

A High-Level Review of UR's RP6 Draft Determination

A note for the Consumer Council for Northern Ireland

17 May 2017

1 Introduction

The Consumer Council for Northern Ireland (CCNI) commissioned Economic Consulting Associates Ltd (ECA) to conduct a high-level review, from the consumer perspective, of the Utility Regulator (UR)'s Draft Determination (DD) on Northern Ireland Electricity (NIE)'s price control for the period 2017 to 2024 (RP6).

This note reports the findings of our high-level review of UR's RP6 DD. Our focus has been on proposals that could have adverse consequences for consumers. We list and comment on individual issues we have identified in section 3, and summarise our key findings immediately below.

2 Key review findings

Cost of capital

NIE's allowed revenue from the return on capital comprises around one-quarter of its total allowed revenue as proposed by UR. UR has proposed a Weighted Average Cost of Capital (WACC) of 3.29%, compared to NIE's request of 4.1%. UR's lower WACC explains over half the difference between UR's proposed revenue allowance for NIE and NIE's own proposal from their business plan.¹ UR's lower WACC is, therefore, a significant part of the lower charges to consumers proposed by UR in its DD compared to NIE's business plan. Notwithstanding that UR proposes a lower WACC than NIE, UR describes its proposed risk-free rate as sitting "at the high-end of the range of current plausible values" (para 12.19) and the value of its proposed expected market return was described by the Competition Commission (CC) in its 2014 report on NIE's price control as an upper limit (issue 2).

¹ Across both transmission and distribution, UR proposes a total revenue allowance for NIE of £1,393.9m compared to NIE's request of £1,562.5 (a difference of £168.6m). Of this, UR's proposal includes £309.9m for the return on capital compared to NIE's request of £397.5m (a difference of £87.6m). Values for calculations are taken from Tables 63, 64, 65 and 66 of RP6 DD.

The UR's proposed values for the expected market return and asset beta are the same as those Ofgem set for the Great Britain (GB) Distribution Network Operators (DNOs)' current price controls. In this regard, we note the latest Ofgem data on the Returns on Regulatory Equity (RoRE) of the GB DNOs, and of the Gas Distribution Networks (GDNs), show all companies are expecting to earn a RoRE in excess of the cost of equity. This is more asymmetric than might be expected of a balanced regulatory settlement. Whilst this does not necessarily mean that the cost of equity has been set too high, it raises the question as whether allowances (of which the return on equity is part) may have been overly generous. To the extent this is true and that UR's approach has been influenced by the regulatory approach in GB, including some of the same values for the cost of equity components, there is a risk of overly generous allowances. In terms of the cost of capital we suggest this might support choosing a value at the lower end of the range of plausible estimates.

We also note several aspects of the UR's approach ought to reduce the risk that NIE bears compared to its current price control. These include UR's proposed cost of debt adjustment (which transfers risk from the company to consumers (issue 1)), the D5 mechanism for incorporating currently uncertain activities into allowed revenues during the price control period (issue 9), and the substitution of outputs and expenditure between direct network investment allowances (issue 11). As these reduce NIE's risk, it is reasonable to expect that, other things equal, they should reduce the return expected by equity investors.

The UR has proposed a cost of debt adjustment (as it has already implemented in gas) which will adjust NIE's allowed rate of return on new debt for the prevailing cost of debt at the point at which NIE raises new debt. This proposal could benefit consumers to the extent that regulators have tended to over-estimate the cost of debt and that the reduction in risk to NIE is reflected in a lower cost of equity. However, under the mechanism, consumers will now carry the risk of increases in the cost of debt during the price control period. As the cost of debt is particularly low at present, there is a real risk that it could rise in coming years and that consumers end up paying more.

Costs and benchmarking

UR used the outputs from a range of models (developed by their consultants) to determine an efficiency gap of around 2% between NIE and the upper quartile performers of the GB DNOs for IMF&T² and indirect costs. These costs make a significant contribution to NIE's opex, which accounts for just over one quarter of its allowed revenue.

Estimates of the efficiency gap ranged from 10.63% (ie less efficient) to -2.37% (ie more efficient) depending on the model and data used. UR took a weighted average of the various efficiency gaps to determine the gap of around 2%. Although a detailed review of these calculations is beyond the scope of our high-level review, we are concerned about the application of a local labour adjustment (issue 3).

In brief, cost data are adjusted for regional wage differences. Under one of UR's approaches, all indirect labour costs are adjusted for these differences, but under another approach only a proportion are adjusted because it is assumed that some of the network's activities occurs outside its region (or that they are competing in a national market). Our concern stems from several factors, including:

² Inspections, Maintenance, Faults and Tree cutting (IMF&T).

- ❑ UR's consultants recommended not applying the local labour adjustment to NIE's costs;
- ❑ UR acknowledges a lack of detail on the assumptions underpinning the adjustments (which were those Ofgem applied in its most recent DNO price control) and could not, therefore, be certain how they applied to Northern Ireland; and
- ❑ NIE confirmed that 100% of their workforce and 100% of their labour costs are incurred within Northern Ireland.

Based on our high-level review, we do not consider that a sufficient case has been made to apply a local labour adjustment to NIE's costs. Given that NIE is in a low-cost region, if only a proportion of its indirect labour costs are adjusted, it will appear more efficient. The effect of not applying this adjustment to only a portion of costs will be to reduce consumer charges, other things equal.

3 Commentary on individual issues

In this section we list the individual issues we identified during our review of the UR's RP6 DD and comment on each. The issues relate to the following areas:

- ❑ Cost of capital
- ❑ Benchmarking
- ❑ Outputs, key performance indicators (KPIs), and incentive and uncertainty mechanisms
- ❑ Pensions
- ❑ Other.

3.1 Cost of capital

Topic:	Cost of debt adjustment	Issue No:	1.
Location in DD:	Para 12.7 and Annex H		
Description of position in DD:	UR has proposed to adjust NIE's allowed rate of return for the prevailing costs of debt at the point at which NIE raises new debt.		
Assessment:	In NIE's current price control, UR set a WACC using a pre-determined cost of debt for the duration of the price control. Under this approach, NIE carries the risk if their actual cost		

of debt is different. In other words, if NIE's debt costs are lower than UR's allowance they benefit, and if higher they bear the cost. Under the approach proposed by UR for RP6, NIE's cost of new debt will be set according to market costs of debt prevailing at the time NIE raises new debt (subject to some adjustments). This means that the risk on the cost of new debt passes from NIE to its customers. There are both potential benefits and disadvantages to customers of this change:

- *Regulators have tended to overestimate cost of debt allowances.* This is illustrated in the figure below, which shows the cost of debt allowed by regulators at various price controls and market benchmarks. In this historical context, had regulators set the allowance for debt based on a prevailing market cost of debt, consumers would have tended to pay less. To the extent this context was to continue in future, customers would likely benefit from the UR's proposed change in approach (see next bullet).



Source: iBoxx, various regulatory determinations

- *Customers now carry the risk of changes to the cost of debt.* The cost of debt is particularly low at the moment and there is a clear risk it could rise in the coming years. For example, we note that the latest Bank of England Inflation Report³ suggests the base interest rate rising from the current 0.25% to around 0.7% by early 2020. If the cost of debt does increase, this does not mean UR's proposed change will necessarily make customers worse off, as this would depend on what cost of debt UR would have allowed had it not proposed to change its approach. In other words, customers would only be worse off if the cost of debt increased above the allowance for the cost of debt that UR would have set, if it still fixed the allowance. Nonetheless, customers do now face the risk of charges increasing as a result of increases in the cost of debt.

³ <http://www.bankofengland.co.uk/publications/Documents/inflationreport/2017/feb.pdf>

❑ UR's proposed change in approach transfers risk from NIE (to customers). As a consequence of this reduction in risk for NIE, it is reasonable to expect a reduction in the return expected by equity investors. Whilst challenging to quantify, this effect ought to be recognised by UR in choosing an appropriate cost of equity (eg see issue 2).

Topic:	Cost of equity and revenue allowances	Issue No:	2.
---------------	---------------------------------------	------------------	----

Location in DD: Chapter 12, para 12.19 and 12.21

Description of position in DD:

UR sets a WACC using the Capital Asset Pricing Model (CAPM). For a number of the components of CAPM (including risk-free rates, expected market returns, and asset betas), UR references GB regulatory precedent (mainly for gas and electricity distribution networks, eg Tables 56 and 57). For example:

- ❑ *Risk-free rate* – UR cites a range of recent decisions on the risk-free rate (from their consultant's report) of 0.5% to 1.5% and chooses a rate of 1.25% to be consistent with the estimate used by the Competition and Markets Authority for Bristol Water (2015). UR note that 1.25% “sits at the high-end of the range of current plausible values” (para 12.19)
- ❑ *Expected market return* – UR proposes an expected market return of 6.5%, which was an “upper limit” identified by the CC in its 2014 report on NIE's price control (para 12.20 and 12.21). This is also the same value as used by Ofgem for the current GB DNO and GDN price controls.
- ❑ *Asset beta* – UR proposes an asset beta of 0.38, consistent with the asset beta set by Ofgem for gas and electricity distribution networks, which is at the bottom end of the range presented of 0.38 to 0.45 (Table 56).

Overall UR's WACC of 3.29% is at the bottom end of a narrow range (of 3.29% to 3.39%) proposed by its consultants (Annex J).

Assessment:

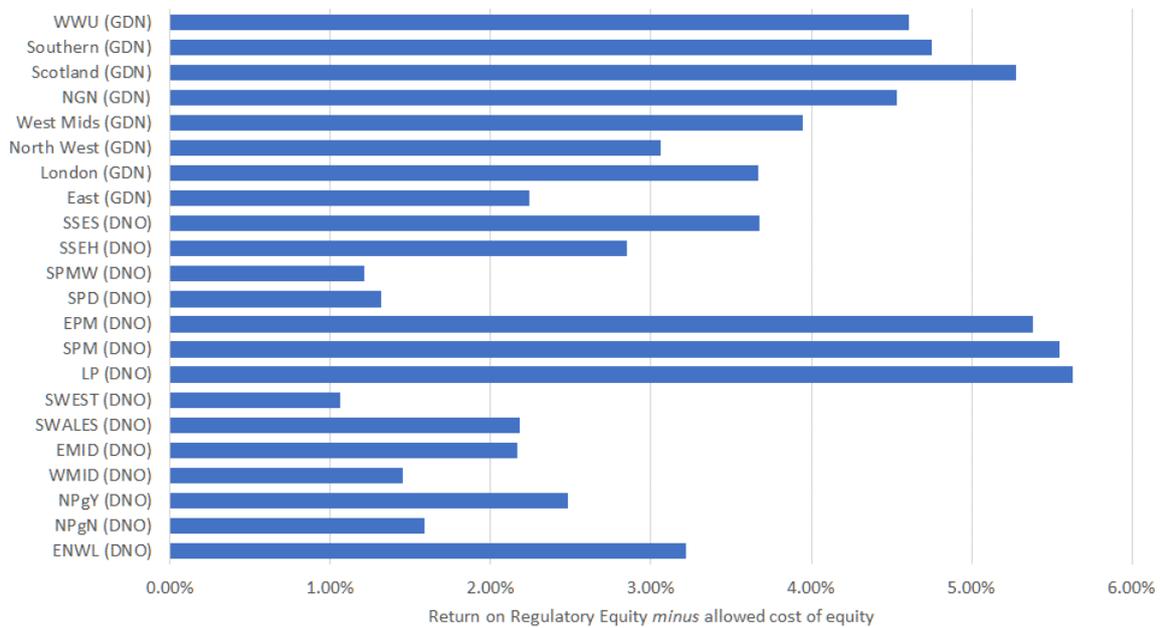
Whilst a detailed assessment of the WACC is outside the scope of our high-level review, we note that UR does not explain the justification for choosing a value at the higher end of the range presented on the risk-free rate nor for an expected market return identified by CC as an upper limit (other than for consistency with other regulatory determinations, which we acknowledge nonetheless is an important consideration).

UR cites ranges for the cost of equity components based on evidence from GB regulatory determinations, and in the cases of the risk-free rate and expected market return, UR proposes values that are the same as those set by Ofgem for the current DNO price controls. In this regard, it is notable that, historically, the return on regulatory equity of the GB DNOs, and of the GDNs, have tended to be above the allowed cost of equity. We show in the figure below the Return on Regulatory Equity (RoRE) in excess of the cost of

equity for the current DNOs and GDN price controls (ie RoRE *minus* allowed cost of equity).⁴ The striking aspect of this performance is that it is 'one-sided', ie all companies are expecting to earn a RoRE in excess of the cost of equity. This is more asymmetric than might be expected in a regulatory settlement that appropriately balances the interests of consumers and companies. Whilst this does not necessarily mean that the cost of equity has been set too high, it does suggest that allowances (of which the return on capital is part) may have been overly generous.

To the extent that UR's approach has been influenced by the regulatory approach in GB, including some of the same values for the cost of equity components, there is a similar risk of overly generous allowances. In terms of the cost of capital we suggest this might support choosing a value at the lower end of the range of plausible estimates.

Return on Regulatory Equity in excess of the cost of equity
(RIIO-ED1 and RIIO-GD1 price controls)



Source: ECA calculations using data from 2015/16 Ofgem RIIO-ED1 and RIIO-GD1 Annual Reports

In addition, UR has proposed mechanisms that reduce NIE's risks, compared to its current price control. These include the proposed cost of debt mechanism and various other uncertainty mechanisms, such as the D5 mechanism, to which over £200m of expenditure may be subject. As these reduce NIE's risk, it is reasonable to expect that, other things equal, they should reduce the return expected by equity investors.

⁴ These data are taken from the latest Ofgem Annual Reports for RIIO-ED1 and RIIO-GD1. These reflect actual performance to date and forecast performance over the remainder of the price control. Links: https://www.ofgem.gov.uk/system/files/docs/2017/02/riio-ed1_annual_report_2015-16.pdf and https://www.ofgem.gov.uk/system/files/docs/2017/02/riio-gd1_annual_report_2015-16_0.pdf

3.2 Benchmarking

Topic: Benchmarking of IMF&T and indirect costs	Issue No: 3.
Location in DD: Chapter 5	
<p>Description of position in DD:</p> <p>UR uses econometric models, developed by its consultants, to set the efficient level of NIE's IMF&T (Inspections, Maintenance, Faults and Tree cutting) and indirect costs. UR uses data from the GB DNOs in these models. UR uses three 'top-down' models and four different sets of data. The data are different in two regards:</p> <ul style="list-style-type: none"> ❑ Data are either 'pre-allocation' of connection costs or 'post-allocation' of connection costs. NIE allocates a higher proportion of its costs to connections (which are outside the price control) than the GB DNOs. As a result, NIE appears more efficient, when compared to the GB DNOs, if connections costs are excluded from the modelling. ❑ Data are either with 'no local labour adjustment' or with 'full local labour adjustment'. Prior to using cost data to assess efficiency, costs are adjusted for regional wage differences (ie higher (or lower) costs for a DNO may result not from inefficiency but simply from higher (or lower) wages in the region). The CC's review of NIE's RP5 price control applied a regional wage adjustment (RWA) to <i>all</i> indirect labour costs. (UR refer to this as the 'no local labour adjustment' approach.) Ofgem, for their most recent DNO price control, applied the RWA to a proportion of the indirect labour costs, on grounds that not all labour costs need be incurred locally. As well as adopting an approach (no local labour adjustment) that is consistent with the CC's approach, UR also adopts the Ofgem approach by applying this local labour adjustment to the GB DNOs and NIE (ie the 'full local labour adjustment'). <p>UR takes a weighted average of the three models across all four data combinations in determining an efficiency factor catch-up (to the upper quartile – the fourth company out of 15 companies) of around 2%.</p> <p>UR also uses three 'middle-up' models as a sense-check on the results of the top-down models and states that the efficiency gaps from the middle-up modelling are within those of the top-down models.</p>	
<p>Assessment:</p> <p>There is significant variation in the efficiency gaps depending on the data used. For example, for model 2, NIE's efficiency gap is shown to vary from 10.63% (ie less efficient) to -2.37% (ie more efficient). The choice of data (and model) therefore has significant implications for the level of catch-up efficiency in IMF&T and indirect costs and charges to consumers.</p> <p>Application of a full local labour cost adjustment has a material impact on the efficiency gap. For pre-allocation data, the efficiency gap range is 7.91% to 10.63% based on no local labour adjustment, but just 0.28% to 1.72% based on full local labour adjustment. Our main</p>	

concern is in relation to the adjustment for local labour. The implication of making this local labour adjustment is that some activity occurs outside a network's region (or that they are competing in a national market):

- ❑ First, UR's consultants, who conducted the data adjustments and modelling, recommended *"not to apply this [local labour] adjustment to NIE networks costs"* (pg 26, Annex B UR RP6 DD). We do not consider that this recommendation should be set aside, and a local labour adjustment made, without clear and strong justification.
- ❑ Second, UR states that it did not have *"access to the detailed underpinning of how Ofgem have arrived at these percentages [for the local labour adjustment]"* and *"cannot be certain that these assumptions hold for a Northern Ireland based network utility."* (para 5.163). It is unclear how it benefits consumers to apply an assumption that is uncertain.
- ❑ Third, UR presents evidence from GB DNOs, showing that *"GB distributors appear to locate their customer service and new connection centres within the region they operate"* (para 5.166). This supports the case for not applying any local labour adjustment.
- ❑ Fourth, NIE confirmed to UR that they locate 100% of their workforce and 100% of their costs within Northern Ireland (para 5.167). In making a local labour adjustment there is an implicit assumption that: some of the costs are incurred outside of the region; and/or that there is a national market for certain resources / roles. The former is demonstrably not true and cannot, therefore, be used to justify a local labour adjustment for NIE. Based on our high-level review of the DD, we saw no evidence justifying the latter possible reason.

Based on the above, we do not consider that a sufficient case has been made to apply a local labour adjustment to NIE's costs. Accordingly, without further evidence, we consider that UR should determine the efficiency gap using data with no local labour adjustment (ie the RWA should apply to all indirect labour costs), or with the local labour adjustment applied only to the GB DNOs' cost data.

Topic: Benchmarking of IMF&T and indirect costs	Issue No: 4.
Location in DD: Table 17 (as amended) and para 5.176	
Description of position in DD: UR states that the efficiency gaps from the 'middle-up' modelling are within those of the top-down models.	
Assessment: This is not true, based on the data presented in Table 17 (as amended), when the models use a 'full local labour adjustment' and a pre-allocation of connection costs. In this case, the middle-up model shows a larger efficiency gap than the top-down models.	

Specifically, the efficiency gap is reported as between 0.21% and 1.74% based on the top-down models and a pre-allocation of connection costs, whereas the efficiency gap for the middle-up model is 2.15%. When the models use a full local labour adjustment and a post-allocation of connection costs, the efficiency gap from the middle-up model only just sits within the range of the top down models. Specifically, the difference is between a range of -2.34% to 0.11% for the top-down models and is -0.01% for the middle-up model. These results would appear to call into question the models based on a full local labour adjustment (see issue no. 4). To the extent that UR continues to apply a full local labour adjustment, then there may be merit in UR including the results of the middle up models in determining the efficiency gap.

Topic: Special factors for IMF&T and indirect costs	Issue No: 5.
Location in DD: Para 5.51 and 5.52	
Description of position in DD: UR uses GB DNO data to inform its assessment of NIE's efficient level of IMF&T and indirect costs. UR highlights four areas where NIE's standards and policies are different (typically lower) than GB DNOs.	
Assessment: UR notes that these factors could warrant a negative special factors adjustment, but that it decided against introducing one for the DD, without explaining why. Making such an adjustment would reduce costs to consumers. UR should consider whether the special factor mentioned is material.	

Topic: Severe weather allowance	Issue No: 6.
Location in DD: Para 6.34 – 6.37	
Description of position in DD: UR has set NIE's severe weather allowance based, in large part, on the costs historically incurred by GB DNOs because of severe weather events.	
Assessment: On average, GB DNOs serve more customers and have more length of lines than NIE (as shown in Table 5 of the UR's RP6 DD), as well as having more dense networks (customer numbers / line length). These different factors may mean different consequences from and costs of responding to severe weather events. For example, a severe weather event affecting a given size of area would (on average) affect more customers and line length of a GB DNO than NIE. Other things equal, this may reasonably be expected to result in greater costs for the GB DNO than NIE. If this is the case, not adjusting for the difference in scale, UR's use of GB DNO data in the DD could result in overstating NIE's severe weather allowance. Accordingly, UR should consider the underlying cost drivers for	

severe weather events in GB and Northern Ireland and whether making adjustment for the difference in scale between GB DNOs and NIE is appropriate.

Topic: Catch-up efficiencies (absence of)	Issue No: 7.
Location in DD: Para 11.12 (and chapter 11 generally)	
Description of position in DD: In relation to the meter installs / changes programme, UR states they did not apply any catch-up efficiency, but will consider further if they should.	
Assessment: For the cost items in Chapter 11, UR appears not to have applied any catch-up efficiencies. To the extent that there are similarities with the costs in the econometric benchmarking (eg indirect costs and overheads) or that NIE are managing the activities with a similar level of efficiency, then UR should consider applying catch-up efficiencies.	

3.3 Outputs, KPIs, and uncertainty and incentive mechanisms

Topic: Outputs and KPIs	Issue No: 8.
Location in DD: Chapter 4	
Description of position in DD: UR is proposing a range of output measures and potential KPIs.	
Assessment: Most of the measures and KPIs are for development in RP6 (and in some cases will inform RP7 – ie in 6.5 years). The potential benefits to customers may, therefore, not be delivered for some time. UR is separately consulting on Guaranteed Standards of Service (GSS), and changes including additional standards, raising some existing standards, and increasing compensation are to be welcomed. To the extent this involves raising standards towards those of the GB DNOs, against which NIE is benchmarked, we agree with UR's approach to not allow NIE additional costs. Connections were identified by consumers, through the Consumer Engagement Advisory Panel (CEAP) Empowering Consumers report, as an area for improvement. It is, therefore, important for NIE and UR to progress the development and reporting of NIE's proposed outputs.	

UR has proposed development incentives in relation to asset health and load indices, asset management, worst served customers, and customer advocacy and survey metrics. UR proposes that these are reputational incentives. Due consideration is needed to maximise the impact of these reputational incentives (eg through comparison to targets, comparison to GB DNOs, and comparison to other sectors). The strength of reputational incentives can be greatly enhanced when they are linked to a financial penalty or reward, as this can draw greater attention than the performance data alone, particularly where the financial adjustments are in period (making the issue more 'immediate'). UR should consider linking these reputational incentives to financial incentives.

See also issues 9, 11 and 12.

Topic: Uncertain transmission investments (D5 projects)	Issue No: 9.
Location in DD: Para 9.20 – 9.31	
Description of position in DD:	
<p>UR proposes to retain the D5 mechanism, introduced by the CC. This mechanism provides for allowances to be set in the price control period for investments (excluding asset replacement expenditure) that are uncertain at the time of the price control review. One project of £22m was determined under the mechanism in RP5. In RP6, NIE listed 15 projects of an estimated value of £250m. UR included £200m for the purposes of illustrating impact on charges.</p>	
Assessment:	
<p>There is a potential step change in the number and value of investments that might be determined within the price control period through the D5 mechanism in RP6 (compared to RP5). As allowances for these will be set outside of the price control, it is vital that subsequent review processes and their application are adequately robust to protect consumers' interests.</p> <p>One important aspect in protecting customers is to establish a clear boundary between upfront allowances and the D5 allowances. This boundary will support UR's assessment of whether consumers have already funded part (or all) of an investment through upfront allowances. It was for this reason that the CC did not allow the inclusion in the D5 mechanism of distribution network expenditure (para 5.265 of CC NIE final determination⁵). However, UR is now proposing that some relatively small distribution reinforcement projects are included through the D5 mechanism (Armagh Main distribution reinforcement at £1.6m and Airport Road distribution reinforcement at £2.7m). This would appear to contradict CC's intent for this mechanism.</p> <p>UR has included within RP6 an "indicative allowance" of £57.9m for three transmission asset maintenance projects (and the above distribution network projects). These costs are indicative as UR states that the projects "are not sufficiently well developed to allow us to determine ex-ante efficient costs". UR's intention, therefore, is to set the level of allowances</p>	

⁵https://assets.publishing.service.gov.uk/media/535a5768ed915d0fdb000003/NIE_Final_determination.pdf

later, during RP6. Again, this potentially weakens the boundary between costs funded through upfront allowances and through within-period determinations. It was for this reason that CC rejected NIE's view that cost uncertainty should determine which projects should be subject to the D5 mechanism (para 5.265 of CC NIE final determination). UR should consider setting the level of allowance for these investments now and including them in allowed revenues if the investment is required during RP6. If the scope of these projects changes, then UR could revisit the cost (as proposed by CC in para 5.278(c) of CC NIE final determination).

Topic: Metering volume driver	Issue No: 10.
Location in DD: Para 11.6	
Description of position in DD: As adopted in RP5, UR has set for the RP6 metering programme a " <i>volume driven allowance and a set unit cost for each type of meter installation</i> ".	
Assessment: A set unit allowance provides a unit cost efficiency incentive for NIE. However, such mechanisms can incentivise doing more work and can create distortionary incentives between meter types depending on the unit rates. To the extent that this mechanism has been in place during RP5, and UR has reported no problems, it seems unlikely to be a significant issue.	

Topic: Direct network investment allowance substitution	Issue No: 11.
Location in DD: Para 13.8 - 13.19, and 14.11 - 14.21	
Description of position in DD: UR has proposed allowing NIE to substitute outputs between different direct network investment allowances. UR proposes a limit of 20% on the value of outputs that can be substituted out from any single direct network investment allowance.	
Assessment: This proposal is intended to afford NIE greater flexibility. A similar substitution mechanism was proposed by NIE and rejected by the CC at RP5, on grounds that NIE already had sufficient flexibility. We note UR's assessment that NIE has generally delivered outputs consistent with its allowances, and that NIE can already substitute outputs within allowances. In this context, UR does not make clear what has changed to demonstrate that more flexibility for NIE is of benefit to consumers. In addition, UR notes (para 14.17) that this mechanism complicates the assessment of deferral of expenditure (which is subject of the D3 mechanism introduced by CC and needed to ensure customers do not pay twice for deferred spend).	

If UR implements the uncertainty mechanism, then the regulator reporting of NIE's performance against outputs as part of UR's proposed Annual Cost and Performance reporting becomes more important. This reporting will support understanding of potential adjustments required at the next price control (subject to performance in the remainder of RP5), as well as tracking and highlighting issues with performance against outputs and volumes in RP6 that will inform the next price review.

Topic: Reliability incentive	Issue No: 12.
Location in DD: Para 14.22 - 14.60	
Description of position in DD: UR proposes to introduce penalties/rewards tied to NIE's performance against reliability targets, with penalties and rewards applied symmetrically for under- and over-performance, respectively.	
Assessment: The introduction of this incentive mechanism is to be welcomed and on a high-level review seems to be well-designed based on regulatory precedent and practice elsewhere. We also note that rewarding NIE for outperformance, as well as penalising it for underperformance, creates a symmetrical incentive. (This avoids the so-called 'cliff edge' effect, as well as the negative effect on WACC that can result from a penalty-only regime.) On the other hand, this may be unfair for customers because it requires them to pay twice, that is, for the incentives as well as the costs of achieving the enhanced performance. Moreover, electricity reliability surveys undertaken in various countries generally show that customers place less value on improvements in reliability than in reductions, so symmetrical incentives would not reflect customer preferences.	

3.4 Pensions

Topic: Regulatory fraction	Issue No: 13.
Location in DD: Para 8.46 - 8.48	
Description of position in DD: UR proposes resetting the 'regulatory fraction' (the proportion that is attributable to services provided to the NIE regulated business versus other entities covered by the NIEPS scheme) from 99.26% in RP5 to 100% in RP6.	
Assessment: At least part of UR's justification for a 100% regulatory fraction is simplicity, which is a laudable objective. It seems a consequence of the UR's proposal regarding the regulatory fraction, that it is minded to grant a pension deficit repair allowance that exceeds NIE's	

request by £0.8 million (UR reports that NIE's request was for £114.5m and UR proposes allowing £115.3m). Notwithstanding the relatively small difference, UR needs a strong justification for providing a larger allowance than NIE requested.

Topic: Allowances for 2022-2024	Issue No: 14.
Location in DD: Para 8.33 - 8.34, 8.58 - 8.59	
Description of position in DD: UR proposes granting pension deficit repair allowances for the last two years of RP6, despite the current deficit recovery period running to 2022.	
Assessment: Whether there will be a deficit or surplus post-2022 is uncertain, and there is no evidence presented in the DD that one outcome is more likely than the other (although we note NIE reports in its business plan (para 7.138) a recent funding update showing a lower funding ratio). It is unclear, therefore, why this should be decided on now in favour of the business, notwithstanding that in NPV terms customers would ultimately pay the same (because of the adjustments that will be made in RP7). One option for UR could be to address this issue as a mid-term review, by which time another Triennial Actuarial Valuation will have been completed.	

3.5 Other

Topic: Indexation of revenues	Issue No: 15.
Location in DD: Para 1.31	
Description of position in DD: <i>"RPI inflation will be applied to NIE Transmission and Distribution allowed revenue each year"</i>	
Assessment: RPI is no longer an official statistic as there are known flaws in its calculation methodology (that may lead to potential upward biases). In 2015, the Johnson Review into measures of inflation concluded that <i>"Government and regulators should work towards ending the use of the RPI as soon as practicable."</i> Ofcom has already set price controls using CPI and, for its pending price control review of water companies in England and Wales, Ofwat has concluded that CPI (or CPIH) should be used instead of RPI. CPI/H tends to be less volatile than RPI, which may be of benefit to consumers as their bills are less volatile as a result. Whilst RPI will continue to be produced, it may be seen as less legitimate by consumers (BoE targets CPI, and media reporting on inflation now largely refers to CPI). Nevertheless, at this stage in the price review, changing from RPI could be detrimental to	

consumers (through the increase in regulatory risk and on the cost capital). UR (and NIE) should consider planning for this change well in advance of the next price control period.