Single Electricity Market Operator (SEMO) Revenue Requirement

Price control commencing 1 October 2013

Consultation Paper

25 April 2013

SEM-12-023

1 EXECUTIVE SUMMARY

Background

The All-Island Single Electricity Market (SEM), commenced operation on 1 November 2007, and is administered by the Single Electricity Market Operator (SEMO), formed through a contractual joint venture between EirGrid and SONI. SEMO recovers its operational and capital costs from market participants.

SEMO is licensed and regulated cooperatively by the Commission for Energy Regulation (CER) in the Republic of Ireland and the Utility Regulator in Northern Ireland. To date, SEMO has been subject to a combined Regulatory Authority (RA) price control. This consultation paper includes proposals for the fifth SEMO price control, commencing on 1 October 2013. It considers the form of regulation, SEMO's allowed revenue and sets out provisional tariffs.

Form, Scope and Duration of price control

A combined RA price control approach is proposed, consistent with previous price controls and SEMO's submission. The price control proposals are based on a 'Business as Usual' approach to maintaining the current structure of the SEM. Any expenditure associated with Market Integration is considered outside the scope of the 2013 price control.

The RAs propose that the new price control period runs for 3 years, from 1 October 2013 to 30 September 2016.

RPI-X regulation is to be applied under a revenue-cap regime on operating expenditure (OPEX) and the required revenue for capital expenditure (CAPEX) is to be recovered through Rate of Return Regulation. Proposals for incentivisation of SEMO are also covered in this paper.

Indexation

SEMO's revenue will be corrected year by year by the outturn rate of inflation (blend between RPI and CPI). All figures in this consultation are presented in March 2012 prices, unless stated otherwise.

Operating Expenditure (OPEX)

The RAs will look to retain efficiencies achieved in the current 2010 price control, although the IT & Communications allowance has increased mainly due to the renewal of a small number of key contracts.

Capital Expenditure (CAPEX)

The RAs recommend the continuation of menu regulation for CAPEX because we believe it can deliver benefits for all stakeholders in the SEM. In broad terms, menu regulation can promote greater control and accountability, and deliver value for customers through revealing and promoting efficiency.

Incentivisation

The RAs are of the view that it will be important to continue to provide SEMO with the right incentives to maintain their current good performance; SEMO should continue to be incentivised on their KPIs targets.

The RAs propose that OPEX will be incentivised via RPI-X regulation, with an X of 1. Once applied, SEMO's allowance for the 2013-16 price control reduces from €29.098 million (as shown in Table 1) to €28.518 million.

	Totals	
	SEMO's Submission	**RAS proposal**
	€ million	
OPEX		
Total Payroll	16.994	14.913
Total IT & Communications	7.832	7.133
Total Facilities and Insurance	4.332	3.339
Total Professional Fees	1.706	1.688
Total General and Administrative	1.107	0.873
Total Corporate Services	1.152	1.152
Total	**33.123**	**29.098**
Cost of Capital		
Depreciation	15.158	14.178
WACC	2.096	1.865
Total	**17.254**	**16.043**
Total Revenue Requirement	**50.377**	**45.141**
CAPEX Submission (incorporated in Depreciation Charge above)	**9.371**	**6.724**

Table 1: Summary of SEMO's submission and RAs proposals

All figures are in March 2012 prices, unless stated otherwise

Provision of Comments

Comments are invited from the industry and stakeholders on all aspects of the price control by 17:00 on Friday 24 May 2013. All responses should be directed to Karen Shiels in electronic format (Karen.Shiels@uregni.gov.uk). A price control decision paper is proposed to go to July SEM Committee and the RAs would expect to publish shortly afterwards.

2 CONTENTS

TABLE OF CONTENTS

All figures are in March 2012 prices, unless stated otherwise

3 INTRODUCTION

3.1 THE SINGLE ELECTRICITY MARKET

The Northern Irish and Irish Governments, the RAs and industry worked together to create an All-Island Energy Market, as outlined in the All-Island Energy Market Development Framework Paper.[1]

The first step in this process was the introduction of an All-Island wholesale electricity market. The Single Electricity Market (SEM) was implemented on 1st November 2007 when the market went live.

The SEM is a centralised or gross mandatory pool market, with electricity being bought and sold through the pool under a market clearing mechanism. Generators receive the System Marginal Price (SMP) for their scheduled dispatch quantities, capacity payments for their actual availability, and constraint payments for differences between the market schedule and actual dispatch due to system constraints. The SEM market rules are set out in the Trading and Settlement Code (TSC)[2].

3.2 ROLE OF SEMO

The development of the SEM led to the requirement for a Single Electricity Market Operator (SEMO) to administer the market. With this in mind the RAs approved the plans of EirGrid and SONI, the transmission system operators for Ireland and Northern Ireland respectively, to establish SEMO on a contractual joint venture basis.

SEMO's role in the market is explicitly defined in the SEM Trading and Settlement Code (TSC), which sets out the rules, procedures and terms and conditions which all parties, including SEMO, must adhere to in order to participate in the SEM. In addition both EirGrid and SONI must comply with the conditions imposed on this activity by their respective Market Operator (MO) Licences[3].

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[1] All-Island Energy Market: A Development Framework, Nov 2004, www.allislandproject.org

http://www.dcenr.gov.ie/NR/rdonlyres/BCF98EC4-7321-4E3F-8685-BFFCA2BF2DF4/0/All_island_Energy_Market_Development_Framework.pdf

http://www.detini.gov.uk/all-island_energy_market_development_framework.pdf

[2] http://www.sem-o.com/MarketDevelopment/MarketRules/TSC.docx

[3] http://www.allislandproject.org/en/single-market-operator-overview.aspx?article=1fd2b5ff-ce2b-464e-8332-eafa06438ba2

As defined in section 1.3 of the TSC, SEMO's role is to 'facilitate the efficient, economic and coordinated operation, administration and development of the Single Electricity Market in a financially secure manner'.

3.3 SEMO REVENUE & CHARGES

SEMO's operational and capital costs are recovered through Market Operator tariffs and fees, which are levied on market participants.

The RAs, in issuing a questionnaire, facilitated SEMO submitting proposals for revenue requirement on a combined basis for the two Market Operator licensees. The specified proportions agreed have regard to comparative levels of energy consumption in the Republic of Ireland and Northern Ireland. The agreed current apportionment between EirGrid MO and SONI MO is 75% and 25% respectively.

In addition to proposals for allowed revenue, SEMO must also present proposals on tariffs to recover imperfections costs. However the RAs will hold a separate consultation on imperfection charges[4] so they will not be covered in this consultation paper.

SEMO's current price control is due to end on 30 September 2013 i.e. it covers a 3 year period from 1 October 2010 to 30 September 2013. Therefore, the revenue and tariffs need to be determined for the next tariff period.

3.4 SEMOS PERFORMANCE TO DATE

SEMO have now been operating for over 5 years as market operator to the SEM. During this period they have faced challenges, such as the implementation of the Intraday project in July 2012, but throughout they have successfully provided a reliable and robust service for market participants.

In recent years both the market and SEMO have reached a level of maturity. For SEMO this has created a favourable environment for them to outperform by circa €2million[5], the operating costs allowed in the first two years of the current 2010-2013 Price Control. CAPEX efficiencies have also been delivered to date, with an underspend of circa €3million expected by the end of September 2013. This saving in capital represents a saving on the allowance that will be returned to consumers. SEMO's outperformance of their capital allowance will generate a reward based on their final outturn capital spend in line with the menu regulation methodology set out in the Price Control decision paper.

[4] June 2013

[5] After adjusting for foreign exchange gains and losses which are fully covered in k factor

All figures are in March 2012 prices, unless stated otherwise

Key Performance Indicators (KPI) help measure the quality of service received by stakeholders. The RAs acknowledge the generally good achievement against targets, in particular the effort made during the implementation of the Intraday project during which only one KPI failed to meet the quarterly predetermined target. However, the RAs also note that at times when significant efficiencies have been achieved, SEMO have missed some KPI targets, in particularly during 2011-2012. We will continue to monitor these KPIs, look for an improvement and assurance that efficiencies are not being delivered at the expense of service.

The RAs will continue to incentivise SEMO to deliver an efficient and robust service in the forthcoming years.

3.5 EXPECTATIONS OF SEMO IN THIS 2013 PRICE CONTROL

In addition to SEMO's requirement to comply with the SEM Trading and Settlement Code and both Market Operator licences the RAs also place importance on SEMO's overall performance. This includes the continuation and improvement of service delivery in meeting stakeholders' expectations.

The RAs set out below their expectations for this price control in relation to performance and service, capital expenditure and operational expenditure. Feedback from SEMO's customers' and their expectations of service are encouraged and will be considered as part of the price control decision process.

In recognising SEMO's generally good performance to date and the significant capital expenditure approved for the 2010-2013 price control, stakeholders would expect SEMO to deliver exceptional service, improved functionality and greater reliability for the full duration of this 2013 price control.

Monitoring Key Performance Indicators (KPIs) is one of a range of approaches the RAs use to measure the 'added value' to customer service. The KPIs currently in place for SEMO are provided in Table 2 below. Comments from market participants and other stakeholders are welcome in relation to the appropriateness of these KPIs and possible suggestions for new KPIs (Section 12 'Incentivisation' provides further information on KPIs).

Metric	Weighting	Target	Upper Bound
Ex-ante pricing report	0.2	99%	100%
Ex-post initial pricing report	0.1	99%	100%
Invoicing	0.2	95%	100%
Credit Cover Increase Notices	0.2	99%	100%
SEMO related Resettlement queries	0.2	<15[1]	10[2]
General queries	0.1	97%[3]	99%[4]

* Actual reward is a provisional figure

1. 15 or less Upheld queries incidents per quarter
2. 10 Upheld queries incidents per quarter
3. 97% of Queries answered within 20 Business days
4. 99% of Queries answered within 20 Business days

Table 2: KPIs in the 2010-2013 price control

Quality of service provided by SEMO should not be compromised in achieving efficiency gains and therefore the RAs would expect a strong KPI performance and clean market audit reports throughout the duration of the 2013 price control.

In relation to improving customer service the RAs are proposing additional funding to facilitate further website development. SEMO intends to carry out a usability review of the website and restructure the underlying data to improve navigation and speed. This is expected to improve market accessibility and transparency of the SEM market information to all consumers, including stakeholders.

The RAs determine SEMO's capital refresh policy of 3 years in respect of critical servers to be quite rigid and a more flexible refresh policy based on operational and available support options should be considered. This could substantially reduce ongoing replacement costs and such a change would also reduce the inherent risks in replacing and upgrading equipment.

The treatment of the OPEX and CAPEX allowances should be dealt with separately and are not interchangeable.

The above mentioned expectations are not exhaustive but highlight areas the RAs place importance on with regards to delivery of customer service, transparency, consistency and improvement of performance.

3.6 REGULATORY APPROVAL PROCESS

A detailed review and analysis of SEMO's submission and associated supporting information has been carried out. The RAs have engaged with SEMO via a price control questionnaire, a number of face to face meetings, and information requests. Based on the information provided, the RAs now publish this consultation paper which details proposals for the allowed revenue for SEMO for the period commencing 1 October 2013 to 30 September 2016.

3.7 LEGISLATIVE AND POLICY CHANGES

Currently the RAs are involved in implementing the European policy in the context of creating a European Internal Market and to that end have produced a European Market Integration draft decision paper[6]. This European Target Model for electricity and the corresponding market design being considered has the potential to significantly change the current SEM design. The scope of the 2013 SEMO price control is detailed in section 5.2.

4 REGULATORY PRINCIPLES

This section outlines the SEM Committee's principle objective and principles behind the regulatory proposals contained in this paper. Any subsequent decisions relating to these proposals will be evaluated against these principles.

The principle objective of the SEM Committee is to protect the interests of consumers of electricity in Ireland and Northern Ireland and wherever appropriate to do so by promoting effective competition.

The SEM Committee, in carrying out their functions, shall have regard to the principles underpinning regulatory activities[7]:

- Transparent
- Accountable
- Proportionate
- Consistent
- Targeted.

[6] http://www.allislandproject.org/en/TS_Current_Consultations.aspx?article=41f5681a-ef37-41ca-ab7d-7a1bdd7db385

[7] The Electricity (Single Wholesale Market) (Northern Ireland) Order 2007

5 FORM, SCOPE & DURATION

5.1 FORM

The SEMO business is unique in a number of ways. Firstly it is a contractual joint venture between the system operator in the Republic of Ireland (EirGrid) and the system operator for Northern Ireland (SONI). This contractual joint venture arrangement with the system operators means SEMO is not a separate legal entity and therefore some aspects of the price control have to include consideration of factors affecting the parent companies e.g. financeability, Weighted Average Cost of Capital (WACC) and recharges. Secondly, the all-island market operator is cross-jurisdictional and is governed by two Market Operator licences issued by the two RAs on the island.

In light of the above, a combined RA price control is proposed for the Market Operator business as a whole. This is consistent with the approach taken for previous SEMO controls.

OPEX

The RAs are minded to continue to incentivise OPEX under Revenue Cap (RPI-X) regulation. Essentially this requires the RAs to determine the revenues that SEMO should be allowed to recover. Revenue Cap regulation incentivises the regulated company to reduce costs by increased efficiency of processes and lower input prices. Any efficiency and price savings are retained by the regulated company while overspends must be absorbed by the regulated company. The overall efficiency and price savings made during the price control period should be reflected in the next price control and therefore the benefit would be passed to consumers in the form of lower prices. The application of RPI-X regulation to OPEX is discussed further in section 8.7.

CAPEX

The 2010 price control allowed for annual CAPEX (except Intraday Trading CAPEX) to be recovered in the same tariff year, as an alternative to rate of return regulation (RAB, depreciation, WACC approach). Mid 2010 price control the SEM Committee approved a CAPEX allowance to facilitate the introduction of Intraday Trading on the SEM. At that time the decision was taken to treat the Intraday CAPEX on a rate of return basis. For the 2013 price control, the RAs are minded to continue with rate of return regulation. With this method of regulation, the actual historical cost is included in the Regulatory Asset Base (RAB) and depreciated straight line over 5 years. In addition, the RAB value is indexed each year and a return (representing compensation for risk and the opportunity cost of the capital) is given. This return is referred to as a Weighted Average Cost of Capital (WACC) and is directly derived from a combination of the WACC applicable to EirGrid and SONI.

An objective assessment of SEMOs proposed CAPEX business cases has been carried out on behalf of the RAs. As capital investment is longer term in nature we have to be mindful of the market integration project changes in 2016. We have previously indicated to SEMO that CAPEX would be assessed in terms of how critical the investment is for the next 3-4 years. The RAs agree it is important to allow SEMO an adequate CAPEX allowance to ensure the SEM continues to meet stakeholder expectations. Some of the CAPEX business cases are discretionary in nature and the RAs have chosen not to approve these projects specifically because of the expected significant market change in 2016 and beyond. Further detail is provided in the CAPEX chapter 9.

Tariffs

Tariffs will be calculated so that OPEX and CAPEX revenues are recovered based on forecasted market demand. This in turn requires the over or under recovery of revenue to be taken into account when finalising tariffs for the following year thus protecting SEMO from any revenue uncertainty arising from the difference from forecasted and actual market demand.

Incentivisation

The RAs are minded to incentivise SEMO's CAPEX. Based on approved business cases, a CAPEX 'baseline' allowance has been calculated (see section 9.6). From this baseline a number of options (packages) have been prepared to create a form of menu regulation. The incentive for SEMO is to choose the option which best reflects their expected risk/reward profile. In summary, if SEMO choose a package less than the baseline they would achieve greater reward i.e. consumers benefit and SEMOs benefit is split. However, should SEMO choose the baseline package or a package greater than the baseline they will receive less benefit from efficiency savings.

Non-network utility regulation

In SEMO's submission they have raised concerns regarding the compensation they receive given the risks the business faces and in particular their relatively low asset base in comparison to other utility companies. Regulators, including the Utility Regulator, have been developing thinking in this area in relation to the appropriate form of regulation for the range of asset light utilities they regulate. Work will continue in this area, however it is unlikely that any conclusions will be reached in time for implementation of the 2013 SEMO price control. Given that the current framework has been tried and tested over a number of years, without any significant issues, the RAs are not minded to make any significant changes to the existing framework in this respect for the 2013 control.

The RAs believe that SEMO will continue to be rewarded with an appropriate return for the risks they face. It should be noted that inflation risk, foreign exchange risk, market volume risk and a return on CAPEX is provided in this price control either directly or via the k factor mechanism. The RAs would appreciate stakeholders views regarding the form of regulation proposed in this price control consultation paper.

The table below details the RAs proposals for the form of regulation.

	OPEX	**CAPEX (New Investments)**	**CAPEX (Investments in depreciation)**
RAs Proposal for 2013-2016	Revenue Cap RPI-X	Rate of Return Regulation + Incentivisation	Rate of Return Regulation
Current Form in Regulation 2010-2013	Revenue Cap RPI-X	Revenue-Cap + Incentivisation	Rate of Return Regulation
2009-10	Cost Pass Through	Rate of Return Regulation	Rate of Return Regulation

Table 3: Price Control Framework Design

5.2 SCOPE

The SEM has provided a platform for the wholesale trade of electricity in the Republic of Ireland and Northern Ireland since go-live in 2007. However, development towards European electricity Market Integration and compliance with the European 'target model' has the potential to significantly change the current SEM design. This represents the next major development of the trading arrangements on the island of Ireland. Due to the proposed implementation of the Market Integration project, it is necessary to define the scope of the 2013 price control.

When the price control questionnaire was issued to SEMO in November 2012, the RAs requested that SEMO assume a '*Business as Usual'* approach to maintaining the current structure of the SEM. This was necessary in order to put the SEMO price control in context when considering the medium term revenue requirement.

Any expenditure associated with Market Integration is considered outside the scope of the 2013 price control. This 'Business as Usual' approach aligns with the SEM Committee commitment 'to maintain the current structure of SEM until 2016 where possible and will not approve material market changes between now and then'[8].

5.3 DURATION

The current price control duration is 3 years, with the next price control due to commence on 1 October 2013. The RAs look to implement a further 3 year price control with the benefit of closely aligning with the timeline for Market Integration. SEMO also support this proposal.

A 3 year price control would conclude on 30 September 2016. The Market Integration Project is due to commence implementation in 2016. The RAs consider that a roll forward of year 3 allowance on a pro-rata basis may be required beyond 30 September 2016 to facilitate transition to the new market. This price control has been structured to facilitate this option. The SEM Committee will decide in 2015 whether a new price control is needed or if a roll forward is to be implemented.

6 INDEXATION

At the request of the RAs, SEMO has submitted their price control information using a mid tariff (March 2012) price base. The RA's proposals for a revenue allowance also use a March 2012 price base. The tariff process will continue to adjust the relevant allowance to account for out-turn inflation.

MO tariffs will be adjusted for out-turn inflation up to March of each year and any further adjustment will be recognised in the K factor adjustment mechanism.

The indexation rate applicable is minded to be a blended rate of outturn CPI based on publication by the Central Statistics Office, Ireland and RPI as detailed by the Office for National Statistics, UK. Again, this is consistent with the current arrangements.

It is worth noting that the Office of National Statistics consulted recently in relation to the appropriateness of the Retail Price Index (RPI)[9]. As a result of this a new index was created. Consideration of this new index has been given by the RAs and they are minded to continue with the existing RPI measurement for the duration of this 2013 price control.

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[8] European Market Integration Next Steps proposed decision paper

[9] http://www.ons.gov.uk/ons/rel/mro/news-release/rpirecommendations/rpinewsrelease.html

7 SEMO'S SUBMISSION

7.1 SUMMARY OF SEMO SUBMISSION

A summary of SEMO's submission is provided in Table 4 below.

SEMO have proposed an increase of just over €1 million in its operating expenditure (OPEX) allowance from €10.011 million in 2012-13 to €11.037 in 2013-14. This represents a 10% increase. The requirement then stabilises with a relatively flat-line proposal of €11.056 million in 2014-15 and €11.030 million in 2015-16.

The capital expenditure (CAPEX) requirement proposed by SEMO for the 3 year period is €9.371 million. This compares to a CAPEX requirement of €18.509 million for the current price control[10]. In addition to this, the RAs approved a further CAPEX allowance of €10.300 million for the Intraday Trading Project which went live in July 2012.

SEMO propose the continuance of the existing framework, but also requested that rate of return regulation (RAB, Depreciation, WACC) be applied to new investments, consistent with the treatment for Intraday trading CAPEX. The continuation of incentives including Key Performance Indicators (KPIs) is favoured by SEMO together with widening the range of KPIs and increasing the financial incentive.

The RAs have assessed all areas of SEMO's submission and supporting information. Priority has been given to the most significant cost categories and any cost areas where SEMO's proposed allowance is higher than expected.

7.2 HIGH LEVEL REVIEW OF HISTORIC VERSUS PROPOSED COSTS

The following table summarises:

- SEMO's actual outturn from 1 October 2010 to 30 September 2012;
- SEMO's estimate outturn for 1 October 2012 to 30 September 2013;
- SEMO's approved allowance for 1 October 2012 to 30 September 2013;
- SEMO's submission for 1 October 2013 to 30 September 2016.

[10] This includes Bi-annual releases but excludes Intraday trading allowance

	Actuals 2010-11	Actuals 2011-12[11]	SEMO's Estimates 2012-13	Allowed Revenue 2012-13[12]	SEMO's Submission 2013-2014	SEMO's Submission 2014-2015	SEMO's Submission 2015-2016	Total SEMO's Submission
	€ million				€ million			
OPEX								
Total Payroll	4.357	4.448	5.262	5.181	5.660	5.667	5.667	16.994
Total IT & Communications	1.423	1.639	2.539	2.194	2.564	2.619	2.649	7.832
Total Facilities and Insurance	1.123	1.136	1.326	1.414	1.438	1.447	1.447	4.332
Total Professional Fees	0.706	0.427	0.739	0.605	0.622	0.570	0.514	1.706
Total General and Administrative	0.236	0.336	0.390	0.437	0.369	0.369	0.369	1.107
Total Corporate Services	0.134	0.387	0.381	0.180	0.384	0.384	0.384	1.152
Total	**7.979**	**8.373**	**10.637**	**10.011**	**11.037**	**11.056**	**11.030**	**33.123**
Cost of Capital								
Depreciation	11.593	13.112	6.627	6.926	5.284	5.045	4.829	15.158
WACC	2.180	0.786	0.942	0.990	0.794	0.726	0.576	2.096
Total	**13.773**	**13.898**	**7.569**	**7.916**	**6.078**	**5.771**	**5.405**	**17.254**
CAPEX recoverable in 1 year	**0.182**	**4.246**	**1.482**	**3.634**				
Total Revenue Requirement	**21.934**	**26.517**	**19.688**	**21.561**	**17.115**	**16.827**	**16.435**	**50.377**
CAPEX Submission (incorporated in Depreciation Charge above)	**2.266**	**12.566**	**2.266**	**2.408**	**4.255**	**3.406**	**1.710**	**9.371**

Table 4: Summary of SEMO Annual Revenue and Submission in March 2012 prices

[11] Actuals 2011-12 partially include Intraday Project when went live 21 July 2012

[12] Allowance reflects the increased revenue requirement for Intraday Project

Some initial observations by the RAs on the figures summarized in Table 4 are as follows:

- An upward step change is evident in OPEX between 2011-12 and 2012-13 due, in part, to Intraday Trading (IDT) being operational. In recognition of enduring additional resources required for Intraday Trading and Fuel Mix Disclosure, the 2012-13 approved allowance was increased by €0.877 million and is included in the €10.011 million allowance shown;

- The treatment of CAPEX in the 2010 price control is different to the treatment proposed in the 2013 price control. For this reason, the figures are not presented on a consistent basis;

- Payroll is the largest single OPEX item, and SEMO is proposing a 9% increase in this area when compared to the 2012-13 allowance. SEMO explains that the increase is due to increased use of contractors and the inclusion of a pension deficit relating to EirGrid employees within SEMO;

- IT and telecommunications is the next largest item within OPEX. A 17% increase on 2012-13 allowance is proposed by SEMO in year 2013-14 which is mainly due to key contract renewals and additional support costs for CAPEX. Facilities and insurance represents approximately 13% of SEMO's proposed OPEX allowance. SEMO's submission shows a slight increase in facilities and insurance costs compared with the 2012-13 allowance, however this cost line still remains higher than actual costs reported in previous years;

- SEMO's professional fees proposal represents 5% of the OPEX submission and decreases over the 3 years. Historically SEMO's revenue requirement for professional fees does fluctuate. Some aspects of professional fees are recurring and predictable other elements are variable depending on the work program;

- General and Administrative costs represent 3% of internal costs for the year 2013-14. These are estimated to continue in line with actual expenditure to date;

- Corporate services also represents 3% of OPEX and has experienced an increase of 188% from 2010-11 to 2011-12. The increase is due to a Group recharge policy change;

- SEMO proposes a decrease in CAPEX allowance for the 2013 price control. The RAs look to continue with CAPEX incentive mechanisms.

The RAs will now consider SEMO's proposal for OPEX and CAPEX in turn.

8 OPERATIONAL EXPENDITURE (OPEX)

In this section, SEMO's operating expenditure (OPEX) proposals, as detailed in Table 5, are discussed.

SEMO have requested a total of €33.123 million[13] of OPEX during the 2013 price control period.

	Actuals - Historic data (€ millions)				SEMO's Submission (€ millions)			
	Actuals 2010-11	Actuals 2011-12	SEMO's Estimates 2012-13	Total	2013-2014	2014-2015	2015-2016	Total SEMO's Submission
	(March 2012 prices)							
OPEX								
Total Payroll	4.357	4.448	5.262	14.067	5.660	5.667	5.667	16.994
Total IT & Communications	1.423	1.639	2.539	5.601	2.564	2.619	2.649	7.832
Total Facilities and Insurance	1.123	1.136	1.326	3.585	1.438	1.447	1.447	4.332
Total Professional Fees	0.706	0.427	0.739	1.872	0.622	0.570	0.514	1.706
Total General and Administrative	0.236	0.336	0.390	0.962	0.369	0.369	0.369	1.107
Total Corporate Services	0.134	0.387	0.381	0.902	0.384	0.384	0.384	1.152
Total	**7.979**	**8.373**	**10.637**	**26.989**	**11.037**	**11.056**	**11.030**	**33.123**

Table 5: Summary of OPEX

In order to determine a suitable OPEX allowance for SEMO, the RA's analysed SEMO's allowed and actual OPEX spend from 1 October 2010 to 30 September 2013 compared to its proposed future spend.

SEMO have provided detail of actual costs incurred for 2010-11 and 2011-12 and estimates for 2012-13. All figures quoted in this chapter are in March 2012 prices.

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[13] SEMO's original OPEX submission is for €32.908 million, but there were also additional IT support costs associated with the implementation of CAPEX projects (which total €0.215 million). SEMO included these in their CAPEX submission. For analysis purposes, the RAs have reviewed the IT support costs for CAPEX within this section of the consultation paper.

8.1 OVERVIEW OF OPEX

As mentioned above, SEMO's OPEX submission excludes costs classified as unpredictable. Unpredictable costs include OPEX associated with major/ material market changes, regulatory decisions or changes to legislation. These costs are deemed uncertain as they cannot be reasonably foreseen by the business. For this reason, it is the RAs view that they will be dealt with as and when they arise.

SEMO's OPEX submission also assumes that uncontrollable OPEX (including Market Audit Fees, Disputes Allowance and Modification Committee's legal allowance) will be treated on a pass through basis. This is discussed further in chapter 13.

Proposed OPEX includes payroll, IT & Communications, Facilities and Insurance, Professional fees, General and Administrative costs and costs associated with Corporate Services. SEMO took a 'business as usual' approach to its OPEX submission, as required by the RAs.

SEMO's OPEX submission totals €33.123 million over the three year price control period, broken down into the following categories:

- Payroll;
- IT & Communications;
- Facilities and Insurance;
- Professional fees;
- General and Administrative;
- Corporate Services.

An annual breakdown of the cost categories is shown in Table 6 below.

	Allowance (€ millions)				Actuals - Historic data (€ millions)				SEMO's Submission (€ millions)			
	2010-11	2011-12	2012-13	Total	Actuals 2010-11	Actuals 2011-12	SEMO's Estimates 2012-13	Total	2013-2014	2014-2015	2015-2016	Total SEMO's Submission
	(March 2012 prices)											
OPEX												
Total Payroll	4.876	4.870	5.181	**14.927**	4.357	4.448	5.262	**14.067**	5.66	5.667	5.667	**16.994**
Total IT & Communications	1.657	2.047	2.194	**5.898**	1.423	1.639	2.539	**5.601**	2.564	2.619	2.649	**7.832**
Total Facilities and Insurance	1.271	1.298	1.414	**3.983**	1.123	1.136	1.326	**3.585**	1.438	1.447	1.447	**4.332**
Total Professional Fees	0.658	0.700	0.605	**1.963**	0.706	0.427	0.739	**1.872**	0.622	0.57	0.514	**1.706**
Total General and Administrative	0.391	0.408	0.437	**1.236**	0.236	0.336	0.39	**0.962**	0.369	0.369	0.369	**1.107**
Total Corporate Services	0.159	0.163	0.18	**0.502**	0.134	0.387	0.381	**0.902**	0.384	0.384	0.384	**1.152**
Total	**9.012**	**9.486**	**10.011**	**28.509**	**7.979**	**8.373**	**10.637**	**26.989**	**11.037**	**11.056**	**11.030**	**33.123**

Table 6: SEMO's OPEX Allowance, Actuals and Submission

SEMO's actual OPEX outturn for the current price control (with estimates for the 2012-13 year) is €26.989 million. This compares to an allowance of €28.509 million[14] and represents an outperformance of 5%. SEMO's proposed total OPEX for 2013-14 (€11.037 million) has increased by around one third since the first year of the 2010 price control (€7.979 million) but shows a relatively flat line trend from 1 October 2013 to 30 September 2016, as illustrated in figure 1.

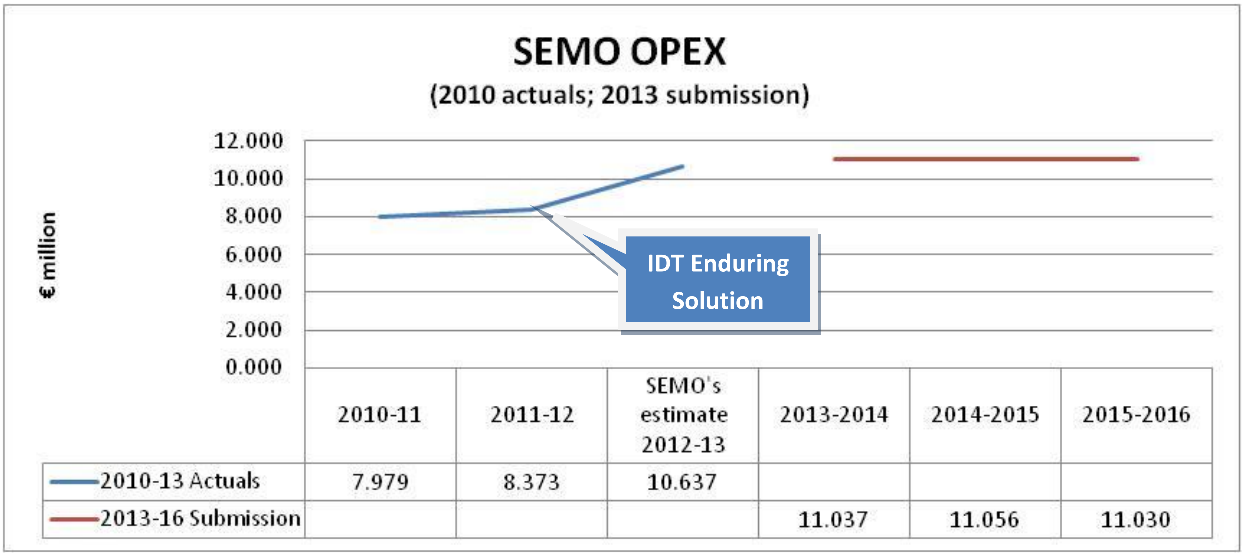

Figure 1: SEMO actual OPEX for 2010-13 and submitted OPEX for 2013-16

The reason for the increase from the start of the 2010 price control is mainly due to the impact of approved Intraday Trading (IDT) arrangements. 2012-13 is the first full year where IDT was in place. Compared to SEMO's (estimated) OPEX for 2012-13 (€10.637 million), their submission for 2013-14 (€11.037 million) has increased by 4%.

Although SEMO's OPEX submission indicated an estimate for 2012-13, the company also furnished the RAs with a quarterly report for the first quarter (October – December) of the 2012-13 year. This shows that €2.260 million of OPEX was incurred, which pro-rates to €9.040 million annually. If this pro-rated figure is analysed instead, SEMO have the potential to outperform their OPEX allowance in all three years of the 2010 price control.

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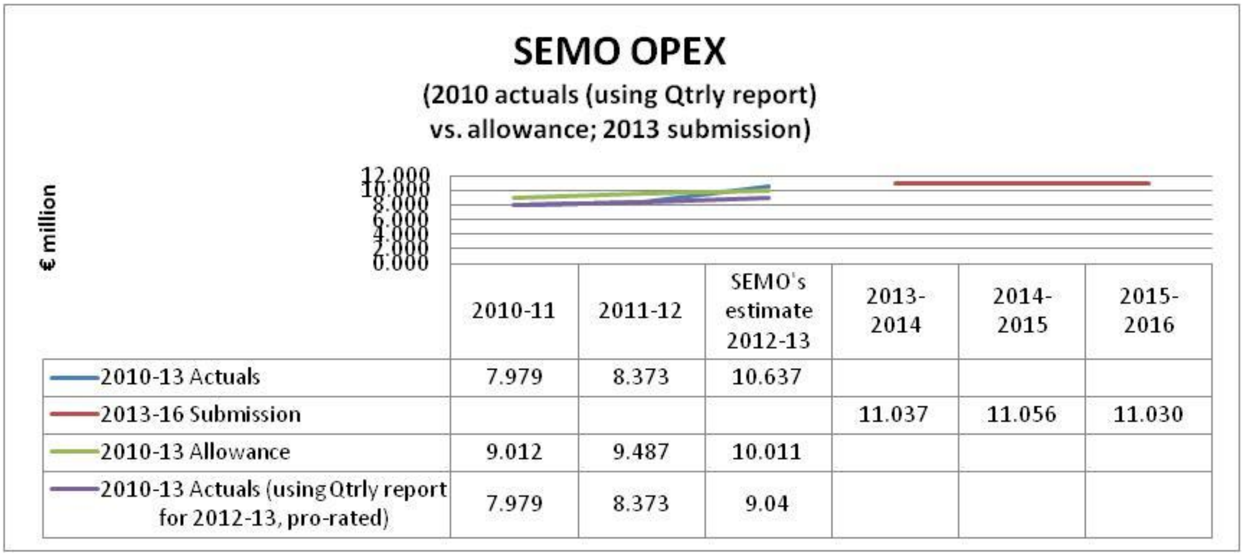
[14] The allowance includes the original approved OPEX allowance for the 2010 price control, plus an additional allowance in respect of IntraDay Trading arrangements which applied from July 2012



	2010-11	2011-12	SEMO's estimate 2012-13	2013-2014	2014-2015	2015-2016
2010-13 Actuals	7.979	8.373	10.637			
2013-16 Submission				11.037	11.056	11.030
2010-13 Allowance	9.012	9.487	10.011			
2010-13 Actuals (using Qtrly report for 2012-13, pro-rated)	7.979	8.373	9.04			

Figure 2: SEMO actual OPEX for 2010-13 (using quarterly report) and submitted OPEX for 2013-16

Payroll and IT & Communications make up a large proportion of SEMO's OPEX submission. For these reasons, the RAs performed a detailed analysis of them. Although Facilities & Insurance has not shown an increase in the same magnitude as the other two cost lines, the RAs have also analysed this cost category in detail since it makes up a significant proportion of total OPEX.

The other OPEX (which includes professional fees, general and administrative support, and corporate services) provided by SEMO were analysed collectively due to their relatively small value. A high level analysis of these costs was completed and is discussed in section 8.5.

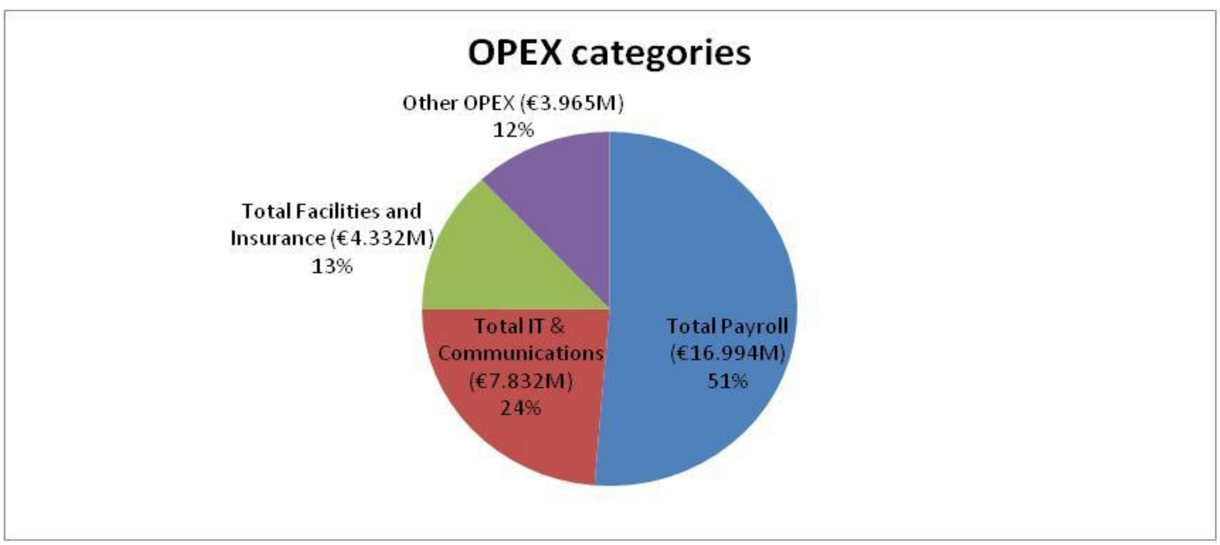


Figure 3: 3 Year Opex Submission by category

All figures are in March 2012 prices, unless stated otherwise

The RAs have outlined their view on each of the three main OPEX cost categories. Respondents' comments are welcome on all aspects.

8.2 PAYROLL

This section discusses SEMO's proposed payroll costs and the RAs assessment of these costs.

SEMO submission

For the 2013 price control, SEMO have requested a three year allowance totaling €16.994 million for payroll. Payroll is the largest cost item in the OPEX submission, making up 51% of OPEX over the three year price control period.

SEMO's payroll consists of:

- Salaries;
- Employers NICS/ PRSI;
- Performance related payments;
- Overtime;
- Other staff costs (which include car allowance and other benefits);
- Pension costs (both ongoing and deficit recovery);
- Contract staff costs.

SEMO's payroll submission, compared to actual payroll expenditure incurred in the 2010 price control, is summarized in Table 7.

PAYROLL	Actuals - Historic data (€ millions)				SEMO's Submission (€ millions)			
	Actuals 2010-11	Actuals 2011-12	SEMO's Estimates 2012-13	Total	2013-2014	2014-2015	2015-2016	Total SEMO's Submission
	(March 2012 prices)							
Salaries	2.868	3.068	3.629	9.565	3.665	3.665	3.665	10.995
Employers' NICS/PRSI	0.326	0.345	0.446	1.117	0.478	0.478	0.478	1.434
Performance related payments	0.409	0.412	0.448	1.269	0.475	0.475	0.475	1.425
Overtime	0.018	0.039	0.055	0.112	0.032	0.032	0.032	0.096
Other staff costs	0.031	0.009	0.046	0.086	0.023	0.023	0.023	0.069
Pension (ongoing)	0.389	0.409	0.46	1.258	0.496	0.503	0.503	1.502
Total Salaries/Pensions etc	**4.042**	**4.282**	**5.084**	**13.408**	**5.169**	**5.176**	**5.176**	**15.521**
Pension deficit	0.000	0.000	0.000	0.000	0.250	0.250	0.250	0.750
Contract staff	0.316	0.166	0.178	0.660	0.241	0.241	0.241	0.723
Total Payroll	**4.358**	**4.448**	**5.262**	**14.068**	**5.660**	**5.667**	**5.667**	**16.994**

Table 7: Payroll

Although in real terms SEMO's payroll projection for 2013-16 is largely flat, the increase which they propose from the current to the 2013 price control can be explained in part by:

- An increase in revenue requirement which is commensurate with a higher headcount since the start of the last price control (due to Intraday Trading arrangements);
- A change in scope of SEMO's activities due to the implementation of the Intraday Trading arrangements which increase the overall revenue requirements;
- Inclusion of pension deficit costs (of €0.250 million per year); and
- An increase in contractor costs (to provide cover for maternity leave and periods of high volume workload).

SEMO's estimate of payroll in 2012-13 is €5.262 million. However, an analysis of their quarterly report for the first quarter of 2012-13 shows an amount of €1.201 million, which pro-rates to an annual amount of €4.804 million. The RA's have analysed the main reasons for increase in payroll in turn. Salary and pension elements of payroll were assessed in most detail since they make up almost 80% of SEMO's submission.

8.2.1 BASELINE HEADCOUNT

SEMO states that their payroll proposals for the 2013 price control period are based on the associated headcount at the 2012 salary and allowance levels. SEMO's revenue requirement for the 2013 price control is derived from an assessed headcount of 64 full-time equivalents

(FTEs)[15]. SEMO quote that 'it is generally felt that once fully staffed the current staffing arrangements are largely sufficient to meet the workload for the forthcoming period'. SEMO has confirmed that one outstanding pre-approved position is currently in the process of being filled through recruitment. SEMO assume that this position will be filled by the start of the 2013 price control.

The 2010 SEMO decision paper quoted a starting baseline headcount of 55. Headcount has increased since the beginning of the 2010 price control because the RAs provided additional revenue in respect of seven full time equivalent resources (FTEs). Six were associated with the need to support the longer working day additional pricing runs and increased workload resulting from the Intraday Trading (IDT) decision. One FTE was associated with the necessity to support the requirements of the SEM Committee decision (*SEM-11-095 Fuel Mix Disclosure in the Single electricity Market)* for the enduring arrangements for the calculation of Fuel Mix Disclosure (FMD) for all participants in the SEM.

The movement in headcount from the start of the current price control is as follows:

	FTEs
Baseline stated at 2010 price control	54
Additional Administrative Assistant	1
Total approved for 2010 price control	**55**
Additions for IDT and FMD	7
Subtotal	**62**
GOO staff member	1
RCUC staff member	1
Total which SEMO's payroll submission is based on	**64**

Table 8: SEMO baseline headcount

SEMO's baseline headcount includes two resources for Guarantees of Origin (GOO) and Reserve Constrained Unit Commitment (RCUC). These have no ultimate cost to SEMO, but SEMO included them in the overall headcount for payroll projection (and accounting purposes).

The RAs have reviewed whether SEMO's proposed headcount of 64 FTEs is required for payroll projection purposes. The baseline of 55 at the start of the 2010 price control included approval for two resources for a software contract. A change in circumstances from the 2010 price control to the 2013 price control is the reduction by half of vendor hours required in relation to

[15] This figure excludes external contractors.

a key software contract. The RAs are therefore of the view the overall payroll allowance can be reduced to reflect this. Due to the complexity of the systems following Intraday Trading, the RA's are of the view that headcount used to base regulated allowance on should be reduced by one.

	FTEs
Baseline stated at 2010 price control	54
Additional Administrative Assistant	1
Total approved for 2010 price control	**55**
Additions for IDT and FMD	7
Subtotal	**62**
GOO staff member	1
RCUC staff member	1
Total which SEMO's payroll submission is based on	**64**
Reduce Headcount by 1	-1
Total for 2013 price control	**63**

Table 9: RAs Proposed baseline headcount

8.2.2 PAYROLL BENCHMARK

For the 2010 price control, the RAs commissioned staff cost analysis which involved a benchmarking exercise against similar IT based companies in Northern Ireland and the Republic of Ireland. The analysis concluded that further efficiencies could be realised in staff costs, and a 7% target was imposed on payroll costs, to be achieved over the three year duration of the price control.

The payroll allowance approved by the RAs for the 2010 price control was €14.299 million (in March 2012 prices). Due to an increase in approved headcount during the price control associated with Intraday Trading and Fuel Mix Disclosure, an additional €0.628 million of payroll was approved from July 2012 to the end of the control period to ensure that SEMO had the finance/resource to carry out the required activity.

SEMO outperformed their payroll allowance by 6% during the current price control, after incurring €14.067 million of total payroll costs as follows:

	2010-11	2011-12	2012-13	Total
Payroll Allowance	4.876	4.766	4.657	14.299
IDT payroll allowance	0.000	0.104	0.524	0.628
Total Payroll Allowance	**4.876**	**4.870**	**5.181**	**14.927**
Actuals & best estimate	4.357	4.448	5.262	14.067
Out/(under) performance	**0.519**	**0.416**	**(0.113)**	**0.822**

Table 10: Payroll outperformance

SEMO's price control submission for the year 2012-13 is based on estimates. SEMO's quarterly report for the first quarter of 2013 shows €1.201 million of payroll costs from 1 October – 31 December (which, if pro-rated to an annual cost would be €4.804 million). If the quarterly results from quarter 1 of 2012-13 are compared to approved allowance instead, total payroll outperformance is 8%.

For the 2013 price control, SEMO provided salary minimum, maximum and average for staff grouped into three bands entitled 'Market professional', 'Senior market professional' and 'Market manager'. It is the RAs view that salaries paid to SEMO staff are higher than average and further efficiencies can be achieved to take account of staff capabilities and knowledge transfer. However, the RAs payroll proposal is projected using a baseline which was decided at the 2010 price control, and which has been subject to a 7% efficiency target.

It was decided in the 2010 SEMO price control that the baseline payroll amount for the 2013 price control would be €4.315 million (in 2009/10 prices). This correlates to an allowance of €4.585 million in March 2012 prices. The payroll baseline for the 2013 price control includes all elements of payroll (except pension deficit contributions) and has been adjusted for contractor costs. The RAs have projected payroll costs for the 2013 price control of €4.971 million per annum as follows:

	Payroll € million
Baseline for 2013 (stated in 2010 price control)	4.585
Minus: contractors	-0.134
Minus: 1 software staff	-0.079
Add: additional allowance for IDT	0.524
	4.896
Adjust for foreign exchange rates since setting 2010 price control:	
75% EirGrid	3.672
25% SONI (apply FX rate)	1.299
Revised baseline for 2013	4.971

Table 11: Proposed payroll (excl. pension deficit and contractor costs)

The RAs propose a payroll allowance of €14.913 million (which excludes consideration of pension deficit and contractor costs). This is 4% lower than SEMO's submission. In recommending a payroll allowance for SEMO, the RAs have used the agreed baseline which was agreed in the 2010 decision paper, and adjusted this to align with headcount.

PAYROLL	SEMO's Submission (€ millions)				RAs Proposal (€ millions)			
	2013-14	2014-15	2015-16	Total SEMO's Submission	2013-14	2014-15	2015-16	Total RAs Proposal
	(March 2012 prices)							
Salaries	3.665	3.665	3.665	10.995				
Employers' NICS/PRSI	0.478	0.478	0.478	1.434				
Performance related payments	0.475	0.475	0.475	1.425				
Overtime	0.032	0.032	0.032	0.096				
Other staff costs	0.023	0.023	0.023	0.069				
Pension (ongoing)	0.496	0.503	0.503	1.502				
Payroll (excl pension deficit and contract staff)	**5.169**	**5.176**	**5.176**	**15.521**	**4.971**	**4.971**	**4.971**	**14.913**

Table 12: Proposed total Payroll (excl. pension deficit and contractor costs)

8.2.3 INCREASE IN PENSION DEFICIT CONTRIBUTION

SEMOs payroll revenue requirement incorporates a provision for both ongoing pension costs and for legacy past service pension arrangements and deficit repair. Ongoing pension costs are included in the payroll analysis discussed in section 8.2.2 above.

The EirGrid staff employed by SEMO have membership of the EirGrid Pension Fund (a defined benefit scheme); SONI staff employed by SEMO have membership of the SONI Limited Pension Scheme (which has both defined benefit and defined contribution sections). SEMO's pension cost submission is in line with the most recent actuarial valuation reports for the two schemes. SEMO have submitted a pension deficit amount of €0.250 million per annum.

The RAs have assessed whether an allowance should be provided for pension deficit cost recovery, by reviewing the treatment given to the previous SEMO price control and the most recent SONI and EirGrid price controls (set by the Utility Regulator and CER respectively).

For the 2010 SEMO price control, the RAs were of the view that the revenue requirement for OPEX should be set at the level that would be possible for a new entrant to undertake SEMO's operational duties. Any costs in excess of that required by an efficient notional company should be borne by SEMO's shareholder. It was therefore proposed that the treatment of pension deficit would not be dealt with as part of the price control process. Paragraph 6.9.1 of the SEMO decision paper[16] for the 2010 price control states 'The pension deficits currently attributable to EirGrid and SONI staff currently working for SEMO are historical liabilities that were incurred before SEMO was set up. Therefore the SEM Committee is of the view that this issue should be dealt with by the parent companies'.

The deficit contributions for SONI were addressed in its 2010-15 price control. The decision published by the Utility Regulator was to allow 100% of ongoing costs associated with the defined benefit section of the SONI Ltd pension scheme, including deficit repair costs. Only 1 SEMO employee was included in the SONI Ltd Pension Scheme so the Utility Regulator deemed this immaterial and included recovery within SONI's regulated allowance.

Of the €0.250 million deficit recovery requested per annum, 100% relates to EirGrid. SEMO explain that the deficit is largely associated with the transfer of staff from ESB when EirGrid was formed in 2006. Recent discussion between the RAs, specifically on this issue, concluded that EirGrid pension deficit should continue to be excluded from the SEMO price control.

The RAs are minded to exclude pension deficit costs from the SEMO price control total payroll allowance.

8.2.4 PROPOSED INCREASED USE OF CONTRACTORS

SEMO's forecasted level of expenditure for the current year, and on an ongoing basis, is over and above the existing revenue cap. SEMO state that this is largely due to unanticipated higher than expected contract costs.

SEMO provided a breakdown of contract staff costs for each year as follows:

[16] http://www.allislandproject.org/en/smo_decision_documents.aspx?article=f0468055-eed1-470b-ad8d-2a7badbe8619

	Description	SEMO submission € million (per annum)
Market operations	3 staff	0.111
Market development	1 student	0.018
SEMO IT	1 student + cover	0.069
Finance	Junior cover	0.043
Total		**0.241**

Table 13: SEMO contractor costs

The RAs accept that contractors offer flexibility in dealing with an uncertain workload and in meeting the demand for specialist skills for a short term requirement. However, we expect that the need for contractors decreases rather than increases since SEMO has now been in operation for over five years and has a structured plan for handling developments to the systems through a series of releases.

SEMO are now at a capacity which they feel is adequate to run the business. We are minded to disallow SEMO's proposal for contract staff.

	Description	SEMO submission € million (per annum)	RAs Proposed Allowance
Market operations	3 staff	0.111	-
Market development	1 student	0.018	-
SEMO IT	1 student + cover	0.069	-
Finance	Junior cover	0.043	-
Total		**0.241**	**-**

Table 14: Proposed contractor allowance

The RAs believe that adequate allowance is provided for human resources elsewhere within total payroll and professional fees (for consultancy support).

8.2.5 CONCLUSION ON PAYROLL

SEMO is a contractual joint venture between EirGrid and SONI; SEMO is based in both Dublin and Belfast. Internal staff are employed by the parent companies. The RAs recognise that contractual and remuneration arrangements are consistent with the approach adopted within each of the two licensed businesses.

The RAs propose to allow a total payroll allowance of €4.971 million per annum (totaling €14.913 million during the price control). The allowance is 12.2% lower than that requested by SEMO. The difference is explained by a reduction in proposed headcount, disallowance of pension deficit costs and a disallowance of SEMO's proposed use of contractors.

PAYROLL	Actuals - Historic data (€ millions)				SEMO's Submission (€ millions)				RAs Proposal (€ millions)			
	Actuals 2010-11	Actuals 2011-12	SEMO's Estimates 2012-13	Total	2013-14	2014-15	2015-16	Total SEMO's Submission	2013-14	2014-15	2015-16	Total RAs Proposal
	(March 2012 prices)											
Salaries	2.868	3.068	3.629	9.565	3.665	3.665	3.665	10.995				
Employers' NICS/PRSI	0.326	0.345	0.446	1.117	0.478	0.478	0.478	1.434				
Performance related payments	0.409	0.412	0.448	1.269	0.475	0.475	0.475	1.425				
Overtime	0.018	0.039	0.055	0.112	0.032	0.032	0.032	0.096				
Other staff costs	0.031	0.009	0.046	0.086	0.023	0.023	0.023	0.069				
Pension (ongoing)	0.389	0.409	0.46	1.258	0.496	0.503	0.503	1.502				
Total Salaries/Pensions etc	**4.042**	**4.282**	**5.084**	**13.408**	**5.169**	**5.176**	**5.176**	**15.521**	**4.971**	**4.971**	**4.971**	**14.913**
Pension deficit	0.000	0.000	0.000	0.000	0.250	0.250	0.250	0.750	0.000	0.000	0.000	0.000
Contract staff	0.316	0.166	0.178	0.660	0.241	0.241	0.241	0.723	0.000	0.000	0.000	0.000
Total Payroll	**4.358**	**4.448**	**5.262**	**14.068**	**5.660**	**5.667**	**5.667**	**16.994**	**4.971**	**4.971**	**4.971**	**14.913**

Table 15: Total payroll proposal

8.3 IT & TELECOMMUNICATIONS

Considering the complex IT systems deployed to support the SEM, IT & Communications is a significant OPEX cost area within SEMO's submission. This category makes up 24% of SEMO's OPEX proposals and the RAs appreciate that this is an area that is critical to the market. To support their analysis, the RAs commissioned Gemserv to undertake a high level review of SEMO's OPEX proposals as part of the overall consideration of CAPEX.

SEMO's submission proposed an allowance of €7.832 million for IT & Communications, broken down as follows:

SEMO's submission shows the following breakdown:

IT & Communications	€ million		
	2013-14	**2014-15**	**2015-16**
Telecommunications	0.227	0.227	0.227
IT Support & Maintenance	2.312	2.312	2.312
Total IT and Telecommunications	**2.539**	**2.539**	**2.539**
IT support for CAPEX	0.025	0.080	0.110
TOTAL	**2.564**	**2.619**	**2.649**

Table 16: Summary of IT & Communications proposed by SEMO

Each cost area identified in Table 16 is considered in further detail below.

8.3.1 TELECOMMUNICATIONS

SEMO's submission of €0.227 million per annum represents an increase of expenditure compared with earlier years. SEMO indicated that the increase is mainly due to the augmentation of communication lines between Dublin and Belfast from 35Mbs to 100Mbs. On the basis that communication contracts have been competitively procured, Gemserv conclude that the annual operating costs appear to be based on good empirical data.

The RAs are therefore minded to allow €0.227 million per annum (totaling €0.681 million) for Telecommunications.

8.3.2 IT SUPPORT & MAINTENANCE

The RAs reviewed, in detail, the IT support and maintenance submission made by SEMO. The expenditure predominantly relates to warranty support and maintenance of both the central market system and corporate systems.

SEMO's projection for the next price control is for costs to stabilise at €2.312 million per annum. However, this represents a 17% increase from the allowance agreed for 2012-2013 to that submitted by SEMO for 2013-14. SEMO have explained that this step change is due to the renewal of a key contract which expired in late 2012, and increased costs for Oracle and Microsoft.

Gemserv carried out a high level review of the increased contract costs from 2012-13 to 2013-14 onwards. Gemserv indicated that although the supplier's headline rate is similar, many items have been separated from the core contract and are paid separately (e.g. Third party vendor support and Oracle licences). Gemserv informed the RAs that several support and software licence costs are provisional sums and could be subject to a reduction when actual costs are established. The RAs reviewed the IT Support and Maintenance costs based on the information provided while considering the revised scope of the key support contract which is in place for 2013-2016.

Compared to SEMO's submission for €6.936 million of IT support & maintenance costs, the RAs are minded to allow €6.285 million.

8.3.3 IT SUPPORT COSTS FOR CAPEX

SEMO propose that additional OPEX is required to support the proposed CAPEX. The RAs propose to disallow support costs relating to any CAPEX projects which the RAs propose to disallow.

Compared to SEMO's submission for €0.215 million of IT support costs for CAPEX, the RA's propose to allow €0.167 million. Annual approved amounts are shown in Table 17.

8.3.4 CONCLUSION ON IT & COMMUNICATIONS

SEMO requested an allowance of €7.832 million for IT & Communications (and associated support costs) for the 2013 price control period. The RAs propose to allow €7.133 million for the 3 year period as detailed below in Table 17.

	SEMO's Submission (€ million)			RAs Proposal (€ million)		
	2013-14	**2014-15**	**2015-16**	**2013-14**	**2014-15**	**2015-16**
Telecommunications	0.227	0.227	0.227	0.227	0.227	0.227
IT Support & Maintenance	2.312	2.312	2.312	2.095	2.095	2.095
Total IT and Telecommunications	**2.539**	**2.539**	**2.539**	**2.322**	**2.322**	**2.322**
IT support for CAPEX	0.025	0.080	0.110	0.015	0.061	0.091
TOTAL	**2.564**	**2.619**	**2.649**	**2.337**	**2.383**	**2.413**

Table 17: Summary of RAs Proposals in respect of IT & Communications

The RAs are proposing to allow the full amount requested for telecommunications which aligns with the recommendation from Gemserv.

The RAs have carried out a detailed analysis of the IT support and maintenance in line with revenue cap regulation. Our proposal takes into account efficiencies made in the 2010-2013 price control to date, followed by an upwards adjustment to recognise, in full, the key contract renewal and increases in relation to Oracle and Microsoft as specifically identified by SEMO.

IT support costs have been reduced in line with the RAs proposals for CAPEX.

8.4 FACILITIES

SEMO has office space in both jurisdictions and will continue to co-locate on property provided by both parent organisations. Facilities costs cover rent, rates, insurance, utilities and also includes cleaning services, maintenance, car parking, security, mail service, copy bureau, switch board and catering and canteen services.

Facilities and insurance represents 13% of the overall proposed OPEX allowance requested by SEMO. SEMO, were required to provide detailed facilities information in the RAs questionnaire but sufficient information was not provided to the RAs. The RAs recognise these costs are predominantly a recharge from Group and have therefore reviewed the EirGrid TSO and SONI TSO price controls regarding decisions in place for facilities costs.

The EirGrid TSO price control[17] assessed the facilities charge and recognised that €1 million would be contributed from SEMO for years 2011 to 2015. Below is the summary table included in the EirGrid TSO price control which we have adapted to show the breakdown of the SEMO (EirGrid Market Operator) proportion.

	EirGrid TSO & MO	EirGrid MO Proportion
	€millions	€millions
Rent (lease)	2.900	0.527
Building Rates (Oval + Deansgrange)	0.400	0.073
Global Rates (Oval + Deansgrange)	0.300	0.055
Facilities and Other Services	1.900	0.345
Total	**5.500**	**1.000**
Less contribution from SEMO	-1.000	
Chargeable to EirGrid TSO	**4.500**	

Table 18: Table from EirGrid price control adapted for EirGrid Market Operator proportion

17 'Decision on TSO and TAO Transmission Revenue for 2011 to 2015' http://www.cer.ie/en/electricity-transmission-network-current--consultations.aspx?article=163210c1-f11f-4713-bfc9-d3b1c2fb4df3&mode=author

Rent forms the largest element of facilities costs. There is no further breakdown of costs for 'Facilities and Other Services'. It should be noted the Deansgrange location relates solely to the TSO business, however costs are currently apportioned to SEMO.

The SONI Market Operator facility costs are determined in the SONI Price Control 2010 – 2015 Decision Paper[18]. The decision was taken to include the costs of the SONI Market Operator as being the most appropriate treatment of SONI's overall facility costs. The facilities allowance within the SONI price control includes an appropriate allowance for the building extension and refurbishment.

Based on the above review and decisions made within the current TSO price controls for both EirGrid and SONI, the RAs believe the appropriate indexed amount applicable to the next SEMO price control is €1.113 million per annum as detailed in Table 19 below.

	Historical Expenditure			SEMO's Proposal			RAs Proposal		
	Actuals 2011 - 2012 (indexed)	**Allowance 2012-2013 (indexed)**	**SEMO's Estimate 2012-13**	**2013-2014**	**2014-2015**	**2015-2016**	**2013-2014**	**2014-2015**	**2015-2016**
	€millions			**€millions**			**€millions**		
Rent & Facilities- EirGrid							1.063	1.063	1.063
Rent & Facilities SONI							n/a	n/a	n/a
Subtotal		1.360	1.276	1.383	1.392	1.392	1.063	1.063	1.063
General Insurance		0.053	0.050	0.055	0.055	0.055	0.050	0.050	0.050
Total Facilities including Insurance	**1.136**	**1.413**	**1.326**	**1.438**	**1.447**	**1.447**	**1.113**	**1.113**	**1.113**

Table 19: Comparison of SEMO's Proposal together with RAs Proposal

The RAs recognise that the majority of facility costs are fixed in the short term and therefore recommend the introduction of a fixed/variable apportionment. The RAs assume 55% of SEMOs facility costs are fixed and therefore 45% would vary with future changes in headcount. This aligns with the assumption in the SONI price control and is assumed appropriate when reviewing the breakdown of EirGrid Market Operator apportioned costs in Table 19 above.

[18] http://www.uregni.gov.uk/news/view/soni_price_control_decision_paper_2010_2015/

8.5 OTHER OPEX

Other OPEX includes professional fees, general and administrative costs, and costs associated with corporate services. Combined, these cost categories make up 12% of SEMO's OPEX submission for the 2013 price control.

	Historic data (€ millions)				SEMO's Submission (€ millions)			
	2010-11	2011-12	SEMO estimate 2012-13	Total	2013-14	2014-15	2015-16	Total
Total Professional Fees	0.706	0.427	0.739	**1.872**	0.622	0.57	0.514	**1.706**
Total General and Administrative	0.236	0.336	0.390	**0.962**	0.369	0.369	0.369	**1.107**
Total Corporate Services	0.134	0.387	0.381	**0.902**	0.384	0.384	0.384	**1.152**
TOTAL OTHER OPEX	**1.076**	**1.150**	**1.510**	**3.736**	**1.375**	**1.323**	**1.267**	**3.965**

Table 20: SEMO's Other Opex

The RAs have performed a high level analysis of these combined costs. SEMO's estimated costs for the last year of the current price control shows a noteable increase which is largely due to a hike in professional fees. However, there is an overall reduction in professional fees from the current to 2013 price control.

The RAs propose to reduce the following cost lines to align with allowed headcount:

- Subscription and membership fees
- Travel and expenses

The following are reduced to align with actual costs incurred in the current 2010 price control as inadequate justification was provided by SEMO to warrant an increase:

- Conferences

The RAs have reduced combined recruitment and training costs significantly to reflect the maturity of SEMO's organisation and comparable costs in similar companies. An overall allowance has been provided for recruitment and training combined (but shown in the 'recruitment costs' line).

Compared to SEMO's submission for €3.965 million of 'other OPEX', the RAs propose to allow €3.713 million (a 6% reduction). The reduction is mainly due to a reduction in combined Recruitment/ Training costs.

8.6 TOTAL OPEX

The RAs analysed the following cost categories within SEMO's OPEX submission:

- Payroll
- IT & Communications
- Facilities and Insurance
- Other OPEX (including professional fees, general and administrative costs, corporate services).

Compared to SEMO's submission for a total of €33.123 million of OPEX, the RAs are minded to approve an allowance of €29.098 million (a 12.2% difference).

The table below summarises the RAs proposals for OPEX.

	SEMO submission (€ millions)			RA's proposal (€ millions)		
	2013-14	**2014-15**	**2015-16**	**2013-14**	**2014-15**	**2015-16**
Total Payroll	5.66	5.667	5.667	4.971	4.971	4.971
Total IT & Communications	2.564	2.619	2.649	2.337	2.383	2.413
Total Facilities and Insurance	1.438	1.447	1.447	1.113	1.113	1.113
Total Professional Fees	0.621	0.569	0.513	0.616	0.564	0.508
Total General and Administrative	0.37	0.37	0.37	0.291	0.291	0.291
Total Corporate Services	0.384	0.384	0.384	0.384	0.384	0.384
Total annual OPEX	**11.037**	**11.056**	**11.03**	**9.712**	**9.706**	**9.680**
TOTAL		**33.123**			**29.098**	

Table 21: OPEX Summary

As noted previously, the RAs are minded to apply RPI-X regulation to OPEX. Our minded-to position is considered further in section 8.7.

8.7 OPEX SAVINGS

A well-established regulatory tool to incentivise OPEX efficiency is Revenue Cap (RPI-X) regulation. Revenue Cap RPI-X regulation can provide strong incentives for efficiency, as any savings above the predicted rate 'X' can be kept by the firm, and it is therefore in the interest of the firm to out-perform.

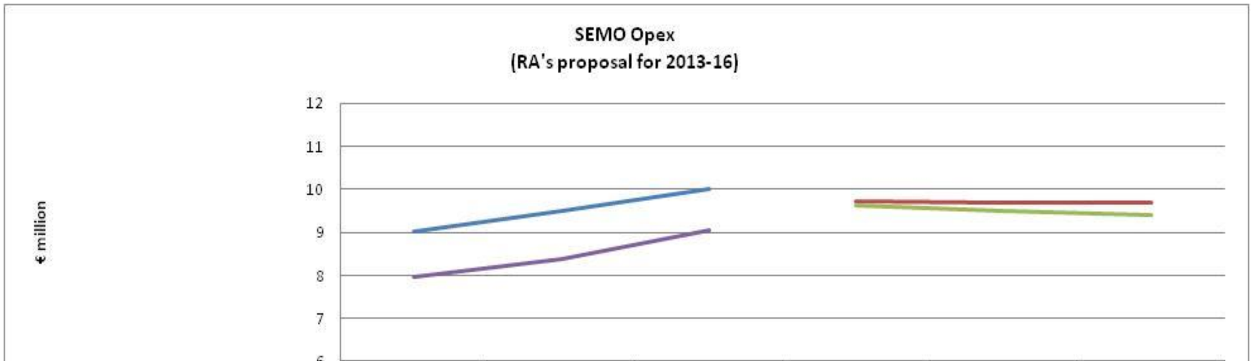
SEMO has been in operation since November 2007 and now believe their operation of the Single Electricity Market has 'reached a level of maturity'. The market has evolved and is more complex in nature over the years including the introduction of Intraday Trading in July 2012. SEMO believe they have 'now largely reached the efficiency frontier in their operations'.

The RAs are of the view that there is scope for SEMO to operate more efficiently and benefit from reduced costs below the out-turn inflation rate. Therefore the RAs recommend a 'X' factor of 1% be applied to SEMOs operational expenditure. This is deemed appropriate for the following reasons:

- SEMO have achieved efficiencies in the first two years of the 2010 price control;
- For the foreseeable future, pay increases are likely to be below RPI in Northern Ireland and CPI in Ireland;
- Although an element of SEMO's workforce is specialised, many of the IT and business processes within SEMO are reasonably generic. It is the RAs view that any leavers during the 2013 price control period can be replaced by staff on lower remuneration packages;
- SEMO have confirmed that 1 approved FTE resource has not yet been recruited, but their payroll allowance is commensurate with staff levels being at full capacity;
- All EirGrid staff have membership of a defined benefit pension scheme. Other similar companies have achieved efficiencies in this area;
- Considerable CAPEX was incurred in the current 3 year price control which should provide opportunity for operational efficiency in the forthcoming years. There is no identified reduction on the OPEX allowance with any of the CAPEX projects;
- Greater experience of operating the settlement market comes from SEMO's operations having reached a level of maturity. The RAs want to encourage SEMO commitment to effectively operate the market through the continuous improvement of the market process.

When RPI-1 is applied to the RA's OPEX proposals, SEMO's allowance for the 2013-16 price control is €28.518 million.

SEMO have proposed the introduction of a three year OPEX rolling mechanism. The allowed OPEX in any year would be the actual OPEX three years previously. The effect of this is to allow SEMO to continue to retain the benefit of any efficiency savings for the full three years. After this point the ongoing benefit passes to consumers in line with accepted regulatory practice. The RAs have considered the introduction of such a mechanism alongside the existing incentive mechanisms within this consultation paper. SEMO have the ability to retain any OPEX outperformance, beyond the limited efficiency reduction of 1%, together with other incentive mechanisms. The RAs consider the existing incentives to be sufficient and therefore are not minded to change the mix of incentives in moving to a rolling mechanism, given the significant change to the market from 2016 onwards.



	2010-11	2011-12	SEMO's estimate 2012-13	2013-14	2014-15	2015-16
2010-13 allowance	9.012	9.487	10.011			
2013-16 RA's proposal				9.712	9.706	9.680
2013-16 RA's proposal (apply RPI-1)				9.614	9.512	9.392
2010-13 actuals (using Qtrly report)	7.979	8.373	9.04			

Figure 4: Proposed Opex with RPI-1

Respondents' views are welcome on all aspects of the OPEX proposals.

9 CAPITAL EXPENDITURE – (CAPEX)

SEMO's capital expenditure (CAPEX) allowance enables it to recover the necessary resources to finance their capital investments from tariffs.

The capital expenditure (CAPEX) requirement proposed by SEMO for the 3 year period is €9.371 million. This compares to a CAPEX requirement of €18.509 million for the current price control. In addition to this, the RAs approved a further CAPEX allowance of €10.300 million for the Intraday Trading Project which went live in July 2012.

Four categories of CAPEX have been identified as part of SEMO's submission:

1. Biannual IT Market Release CAPEX;
2. Biannual IT Market Release Support CAPEX;
3. Predictable Business CAPEX;
4. Unpredictable Business CAPEX.

Table 22 shows a breakdown of SEMO's CAPEX submission for each category for the 2013 price control period.

SEMO CAPEX Submission	2013-14	2014-15	2015-16	Total € million
Biannual IT Market Release capex	1.320	1.320	0.660	3.300
Biannual IT Market Release Support capex	0.408	0.408	0.200	1.016
Predictable Business capex	2.377	1.528	0.700	4.605
Unpredictable Business capex	0.150	0.150	0.150	0.450
Total	**4.255**	**3.406**	**1.710**	**9.371**

Table 22: Summary of SEMO CAPEX submission

The RAs commissioned Gemserv to carry out a review of SEMO's proposed IT CAPEX plans. Gemserv were asked to review all business cases, assess the timing of investment, provide a high level review of associated IT & Communications OPEX for reasonableness (discussed in section 8.3), identify SEMO-specific and group-wide projects, and validate the CAPEX narrative from SEMO while taking into account future changes such as Market Integration (see section 3.6).

Gemserv's analysis has assisted the RAs in forming a view of an appropriate allowance for each CAPEX category. Each of the four categories of CAPEX is considered below.

9.1 BIANNUAL IT MARKET RELEASE CAPEX (€3.300M)

Biannual IT Market Release CAPEX will allow SEMO to deliver market modifications, non Trading and Settlement Code changes, system defects and operational efficiencies.

SEMO is currently in the process of negotiating a contract with a software vendor for six biannual releases over a period of three years, commencing with the October 2013 release until April 2016[19].

SEMO have submitted a Biannual IT Market Release CAPEX amount of £3.300 million. Gemserv comment that most markets plan for future change to enable the central and participant systems to always be aligned and to ensure adequate resources are available to implement change and thereby minimise risk. SEMO plans for two software releases per year. The RAs are satisfied that this is typical for such systems. ESB and NIE have a similar release strategy for their Meter Data Provider (MDP) systems, as does ELEXON (the GB central market operator).

[19] Prior to SEMO's 2013 price control submission, agreement was gained from the RAs to sign a contract with a supplier for six system releases over the three-year price control period.

The RAs recognise that the new proposed contract value is almost half the value of the previous contract for the 2010-13 price control. It is the RAs view that SEMO has tried to negotiate a more cost effective development solution. This seems sensible in an environment where the Central Market Systems (CMS) are maturing and the number of Trading and Settlement Code (TSC) Modifications and related change requests are expected to continue to decline.

The RAs are minded to approve the requested amount of €3.300 million. This business case is unique in that a specific number of hours will be acquired. Therefore the RAs require SEMO to manage these hours so as they are utilised in the best possible way over the 3 year period.

9.2 BIANNUAL IT MARKET RELEASE SUPPORT CAPEX (€1.016M)

In addition to the above funding for the new software vendor contract, SEMO proposes that each release would introduce a series of ancillary costs, totaling €1.016 million. These include:

- Factory acceptancy testing
- Support from software vendor for deployments
- Testing system support
- Application upgrades
- AMOR change request
- Bearing Point change requests

Support costs amount to almost one third of the main project costs. There is limited historic evidence to date to support this allowance. SEMO’s submission for application upgrades also represents 23% of the total proposed support allowance, but there is no way of telling how many application upgrades might be necessary.

The RAs are of the view that release related support costs are a pragmatic attempt by SEMO to predict the costs of unknown changes and what the support costs of such changes might be. However these costs could be substantially reduced if there are no large or complex releases within the control period.

The RAs are minded to approve an amount of €0.655 million. The reason for this is explained further in section 9.6, which comments on how we have set the CAPEX baseline.

9.3 PREDICTABLE CAPITAL EXPENDITURE (€4.605M)

A predictable CAPEX allowance enables SEMO to plan for hardware and software upgrades and the implementation of additional operational support systems.

SEMO submitted 10 business cases (totaling €4.605 million) for investments such as IT infrastructure requirements, additions to and upgrade of operational support systems, reporting requirements, telecommunication upgrade etc.

When proposing an allowance for predictable CAPEX, the RAs have been influenced by the uncertainty in the future development of the present systems with EU cross border trading and market integration proposals being discussed.

Stakeholders should note that it has been difficult to carry out a detailed assessment of SEMO's proposed predictable CAPEX because the scope of the work is not well defined and the detailed derivations of the proposed costs are not available. SEMO have indicated that the proposed allowances are provisional sums built on whatever empirical data was available during the budget development. Unless stated to the contrary, none of the provisional sums are supported by competitive market testing.

For the more discretionary expenditure no evidence has been provided in relation to the need for the expenditure. Cost benefit analyses has yet to be carried out to warrant such expenditure.

SEMO has provided the cost of each project based on their best estimates. There has been no formal competitive procurement process in order to establish the overall cost. The RAs are of the view that there is a degree of uncertainty on SEMO's estimates and therefore SEMO should be incentivised to maximize any opportunity for cost reductions. This is discussed further in section 9.6.

The RAs are minded to approve an allowance of €2.769 million for predictable CAPEX, compared to SEMO's submission of €4.605 million. A summary of these predictable business cases is provided below in Table 23.

		SEMO's Submission € millions				RAs Proposals € millions			
Item	**Predictable CAPEX Item**	**2013-14**	**2014-15**	**2015-16**	**Total**	**2013-14**	**2014-15**	**2015-16**	**Total**
1	CMS Infrastructure	0.330	0.224	0.367	**0.921**	0.213	0.144	0.237	**0.594**
2	Website Infrastructure & Services Upgrade	0.525	0.095	0.023	**0.643**	0.236	0.061	0.015	**0.312**
3	Sharepoint: Upgrade and Refresh Hardware	0.416	0.050	0.110	**0.576**	0.268	0.032	0.071	**0.371**
4	Corporate Systems Refresh	0.960	0.220	0.110	**1.290**	0.619	0.142	0.071	**0.831**
5	Teleommunications Links		0.500		**0.500**		0.322		**0.322**
6	Participant Self Service Training	0.100	0.050		**0.150**				**0.000**
7	Technical Upgrade of Microsoft Dynamics		0.189	0.050	**0.239**		0.122	0.032	**0.154**
8	Security Intrusion (Protection of CMS)		0.100		**0.100**		0.064		**0.064**
9	Virtualisation of Oracle & network devices	0.046	0.100		**0.146**	0.030	0.064		**0.094**
10	Upgrade of SupportWorks Helpdesk			0.040	**0.040**			0.026	**0.026**
		2.377	1.528	0.700	**4.605**	1.365	0.953	0.451	**2.769**

Table 23: Summary of Predictable CAPEX including RAs Proposals

Some projects are recognized by the RAs as critical for the business continuity. Nonetheless, the RAs welcome views of Market Participants in relation to SEMO's CAPEX business cases and the RAs proposals.

9.4 UNPREDICTABLE BUSINESS CAPEX (€0.45M)

The unpredictable business CAPEX is a discretionary fund requested by SEMO to cover the costs of unforeseen Group projects and CMS events.

The RAs appreciate that all IT managers need to have the ability to make unexpected purchases. This allowance could be described as a contingency allowance for capital items either missed in the submission or too small to be individually specified.

SEMO proposes an allowance of €0.150 million per annum to cover unplanned spending in relation to Group projects which are currently not fully developed and unpredictable system events such as failure of software or hardware components, software upgrades, availability of new products on the market to address longstanding issues. In respect of the Group projects SEMO envisages being a part of and gaining from the larger Group requirements as scale and synergies are applied.

The proposed budget, when assessed in isolation, is 60% of the previous price control proposals (€0.750 million) and on that basis seems to be reasonable. However, in considering the overall capital request which are based mainly on provisional amounts with some 'if needed' cost lines. Based upon the limited information made available all proposals look well provided for and it can be expected that savings will be made.

With the continuation of menu regulation SEMO has the freedom to choose a higher allowance within the menu packages to cover any unpredictable expenditure. However, SEMO would receive diminished rewards for under expenditure.

Therefore the RAs are minded to disallow this amount.

9.5 MAJOR CAPITAL EXPENDITURE

Aside from the four main CAPEX categories discussed above, there are a number of potential CAPEX projects which are at present too uncertain to provide an allowance for.

SEMO have identified the following initiatives in their Forward Work Programme. Their impact and timescales are not (yet) definable so even forecasting a provisional expenditure is premature:

- EU Market Integration and SEM Market Integration Project
- UK Electricity Market Reform
- Access to Market - Tie Break Decision
- Demand Side Participation
- Energy Storage
- Regulation on Energy Market Integrity and Transparency (REMIT)

Such CAPEX projects predominantly relate to changes which may significantly impact the SEM in terms of the Trading and Settlement Code (TSC) and supporting systems. SEMO propose seeking further capital and operational allowances as part of the annual adjustment process. The RAs are of the view that major changes to the TSC will only occur in exceptional circumstances and will be address only when necessary.

As the market integration project continues to develop the SEM Committee has provided clarity on the SEM Committee's position and intention over the next few years in its publication of the 'European Market Integration Next Steps proposed decision paper'. The SEM Committee, in referring to the SEM Design Stability to 2016 'commits to maintaining the current structure of

SEM until 2016 where possible and will not approve material market changes between now and then'.

For any major capital expenditure SEMO will be required to present their expenditure plans to the RAs which in turn will determine the amounts and mechanisms for recovery of the required revenue.

9.6 RAs PROPOSAL FOR CAPEX BASELINE

SEMO has a duty to minimise overall costs by efficiently and economically procuring and implementing services as required in both jurisdictional market operator licences. Therefore SEMO has an element of control over the expenditure of each of the CAPEX items identified in their price control submission.

Table 24 below summarises the amounts involved in the determination of SEMO's CAPEX baseline:

	SEMO's Submission				RAs Proposal			
SEMO CAPEX Submission	**2013-14**	**2014-15**	**2015-16**	**Total € million**	**2013-14**	**2014-15**	**2015-16**	**Total € million**
Biannual IT Market Release capex	1.320	1.320	0.660	**3.300**	1.320	1.320	0.660	**3.300**
Biannual IT Market Release Support capex	0.408	0.408	0.200	**1.016**	0.263	0.263	0.129	**0.655**
Predictable Business capex	2.377	1.528	0.700	**4.605**	1.365	0.953	0.451	**2.769**
Unpredictable Business capex	0.150	0.150	0.150	**0.450**	0.000	0.000	0.000	**0.000**
Total	**4.255**	**3.406**	**1.710**	**9.371**	**2.948**	**2.536**	**1.240**	**6.724**

Table 24: Summary of RAs CAPEX baseline

The RAs have taken account of the fact that SEMO's proposals for IT market release support and predictable CAPEX have been developed using many sources with varying degrees of confidence. The predictable CAPEX budgets are mainly based on provisional sums. SEMO's proposal also includes unpredictable expenditure which has been disallowed in full as the RAs believed a contingency is not necessary based on the high level estimates of each business case.

The RAs have also disallowed the 'optional' CAPEX relating to the development of mobile 'apps' and training courses as they require further research and cost benefit analysis. Having considered the predictable and release support CAPEX outturn expected for the 2010-2013 price control a 35% saving is identified when comparing the indexed approved allowance. SEMO has submitted their 2013-2016 costs using a similar basis to the 2010 price control and as such the RAs are minded to apply the 35% reduction to the 2013-2016 submission as identified above in Table 24.

Therefore the RAs propose that the baseline for controllable CAPEX is to be set at **€6.724 million.**

9.6.1 CAPEX INCENTIVISATION

Incentivisation is an integral part of this price control and the following reasons identify the need for CAPEX incentivisation in this price control:

- Budgets are prepared up to 4 years out so it is understandable that a pragmatic approach might be taken to ensure that most eventualities are catered for. In these circumstances it is reasonable to predict that most of the proposed initiatives, although not all, will result in a lower outturn costs than the budgeted amounts;
- There are many unknowns facing the SEM and this brings risk to budget predictions;
- Although the RAs are minded to approve the proposed allowance for biannual IT market release support CAPEX, the scope of the support required has not been provided;
- The scope of predictable CAPEX is not well defined in some cases and a detailed derivation of costs was not made available by SEMO;
- Although the RAs are of the view that development of the website could be beneficial and has allowed for this, it is dependent on the results of research into participants requirements;
- Provisional sums were provided for SANs, telecommunications links and virtualization of Oracle and network devices.

In preparing this consultation paper the RAs have considered alternative approaches for the CAPEX determination. These include consideration of the traditional single option which comprises of a 'take it or leave it' allowance and the provision of a range of options with varying risks and rewards under menu regulation. The options are structured so that SEMO has an incentive to choose the option that matches most closely the outcome expenditure expected by SEMO.

Menu regulation was introduced in the current price control and will be fully assessed at the close of the current price control in September 2013. The RAs look to continue menu regulation by providing SEMO with a range of options which allow them to manage their risk and reward expectation.

9.6.2 MENU REGULATION INCENTIVISATION

The menu regulation options are carefully structured so that SEMO has an incentive to choose the option that matches most closely the outcome it expects. Once an option has been chosen, SEMO still has an incentive to out-perform and is encouraged to aim for efficient expenditure plans by strongly rewarding out-performance against more challenging expenditure targets.

SEMO would essentially be allowed to choose between getting:

- a lower cost allowance with a high-powered incentive scheme allowing them to retain significant benefits from under-spending; or
- a higher cost allowance with a low-powered incentive scheme giving relatively small rewards for under-spending.

With menu regulation SEMO will recover its actual expenditure plus or minus rewards or penalties which depend on the expenditure forecast it chooses and how actual expenditure compares to forecast.

The RAs are responsible for:

1. Deciding a 'baseline' level of expenditure for SEMO. This forms the basis against which menu choices are calibrated.
2. Comparing SEMO forecast as the RAs baseline.
3. Calculating menu rewards/penalties by applying to the baseline figure the incentive rate correlating to the package chosen and outturn achieved. The maximum reward and maximum penalty will not exceed those defined in Table 25 below.

The table below lists (in the green row) 11 different packages which will be offered to SEMO (as a percentage of the baseline). The dark blue column lists the outturn expenditure over three years (as a percent of the baseline €6.724 million). Across the table, the reward or penalty associated with each choice of package are shown. SEMO would maximize their reward by selecting the package which matches with their ‘true’ expenditure expectations for the outturn figure (Dark Blue Column).

	Menu Choices: Reward/Penalty in percentage terms										
	Package 1	Package 2	Package 3	Package 4	Package 5	Package 6	Package 7	Package 8	Package 9	Package 10	Package 11
	80%	85%	90%	95%	100%	105%	110%	115%	120%	125%	130%
75%	10.80%	10.67%	10.45%	10.14%	9.75%	9.27%	8.70%	8.04%	7.30%	6.47%	5.55%
80%	9.20%	9.16%	9.03%	8.81%	8.50%	8.11%	7.63%	7.06%	6.40%	5.66%	4.83%
85%	7.60%	7.64%	7.60%	7.47%	7.25%	6.94%	6.55%	6.07%	5.50%	4.84%	4.10%
90%	6.00%	6.13%	6.18%	6.13%	6.00%	5.78%	5.48%	5.08%	4.60%	4.03%	3.38%
95%	4.40%	4.62%	4.75%	4.79%	4.75%	4.62%	4.40%	4.09%	3.70%	3.22%	2.65%
100%	2.80%	3.11%	3.33%	3.46%	3.50%	3.46%	3.33%	3.11%	2.80%	2.41%	1.93%
105%	1.20%	1.59%	1.90%	2.12%	2.25%	2.29%	2.25%	2.12%	1.90%	1.59%	1.20%
110%	-0.40%	0.08%	0.48%	0.78%	1.00%	1.13%	1.18%	1.13%	1.00%	0.78%	0.48%
115%	-2.00%	-1.43%	-0.95%	-0.56%	-0.25%	-0.03%	0.10%	0.14%	0.10%	-0.03%	-0.25%
120%	-3.60%	-2.94%	-2.38%	-1.89%	-1.50%	-1.19%	-0.97%	-0.84%	-0.80%	-0.84%	-0.97%
125%	-5.20%	-4.46%	-3.80%	-3.23%	-2.75%	-2.36%	-2.05%	-1.83%	-1.70%	-1.66%	-1.70%
130%	-6.80%	-5.97%	-5.23%	-4.57%	-4.00%	-3.52%	-3.13%	-2.82%	-2.60%	-2.47%	-2.43%

Table 25: Menu of choices

The greatest possible total reward and the minimal penalty for each level of actual expenditure have been highlighted in the menu table above (light blue).

Worked examples: The table below illustrates the nominal values involved in the incentive scheme.

	Menu Choices: Allowed Expenditure and Reward/Penalty in €'000										
	Package 1	Package 2	Package 3	Package 4	Package 5	Package 6	Package 7	Package 8	Package 9	Package 10	Package 11
	5,379	5,715	6,052	6,388	6,724	7,060	7,396	7,733	8,069	8,405	8,741
5,043	726	717	703	682	656	623	585	541	491	435	373
5,379	619	616	607	592	572	545	513	474	430	380	324
5,715	511	514	511	502	487	467	440	408	370	326	276
6,052	403	412	415	412	403	389	368	342	309	271	227
6,388	296	311	319	322	319	311	296	275	249	216	178
6,724	188	209	224	232	235	232	224	209	188	162	129
7,060	81	107	128	142	151	154	151	142	128	107	81
7,396	-27	5	32	53	67	76	79	76	67	53	32
7,733	-134	-96	-64	-37	-17	-2	7	10	7	-2	-17
8,069	-242	-198	-160	-127	-101	-80	-66	-57	-54	-57	-66
8,405	-350	-300	-256	-217	-185	-158	-138	-123	-114	-111	-114
8,741	-457	-401	-351	-307	-269	-237	-210	-190	-175	-166	-163

Table 26: Menu of choices (worked example)

Example 1

For example, suppose SEMO chooses package 5 (100% of the RAs baseline). It can be seen from the table that SEMO would be rewarded with €0.235 million for spending €6.724 million. This reward is a premium for keeping the capital expenditure exactly equal to the RAs expectations.

Example 2

Suppose SEMO chooses package 9, €8.069 million (which corresponds to 120% of the RAs baseline) and the outturn expenditure on CAPEX by the end of three years is €5.715 million (which corresponds to 85% of the baseline). SEMO would receive a reward of €0.370 million. Given the outturn figure of €5.715 million (85% of the baseline), SEMO would be better off if they chose package 2. In this case the reward would be €0.514 million (7.64% of the baseline) rather than €0.370 million.

The examples above illustrate the incentive to SEMO to choose the package that reflects their expectations on the outturn CAPEX more accurately.

For most of the scenarios SEMO's reward or penalty would be complimented by an adjustment to the next revenue determination. The following equation would be used to determine the adjustment to the next tariff period.

$$\text{CAPEX } k = (\min(8{,}741, Outturn\ CAPEX) - CAPEX\ Tariff\ Revenue) + (Reward{:}\,Penalty)$$

Ultimately menu regulation would allow for a certain degree of disagreement between the RAs and SEMO's forecast. If SEMO disagree with the RAs forecast (baseline), it is a question of choosing a package with allowed expenditure above the baseline. The price of this choice would be a lower reward on under expenditure and a higher penalty on over expenditure.

The RAs are minded to continue the application of menu regulation, and have modified the menu choices and reward/penalty to give an appropriate risk/reward profile specific to this 2013-2016 price control. Menu regulation has the potential to deliver benefits for all stakeholders in the SEM by promoting greater control and accountability and delivering value for customers through revealing and promoting efficiency.

9.6.3 REGULATORY APPROACH TO MONITOR THE DELIVERY OF CAPEX ITEMS

Menu Regulation is an advanced form of regulation and requires 3 distinct components[20]:

1) **Controllability** – the regulator knows that the operator can control how to perform the task
2) **Predictability** – the regulator and the operator can control how to perform the task
3) **Observability** – the regulator can check ex post the actual outcome.

The following general bullets outline the responsibility of SEMO and the approach the RAs will take in monitoring the delivery of each CAPEX business case:

- Timely notice should be given by SEMO of their intention to no longer take forward any capital business cases approved for the price control period;
- In the event of any of the projects submitted being called off by SEMO, the RAs would revise the baseline and the revenue requirement downward. The same incentive scheme would apply. This mechanism would prevent SEMO being rewarded simply by not implementing projects;
- SEMO would require the RAs approval in order to make any substitution to the list of projects submitted;
- The RAs will monitor the delivery of all projects composing the RAs baseline;
- Where the RAs deem that benefits gained have been as a result of material forecast error rather than efficiency gains, benefits will be clawed back.

To enhance the 'observability' aspect of menu regulation the RAs must continue to receive an annual capital update in the form of an End of Year Capital Report already produced by SEMO. The RAs expect the following information (in addition to the information identified above) to be made available to the RAs:

- Each business case must be assigned an accounting cost centre within the Microsoft Dynamics software. This allows for a summary of actual outturn corresponding to each business case approved. This would significantly improve the visibility of CAPEX outturn.
- The End of Year Capital Report should summarise any projects which are no longer deemed necessary or where alternative expenditure would be more appropriate. Such projects would have already been brought to the RAs attention on a timely basis.
- The End of Year Capital Report should confirm the following (where appropriate):
    - That no project has been withdrawn or is likely to be withdrawn;
    - That no substitution has taken place or is likely to take place.

[20] EUI Working Papers: Implementing Incentive Regulation and Regulatory Alignment with Resource Bounded Regulators

- This report should be submitted to the RAs by 31st January of each year.

An estimated timeframe should continue to be incorporated into the End of Year Capital Report.

10 REGULATED ASSET BASE (RAB)

The historical cost method, as decided in previous price controls, will be used for the valuation of any assets to be applied to SEMO's RAB.

The projected value of the SEMO RAB for the end of September 2013 is €13.951 million (based on SEM Day 1+, 2009-2013 capitalised assets and the Intraday Trading Project). The SEM Establishment cost was fully depreciated in October 2012 and is therefore no longer included in the RAB. The RAB additions in respect of the current 2010-13 price control, which includes the Intraday Trading project, **have yet to be finalised and agreed with the RAs**. Therefore the projected opening Net Book Value uses provisional figures submitted by SEMO in respect of additions from October 2010 to September 2013.

The provisional value of the Regulatory Asset Base for October 2013 is outlined in Table 27 below:

Summary	RAB Value at 01 October 2013
	€ millions
Day 1+	0.819
Other Assets Capitalised in 2009-10	0.829
Additions in 2010-2013 (IT Releases)	4.541
Intraday Trading Asset	7.762
Opening RAB Value October 2010	**13.951**

Table 27: SEMO's RAB - Opening Value

For the purposes of the Market Integration project an estimated closing RAB value at September 2016 is estimated to be €6.496 million.

11 WEIGHTED AVERAGE COST OF CAPITAL (WACC)

The application of a Weighted Average Cost of Capital (WACC) to a Regulated Asset Base (RAB) is a form of remuneration for the exposure to systematic risk.

The proposal made by SEMO is to continue with the current WACC mechanism which blends the two System Operator WACCs in accordance with specified proportions, currently 75% for EirGrid and 25% for SONI. Table 28 below shows the WACC applicable in the existing price controls for both SONI and EirGrid system operators. Both these price controls conclude in September 2015 and December 2015 respectively. Therefore an estimate is reflected for SEMO's year 2015-16 which will be adjusted to reflect the decision made in the next price controls for both SONI and EirGrid System Operators. A further adjustment will be required to update changes in the taxation rate assumption.

WACC Rate	Specified Proportion	WACC 2013-14	WACC 2014-15	Estimated WACC 2015-16
EirGrid Transmission System Operator	75%	5.95%[21]	5.95%	5.95%
SONI Transmission System Operator	25%	5.58%[22]	5.58%	5.58%
Blended Rate for SEMO WACC		**5.86%**	**5.86%**	**5.86%**

Table 28: Value of WACC for SEMO

While market operation may involve a different set of systematic risk factors from system operation, the RAs do not see any convincing basis for concluding that overall exposure to systematic risk being materially different from that of the system operators.

Based upon SEMO's projections of the Regulated Asset Base (RAB) they submitted an estimated revenue requirement in respect of the WACC. This represents the opportunity cost of the capital invested and thereby is a form of remuneration for risk exposure.

WACC Revenue Allowance	2013-14	2014-15	2015-16	Total € millions
Total WACC	**0.794**	**0.726**	**0.575**	**2.095**

Table 29: SEMO's WACC submission

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[21] Pre-tax WACC as defined in Decision on EirGrid TSO transmission revenue for 2011 to 2015

[22] Pre-tax WACC as defined in SONI Price Control 2010 – 2015 Decision Paper

11.1 CONCLUSION ON THE WACC

The RAs have not found any robust case for using a different WACC figure for SEMO than for the system operators. Therefore, we are of the view that SEMO's WACC should continue to be determined in accordance with the WACC of the system operators, EirGrid and SONI. The RAs have calculated a proposed WACC using the baseline of €6.724 million to produce the table below:

WACC Revenue Allowance	**2013-14**	**2014-15**	**2015-16**	**Total € millions**
Total WACC	**0.753**	**0.637**	**0.475**	**1.865**

Table 30: RAs WACC Proposal

Both companies (EirGrid and SONI) are due to have their next price controls implemented during SEMO's 2015-16 price control year. Therefore SEMO's WACC should be adjusted in line with the WACC decisions reached by CER and UR in the forthcoming EirGrid and SONI price controls. Essentially SEMOs WACC will track the prevailing WACC of the two System Operators.

11.2 DEPRECIATION

The depreciation charge forms one of the two largest components of SEMO's revenue request. The SEM Establishment project has now been fully depreciated and this has resulted in a substantial fall in the depreciation charge for 2012-13 onwards.

SEMO has proposed to continue to depreciate its assets subject to straight-line depreciation over a five year period. SEMO's depreciation allowance includes amounts both for depreciation on its existing RAB and for depreciation associated with its proposed CAPEX.

The table below shows SEMO's proposed depreciation figures:

Summary	**2013-14**	**2014-15**	**2015-16**
		€ millions	
Depreciation Charge	5.284	5.045	4.829

Table 31: SEMO's submission for Depreciation

The RAs have projected the depreciation charge as shown in Table 32 below. This is based on the revised baseline of €6.724 million CAPEX, and the continuation of the 5 year straight-line depreciation policy.

Summary	2013-14	2014-15	2015-16
		€ millions	
Depreciation Charge	5.146	4.689	4.343

Table 32: RAs Proposal for Depreciation

12 INCENTIVISATION

12.1 KEY PERFORMANCE INDICATORS

In the 2010 price control determination for SEMO, the RAs decided that a reward mechanism equivalent to 3% of total OPEX revenue for each year would be implemented for outperformance of targets related to a set of key performance indicators (KPIs).

12.2 PERFORMANCE AGAINST INDICATORS

SEMO provided their performance levels for KPIs for the first two years of the current price control (i.e. October 2010 – September 2012).

2010/2011 Actuals

Metric	Weighting	Target	Upper Bound	Actual Average Performance	Actual reward	3% Incentive Pot available
Ex-ante pricing report	0.2	99%	100%	99.45%	€ 39,534	€ 52,710
Ex-post initial pricing report	0.1	99%	100%	99.45%	€ 13,179	€ 26,355
Invoicing	0.2	95%	100%	98.63%	€ 38,274	€ 52,710
Credit Cover Increase Notices	0.2	99%	100%	100.00%	€ 52,710	€ 52,710
SEMO related Resettlement queries	0.2	<15[1]	10[2]	100.00%	€ 52,710	€ 52,710
General queries	0.1	97%[3]	99%[4]	98.83%	€ 20,642	€ 26,355
Total 2010/2011					€ 217,049	€ 263,550
				Overall performance:	82.35%	

Table 33: SEMO actual performance and reward Oct 2010 – Sept 2011

Metric	Weighting	Target	Upper Bound	Actual Average Performance	Actual reward*	3% Incentive Pot available
Ex-ante pricing report	0.2	99%	100%	99.18%	€ 28,432	€ 56,925
Ex-post initial pricing report	0.1	99%	100%	99.45%	€ 21,347	€ 28,462
Invoicing	0.2	95%	100%	96.86%	€ 27,039	€ 56,925
Credit Cover Increase Notices	0.2	99%	100%	100.00%	€ 56,925	€ 56,925
SEMO related Resettlement queries	0.2	<15[1]	10[2]	100.00%	€ 56,925	€ 56,925
General queries	0.1	97%[3]	99%[4]	96.43%	€ 4,720	€ 28,462
Total 2011/2012					€ 195,388	€ 284,623
			Overall performance*:		68.65%	

* Actual reward is a provisional figure

1. 15 or less Upheld queries incidents per quarter
2. 10 Upheld queries incidents per quarter
3. 97% of Queries answered within 20 Business days
4. 99% of Queries answered within 20 Business days

Table 34: SEMO actual performance and provisional reward Oct 2011 – Sept 2012

In summary, the quarterly performance across 6 KPIs in the two year period October 2010 to September 2012 equates to 48 indicators. Of these, 29 indicators showed that actual performance was 100%, 9 indicators were partially met (and therefore partially rewarded) and 10 indicators did not meet the target.

With regard to the General Queries KPI, there has been a notable reduction in performance between 2010-2011 and 2011-2012. In 2011-2012, SEMO failed to meet the target in 3 quarters and obtained a partial reward for quarter 3 (April to June) 2012. The RAs requested information for quarter 1 of 2012-2013 (October to December 2012) which shows an improved actual performance of 97.66%. This performance is above the 97% target and reflects SEMOs efforts to restore performance in this area.

12.2.1 SEMO'S PROPOSALS FOR THE NEXT PRICE CONTROL

Incentives should encourage improved performance and are an effective mechanism to encourage benefit to stakeholders with better quality and service. They also benefit the regulated company by recognizing the 'value add' of the overall business by offering a monetary reward. The reward should reflect the consumers' willingness to pay for an improvement in performance standards. It is imperative that the incentives evolve with the organization and represent a challenging target which is attainable with the utilisation of resources provided.

In the 2010 price control, the RAs decided that a reward mechanism equivalent to 3% of the total OPEX revenue for each year would be implemented for out-performing targets for six key performance indicators (KPIs). In the recent price control submission, SEMO has proposed eight KPIs against an overall incentive pot of 6% of OPEX allowance per annum. Based on the proposed allowance (double the existing reward pot), the two approaches would result in the following upper bounds:

	2013-2014	2014-2015	2015-2016
		€ millions	
Current approach (3%)	0.331	0.332	0.331
Proposed approach (6%)	0.662	0.663	0.662

Table 35: Proposed pot for KPI incentive scheme based on SEMO submission

Furthermore SEMO have proposed that in terms of assessing the KPIs, a measure should be taken at the end of each month. If the KPI is achieved overall throughout the month, the reward for that month shall be earned. This approach represents a further relaxation of the prevailing quarterly criteria.

An underlying assumption in assessing the KPIs is the understanding that external factors outside of the Market Operators direct control are excluded e.g. Limited Communication failure by Market Participant, late provision of data by System Operators or the Meter Data Provider, Government policy changes, Regulatory Authorities policy changes etc.

The RAs agree that in recognition of higher performance gained from the value added by management and the investment strategy, incentives should evolve as the business matures. The RAs propose increasing the incentive pot from 3% to 4% of OPEX revenue while also revising the target levels where appropriate. This recognises the greater experience gained over the years in managing the market operator business. The RAs also recommend maintaining the quarterly assessment, based on an average value of each KPI over that period. The RAs believe this incentivises SEMO to maintain good performance over a longer period to the benefit of participants in the form of a consistent good service.

12.2.2 SEMO'S PROPOSALS FOR NEW KPIs

SEMO has proposed lower targets than those currently in place for most of the existing KPIs and has proposed two new KPIs.

	Weighting			Target			Upper Bound		
		SEMO	RAs			RAs		SEMO	RAs
	Current	Proposed	Proposal	Current	SEMO Proposed	Proposal	Current	Proposed	Proposal
Ex-ante pricing report	0.2	0.1	0.1	99%	97%	99%	100%	100%	100%
Ex-post initial pricing report	0.1	0.1	0.1	99%	97%	99%	100%	100%	100%
Invoicing	0.2	0.2	0.2	95%	95%	97%	100%	100%	97%
Credit Cover Increase Notices	0.2	0.1	0.1	99%	98%	99%	100%	100%	100%
SEMO related Resettlement queries	0.2	0.15	0.2	<15	<30	<9	10	10	5
General Queries	0.1	0.15	0.15	97% - 20 days	97% - 30 days	99% - 20 days	99% - 20 days	99% -30 days	100% - 20 days
Central Market System Availability (7am 5pm Mon-Sun)		0.1	0.15		97%	99.90%		99%	100%
Customer Training/Stakeholder Engagement		0.1			1 Market Training Programme for market participants per annum and 6 individual customer meetings per quarter				

Table 36: SEMO and RAs proposals for KPI incentive scheme

System Availability may be considered appropriate as a KPI as it can be termed as a critical success factor in relation to the SEMO business. The KPI would be assessed against availability of the system during 7am to 5pm Monday to Sunday and would exclude any planned outages. An assessment carried out on behalf of the RAs in relation to system availability concluded that the Market Operator systems have high levels of resilience and mainly 'hot' standby facilities in line with the expectation for a high availability market critical system. With the systems and infrastructure in place, participants would not expect the systems to have unplanned outages for more than 8 hours per year. This implies an availability target of approximately 99.9%.

Customer training and stakeholder engagement are important aspects of the SEMO business. This current centralised training arrangement benefits SEMO and participants in terms of reduced errors and good understanding held by participants. The RAs welcome participants comments in relation to the possible introduction of this KPI.

In addition to the above, the RAs welcome responses from market participants in relation to Key Performance Indicators as a whole. The choice of indicators needs to be based on the aspects of SEMOs performance which are of greatest importance to market participants. With this in mind the RAs are considering revising the current 'General Queries' KPI, which requires 97% to be satisfactorily resolved within 20 days, and has been in discussions with SEMO regarding the possible introduction of an 'Indicative Settlement' KPI.

The RAs would appreciate responses from market participants to the proposed KPIs and any suggestions of new KPIs. The list below is not exhaustive but it provides some ideas of the RAs current thinking regarding the introduction of 1 or 2 new KPIs:

- Indicative Settlement reports
- Participant Information Reports (PIRs)
- MIUNs
- Meeting Settlements and report timescales as defined in T&SC
- Data quality
- Stakeholder communication
    - 80% of telephone calls answered within 3 rings
    - Initial response to all communications within 1 working day
    - 50% of questions answered satisfactorily within 1 working day
    - 80% of questions answered satisfactorily within 3 working days
    - 100% of questions answered satisfactorily within 20 working days (current target is 97%)

Furthermore, the RAs are considering the introduction of symmetrical KPIs which implements a reward and penalty as opposed to the current asymmetric approach which provides for a reward only. The RAs may also consider applying greater emphasis to the overall performance of the KPIs and the introduction of a maximum for the incentive pot.

13 K FACTOR

An annual adjustment to the revenue allowance is necessary when setting the market operator tariffs for the forthcoming tariff year. Such an adjustment is referred to as a 'k factor adjustment' and is a mechanism which manages specific areas of SEMO's business which are exposed to risk. Therefore this adjustment factor reduces SEMO's overall risk profile.

13.1 SEMO'S PROPOSALS

SEMO have proposed that the following general principles are incorporated into the k factor adjustment and thereby be treated on a cost pass through basis:

- An adjustment for such items as are necessary as part of the revenue control framework;
- Unanticipated fluctuations in OPEX;
- Working capital requirements which may arise due to fluctuations in revenue recovery until such time as corrected through the k factor process;
- Uncontrollable costs (specifically identified in the submission to include Market Audit Fees, Disputes Allowance, and Modification Committee's legal allowance);
- Any events which significantly impact the SEM regulated business.

13.2 RAs VIEW

It is the RAs view that the K factor mechanism is an appropriate and necessary tool to mitigate, to some extent, SEMO's exposure to risk. However, caution needs to be applied in relation to the items which are managed within this adjustment mechanism. The RAs strongly agree with the continuation of specific items being recognised upfront as being appropriate for a k-factor adjustment and are therefore concerned with SEMO proposing the inclusion of broad terms like 'such items as are necessary' and 'unanticipated fluctuations'.

As the Market Integration project continues to develop, the SEM Committee has provided clarity on its position and intention over the next few years. This is outlined in its publication of the 'European Market Integration Next Steps proposed decision paper'[23]. The SEM Committee, in referring to the SEM Design Stability to 2016, 'commits to maintaining the current structure of SEM until 2016 where possible and will not approve material market changes between now and then'.

The RAs do not foresee the inclusion of variances in dispute allowance and Modification Committee's legal allowance as being appropriate for the k factor mechanism. In general, the management of costs is largely a matter for SEMO, unless specifically identified as an appropriate k factor adjusting item above.

<u>The k factor adjustment specifically allows for the following:</u>

[23] http://www.allislandproject.org/en/TS_Current_Consultations.aspx?article=5dc5e905-db0a-4cde-b3bb-5cf9b1873559&mode=author

- Adjustment to allowed revenues to reflect any over or under recovery of revenue in comparison with the revenue allowance;
- Foreign exchange gains or losses catered on a cost pass through basis;
- Interest on funding from the parent company, EirGrid Group;
- Interest received on surplus funds;
- Market audit adjustment to reflect actual expense;
- Any capital underspend/ overspend in relation to the chosen menu package. The k factor is limited for capital overspend;
- Depreciation and WACC on capital expenditure. This specific treatment is required given that the timing of the capital expenditure could deviate from the initial expectations and therefore will have a resulting impact on the depreciation and WACC costs;
- KPI reward and CAPEX menu regulation reward/penalty will be recovered through an adjustment of the K factor;
- Any actual net outturn tax loss relating to accelerated recovery of CAPEX and any other adjustments necessary specific to accelerated recovery;
- Uncertain costs arising from events which significantly impact SEMO which cannot be reasonably foreseen by SEMO, specifically:
    - Changes in legislation or regulation that impose unforeseen costs to SEMO's operations and capital investment;
    - Restructuring costs driven by changes in legislation.

The RAs would continue to expect an ex-post review report outlining separately the market operator tariff adjustments with detail provided in a line-by-line analysis. This report will continue to be received in May each year to facilitate the annual tariff process. This report will detail the k factor for the most recent year end September.

On receipt of this report the RAs will carry out a review and engage with SEMO to discuss any areas requiring clarification. Once all issues are closed, the RAs will seek approval, from the SEM Committee for the k factor adjustments as part of the overall market operator tariff approval process.

13.3 MANAGING UNCERTAINTY AND RISK

As with any business there is an element of inherent business risk. The SEMO business is unique in that it is a contractual joint venture between the system operator in Ireland (EirGrid) and the system operator for Northern Ireland (SONI). SEMO also have a licence requirement to have in place a parent company guarantee from EirGrid PLC (the legal and beneficial owner), which includes a requirement to ensure at all times the licencee shall have adequate financial and non financial resources in order that it may perform its obligations. Some aspects of the price control take consideration of these arrangements e.g. financeability, Weighted Average Cost of Capital (WACC) and recharges. This is consistent with the arrangements for the current price control.

However as a regulated business, the exposure to risk is mitigated with a K factor mechanism, which provides for specific items, should they arise, to be addressed through a K factor adjustment. The K factor mechanism for this price control is consistent to that applied in the current price control and mitigates company risk by allowing an adjustment for under recovery of revenues; for foreign exchange rate losses; and for interest on funding from the parent company. Other measures are also included in the K factor mechanisms to protect consumers.

The RAs acknowledge that SEMO have been proactive in mitigating risks and this has been evident in the current price control, with their day to day operation of the market and the implementation of various projects.

The RAs do not perceive that SEMOs risk profile will increase for the duration of this 2013-2016 price control, particularly given that the SEM Committee have stated their intention to 'maintain the current structure of the SEM until 2016'[24]. The RAs recognise there is uncertainty regarding the timing of the implementation of the Market Integration project after 2016. Therefore the RAs have provided for a 'roll forward' of the year 3 allowance, of the 2013-2016 price control, on a pro-rata basis. This will ensure that SEMO is financeable during the transition period to the new market arrangements.

This price control has been prepared by considering each cost area to arrive at an overall allowance, as with all price controls, following acceptance of the price control determination, the management of costs is a matter for SEMO unless specifically identified as a K factor adjustment item.

14 FORM AND MAGNITUDE OF CHARGES

As part of its role in the administration of the market there are charges which SEMO must levy in order to recover its own allowed costs and allowed market related costs. These charges consist of:

- energy and capacity charges
- the accession fee
- the participation fee
- the Imperfections charge
- the Market Operator charges

In order to be sustainable and cost-effective, the tariffs should seek to accurately recover the costs identified in a broadly cost-reflective way and to reflect an optimal regulatory approach.

For SEMO's costs, the TSC allows for allocation of costs to a number of fees and charges. In respect of this allocation, as with the cost analysis, stability is considered to be delivered given the proposal that the current split between the SEMO variable and fixed charges is maintained and that the Accession and Participation Fees continue to reflect the costs of accession and registration.

14.1 ENERGY AND CAPACITY CHARGES

The structure and detail of charges for energy purchased from the 'pool' is defined in the TSC. It will be a per MWh charge, the amount of which will be set for each half hour. This paper does not make any new decisions in relation to the form and magnitude of energy charges.

14.2 ACCESSION FEES

The TSC states that the accession fee will be a fee paid to SEMO by each applicant for accession to the TSC, to cover the SEMO's costs incurred in assessing the application. The RAs have fixed this fee at €1,115 for the current price control period. Currently these fees are simply netted off overall SEMO costs.

The RAs do not envisage a substantial change to the current accession fee, but will review this as part of the market operator annual tariff process.

14.3 PARTICIPATION FEES

In the TSC the participation fee is defined as “the fee payable with an application to register and become a participant in respect of any unit. The RAs have fixed this fee at €2,788 for the current price control period. Currently these fees are simply netted off overall SEMO costs.

The RAs do not envisage a substantial change to the current participation fee, but will review this as part of the market operator annual tariff process.

14.4 MARKET OPERATOR CHARGES

The TSC states that the Market Operator Charge shall comprise of:

- a Fixed Market Operator Generator Charge, which may be different for each Generator Unit;
- a Fixed Market Operator Supplier Charge, which may be different for each Supplier Unit; and
- a Variable Market Operator Charge applicable to all Participants in respect of their Supplier Units, expressed in €/MWh.

During the new tariff period, these charges will recover SEMO’s operational costs, the appropriate amount of depreciation associated with the SEM related capital costs incurred by EirGrid Market Operator and SONI Market Operator, and the appropriate blended WACC.

The RAs propose that the majority of costs, 95%, be recovered through the Variable Charge. It is proposed that the fixed charges to Generators and Suppliers will recover the remaining 5% of all costs.

The final values of the 2013-14 Market Operator tariffs will be published following the price control determination in July 2013. Licence modifications will be consulted and finalised for implementation as soon as possible thereafter. Based on the proposals contained in this consultation paper and on the parameters provided by SEMO, the following provisional tariffs are provided:

Parameters	
% of Charge that is fixed	5%
% of Charge that is variable	95%
Number of Generator Units	170
Number of Supplier Units	72
Installed capacity on Island of Ireland (MW)	11,873
Number of GWh in pool	32,900

Table 37: MO parameters and charge

	Current 2012-13	SEMO's 2013-14	RAs 2013-14
Costs to be Recovered by SEMO	€24.176 million	€17.115 million	€15.611 million
Recovery via Fixed Charge	€1.209 million	€0.855 million	€0.781 million
Recovery via Variable Charge	€22.967 million	€16.259 million	€14.830 million
Fixed Generator Charge (per MW)	€100	€71	€64
Fixed Supplier Charge (per Unit)	€366	€259	€236
Variable Supplier Charge (per MWh)	€0.698	€0.494	€0.451
Accession Fee	€1,115	€1,115	€1,115
Participation Fee	€2,788	€2,788	€2,788

Table 38: High Level projection of tariff 2013-14 compared to current tariff period 2012/13 (NB: projected excludes K factor adjustment and reflect change in CAPEX treatment from accelerated recovery to rate of return regulation)

15 PROVISION OF COMMENTS

The RAs request comments on the proposals set out in this consultation paper. All comments received will be published, unless the author specifically requests otherwise. Accordingly, respondents should submit any sections that they do not wish to be published in an appendix that is clearly marked “confidential”.

Comments on this paper should be forwarded, in electronic form, to Karen Shiels at Karen.Shiels@uregni.gov.uk by 17:00 on Friday 24 May 2013.