff employed (the organisational headcount) as not all staff will work full-time hours. For example, at 31 March FY24, Power NI had an FTE of 312 but had an organisational headcount of 357 (based on a standard work week of 37 hours).

Price Control period and result in an annual 2.0% reduction of £795k and a total 2.0% reduction of £3.18m in Net OPEX across the four-year SPC25 Price Control period. **The total value of the net Opex for SPC25 Price Control using UR's proposed costs is £152m.** Changes to forecast costs are highlighted in green text and all costs are in the 23/24 prices.

Cost Category	UR PROPOSED COSTS (£m)				
	FY25	**FY26**	**FY27**	**FY28**	**FY29**
Salaries	17.218	17.502	17.650	17.667	17.651
Materials	3.681	3.474	3.326	3.448	3.321
Total Bad Debt	1.622	1.682	1.785	1.899	2.003
Outsourced IT and Software	7.423	7.383	7.226	6.459	6.423
Agents (PPM)	3.750	3.497	3.573	3.590	3.665
Shared IT Systems	3.922	4.394	4.310	3.699	3.663
Shared Services	0.353	0.685	0.896	0.718	0.831
Net OPEX (excl. ROI recharge, pass through and depreciation)	**37.969**	**38.617**	**38.766**	**37.48**	**37.557**
RoI recharge[16]	1.826	1.926	2.036	2.149	2.231
Gross Opex (excl. pass through)	39.795	40.543	40.802	39.629	39.788
Pass through costs	0.835	0.835	0.835	0.835	0.835
Opex Gross (excluding depreciation)	40.630	41.378	41.637	40.464	40.623
Total Depreciation[17]	2.221	3.667	3.759	3.804	3.552
-Depreciation through Et -Depreciation through Pf	(1.249) 0.972	(2.504) 1.163	(3.407) 0.353	(3.466) 0.337	(3.235) 0.317
Opex Gross excl. depreciation recovered in Et	40.63	41.378	41.637	40.464	40.623
Amounts recovered through Pf -Gross opex excl. passthrough - Depreciation through Pf **Total Pf[18]**	 39.795 0.972 **40.767**	 40.543 1.163 **41.706**	 40.802 0.353 **41.155**	 39.629 0.337 **39.966**	 39.788 0.317 **40.105**

Table 4.2: UR Proposed OPEX Costs for FY25 and FY26-FY29

- **Salaries –** costs show minor increases during the Price Control due to annual salary increases and a projected reduction in frontline FTE. UR has adjusted

[16] These are forecast costs taken from the BEQ but are likely to change once the outcome of the Gemserv review is finalised.
[17] These are forecast costs taken from the BEQ but are likely to change once the outcome of the Gemserv CC&B review is finalised. Additionally, Power NI have yet to bring forward proposals for Digital Engine and the basket of costs associated with those depreciated through Pf.
[18] This total is based on determined and forecast costs and are subject to change

the salaries costs by £395k for each year of the Price Control period, in line with the FY25 proposed decision.

- **Outsourced IT and Software -** costs are higher in the first two years of the Price Control and reduce again from FY28 onwards. UR has adjusted the outsourced IT and software costs for the Price Control period and have removed costs of £400k per year for one category. Further information on the reason for these adjustments can be found below.

- **Cost Sharing Mechanism** - UR is suggesting the introduction of a symmetrical 35:65 cost risk sharing mechanism across all opex categories, to promote efficiency for the duration of the SPC25 Price Control.

4.14 At this time and in the absence of more up to date information we have used the forecast costs as a placeholder for RoI recharge and subject to further clarification on other intangibles, or any other costs it may be necessary to revised these for the Final Determination.

Salaries

4.15 Over the Price Control period, Salaries costs are forecast to increase in real terms from £17.6m in FY25 to £18.0m in FY29, with a small reduction in actual staff numbers.

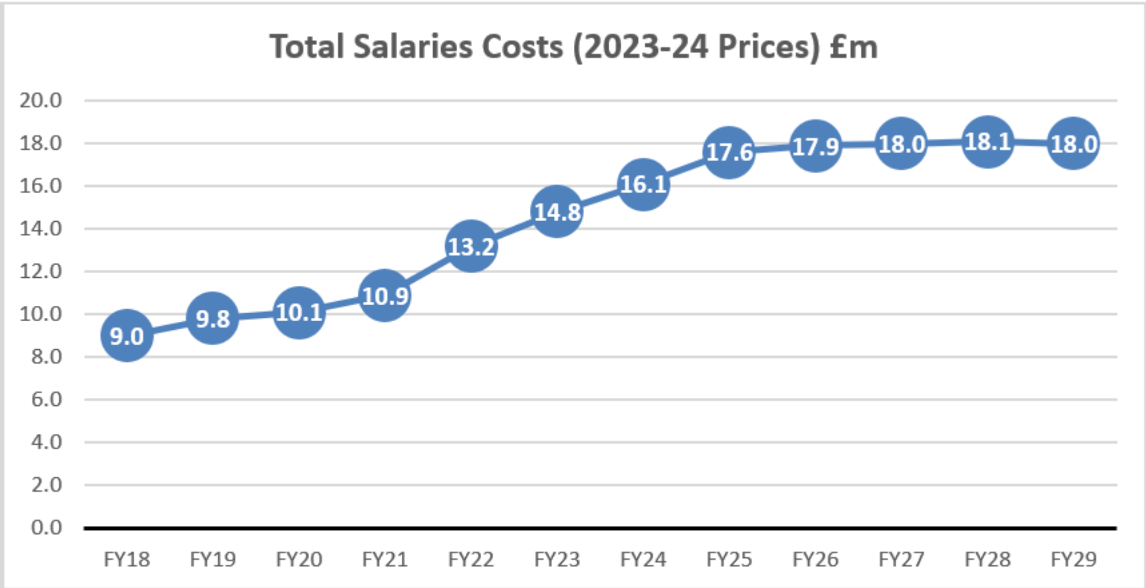

Figure 4.1: Salaries actual and forecast costs FY18-FY29

4.16 Salaries have been forecast to increase in real terms from £16.1m to £17.6m in FY25 due to increased FTE - including new roles - and payment of annual pay awards and bonuses including living wage increases for staff at the lower end of pay scales. Based on average FTE numbers, Power NI have forecast an increase of 27.8 FTE in FY25, with the majority of these increases set to maintain during the Price Control period.

4.17 During the Price Control period, Power NI have forecast that salary costs will increase at a low steady rate due to annual pay awards and bonuses including living wage increases for staff at the lower end of pay scales. A reduction of 8.1 FTE between FY26 and FY29 has been forecast due to anticipated headcount reductions in the Contact Centre. All other teams (except Billing) are projected to maintain FY25 FTE levels. Power NI assume that going forward, the peak energy crisis will abate to a degree and that there will be a reduction in the headcount required in the Contact Centre as the situation normalises and frontline call volumes reduce. There is also a growing focus on maximising self-service options. Currently, self-serve accounts for approximately 10% of all Power NI contacts, with plans to expand the offer as the energy transition evolves and digitalisation of services increases. This will further reduce the demand on Contact Centre staff.

FTE Reduction

4.18 Power NI state that the forecast FTE increase in FY25 consists of backfill for one vacant role, eighteen new roles and FTE uplift for existing roles/teams. FTE increases are offset slightly by forecast FTE reductions in some frontline teams e.g. Contact Centre and Billing. Power NI state that the FTE increase will allow it to maintain its industry leading standards of customer service, efficiency, innovation, and best practice as the dominant electricity supplier in Northern Ireland.

4.19 Following extensive engagement with Power NI and analysis of the forecast salary costs and FTE numbers, UR proposes not to allow 7.8 FTE for FY25 which will maintain into the Price Control period. This is a reduction of FTE from Power NI's closing FY24 forecasts and equates to an OPEX reduction of £395k for FY25 and for each year of the Price Control (in 23/24 prices).

4.20 UR proposed salaries allowances for FY25 and FY26-FY29 have been calculated by subtracting the FY24 average FTE cost for the additional roles that have not been allowed from the forecast salary costs. FY24 average FTE costs have been used to calculate the disallowed amount for salaries rather than future forecast costs as future costs include salaries for staff that have not been allowed in the Price Control, some of whom were at a more senior level attracting higher salaries. Overall, we take the view that, where the company has identified 'vacant' roles in its staff structure, this is not sufficient evidence in itself that these roles should be funded for the next Price Control. Instead, we will always place more weight on the actual current costs of the business, recognising that any organisation is in a continuous state of flux and there will always be some vacant roles in its current staffing. In doing so, we note that the company has decided to discharge its functions within its current cost base without these roles in place. The following roles have not been allowed:

a) **Sales and Retention:** At the close of FY24 the Sales and Retention team had 32.0 FTE, and this was forecast to increase to 33.8 in 2025. UR proposes not to allow this increase of 1.8 FTE for the following reasons. Power NI has seen strong growth in customer numbers in recent years and at September 2024[19], they held a domestic market share (by connections) of 61.1%, dominating both the credit and prepayment sectors in Northern Ireland. The recent announcement of Electric Ireland's withdrawal from the domestic supply market in Northern Ireland will potentially increase Power NI's market share even further. UR further assess that multiple new entrants to the supply market in the coming years are unlikely due to the small size and increasing saturation of the Northern Ireland market. The entry of Share Energy into the Northern Ireland domestic market in September 2024 means that it is too early to draw any conclusions about customer switching rates to this new company.

b) **Finance**: UR proposes not to allow the new Technical Reporting Accountant role as requirements mainly appear to be anticipatory rather than mandatory and reporting appears to be for internal or Group information. We understand that these requirements remain uncertain and roles with a significant amount of Group requirements have not been allowed. Compliance work could also be absorbed by the new Compliance & Risk Business Analyst.

c) UR proposes not to allow a new Projects & Change Business Analyst role as this involves a significant amount of work on behalf of Group as well as procurement work which it is assessed can be covered by existing resource. While the introduction of the new Procurement Act will require a resource commitment for initial training and navigating teething problems, it is anticipated that the new system will streamline procurement processes in the longer term.

d) UR proposes not to allow a new Graduate Trainee role as this is not a mandatory role and has been suppressed in recent years.

e) UR proposes not to allow backfill of one role in the Qlikview Team as this team has been successfully functioning at or below the FY24 average FTE level for a number of years and the need for backfill,

[19] Q3 QREMM 2024 (https://www.uregni.gov.uk/publications/remm-transparency-reports-2024

particularly at a Senior level which attracts a higher cost, has not been sufficiently demonstrated.

f) **Trading**: UR has sought expert internal advice on the forecast FTE in Trading due to the specialised nature of this work area. UR proposes not to allow a new Analyst role for Trading Operations. As Power NI trades predominantly in the Day Ahead Market (DAM) it is assessed that the increase in Intra-Day Trading markets from four to six will not have a significant impact on the business and therefore the need for an additional Trading Analyst has not been sufficiently demonstrated.

g) **Customer Value Maximisation**: One new Manager role was forecast. UR proposes not to allow this new role as Power NI have not provided specific details of the ways in which customer behaviour has changed and how these changes directly translate to this additional role. In addition, the reason for recruitment of an individual at a more senior level has not been demonstrated.

Materials and Bought in Services (MBIS)

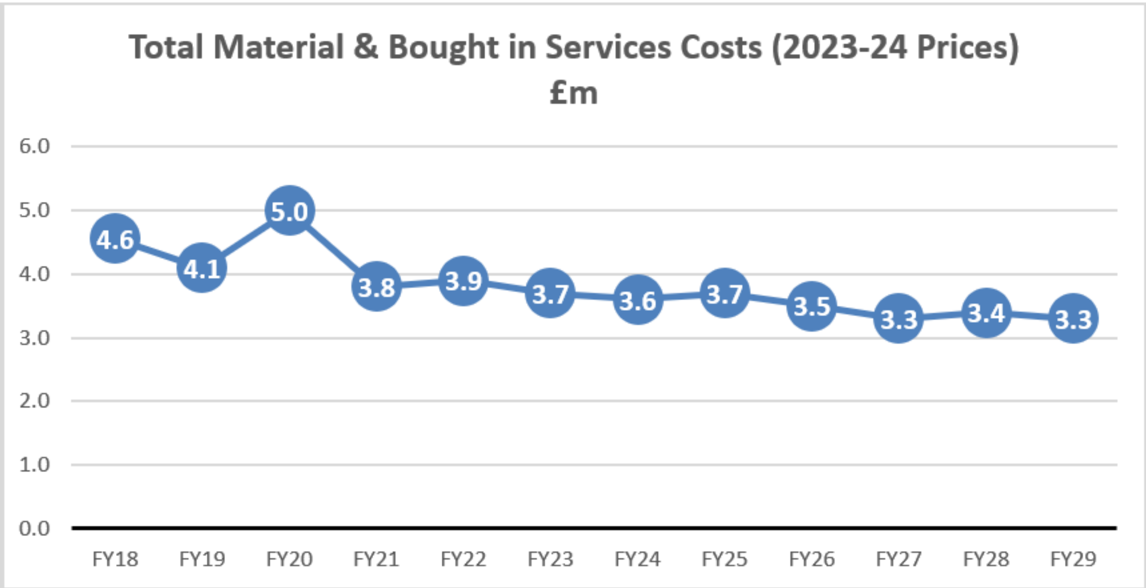

Figure 4.2: MBIS actual and forecast costs FY18-FY29

4.21 Over the Price Control period, Materials costs are forecast to reduce from £3.7m in FY25 to £3.3m in FY29, with an average annual cost of £3.4m. Since 2022, Power NI report that Materials costs have been falling in real terms and they are forecast to continue to decrease during the Price Control. These decreases are driven largely by a reduction in legal and professional costs and non-payroll staff costs.

4.22 Forecast MBIS costs are consistent with the Power NI's historical costs and are relatively unchanged for the duration of the Price Control. All costs are necessary for the running of the business.

4.23 Following scrutiny of the proposed costs UR proposes to allow forecast MBIS costs.

Bad Debt

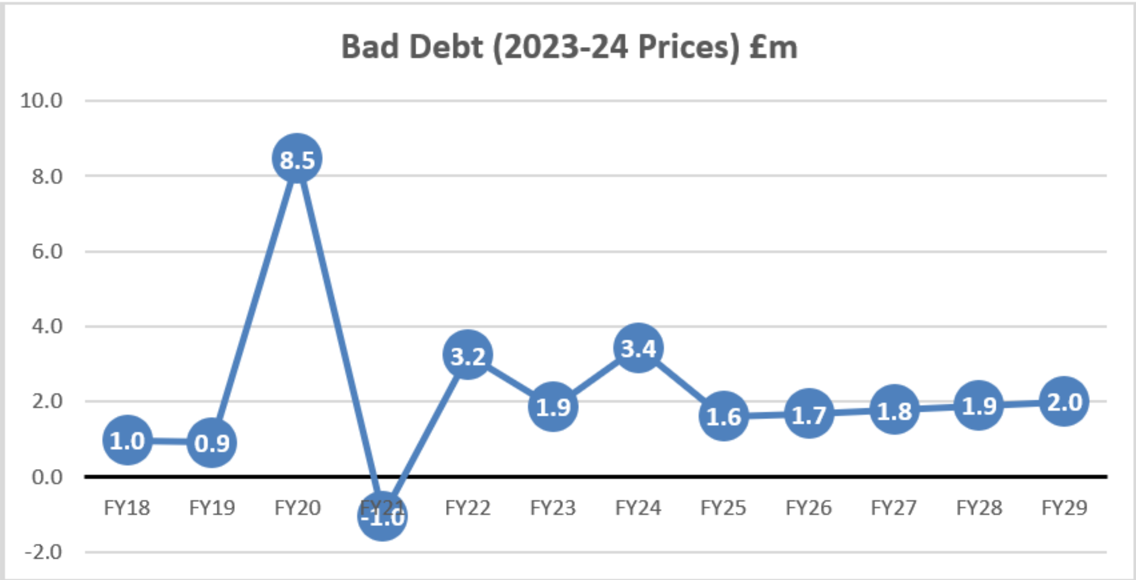

Figure 4.3: Bad Debt actual and forecast costs FY18-FY29

4.24 Within the Price Control, Bad Debt is forecast to increase only very slightly each year in real terms. As actual write offs are forecast to remain around the same level of £0.4-0.5m per year from FY25, these increases are due to a small amount of anticipated upward annual movement in the provision. Despite reduced market volatility and decreases in wholesale energy prices and inflation, consumer tariffs remain significantly higher than prior to the cost of energy and living crises.

4.25 UR proposes to allow forecast Bad Debt costs.

4.26 In the Final Approach paper, UR stated that it was considering moving Bad Debt costs from an ex-ante allowance in the **S_t term** of the Licence to an allowance for actual bad debt write-offs recovered through the **E_t (pass through) term**.

4.27 UR has assessed that maintenance of current staffing levels in the Debt team during the Price Control period will assist with mitigating the risk of bad debt, and the number of prepayment meter customers is forecast to maintain at around 39% of all residential customers, further reducing potential bad debt exposure. For these reasons, UR proposes to retain Bad Debt in the **S_t term**.

Outsourced IT and Software (including printing)

4.28 Outsourced IT and Software costs have been forecast to increase in real terms from £4.6m in FY24 to £7.7m in FY25. This is due to projected increases in Software including strategic projects costs and – to a lesser extent – Managed Service and Software as-a-Service costs.

4.29 Outsourced costs are then forecast to remain relatively steady in real terms in the first half of the Price Control before reducing in FY28 and FY29. This reduction in the second half of the Price Control equates to a 12.8% cost reduction from FY26 to FY29 and is due to anticipated decreases in strategic projects costs in FY28 and FY29 following a period of increase due to implementation of the SAP Hana finance system upgrade in FY26 and FY27.

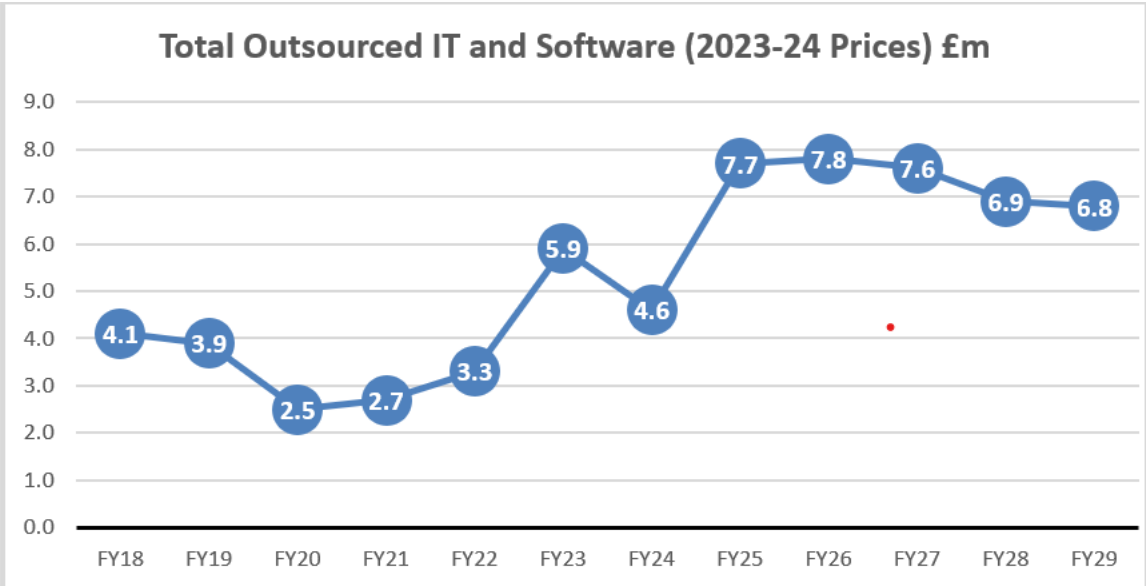

Figure 4.4: Outsourced actual and forecast costs FY18-FY29

4.30 Power NI have included an additional uplift amount of £2.2m for software in FY25 which maintains into each year of the Price Control period FY26-FY29. All of the software that Power NI are requesting allowances for relates to enhancing systems, data governance/compliance and important cyber security systems.

4.31 Costs are based on an outsourced implementation charge, software costs plus third-party markup, and ongoing licensing fees each year. A summary is shown in Table 4-3 below:

(2023-24 prices)	FY25 £000s	FY26 £000s	FY27 £000s	FY28 £000s	FY29 £000s	Total
Implementation	£765	£750		£304	£298	**£2,117**
Recurring	£1,616	£1,615	£1,615	£1,616	£1,615	**£8,077**
Total	**£2,381**	**£2,365**	**£1,615**	**£1,919**	**£1,913**	**£10,194**

Table 4.3: Additional IT uplift implementation and recurring costs FY25-FY29

4.32 UR has held discussions with Head of IT Systems and Head of Strategy and Architecture for Energia. As a result, additional information has been provided regarding the costs of the requested systems. We have also applied our own experience in IT systems and Price Controls and were satisfied that the requested allowances were within an acceptable limit of the activities required with one exception.

a) UR has had discussions with IT and finance experts who have verified that the consultancy cost for mandatory Network and Information Systems (NIS)[20] compliance requirements in FY25 seems appropriate but that this would not need to be a recurring annual cost. Furthermore, it is assessed that the planned use of the remainder of NIS forecast costs for FY25 and the Price Control period has not been sufficiently demonstrated by Power NI.

b) UR proposes to allow Outsourced IT and Software costs for FY25 and the SPC25 Price Control period **except for NIS Compliance costs which are capped at a one-off in FY25 of £127k.**

c) UR proposed Outsourced allowance for FY25 has been calculated by subtracting the difference between NIS consultancy costs (£127k) and overall forecast NIS costs (£400k) from the forecast FY25 outsourced costs. For the Price Control period, all NIS costs (£400k annually in 23/24 prices) have been subtracted from the forecast outsourced costs.

4.33 Also, within this opex category the costs of printing are included. In the SPC25 Final Approach, UR stated that it was considering moving Printing Payment and Mailing costs from an ex-ante allowance in the **S_t term** of the Licence to recovery through the **E_t (pass through) term**, based on actual costs or an ex-post volume driven allowance. Specifically in relation to Printing, Power NI have forecast a continued reduction in costs in FY25 and into the Price Control period. Currently these costs are covered by the 2022 cost sharing mechanism that allows Power NI to retain 35% of any PPM efficiency savings and return 65% back to the customer. This specific cost

[20] Network and Information Services (NIS) is a mandated compliance requirement from the Department of Finance for all operators of essential services such as Power NI.

share mechanism will end on 31 March 2025.

4.34 The continued decrease in Printing costs is a strong driver for retaining these costs in the **S_t term**. In addition, Power NI are moving towards paperless billing. This will reduce printing costs further as capability embeds and more customers hopefully choose to go paperless. While a cohort of customers will prefer or require more traditional forms of written communication, demand in this area is likely to decrease going forward. Furthermore, the further development of customer facing apps, should reduce the need for printing. For these reasons, UR proposes to retain Printing, Payment Providers and Mailing in the **S_t term.**

Agency Costs (Payment Providers and Mailing)

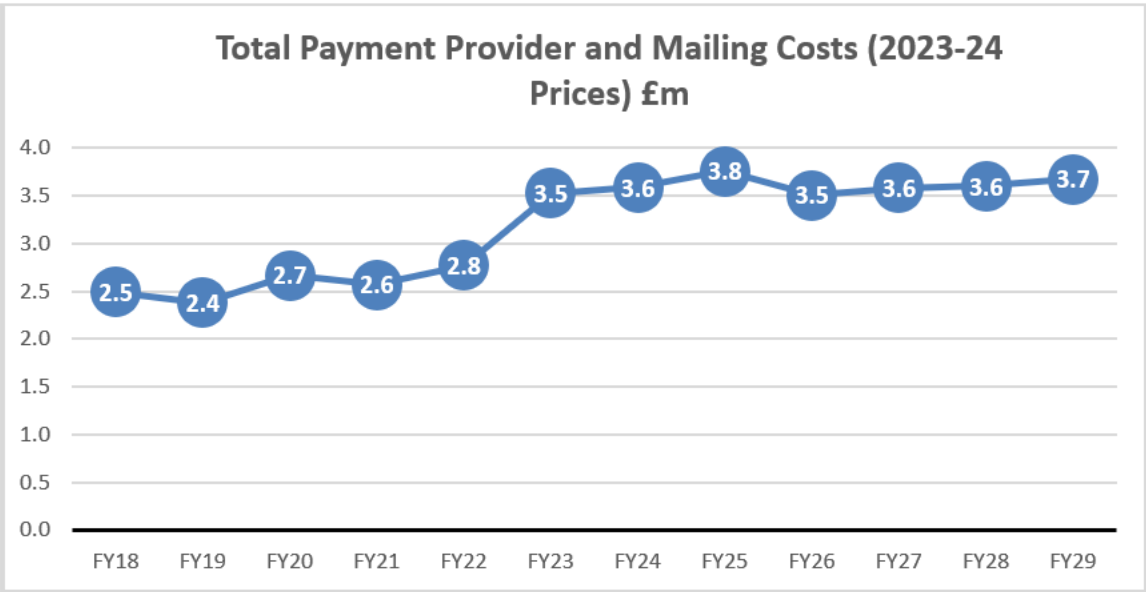

Figure 4.5: Total Payment Provider and Mailing actual and forecast costs FY18-FY29

4.35 Over the duration of the Price Control Power NI forecast that Payment Providers and Mailing costs will initially decrease to £3.5m in FY26 before steadily increasing to £3.7m in FY29. Drivers for the increase include increased Power NI customer numbers, increased processing costs from payment providers, and increased postage costs as a result of Royal Mail price increases.

4.36 UR is minded-to allow proposed forecast Agency costs.

4.37 As previously noted, in the SPC25 Final Approach, UR stated that it was considering moving PPM costs from an ex-ante allowance in the **S_t term** of the Licence to recovery through the **E_t (pass through) term**, based on actual costs or an ex-post volume driven allowance. However, concerns were expressed, particularly from UR Consumer Protection team, as to whether this would remove any incentive for Power NI to be more efficient.

4.38 UR proposes to retain Payment Providers and Mailing costs in the **S_t term.**

Shared IT Systems and Shared Services

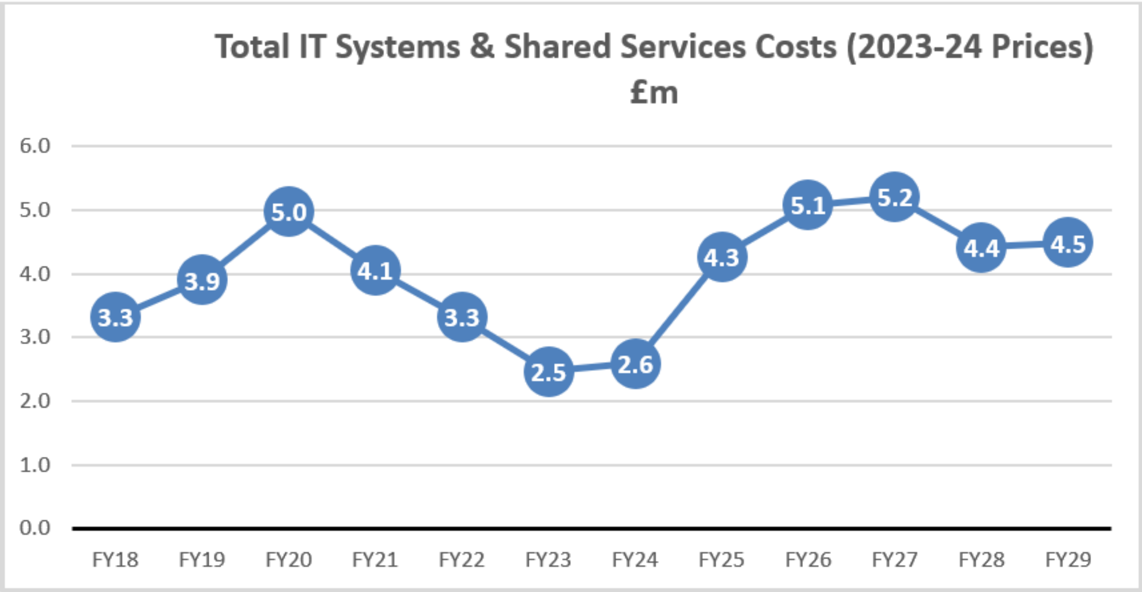

Figure 4.6: Total IT Systems & Shared Services actual and forecast costs FY18-FY29

4.39 The regulated part of Power NI shares other resources with the non-regulated parts of the business and the wider Energia Group. Power NI's share of shared HR and other staff are included under Salaries costs and have been considered there. Within Shared IT Staff and Systems and Shared Non-staff Services there are recharged credit amounts received by the regulated (domestic) part of Power NI's business from Energia and the deregulated (commercial) part of Power NI's business for use of services owned by the regulated part e.g. Power NI's CC&B system. This has been taken into account to reflect the true cost of the Total Shared IT Systems and Shared Non-Staff Services.

4.40 UR proposes to allow forecast Shared IT Systems and Shared Services costs.

Depreciation

4.41 Depreciation costs consist of the annual total of monthly depreciation and amortisation instalments to pay back monies used for expenditure on tangible and intangible assets and projects. Payback periods are calculated depending on the nature of the asset and reflect their likely useful economic life. Tangible assets are generally physical assets such as buildings and fixtures and are depreciated over three years. Intangible assets are generally non-physical or digital assets such as IT systems and are amortised over five years.

4.42 Depreciation costs are forecast by Power NI to increase in real terms from £2.2m in FY25 to £3.7m in FY26. Costs then rise slightly each year to FY28 before reducing in FY29 but remain at a generally similar level during the Price Control period.

4.43 The assets and projects included in Depreciation costs include the following:

a) Tangible assets

- Fixtures & Fittings – refurbishment of the Omagh site in FY25.
- Other Tangible – laptop and server costs.

b) Intangible assets

- CC&B upgrade. The cost of the CC&B upgrade is currently being reviewed and we are awaiting the outcome of that with regard to the costs associated with the new system. Power NI has forecast that the next CC&B upgrade is forecast to start being depreciated in FY29. We are of the view that including depreciation forecast costs for the commencement of a second upgrade within the FY26-29 Price Control period to be premature.

- I-SEM (Endur system) – the main asset was fully depreciated in FY24, and the remaining balance relates to the later enhancements due to potential market changes. We are content with these costs.

- Digital Engine – UR will require a proposal for this project. It is expected that this project may include development of apps, systems integrations or digital sustainability as the energy transition progresses. However, to date UR has not been furnished with any information on this project. It will be necessary for UR to allow these costs subject to a detailed proposal on the nature and scope of the project and it would require a detailed programme of deliverables and detailed associated costs. Power NI will also be required to demonstrate that this project is in the interest of its regulated customers.

- Other Intangible – these costs include a variety of smaller projects. Costs between FY27 and FY29 are mainly for smart readiness. We have already indicated in our approach paper and consultation that this Price Control would not include smart meters. However, at this time we have split Other Intangibles. In FY26 we have assumed that the other intangible amount is a basket of smaller projects, and this will be recovered through the Pf term. Power NI have indicated that the depreciation amounts for other intangibles from 2027-29 are for smart readiness and so will be recovered through the new Et term which we are minded-to create. However, we will require Power NI to provide further information on the content of Other Intangibles and to provide UR with a detailed proposal of the Smart readiness proposal for approval which details the nature, scope and deliverables and how this will be of benefit to its regulated customers.

4.44 Depreciation for the Price Control period will be recovered through a combination of pass through terms in the E_t term and through the Pf term. Where appropriate these will be adjusted via the A_t.

4.45 For the avoidance of doubt, within the current Et terms, term (h) allows for recovering depreciation costs for the Customer Care & Billing upgrade, (CC&B), term (g) for recovery of the depreciation of the Endur system. We consider creating an additional Et term as appropriate to cover the Digital Engine depreciation costs and a new term for smart readiness. The table below details how the depreciation cost will be allocated between $\mathbf{P_f}$ and $\mathbf{E_t}$ terms.

(2023-24 prices)	FY26 £m	FY27 £m	FY28 £m	FY29 £m
Et terms				
CC&B	1.483	1.461	1.437	1.409
ISEM	0.061	0.049	0.045	0.041
Digital Engine	0.961	1.278	1.472	1.283
Other Intangible		0.619	0.512	0.502
Total Et	**2.504**	**3.407**	**3.466**	**3.235**
Pf term				
Other Intangible	0.750			
Fixtures & Fittings	0.024	0.022	0.019	0.018
Other Tangible	0.203	0.148	0.137	0.135
Lease	0.186	0.183	0.181	0.164
Total Pf	**1.163**	**0.353**	**0.337**	**0.317**
Total Depreciation	**3.667**	**3.759**	**3.804**	**3.552**

Table 4.4: Depreciation amounts through Et and Pf

4.46 The SPC25 margin has been calculated to cover the cost of financing the fixed assets detailed in the depreciation calculations with effect from 1 April 2025, and therefore going forward there will be no need for a separate rate of return allowance/ separate Regulated Asset Base (RAB) calculation from this point onwards.

4.47 If during the Price Control there is any large, unforeseen capex we would enter into discussions with Power NI with regards to the best mechanism to recover costs. This may be through a RAB calculation with a rate of return of the agreed Weighted Average Cost of Capital.

RoI Recharge

4.48 Within the opex is an amount each year for RoI recharge which refers to the domestic Energia customers who are serviced via Power NI's CC&B system and for which Power NI receive a cost per customer from Energia. This cost will be allowed within the Opex. The amount per customer is currently being reviewed by Gemserv as part of their CC&B upgrade review. Hence, the amount per customer, following their review, is likely to change. At this time and in the absence of more up to date information we have used the forecast costs as a placeholder, but these will be revised for the Final Determination.

5. Margin Review

Introduction to the margin review

5.1 Power NI must finance a range of fixed capital assets and working capital requirements to finance its overall function. As a service business, the company's fixed asset base, primarily consisting of investment in IT software and hardware is relatively small. Its overall capital requirement is dominated by a range of collateral requirements necessary to engage in the energy market, purchase network services or provide collateral in respect of hedging contracts. While much of this collateral is posted a short time in advance of purchase and payment for energy and network services, it persists on a rolling basis as a working capital.

5.2 In some cases, the company must either post cash as collateral or it can provide a letter of credit or other security in lieu of a cash posting. However, in some cases the company does not post any collateral against potential future liabilities. In the remainder of this chapter, we will refer to cash investment or collateral posting as equity and other capital as contingent capital.

5.3 In its Business Plan submission, the company estimated its capital requirement for the SPC25 Price Control period as £308m. The company estimated the cost of financing this working capital as £33.6m per annum, calculated as shown in Table 5.1.

	Capital (£m)	Finance rate	Margin £m
Working capital (equity)	258	13.8%	35.7
Working capital (contingent capital)	50	3.0%	1.5
Interest earned on deposits	(35)	5.2%	(1.8)
Required margin			35.3
Less amounts recovered through $\mathbf{G_t}$			(1.7)
Net margin to be recovered through $\mathbf{S_t}$			33.6
Forecast revenue			738.9
Net margin / forecast revenue			4.6%

Table 5.1: Power NI's estimate of margin (£m nominal)

5.4 It is common practice to express cost of financing electricity supply companies as a margin, being the percentage of revenue. However, in the design of the Price Control the margin is expressed as a monetary value which is then varied in line with inflation, number of customers and the market price of energy as described in Chapter 3. In the previous Price

Control, the margin was commonly referenced as 2.2%, although the actual percentage value varied as customer numbers varied, reducing as customer numbers increased.

5.5 The level of margin proposed by the company, expressed as a percentage of turn-over is a material increase compared to the previous Price Control.

5.6 In its submission, Power NI identified a number of issues to explain the increase. It argued that reform of the wholesale market reform through the introduction of I-SEM had increased their working capital and collateral requirements. It pointed to the cessation of the Power Procurement Business which had provided an implicit collateral and working capital offset to Power NI's retail operations. It also suggested that its risk environment has increased due to a level of supplier turbulence within the market and point to the recent exit of Electric Ireland from the domestic market. They also argue that the previous methodology was not adequate to ensure their financeability and have suggested a new methodology based on a percentage of turnover.

5.7 We have carefully considered Power NI's margin submission and engaged consultants (First Economics) to provide review, analysis and advice on the submission. Based on our analysis of the information provided by Power NI and the advice of our consultant, we propose a margin of £15.9m/a for the SPC25 Price Control (in nominal terms) this is equivalent to a margin of 2.2% of revenue. In view of the impact which the forecast price of energy and forecast number of customers has on the calculation of margin, we propose to vary the margin to reflect differences between actual values of these parameters and those used to forecast the margin of £15.9m/a (in nominal prices) in this Draft Determination.

5.8 The material difference between the value of the margin requested by the company and the value of the margin included in this Draft Determination arise from a difference of interpretation of the UR's principle statutory objective and how this should be applied. Before setting out the detail of our assessment of determined margin, we provide an explanation of the basis of our assessment.

5.9 In presenting our assessment of the margin, we have followed the approach adopted by the company which determined the cost of working capital in nominal terms. In its submission, the company included an assessment of working capital for a market price of energy of £100, £200 and £300 /MWh. Its proposed margin is based on a market price for energy of £150 MWh, applying the same nominal value in each year of the Price Control. However, the Licence operates in real (October 2023) prices, applying CPIH as a general measure of inflation when determining tariffs in nominal terms.

Having determined a margin in nominal terms, we also set out how this will be converted to October 2023 prices for the purpose of the Licence and how the scaling factors for market price of energy and customer numbers will be applied.

Basis of our Draft Determination of margin

5.10 In its submission on margin, the company set out its view of the UR's principal statutory objective, quoting from Article 12 of the Energy Order with some emphasis added, as follows:

"to protect the interests of consumers of electricity supplied by authorised suppliers (wherever appropriate) <u>by promoting effective competition</u> between persons engaged in, or in commercial activities connected with, the generation, transmission, distribution or supply of electricity."

5.11 Having applied this emphasis to the wording of the Energy Order, the company restated the UR's statutory principal objective as: "the UR's principal objective is therefore to protect the interest of consumers by promoting effective competition." In restating our principle statutory objective, the company has chosen to remove the words "where appropriate" and then proceeded on the basis that these words have no effect.

5.12 It then concluded that: "Both the protection of customers – i.e., ensuring the margin is not set too high to the detriment of customers where Power NI has a dominant position in the marketplace – and the promotion of competition – i.e., ensuring the margin is not set too low to the detriment of competition, and of customers through the benefits that competition and competitive entry bring – are important."

5.13 In our view, there is no need to amend or restate the UR's statutory principal objective, or to seek to emphasise some words in it above others.

5.14 Properly stated, the UR's principal objective requires it to promote effective competition only where UR deems this to be the appropriate mechanism to protect consumers. Competition is a means to an end and not an end in itself. The promotion of competition, however desirable, does not displace the overriding importance of consumer protection.

5.15 UR is committed to the promotion of a competitive supply market in NI. However, the suggestion that UR's statutory duties require Power NI to be permitted a higher margin – so as to, in effect, create greater headroom for new suppliers to enter the market and so facilitate market entry – is not consistent with UR's statutory duties as written. In effect it would privilege the promotion of competition (which is a means to an end) above the desired end of protecting the majority of consumers (among other things by keeping their electricity prices at a reasonable level). This would be the opposite of the approach actually required by the duties.

5.16 Applying its interpretation of our principal objective, the company has proposed a margin based on a stand-alone company. The company does not explicitly define what it means by the term stand-alone company, but we infer the following from its approach:

a) That the company should be considered and financed as if it were a supply company which operated in a competitive market without the protections which regulation affords to Power NI.

b) That UR should determine the margin for Power NI on a notional company basis without reference to the individual circumstances of the company as it currently exists.

5.17 Having established its approach on a stand-alone company basis, the company provided estimates for a series of categories of working capital. In some cases, Power NI's forecasts are, very deliberately, not the capital requirements that the real-life Power NI business has or is likely to encounter, but rather Power NI uses estimates of the capital that a hypothetical 'stand-alone' competitor would face if it were to take on Power NI's regulated customer book.

5.18 In calculating the cost of financing its capital requirement, the company assumed that a stand-alone company would only be able to finance 16% of its capital requirement through a revolving credit facility at a rate of 3%. It proposed that the remaining 84% of the working capital should be financed through a cost of capital (in practice a cost of equity) of 13.8%. This hypothetical approach bears no resemblance to the actual financing structure of the existing company.

5.19 The cost of equity proposed by the company was calculated to reflect the risk profile of a competitive company operating in the GB electricity supply market. While the company considered the protections afforded to its regulated business through a strong regulatory contract, it dismissed these, providing counter arguments. We did not consider these counter arguments compelling. For example:

a) The company highlights the risk that it might build up an excessive under-recovery (**K_{St}**) which would increase future tariffs. It suggested that this created a risk that its customers would move to other suppliers. In response, we note that:

(i) The company is able to mitigate the build-up of a material under-recovery by seeking a tariff review.

(ii) If the under-recovery came from a loss of market share due to increased and more effective price competition, the company is able to respond by offering a tariff which is lower than the regulatory maximum, provided it can be competitive.

(iii) There is no evidence that this has been an issue in the past with market share both rising and falling at times without any apparent correlation to $\mathbf{KS}_t$.

(iv) There are also periods of over-recovery which results in the company offering a lower future tariff as the over-recovery is unwound. These periods offer the company an opportunity to gain market share.

b) The company also highlighted its position as Supplier of Last Resort (SOLR) and stated that its margin should be set at a level to ensure it can continue to robustly fulfil this retail market backstop related role. The company highlighted previous SOLR events which covered 1200 and 725 customers. It also highlighted the withdrawal of Electric Ireland from the Northern Ireland retail market as a further example, although this is an orderly withdrawal which a gradual transition of consumers to other companies. This risk should be set in the context of Power NI increasing its customer base by more than 2,500 per month in 2023 on average, planning for an increase of 3.6% per annum (>20k) during the SPC25 Price Control and continuing to actively promote its service to new consumers. In addition, our proposal to vary the margin in response to customer numbers will ensure the company receives adequate margin in respect of new customers as these events arise.

5.20 We understand the concept of a notional company and note that Ofgem, which regulates large numbers of similar companies across GB, routinely sets Price Controls on a notional company basis. However, UR has historically not sought to do this. Instead, we have set each Price Control on the basis of the individual circumstances of the relevant company. We have concluded that it is right to continue this consistent regulatory approach in this Price Control, taking account of the facts which UR is faced with at the time this decision falls to be made. These facts include the current structure of the Power NI business. We do not consider that it would be in the interest of consumers, and therefore not in line with our principal objective, to increase the margin of Power NI above that required by its existing structure in a way which would increase the potential profit of a dominant supplier which already benefits from its historical position as the incumbent supplier when supply competition was first introduced, its scale and a strong regulatory contract which makes for provision for full cost recovery of major elements of its costs.

5.21 The practical consequences of this approach are that:

a) We have taken account of the protections afforded to the company in its Licence which allows it to recover significant parts of its cost base, including energy market costs, network costs and energy subsidy costs. As a result, we have determined a lower cost of equity than that proposed by the company to reflect the lower risk the company is exposed to compared to a supply company operating in the competitive GB market.

b) We have taken account of the circumstances of the company at the time this determination is made. In particular, we have taken account of the way in which the company is able to finance its current working capital using a higher proportion of contingent capital.

5.22 Applying these general approach and principles, we have determined a margin for the SPC25 period of £15.9m/a, compared to the margin of £33.6m proposed by the company (both figures in nominal terms). This margin is based on a market cost of energy of £150 /MWh (constant in nominal) over the SPC25 period. It is also based on the company's estimate of the number of consumers over the SPC25 period. Given that the future market price of energy and the number of consumers served are both uncertain, we have proposed a mechanism which allows the actual margin recovered to flex as the market price of energy and the number of consumers change.

5.23 Our determination takes account of the expert advice provided by First Economics. We have published this advice as Annex A of this determination. In the following sections of this Chapter, we provide a summary of our assessment of the company's submission and our determination of margin, taking account of the advice provided by First Economics. We also set out how we propose to apply the determined margin in the calculation of the $\mathbf{S}_t$ term, including how it would be varied to reflect the actual market price of energy and the actual number of consumers served.

Methodology

5.24 Power NI's described its approach to assessing of margin for SPC25 as follows: "each element of capital committed to or available to the business is identified and an appropriate pricing applied based on an assessment of the appropriate capital structure and an estimate of the market pricing of that capital".

5.25 As set out in our consultant's report in Annex A, we agree with the company on the broad methodological approach to the determination of margin as:

Profit in £m = capital base x percentage cost of capital*.*

5.26 The thinking behind this approach is that profit is first and foremost a return that can be distributed to investors, either in the form of fees and/or interest payments (in the case of debt obligations) or as potential dividends and/or capital appreciation (in the case of equity investments). To calibrate the appropriate amount of profit, it makes sense to think in terms of the percentage return on any debt that a company is taking and/or the percentage return on the equity capital that shareholders have agreed to put behind a firm.

5.27 This aligns with the way that investors view investments in companies. If the percentage return that is factored into the Power NI supply Price Controls is set so that it is in line with the risk-adjusted returns that are available elsewhere on other similar-looking investments (i.e. in line with the opportunity cost of capital), it ought to be that providers of capital will look favourably on the regulated supply businesses as investments and exhibit a willingness to supply the facilities and equity capital base that the businesses need in order to provide services to customers. We can also say that mistakenly setting returns above the opportunity cost of capital will result in customers paying more than they strictly need to. Conversely, if the returns on offer lie below the opportunity cost of capital, there is a danger that investor community might shun a supplier – i.e. a licensee will not be 'financeable' – thus presenting an avoidable risk to service.

5.28 In summary, our determination of margin must first assess the capital requirement and then determine the appropriate percentage cost of capital which must be applied to either the total capital requirement or to individual components of the capital requirement.

Capital Requirement

Power NI's assessment of capital requirement

5.29 Power NI developed a detailed bottom up assessment of capital requirements for the four years of the SPC25 Price Control. This assessment was prepared:

a) for ten individual component of capital requirements summed to an overall capital requirement;

b) on the basis of nominal costs allowing for inflation;

c) on a monthly basis, allowing annual averages and annual peak month values to be calculated;

d) including projections of customer numbers and average energy consumption per household;

e) with separate assessments for three scenarios based on different market cost of energy of £100, £200 and £300 /MWh, in the company's analysis, the cost of energy for each scenario was held constant in nominal terms in each year, declining in real terms;

5.30 The company assessment of margin for SPC25 was based on a capital requirement of £308m being:

a) the average of the annual average capital requirement for each year of SPC25; and,

b) the average of the scenarios for the market cost of energy of £100 and £200 /MWh, effectively a market cost of energy of £150/MWh.

5.31 The average annual working capital calculated by the company for each of its energy price scenarios is shown in Table 5.2

Market price of energy	FY26	FY27	FY28	FY29	Average
£100/MWh	205	219	230	248	226
£200/MWh	353	379	400	428	390
£300/MWh	481	519	549	587	534
Power NI assessment at150/MWh	279	299	315	338	308

Table 5.2 Power NI's assessment of average working capital (£m nominal)

5.32 Underpinning these average values is the company's assessment of working values which show an annual pattern with the peak values occurring in the winter. This assessment is reproduced in Figure 5.1 below.

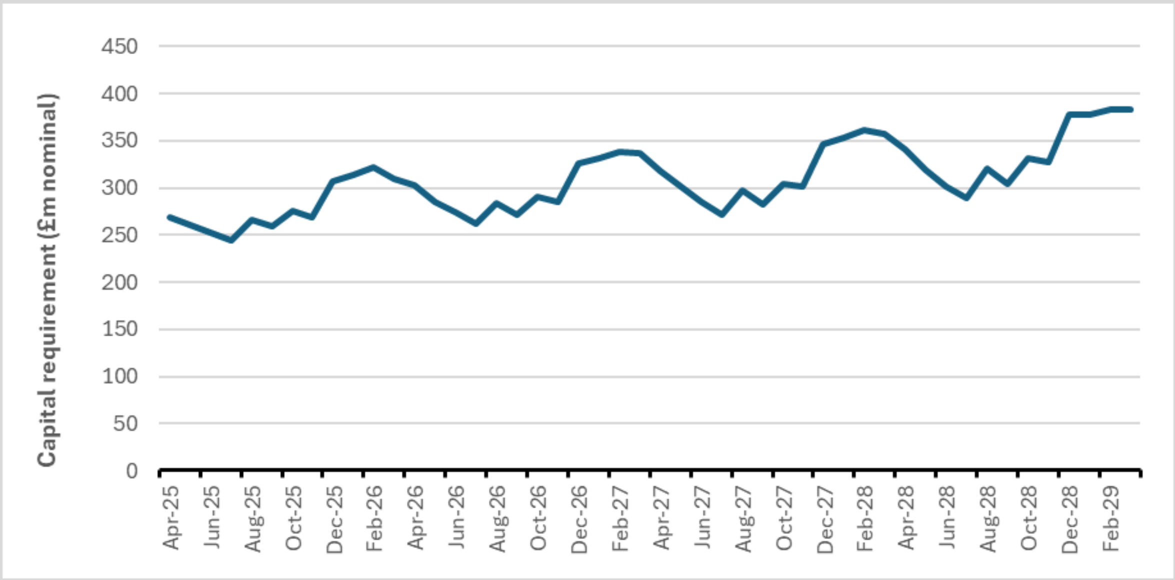

Figure 5.1: Power NI's assessment of monthly capital requirement over SPC25

5.33 The company's assessment shows a gradual upward trend in working capital over time underpinned by growth in customer numbers, growth in consumption per customer and inflation. The difference in annual average and annual peak month is circa 14%.

5.34 The company's assessment of average working capital also shows a strong dependency on the market price of energy, reflecting the impact that this has on collateral and security deposits the company has to make to purchase energy from the Single Electricity Market (SEM) and when it hedges forward energy prices.

5.35 The variation of working capital with market price of energy is shown on Figure 5.2. While not a strict linear relationship, it shows a strong linear trend with an approximate fixed value of £76m and a variable element of £1.54m of working capital for every £1/MWh increase in the market price of energy. It reinforces the fact that the market price of energy is a key determinant for the capital requirement.

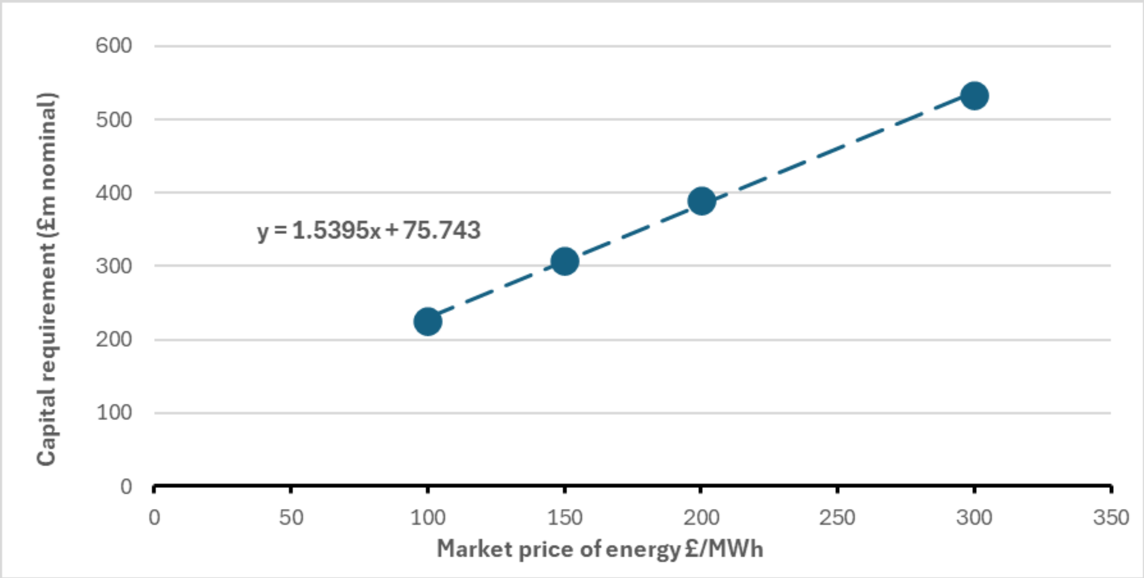

Figure 5.2: Variation of working capital with the market price of energy

5.36 The company's assessment of its capital requirement is built up of detailed assessments of 10 components covering:

a) Fixed assets: where the company has invested in premises, office equipment, IT software and hardware and other capital assets to deliver its service.

b) Working capital: dominated by payments for energy and network services paid in advance of collecting revenue from consumers.

c) Collateral and security deposits: Power NI must post cash or collateral for the purchase of energy in the SEM and in anticipation of the network charges it will incur. It might be required to post collateral in respect of hedging contracts it enters into in respect of future energy costs or foreign exchange rates.

d) Stand-by capital: it may also be appropriate for a supply company to have an amount of cash on standby to deal with unforeseeable day-to-day deviations to cash flow.

5.37 A breakdown of Power NI's assessment of capital requirements by component is reproduced in Table 5.3.

	Category	Capital Requirement (£m)	Capital Requirement (% of total)	Current means of financing
1	Net Working Capital	31	10%	Equity
2	Intra-Month	8	3%	Equity
3	K-Correction	27	9%	Equity
4	Prefunding	6	2%	Equity
5	NIE Networks & SONI	18	6%	Contingent
6	SEMO & NEMO	32	11%	25% Equity, 75% contingent
7	CFDs	37	12%	25% Equity, 75% contingent
8	GB Power	112	36%	None
9	FX	24	8%	Parent company guarantee
10	Fixed Assets	13	4%	Equity
		308		

Table 5.3: Power NI's assessment of capital requirement by component (£m nominal)

5.38 We asked the company to provide information on how each component of its capital requirement is currently financed and have included this information in Table 5.3. Based on the information provided by the company, it currently finances as equity (cash) 33%, 23% by contingent capital (letters of credit) with 44% supported by actual or implied parent company guarantee. This compares to the company's assessment of margin for SPC25 where it assumes that 84% of its working capital should be financed by consumers as equity. This difference is critical to the difference between how the company and UR have approached the determination of margin in principle as described in the section above beginning at Paragraph 5.10.

UR's determination of capital requirement

5.39 We agree with the categories of capital the company has considered in its assessment. We note the assessment prepared by our consultant on capital requirement and the recommendation that the overall capital requirement proposed by the company should be reduced by £15m. We have set out our views on the assessment of each category of capital requirement below. But first we have reviewed the company's assumptions on inflation, customer growth, consumption growth and market cost of energy which are key common drivers in its projection of capital requirement.

5.40 The company has calculated working capital in SPC25 assuming the level of inflation set out in Table 5.4. We consider these assumptions reasonable, but that they do not apply to the cost of energy in the assessment of working capital which has been set and a constant in each year. We have taken account of this when determining a margin on October 2023 prices for the purpose of the Licence and when determining scaling factors in respect of customer numbers and market price of energy which are applied to the determined value of margin in the Licence when determining the maximum regulated tariff.

	FY25	FY26	FY27	FY28	FY29
Annual inflation	3.00%	2.00%	2.00%	2.00%	2.00%

Table 5.4: Power NI's assumption for inflation in SPC25

5.41 The company's assessment of capital requirement assumes the rate of growth in customer numbers over SPC25 set out in in Table 5.5. This forecast is underpinned by an assumed the addition of circa 20,000 customers per annum. This assumption of sustained growth comes after a six year period when customer numbers increased by 10% in total, mainly driven by growth of 7% in FY24 largely due to customers moving from Electric Ireland to Power NI. The assumption that consumer numbers will increase by 20% in the next five years (taking Power NI market share to circa 70%) seems optimistic when most recent customer data suggests that annual growth has fallen to 2.4%. However, we have used the Power NI figures in our determination, but continue to vary margin allowed in the maximum regulated tariff in proportion to consumer numbers.

	FY25	FY26	FY27	FY28	FY29
Growth in consumers	3.9%	3.7%	3.7%	3.6%	3.5%

Table 5.5: Power NI's projection of consumer numbers in SPC25

5.42 The company's assessment of capital requirement assumes the consumption per consumer will grow in SPC25 as shown in Table 5.6. The company's assessment is based on the Generation Capacity Statement (GCS) with an average growth rate of more than 4% per annum for domestic properties as low carbon technologies such as electric cars and heat pumps are connected. This rate of growth did not materialise in FY24 when consumption per customer fell slightly. However the company has assumed that the GCS projections will be maintained, resulting in an increased percentage uplift in FY25. In our Final Determination for RP7 we highlighted the risk that the rate of connection of LCT technology might lag behind targets and that this would increase tariffs for all consumers in the short term. In the case of Power NI, its latest tariff covers the period from

December 2024 to November 2026 (most of the first two years of SPC25), the forecast total meter point sales were more than 10% lower than the company's forecasts for the same period in SPC25. There is a risk that the consumption figures used by the company to determine margin for SPC25 are at the upper end of expectations. Based on the trend presented in Figure 5.2, if consumption over the SPC25 period was 10% lower than projected, working capital would reduce by circa £20m.

	FY25	FY26	FY27	FY28	FY29
Average consumption kWh/cust	3369	3508	3651	3796	3932
Growth in consumption	9.6%	4.1%	4.1%	4.0%	3.6%

Table 5.6: Power NI's projection of consumption per consumer in SCP25

5.43 The company's assessment of working capital is based on a market price for energy of £150 /MWh over the SPC25 period.

5.44 In recent years there has been a significant peak in electricity prices as shown in the SEM Day Ahead Market prices on Figure 5.3 as gas prices increased as a result of the economy recovery following Covid19 and the war in the Ukraine. While some stability has returned to markets, market prices for electricity have settled at about £100/ MWh compared to £50 or less before 2021. The recent Power NI tariff review for the period from December 2024 to November 2026 (including much of the first half of the SPC25 Price Control period), was based on a market price of energy of £100/MWh, reflecting market information on forward prices for electricity. On the basis of current and forward prices for electricity, using a market price of electricity of £150/MWh would appear to provide some headroom in a forward looking determination of margin. However, it is a matter of fact that this price was exceeded 25% of the time in the SEM DAM (on a 12 month rolling average basis) since October 2018. While the lesson of the recent past is that we must be cautious about projecting economic conditions from current conditions, it is also true that the recent spikes in energy prices were driven by extreme events and we should not assume that they are a guide to the future. Therefore, we have concluded that a market price of energy of £150/MWh is a conservative basis for determining a forward looking margin which, on the basis of current forward prices for energy, includes headroom. We have assessed the company's proposed capital requirement on this basis.

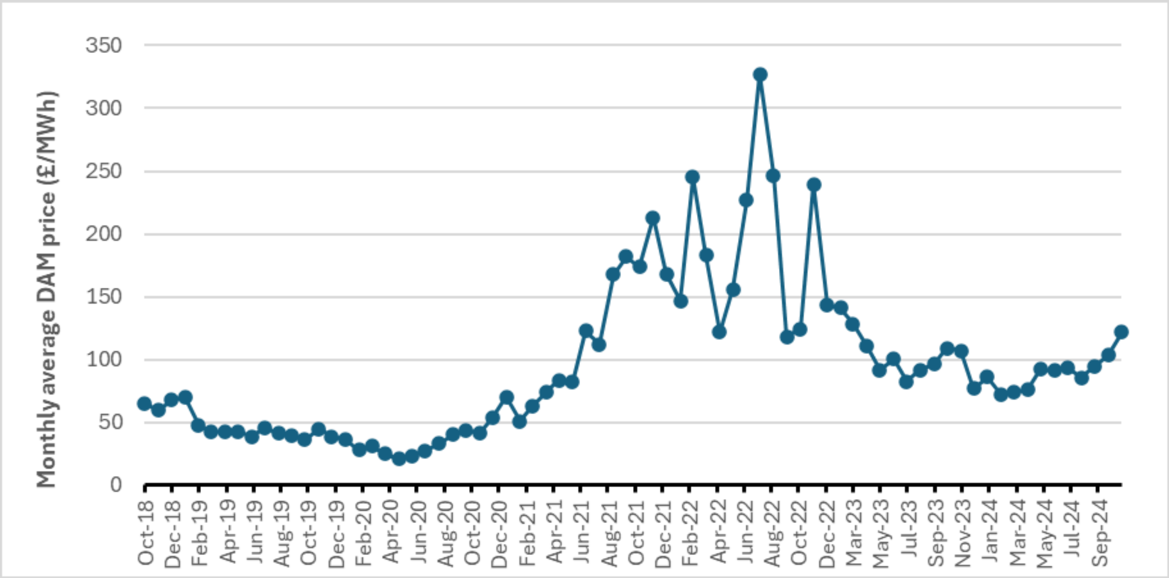

Figure 5.3. Monthly average SEM Day Ahead Market prices (£/MWh)

5.45 The company's assessment of working capital for the SPC25 Price Control period is summarised in Table 5.3. Our economic consultant's assessment of the individual categories is set out in Annex A, including a recommendation that the total quantum of working capital should be reduced by £15m for the purpose of determining the margin.

a) **Net Working Capital**: Power NI's forecast of networking capital is based on very cyclical positive values compared to recent historical values which have been negative, subject to a limited number of positive values in 2022. The company has added an amount of circa £5m against a risk that debtor days will increase without providing an explanation of why this is justified. Taking account of the comparison of historical data and forecast of networking capital and the extra allowance for increased debtor days, the company's assessment of an average capital requirement of £31m appears conservative.

b) **Intra-Month**: Power NI has identified an additional capital requirement to cover the peak day in month. We have accepted this assessment.

c) **K-Correction**: The method by which the company's tariff is set exposes it to over and under-recovery of costs. These over / under recovery of costs are recovered in future tariffs. However, in the event of an under-recovery, the company must finance the cash flow until it transfers forward into tariffs. Power NI undertook an analysis of future K factor values which suggested that it would be required to finance an average value of £12m over the SPC25 Price Control period. This forecast was more peaky than historical values and mainly generated only positive values when the past has included over and under recovery. For the purpose of establishing a capital requirement, the company increased its bottom up value by a further £15m. In support of this it provided information on monthly K factor which looked back at the peak K factor by quarter from 2020. This showed that the peak under-recovery exceeded £20m in 8% of quarters, with a peak under-recovery of just over £30m. However, we are concerned that the company is, in this case considering historical peaks when in other areas it uses bottom up assessments based on short term peaks. In view of the bottom up assessment provided and the historical values, a value in the range £12m to £20m would appear to be a conservative estimate compared to the £27m average proposed by the company.

d) **Prefunding**: Power NI has identified an additional capital requirement necessary to ensure that cash is available in its bank accounts to cover clear payments when they arise. We have accepted this assessment.

e) **NIE Networks & SONI**: Power NI must post collateral with NIE Networks and SONI in advance of using both network and system services. Considering, the current levels of expenditure, expected increases in network charges as a result of the RP7 Final Determination and recent increases in system service charges, the company's forecast of capital requirement appears to be reasonable.

f) **SEMO & NEMO**: Power NI must post collateral in the energy market in advance of trading. Considering the relationship between these collateral requirements and the market price of energy reflected in historical collateral requirements, the company's assessment of working capital for this component at a market price for energy of £150/MWh is reasonable.

g) **CfDs (energy price hedges)**: The company hedges its forward price of energy through Contracts for Difference with Irish generators. The actual level of working capital requirement at any point in time will depend on the price of power relative to the hedged price. However, Power NI's forecasts are at and above the recent peak in the historical level of collateral posed.

h) **GB Power (energy price hedges)**: Power NI enters into energy price hedges in GB markets as proxy hedge where there is insufficient capacity for the market in hedging contracts on the island of Ireland. It does not make collateral payments on these contracts and has constructed a capital requirement on a similar basis to the CfD hedging contracts.

i) **Foreign Exchange (FX hedges)**: Power NI has set out potential collateral requirements for FX hedges for payments and hedges denominated in euros. The potential collateral is dominated by forward hedges for energy which make up 80% of the average hedged values. This is assumed to be hedged on a rolling basis at a relative constant amount increasing with consumption. The remainder of the FX hedge is in respect of SEM market charges denominated in euros. Tariffs are set at the start of each year and the amount hedged declines over the year. The overall profile of future capital requirement for FX hedging is more level than the historical capital requirement of FX hedges, suggesting a marked shift in forecast approach compared to historical approach. Had the forecast profile reflected the historical profile the average FX capital requirement would have been lower by circa 30%.

j) **Fixed Assets**: The company has assumed that fixed assets would increase in the last 18 months of the SPC25 Price Control period due to additional expenditure on smart metering and the introduction of a new customer contact and billing system. We plan to address these through the $\mathbf{E_t}$ mechanisms once the costs are known. The company is currently in the process of replacing its customer contact and billing system and the final costs are not yet known. We will review the fixed asset capital requirement for the Final Determination when there will be a better estimate of out-turn cost. We note that the company's approach to including fixed asset value in the capital requirement underpinning the margin will require careful consideration of depreciation of $\mathbf{E_t}$ terms to ensure that the calculation of depreciation and any allowance for return is consistent with their treatment in the calculation of margin.

5.46 Our review of the components of working capital confirms the view of our economic consultation that "it would not be unreasonable to mark down Power NI's forecast capital requirements in the areas we have highlighted by around £10-20m". For the purpose of calculating margin, we have marked down the working capital by £15m as shown in Paragraph 5.45.

Cost of capital

5.47 When calculating the cost of financing the capital requirement we have to consider reasonable rates for:

a) Equity.

b) Contingent capital.

c) Interest on various deposits.

d) Allowance for the ability for the company to recover part of its cost of financing through the Gt term.

Cost of capital (equity)

5.48 In calculating the allowed cost of equity, UR, like most economic regulators, used the Capital Asset Pricing Model (CAPM) to determine the returns that shareholders require in exchange for their equity investments. CAPM estimates the required return to be a function of the risk-free rate (Rf), the expected return on the market portfolio (Rm) and a firm-specific measure of risk (the equity beta (ße) as follows:

$$Ke = Rf + \beta e * (Rm - Rf)$$

5.49 This is the same approach adopted by the company. The key parameters used in our assessment are set out in Table 5.7 where they are compared to the parameters proposed by the company.

Parameter	Power NI	UR
Expected market return	9.4%	8.9%
Risk-free rate	4.6%	4.0%
Asset beta	1.2	0.75
Cost of equity	10.4%	7.7%
Tax rate	25%	25%
Pre-tax cost of equity	**13.8%**	**10.2%**

Table 5.7: Cost of equity proposals for SPC25

5.50 The proposed cost of equity is based on the advice of our consultant as set out in Annex A, noting:

a) We agree with the company that the cost of capital of cash investments and collateral posting should be calculated as equity only (gearing = 0%).

b) We have adopted a value for expected market returns in real terms of 6.75%, consistent with our recent determination for NIE Networks (RP7), compared to the value of 6.65% proposed by the company. In the past, regulators have commonly used a value of 6.5%. We adopted a slightly higher value in RP7, noting the move to higher real rates of interest and Ofgem and Ofwat's indications that they would consider ranges with higher upper values for their next round of network Price Controls. To covert this to a nominal value, we have adjusted for CPIH inflation of 2%, being the value projected by OBR at the end of its latest forecasts.

c) We have adopted a risk free rate of 4%. This is based on our analysis for the RP7 Price Control which is based on a basket of index linked gilts and two types of AAA non-government bonds weighted at 50:25:25. This was based on August 2024 data and we propose to update this assessment using the latest information available when we reach our Final Determination.

d) We have adopted an asset beta of 0.75 as recommended by our consultants compared to the figure of 1.2 used by Power NI. This is an increase from the value of 0.6 used in previous supply Price Controls. The company's position is that we should adopt an asset beta of 1.2, consistent with that used by Ofgem when determining price caps for GB supply company. We note the strong regulatory protections available to Power NI which include mechanisms to recover its energy costs and a range of network, market and energy incentive costs. We disagree with Power NI's premise that it has a similar risk profile to GB supply companies operating in a commercial / competitive environment where the experience of company failure in recent times reveals a higher risk. We note that an asset beta of 0.7 to 0.8 is consistent with the average equity beta of 1.0 after accounting for the average level of gearing exhibited by UK listed firms.

e) The data above is the basis for a post tax cost of equity. We have adjusted this to a pre-tax cost of equity by allowing for corporation tax at 25%.

Contingent capital

5.51 Power NI proposed a rate of 3% for continent capital applied to the £50m revolving credit facility included in its assessment of margin on a stand-alone company basis. Our consultant considered a range of precedents on the cost of contingent capital and noted that the evidence clearly pointed to a range between 2% and 3% and used a value of 3% at the upper end of this range to estimate a margin for Power NI. We have adopted this approach in our determination, recognising the risk that Power NI carries in financing its activities.

5.52 In line with the recommendations given by our consultant, we have applied this rate for estimated capital requirements where Power NI does not post collateral at present. This approach provides for any implicit cross subsidy that Power NI receives from its parent company that relieves it of obligations that it might otherwise face as a stand-alone entity in respect of counterparties.

Interest on various deposits

5.53 We have allowed for interest on our revised estimates of the capital requirement for K-factor and SEMO & NEMO cash amounts. We have used the interest rate proposed by the company and the adjusted the amounts this applied to reflect the amendments we made to the working capital. We will adjust the rate of interest to take account of more up to date information for the Final Determination.

Allowance for the ability for the company to recover part of its cost of financing through the Gt term.

5.54 The company is able to recover actual costs of letters of credit through the Gt term of the Licence. We have used the company's estimate of £1.8m for this adjustment.

Determination of margin

5.55 Following the approach outlined above, we have prepared a bottom up estimate of margin of £11.7m, equivalent to 1.6% of revenue. This takes account of:

a) Our decision to reduce the capital requirement by £15m with the adjustments made to components where equity is required.

b) The application of a cost of equity of 10.2%.

c) A cost of contingent capital of 3.0%

d) The allocation of capital requirement between cash (equity) and contingent capital in the same way as the company currently finances these activities.

e) The application of the contingent capital rate to estimated working capital where the company does not currently post any collateral in lieu of any real or implied company or parent company guarantee.

f) The deduction of deposit for the amount of K-factor and SEMO & NEMO cash collateral.

g) The deduction of actual costs of letters of credit which the company can recover through the Gt term.

5.56 Our bottom up calculation of margin is presented in Table 5.8 below.

Capital Requirement	Capital (£m)	Funding	Allocation (%)	Allocation (£m	Rate	Margin
Net working capital	22.5	WACC	100%	22.5	10.20%	2.3
Intra-Month	8.1	WACC	100%	8.1	10.20%	0.8
K-Correction	23.9	WACC	100%	23.9	10.20%	2.4
Prefunding	5.9	WACC	100%	5.9	10.20%	0.6
NIE Networks & SONI	17.7	Contingent	100%	17.7	3.00%	0.5
SEMO & NEMO	32.5	WACC	25%	8.1	10.20%	0.8
		Contingent	75%	24.4	3.00%	0.7
CFDs (energy hedges)	37.2	WACC	25%	9.3	10.20%	0.9
		Contingent	75%	27.9	3.00%	0.8
GB Power (energy hedges)	111.5	Contingent	100%	111.5	3.00%	3.3
FX	23.7	Contingent	100%	23.7	3.00%	0.7
Fixed Assets	10	WACC	100%	9.9	10.2%	1.0
Total				292.8		15.1
Less interest on deposit (K-factor and NEMO/SEMO) equity				32.0	5.2%	(1.7)
Less amount recovered through $\mathbf{G_t}$						(1.7)
Net margin to be recovered through $\mathbf{S_t}$						11.7

Table 5.8: UR proposed margin (nominal prices)

5.57 Our bottom up assessment of margin to be recovered through $\mathbf{S_t}$ is the equivalent of 1.6% of revenue. Our consultant has recommended that UR should provide some headroom above this figure, suggesting that we do not reduce the margin below the current margin rate of 2.2%, the equivalent of £15.9m (holding the value of revenue excluding margin constant). This approach is consistent with the with the principle UR has applied in previous supply Price Control reviews for a layer of standby risk capital that would ensure that Power NI is capable of remunerating investors ex-ante for making long term commitments to the business. It makes provision for the possibility that capital requirements will exceed the level identified by Power NI within year, between years or in the event of unforeseen changes in circumstances including changes in the way that different components of the capital requirement must be financed. And it provides errors in the way the company has estimated capital requirement which we have largely accepted as the basis of our own assessment.

Adjusting the determined value of margin for inflation

5.58 Power NI has assessed its margin based on an average working capital over the 4 years of the SPC25 Price Control. This approach averages nominal values which allow for an element of inflation. In practice, the value of margin included in tariffs is determined from the formula for St in the Licence which requires input values (including the determined value of margin on October 2023 prices (CPIH deflated). We have made a simple adjustment, anchoring the nominal determined value of margin of £15.9m at the mid point of the SPC25 period (the end of March 2027) and using the inflation factors used by the company to determine nominal values in its business plan submission. Taking a factor of 1.0823 to convert to October 2023 prices, we arrive at a margin of £14.6m as the allowance for $\mathbf{P_v}$ (the determined value of margin) in the proposed Licence formula for $\mathbf{S_t}$.

5.59 However, we note that the value for the market price for power of £150/MWh is held constant in the calculation of margin in nominal terms. Applying the same approach gives a representative market price for power of £139 at October 2023 prices.

Margin Structure

5.60 The determined margin is based on an assumed market price of electricity of £150/MWh. Recent history has shown the market price of electricity can be highly variable and changes in this price will have an impact on working capital and the cost of financing Power NI.

5.61 In the past the Licence has allowed 30% of the $\mathbf{S_t}$ term to vary with the number of customers. This figure of 30% was close to the determined monetary value of the margin. This provided some protection to both Power NI and customers that the allowed margin would vary as the number of customers reduced or increased and that the margin was not a barrier to Power NI taking on new customers.

5.62 However, as Power NI has noted, its margin fell in percentage terms as the cost of energy rose. Conversely, a fixed margin would increase if the cost of energy decreased.

5.63 Looking backwards, a market price of energy of £150/MWh has been exceeded frequently in the recent past. Looking forward, the market price for energy has been lower than the £100 /MWh for most of 2024 and forward prices for energy also appear to be at or below £100 /MWh for the next 2 years. The most recent Power NI tariff review, effective from December 2024, which covers most of the first half of the SPC25 Price Control, is based on a market price for power of £100/MWh.

5.64 In view of the uncertainty over the future market price for energy and the fact that margin is sensitive to this parameter, we consider how much of each component of the working capital and the associated margin contribution was related to the market cost of energy. This assessment was based on the company's assessment of working capital at £100, 200 and 300/MWh. and how much was fixed. This revealed that 24% of our determined margin at £150/MWh was 'fixed' and the remaining 76% varied with the market price of power (at a fixed number of customers). We have used a simple 25%, 75% split in our subsequent assessment.

5.65 Because of this relationship, we consider it appropriate to make provision for the margin recovered by the company to vary with both customer numbers and market price of power. Our proposal is that:

5.66 The 25% or the margin seen to be 'fixed' (at a constant number of customers) will vary in proportion to customer numbers only.

5.67 The 75% of the margin seen to be variable in terms of market price of energy (at a constant number of customers) will be varied in proportion to the product of the proportion of customers and the market price for energy. This recognises that the relationship between the market price of energy is a surrogate for the cost of energy (customer numbers * consumption/customer numbers* market price of energy). We have not factored the actual consumption per customer into our proposals as it adds further complexity. We note that the risk of exceeding the consumption per customer assumed by the company in its assessment of margin is unlikely unless there is a material increase in the rate of LCT connections.

5.68 Therefore, our proposal for a factor to vary the determined margin in line with customer numbers and market price of power is:

Allowed margin in any relevant year = Determined margin of £14.6m (in October 2023 prices) * Margin factor

Margin Factor = 25% * CUST + 75%* CUST * MPE

or

Margin Factor = CUST * (25% + 75% * MPE)

5.69 Where the value of CUST (number of customers) and MPE (market price of energy) are the ratios of actual value to determined value (actual/determined) as defined in Table 5.9 below.

	Determined value	Actual value
CUST	The average number of customers served used by Power NI in its assessment of margin = 576,498	The number of customers as on 30th September in the relevant year.
MPE	The average market price of energy used by Power NI in its assessment of margin (£150/MWh) converted to October 2023 prices: = 139/MWh	The higher of the average rate of energy price hedged in the year or the highest average price of energy in the DAM for the relevant year (being the highest of the average price of energy in the DAM in Q1, Q2, Q3 and Q4 of the relevant year).

Table 5.9: Proposed definition of margin structure terms

5.70 In our view, this proposal:

a) Reflects the underlying variability of margin relative to customer number and the market price of power.

b) Is practical in application.

c) Reflects the decisions that Power NI will have to make at any point in time, taking account of the higher of power prices as revealed in forward look hedges and the actual cost of power revealed in the DAM.

d) Moderates the impact of changes in power price and customer numbers on margin as a percentage of turnover.

6. Consultation and Next Steps

6.1 This Draft Determination has been published for consultation. UR is keen to hear the views of interested stakeholders. It is an open consultation, and we are keen to hear the views of consumers and stakeholders on any issues connected to this Price Control.

Responding to this consultation

6.2 Responses to this consultation should be forwarded to reach UR on or before 5pm on Monday 3 March 2025 and should be addressed to:

Fiona Rooney
Utility Regulator
Queens House
14 Queen Street
Belfast
BT1 6ED

6.3 Our preference is that responses are submitted by email to:

Email: fiona.rooney@uregni.gov.uk and cc.
Electricity_Networks_Responses@uregni.gov.uk

This document is available in accessible formats. Please contact fiona.rooney@uregni.gov.uk to request this.

Publication of responses

6.4 We plan to publish in full the responses received to this consultation. We also plan to publish a summary of the responses and how we have addressed them in finalising our approach to this Price Control.

6.5 Your response may be made public by the Utility Regulator. If you do not want all or part of your response or name made public, please state this clearly in the response by marking your response as 'CONFIDENTIAL'. Any confidentiality disclaimer that is automatically produced by an organisation's IT system or is included as a general statement in your fax or coversheet will be taken to apply only to information in your response for which confidentiality has been specifically requested.

6.6 If you want other information that you provide to be treated as confidential, please be aware that, under the Freedom of Information Act 2000, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential.

6.7 Information provided in response to this consultation, including personal information, may be subject to publication or disclosure in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 and the Data Protection Act 2018).

6.8 As stated in the GDPR Privacy Statement[21] for consumers and stakeholders, any personal data contained within your response will be deleted once the matter being consulted on has been concluded though the substance of the response may be retained.

Subsequent decisions and key milestones

6.9 Once we have considered the responses to this Draft Determination, we will publish a Final Determination of the Power NI Price Control on at the end of April 2025. At the same time, we will publish draft licence modifications which give effect to our Final Determination. These licence modifications will be subject to further consultation in line with the requirements of Article 14 of the Electricity (Northern Ireland) Order 1992[22] (the Electricity Order). Having considered the responses to the consultation, we intend to publish our final decision on licence modifications at the end of June 2025.

6.10 Subject to any appeal to our final decision, the licence modifications will be made at the end of August 2025 (56 days after the licence modification decision notice is expected to be published). However, once the licence modifications are made, they will apply in respect of the whole of the first year of the new control period (i.e. on and from 1 April 2025). In practical terms, therefore, the timing of the licence modifications coming into force will be designed to ensure that all the licence formalities are fully satisfied, but the application of the new Price Control once the modifications are made will be such as to ensure that the Price Control allowances and outputs will apply with effect from the 1 April 2025.

6.11 Any licence modification decision made under Article 14 of the Electricity Order may be appealed to the Competition and Mergers Authority (CMA) by:

- the licence holder concerned;
- any other licence holder materially affected by the decision;

[21] GDPR - Privacy Notice (consumers and stakeholders).pdf (uregni.gov.uk)
[22] The Electricity (Northern Ireland) Order 1992

- a qualifying body or association representing a licence holder concerned or a licence holder materially affected by the decision; or

- the Consumer Council for Northern Ireland.

As set out in Schedule 5A, paragraph 1(3) of the Electricity Order, any application to the CMA for permission to appeal is not to be made after the end of 20 working days after the day on which the decision is published.

6.12 If an appeal is brought to the CMA, the CMA will in a first step decide whether to give permission for the appeal to proceed or not. If permission is granted, the CMA has a period of 4 months, or in the case of licence modifications relating to Price Controls 6 months, in which to determine the appeal. These timelines can be extended to 5 months or 7 months for licence modifications relating to Price Controls, if required.

6.13 The key milestones described above and summarised in Figure 6.1 below.

Date	Milestone
December 2024	UR publishes Draft Determination for 8-week consultation.
March 2025	Consultation on Draft Determination closes.
April 2025	UR publishes Final Determination and proposed licence modifications.
May 2025	Consultation on licence modifications closes.
June 2025	Decision on licence modifications published.
August 2025	Licence Modifications become effective.

Figure 6.1: Key milestones