System Operator for Northern Ireland

Utility Regulator's Consultation on Approach to the 2014 Power NI Supply Price Control

A Response by SONI

22 March 2013

Introduction

1. SONI welcomes the opportunity to respond to the Utility Regulator's consultation paper on the approach to the 2014 Power NI supply price control. SONI is licensed to participate in the Transmission of Electricity in Northern Ireland; SONI is also licensed as SEM Operator for Northern Ireland.

2. SONI supports the Utility Regulator's desire to engage in the development of the forthcoming control 'in an entirely transparent and structured manner'. SONI also supports the Utility Regulator's ongoing commitment to the principles of better regulation: transparency, consistency, proportionality, accountability and appropriate targeting.

3. SONI's own establishment through divestment from NIE was precisely to help deliver competition in both generation and supply to the benefit of customers in Northern Ireland. Regulated price controls are at best a proxy to competition and should only be employed where effective competition is either not possible (e.g. regulated natural monopolies) or not yet fully developed (e.g. in the case of supply businesses prior to fully effective liberalisation). They should therefore be reviewed on an ongoing basis to determine their necessity and extent; that the Utility Regulator is doing this in the case of Power NI is welcome.

4. Clearly many matters raised within the Utility Regulator's consultation paper are of specific interest to Power Ni itself, those in direct competition with it, and its customers. SONI does not comment on these issues. SONI is however similar to Power NI in that it is a regulated business with a relatively low physical Regulatory Asset Base but subject to significant financial through flows and consequential working capital requirements. SONI's response therefore concentrates on these issues.

Allowable Operating Expenditure

5. In relation to the provision of operating expenditure for Power NI (Section 4 of the Consultation Paper), SONI supports the roll over approach with the adjustments proposed. SONI in particular supports the forward looking adjustment for Real Price Effects and ongoing productivity assumptions recognising that labour input costs in energy markets are currently relatively buoyant and that the level of ongoing productivity improvement from a less capital intensive supply business is relatively lower than might be expected from a traditional utility such as NI Water.

Assessing Margins – Purpose and Approach

6. Section 5 of the consultation paper discusses the appropriate margin that should apply to the Power NI business. SONI finds a considerable number of points within the Utility Regulator's discussion of that which is appropriate with which it agrees. Specifically SONI agrees with the statement made by the Utility Regulator that '*UR proposes to pay particular attention to the risks that a business such as Power NI faces and the fair and reasonable reward that investors should expect for bearing that risk'.* Remuneration for risks faced, including reputational and other risks, must, in SONI's view, form a key part of any regulatory determination.

7. However there are a number of points where SONI would tend to disagree with the Utility Regulator.

    a. Specifically SONI would not agree that it is not appropriate in assessing the capital base of the business to include intangibles such as brand value. The purpose of the regulated price control is to provide for a level competitive market playing field and to simulate the prices, including the returns required by investors, in a competitive business. In a competitive business brand and reputation have value and investors are rewarded for creating such enterprise value and must expend money to develop it if entering a market afresh. To not provide for this in the prices charged by Power NI would be to accord Power NI an unfair competitive advantage in pricing relative to other market participants (thus distorting 'fair' competition) and to undervalue the 'service' provided by it to customers.

    b. While SONI agrees with the Utility Regulator's statement in Paragraph 5.20 that the objective is that shareholders should not expect to make supernormal profits or sub normal returns, SONI does not agree that this necessarily translates into what the Utility Regulator terms '*a fair bet in which the chances of making money or losing money are equally balanced*'. Financial markets are underpinned by investors who are risk averse and who require compensation (over and above a 'fair bet' where the odds are somehow equal in respect of reward or loss) in order to make investment. This is equally true in terms not only of investment in physical infrastructure but also in the management of exposure to operational or other risks.

       In a traditional asset based utility this requirement to be compensated for natural investor risk aversion is factored into the Weighted Average Cost of Capital (WACC) applied to the RAB and which seeks to compensate investors for all risks. Where the regulated business is asset light then this compensation for the management of risk must be factored in elsewhere in the regulatory model and 'a fair bet' must reflect the level of systematic risk exposure (including the necessary compensation for investor risk aversion). Appropriate compensation for such systematic risks, including operational risks, must also be provided in another form.

c. Furthermore SONI would question the Utility Regulator's proposed approach to the compartmentalisation of risks and would rather suggest a holistic approach of that which is needed to ensure the business is financeable is that which is more appropriate (see next section).

   For example, on the one hand a number of the risks/ requirements may themselves be diversifiable which means to treat them as simply additive would be to over provide for the necessary funding/ support; on the other hand it is necessary that the business is not structured simply to manage each specific risk against the probability of its incurrence but rather the totality of the business requirements as a whole.

   This is likely to mean the business requires not only standby facilities and short term capital requirements but an element of equity held as a base case in order to be able to support the putting in place of such facilities as such facilities cannot be 100% debt financed. This equity will need to be remunerated in the model regardless of whether the risks crystallise or not even in the case of conditional financing (ref. Paragraph 5.18).

Financeability – the Ultimate Test

8. As outlined above it is not the individual building blocks of the price control which matter most but the overall outcome and whether it meets the Utility Regulator's primary objectives – to protect consumers and to ensure that licensed businesses can efficiently finance their activities therefore also ultimately protecting consumers. To that end financeability and its assessment is key. While SONI agrees with the Utility Regulator that the traditional tests of financeability employed by regulators in the case of network utilities are not necessarily appropriate it is vital that in assessing financeability that the Utility Regulator has robust evidence for the two approaches proposed by it:

   a. Showing that the return on offer compares favourably with the returns investors can get by investing in efficient businesses with similar risk profiles; and

   b. Showing that the return on offer is capable of supporting and sustaining the investor capital that an efficient company would need for fixed assets and working capital plus a reasonable buffer to accommodate unanticipated financial shocks.

9. Moreover in respect of these two approaches it is less a bottom up assessment and more an overarching assessment which is appropriate. As SONI has highlighted above a bottom up approach can lead to compartmentalisation of the issues which itself may lead to a sub-optimal solution. It is the overall benchmarking of returns and margins which is of primary importance/ relevance.

Further Development of the Regulatory Framework for Asset Light Businesses

10. Finally, it is important that the regulatory model, particularly in the case of asset light businesses, provides the appropriate incentive to ensure that value add is delivered for consumers.

    A traditional regulated utility delivers value through its investment in physical infrastructure; regulators remunerate it for this through the regulated opportunity cost of capital with a desire by regulators to ensure that such cost of capital is set at a sufficient level to ensure the consumer enhancing NPV positive investments are delivered. Any margin over and above the market cost of capital remunerates the utility for the value it is creating by bringing together the factors of production.

    In the case of asset light utilities it is not so much through the provision of infrastructure but through their actions that they influence, and influence significantly, the cost base and service levels experienced by others. SONI has alluded to this fact when discussing the importance of including business enterprise value in the assessment of Power NI's required revenue above.[1] Moreover, it is vital in considering the regulatory model to define and remunerate appropriately the actual assets which are being employed in the delivery of the services whether they be physical assets, financial assets, human capital, intellectual capital or intellectual property. SONI looks forward to further discussions with the Utility Regulator concerning these matters.

[1] Ultimately if margins are appropriately benchmarked to comparable competitive businesses this should be captured within this.