System Operator for Northern Ireland

Draft Determination Northern Ireland Electricity Transmission and Distribution Price Controls 2012 -17

A response by SONI Ltd

19th July 2012

Introduction and Background

SONI welcomes the opportunity to respond to the Utility Regulator's draft determination on the Price Control for Northern Ireland Electricity's Transmission and Distribution Businesses 2012-2017 (RP5). SONI is the Transmission System Operator for Northern Ireland and is responsible for operating a safe, secure and reliable transmission system in the interests of consumers.

It is critically important to SONI that NIE T&D has in place a price control which provides for the necessary investment to ensure that the transmission system continues to meet appropriate operating and planning standards such that SONI can fulfil its functions and that the investment is financeable by NIE and delivered in a timely fashion. It is also important that the control represents only the efficient level of expenditure and that consumers pay only what is appropriate. SONI supports the Utility Regulator's approach of seeking to ensure value for money for customers, ensuring security of supply by maintaining and developing a network that is fit for purpose and to facilitate sustainability in the generation and consumption of electricity. In this it is recognised there is a trade off between the cost consumers may face today and a fit for purpose network that supports sustainability in the long term. The current drive to meet enhanced renewables targets, much of which is sourced from lower densely populated areas, may mean increased strategic investment in the network but is part of an objective of delivering an overall value chain which benefits consumers and society.

This control is being consulted upon at the same time as the Utility Regulator, exercising its functions through the SEM Committee, is considering the certification of the current transmission arrangements in Northern Ireland under the European Third Package Directive EC 2009/72. SONI has elsewhere expressed its view that the current arrangements are not certifiable under the Article 9(9) test and that changes will be necessary if Northern Ireland is to be compliant. SONI endorses the draft determination recognition that changes may be necessary. The separate consideration of transmission and distribution revenue requirements is also important in this regard and the draft determination has made significant steps in this regard. Ultimately transmission should be considered as if a separate price control was in place for both transmission and distribution and this should be reflected in the final determination. This will facilitate any wider changes which may need to be made post the outcome of the certification process.

While this represents SONI's response to the consultation, given SONI's particular status, role and responsibilities in managing the transmission network in Northern Ireland, and it's role as a member of ENTSO-e, SONI would expect to be involved in more detailed discussions on the investment plans that may be required with both the Utility Regulator and NIE. The Utility Regulator notes SONI's role in being able to provide an oversight of the lifetime costs of investments. SONI would note that much of the EHV investment associated with both renewables and interconnection is specifically excluded from consideration as part of the Draft Determination. SONI would expect to be part of a formal engagement with both NIE and the Utility Regulator further to ensure that what is ultimately required, and which is therefore also being assumed by SONI in progressing other activities within SONI's remit (see box below), is ultimately progressed and delivered in a timely and efficient manner.

An Adequate Transmission Network

SONI has highlighted above the importance of adequate and strategic investment in the transmission network. The NIE T&D control must make provision for network plans to be implemented, the network to be adequately maintained & allow sufficient resources and provide flexibility for the development of the network to accommodate the increasing variability in technology and number of connections

SONI and NIE currently interact to achieve / meet licence obligations via the Transmission Interface Agreement. Among other issues this Agreement deals with the exchanges of information required to establish the transmission investment plans that are required for SONI delivery of:

a) The Seven Year Transmission Capacity Statement
b) The Seven Year Generation capacity Statement
c) Generator TUoS tariffs
d) Transmission connections
e) TUoS Agreements
f) Firm Access Quantities
g) Generator Output Reductions report

For all these processes to be effectively delivered by SONI a clear and concise knowledge of NIE transmission investment plans is required. In general SONI supports the 3-pot approach proposed by UReg as being appropriate although SONI often does not have visibility of the age and condition of NIE's assets and must therefore rely on them to prioritise the work appropriately. More generally SONI would have some concerns that, particularly regarding the proposals around Fund 3 (the significant transmission works), there is no forward looking clarity that meaningfully covers the five to seven year horizon required for SONI processes within the RP5 process.

Box – Some Effects of Absence of Visibility of Forward Investment on SONI Processes.

The Seven Year Transmission Capacity Statement

The SONI Licence Condition 33, Transmission System Capacity Statement requires, for example "a commentary prepared by the Licensee indicating those measures of which it is aware that are being taken (or are planned to be taken) to meet forecast peak demand on the transmission system". A large proportion of this commentary would refer to the investment required by NIE to deliver transmission infrastructure to facilitate the connection and secure operation of renewable generation. If the Fund 3 expenditure is going to be approved on a Project by Project basis there needs to be an understanding in place between SONI, NIE and the Utility Regulator regarding the transmission "plans" that can be utilized on a seven year horizon.

Generator TUoS tariffs

The position with respect to forward looking strategic transmission plans is even more relevant to calculation of all-island GTUoS tariffs. The present approved methodology requires "approved" transmission developments on a five year horizon to be included. SONI would be concerned that year by year approvals of significant transmission projects may add to annual tariff variances for certain generators. The document also refers to the possibility of a separate WACC for differing transmission asset categories. SONI would also need to investigate the potential impact this may have on the calculation of GTUoS tariffs.

Connection arrangements for generators

Under proposals presently being consulted upon SONI will be required to calculate transmission Firm Access Quantities (FAQ) for generations connecting to the distribution and transmission networks. This will require concise details of transmission infrastructure over a seven year horizon. The requirement is the same for calculation of Generator Output Reductions. It would be beneficial for SONI to understand how we can use NIE "plans" for inclusion in such processes so as to give sufficient transparency to connecting generators while respecting an arrangement between NIE and the Utility Regulator that allows for every project to be separately "approved".

SONI believes that given its unique and independent position in the industry, it is uniquely placed to consider the total lifetime costs of the network investment and to plan a network which balances the ongoing costs of dispatch of out of merit generation and constraints with the lifetime capital and maintenance costs. This absence of such end to end assessment is a failing of the current industry arrangements. SONI notes that the Utility Regulator concurs with this assessment and advises that NIE T&D should work with SONI to determine the whole costs of deferring investments, including constraint costs. This would enable more robust investment appraisal to be put in place for transmission projects, however only a model of single accountability will ultimately deliver the optimum outcome. SONI is happy to work with NIE and the Utility Regulator in this regard.

SONI is owned by EirGrid plc which also holds the licence as TSO in Ireland. EirGrid's TSO business has responsibility for network planning in Ireland and is currently developing a number of projects on a cross border all island basis with NIE to harvest most efficiently renewable electricity across the island and to support the SEM. It is important that a common all island approach is taken to the development of the transmission networks across the island and that neither the approvals nor price control arrangements pertaining in either jurisdiction run counter to or hinder the delivery of the most overall efficient or optimal solution. EirGrid looks forward to working with both NIE and the Utility Regulator in the delivery of cross border infrastructure between Ireland and Northern Ireland.

A Financeable Price Control

In addition to a price control which supports an adequate transmission network the overall arrangements must be financeable if this network is to be delivered to the benefit of Northern Ireland consumers.

SONI notes the Utility Regulator's assessment of the overall financeability of its proposals in Section 18. It would in general have been beneficial had a financial model been made available to respondents as part of the consultation exercise. Even in the absence of a financial model it would be SONI's assessment that additional equity will be required under the proposals if the level of interest cover and other financial metrics that are in general associated with an investment grade rating are to be maintained by NIE. EirGrid has previously highlighted its concerns on relying wholly on additional equity to bridge financing requirements. Elsewhere, where such an approach is employed, such as by

Ofgem for the Scottish transmission companies under RIIO-T1 it has resulted in additional provision for equity raising which can be worth the equivalent in some instances of up to 0.2% points on the WACC. It is therefore not a costless option.

The financeability of the T&D business is particularly stretched by the inherent cash squeeze in the current regulatory model through the application of real returns with an indexed RAB whereas debt costs must be met in nominal terms. Given the Utility Regulator's forecast of inflation expectations of an RPI of 3.35% at the notionally assumed gearing of 60% the basic model is only 'PMICR sustainable' to a ratio of 1.11 against the existing embedded cost of debt. This is below the necessary level. Therefore if NIE were to be geared at the level assumed by the Utility Regulator in its Weighted Average Cost of Capital assessment (60%) the proposals as set out would not be financeable in the absence of additional equity injection.

In the Utility Regulator's assessment of the WACC itself it has built in average RPI inflation expectations of 3.35%. These were taken from the Office of Budget Responsibility forecast paper in November 2011. The more recent OBR forecasts (March 2012) forecast an average RPI for the same period of c.3.15%. Thus, as SONI in general believes that the most recent inflation forecasts should be taken into account in setting the price control, in order to maintain the same nominal returns (which was the basis upon which the original real numbers were derived) the real Vanilla WACC must be raised by c.0.2% to leave both the utility (and the consumer) in no worse position. There is also a corresponding knock on in other parts of the control such as consideration of Real Price Effects and expected levels of real wage inflation. SONI and NIE continue to recruit at the UK and RoI market rates for engineering and IT resources. These numbers can be further updated with those in the OBR's November paper if this is available prior to the publication of the Final Determination.

On the parameters building up the real WACC, SONI would in general note that they are not far from recent regulatory precedent. However, it is important to understand and consider the WACC as only one part of the overall building block approach to the price control and that elsewhere where lower WACCs have been applied they have usually been levered or complemented by more high powered incentive schemes with an overall Return on Regulated Equity (RoRE) approach adopted. Further work remains to be done by the Utility Regulator in this regard. Furthermore, SONI believes a much fuller discussion should be held on the use of Debt Betas in the determination of the cost of capital and would note that the Utility Regulator itself is not consistent in its approach employing a debt beta here and indeed in the recent SONI determination but not employing one in the most recent assessment of the cost of capital for the BNE.

On the application of a differential WACC for new investment in renewables requirements SONI believes there is insufficient justification to suggest the WACC would be significantly different and indeed that the approach proposed is at variance with the Utility Regulator's earlier work commissioned from First Economics which suggested new investment was the riskier element of the business and that recovery of sunk investment in general the lower risk activity. SONI would be happy to discuss its points on both the WACC and overall financeability of the control further with the Utility Regulator team.

Conclusion

The RP5 determination is an important paper in setting out the revenue for the delivery of the electricity network as part of the overall delivery of Northern Ireland's policy goals under the Strategic Energy Framework. In this response SONI has stressed the importance of both an adequate transmission network, a financeable price control and one which ultimately delivers for consumers, both today and in the future.

As Transmission System Operator SONI has an critically important role to play and looks forward to further engagement with both NIE and the Utility Regulator in determining the necessary investments for the future. SONI has indicated the degree to which the current proposals, and some of the uncertainty concerning which future projects will be delivered, and when, impinges upon its ability to fulfil its current responsibilities. SONI expects there will be some changes in this regard following the outcome of the TSO certification process which is currently being conducted in parallel. SONI would welcome the opportunity to discuss this response and the arrangements around RP5 more generally with the Utility Regulator.