

Draft Determination to the Price Control 2015-2020 for the Electricity System Operator for Northern Ireland (SONI)

April 2015



About the Utility Regulator

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

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

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

We are based at Queens House in the centre of Belfast. The Chief Executive leads a management team of directors representing each of the key functional areas in the organisation: Corporate Affairs; Electricity; Gas; Retail and Social; and Water. The staff team includes economists, engineers, accountants, utility specialists, legal advisors and administration professionals.

Our Mission

Value and sustainability in energy and water.

Our Vision

We will make a difference for consumers by listening, innovating and leading.

Our Values

Be a best practice regulator: transparent, consistent, proportional, accountable, and targeted.

Be a united team.

Be collaborative and co-operative.

Be professional.

Listen and explain.

Make a difference.

Act with integrity.

Abstract

The purpose of this document is to inform stakeholders on the Draft Determination (DD) in relation to the next price control for the electricity transmission System Operator for Northern Ireland (SONI). This price control is due to be effective from 1 October 2015.

Audience

Regulated Companies; Consumer Groups; Industry and Statutory Bodies.

Consumer impact

SONI has a pivotal role in terms of 'keeping the lights on'. Both the effectiveness and efficiency of SONI are key to industry and consumers.

Impact on tariffs – the draft determination for this price control will increase tariffs for a domestic customer in 2015/16 of approximately £1.50 - £1.80 representing 21% of SONI's System Support Services tariff.

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Executive Summary

Context

SONI Ltd holds two licences giving SONI responsibilities as Transmission System Operator (TSO) and Single Electricity Market Operator (SEMO). It was acquired by EirGrid plc, the electricity transmission system operator for the Republic of Ireland, following its divestment from Northern Ireland Electricity plc (NIE) in 2009. SONI is a monopoly and therefore subject to a regulated price control. This paper focuses solely on SONI's role as Transmission System Operator (TSO).

The current 2010-15 price control period will end on 30 September 2015. SONI have issued a disapplication notice to the Utility Regulator to ensure the current price control ends on 30 September 2015 and a new price control and subsequent licence modifications are in place and effective from 1 October 2015. The subsequent price control period is expected to cover the period 1st October 2015- 30 September 2020. This Draft Determination consultation paper discusses the performance expectations, risks and appropriate allowances specific to the SONI system operation business for this period. In making this draft determination the Utility Regulator has considered the key areas of the Competition Commission Final Determination¹ on NIE's RP5 Price Control, where relevant.

The overall objective of this price control is to ensure that SONI can continue to operate the transmission system in Northern Ireland securely and efficiently and at a reasonable cost to consumers. The Utility Regulator proposes to continue with a RPI-X type price control, designed to incentivise SONI to control its operating and capital costs.

Challenges expected during 2015-2020

Challenges identified by SONI relevant to the 2015 to 2020 period include:

- Ensuring the business is appropriately financed to carry out its activities.
- Operating the power system in a manner to facilitate the 40% target for electricity production from renewable sources by 2020.
- Facilitating the EMR, I-SEM and DS3 requirements to be implemented and permit Northern Ireland to remain compliant with European legal requirements.
- Developing its systems including its IT systems, to meet the evolving business needs and enhance data transparency and increase network and IT security.
- Responding appropriately to future developments in EU and DETI policy.
- Putting frameworks in place to deliver under the European Network Codes and assist the UK to avoid potential infringement and/ or infraction proceedings.

Draft Determination principles

This draft determination consultation paper outlines the assumptions in relation to the principal components of SONI's allowed revenue: operating costs, allowances for

¹ <https://www.gov.uk/cma-cases/northern-ireland-electricity-price-determination>

depreciation on the asset base together with a reasonable return on SONI's regulatory asset base. In addition, the Utility Regulator states the assumptions in relation to proposed levels of capital expenditure. All values are shown in April 2014 prices using RPI where appropriate. The main aspects of this Draft Determination are outlined below.

Margin and cost of capital

SONI consider the current framework using WACC applied to the RAB a means of obtaining returns was unfinanceable and proposed the application of a margin, in addition to the WACC* RAB approach. The Utility Regulator considers there is insufficient basis for allowing an additional return over and above the WACC*RAB. This approach ensures the interests of consumers are protected together with the regulated business being financed and their investors are not unfairly treated. The cost of capital proposed by SONI is 5.42% pre-tax (4.69% vanilla), assuming 55% gearing. This draft determination proposes this level of return with no additional margin.

Opex

SONI's price control submission included a breakdown of actual and forecast (2014-15) operating (opex) costs for the current price control 2010-15 and additionally a forecast of costs for the 2015-20 period. The Utility Regulator has performed detailed assessment of opex elements including payroll, pensions, IT and telecommunications, professional fees, facilities and other opex. SONI proposed opex costs of £67.93m for the period; based on analysis the Utility Regulator proposes an allowance of £54.50m. The Utility Regulator intends introducing new opex regulatory cost reporting measures to cover the price control and beyond.

Capex

SONI proposed a capital expenditure (capex) allowance of £9.12m for the period. The Utility Regulator considers a level of £6.62m to be appropriate. To improve capital reporting, the Utility Regulator intends introducing new capex regulatory cost reporting measures to cover the price control and beyond.

Total allowed revenue

Overall SONI's business plan proposed a level of allowed revenue of £128.23m. Following our assessment and analysis, the Utility Regulator considers a level of £95.15m to be appropriate. The estimated impact of the Utility Regulator's proposals on the 2015/16 System Support Services (SSS) tariff is an estimated 21% increase which has an overall effect of an average of £1.50-£1.80 per domestic customer. This compares to a 44% increase proposed by SONI corresponding to an average increase of £3.50 - £3.80 per domestic customer. SSS charges usually represent about 2-3% of the proportion of the total electricity bill. Table 1 below shows the components of allowed revenue proposed by SONI and the Utility Regulator's level set in this Draft Determination:

Table 1: Summary of SONI's allowed revenue (April 2014 prices)

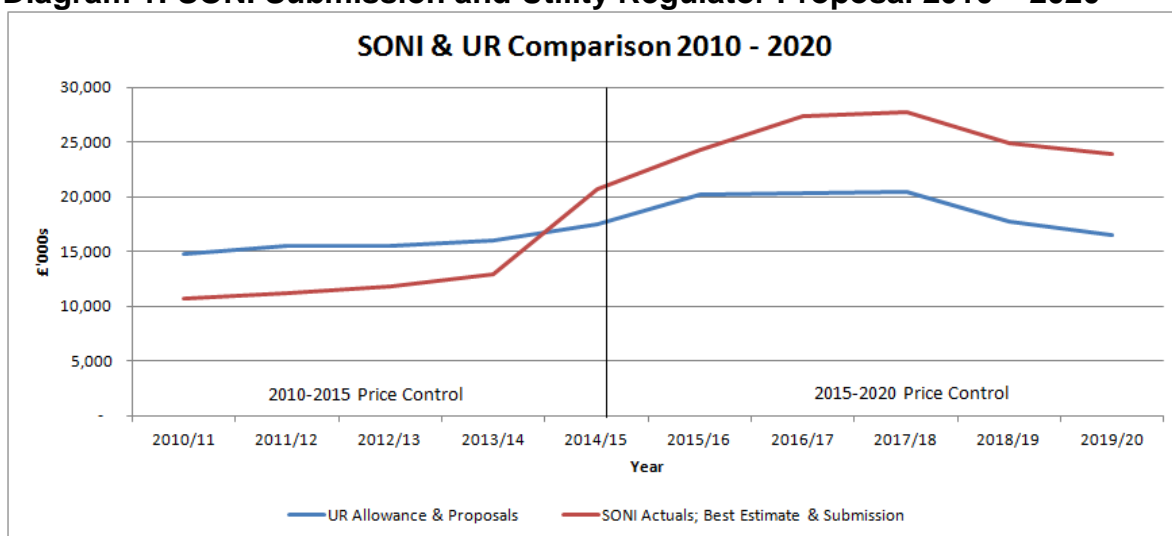
	2010 - 2015 Allowance	2010 - 2015 SONI Actuals	2015 - 2020 SONI Submission	2015 - 2020 UR Proposals	Variance 2015 - 2020 Submission & UR Proposals %
	£'000	£'000	£'000	£'000	%
Payroll (incl ongoing pension)	33,282	31,219	44,366	37,576	15%
IT and Telecoms	10,559	7,988	9,501	9,501	0%
Other Operating Costs	7,919	5,651	13,321	6,681	50%
Pension Deficit	172	391	740	740	0%
	51,932	45,249	67,928	54,499	
Depreciation	19,336	9,940	10,074	10,279	-2%
Rate of Return	4,538	4,115	2,731	1,538	44%
	75,806	59,304	80,733	66,316	18%
Innovation Fund			2,500	0	100%
Remunerate Contingent Capital (PCG)			6,900	0	100%
Margin			13,000	0	100%
	75,806	59,304	103,133	66,316	36%
Network Planning Function	3,100	6,828	25,100	25,100	0%
ENTSOE & Section 75 (previously Dt)				3,730	
Total	78,906	66,132	128,233	95,146	26%

Conclusion

Overall, the Utility Regulator has proposed reasonable approaches and supporting evidence in formulating this Draft Determination. The proposed Draft Determination allowance of £95.15m is a 44% increase from SONI's actual spend in the last price control, although this new price control will include £25.1m of Network Planning Project costs. If Network Planning was excluded this allowance represents a 6% increase from the actual spend in the 2010-2015 price control.

The overall allowance will also increase within the period once the DS3 and ISEM project costs have been approved. The Utility Regulator intends considering relevant representations and feedback from stakeholders in making a final determination for SONI's allowed revenue for the 2015-2020 period.

Diagram 1: SONI Submission and Utility Regulator Proposal 2010 – 2020



1. Introduction

1. The System Operator for Northern Ireland (SONI) is responsible for planning and operating the electricity transmission network in Northern Ireland. SONI is a monopoly and therefore subject to a regulated price control. This draft determination paper discusses the performance expectations, risks and appropriate allowances specific to the SONI system operation business for the forthcoming five year period 2015 – 2020.

1.1 Company Overview

2. SONI Ltd holds two licences giving SONI responsibilities as Transmission System Operator (TSO) and Single Electricity Market Operator (SEMO). This paper focuses solely on SONI's role as Transmission System Operator (TSO).
3. As a holder of a transmission licence SONI has a legal² responsibility to take such steps as are reasonably practicable to –
 - a) ensure the development and maintenance of an efficient, co-ordinated and economical system of electricity transmission which has the long-term ability to meet reasonable demands for the transmission of electricity;
 - b) contribute to security of supply through adequate transmission capacity and system reliability; and
 - c) facilitate competition in the supply and generation of electricity.
4. Core functions of SONI include:
 - operating the transmission network, including both near and real time;
 - balancing the system to achieve the lowest cost of production; and
 - planning the transmission network from need identification through to progressing projects to the point of obtaining all necessary consents.
5. SONI Ltd was acquired by EirGrid plc, the electricity transmission system operator for the Republic of Ireland, following divested from Northern Ireland Electricity plc (NIE) in 2009. Other businesses within EirGrid Group include EirGrid Interconnector Ltd (licence to own and operate the East West Interconnector (EWIC)) and EirGrid Telecoms Ltd. EirGrid Group structure is shown below in Diagram 2.

² The Electricity (Northern Ireland) Order 1992 Article 12 paragraph 2

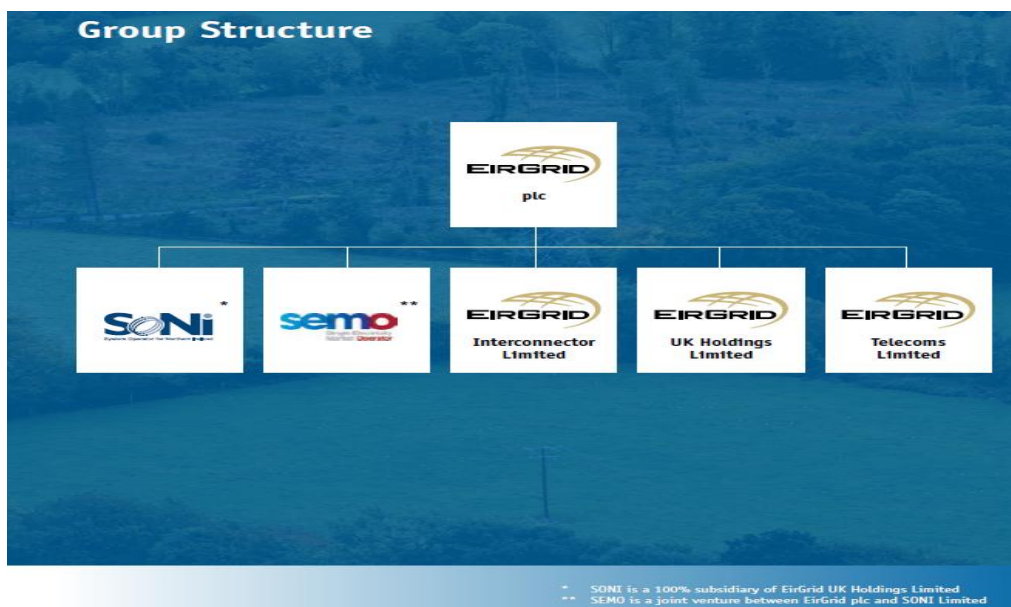


Diagram 2: EirGrid Group Structure (Source: EirGrid Annual Report 2013)

6. Within SONI TSO licence SONI can perform some duties by acting in conjunction with the Republic of Ireland system operator. These include establishing and operating a merit order system for SEM generation.
7. The role of Transmission System Operator (TSO) in Northern Ireland has evolved in recent years in a number of respects. This includes the implementation of the European Union Third Energy Package involving the European Commission's decision to certify SONI as the Northern Ireland TSO, independent from generation and supply interests, resulting in the transfer of the transmission network planning function from NIE to SONI in May 2014.
8. Furthermore the generation mix SONI manage continues to change due to the increase in renewable energy. Almost 20% of Northern Ireland's electricity demand came from renewable energy sources in 2014. During January 2015, 42% of electricity need came from wind energy setting a record and also representing significant progress towards the Northern Ireland's Executive's target of 40% of electricity from renewable sources by 2020.

1.2 Regulatory Framework

9. The role of SONI as TSO is defined in statute, its licence and mandatory codes and agreements. SONI TSO's allowed revenue is determined by the Utility Regulator made up of a number of components³ as detailed within their licence.

³ SONI's TSO allowed revenue will also include a 25% proportion adjustment for the all-island Dispatch Balancing Cost Incentive. SEM Committee decision SEM-12-033. Licence Modifications to SONI TSO licence are currently being drafted.

10. In any year SONI are subject to an annual revenue cap denoted by $MTSO_t$. A summary of the components is provided below:

$$MTSO_t = ATSO_t + BTSO_t + DTSO_t + KTSO_t$$

- A_{TSO_t} includes the total cost estimate relating to Ancillary Services (System Support Services). These costs are treated as pass-through and are considered to be outside of SONI's price control.
 - B_{TSO_t} is SONI's allowed revenue to cover their operating costs (OPEX), depreciation on the Regulatory Asset Base (RAB) and an appropriate return on those assets. These costs are defined within this price control.
 - D_{TSO_t} encompasses price control excluded costs which are considered on an individual basis by the Utility Regulator. These costs are treated as pass-through as they are considered to be outside of SONI's control. Such costs are defined in the annex to SONI's licence and include the cost of implementing changes of law or significant policy changes.
 - K_{TSO_t} is a correction facility whereby under or over-recoveries in the previous year(s) can be collected by the business (under-recovery) or given back to consumers (over-recovery) adjusted for interest.
11. The focus of this paper is on the B_{TSO_t} component for which the Utility Regulator will determine an allowed revenue following an assessment of expected performance and risks. The D_{TSO_t} and the K_{TSO_t} is discussed in chapter 11.

1.3 Responses to Consultation

12. As a public body and non-ministerial government department, the Utility Regulator is bound by the Freedom of Information Act which came into effect on 1 January 2005. According to the remit of the Freedom of Information Act, it is possible that certain recorded information contained in responses can be put into the public domain. Hence it is possible that all responses made to consultations will be discoverable under Freedom of Information Act, even if respondents asked the Utility Regulator to treat responses as "confidential".
13. It is therefore important that respondents note these developments and in particular, when marking responses as "confidential" or asking the Utility Regulator to treat responses as confidential should specify why they consider the information in question to be confidential.
14. Confidentiality disclaimers created automatically by your company's email system will not normally be treated as sufficient in terms of a confidentiality request.
15. This is an open consultation. The Utility Regulator has not posed any specific questions in this paper. Instead stakeholders are invited to express a view on any particular aspect of the paper.

16. Responses should be received by 5 pm on 14th May 2015 and should be addressed to:

Jody O'Boyle and Karen Shiels
Utility Regulator
Queens House
14 Queen Street
Belfast
BT1 6ED

E-mail: Jody.OBoyle@uregni.gov.uk and Karen.Shiels@uregni.gov.uk

2. Approach to Price Control

2.1 Regulatory Principles

17. The principal objective of the Utility Regulator is to protect the interests of consumers of electricity in Northern Ireland and where appropriate to do so by promoting effective competition.
18. The Utility Regulator, in carrying out the above objective, will have regard to:
 - a) the need to secure all reasonable demands in Northern Ireland or Ireland for electricity to be met; and
 - b) the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under statute.
19. The Utility Regulator's task essentially consists of creating a framework within which the regulated business receives a reasonable assurance of a revenue stream in future years that will cover its costs in return for providing monopoly services to an acceptable quality.
20. The Utility Regulator considers this approach to be consistent with the principles of better regulation⁴ which the Utility Regulator continues to apply: transparent, consistent, proportionate, accountable, and targeted.
21. The Utility Regulator when carrying out their duties does not operate in isolation but works closely with a range of other stakeholders. Key stakeholders in relation to the operation of the power system in Northern Ireland include:
 - System Operator for Northern Ireland (SONI)
 - Government bodies e.g. Department of Enterprise, Trade and Investment (DETI)
 - Market participants including generator units and developers
 - Moyle Interconnector
 - EirGrid PLC
 - NIE Ltd
 - Renewable Groups
 - Consumer Council

2.2 Policy Framework

22. There are a number of policies which will have an impact on SONI during the next price control.

⁴ Department for Business Innovation & Skills, *Principles for Economic Regulation*, published April 2011. A copy of this paper is available at:
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31623/11-795-principles-for-economic-regulation.pdf

23. Those which are expected to directly impact on the price control process at this time are:

- the 40% renewable target as set by The Department of Enterprise, Trade and Investment (DETI) within their Strategic Energy Framework⁵ (published in 2010). The objective is for 40% of Northern Ireland's electricity consumption to be met by renewable electricity production by 2020.
- European legislation requires the development of Network Codes as a tool to reach the European objective to harmonise cross-border rules. This is being co-ordinated by the European TSO (ENTSO-E) with close cooperation with stakeholders including national TSOs. The development of Network Codes will have a particular impact on SONI's Grid Code going forward.
- The transfer of the transmission network planning function in May 2014 has a fundamental change on this 2015 – 2020 price control as the responsibility and subsequent costs now lie with SONI and no longer NIE. Consideration must be given to the subsequent impact this transfer will have on both SONI's price control and NIE's price control while maintaining the view that the consumer should not be materially impacted by this transfer of network planning function from NIE to SONI.

24. While the following may not directly be a part of this price control they will have an overall impact on the SONI system operator business:

- the implementation of the Integrated Single Electricity Market (I-SEM) across Ireland and Northern Ireland in 2017. This is required to contribute to the implementation of the European Union Target Model which has the objective of harmonising arrangements for the cross –border trading of wholesale energy and balancing services across Europe.
- DS3 – Delivering a Secure Sustainable System. A joint project between the Utility Regulator, the Commission for Energy Regulation (CER) in Ireland, EirGrid TSO for Ireland and SONI is seeking to redesign the ancillary services arrangements in order to meet the needs of the system in 2020 as a result of the 40% renewable target.
- the Electricity Market Reform (EMR) is designed to decarbonise electricity generation across the UK and ultimately minimise the cost of electricity to all UK consumers. The most significant element of EMR for Northern Ireland is the implementation of Contracts for Differences (CfDs). This was introduced in GB from October 2014; it is proposed that CfDs will replace the Northern Ireland Renewables Obligation from 1 April 2017 with the first CfD payments expected to flow from that date. It is expected that new system and settlement processes will be required to enable SONI to provide any necessary information to the Settlement Services Provider.

⁵ http://www.detini.gov.uk/strategic_energy_framework_sef_2010_-3.pdf

25. There is a degree of uncertainty both in terms of the scope and cost recovery of the above policies and their subsequent impact on the SONI TSO business. For example the implementation of I-SEM and DS3 are determined as SEM matters, however SONI have included cost estimates for DS3 within their price control submission given the interlink with the 40% renewable target.
26. Furthermore SONI have included within their submission estimated costs associated with operating within the I-SEM. In respect of EMR work is continuing with DETI who are expected to determine on the cost recovery mechanism. The Utility Regulator will provide the necessary structural flexibility to accommodate these policies and their impact on SONI's costs within this price control.

2.3 Proposed Approach

27. A SONI Price Control Approach Paper⁶ was published by the Utility Regulator in July 2014 together with a Business Plan Information Requirement being issued to SONI outlining both numerical and written information requests.
28. The overall purpose of this price control is to ensure that SONI can continue to plan and operate an efficient, co-ordinated and economical system for the transmission of electricity in Northern Ireland.
29. The Utility Regulator will consider SONI's performance and expected performance, with the use of incentives if necessary. SONI's responses were assessed on the basis of the proposed approach outlined below:
 - Operational Expenditure (OPEX): Continue to use the ex-ante revenue cap framework to incentivise SONI to manage and control costs. Where possible, benchmarking has been carried out particularly in relation to payroll and ongoing pension contributions. Consumers have to date funded Northern Ireland regulated companies (those subject to a price control) historic pension deficit costs in full. As from 31 March 2015 any future incremental pension deficit amounts will not be recovered from consumers but will be funded 100% from shareholders⁷. The overall proposed OPEX allowance is set net of group recharges.
 - Capital Expenditure (CAPEX): The CAPEX allowance will continue to be set on an ex-ante basis with a proposed allowance representing a revenue cap being provided.
 - Risk: Appropriate financing to address SONI's risk profile. This risk remuneration allowance is reflected within the WACC calculation.

⁶http://www.uregni.gov.uk/news/view/approach_paper_to_the_price_control_for_the_electricity_system_operator_for/

⁷ Pension Deficit Recovery – A Utility Regulator Position Paper
http://www.uregni.gov.uk/uploads/publications/UR_Position_Paper_-_Pension_Deficit_Recovery_v1_0.pdf

- Incentives: Consider SONI's current incentives, including those set by the SEM e.g. dispatch balancing cost incentivisation⁸ and reputational incentives together with the need for additional incentives.
 - Uncertainty Mechanisms: These provide the necessary flexibility to adjust allowances due to change of law/regulation and other unforeseen costs. Consideration will be given to the need to outline a materiality threshold and specify a pre-defined category of events which can be accommodated within mechanisms such as Dt terms and K factor correction factors.
 - Reporting: The need and benefit for enhanced monitoring of SONI will also be considered. This will include a review of the merits of annual ex-post reporting being introduced during the price control period.
 - Tariffs: The Utility Regulator proposes to continue with a revenue cap approach for SONI's tariffs by setting the maximum allowable revenue to be recovered.
30. In April 2014 the Competition Commission (now the Competition Markets Authority (CMA)) published their Final Determination in relation to NIE Transmission and Distribution price control⁹.
 31. This determination is relevant to the electricity industry within Northern Ireland and considers key areas of the Competition Commission Final Determination in respect to SONI's price control.
 32. The Utility Regulator also received analysis from external consultants on SONI's proposed submission. These consultants include CEPA, GEMSERV, and RECKON LLP.
 33. In respect of the price control proposed approach, it is appropriate to acknowledge that, within the wider scope of the Utility Regulator regulating SONI, there is an active workstream reviewing the Independence of the Transmission System Operator Business as detailed within SONI's TSO licence Condition 12.
 34. This review is both from the perspective of SONI System Operator being independent from generation and supply interests together with independence from the point of view of SONI System Operator within the overall EirGrid Group.
 35. The Utility Regulator will continue to engage with SONI and EirGrid throughout this separate process with a view to publically consulting upon licence modifications.

⁸ SEM Decision Paper – Incentivisation of All-Island Dispatch Balancing Costs SEM-12-033

http://www.allislandproject.org/en/transmission_decision_documents.aspx?article=40b93d75-e3f6-4eef-b997-3d9209a2b7d8

⁹ <https://www.gov.uk/cma-cases/northern-ireland-electricity-price-determination>

2.4 Duration

36. The current price control will end on 30 September 2015. SONI have issued a disapplication notice to the Utility Regulator to ensure the current price control ends on 30 September 2015 and a new price control and subsequent licence modifications are in place and effective from 1 October 2015.
37. As outlined in the Approach Paper published in July 2014, this price control is expected to be for a five year period from 1 October 2015 to 30 September 2020.

3. SONI Performance to Date

38. The 2010 – 2015 price control decision paper¹⁰ was set in the context of government targets for increased renewable generation. SONI therefore requested increased resources to operate the power system, to manage the increase in renewable generation and associated connections and to cope with significant infrastructure development.
39. As a response to the 2010 – 2015 price control request the Utility Regulator provided an allowance for 19 additional full time equivalent staff together with sufficient CAPEX to refresh and enhance assets, ensure that it is able to manage and connect renewable generation, manage the impact of European and SEM developments and to respond adequately in emergency situations.
40. An increase of 22%, in real terms, to SONI's allowances was provided as recognition of the need for additional resources required due to the increased level of wind generation on the system to meet the government's target of 40% electricity demand to be met from renewable sources by 2020. In terms of cost management efficiency gains could be retained by SONI however any over expenditure would conversely have to be absorbed by SONI.
41. The electricity market, within which SONI has operated the transmission system, continued to evolve due to the European Union requirements such as the Third Energy Package; the introduction of intraday trading and changes to the generation mix to include increased renewable generation.
42. SONI has embraced these challenges to maintain a safe and reliable transmission system with 97.99% annual availability during 2013 (97.79% 2012). As a comparison National Grid achieved 99.99% electricity transmission system reliability during 2013/14¹¹. System security is another key performance measure which captures reported incidents resulting in loss of supplies to consumers.
43. During 2013 four reported incidents were experienced which all related to the severe weather conditions experienced in March 2013. During 2012 SONI reported two incidents which related to a testing malfunction and a significant loss of generation at Aghada power plant in Cork. Quality of service can be measured by the number of frequency excursions within a year. During 2012 and 2013 there were no voltage excursions exceeding the permitted limits¹². SONI's has a high reputation incentive underpinned by their safety and reliability records.
44. A further measure is financial performance for which SONI mention in their submission they have 'made considerable profits under the revenue cap' mechanism. In relation to the SONI TSO licence activity SONI has reported a profit

¹⁰ http://www.uregni.gov.uk/uploads/publications/SONI_Price_Control_decision_Paper_-_FINAL.pdf

¹¹ <http://www2.nationalgrid.com/responsibility/how-were-doing/grid-data-centre/Customer-service-and-network-reliability/>

¹² The Electricity Supply Regulations (Northern Ireland) 1991

before taxation of £4.4m (4.7% of revenue) in 2013, £4.4m (7.1% of revenue) in 2012 and £5.0m (8.5% of revenue) in 2011.

Table 2: 2010-2013 SONI TSO Profitability

SONI TSO Profitability Summary			
	2010/11	2011/12	2012/13
	£'000	£'000	£'000
Operating Profit (EBIT)	5,777	5,588	4,944
Operating Profit (EBIT) Margin	10%	9%	5%

* Source: Regulatory Accounts

3.1 Outlook of SONI for this 2015 – 2020 Price Control Period

45. The Transmission System Operator is required to maintain a continuous balance between electricity supply from generators and demand from consumers while also ensuring the provision of reserves that will allow for sudden contingencies. Given this critical role entrusted to SONI the Utility Regulator expects SONI to fully comply with the SONI Transmission Licence, various codes (e.g. Grid Code), agreements (e.g. Operational and Agency agreement with the Moyle Interconnector) and arrangements (e.g. Transmission Interface Arrangements with NIE) in place. By complying with these requirements SONI would be expected to plan and operate a safe, secure, efficient and reliable transmission network for 2015 – 2020.
46. The critical role SONI have in keeping the lights on places a strong reputation incentive on SONI in relation to their overall performance. SONI are obliged to report annually¹³ on their performance in maintaining transmission system security, availability and quality of service. The Utility Regulator will continue to monitor SONI's performance on a timely basis as Northern Ireland's electricity environment continues to evolve to comply on a European spectrum together with a greater dependency on renewable generation in order to meet the Department's 40% renewable generation target by 2020.
47. In relation to costs, once the Utility Regulator has set the allowances, the management of costs is a matter for SONI. Compliance, performance and quality of service provided by SONI should not be compromised in achieving efficiency gains.
48. The paramount output relating to SONI for the 2015 – 2020 period is the maintenance of security of supply. This relates to operating the transmission network system in a safe and reliable manner with system availability expected to be maintained to at least the 97.99% level reported for 2013. SONI are now responsible for planning the transmission network giving SONI more control in maintaining or improving overall system availability.

¹³ SONI Transmission Licence Condition 20 paragraph 11. SONI shall report, to the Authority, performance details within two months after the end of each financial year.

49. SONI would be expected to focus on contributing to the successful implementation of DS3 (October 2016) and I-SEM (October 2017) in conjunction with the Commission for Energy Regulation (CER) and the Utility Regulator. The DS3 project is directly linked to the Northern Ireland Executive's 40% renewable target for 2020.
50. In terms of SONI system operator's ongoing responsibility, SONI have an obligation to manage constraints on the network in an economical and effective manner. This requirement is further incentivised by the SEM Committee's Dispatch Balancing Cost Incentivisation Decision Paper¹⁴ which aims to reduce the cost of constraints on an all-island basis for which the market operator (SEMO) is responsible for settling.

¹⁴ http://www.allislandproject.org/en/transmission_decision_documents.aspx?article=40b93d75-e3f6-4eef-b997-3d9209a2b7d8

4. SONI Price Control Submission

51. The Utility Regulator issued a Business Plan Information Requirement to SONI in July 2014 to cover the 2015-2020 price control period. SONI made their submission to the Utility Regulator on 21st October 2014. SONI's Business Plan submission for 2015-2020 was a comprehensive set of primary papers comprising in excess of 1000 pages together with supporting documents and spreadsheets.

52. A summary of these papers are now outlined;

- Paper 1 related the overall structure of the SONI price control submission.
- Paper 2 provided an overview of SONI. This specifically covers the nature of the business, its role in the industry and the expected challenges to 2020. Financeability was specifically referenced as being the most significant question to be addressed in the price control.
- Paper 3 provided detail on SONI's role and the company structure within EirGrid Group. An analysis of 2010 – 2015 outturn and future business drivers was provided. Acknowledgement was given to benchmarking which concluded that there is an absence of comparator companies for benchmarking purposes.
- Paper 4 focused on SONI's System Operator cost base. This paper provides analysis of the potential evolution of the costs in the 2015-2020 period. This included productivity growth, real price effect and caution regarding the use of benchmarking.
- Paper 5 was in the form of spreadsheets responding to the Utility Regulator's Business Plan Information Requirements schedules for 2015-2020.
- Paper 6 detailing SONI's business characteristics in the context of the current regulatory framework. This paper discusses the financeability framework including the treatment of allowable revenues, risks, capital and financial returns.
- Paper 7 detailed SONI's Revenue Model for the period 2015 – 2019 including an assessment of SONI's operation in the current regulatory revenue framework together with an assessment of profitability measures to ensure financeability.
- Paper 8 provided an assessment of an appropriate Weighted Average Cost of Capital (WACC) to determine the allowed returns on SONI's Regulated Asset Base.
- Paper 9 considers the incentive framework and provided historical performance to date together with a range of proposed incentives for 2015-20.
- Paper 10 discusses Information System requirements / drivers for 2015-2020.

- Paper 11 to 11.4 was a series of papers on Network Investment Planning and the subsequent transfer from NIE to SONI. The treatment within the current regulatory revenue framework is considered includes project identification, capex project consents, the connection offer process and the implementation of access policy by SONI.
- Paper 12 focused on operational performance and challenges in the 2015-2020 period. Particular focus was given to DS3 and the 40% renewable target. Other aspects identified were I-SEM, Network Codes Electricity Market Reform and the transfer of network planning.
- Paper 13 is an actuarial valuation of SONI's pension scheme as at 31 March 2013.

53. SONI also provided a number of appendices to accompany their submission.

54. SONI is requesting a total amount of £128 million for the period 2015-2020, which equates to a request for an annual average revenue requirement of over £20 million as well as additional CAPEX allowance in the region of £5 million per annum specifically for network planning project costs.

55. SONI state that they are an asset light business and subsequently their fundamental concern relates to overall financeability. Therefore SONI have submitted a regulatory framework which would provide SONI with a rate of return (WACC), margin, contingent capital remuneration, Parent Company Guarantee (PCG) remuneration and intangible asset remuneration.

56. A summary of SONI's submission is shown in the following table.

	2010 - 2015 Allowance	2010 - 2015 SONI Actuals	2015 - 2020 SONI Submission
	£'000	£'000	£'000
Payroll (incl ongoing pension)	33,282	31,219	44,366
IT and Telecoms	10,559	7,988	9,501
Other Operating Costs	7,919	5,651	13,321
Pension Deficit	172	391	740
	51,932	45,249	67,928
Depreciation	19,336	9,940	10,074
Rate of Return	4,538	4,115	2,731
	75,806	59,304	80,733
Innovation Fund			2,500
Remunerate Contingent Capital (PCG)			6,900
Margin			13,000
	75,806	59,304	103,133
Network Planning Function	3,100	6,828	25,100
ENTSOE & Section 75 (previously Dt)			
Total	78,906	66,132	128,233

Table 3: 2010/2015 Allowance/Actuals and 2015/2020 SONI Submission

57. SONI's request for £128 million over the 2015 - 2020 price control period would be a 94% (56% excluding Network Planning) increase on their actual spend in the last price control period.

5. Opex

58. The Opex allowance is included within the B_{TSO} component of SONI's allowed revenue to cover their operating costs (Opex), depreciation on the Regulatory Asset Base (RAB) and an appropriate return on those assets.
59. This chapter will look at;
- a. Payroll and Headcount
 - b. Pensions
 - c. Telecoms and IT
 - d. Professional Fees
 - e. Facilities
 - f. Other Opex
60. The Utility Regulator analyzed the company's allowed and actual Opex spend from 2010/2015. Each of the above categories is discussed in turn below; the Utility Regulator also received analysis from external consultants on SONI's proposed Payroll, telecoms and IT, etc.

Table 4: 2015-2020 SONI Opex Submission

	2015 - 2020 SONI Submission £'000
Payroll (incl ongoing pension)	44,366
IT and Telecoms	9,501
Other Operating Costs	13,321
Pension Deficit	740
	67,928

5.1 Payroll and headcount

61. This section discusses the proposed payroll and headcount costs submitted by SONI and the Utility Regulator's assessment of these costs. The Utility Regulator, in carrying out this assessment has given regard to the current and future potential activities that SONI will require resource to enable it to fulfil its duties within this price control period. This includes operating the system following implementation of I-SEM and DS3.

5.1.1 SONI Submission on Payroll/Headcount.

62. In its submission to the Utility Regulator, SONI described an Eirgrid group recharge policy that details how OPEX and CAPEX are allocated and accounted for in addition to how group structure related recharges are calculated and apportioned between business units. SONI identified the reason for this was to ensure that each regulated licence business is accorded the complete costs of its operations.

63. In August 2011 the 'Cross Charging Policy' produced by Eirgrid Finance was developed in response to changes in its group organisation; in June 2013 this policy was superseded by a Cost Allocation & Recharge Policy between SONI and the Eirgrid groups. This Cost Allocation & Recharge Policy affects SONI and Eirgrid staff.

64. SONI have stated that there are a number of roles and/or projects which require staff to work for a group activity rather than solely for the licence or cost centre within which the initial cost centre resides so that staff are organised to deliver the required outcomes in the most efficient manner.

65. Activities that could be recharged include where staff members are working on a specific project for a specific time their associated costs are likely to be 'capitalised' to that project and where staff spend a significant ($\geq 25\%$) portion of their time working for a different licence unit (than where the initial costs are accounted for), the associated budgeted payroll costs (incl. salary, taxes and pension contributions) will be recharged based on the proportion of time spent between licensed activities.

66. SONI also indicated that sharing of specialised staff across the Eirgrid business has generated value in two ways:

- More efficient shared services: streamlining of governance processes and efficient allocation of support staff has allowed a greater volume of work to be managed within tight revenue restrictions.
- Appropriate specialisation: There is significant commonality between SONI and EirGrid's TSO licence obligations, and indeed other mandatory provisions.

67. SONI identified a number of areas where it believes it will require significant increases in headcount / payroll within this price control. This is required to address an increase in workload over and above the 'business as usual', while no headcount

/payroll details of these increases have been included in the submission the areas identified by SONI include;

- A significant and enduring increase in operational headcount required for the implementation of DS3 System Services.
- An increase in operational headcount required to oversee the business process changes associated with the development of European Network Codes.

68. In its submission SONI identified some specific additional staffing requirement for the price control period; this included 10 additional Grid Operations Department – Realtime staff and 3 additional IT related staff.

69. SONI also stated that it is required to offer competitive remuneration packages in order to attract and retain suitably qualified professional staff with experience in Power Systems, IS software development or regulatory experience within the NI, RoI and UK labour markets. They commented that their payroll costs have reflected the position of remaining competitive within the market and they benchmarked themselves against other utilities/high-tech. organisations within NI/UK. They believe that their payroll remuneration is competitive when compared to market rates for similar professional staff.

70. SONI have forecasted that they will need 113 FTE for the 2015/2020 price control period and have a requested £44.37m for payroll, which is about £8.5m per annum. SONI’s actual payroll in the last price control was on average less than £6.5m per annum.

Table 5: 2015-2020 SONI Payroll Submission

	SONI Submission 2010-2015 (£'000)	SONI Submission 2015-2020 (£'000)
Basic salaries and wage expense (included Ee's pension contribution)	£21,915	£29,172
Overtime	£870	£863
Other Allowances - Standby	£160	£85
Bonus & Profit related pay	£2,061	£2,856
National Insurance Contributions-Employers	£2,795	£4,255
Pension Costs - Defined Benefit Scheme- Employers	£2,968	£3,849
Pension Costs - Defined Contributions Scheme-Employers	£1,260	£2,652
Agency Staff	£164	£634
Average Number of Full Time Equivalents (FTEs) inc planning	90	113
Total Salaries and extra	£32,193	£44,366

71. The detailed headcount information as part of the Business plan request was not provided for by SONI in its initial submission. When submitted SONI highlighted that it was important to note the context that it was supplied in.

72. SONI stated that while the information lists the headcount who are contracted to SONI, it did not cover the full remit of activities which SONI undertakes. They noted that the Eirgrid organisation structure detailed in the submission will not align to this schedule and hence to overall revenue requirements, which they state are more correctly assessed on the basis of total labour cost (including allocations).

73. SONI also informed the Regulator that they could not provide the Regulator with its detailed salary information request due to legal data protection restrictions.

5.1.2 Utility Regulator review of Payroll / Headcount

74. The Utility Regulator recognises that payroll is a key area for the SONI price control. There is limited benchmarking information available for the system operator; however benchmarking has been applied by other methods such as ASHE¹⁵ to review SONI.

75. SONI currently employs 128 staff at Castlereagh House. These are shared between TSO licence activities and MO licence activities.

76. According to SONI there is 98 staff directly employed under SONI Ltd contracts for TSO related activities prior to cross-charging between the TSO entities. 12 staff transferred from NIE associated with the Network Planning function, and they have 18 staff associated with SEMO. SONI therefore state that their total contracted staff including SEMO is 128.

77. In SONI's submission, there is a significant increase between year to year analysis for 2013/14 and 2014/15. Between these two years the total payroll costs increases by about 20% and their proposed headcount only increases by 2 staff.

Table 6: 2015-2020 SONI Payroll Year to Year Comparison

£'000	ACTUAL			BEST ESTIMATE		SONI FORECAST				
	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
Basic salaries and wage expense (included Ee's pension contribution)	3,379.34	3,902.27	4,427.60	4,917.14	5,289.13	5,776.26	5,888.67	5,838.71	5,853.12	5,815.65
Basic salaries plus Bonus	3,636.86	4,294.43	4,837.92	5,346.62	5,860.24	6,347.36	6,459.77	6,409.81	6,424.23	6,386.75
Total costs + additions- overtime / pensions costs etc	4,850.04	5,426.83	6,041.40	6,318.54	7,695.47	8,413.71	8,581.88	8,537.94	8,555.91	8,791.36
Number of Full Time Equivalents (FTEs) inc plann	75	82	95	98	99.75	111.5	112.75	112.75	113	113
Average Basic salaries and wage expense (included Ee's pension contribution)	45,057.87	47,588.62	46,606.36	50,174.94	53,023.91	51,805.01	52,227.68	51,784.57	51,797.54	51,465.94
Average Basic salaries and Bonus	48,491.44	52,371.09	50,925.52	54,557.32	58,749.25	56,927.01	57,292.90	56,849.78	56,851.55	56,519.95
Average Overall package	64,667.23	66,180.88	63,593.73	64,474.88	77,147.55	75,459.31	76,114.27	75,724.55	75,716.05	77,799.67
Annual overall package % increase from year to year		2%	-4%	1%	20%	-2%	1%	-1%	0%	3%

78. The increase in payroll includes a 30% increase in National Insurance a 40% increase in Pensions costs a 33% increase in bonus and profit related pay, an increase in agency staff and reduced recharge costs. SONI stated that these increases were a forecast estimate. As the 2014/15 forecast year included significant increases the Utility Regulator therefore has used the 2013/14 actuals year as a base year when compiling its analysis.

79. SONI also included in its submission the headcount staff that relate to the connections business which they separately invoice for. These staff have been funded by connectees through the Transmission and Distribution connection

¹⁵ Annual Survey of Hours and Earnings (ASHE)

<http://www.ons.gov.uk/ons/rel/ashe/annual-survey-of-hours-and-earnings/index.html>

charging process. The Utility Regulator's position remains unchanged from the 2010 – 2015 price control, connections staff should not be considered for this proposed price control.

80. The volume of connections have increased over the last price control and are expect to increase over the next few years to reach the 40% target. In the last 2010/2015 Price control it was decided that 5 connection staff should be removed from the SONI price control related headcount, the Utility Regulator has decided to continue to exclude these 5 connection related headcount from the SONI submission headcount. Given the increase in connections the work in this area may increase, however this draft determination limits the headcount reduction to five full time equivalents.
81. The average basic salaries and wage expense (included employees pension contribution) from SONI staff on 2013/14 was over £50k, (£4.9m /98 staff).
82. SONI's also has a bonus and profit related pay this is approximately 10% of the base salaries; this bonus element has been allowed. It should be noted that profits where appropriate should be shared with staff and not further requested to be funded from the NI consumer. With the bonus and profit related pay included within the average salaries, this increases the mean annual pay to approx £55k per employee.
83. The Utility Regulator compared SONI's salaries with the UK ASHE annual earnings survey which is published by the Office of National Statistics. ASHE compares occupations and regional earnings and it is a sample of the actual earnings of employees. The earnings are broken down into percentile bands so that higher earnings are tracked differently to lower earnings.
84. ASHE publishes earnings estimates at 10 centile intervals. (Table 14.7a – All Employees by Occupation (SOC 4) (annual pay)) can be found at <http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-337425> - Table 15 (NI).7a Annual pay - Gross (£) - For all employee jobs a: Northern Ireland, 2014 – was also reviewed but the sample size was limited.
85. The Utility Regulator has reviewed the staff in ASHE which have a similar roles to those identified in SONI, these include eg, Engineering professionals, Electrical engineers, Engineering professionals n.e.c., IT specialist managers, IT project and programme managers, IT business analysts, architects and systems designers. The average mean for similar related jobs from ASHE, including bonus, was over £46k.
86. The SONI mean annual pay is on average over 19% higher that the UK mean for relevant roles. SONI's remuneration therefore falls within the 80 percentile of the ASHE ranking.
87. Based on the ASHE analysis the Utility Regulator proposed to reduce the mean average 2013/2014 bases salary by 5% and use this as the benchmarked allowance for the 2015/2020 price control period.

88. This reduction would mean for this price control period SONI staff would have an average salary including bonus of £52.5k which is still significantly above the ASHE mean of £46k but would equate to about 75 Percentile on the ASHE banding.
89. With regard to additional headcount, SONI requested 10 additional heads to Grid operations; they received 7 additional heads in this area in the last price control. SONI also requested 3 additional IT staff. Having considered SONI's request for additional headcount the Utility Regulator has decided to allow for 3 additional heads in Grid operations and 1 additional IT staff.
90. While SONI have requested 13 additional staff, insufficient evidence was received to justify each of these additional roles. However the Utility recognised the workload activities for the 2015 – 2020 period and it is on this basis that 4 additional staff have been allocated. The Utility Regulator will engage further throughout the consultation period with SONI on the specific need of the proposed additional headcount.
91. Within the transfer of network planning function, 19 roles were identified under TUPE (Transfer of Undertakings (Protection of Employment)) which transferred to SONI, although 12 staff physically transferred from NIE, this will be discussed further in Chapter 12.
92. In this price control the Utility Regulator has provided for 84 roles (this amount is from the last price control and excludes connections related staff), 19 roles was TUPE across for transfer of planning, so the total headcount provided for in this price control will increased to 107 (84 +19 TUPE + 3 additional Grid Operations + 1 addition IT).
93. SONI requested 113 FTE for the 2015/2020, this draft determination provides for **107** FTE excluding the connections staff. This will provide SONI with the relevant headcount to facilitate the transfer of planning function and operate the system within 2015-2020 period including operating DS3 and I-SEM.

5.1.3 The Utility Regulators proposal on Payroll / Headcount

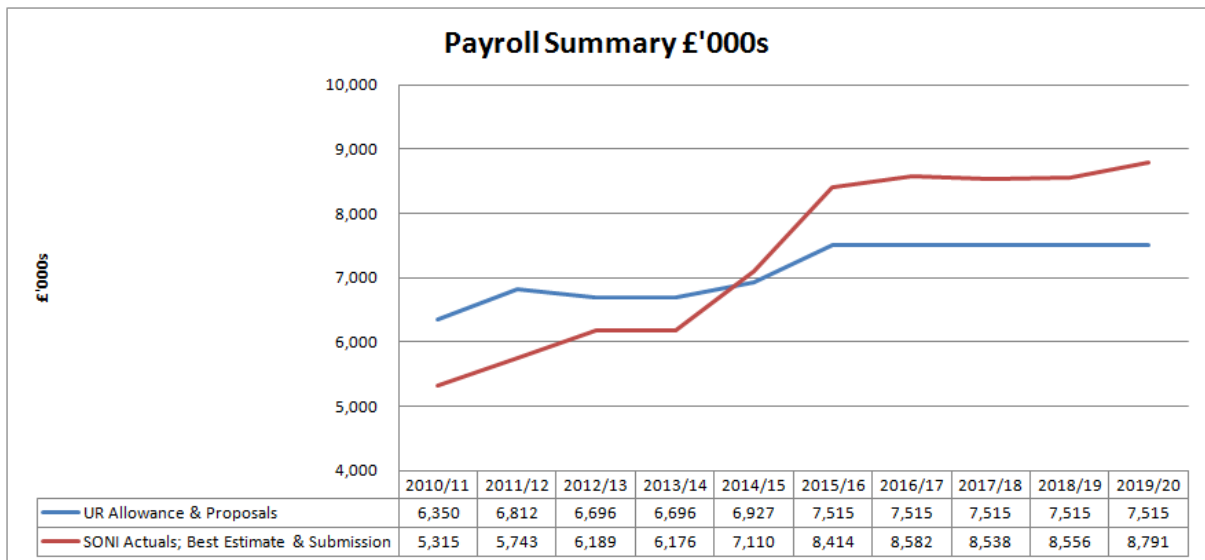
94. SONI in its submission requested £44.37m for payroll (which included connections) in this price control period, the Utility Regulators draft decision is to set SONI's payroll cost to £37.6m excluding connections) for the next price control period.

95. The following table provides the SONI Submission and Utility Regulator Draft determination on Payroll.

Table 7: 2015-2020 SONI Payroll Draft Decision

	SONI Submission 2015-2020 (£'000)	UR Draft Determination (£'000)
Basic salaries and wage expense (included Ee's pension contribution)	£29,172	£25,501
Overtime	£863	£863
Other Allowances - Standby	£85	£85
Bonus & Profit related pay	£2,856	£2,550
National Insurance Contributions-Employers	£4,255	£3,741
Pension Costs - Defined Benefit Scheme- Employers	£3,849	£2,976
Pension Costs - Defined Contributions Scheme-Employers	£2,652	£1,860
Agency Staff	£634	£0
Average Number of Full Time Equivalent (FTEs) inc planning	113	107
Total Salaries and extra	£44,366	£37,576

Diagram 3: 2015-2020 SONI Payroll Summary



5.2 Pensions

96. During December 2014 the Utility Regulator published a Pension Deficit Recovery Position Paper¹⁶. This paper follows the pension deficit decision made by the Competition Commission's (now the Competition Markets Authority-CMA) final determination on NIE price control in 2014.
97. In respect of all remaining price controlled businesses with pension deficits, of which SONI Ltd is one, the Utility Regulator's position is the introduction of a "cut-off" date of **31 March 2015**. Up to this date a historical pension deficit will be 100% recovered from consumers after which any incremental deficit will be 100% funded by the licensee.
98. The SONI Ltd Pension Scheme consists of a Defined Contribution (DC) scheme (the 'Options Plan') and a Defined Benefit (DB) scheme (the 'Focus Plan').
99. In considering SONI Ltd's pension submission the Utility Regulator has given consideration to:
- The ongoing costs of the Defined Contribution Scheme
 - The ongoing costs of the Defined Benefit Scheme
 - Deficit costs associated with the Defined Benefit Scheme
 - Section 75 deficit costs arising from the divestment of SONI from Viridian in 2009
 - Any impact on SONI's pension costs of the transfer of the Network Planning function from NIE in 2014.
100. Each of the above categories of costs is now discussed in turn.

5.2.1 Defined Contribution (DC) Scheme: 'Options Plan'

101. The 'Options Plan' is the only section of the SONI Ltd Pension Scheme which remains open to new members. At the time of SONI's submission the 'Options Plan' contained 89 members.
102. The Utility Regulator has reviewed the 6-8% level of contributions payable by both employees and SONI Ltd to the 'Options Plan'. An analysis of data available on the Office of National Statistics (ONS) website indicates that the weighted-average contribution rate for a private sector pension scheme with DC membership of c100 members is around 6%.
103. In addition to employer contributions to the 'Options Plan', SONI Ltd contributes 3% administration fees. The Utility Regulator is encouraged that this represents a 50% reduction in the administration cost for the DC scheme proposed

¹⁶ http://www.uregni.gov.uk/uploads/publications/UR_Position_Paper_-_Pension_Deficit_Recovery_v1_0.pdf

by the company at the last price control review. The Utility Regulator proposes to approve a separate administration fee of 3% for the DC section of the pension scheme. This proposed allowance is based upon benchmarked administration fee contribution rates.

5.2.1.1 The Utility Regulators proposal on DC scheme

104. The Utility Regulator proposes to provide an employer contribution rate of 6% for the Defined Contribution 'Options Plan'. This aligns with the ONS benchmarking data available.
105. The DC pension scheme allowance will be included within the overall payroll allowance outlined in section 5.1.

5.2.2 Defined Benefits (DB) Scheme: 'Focus Plan'

106. The 'Focus Plan' is the Defined Benefit (DB) section of the SONI Ltd Pension Scheme; this is a more expensive section of the scheme than the 'Options Plan' because retirement benefits payable are based on salary and length of service.
107. The DB section of the pension scheme was closed to new entrants in 1998, however due to exceptional circumstances was reopened in May 2014 in order to transfer six employees transferring from NIE who were members of a defined benefit section of the NIE Pension Scheme.
108. At the time of submission there were 32 active members in the 'Focus Plan'. All of the DB members have 'protected persons' status outlined in the Electricity (Protected Persons) Pension Regulations (Northern Ireland) 1992. This means that SONI Ltd, as the employer, is limited in its ability to change the pension scheme rules and member benefits which were in place when the industry was privatised.
109. Employees in the defined benefit section of the scheme contribute 6% of pensionable pay and SONI Ltd as the employer contributes 40% of pensionable pay (increased mid-2014 from 28%). SONI justify this increase in employer contribution rate by referring to actuarial advice in the most recent actuarial valuation report at 31 March 2013.
110. The actuarial assumptions, set by SONI Trustees, in the 31 March 2013 valuation are considered more prudent than those applied at 31 March 2010, thereby increasing the employer contribution rate required.
111. A review of the Employer Standard Contribution Rate (SCR) contribution percentage payable by electricity companies in GB (at March 2010) by GAD¹⁷ for Ofgem reveals an average employer contribution of 26% (excluding pass service liability). When this average is compared with SONI's current employer DB

¹⁷ <https://www.ofgem.gov.uk/ofgem-publications/42780/gad-peniosn-report-16052012.pdf>

contribution rate of 40% it is clearly higher than the average for the electricity industry reported in this GAD report to Ofgem.

5.2.2.1 The Utility Regulators proposal on DB scheme

112. As this price control will become effective after the “cut-off date” of 31st March 2015 the Utility Regulator has relied upon benchmarking information in order to assess a reasonable and appropriate Employer pension contribution for this price control period.

113. Given SONI’s protected benefits are considered to be more generous than average and the time lag since the GAD review of defined benefit contribution rates was carried out the Utility Regulator proposes to allow a 28% employer contribution rate. The Trustees of SONI Ltd pension scheme review and agree the assumptions of the scheme. These assumptions would expect to include contributions from employees and employers. It is the responsibility of SONI Ltd to endorse and manage these as the employer.

114. The ongoing pension costs relating to the system operator business, for both employee and employer, are considered as part of the overall payroll allowance outlined in section 5.1.3 **The Utility Regulators proposal on Payroll / Headcount.**

5.2.3 Defined Benefits Scheme Pension Deficit

115. The defined benefit scheme is, by its nature, exposed to risk resulting in the value of the scheme being higher (surplus) or lower (deficit) than the liability imposed by the pension obligations defined within the scheme. Due to this risk, SONI closed the defined benefit section of their scheme in 1998.

116. The latest actuarial valuation report which SONI provided to the Utility Regulator relates to the scheme as at 31 March 2013. The pension deficit, based on Trustee’s assumptions including the use of CPI rather than RPI indexation, was £1,146,000; this correlates to a 95% funding level and compares to a £681,000 deficit at the 31 March 2010 actuarial valuation. To address the deficit, SONI Ltd has proposed payments of £148,000 per annum for the 2015 – 2020 period.

5.2.3.1 The Utility Regulators proposal deficit amount

117. An actuarial valuation is carried out for the SONI DB scheme every three years. An assessment carried out by the Utility Regulator as to why the deficit amount has increased from 2010 to 2013 reveals it is predominantly due to a change in financial assumptions.

118. Real yields on index-linked gilts decreased significantly between March 2011 and March 2012. In turn, this has led to a decrease in the discount rates used to value the SONI Ltd Pension Scheme's liabilities, which has increased the value of the liabilities.
119. It is common practice for companies to receive an annual funding update between the three year full valuations. The Utility Regulator requested of SONI an actuarial funding update as at March 2014 but this has not yet been provided by SONI.
120. Following the publication of the Pension Deficit Position Paper the Utility Regulator has requested that SONI provide an actuarial valuation report for the SONI Ltd pension scheme as at 31 March 2015. This report is expected to be received within a timeframe suitable for updating the final determination on the price control.
121. A pension deficit recovery of 10 years is proposed to reflect the average remaining service of active members. Based upon the 31 March 2013 pension deficit of £1,146,000 and a recovery period of 10 years the pension deficit recovery allowance for the purposes of this consultation, are set out in Table 8 below:

Table 8: Summary of Pension Deficit Submission and Proposal

Pension Deficit Recovery based upon 31 March 2013 Valuation of £1,146,000	SONI Submission £'000	URs Proposals £'000
	Total	Total
Total	740	740

122. Following receipt of an updated pension deficit actuarial valuation as at 31 March 2015 the Utility Regulator intends to perform a detailed assessment of the appropriate historical pension deficit consumers are obliged to pay at this cut-off date of 31 March 2015.

5.2.4 Section 75 of the Pensions Act 1995

123. Section 75 of the Pensions Act 1995 sets out certain conditions where an employer is required to immediately make good a pension deficit rather than correcting the deficit over a period of time. The relevant condition is in the circumstances where there is a transfer of ownership and the new owner is no longer a contributor to the pension scheme but the employees remain part of the original scheme: this is the case with SONI as a result of divestment from the Viridian group in 2009. The divestment of SONI from Viridian resulted in a number of members choosing to leave their liability with the Viridian Group Pension Scheme.
124. In 2011 SONI notified the Utility Regulator of a section 75 debt amounting to

£1.85m which SONI had already incurred in respect of the SONI Ltd Defined Benefit Pension Scheme. The Utility Regulator approved this section 75 pension liability in 2012 as a 'Dt allowance' on the basis the liability would be recovered from April 2010, over 15 years on an NPV neutral basis calculated by reference to the Bank of England rate plus 1.5%. This allowance will continue to be provided to SONI until 31 March 2025.

Table 9: Summary of Section 75 Pension Deficit Dt Approval

s75 Crystallised deficit £1.85m	2015/2016	2016/2017	2017/2018	2018/2019	2019/2020
15 years	142,600	142,600	142,600	142,600	142,600
Discount rate	1.126	1.149	1.172	1.195	1.219
	126,625	124,142	121,708	119,321	116,982
Rate applied - base rate + 1.5%	2.00%	2.00%	2.00%	2.00%	2.00%

125. As the Utility Regulator is setting a new price control it is proposed for this period to incorporate this approved Dt allowance within SONI's price control allowance rather than as a Dt item from September 2015.

5.2.5 Transfer of Network planning function from NIE

126. In 2014 SONI took responsibility for planning the transmission network from NIE. This is further detailed in chapter 11.

127. Upon receipt of the 31 March 2015 valuation the Utility Regulator will consider the overall impact of this transfer. Consideration must be given to the NIE price control and the impact the above transfer of pension deficit to SONI will have. The Utility Regulator is of the view that the consumer should not be materially impacted by this transfer of network planning function from NIE to SONI.

5.3 Telecoms and IT

128. The Utility Regulator has reviewed SONI's IT OPEX submission within which the key elements are the Operational Telephony Network (shared with NIE), EMS support and various other applications.

129. IT OPEX is strongly correlated to the IT CAPEX and therefore as additional complexity is introduced within CAPEX, additional support and maintenance will also be required.

Table 10: 2015-2020 SONI Telecoms and IT Submission

OPEX IT Analysis	Description	ACTUAL			BEST ESTIMATE		FORECAST				
		2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
		£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000
Telecommunications											
	OTN (Operational Telephony Network)	£666	£807	£889	£662	£895	£907	£919	£932	£932	£932
	Calls, Rental, Support, internet	£72	£64	£75	£75	£75	£75	£75	£75	£75	£75
	Equipment	£0	£3	£3	£0	£23	£23	£23	£23	£23	£23
	Total Telecommunications	£738	£874	£968	£737	£993	£1,005	£1,017	£1,030	£1,030	£1,030
Hardware Warranty and Support											
	Maintenance & Support	£31	£30	£65	£65	£65	£65	£65	£96	£96	£65
	Hardware	£23	£22	£19	£20	£20	£20	£20	£20	£20	£20
	Total Hardware and Support	£54	£52	£84	£85	£85	£85	£85	£116	£116	£85
Software Licences and Support											
	Energy Management System	£112	£149	£140	£98	£118	£118	£118	£118	£118	£146
	Other Applications	£537	£427	£408	£509	£571	£575	£630	£660	£684	£736
	Total Software Licences and Support	£648	£575	£548	£607	£689	£693	£748	£778	£802	£882
	Total	£1,440	£1,501	£1,599	£1,429	£1,767	£1,783	£1,850	£1,924	£1,948	£1,997

130. The Utility Regulator considers that there may be areas of the proposed allowance where cost saving can be achieved but these will not be large. Therefore the SONI proposed allowance for IT OPEX seems appropriate given the business critical nature of the SONI business.

131. The Utility Regulator proposes to allow SONI's Telecoms and IT submission in full.

5.4 Professional Fees

Table 11: 2015-2020 SONI Professional Fees Submission

Professional Fees	Description	ACTUAL			BEST ESTIMATE		FORECAST				
		2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
		£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000
Network Planning Consultancy						£38	£121	£121	£121	£121	£80
Grid Code		£20	£91	£64	£39	£46	£46	£46	£46	£46	£46
Legal Costs (excluding Network Planning Function)		£110	£90	£65	£43	£100	£100	£100	£100	£100	£100
Professional Services (Excluding Network Planning Function)		£20	£45	£177	£51	£108	£108	£108	£108	£108	£108
Other - please specify											
	Public Affairs					£208	£208	£208	£208	£208	£208
	DS3						£417	£417	£292		
Total						£150	£226	£306	£133	£499	£999
							£999	£999	£874	£583	£542

132. SONI have proposed an annual Network Planning Consultancy cost of £121,000 per annum with a reduction to £80k in the final year. This relates to the ongoing 'business as usual' aspect associated with network planning and is a separate allowance proposed by SONI from the network planning pre-construction projects.

133. The Utility Regulator considers this to be excessive and propose a level of £50k per annum. Given this relates to the transfer of network planning from NIE further consideration of this cost is necessary given the proposed payroll allowance provided for the 19 TUPE roles identified as part of the transfer from NIE. This will be considered further both in terms of links with the pre-construction project costs and would be expected to form part of the cost adjustment to NIE's price control. These

discussions are ongoing with both NIE and SONI and are further outlined in Chapter 11.

134. Grid Code is a live technical document which will be subject to modifications throughout the 2015 – 2020 period. The Utility Regulator proposes to allow the Grid Code allowances sought by SONI.
135. The Utility Regulator has considered SONI's proposals in relation to general legal costs and does not consider that there is sufficient evidence to support an annual legal cost of £100k. Having reviewed the actual level of costs together with the knowledge that SONI has strengthened their internal legal support recently an annual allowance of £65k is being proposed. This reflects the level in 2012-13 and is the latest actual cost value.
136. SONI have proposed an annual cost of £108k for professional services. The Utility Regulator has had to assume this relates to ongoing professional services such as audit fees. Having reviewed historical actual costs a proposed allowance of £65k per annum is also being proposed for professional fees.
137. The public affairs cost, of £208 per annum, sought by SONI is a new price control cost request associated with network projects and connections. SONI advise that these additional services are to support a dedicated team of in-house public affairs advisors. The additional external services include additional public consultation, stakeholder engagement and media relations. SONI further comment these resources will only be retained for as long as needed.
138. The Utility Regulator has reviewed the need for this specific public affairs support which amounts to over £1 million for the five year period. Stakeholder engagement is recognised to be a key aspect of the Northern Ireland electricity industry and to that end the Utility Regulator is proposing, within the Other Opex section 5.6, to allow SONI's submission for stakeholder events, which is almost double the actual cost reported for 2013-2014. This stakeholder event allowance together with SONI's reference to an existing dedicated team of in-house advisors is viewed as sufficient resource.
139. The public affairs costs could be perceived to over-lap with the costs associated with specific pre-construction projects and there is a risk of an allowance being provided in two separate places. The Utility Regulator therefore proposes to disallow this specific cost request given resources provided elsewhere in this proposed price control.
140. SONI have requested a specific allowance for DS3 professional fees for the three years 2015 – 2018. DS3 is a specific consideration of the SEM Committee separate from the price control. The Utility Regulator proposes to not include a provision for this allowance within the Draft Determination. However, there is clearly a direct correlation between the 40% renewable target by 2020 and the DS3 project. Therefore further work is needed within this price control process in terms of how this price control will interact with the DS3 workstream.

141. Table 12 below summarise the proposed allowances which in total proposes a five year allowance of £1.1 million against SONI's submission of £3.9 million.

Table 12: 2015-2020 Professional Fees Draft Decision

Professional Fees	Description	FORECAST				
		2015/16	2016/17	2017/18	2018/19	2019/20
		£'000	£'000	£'000	£'000	£'000
Network Planning Consultancy		£50	£50	£50	£50	£50
Grid Code		£46	£46	£46	£46	£46
Legal Costs (excluding Network Planning Function)		£65	£65	£65	£65	£65
Professional Services (Excluding Network Planning Function)		£65	£65	£65	£65	£65
Other - please specify						
	Public Affairs	£0	£0	£0	£0	£0
	DS3	£0	£0	£0	£0	£0
Total		£226	£226	£226	£226	£226

5.5 Facilities

142. Facilities costs include rates; heat, light and power; security; cleaning services; maintenance; building and contents insurance; mail service and switchboard.

143. In October 2014 SONI completed their building extension and refurbishment of the existing building. As a result costs relating to facilities will increase from 2014 onwards. Upon completion the building will have space for the current 128 staff¹⁸ with a buffer of 20 desks to cover both long term and temporary increase and the associated space required for meetings and video conferencing.

144. Business rates have previously been treated as a recurring Dt cost as opposed to a price control cost. In an effort to reduce the number of Dt items the Utility Regulator has included business rates within this price control allowance.

145. The Utility Regulator requested SONI submit total facility costs for Castlereagh House reflecting their role as both system operator and market operator. The Utility Regulator has assessed these costs based upon an average cost per head based upon 148 staff which the building can now accommodate. The Utility Regulator is minded to allow the full amount of facilities allowance sought which encompasses all activities of SONI Ltd.

¹⁸ SONI Ltd staff in total including market operator employees

Table 13: 2015-2020 Facilities Draft Decision

Facilities Analysis	ACTUAL			BEST ESTIMATE		FORECAST					Total 2015-2020 £'000
	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	
	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	
Building Rates - Castlereagh House	-£449	£84	£83	£84	£147	£147	£147	£147	£147	£147	£735
Heat: Light & Power	£118	£116	£129	£183	£176	£176	£176	£176	£176	£176	£880
Security	£116	£113	£123	£93	£107	£107	£107	£107	£107	£107	£535
Maintenance	£59	£59	£70	£94	£82	£82	£82	£82	£82	£82	£408
Building & Contents Insurance	£26	£27	£22	£40	£50	£50	£50	£50	£50	£50	£250
Mail service/Switchboard	£2	£2	£2	£2	£3	£3	£3	£3	£3	£3	£18
	-£128	£401	£430	£495	£564	£564	£564	£564	£564	£564	£2,821

5.6 Other OPEX

146. Other OPEX consists of a wide range of smaller costs associated with staff related costs (recruitment costs, subscriptions and membership fees, training, employee welfare), general and administrative costs (weather forecasts, stakeholder engagements and industry events, payroll charges, rent for emergency control centre and water rates).

5.6.1 SONI's Submission

147. SONI have forecasted an annual increase of £837k representing 132% from 2016/17 onwards. This translates to SONI requesting £6.5m of which £3.3m relates to a new European membership (CORESO: a body who proactively helps TSOs to ensure security of supply on a European regional basis).

5.6.2 The Utility Regulators Proposal

148. In relation to the CORESO membership the Utility Regulator has excluded this item due to lack of justification of both need and costs. The costs are similar to the allowance provided for National Grid in the UK. If this membership becomes mandatory SONI can request the membership fee via the Dt process. Any such Dt request will consider the need to offset other SONI costs/activities.

149. SONI have proposed a higher allowance for stakeholder and industry events for which the Utility Regulator supports and proposes to allow. Other costs have been compared with actuals and/or been assessed on a per employee basis to arrive at an appropriate allowance.

Other Opex	SONI Submission £'000	UR Proposal £'000
Staff Related Costs	5,771	2,076
Other Opex	734	655
Total	6,505	2,730

Table 14: Other Opex Summary of SONI's Submission and UR Proposal

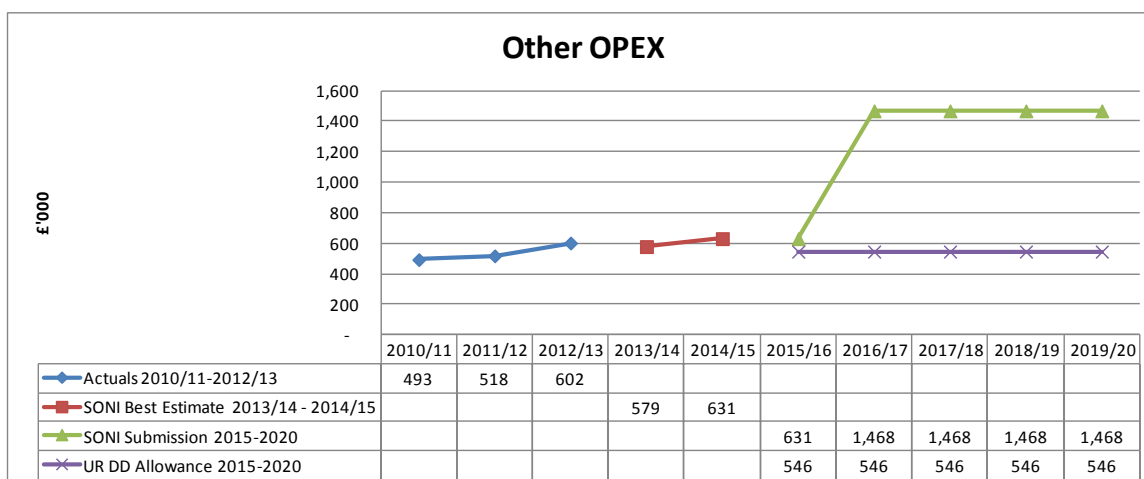


Diagram 4: 2015-2020 SONI Opex Submission and Utility Regulator proposal

5.7 OPEX Draft Decision

150. Details of SONI's submission and the Utility Regulator's proposals (in £000's) are provided in the table below.

	2015 - 2020 SONI Submission £'000	2015 - 2020 UR Proposals £'000	Variance 2015 - 2020 Submission & UR Proposals %
Payroll (incl ongoing pension)	44,366	37,576	15%
IT and Telecoms	9,501	9,501	0%
Other Operating Costs	13,321	6,681	50%
Pension Deficit	740	740	0%
	67,928	54,499	20%

Table 15: 2015-2020 SONI Opex Submission and Utility Regulator proposal

6 Capital Expenditure (CAPEX)

6.1 SONI Submission on CAPEX

151. The capital expenditure (CAPEX) allowance which will be provided to SONI, through the depreciation charge, will enable SONI to recover the necessary resources to finance their capital investments from tariffs.
152. As Information Technology (IT) is at the heart of SONI's functions their CAPEX submission is predominantly IT related based upon the EirGrid Information Services (IS) Strategy for 2015 – 2017.
153. This document outlined the EirGrid IS Strategy for three years and provides a framework for decisions in relation to:
- EirGrid Group Vision: to be a world leading grid company
 - EirGrid Group IS Mission: to provide innovative IS solutions and services to drive and support group strategy
154. SONI have presented their Regulatory Asset Base (RAB) and CAPEX additions in 2014/15 prices. The Utility Regulator has revised SONI's RAB and CAPEX additions to April 2014 prices in order to remain consistent throughout this paper.
155. The CAPEX requirement proposed by SONI for the 5 year period is £9.1 million. This compares to a total CAPEX allowance of £8.6 million¹⁹ for both the building extension/refurbishment and IT CAPEX provided for in the current 2010 – 2015 price control.
156. It should be noted SONI's expenditure within 2010 - 2015 has exceeded the CAPEX allowance by £1.7 million (19%) with total projected expenditure of £10.3 million. Further details on the proposed treatment of this overspend and the impact on the depreciation charge is included in paragraph 175 of this chapter.
157. The Business Plan Information Requirement issued to SONI required a business case for each category of CAPEX together with the expected benefit and justification of the proposed allowance. The SONI CAPEX submission was limited in this regard.
158. SONI argue this detail requested was difficult as the exact CAPEX needs for the next 5 years are not fully know given the level of change which can occur within a 5 year period, particularly within IT.
159. Table 16 below summarises the CAPEX submission by SONI for the next 5

¹⁹ Indexed to March 2014 prices

years to 2020. A detailed breakdown is provided in Appendix 1.

Capital Expenditure Summary			SONI Submission £'000
Item			Total
1	IS Infrastructure		1,262
2	Corporate Systems		987
3	Energy Management Systems-All Island Operations		2,475
4	EDIL/RCUC/AMP		1,201
5	TUoS/Settlement/Metering		757
6	Big Data/Data Mining		475
7	DS3/Smart Grids		1,292
8	Operation Changes - Network Codes		202
9	Concrete Repair		194
10	Facilities Improvements		280
Total			9,123

Table 16: SONI CAPEX Submission 2015 – 2020

6.2 Utility Regulator Assessment of SONI CAPEX Submission

6.2.1 EirGrid's IS Strategy

160. When translating this strategy into costs the Utility Regulator has considered supporting business critical and other costs which are deemed appropriate and reasonable for operating the transmission system. The Utility Regulator has carried reviewed SONI's CAPEX submission and proposes a reduction to that submitted by SONI. A summary of the proposal is below in Table 17.

Capital Expenditure Summary		SONI Submission £'000	UR's Proposals £'000	% Reduction
Item		Total	Total	
1	IS Infrastructure	1,262	1,135	10%
2	Corporate Systems	987	889	10%
3	Energy Management Systems-All Island Operations	2,475	2,227	10%
4	EDIL/RCUC/AMP	1,201	1,081	10%
5	TUoS/Settlement/Metering	757	681	10%
6	Big Data/Data Mining	475	427	10%
7	DS3/Smart Grids	1,292	0	100%
8	Operation Changes - Network Codes	202	181	10%
9	Concrete Repair	194	0	100%
10	Facilities Improvements	280	0	100%
Total		9,123	6,622	27%

Table 17: SONI Proposed CAPEX 2015 – 2020 Compared to Utility Regulator Proposals

161. It is accepted that the costs submitted are provisional, as the procurement process has yet to be carried out. The projects appear to be well provided for with high level estimates, which in some cases are discretionary. This explains the rationale behind a general 10% reduction.
162. The SONI cost submissions seem to be well provided for. Many of the costs lines seem to be based on empirical information while others are provisional sums based on assumptions. In relation to the provisional sums the requirements are presently not adequately defined for an accurate estimate to be determined. For an ex ante allowance SONI appear to include contingency provisions based on worst case scenarios to ameliorate the risk of getting it wrong. In this regard SONI seems to have taken a risk adverse approach.
163. The Energy Management System (EMS) is the most business critical system for SONI. EirGrid's verbal depiction of SONI's control room strategy including the new EMS system, presently being commissioned, seems to provide benefits for customers in both jurisdictions. Having the ability to seamlessly transfer operational responsibilities to the other control centre, in times of distress, provides a higher level of resilience than transferring resources to an (unmanned) disaster recovery centre.
164. EirGrid are apportioning the costs of the new EMS system on a 50:50 basis between EirGrid and SONI. The cost of all shared projects should result in an overall reduction for SONI when compared with an equivalent standalone project. It could be argued that as SONI would normally require a smaller system, for Northern Ireland in isolation, and paying 50% of a larger system for both locations could be construed as inequitable. However to provide control room support for Ireland (along with the counterfactual) is in the interests of both Ireland and Northern Ireland customers to have systems with equal capabilities. Therefore the Utility Regulator is proposing £2.2 million to support necessary upgrades to the new EMS system throughout 2015 – 2020.
165. Northern Ireland and Ireland have world leading and demanding targets for the production of renewable energy. Managing the stability of the system with large amounts of non-synchronous electricity production brings with it new challenges and issues. These challenges are compounded by the lack of support from other jurisdictions as both interconnectors to Scotland and Wales are Direct Current (DC) and provide little real primary response capability. SONI have proposed many new items of investment that are intended to directly, or indirectly, support addressing this challenge. These budgets propose higher levels of IT spend to develop techniques that can control this changing generation mix alongside the optimum level of ancillary services.
166. From discussions with SONI, some budget projections will cover SONI's present aspirations but it is not clear how this expenditure will interface with DS3 budgets. The Utility Regulator proposes to defer including a provision for this specific DS3 allowance within the Draft Determination. However, there is clearly a direct correlation between the 40% renewable target by 2020 and the DS3 project.

Further work is needed within this price control process in terms of how this price control will interact with the DS3 workstream.

167. In respect of Corporate Systems there are some new costs which appear to be discretionary and it is not clear if EirGrid group has a positive business case as insufficient discrete cost savings have been identified in the submission.
168. The Utility Regulator proposes to scale down the IT CAPEX allowances by 10% with the DS3 allowance currently being proposed for deferral. In summary the rationale for the 10% reduction is due to prudent estimates which are well provided for and in some cases discretionary. Therefore the Utility Regulator is proposing to provide a CAPEX allowance of £6.6 million, which relates to IT, representing almost £2 million more (in real terms) than the IT CAPEX provided for the five year period 2010 – 2015.

6.3 Facilities CAPEX

6.3.1 Concrete Repair £194,000

169. This is the repair to the façade of the original 1970 building, where concrete carbonation is causing the gradual destruction of the outside of the building. Within the 2010 – 2015 price control submission SONI identified the carbonation of concrete and steel carbonation as major issues at that time.
170. Following a feasibility study and cost assessment carried out in 2011 on behalf of the Utility Regulator, SONI were provided with the full allowance sought for building works which included remedial work and re-cladding to the existing concrete façade.
171. SONI were allowed a building extension and refurbishment allowance of £3m within the 2010 -2015 but have chosen to defer this work. The Utility Regulator is minded not to allow this amount of £194,000.

6.3.2 Facilities Improvements £280,000

172. SONI have requested CAPEX for a range of facility improvements, however insufficient business cases or justification was received. Given SONI have just completed, in 2014, extending and refurbishing their existing building the Utility Regulator will require strong justification for this request.
173. As insufficient justification has been provided and the Utility Regulator is minded not to allow this request for £280,000. Again there was an expectation that the £3m building allowance was provided for the long term facility requirement so it is surprising that general facilities improvements are needed.

6.4 Overview of current 2010 – 2015 Price Control Expenditure

174. Table 18 below summarises the capital expenditure allowances provided to SONI upon which the annual depreciation charge is calculated.

Table 18: SONI CAPEX 2010 – 2015 Allowance and Actual Spend Comparison (April 2014 prices)

	Building	EMS	IT & Comms	Other CAPEX	Total
UR 2010 - 2015 Decision Paper	3.0	1.4	4.1	0.2	8.6
SONI Actual Spend	3.4	3.4	3.4	0.2	10.3
Underspend/(Overspend)	(0.4)	(2.0)	0.8	0.0	(1.7)

175. SONI have overspent by £1.7m on the overall CAPEX allowance within the current price control. This overspend relates to the building extension and refurbishment together with business critical EMS system. The overspend on the EMS system is approx £2m. SONI implemented a new EMS system in 2010 and requested and subsequently were provided with upgrade allowances throughout the 5 year period. Instead SONI have chosen not to upgrade the system but commission a new EMS system which harmonises with the replacement EMS system within EirGrid.

176. The Utility Regulator does not dispute the need for a new EMS system, with further additional functionality to manage additional renewable generation on the system over the next 5 years. However the Utility Regulator does have difficulty with the timing of this project, which is due to be commissioned September 2015, within the current price control.

177. Consumers are continuing to pay for the 2010 EMS system and various wind productivity tools via the depreciation charge through to 2018 and in some cases beyond. Therefore consumers are continuing to pay for a system which has been made redundant and SONI have assumed in their depreciation submission for 2015 – 2020 the consumer will also pay for the new 2015 EMS system in full. SONI committed to overspending on the CAPEX allowance without the need and justification with the Utility Regulator but with the expectation that consumers would fund the overspend.

178. The principles set out in the 2010 – 2015 SONI Price Control Decision Paper is repeated below:-

“As the Utility Regulator has decided to approve allowances for both Capex and Opex, the Utility Regulator gives SONI autonomy to allocate the allowances for each category of Opex and Capex in the most efficient manner according to their business requirements. Efficiency gains can be retained by SONI and any over expenditure would conversely have to be absorbed by SONI.”

179. It appears SONI’s proposals contradict the decision paper principle and

haven't been consistent with the approach outlined in the 2010-2015 price control decision paper.

6.5 Regulatory Approach to Monitoring the Delivery of CAPEX Items

180. The Utility Regulator intends to introduce a new format of detailed regulatory cost reporting during the price control.

181. In preparation for the introduction of this the Utility Regulator are proposing SONI maintain appropriate records to facilitate the actual spend allocated to the relevant CAPEX allowance provided from 1 October 2015.

182. This will facilitate transparency of business need throughout each year of the 2015 – 2020 price control.

7 Financeability

184. SONI's revenue is comprised of five main components: pass through costs, OPEX, a depreciation allowance, a market return estimated as $RAB * WACC$ and a k factor correction mechanism.
185. SONI must be appropriately financed to fulfil its regulatory activities over the price control period and in doing this the Utility Regulator must protect the interests of current and future customers.

7.1 SONI Submission on Financeability

186. SONI consider it is unable to adequately finance its functions under the current regulatory regime for the following reasons:
- A. As a Transmission System Operator- not the Owner; it is considered 'asset light.'
 - B. That the use of financial metrics, typically used for traditional utilities, to test the ability of the regulated business to maintain investment grade ratings and raise debt effectively is inappropriate.
 - C. It is not remunerated for the costs and/ or risks associated with deploying capital.
 - D. It requires 'significant unremunerated standby or contingent capital greater than its remunerated RAB base.'
 - E. SONI consider it has a high level of 'operational gearing' due to the value of physical assets being very low relative to turnover and operating costs.
 - F. That the value of intangible business assets is not specifically recognised.
 - G. That an assessment of financeability should encompass: tangibles, intangibles, contingent and working capital.
 - H. SONI consider that there are risks should it be unable to access capital from the markets including its inability to deliver I-SEM, DS3 and delivery of European Network Codes requirements.
187. SONI consider that their current regulatory framework using WACC applied to the RAB a means of obtaining returns is 'unfinanceable going forward' and does not recognise the value of intangible assets within the business.
188. They have proposed the introduction of a new framework with the following characteristics:
- A. Incorporates appropriate working and contingency capital allowances (debt and equity).
 - B. Maintains WACC* RAB return to remunerate capital (tangible) investments.
 - C. Establishes a margin to remunerate operational risk and capital (intangible) investment.
 - D. Implements an incentives regime (potential for additional returns in return for value-add).
189. SONI's consultants, KPMG provided these conclusions following their

financeability review:

- A. The current regulatory regime is neither fit for purpose nor financeable.
- B. A strong credit rating was necessary.
- C. SONI should target financial metrics consistent with a strong credit rating, including an EBIT of 10-12%.
- D. The cost of working and contingent capital should be remunerated.
- E. The unstable and 'somewhat unpredictable cashflow profiles combined with a small balance sheet mean that SONI would not be able to access debt capital markets and could not fund new investments at the notional gearing level assumed.'

7.2 Financeability during the 2010-2015 Period

190. Table 19 below summarises SONI's operating profit (before interest and tax) reported within their regulatory accounts

Table 19: 2010 – 2013 SONI TSO Profitability

SONI TSO Profitability Summary			
	2010/11	2011/12	2012/13
	£'000	£'000	£'000
Operating Profit (EBIT)	5,777	5,588	4,944
Operating Profit (EBIT) Margin	10%	9%	5%

* Source: Regulatory Accounts

191. As a result of further engagement with SONI they have outlined the following key sources from which their profits (before interest and tax) are derived:

- Regulated returns on the Regulatory Asset Base associated with tangibles;
- The difference in regulatory and statutory depreciation – this comprises two parts (i) differences in the timing of the return of capital invested; and (ii) an element of the return on tangible RAB to deal with nominalisation
- Savings/ efficiencies made on opex under the revenue cap.

192. The contribution of the various factors in the 2010-2015 period are shown in the table below.

Table 20: SONI's Assessment of Financial Contribution in 2010-2015 Period

Element	Financial Contribution in the 2010 - 2015 Price Control
WACC return on tangible RAB	£4.5m
Difference in regulatory and statutory depreciation	£9.1m
Savings/efficiencies under the revenue cap	£7.4m
Payments/penalties for regulatory incentives	Nil

Source: SONI

193. SONI comment that a number of the factors which contributed to SONI profitability, and therefore financeability, in the 2010-2015 period are not expected to be repeated for the forthcoming period, thereby giving rise to the need to address the financeability challenge if the associated public policy objectives are to be met.

7.3 Financeability over the 2015-2020 Period

194. In SONI's view, the regulatory revenue model (effectively the building blocks which make up the price control framework) is no longer fit for purpose and will not leave SONI financeable.
195. SONI consider that during the 2015-20 period they will be facing financeability issues as it will need to access market debt to fund tangible assets (e.g. I-SEM, DS3), and it will require funding to bring forward early stage network project expenditure.
196. SONI also state that they consider its working capital risk will increase and its operational gearing is over twice the 2010 level.
197. They also comment that they would like to pay equity dividends, providing it has performed adequately and managed its business efficiently.
198. SONI have requested the introduction of a range of new cost lines under the umbrella of financeability. These are margin, remuneration for intangible assets, contingent capital, and working capital.
199. The Utility Regulator has given consideration to each of the above financeability areas detailed in SONI's submission. This draft determination reflects analysis based on SONI's submissions which will continue to be assessed for the final determination.

7.4 Working Capital

200. Working capital is critical to any company and SONI have provided examples of when SONI may require additional working capital facilities. These include a shortfall in TUoS revenues due to actual demand levels being lower than the assumption made in tariffs; shortfall in Dt expenditure for which the k-factor process may take more than two years; increased pass-through costs; bad debt from a SONI customer; and liabilities falling due to creditors.
201. SONI manage their working capital needs in a number of ways including temporary intercompany loan funding provided to SONI Ltd from EirGrid plc. This is typically repaid by SONI Ltd to EirGrid plc. within a very short timeframe.
202. The regulatory balance sheet for SONI's system operator business provides some information about working capital and its sources. For the three most recent years for which data was provided (2010 – 2013) the following conclusions have been drawn by the Utility Regulator:
- A. A large proportion of SONI's working capital was met through trade sources, not investors.
 - B. The K factor position was the main determinant of the working capital provided by investors in the system operator business.
 - C. In the absence of a K factor under-recovery, the balance sheet working capital requirement was less than £2 million in the two most recent years for which data has been provided.
203. Based on the assessment of the information provided it is clear the K factor position is a key driver of the working capital requirement of the business.
204. Currently SONI is remunerated for working capital through the K factor adjustment for interest equivalent to the Danske Bank base rate (currently 0.5 per cent). In light of the analysis carried out, the Utility Regulator is proposing to provide within the K factor an allowance for under-recoveries to attract an interest rate set to one-year LIBOR plus 2 per cent. K factor is explained in further detail in section 11.
205. This reflects that the relevant cost of debt will be relatively low as it is short term borrowing with a high probability of repayment (as SONI is very likely to be able to recover amounts allowed for through the K factor).
206. The above proposal avoids the situation where consumers are being asked to pay to finance an amount of working capital at all times whether or not it is used and therefore the proposed approach represents better value for money for the customer.

7.5 Margin

207. This section discusses the Utility Regulator’s assessment of the applicability and the level of a regulatory return in the form of a margin. This is in addition to the return in the form of a WACC, as was submitted by SONI in its Price Control submission.

7.5.1 SONI Submission on Margin

208. SONI considered the Price Control should provide an amount of allowed profit (£13m over 5 year period) expressed as a margin on turnover or on Earnings Before Interest and Tax (EBIT).

209. They consider this would represent remuneration for the value of the physical assets employed in the business for the following reasons:

- A. That SONI is an ‘asset light’ business with a high intangible asset value.
- B. That the value of physical assets is low relative to both its turnover and the economic value of its work for the electricity industry. In view of this, they consider it more appropriate to utilise a margin rather than a rate of return on capital.
- C. That the financial risks inherent in its business mean SONI requires amounts of working capital over and above the RAB, which add significantly to capital employed in the business.
- D. That SONI should target an EBIT of 10-12% for credit rating requirements- which they consider equivalent to around 2.5% of total turnover, as a suitable margin. They consider this level would be required in order to obtain the required credit rating level.

7.5.2 The Utility Regulator Proposal on Margin

210. The Utility Regulator has considered the appropriateness of introducing a margin in addition to the WACC*RAB approach. In considering a margin, the Utility Regulator views it as being simply a method available for addressing financeability based on overall need and does not view a margin as a regulatory principle.

211. SONI mention in their submission they have ‘made considerable profits under the revenue cap’ mechanism. In relation to the SONI TSO licence activity SONI have reported operating profits outlined in Table 21 below.

Table 21: 2010-2013 SONI TSO Profitability

SONI TSO Profitability Summary			
	2010/11	2011/12	2012/13
	£'000	£'000	£'000
Operating Profit (EBIT)	5,777	5,588	4,944
Operating Profit (EBIT) Margin	10%	9%	5%

* Source: Regulatory Accounts

212. Based upon recent historical data the current revenue cap and WACC*RAB approach has provided SONI with a sufficient and appropriate regulatory framework from which they have benefited from an operating profit margin. However SONI argue this regulatory framework is no longer fit for purpose going forward.
213. SONI have cited the Power NI price control as a comparative for which a margin is provided as part of the overall regulatory framework.
214. Emphasis was made in SONI's submission to the Power NI business. This comparison specific related to Power NI's current price control decision which includes an allowed margin. A specific evaluation was carried out to consider if Power NI was a reasonable comparator to SONI.
215. SONI operates the system as a monopoly whereas Power NI is an incumbent supplier within an increasingly competitive market. Therefore given the different risk profiles the Utility Regulator does not think this comparison with Power NI and SONI's conclusions from it are valid.
216. The Utility Regulator therefore proposes not to introduce an additional margin for SONI as it does not appear to represent value for money for consumers. The evidence is insufficient to draw any justifiable conclusions and therefore, as mentioned above in the working capital section 7.4, the Utility Regulator does not see the need for the requirement of a margin.

7.6 Intangible Assets

217. In SONI's view they have significant intangible assets which are their people and their significant knowledge and expertise, i.e. high human and intellectual capital. SONI further explain that these assets form a major element in the ability of the business to carry out its regulatory obligations in the same way that physical assets contribute to traditional utilities or Transmission Asset Owner's. Traditional utilities receive regulated remuneration for their large tangible asset base where as SONI receives no remuneration for its large intangible asset base.
218. The Utility Regulator has considered the need to remunerate SONI for intangible assets and the assessment is summarised below. The Utility Regulator recognises that SONI has intangible assets which have been generated internally through its staff knowhow, its business processes and so on. Whilst SONI does not show these assets on its balance sheet, there is acceptance that they never the less have an economic significance.
219. In the Utility Regulator's view SONI is likely to have acquired such intangible assets in the form of
- purchasing them from external sources e.g. staff training programmes;
 - creating intangibles from internal resources e.g. in house staff training;
 - recruiting and employing staff who come with relevant knowledge or skills.

220. Investments in tangible or intangible assets would only qualify for remuneration under the price control insofar as they represent investment by SONI's owners and funders, rather than an accumulation of value from amounts previously allowed as operating costs or RAB additions through past price controls.
221. Human and intellectual capital, whether internally generated or purchased, whether capitalised or not, would be expected to have been covered by ordinary price control allowances. SONI has not told us about any extra-ordinary items for which this expectation would be inappropriate.
222. The Utility Regulator does therefore not proposing a remuneration for this requirement within SONI's submission.

7.7 Contingent Capital

223. SONI consider allowances are required to cover timing differences between receipts and payments. Therefore SONI Ltd has reviewed their funding requirements and have put in place Revolving Credit Facilities of £12 million for unbudgeted constraint payments. In addition EirGrid plc has provided 'maximum aggregate financial support' in the form of a £10 million Parent Company Guarantee for SONI Ltd to have adequate financial and non-financial resources to perform its obligations in accordance with the requirements of both SONI's system operator and market operator licences.
224. SONI are seeking remuneration of 6.27% on the total value of £22 million for these facilities. This equates to £6.9m for the 5 years (£1.38m per annum).
225. The approach taken by the Utility Regulator was to assess the need, specifically in relation to the SONI system operator business, for this contingent capital together with consideration for the responsibility of the Single Electricity Market (SEM) constraint payments and related decisions taken by the SEM Committee in relation to the market operator business.
226. In arriving at the proposed position the Utility Regulator has taken the view that the volatility of the constraints payments is the responsibility of the market operator business (SEMO) for which there is a separate regulatory price control in place. The basis for this assumption is the current SEMO price control²⁰ provides for the following provisions:
- Parent Company Guarantee £10 million: *"This amount has been determined based on an assessment of the fair value of the requirement to have in place the Parent Company Guarantee and the likely cost of procuring such a facility for contingent capital."*

²⁰ SEMO 2013 – 2016 Price Control Decision Paper

http://www.allislandproject.org/en/smo_decision_documents.aspx?article=4b8da800-e911-48bb-8a14-a54137f9c287

- Timing differences resulting in an under recovery of costs, including constraint costs, are captured within the SEMO k factor correction mechanism. Should SEMO require funding from either EirGrid TSO or SONI TSO in the interim, interest on this funding is also provided for through the SEMO k factor.
227. Within the SEMO price control the SEM Committee also commented that they *“acknowledge the licence requirement for contingent capital and have decided to remunerate SEMO a fair value for this, having been assured that neither EirGrid nor SONI are remunerated for such a provision in their respective price controls.”*
228. As indicated within the introduction of this paper SONI Ltd holds two licences and has two separate price controls. Required elements of one price control should not be captured within the submission of a separate price control.
229. Following an overall assessment of SONI system operator’s capital requirements the Utility Regulator is of the view that the facilities that SONI Ltd have in place are for the benefit of the SONI market operator business and that the market operator price control provides some remuneration for them. There would be a risk of double counting if the SONI price control was to take account of these facilities without a clear identification of the part, if any, which is for the benefit of the system operator business.

7.8 Other Aspects

230. SONI wishes to pay EirGrid dividends in the 2015 – 2020 price control period should SONI perform adequately in the future. In SONI’s view they have unremunerated retained earnings on its own balance sheet however SONI has not paid a dividend since its acquisition by EirGrid in 2009 despite having made considerable profits under the revenue cap and indeed is prohibited from doing so under Licence where it might cause it to be in breach of its obligation, including that of having available adequate resources.
231. Within SONI’s current licence there are specific criteria and restrictions in place before SONI can declare a dividend including assurances that SONI have sufficient financial resources available for the coming year. Over the past few years, whilst SONI has not paid dividends, it has been returning capital by reducing debt, and consequently it has reduced the amounts that it holds as current assets less current liabilities. As of 30 September 2013, all of SONI’s current assets were financed from current liabilities rather than by equity or long-term debt.
232. While it is recognised SONI have a pivotal part to play in the electricity industry, the Utility Regulator views any resulting value add as having no bearing on the price control or the profits allowed as the price control is designed to allow the reasonable costs of running the efficient business.
233. Within section 7.2 above SONI identified they have not received any financial

payment (or paid any financial penalty) in respect of regulatory incentives during the 2010 – 2015 price control. While this is true, it only reflects the position up to year ended 30 September 2013. In respect of the two years remaining (2014 and 2015) SONI have the potential to achieve a cumulative total of c£1million as an incentive payment should they manage constraints to be lower than forecast to the extent set out in the incentive mechanism.

234. Since the 2010 -2015 price control decision the SEM committee has introduced a sizeable incentive mechanism in terms of reduced constraint costs effective from 2012/13 which has the potential to provide c£0.5m of an annual incentive payment to SONI. Furthermore, SONI have made a healthy profit margin within the current regulatory framework.

235. In terms of providing SONI with a suitable return which takes account of their risks SONI have cited a First Economics²¹ paper which was commissioned by the Utility Regulator for the NIE price control.

‘the sensitivity of profit to out-/under-performance against the networks’ price control assumptions. In particular, it is now widely acknowledged in regulation that companies which have small RABs in comparison to ongoing revenues present shareholders with much greater risk than companies which have large RABs in comparison to ongoing revenues.’

The report continues;

‘the variability in out-turn profits is not just a function of the likelihood and scale of cost and demand shocks, but also the upfront margin that is factored into allowed revenues. Holding all other things equal, shareholders in a regulated company with a small RAB/profit relative to ongoing costs are likely to suffer proportionately more when downside shocks occur (and gain more following upside events) in comparison to shareholders in firms whose RABs/profits are large relative to ongoing costs. This volatility in profits makes companies with high ‘operational gearing’ more risky in the eyes of shareholders causing them to demand higher upfront returns.’

However when this report is read in full the regulatory company comparison observes that ‘SONI’s relatively small RAB explains their high cost of capital’. Indeed First Economics carried out an analysis of SONI’s WACC within the 2010-2015 price control. After considering SONI’s arguments, First Economics concluded that the WACC approach, sufficiently captured SONI’s higher operational gearing risk, and remained appropriate for SONI to finance their activities.

7.9 Applicability of WACC * RAB

236. The Utility Regulator considers the WACC*RAB approach to remain appropriate for SONI as it can ensure that the interests of consumers are protected together with the

²¹ First Economics “An Estimate of NIE T&D’s Costs of Capital” December 2011

regulated business being financed and their investors are not unfairly treated.

237. To ensure the WACC*RAB approach provides an appropriate return the RAB must represent a reasonable measure of the economic value of assets used in the business, limiting expected profits to a reasonable return on the RAB ensuring that the regulated company's prices do not exceed the price that would be expected to be charged in a competitive or contestable market for a comparable service as that provided by the regulated business.
238. Furthermore, provided that the RAB represents a reasonable measure of the capital contribution that investors (both equity and debt) have made to the business, limited expected profits to a reasonable return on the RAB ensures that, in expectation value, customers will receive value for money from the arrangements put in place by the regulatory system to allow capital to be raised for the regulated business.

7.10 Impact on Financial Ratios

239. The results shown below in Table 22 and Table 23 show the results from preliminary financial modelling using the proposed cost of capital assumptions and the proposed Utility Regulator decisions on the operation of the price control.

Table 22: Modelled financial ratios (2010/11 to 2014/15)

	2010/11	2011/12	2012/13	2013/14	2014/15
Profit Margin (EBIT/revenue)	9.65%	7.18%	5.78%	4.69%	2.15%
Return on equity (Profit after interest costs/Equity)	N.A	722%	126%	59%	22%
Gearing (Debt/RAB)	80%	56%	34%	23%	7%
Net gearing ((Debt minus cash)/RAB)	81%	83%	0%	22%	-29%
Operational gearing ratio 1: (RAB/Total expenditure)	0.34	0.27	0.21	0.15	0.12
Operational gearing ratio 2: (5 year CAPEX/RAB)	0.38	0.34	0.29	0.41	0.50
Notional interest cover ratio (based on 55% gearing) (EBIT/Notional interest)	6.36	7.35	8.12	9.71	4.76
Notional interest cover ratio (based on 55% gearing) (EBITDA/Notional interest)	8.13	9.80	11.35	13.81	15.03

Table 23: Modelled financial ratios (2015/16 to 2019/20)

	2015/16	2016/17	2017/18	2018/19	2019/20
Profit Margin (EBIT/revenue)	0.35%	0.26%	0.24%	0.23%	0.23%
Return on equity (Profit after interest costs/Equity)	4%	3%	3%	3%	3%
Gearing (Debt/RAB)	No debt	No debt	No debt	No debt	No debt
Net gearing ((Debt minus cash)/RAB)	-84%	-124%	-149%	-163%	-157%
Operational gearing ratio 1: (RAB/Total expenditure)	0.07	0.05	0.05	0.05	0.05
Operational gearing ratio 2: (5 year CAPEX/RAB)	0.89	1.15	1.28	1.51	1.64
Notional interest cover ratio (based on 55% gearing) (EBIT/Notional interest)	1.37	1.37	1.37	1.37	1.37
Notional interest cover ratio (based on 55% gearing) (EBITDA/Notional interest)	17.00	10.40	9.15	9.24	8.79

240. The draft financial model assumes that no dividends are paid out, leading to the repayment of all debt and the accumulation of cash. This explains the low forecast return on equity of around 3 per cent. This is lower than the allowed cost of equity because that allowed cost of equity is for a notional gearing of 55 per cent.
241. The operational gearing ratios indicate that the system operator business might have higher operational gearing in the future than in the past. The apparent operational gearing is much higher than for infrastructure utilities. This might not be compatible with the assumed level of gearing. The allowed rate of return on capital does and will continue to be higher in order to reflect operational gearing.
242. The EBIT ratios calculated in the draft financial model assume that accounting depreciation will mirror RAB depreciation. As a result, they are not improved by the acceleration of depreciation on the non-building RAB. In reality, accounting depreciation could be lower than RAB depreciation, which would improve the EBIT ratios.
243. The EBITDA interest cover ratio does not depend on accounting depreciation, and is improved by the acceleration of depreciation on the non-building RAB. The resulting level is relatively high, even on the assumption that 55 per cent of the capital is in the form of debt. It is unlikely that the EBITDA interest cover ratio would

be the main constraint on debt financeability.

244. The financial model and the above financial ratios are preliminary and currently do not reflect pre-construction assets given the discussions that will take place over the coming weeks between SONI, NIE and the Utility Regulator in terms of the treatment and adjustments necessary regarding the costs. The financial model and subsequent financial ratios will continue to be revised over the coming weeks in preparation for the final determination.

7.11 Summary

245. In terms of working capital the Utility Regulator proposes to increase the K factor provisions to allow a higher rate of interest of one-year LIBOR plus 2 per cent (currently Danske Bank base rate, (0.5 per cent)) to be recovered by SONI in cases where an under-recovery has occurred. This should protect consumers as they will only pay for the reasonable financing costs of such an under-recovery, but only when an under-recovery has actually occurred.
246. Overall, the Utility Regulator has found insufficient basis for allowing any additional return, whether in the form of additional capital over and above the RAB, or in the form of a margin, for any working capital, contingent capital or intangible capital. The Utility Regulator does not think that these are necessary or that it would represent value for money for customers.
247. Following a consideration of SONI's submission and other relevant factors, the Utility Regulator proposes to continue to apply the regulatory mechanism of WACC * RAB to remunerate the business for cost of capital employed.

7.13 Weighted Average Cost of Capital (WACC)

7.13.1 Introduction to WACC

248. This section gives consideration of SONI's submission and the Utility Regulator's assessment of the appropriate level of WACC to apply. The Utility Regulator, in carrying out this assessment has given regard to the current and future potential activities that SONI will require resource to enable it to fulfil its duties within this price control.

249. UK regulators generally use base estimates of the WACC on a traditional capital structure comprising a substantial amount of investment grade corporate debt and a substantial amount of equity notionally raised on a public stock market. The WACC is intended to reflect the regulated company's expected cost of capital employed.

250. In setting price limits the Utility Regulator will consider the appropriate WACC that SONI should earn on its Regulated Asset Base (RAB). As prices and RAB are adjusted by outturn inflation, the real cost of capital is relevant.

251. The weighted average cost of capital (WACC) is the weighted average of two components: the cost of equity (R_e); and the cost of debt (R_d), where the weighting represent the proportions of debt and equity in a firm's capital structure.

252. The WACC is calculated using the following formula:

$$\text{WACC (Vanilla)} = g \times R_d + R_e (1 - g)$$

g is gearing

R_d is cost of debt

R_e is cost of equity

253. The Utility Regulator has monitored regulatory decisions and has considered the cost of equity in greater detail. The Capital Assets Pricing Model (CAPM) was used to calculate the cost of equity. This method relates the cost of equity to the risk-free rate (R_f), the expected return on the market portfolio (R_m) and a business specific measure of investors' exposure to systematic risk (Beta or β) using this formula:

$$R_e = R_f + (R_m - R_f) \times \beta$$

7.13.2 SONI's Submission on WACC

254. SONI engaged consultants KPMG to provide an assessment of the Weighted Average Cost of Capital to apply to SONI which is summarised in the following table:

Table 24: SONI WACC Submission for 2015-2020

Components of the Proposed Rate of Return	SONI's WACC submission 2015-2020
Cost of debt	3.20%
Cost of equity	6.50%
Gearing	55%
WACC (Vanilla)	4.69%
WACC (Pre tax)	5.42%
Components of the Cost of Equity:	
Risk-free rate	1.50%
Asset beta	0.45
Equity beta	1.00
Equity risk premium	5.00%
Cost of equity	6.50%
Components of the Cost of Debt:	
Risk free rate	1.50%
Debt Premium	1.50%
Issuance costs	0.20%
Cost of debt	3.20%

255. KPMG suggest that an atypical capital structure may be appropriate in SONI's circumstances for the following reasons:

- A. SONI's physical investment in tangible assets (remunerated through the WACC applied to RAB) is modest by comparison with the level of intangible assets (e.g. human and intellectual capital). The latter effectively financed by equity.
- B. No dividend has been paid by SONI since its acquisition by EirGrid in 2009.
- C. Capital raised by SONI consists of at least as much of contingent and working capital (currently not remunerated by the WACC) as it does of capital for investment in physical assets.
- D. In relation to tangible assets and physical investment (which are remunerated through the WACC), the investment profile is periodic, lumpy and largely driven by regulatory and public policy decisions.
- E. They consider that the WACC applied to the RAB approach cannot alone fully account for SONI's required return, given the company's risk and profile of activities. Therefore, WACC should form a part of a suite of building blocks of the appropriate total return.
- F. Another approach suggested is the intangible asset value is added to the RAB or alternatively the WACC is increased to 'address the gap.'

256. Overall, SONI are in favour of the WACC being applied to the 'physical' RAB and have proposed using a pre-tax WACC of 5.42% to provide a return on RAB (this is equivalent to a Vanilla WACC of 4.69%). SONI have applied a pre-tax WACC of 5.42% within their calculations. SONI comment they carry 'extreme levels of

operational gearing risk' for which the WACC should be only one aspect of the regulatory framework to address this.

7.13.3 SONI's Submission - Level of Gearing

257. KPMG propose a level of gearing of 55% with the following factors cited:
- A. The gearing as measured by gross debt at 2013 is 37% (borrowings of £5.57m compared to a RAB of £15m). If gearing as net debt (taking account of any cash) was applied this would result in a lower level of gearing.
 - B. Using a notional gearing assumption of 55% may result in a lower WACC than if SONI's actual gearing was used (assuming the Miller- Modigliani theorem would not apply and the optimal level of gearing would be at or above 55%).
 - C. In contrast, KPMG state that using a notional gearing assumption of 55% when estimating the regulatory WACC for SONI remains appropriate as it is applied to only one part of the asset base – i.e. the assets within the RAB.
 - D. KPMG state it would be inappropriate for the issues related to the presence of intangible assets and a higher overall capital employed, which might imply a higher overall required return to be addressed either through the gearing in the WACC or the WACC rate itself.
 - E. The 'unremunerated' contingent capital of £22m – comprising £12 m of a debt facility 'supported by £10m of equity' in the form of a parent company guarantee reflected 55% debt and 45% equity balance.
 - F. Assuming issues relating to intangible assets and a higher overall capital employed are addressed elsewhere, the conventional notional gearing estimate can be applied to SONI's WACC with a notional range of 45-55%.

7.13.4 SONI's Submission - Cost of Debt

258. SONI's submission in relation to cost of debt concluded:
- A. SONI does not hold any publicly traded bonds and its only debt finance is via bank loans.
 - B. KPMG considered the real risk-free rate to be 1-2% and they suggested a mid-point estimate of 1.5% plus an uplift of 20 base points as the assumed issuance costs to be added.
 - C. In addition KPMG propose the addition of a debt premium of 1.5% which produces a cost of debt of 3.2% above RPI (including issuance costs).

7.13.5 SONI's Submission - Cost of Equity

259. SONI's submission in relation to cost of equity concluded:
- A. KPMG assumed the same risk free rate that applied to the cost of debt assumptions- i.e. 1.5%. These assumptions translate to an assumed cost of equity of 6.5% above RPI- which they consider to be at the uppermost level of the Competition Commission range of 5 - 6.5%. This assumes an inferred equity risk premium of 5%.

- B. KPMG applied the estimated asset beta of 0.45 used in the previous SONI price control and assumed gearing of 55% to derive an equity beta of 1. In KPMG's opinion SONI's equity risk is assumed to be broadly equal to the overall market.
- C. Using a cost of equity of 6.5% (post-tax) and a corporate tax rate of 20%, the equivalent pre-tax cost of equity is estimated at 8.13%.

7.13.6 SONI's Submission - Taxation

260. KPMG have proposed adopting an allowance for corporation tax using a pre-tax WACC with 20% corporation tax rate assumed.

7.13.7 The Utility Regulator Proposal - Capital Structure

261. The Utility Regulator considers the capital actually employed in SONI's business predominantly corresponds to SONI's tangible assets. This capital is small relative to its tangible asset base.
262. For a UK based regulated utility, it is not unusual for an investment profile to be periodic, lumpy and largely driven by regulatory and public policy decisions.

7.13.8 Recent Cost of Capital Estimates

263. The following table shows the various estimates in recent UK price control decisions:

Table 25: Summary of regulator cost of capital estimates in 2014

	Asset base indexation	Gearing	Equity beta	Cost of debt	Cost of equity	Vanilla WACC net of RPI
BT Openreach*	None	32%	0.69	5.50%	7.95%	7.20%
BT WBA*	None	32%	1.17	6.00%	10.35%	9.00%
ED1 non-WPD	RPI	65%	0.9	2.60%	6.00%	3.80%
ED1 WPD	RPI	65%	0.9	2.60%	6.40%	3.90%
Gatwick	RPI	55%	1.13	3.20%	8.76%	5.70%
Heathrow	RPI	60%	1.1	3.20%	8.58%	5.40%
NERL	RPI	60%	1.11	2.50%	6.87%	4.20%
NI Water	RPI	50%	0.83	1.41%	5.65%	3.50%
NIE	RPI	45%	0.6–0.7	3.10%	3.4–5.0 %	4.10%
Water enhanced	RPI	65%	0.8	2.75%	5.65%	3.90%
Water other	RPI	65%	0.8	2.59%	5.65%	3.70%
Water uplifted	RPI	65%	0.8	2.84%	5.65%	3.90%

*A nominal cost of capital is used for the price control decisions related to BT; the Ofcom statement says that RPI was assumed to grow by 3.2 per cent a year.

7.13.9 The Utility Regulator Proposal - Gearing

264. KPMG proposed a gearing ratio of 55%. Additional commentary was provided on the assumptions in arriving at this level. The Utility Regulator differs in some areas with the reasoning of some of the assumptions and arguments. However overall, the Utility Regulator is content to adopt a notional gearing level of **55%**. This level of gearing also corresponds to the level of 55% adopted in the 2010-15 price control.

7.13.10 The Utility Regulator Proposal - Cost of Debt

265. KPMG proposed a cost of debt level of 3.2% above RPI. This including an allowance for issuance costs which is in line with what has been used in the recent NIE price control. This is higher than Ofgem's recent assumption of 2.6%²².

266. This 3.2%, above RPI, is calculated as the sum of:

- a) The spreads between yields on corporate debt issued by comparator companies and the yields on UK government gilts (1.5%)
- b) the real risk free rate (1.5%)
- c) an allowance for issuance costs (0.2%)

267. The Utility Regulator considers a cost of debt of **3.2%** to be broadly representative.

7.13.11 The Utility Regulator Proposal - Cost of Equity - Equity Beta and Asset Beta

268. A firm's equity beta, β_e is a measure of the riskiness of a firm and may be considered as a measure of the systematic risk that a company has, relative to the market portfolio. Typically company beta values would be obtained by measuring the correlation between movements in a company's share price and movements in the value of the stock market as a whole.

269. As SONI is not listed on the UK stock exchange, the next best alternative is to compare beta values for similar companies and make a judgment based on this comparison.

270. KPMG has applied an equity beta of 1 thereby assuming overall market return estimate. As SONI may be subject to higher operational gearing, than that assumed in the current 2010 -2015 price control, the Utility Regulator is therefore proposing to increase the equity beta from the current beta of 0.88 to a equity beta of 1.

²² <https://www.ofgem.gov.uk/press-releases/equity-market-return-consultation-reducing-cost-capital-electricity-distribution-companies>

271. An asset beta, β_a is a hypothetical measure of the beta that a firm would have if it had no debt and were financed entirely by equity. The asset beta is calculated using the following formula:

$$\beta_a = (1 - g) \beta_e + g \beta_d$$

β_a is a firm's asset beta,
g is gearing
 β_e is the equity beta
 β_d is the firm's debt beta

272. The Utility Regulator has considered comparator company analysis in order to determine an appropriate value for asset beta. This includes considering recent beta estimates made by regulators in the UK (Utility Regulator, Ofwat, Ofgem, CAA and Ofcom) and also relevant Competition Commission estimates of asset beta.

273. The Utility Regulator is broadly content with SONI/KPMG's representations on the level of asset Beta assuming the notional gearing (55%) and level of equity beta as being equal to the market risk level (1) to produce an overall asset beta of **0.45**.

7.13.12 The Utility Regulator Proposal - Risk-Free Rate and Equity Risk Premium

274. The Utility Regulator has drawn on evidence from recent market rates for risk-free and market returns. The Utility Regulator has reviewed the risk-free rate assumptions made in recent determinations by Ofgem (gas and electricity), Ofwat (BT), CAA (airports), and the Competition Commission determinations of NIE and Bristol Water. The range of risk-free rates analysed ranged from 0.5% to 2%.

275. The Competition Commission had a range for the risk-free rate in the NIE determination of 1% - 1.5%, with a point estimate of 1.5%. The Utility Regulator considers that a risk-free rate (R_f) of 1.5% is an appropriate benchmark.

276. Using the estimated parameters of the risk-free rate (1.5%) and the total market return of 6.5% the inferred Equity Risk Premium is 5.0%.

277. Overall, the Utility Regulator is content to use an overall cost of equity of **6.5%** above RPI.

7.13.13 The Utility Regulator Proposal - Taxation

278. KPMG suggest making an allowance for corporation tax by using a pre-tax WACC. This effectively amounts to making a tax allowance based on the statutory rate applied to the return on equity net of RPI.

279. The Utility Regulator will apply the Northern Ireland applicable corporation tax

rate which is currently at 20%. This is reflected within WACC calculations.

280. The Utility Regulator is considering changing to a Vanilla WACC which excludes any adjustment for tax. The Final Determination will provide further clarity on the treatment of tax should a Vanilla WACC be adopted.

7.13.14 Overall WACC Proposal

281. The Utility Regulator has also considered SONI's specific circumstances in setting an appropriate WACC level. As SONI have higher operational gearing than traditional utilities some components within the WACC are higher than those applied in other price controls. It is proposed to set the WACC at the pre-tax level of **5.42%**. This also aligns with SONI's submission.

282. This is similar to SONI's current WACC for 2014-15 of 5.44%. A comparison with the current WACC shows a reduced cost of debt reflecting a lower risk free rate and reflects the increase in the equity beta and equity risk premium. The proposed WACC continues to provide for the high operational gearing risk SONI is exposed to.

283. SONI's response to the 2010 – 2015 price control consultation paper²³ concluded that the WACC can only address so much in the SONI context and that the WACC must be supported by broader measures which support financeability across the model. SONI also commented that the WACC proposed in the 2010 – 2015 consultation paper is insufficient to support the cost of capital that will be faced by SONI over the forthcoming period.

284. The outturn within the past and current price controls support the proposal to continue with the current regulatory framework. The Utility Regulator cannot, at present, support changing the regulatory framework having proposed an increased equity beta of 1 and an increase in working capital and associated interest requirements.

²³ http://www.uregni.gov.uk/uploads/publications/SONI_WACC_response_paper_-_attachment.PDF

285. The Utility Regulator's summary of allowed WACC is shown in the table below:

Table 26: SONI WACC for 2015-2020 compared with Current 2010-2015 WACC

Components of the Proposed Rate of Return	Values 2010-2015 Decision	Values UR Propose 2015-2020
Cost of debt	3.50%	3.20%
Cost of equity	6.17%	6.50%
Gearing	55%	55%
WACC (Vanilla)	4.70%	4.69%
WACC (Pre tax)	5.44%	5.42%
Components of the Cost of Equity:		
Risk-free rate	2.00%	1.50%
Asset beta	0.45	0.45
Equity beta	0.88	1.00
Equity risk premium	4.75%	5.00%
Cost of equity	6.17%	6.50%
Components of the Cost of Debt:		
Risk free rate	2.00%	1.50%
Debt Premium	1.50%	1.50%
Issuance costs	Included within Debt Premium	0.20%
Cost of debt	3.50%	3.20%

8. Regulatory Asset Bases (RABs) and Depreciation

8.1 SONI Submission of RABs and Depreciation

286. SONI have two separate RABs, one relating to the building following the recent extension and refurbishment, the other relates to all remaining assets which are predominantly IT related.

8.2 The Non Building RAB

287. The Regulatory Asset Base (RAB) submitted by SONI has an opening RAB balance for 1 October 2015 of £7.837m. In arriving at this figure SONI took the 1 October 2010 opening RAB, added **actual cost** of additions, less the allowed depreciation and indexed this to April 2015 prices. It should be noted that overall SONI have overspent on their non building capital allowance in the current 2010 – 2015 price control to the value of £1.3m, therefore adding actual costs SONI are expecting to claim this overspend from consumers via the depreciation charge.

288. SONI have assumed a continuation of the eight year straight line depreciation policy put in place by the 2010 – 2015 current price control.

289. The Non Building RAB as submitted by SONI is summarised in Table 27 below.

Table 27: SONI Non-Building RAB Submission (April 2015 prices)

SONI Non-Building RAB Submission	2015/16 £'000	2016/17 £'000	2017/18 £'000	2018/19 £'000	2019/20 £'000	Total £'000
Opening RAB Value	7,837	6,682	6,869	7,177	7,419	
Additions	1,903	1,710	1,618	1,835	2,033	9,097
Depreciation 8 years SL	3,058	1,522	1,310	1,592	1,898	9,380
Closing RAB Value	6,682	6,869	7,177	7,419	7,554	

8.3 The Building RAB

290. A similar approach to the non-building RAB has been applied to the building RAB as actual costs have been included within additions. Therefore the £400k overspend is included in actual costs and SONI are expecting to claim this overspend from consumers via the depreciation charge.

291. SONI have assumed a continuation of the 25 year straight line depreciation

policy put in place by the 2010 – 2015 current price control.

292. The Building RAB as submitted by SONI is summarised in Table 28 below:

Table 28: SONI Building RAB Submission (April 2015 prices)

SONI Building RAB Submission	2015/16 £'000	2016/17 £'000	2017/18 £'000	2018/19 £'000	2019/20 £'000	Total £'000
Opening RAB Value	3,012	3,079	2,941	2,921	2,779	
Additions	200		119			319
Depreciation 25 years SL	133	137	140	142	142	694
Closing RAB Value	3,079	2,941	2,921	2,779	2,637	

8.4 The Utility Regulator Proposal for RAB and Depreciation

293. The Utility Regulator has adjusted SONI's submission from April 2015 to April 2014 prices for consistency with the overall price base for this price control paper.

294. Consideration has been given to the appropriateness of an eight year depreciation period for the Non-Building RAB. This following concerns that consumers continue to be funding assets for which SONI have made redundant e.g. 2010 EMS system and related EMS tools.

295. The assessment concludes that over a five year period most of the IT systems will be replaced or upgraded. SONI's CAPEX proposals indicate that this expected refresh cycle is built into their cost submission. Therefore the Utility Regulator proposes to depreciate all future IT CAPEX additions over a five year period and not the present eight year period.

296. No change is proposed to the 25 year straight line depreciation policy applied to the building RAB.

297. As mentioned in section 6.4 the Utility Regulator proposes to allow the continuation of the depreciation calculation based on the 2010 – 2015 CAPEX allowance provided thereby excluding any overspend during the 2010 – 2015 period.

298. When the above adjustments are applied the RABs being proposed by the Utility Regulator are demonstrated in the tables below for both the Non-Building RAB and the Building RAB.

UR Non-Building RAB Proposal	2015/16 £'000	2016/17 £'000	2017/18 £'000	2018/19 £'000	2019/20 £'000	Total £'000
Opening RAB Value	6,431	3,713	3,226	2,885	2,927	
Additions	1,365	1,264	1,003	1,327	1,664	6,622
Depreciation 5 years SL	4,083	1,750	1,344	1,285	1,236	9,698
Closing RAB Value	3,713	3,226	2,885	2,927	3,356	

Table 29: UR Proposed Non-Building RAB and Depreciation for 2015 – 2020

UR Building RAB Proposal	2015/16 £'000	2016/17 £'000	2017/18 £'000	2018/19 £'000	2019/20 £'000	Total £'000
Opening RAB Value	2,443	2,327	2,210	2,094	1,978	
Additions	-	-	-	-	-	-
Depreciation 25 years SL	116	116	116	116	116	582
Closing RAB Value	2,327	2,210	2,094	1,978	1,861	

Table 30: UR Proposed Building RAB and Depreciation for 2015 – 2020

299. When these RAB values are combined the opening RAB values at 1 October 2015 are proposed to be £8.9 million reducing to £5.2 million at the close of the price control period 30 September 2020.

300. While the I-SEM project is outside of the scope of this price control it is important to bear in mind SONI's Non – Building RAB is expected to increase further in 2017-18 once I-SEM is commissioned. This is expected to be factored into the financial modelling, in preparation for the Final Determination.

9. Rate of Return

301. This section discusses the proposed rate of return for SONI in this price control.

302. Based on the submitted RAB and CAPEX additions from SONI, together with their proposed pre-tax WACC of 5.42%, the rate of return requested from SONI is detailed in Table 31 below.

SONI WACC Return Submission	2015/16 £'000	2016/17 £'000	2017/18 £'000	2018/19 £'000	2019/20 £'000	Total £'000
Average Non-Building RAB	7,259	6,775	7,023	7,298	7,487	
Average Building RAB	3,046	3,010	2,931	2,850	2,708	
Total Average RAB Values	10,305	9,786	9,954	10,148	10,195	
Pre-tax WACC	5.42%	5.42%	5.42%	5.42%	5.42%	
Rate of Return	559	530	540	550	553	2,731

Table 31: SONI WACC Return Submission for 2015 – 2020

303. SONI's RAB was submitted in 2014/15 prices. The Utility Regulator's average RAB and WACC is applied to a RAB in April 2014 price bases in order to remain consistent with this price control paper.

304. Based on the adjusted RAB, CAPEX additions as proposed by the Utility Regulator, 5 year depreciation policy and the proposed pre-tax WACC of 5.42%, the rate of return proposed for SONI is detailed in Table 32 below.

UR WACC Return Proposal	2015/16 £'000	2016/17 £'000	2017/18 £'000	2018/19 £'000	2019/20 £'000	Total £'000
Average Non-Building RAB	5,072	3,469	3,056	2,906	3,141	
Average Building RAB	2,385	2,268	2,152	2,036	1,919	
Total Average RAB Values	7,457	5,738	5,208	4,942	5,061	
Pre-tax WACC	5.42%	5.42%	5.42%	5.42%	5.42%	
Rate of Return	404	311	282	268	274	1,538

Table 32: UR WACC Return Submission for 2015 – 2020

305. A pre-tax WACC has historically been used for SONI. The Utility Regulator is considering changing to a Vanilla WACC (proposed 4.69%) which excludes any adjustment for tax. The Final Determination will provide further clarity on the treatment of tax should a Vanilla WACC be adopted.

10. Incentives

306. This section discusses the proposed incentives submitted by SONI and the Utility Regulator's assessment of these costs.

10.1 SONI's Submission on Incentives

307. SONI provided an overview paper on incentives and the importance they should have in SONI's regulatory framework. SONI stated that their proposed incentives are designed to ensure customers in Northern Ireland continue to receive high quality supply and will also enable SONI to deliver further substantive savings to customers through its actions. SONI comment that they are an atypical utility business and are asset light with correspondingly limited underlying equity return on capital employed.

308. SONI's argued that it's "value add" arises from its core operational activities – technology solutions & knowledge networks/relationships and this should be incentivised. Furthermore SONI's direct costs represent less than 2% of the value chain, while having direct influence on 10-15% and varying influence on 50% plus.

309. SONI view the influence they have on the value chain needs to be unlocked and thus the focus of incentives must be on outputs and outcomes. SONI also state that the Regulator should introduce a workable incentives framework which does not compromise their ability to fund, develop, provide and receive appropriate returns.

310. SONI's submission considered that the application of longer-term incentives was appropriate, and stated that such an approach provides a portfolio of incentives balanced across all the lenses of the business including, *inter alia*,

- Cost management
- Balancing Costs
- Operational Performance
- Enhanced Network solutions
- Innovation

311. SONI commented on the typical operational performance incentives of System Minutes Lost (SML) and System Frequency and provided comments on an incentive for grid delivery and PCI projects.

312. SONI also requested a R&D Innovation fund in addition to and distinct from the financial incentive for delivering operational efficiencies. They propose a gain-sharing mechanism or finder's fee in respect of improvements where the TSO can clearly demonstrate that a policy, process or design improvement introduced by the business results in a quantifiable benefit to the electricity consumer. A number of areas were proposed that should fall within the scope of such incentives;

- Delivery of Enhanced System Coordination;
- Delivery of Enhanced System Operation;

- Delivery of Enhanced System Capacity.

313. An investment of £2.5m was requested specifically for innovation. This is to develop a new framework for performance incentives to ensure value adding outcomes in operation of the system and network delivery are committed to and delivered. The £2.5m submitted by SONI is to be developed through funded engagements with research institutions in Northern Ireland as well as part funding small scale technology trials over the review period.

10.2 The Utility Regulator Proposal on Incentives

314. In the past incentives were discussed to incentivise SONI to reduce constraints and system support (ancillary services) costs, as well as operational performance incentives of System Minutes Lost (SML) and System Frequency.

315. These incentives are more functional based, business as usual and are linked to impact of the SEM committee and the all-island market, as well as TSO incentives on an all-island basis.

316. With the implementation of the SEM on 1 November 2007, constraint costs were no longer recovered separately by EirGrid and SONI (TSOs) in the Republic of Ireland and Northern Ireland respectively. Instead an all-island levy, administered through the all-island SEMO (Single Electricity Market Operator) Imperfections Charge, was established to cover these costs.

317. Since 1 October 2012 the SEM Committee has put in place an incentive on the TSOs to manage Dispatch Balancing Costs (DBC) in an all-island context. This provides SONI with an incentive to operate Dispatch Balancing Costs within a baseline and to retain 10% of every 2.5% below the target and to be penalised 5% of every 2.5% above the target.

318. These payments and penalties are administered across both TSOs on a 75:25 split basis, upon ex-post review. Payments and penalties upon completion of the ex-post review are fed through to the annual TUoS revenue allowances in ROI and NI.

319. The Dispatch Balancing Costs incentive will continue and any changes to this will be approved through the SEM Committee.

320. The Utility Regulator engaged further with SONI regarding the £2.5m innovation fund. A Cost Benefit Analysis and risk allocation was requested for each project quantifying the benefit expected against this cost to consumers.

321. Insufficient detailed information was provided as to why this expenditure was likely to be in consumers' interests and how SONI proposed to spend the £2.5m R&D allowance. There has been insufficient evidence presented that this allowance of £2.5m would lead to lower charges for electricity consumers.

322. The Utility Regulator is proposing not to provide the additional investment fund for R&D that SONI have requested, as there is insufficient confidence that such allowance would be cost-effective for consumers.

323. Given the introduction of the sizeable financial incentive introduced by the SEM Committee (since the last price control was put in place), the reputational incentive SONI has within the Northern Ireland electricity industry and an obligation to take reasonable steps to ensure the system is operated in an economical and efficient manner, the Utility Regulator is of the view that further incentives are not necessary and is therefore not proposing any additional incentives for this price control period.

11. Uncertainty Mechanism (Dt) and K Factor

324. In the current 2010-20105 SONI price control it was recognised that the **D_{TSO}** term would be used to cover unforeseen items.
325. The Utility Regulator has proposed in this draft determination to remove some previous Dt requests's and incorporate them into the 2015-2020 price control as a price control cost such as the European TSO (ENTSOE) membership and tariffs, business rates and section 75 pension liability.
326. SONI are obliged to pay ENTSOE membership and tariffs annually. Given the Utility Regulator's desire to reduce recurring annual Dt requests a proposal of £600k per annum is being made for ENTSOE costs. This estimated allowance is based on historical information. Given the volatility of the annual payment it is proposed to treat ENTSOE costs as pass through with an adjustment for actual annual cost proposed within the K factor adjustments. Over the five year period this equates to £3m estimated allowance before any ex-post adjustments.
327. The Utility Regulator is also proposing to restrict the Dt term within SONI licence, this is reflective of the Competition Commission decision on NIE. The Commission removed the general reopener term (Dt) which they said give the regulated company insufficient incentive to be efficient and so exposed consumers to the risk of excessive costs. While the Dt term remained in NIE's licence it was restricted to certain items.
328. The Utility Regulator is therefore proposing to draft licence modifications to restrict the Dt term by specifying a pre-defined category of events.
329. The Utility Regulator is also considering the need to increase the existing de minimis of £20k, in relation to Dt requests. Given the overall proposed allowances, for example payroll and IT, and a desire to enable the effective reduction of Dt requests the materiality threshold is being proposed to increase to a de minimis amount of £200k. This is viewed as an effective way in reducing unnecessary regulatory burden going forward.
330. For the Dt mechanism the Utility Regulator is proposing to only allow the following elements for consideration:
- Change of Law/regulation
 - I-SEM TSO related costs
 - DS3 related Costs
 - EMR related Costs
 - Smart Grid Costs
 - Interconnector Administration Costs
 - CORESO or alternative membership

331. The Utility Regulator will assess any of the above requests and will provide appropriate approval if it is determined to be in the public interest of the consumer.

332. While the Dt item generally reflects new elements which were unforeseen at the time of setting the price control or alternatively the scope was not sufficiently defined to enable an estimation of costs an annual K factor correction mechanism exists for known costs which require adjustment on an ex-post basis.

333. This K factor adjustment (K_{TSO}) addresses specific areas of the SONI TSO business which are exposed to risk and therefore is a key component reducing SONI's system operator exposure to risk.

334. The specific K factor adjustment factors being proposed by the Utility Regulator are listed below:

- Adjustment to allow revenues (including At costs relating to System Support Services) to reflect any over or under recovery of revenue in comparison with the revenue allowance (i.e. adjust for market demand)
- Under recoveries representing working capital requirement to attract an interest rate set to one-year LIBOR plus 2 per cent. This proposal reflects an increase from the current Danske Bank base rate of 0.5 per cent currently reflected within SONI's TSO licence.
- Interest received on over-recoveries is assumed to be set at one-year LIBOR plus 1 per cent, until such time as they are repaid to consumers.
- Adjustments for indexation given the price control allowances are set at April 2014 prices.
- Dispatch Balancing Cost Incentivisation annual reward or penalty until such time as the licence reflects the appropriate changes.
- Any appropriate adjustment to reflect the proposed 50/50 cost share incentive. Should this be introduced this will include adjustments to OPEX, depreciation and WACC.
- Any adjustment resulting from the 'demonstrably inefficient clause' proposed in paragraph 348 below.

335. An annual adjustment is proposed to be made for pass through costs which include licence fees, as these are subject to change, and European TSO (ENTSOE) membership and tariff. The ENTSO-E cost has historically fluctuated and therefore an ex-post adjustment is proposed to adjust the estimated allowance of £600k per annum. This proposal would remove ENTSOE costs from the Dt mechanism.

336. In respect of financing costs associated with constraint cost the Utility Regulator considers these to be captured within the current SEMO price control and proposes that these financing costs will no longer be recoverable within this SONI system operator price control.

11.1 Cost Risk Sharing Mechanism

337. The Utility Regulator wants to ensure that SONI is properly incentivised, given the lessons learned from the interaction with the Competition Commission (CC) and the NIE Final Determination²⁴, the Regulator believes that there is merit in introducing a cost risk-sharing mechanism under which 50 per cent of any difference between the Final determination assessment of SONI's expenditure requirements and SONI's out-turn expenditure in a particular financial year is passed through to consumers through adjustments to SONI's regulated revenue.
338. This is the same mechanism as introduced by the CC to NIE. The rate of 50 per cent will apply to SONI's opex and capex. Similar to the CC in determining this mechanism the Utility Regulator has sought to ensure that SONI would face clear and strong financial incentives to operate and invest efficiently and to avoid unnecessary expenditure.
339. The Utility Regulator believes that this 50/50 framework approach does not compromise SONI's ability to fund, develop, provide and receive appropriate returns, and that this approach gives SONI sufficient incentive to be efficient.
340. The 50/50 mechanism seeks to encompass the full spectrum of SONI's statutory and licence duties and does not focus any one aspect of the TSO's business at the direct expense of the others.
341. The cost risk-sharing mechanism can help reduce consumers' financial exposure to the risks of:
- deferral or abandonment by SONI of investment projects that are included in the expenditure forecasts used by the UR to calculate the price control; and
 - those regulatory expenditure forecasts being too high for any other reason.
342. The Utility Regulator's draft decision is therefore to introduce a cost risk-sharing mechanism similar to that imposed on NIE for the RP5 price control.
343. This will be as an annual adjustment to revenues for cost risk-sharing purposes. the Utility Regulator proposes a scheme that has the following features;
- The cost-risk sharing percentage is specified as 50 per cent,
 - The cost risk-sharing mechanism would apply to all SONI's costs across opex and capex which are not specifically excluded. Excluded items would comprise of the costs of items identified for cost pass-through; and
 - For both opex and capex the value of the adjustment would be calculated as the relevant difference in expenditure, multiplied by the value of the cost risk-sharing percentage (50 per cent).
344. These mechanisms would rely on annual reporting of cost data and

²⁴ https://assets.digital.cabinet-office.gov.uk/media/535a5768ed915d0fdb000003/NIE_Final_determination.pdf

calculation of the price control according to specified formulae and the latest data.

345. The Utility Regulator intends publishing with the final determination a financial model detailing the decisions within this price control to aid transparency and accountability. This will also aid the Utility Regulator to manage the adjustments to SONI's regulated revenue.

11.2 Other arrangements

346. The Utility Regulator is also considering putting arrangements in place to ensure that some form of price control would apply to SONI after the planned end date, in case of a failure to implement a new price control in time.
347. The Utility Regulator is considering proposing licence modifications with the effect that, in the period from the end of a price control until such time as the next price control commences, the restriction on SONI's maximum regulated revenue is replaced with a restriction of no increases from the tariffs set from the last year of the last agreed price control, until such times as a new agreed price control is in place. This is similar to the conditions that the Competition Commission placed on NIE in their final determination.
348. Having considered that the Ofgem and the Competition Commission's terminology of '**demonstrably inefficient or wasteful**' the Utility Regulator is also proposing that there should be a provision within SONI's Licence conditions which enables the Utility Regulator to determine adjustments to SONI's maximum regulated revenues or RAB to protect consumers from exposure to any costs that the Utility Regulator has found to be demonstrably inefficient or wasteful.
349. This clause will apply across all areas of SONI's expenditure and is also in line with the Competition Commission's final determination on NIE.

12. Transfer of Planning Function

350. As part of the implementation of IME3 in Northern Ireland, SONI's²⁵ and NIE's²⁶ transmission licences were modified on the 28th March 2014 to transfer the responsibility for planning the network from NIE to SONI.
351. SONI state that their ongoing costs have increased in a number of ways as a result of the transfer of activities from the transfer date. They state that these costs can be broken down into;
- Cost 1: Costs associated with the transfer of activities;
 - Cost 2: Recurring costs that do not result in the creation of a specific asset (routine licence obligations); and
 - Cost 3: Costs that are incurred to develop a fixed asset.
352. Previously these costs would have been completed by NIE and put on the TUoS tariffs to NI demand customers and all island generators in the "unprofiled" part of the tariffs.
353. Two options are open to the Utility Regulator to deal with these costs within SONI – expense the cost through SSS tariff or replication of the NIE arrangements by capitalising the costs through TUoS Tariffs.
354. In their submission SONI has identified issues with this being recovered through SSS tariff, as they indicate that this may result in a distortion to the current cost allocation as previously 25% of this cost was recovered from all-island generation.
355. SONI has stated that all transmission capital projects follow a multi-phase development process, referred to as the Transmission Project Lifecycle, as follows:
- Phase 1 (SONI) is Project Identification – systems analysis and other studies confirming the need for, and nature of the project;
 - Phase 2 (SONI) is Pre-Construction – including, Functional Design, Consultation, Environmental assessments (where required), Wayleaving, and the statutory consenting of a proposal; and
 - Phase 3 (NIE) is Project Construction – Detailed Design, construction and ultimate energisation and close out of the project.
356. Some of the costs that are incurred to develop a fixed asset could be significant and be developed over a long time frame and these will require Regulatory approval. SONI has suggested that they will 'carry' the costs on a rolling basis until each project is ready to be developed by NIE.

²⁵ http://www.uregni.gov.uk/uploads/publications/SONI_Transmission_Licence_-_Clean_with_IME3_Modifications_Effective_from_28_March_2014.pdf

²⁶ http://www.uregni.gov.uk/uploads/publications/NIE_transmission_Licence_-_IME3_Modifications_-_effective_28_March_2014.pdf

357. The costs will be collated by SONI and charged to NIE under each Transmission Project Instruction (TPI). They also state that the cost of financing the working capital associated with the deferred income from NIE must be provided for under the Revenue Control.

358. SONI estimate that over the next price control period it will spend approximately £20m+ on Phase 2 Capex preconstruction projects which equates to about £5m per annum.

12.1 The Utility Regulator Draft Decision on Transfer of Planning

359. The transfer of planning of the network from NIE to SONI was implemented to ensure that the investment decisions are made by a body that is independent of generation and supply. SONI now has responsibility for planning the development of the transmission network.

360. As per the Competition Commission's Final Determination, this cost is already included in the NIE price control for the period 1st April 2012 – 30th September 2017 (The RP5 price control period). SONI are responsible for Transmission planning from 28th March 2014 onwards. SONI's new price control starts on 1 October 2015; therefore, the transmission planning in both SONI's old and new price controls needs to be accounted for.

361. It is the Utility Regulator's view that the consumer should not be materially impacted by this transfer of network planning function from NIE to SONI. For the costs associated with the transfer it is expected that SONI regulated revenue would increase and NIE's regulated revenue would decrease by a similar amount.

362. Cost 1: Costs associated with the transfer of activities. - SONI have estimated that the External Pre-Transfer Costs incurred by SONI will be above £250K, they state that they have outstanding issues and are still to advise the Utility Regulator of the finalised costs associated with the pre-transfer.

363. Cost 2: Recurring costs – SONI have identified ongoing costs within the submission these include, over £0.5m for Network Planning Consultancy (in paragraph 133 it was proposed to reduce the consultancy element to £50k per annum) and approximately £3m for Network Planning payroll associated costs.

364. Cost 3: Costs that are incurred to develop a fixed asset:

- (A) SONI have provided an estimated cost associated with this activity over the 2014/2015 period, they estimate it to be approximately £8m+ with expected contributions of £3m+. The Utility Regulator has to further scrutinise the costs that will be attributable to monies actually spent prior to recovery and during the 2014/2015 period and will be evaluating this during the consultation period.

(B) In the new price control period 2015-2020, SONI estimate that the costs associated with this activity will be above £20m+.

365. The Competition Commission's Final Determination framework allowed the Utility Regulator to adjust NIE's maximum revenue and RAB to allow for additional investment projects to increase the capacity and capabilities of NIE's / SONI's Transmission system.
366. This mechanism was classified as the D5: Investments to increase transmission system capacity. A prerequisite for any project to be within scope of the D5 mechanism is that the investment is requested by SONI.
367. Projects identified under the D5 mechanism will therefore be initiated by SONI. It is expected that SONI will submit a CBA type report to the Utility Regulator to identify the need for each D5 project. The proposed work will only proceed subject to an appropriate regulatory approval being granted by the Utility Regulator.
368. This CBA type submission will provide the Utility Regulator with an introduction to the request and detailed justification of need for the project. It will provide detail of the scope of works and a costs element of the each of the requirements which SONI will be caring out. It will also have a project plan of delivery of the pre-construction activities.
369. SONI and NIE will need to work together to provide estimations of the full project cost and timelines for assessment by the UR.
370. SONI will also be required to report its outturn activities annually on each project to a reporting template in conjunction with NIE, to enable the Utility Regulator to obtain a complete picture of each D5/transmission project at a pre-construction and a construction level.
371. This Utility Regulator is conscious that there is clear responsibility for each party involved in the transfer of planning and the costs associated with this activity will need to be accurately reported so it may be included in the relevant NIE / SONI price control / tariffs.
372. During the transfer, 19 roles were identified and have been added to SONI's headcount as identified in paragraph 91. It is expected that this increase in headcount will impact the level of professional fees that will be required to complete this activity as stated in paragraph 133.
373. As SONI has the ability to request additional monies to fund these transmission projects, the Utility Regulator will consider these roles when evaluating each request for regulatory approval.
374. SONI have estimated costs associated with this activity to be in the region of £25.1m. They proposed that these costs are processed through the Capex element of their price control, with SONI capitalising the activity and then charging NIE an invoice on project hand over.

375. The Utility Regulator has concerns around the capitalisation of the projects (some of which may not materialise to construction) and the issuing of invoices to NIE rolling into future years and price controls. This could create revenue spikes to NIE and SONI if a large number of projects are handed over during a short time period.
376. While the Utility Regulator proposes to facilitate SONI's request for £25.1m, each project will be assessed on its merits and only proceed subject to an appropriate regulatory approval being granted by the Utility Regulator.
377. It is minded to treat these costs as an Opex cost, as the planning activity is now a routine part of SONI's role. This may result in an Opex increase of approximately £5m per annum of the price control. This approved amount will also be subject to the 50/50 sharing mechanism.
378. Further discussion will be developed with SONI and NIE during the consultation period on the costs associated with the transfer of planning function and on the process of the treatment of pre-construction / D5 projects.

13. Allowed Revenue

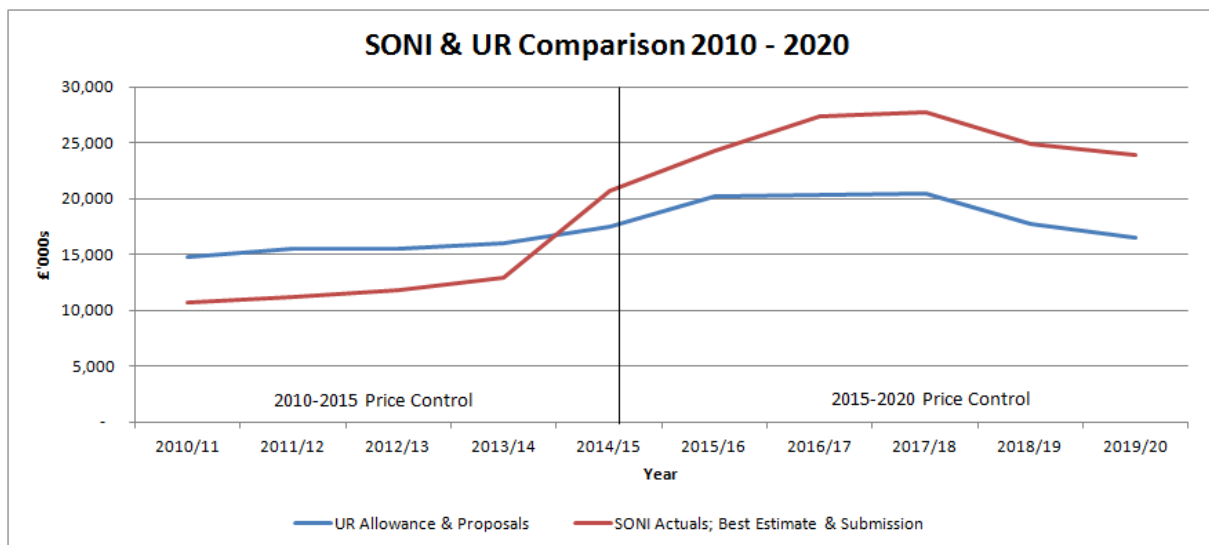
379. This draft consultation paper presents the Utility Regulator’s proposed allowed revenue for the SONI price control 2015-2020 of £95m, compared to SONI’s submission of £128m.

380. The summary below provides a comparison between the current price control allowance, SONI actuals and best estimate, SONI’s forecast submission and the Utility Regulator’s proposals.

Table 33: Summary of SONI’s allowed revenue (April 2014 prices)

	2010 - 2015 Allowance	2010 - 2015 SONI Actuals	2015 - 2020 SONI Submission	2015 - 2020 UR Proposals	Variance 2015 - 2020 Submission & UR Proposals %
	£'000	£'000	£'000	£'000	%
Payroll (incl ongoing pension)	33,282	31,219	44,366	37,576	15%
IT and Telecoms	10,559	7,988	9,501	9,501	0%
Other Operating Costs	7,919	5,651	13,321	6,681	50%
Pension Deficit	172	391	740	740	0%
	51,932	45,249	67,928	54,499	
Depreciation	19,336	9,940	10,074	10,279	-2%
Rate of Return	4,538	4,115	2,731	1,538	44%
	75,806	59,304	80,733	66,316	18%
Innovation Fund			2,500	0	100%
Remunerate Contingent Capital (PCG)			6,900	0	100%
Margin			13,000	0	100%
	75,806	59,304	103,133	66,316	36%
Network Planning Function	3,100	6,828	25,100	25,100	0%
ENTSOE & Section 75 (previously Dt)				3,730	
Total	78,906	66,132	128,233	95,146	26%

Diagram 5: Summary of SONI’s allowed & Proposed Revenue



381. The cost profile depicted above shows a downward trend from 2018. This is due to SONI's profile of expected network planning costs in relation to pre-construction projects.
382. The proposed Draft Determination allowance of £95m is a 44% increase from SONI's actual spend in the last price control, although this new price control will include £25.1m of Network Planning Project costs. The overall allowance will also increase within the period once the DS3 and ISEM project costs have been approved.
383. The paramount output relating to SONI for the 2015 – 2020 period is the maintenance of security of supply. This relates to operating the transmission network system in a safe and reliable manner with system availability expected to be maintained to at least the 97.99% level reported for 2013. SONI are now responsible for planning the transmission network giving SONI more control in maintaining or improving overall system availability.
384. SONI would be expected to focus on contributing to the successful implementation of DS3 (October 2016) and I-SEM (October 2017) in conjunction with the Commission for Energy Regulation (CER) and the Utility Regulator. The DS3 project is directly linked to DETI's 40% renewable target for 2020.
385. In terms of SONI system operator's ongoing responsibility, SONI have an obligation to manage constraints on the network in an economical and effective manner. This requirement is further incentivised by the SEM Committee's Dispatch Balancing Cost Incentivisation Decision Paper²⁷ which aims to reduce the cost of constraints on an all-island basis for which the market operator (SEMO) is responsible for settling.
386. Fulfilling these outputs would ensure SONI operate a safe, secure, efficient and reliable transmission network for 2015 – 2020.
387. The estimated impact of the Utility Regulator's proposals on the 2015/16 SSS tariff is an estimated 21% increase²⁸ which has an overall effect of an average of £1.50-£1.80 per domestic customer. This compares to a 44% increase proposed by SONI corresponding to an average increase of £3.50 - £3.80 per domestic customer. SSS charges usually represent about 2-3% of the proportion of the total electricity bill.

²⁷ http://www.allislandproject.org/en/transmission_decision_documents.aspx?article=40b93d75-e3f6-4eef-b997-3d9209a2b7d8

²⁸ Part of this increase is linked with the transfer of planning function and the Utility Regulator would expect the NIE tariff to decrease by a similar amount that is associated with this element within the RP5 allowance.

14. Next Steps

388. The Utility Regulator welcomes comments from all interested parties on its proposals for SONI's revenue for the 5 years to 1 October 2020. Comments should be sent to Jody O'Boyle and Karen Shiels at the address in Section 1 of this paper.

389. Responses should be received by 5pm on Thursday 14th May 2015.

390. During the consultation period:

- The Utility Regulator will further assess the appropriate headcount and payroll for SONI.
- The Utility Regulator will assess the 31 March 2015 Pension Actuarial Report for SONI.
- The Utility Regulator will draft the licence changes required to support the proposed price control.
- The Utility Regulator will further engage with SONI and NIE on the transfer of planning function.

391. The Utility Regulator intends to publish with the final determination a financial model detailing the decisions within this price control to aid transparency and accountability.

392. The Utility Regulator proposes to publish the decision paper before the end of June 2015.

Appendix 1

Detailed breakdown of SONI's CAPEX submission and the Utility Regulator's proposals.

Item	Capital Expenditure Summary	SONI's Submission €'000					Total	URs Proposals €'000					Total	
		2015-16	2016-17	2017-18	2018-19	2019-20		2015-16	2016-17	2017-18	2018-19	2019-20		
1	IS Infrastructure													
	Common IT Infrastructure	0	0	0	303	101	404	0	0	0	273	91		
	Hardware Replacement	40	0	101	0	0	140	36	0	91	0	0		
	Firewalls	0	242	0	0	0	242	0	218	0	0	0		
	Memory and Storage Expansion	0	101	41	0	0	141	0	91	37	0	0		
	Desktop Infrastructure	41	41	71	140	41	333	37	37	64	126	37		
	Subtotal	80	384	212	444	141	1,262	72	345	191	399	127	1,135	
2	Corporate Systems													
	Dynamics	44	44	44	44	44	218	39	39	39	39	39		
	Customer Relationship Management System (CRMS)	203	0	0	0	0	203	182	0	0	0	0		
	Human Resources Management System (HRMS)	0	0	164	0	0	164	0	0	147	0	0		
	SharePoint Migration and Enhancements	50	50	0	0	50	151	45	45	0	0	45		
	Productivity Tools	50	50	50	50	50	252	45	45	45	45	45		
	Subtotal	347	144	258	94	144	987	312	130	232	85	130	889	
3	Energy Management Systems-All Island Operations													
	EMS Platform	93	0	0	404	1,211	1,708	84	0	0	364	1,090		
	EMS Enhancements	101	0	0	101	0	202	91	0	0	91	0		
	Wind Dispatch	161	121	121	121	41	565	145	109	109	109	37		
	Subtotal	355	121	121	626	1,252	2,475	319	109	109	563	1,127	2,227	
4	EDIL/RCUC/AMP													
	EDIL: Electronic Dispatch Instruction Logger	100	71	41	20	20	252	90	64	37	18	18		
	RCUC: Reserve Constrained Unit Commitment	80	80	80	80	80	402	72	72	72	72	72		
	AMP: Auction Management Platform	109	109	109	109	109	547	99	99	99	99	99		
	Subtotal	290	261	231	210	210	1,201	261	235	208	189	189	1,081	
5	TUoS/Settlement/Metering													
	CSB Upgrade	0	0	151	0	0	151	0	0	136	0	0		
	CSB (HAS for NI)	121	0	0	0	0	121	109	0	0	0	0		
	MV90/Converge/MASS	50	50	0	0	0	101	45	45	0	0	0		
	App Enhancements/Consolidations	41	41	101	101	101	384	37	37	91	91	91		
	Subtotal	212	91	252	101	101	757	191	82	227	91	91	681	
6	Big Data/Data Mining													
	Data Management	50	0	0	0	0	50	45	0	0	0	0		
	Big Data/Data Analytics	0	101	41	0	0	141	0	91	37	0	0		
	Website	81	0	0	0	0	81	73	0	0	0	0		
	Middleware	101	101	0	0	0	202	91	91	0	0	0		
	Subtotal	233	202	41	0	0	475	209	181	37	0	0	427	
7	DS3/Smart Grids													
	DS3	101	151	152	0	0	404	0	0	0	0	0		
	DS3 tools - ramping, voltage management, frequency management	0	101	202	202	101	605	0	0	0	0	0		
	SmartGrids	61	0	101	101	20	283	0	0	0	0	0		
	Subtotal	162	252	454	302	121	1,292	0	0	0	0	0	0	
8	Operation Changes - Network Codes	0	202	0	0	0	202	0	181	0	0	0	181	
9	Concrete Repair	194	0	0	0	0	194	0	0	0	0	0	0	
10	Sterile Zone Lighting	116	0	0	0	0	116	0	0	0	0	0	0	
11	Facilities Improvements	0	0	115	0	0	115	0	0	0	0	0	0	
12	Fire Protection	48	0	0	0	0	48	0	0	0	0	0	0	
	Total	2,037	1,656	1,684	1,777	1,970	9,123	1,365	1,264	1,003	1,327	1,664	6,622	