SONI Revenue Review 2015-2020

SONI Response Appendix to:

NIAUR Draft Determination (of 2nd April 2015)

18 May 2015

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1 Introduction

SONI (System Operator Northern Ireland) is the holder of a licence to Participate in the Transmission of Electricity under Article 10(1)(b) of the Electricity (Northern Ireland) Order, 1992. SONI is charged with operating a safe, secure, reliable and efficient transmission system for Northern Ireland. Since 1 May 2014 SONI has been responsible for the identification and advancement of network developments, including all such works as are necessary to achieve the requisite statutory and associated consents.

In October 2014 SONI made its submission to the Northern Ireland Authority for Utility Regulation (NIAUR) regarding allowable revenues for the period 2015/20. SONI subsequently responded to 9 sets of queries received from NIAUR in the period December 2014 to March 2015. In addition 4 subject matter meetings were held regarding specific elements of the review – namely Information Systems and financeability, which SONI had highlighted as being of particular concern to it. External consultants were present at certain meetings. A meeting was held to discuss an overview of NIAUR's thinking regarding the Draft Determination (DD) on March 4th.

On Friday 3rd April 2015, NIAUR published its Draft Determination (DD) on SONI allowable revenues. This document forms part of the SONI response to same. Since publication of the DD SONI has also met with NIAUR on two occasions to allow for further engagement on the issues.

From a SONI perspective, NIAUR has two key statutory objectives in relation to revenue controls, which are complementary rather than mutually exclusive:

1. Protect the interests of customers; and
2. Ensure that licensees are able to finance their activities.

SONI believes the proposals within the NIAUR DD significantly risk the financeability of SONI and/or its ability to carry out its licenced obligations. Alongside proposing significant cuts to the forecast costs of undertaking the activities required to satisfy its licence obligations, it proposes a financial return of c. £0.3m p.a., or <0.3% EBIT whilst at the same time requiring SONI to:

1. Manage the operational risks, and any costs, associated with ensuring industry payments.
2. Forego remuneration of the efficient cost of holding £22m debt + equity capital.
3. Implement c. £22m operational cost cuts whilst delivering the outputs required from its licence.
4. Fund 50% of any additional costs over allowances – OpEx or CapEx (which total c. £20m annually).
5. Pay, from its own funds, any and all D_t costs which are >£0.2m.
6. Absorb the additional c. £2m investment in the EMS IT system despite it being in the customer best interest to do so.
7. Fund significant IT investments required due to externally mandated requirements, approved by NIAUR; c. £15m in the next 2/3 years.

The set of arrangements referred above would not satisfy a robust financeability test. In addition when assessed against other regulatory regimes, including those of NIAUR, SONI appears to be an outlier in terms of the lack of suitable framework and appropriate assessment of financeability.

2 Overview

The DD has raised serious concerns within SONI in terms of its ability to carry out its licence obligation activities over the 2015/20 period which is covered by this price control/revenue review. The breadth of issues raised will be addressed throughout this response. This section is provided to highlight the overarching concerns of the business in terms of the totality of the DD, as distinct from the separate components of the DD.

2.1 Financeability

The central tenet of the SONI submission – ensuring financeability in the context of the scale of activities, risks and investments, which SONI will have to undertake and manage during 2015/2020, in order to deliver efficient outputs for consumers - has not been addressed by NIAUR. SONI sought advice from independent experts, as part of this review, to examine SONI financeability, how it can be measured, and what is required in order to satisfy it. Based on a foundation assumption that efficient costs were recoverable, it was deemed that the financeability issue could be addressed by:

2.1.1 Setting an efficient cost for the remuneration of contingent capital

SONI holds significant capital £22m (debt & equity) in order to support the various financial requirements and risks faced by the business. Contrary to the DD SONI holds this capital on account of the requirements of the SONI System Operator (SO) license and as such it receives no remuneration for same. This is not consistent with standard regulatory revenue frameworks and indeed with frameworks employed and approved by NIAUR itself. Section 6 of this document explores this issue, examining both the SONI submission and the NIAUR proposals, in more detail.

2.1.2 Satisfying overall financeability tests

It is standard regulatory practice for regulators to employ financeability tests to satisfy themselves that their collective decisions on allowable costs and revenues result in the licensee being financeable. A robust financial model can provide some input into the overall financeability test question however it cannot by itself provide or confirm a robust answer. SONI sought external advice to ascertain the basis for a suitable test that could be applied to SONI and to assess if SONI revenues would satisfy that test. The advice concluded that without amendment, the SONI regulatory revenue model would not satisfy the test of being financeable. The DD proposes to continue with the current model, providing for c. £0.3m p.a. return (or c. <0.3% EBIT) without any reference to how this has been deemed to be financeable. Section 7 of this document explores this issue, examining both the SONI submission and the NIAUR proposals, in more detail.

2.2 Proposals on Costs

The DD includes significant amendments to the SONI submission with regard to both the treatment and forecasts of costs for the 2015/20 period. Both individually, and collectively, these will result in SONI having significant difficulty in meeting its SO licence obligations. SONI is especially concerned with the following key areas:

2.2.1 Network planning

In May 2014 SONI was mandated, via a change in law and SO licence obligation, to become responsible for a set of additional activities which comprise the network planning function, previously carried out by NIE, the Transmission Asset Owner (TAO). This is a legal requirement determined by the European Commission and

overseen by NIAUR (both separately and as part of its role in the SEM Committee) in terms of its role in approving the necessary regulatory licence obligations placed on SONI and ensuring EU certification.

NIAUR is proposing, in the DD, with limited and questionable justification, that costs associated with network planning be recovered on an operational cost basis, rather than capitalised. This is despite them being capital costs in nature and this being their treatment previously under NIE. SONI does not believe this represents good practice or that it is in the best interest of consumers.

In addition, as part of its payroll analysis and allowance provision NIAUR is proposing that SONI will only be provided with an allowance for payroll and pension contributions based on a hypothetical assessment of what those costs should be without any regard for what those costs actually are and notwithstanding that these are legal obligations inherited by SONI.

Sections 3 & 4 of this document explore the above issues in more detail and it is also referred to under section 2.3.2 below.

2.2.2 Operational & payroll

In April 2011, NIAUR published its previous determination with regard to setting efficient/allowable costs for the 2011/15 period (2011 Decision). In its submission to NIAUR for the 2015/20 process, SONI set out how its actual operational costs are expected to outturn below the overall approved allowance, as a result of SONI efficiencies achieved, which now transfer to customers in the form of a reduced baseline costbase (Paper 3: Analysis of Outturn & Future Business Drivers). As such, it is reasonable for SONI to consider this baseline costbase is efficient.

This said, the make-up of this costbase has evolved during that time due to the changed organisation structure which is now in place. As such SONI incurs its own costs in addition to a series of group recharges, both positive and negative. However in its DD, all recharge elements of costs were 'stripped out' of the SONI submission costs even though the 2011 Decision specifically included provision/non-provision due to the existence of synergies with EirGrid.

Instead, NIAUR is proposing to disregard its own revenue cap set for 2015, in addition to the inputs of the SONI submission, and instead rebuild a payroll cost based on:

- The 2011 Decision of SONI SO staff requirements (the concept of which no longer exists);
- Adding the 19 TUPE network planning roles and 4 (of 13) new resources proposed for 2015/20; and
- Calculating a forecast per person cost based on actual average costs, adjusted by reference to a non-comparative benchmark - hence reducing it by c.20%.

Thus NIAUR is proposing to penalise SONI for operating efficiently during 2011/15, absorb an immediate reduction in revenues aligned to a c. 20% reduction in average remuneration for staff and absorb costs associated with legal and contractual obligations (NIE staff transferred under a change in law overseen by NIAUR). Section 4.1 of this document explores this issue in more detail.

2.2.3 Exclusion of 'Real Price Effects' provision

NIAUR has stated that it will apply the Retail Price Index (RPI) to index allowances over 2015/20 however RPI is an index designed to reflect the general increases in costs within the economy whereas the underlying costs of a company will not move directly in line with this. It is standard for regulators to include an adjustment for Real Price Effects (RPE) into its revenue regulation frameworks and provision for RPE is standard practice employed by regulators, including NIAUR, and the Competition Commission (CC). In this DD, NIAUR has made no reference to RPE or the independent advisors' report included in the SONI submission referencing it to be c.

1% per annum and there is no provision for same is included in the DD. Section 4.2 of this document explores this issue in more detail.

2.2.4 Disallowing 2011/15 capital expenditure

As per the DD, additional investments in non-network IS (£1.2m) and Buildings (£0.4m) Capital Expenditure were made by SONI in its submission by inclusion in the Opening 2015/16 Regulated Asset Base (RAB), for the return, via an approved regulatory depreciation charge, during 2015/20

The additional non-network IS investment is due to expenditure on the Energy Management System (EMS). During 2011/15, SONI revised its plans on expenditure in relation to EMS. This was due to the fact that the upgrade allowed for in 2011 would have resulted in inefficient cost for consumers, given that greater benefits and cost efficiencies for consumers would result from a significant upgrade to deliver an enhanced level of functionality in line with future requirements whilst at the same time ensuring that the 'new' integrated EMS had equal capabilities in both jurisdictions and could be, as they currently are, operated independently from either location. The additional EMS investment, over allowance, was c. £2.0m.

In the DD, NIAUR appears to propose disallowing these additional costs to be added to their respective SONI RABs – not for the 2011/15 period but for the 2015/20 period - hence disallowing the return of same through the depreciation charge, and hence deeming these investments, which were delivered for the benefit of the Northern Ireland customer, to be funded by SONI. If the investments are not allowed to be recovered during 2015/20 then SONI will have to resubmit to NIAUR, the costs associated with not having made the investments. These would be greater than the investment costs themselves. Section 5.1 of this document explores this issue in more detail.

2.2.5 Reduce 2015/20 capital investment

In the DD, NIAUR proposes removal of the £1.3m DS3/Smart Grids IT programme from the suite of programmes included in the SONI submission in addition to reducing the forecast costs of each of the other 7 IS programmes by 10% (£0.7m).

SONI wishes to make clear that the forecast submitted to NIAUR does not include DS3 System Service workstream which is the only workstream governed by the SEM Committee, which will make a determination on that programme costs. IS CapEx costs for DS3 System Services were not included in SONI's submission on forecast IS costs. The costs associated with the remainder of the entire DS3 programme were included as these are not part of the System Service workstream. If the proposal to remove the entire programme from the forecast is implemented there is likely to be delays in facilitating the implementation of the DS3 System Service workstream governed by the SEM Committee as well as impacts on the overall DS3 programme.

In addition, NIAUR proposes removing the £0.5m investment in the SONI building submitted by SONI associated with concrete degradation and other associated issues. Section 5.2 of this document explores these issues in more detail.

2.2.6 Limiting D_t Recovery

In section 11, NIAUR states that it is considering limiting D_t requests to a set list of costs and only those >£0.2m to reduce 'unnecessary regulatory burden' going forward. It is the nature of the NIAUR regulatory revenue framework that there is a requirement for D_t requests resulting in unnecessary regulatory burden for both NIAUR and SONI. SONI encourages and would support efforts to reduce D_t requests under an *ex ante* regulatory revenue framework however this can only be achieved if it has the financial resources to underpin the payment of costs incurred in carrying out its licenced activities. Simply limiting the items and introducing a >£0.2m threshold, is not a sustainable solution. Given that NIAUR is proposing SONI has an annual return of c. £0.3m it is not reasonable to assume that SONI can incur the costs associated with non-qualifying D_t items.

The CC determination on the NIE referral considered the application of D_t adjustments and concluded that the ability to approve, on a case-by-case basis, additional cost to be recovered through NIE's revenue control (under the Dt term of the price formula) operated against the public interest as it did not provide for the general incentives for the efficient management of costs as provided for under the revenue cap. As the CC stated, the scope for approval of such costs was in the NIE case, and has in the SONI case, been limited to a cost pass-through basis, which would give NIE insufficient incentives to be efficient and so exposed consumers to the risk of excessive costs (as per paragraph 14 b iv).

2.3 Legal Requirements

Throughout the DD NIAUR appears to propose to overwrite the industry and licence structures in relation to SONI – the following are some examples:

2.3.1 Separate SO & MO licences

SONI has both a licence to participate in the transmission of electricity (subsequently certified as same by both NIAUR and the EU) and a licence to act as SEM Operator; both granted by the Department of Enterprise, Trade and Investment. SONI is not responsible for determining licence obligations and hence references between one and other licence is not due to SONI. Each licence has specific responsibilities, obligations and, as noted in the DD, separate regulatory price controls.

As part of its submission on SO revenue requirements SONI only included issues and costs in relation to its SO licence. NIAUR appears to have misinterpreted this – it states that 'required elements of one price control should not be captured within the submission of a separate price control' (para. 228) and SONI has both complied with and supports this position. NIAUR goes on to state that in its view SONI Ltd capital requirement facilities in place are for the 'benefit of the SONI market operator business' (para. 229). However the SONI SO licence clearly states the requirement for SONI, as SO, to fund surplus cash requirements. As such it is clear that the SO licensee is required to be capable of financing that licence obligation. In its DD NIAUR appears to reject this.

2.3.2 New Change in Law 2014 obligations

During 2014, SONI was mandated, via a change in law and SO licence obligation, to become responsible for a set of additional activities which comprise the network planning function, previously carried out by NIE (TAO). This is a legal requirement determined by the European Commission and overseen by NIAUR (both separately and as part of its role in the SEM Committee) in terms of its role in approving the necessary regulatory licence obligations placed on SONI and ensuring EU certification. Two key aspects of this change in law are:

2.3.2.1 Treatment of Network Planning Costs

In this DD, NIAUR states it has a concern around the capitalisation of project costs, despite this being considered the most correct accounting mechanism. The concern cited by NIAUR was that such treatment could result in revenue spikes to NIE and SONI. This is not correct and SONI was, and is, simply seeking to replicate the arrangements as pertained prior to the transfer.

2.3.2.2 Treatment of Costs of Transferred staff

As part of the change in law process, a total of 19 NIE roles which fell under the definition of TUPE were deemed to exist in relation to network planning, including 12 personnel who actually transferred to SONI. By change of law and regulatory licence therefore, SONI is liable to remunerate those personnel on the basis of their transferred arrangements, not by its own accord. SONI has no control over these costs (employment or pension) as TUPE and Protected Person legislation pertains. SONI advised NIAUR on numerous occasions in writing, prior to the transfer itself, that it could only take on the transfer on the basis that it could recover the costs it was inheriting by virtue of law

SONI cannot operate on a basis whereby it inherits liabilities by virtue of law (in the interests of overall industry structure) and that somehow these can be disallowed or reassessed. It is neither appropriate nor reasonable for NIAUR to determine that it will allow only a portion of these costs during 2015/2020.

2.3.3 Innovation funding

Investment in system-level RD&D in Northern Ireland is critical for SONI to plan, develop and operate a reliable transmission system in line with public policy, for the benefit of all consumers. This requirement for incentives is recognised under Directive 2009/72/EC, which sets out that under Article 37(8) that;

> *"In fixing or approving the tariffs or methodologies and the balancing services, the regulatory authorities shall ensure that transmission and distribution system operators are granted appropriate incentive, over both the short and long term, to increase efficiencies, foster market integration and security of supply and support the related research activities."*

Clearly improvements in policies and practices or the introduction of more effective or appropriate technological solutions will deliver long term benefit to electricity customers, whether through decreasing the costs of network build or improving the reliability of transmission equipment and the transmission system as a whole. However, under the split responsibility model, SONI has no direct incentive to seek out such efficiency improvements in relation to network development as the outcome does not impact on its own internal revenues. Indeed it is incentivised to do quite the opposite. This is particularly the case where the pursuit of such efficiencies or gains would require additional expenditure by the company.

In general regulators acknowledge the contribution that innovation and incentivisation can make in delivering benefits to utility consumers and other stakeholders, and that seed capital or investment is required in order to maximise those benefits. SONI further notes that the proposed approach set out is inconsistent with developing EU regulatory best practice in this area. Recent regulatory decisions or proposals for the treatment of innovation costs include the GB SO, GB DNO, Finnish DSO all making available innovation funds in the region of c. 1% revenues. In determining to provide no provision for investment it is clear that the benefits of same will not accrue to consumers.

2.4 Reporting requirements

SONI would welcome working through with NIAUR an overview of the current regulatory reporting arrangements. Any such arrangements must be proportionate to the SONI business. Substantial increases and/or changes in reporting requirements may require additional systems and/or personnel and will require that NIAUR ensure appropriate provision is made to cover such costs.

2.5 Misrepresentation of SONI and the SONI submission

There are a number of examples in the DD of figures/statements which SONI believe are not accurate or a fair representation of the SONI submission. These include, *inter alia*:

- The figures submitted by SONI have been re-presented by NIAUR throughout the DD. SONI notes the altering of certain numbers while others appear to have been accumulated without any details of amendments making it difficult to reconcile back to the SONI submission. This starts with Table 1 (including payroll, other operating costs and pension deficit), Tables 3 & 4 (SONI submission OpEx), Table 8 & 15 (SONI submission Pension Deficit).

- The figures included in Section 5 on Capital Expenditure were rebased to April 2014 prices thereby reducing the forecast programme costs from £9.4m to £9.1m. As SONI made its submission to NIAUR in October 2014, its submission was made in 2014 prices.
- Para. 25: NIAUR states that SONI have included cost estimates for DS3 within its price control submission however this is not the case. SONI did not include any costs associated with the implementation of either I-SEM or the DS3 System Services workstreams, both of which will be determined by the SEM Committee. However, the costs associated with the remainder of the DS3 programme were included (ref. Section 2.2.5 above).
- Para. 42: re safe and reliable system – NIAUR has compared SONI Transmission Availability against National Grid Reliability statistics and this is incorrect. The National Grid Availability is actually 94.5% as compared to SONI's 97.99%. (See http://www2.nationalgrid.com/UK/Industry-information/Electricity-transmission-operational-data/Report-explorer/Performance-Reports/
- Para. 55: NIAUR states that SONI submitted 'a regulatory framework providing…..WACC return, margin, contingent capital remuneration, PCG remuneration and intangible asset remuneration'. The statement and the inference are both factually incorrect.
- Para. 73: Regarding the detailed salary information requested - NIAUR states SONI could not provide the information due to legal data protection restrictions; however NIAUR fails to acknowledge that in order to address the fact that NIAUR requested information SONI could not legally provide, SONI submitted instead a statement of detailed salary information - at a sub group level in order to protect personal identities and provided independent benchmarking of human resource and personnel costs.
- Para. 79: Regarding Connections staff - NIAUR incorrectly states that SONI included in its submission the staff that relate to the connections business 'which they separately invoice for' and that these staff 'have been funded by connectees…' hence these staff should not be considered for this price control. This is not an accurate interpretation of this area of work. Further, contrary to Para. 80: there are not '5 connections staff' that form part of the SONI contracted staff, who work solely and 100% on connections, with 100% of the SONI cost being invoiced to connectees. There are a number of staff from within the total SONI contracted staff who carry out connections work as part of their role and where SONI invoices the connectees a regulated charge for the works carried out. The 5 staff should be reinstated to the SONI payroll costs and SONI can reimburse the customer for the payments received. This would reduce the risk that SONI over or under recovers its costs as well as reduce the unnecessary regulatory burden referred to in section 2.4.1.
- Para. 177: Statement that 'Consumers are continuing to pay for the 2010 EMS system and various wind productivity tools via the depreciation change 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'. This appears to infer that SONI rendered the EMS system redundant and opted to implement a new system resulting in consumers paying redundant or inefficient costs whereas in fact the opposite is the case – SONI made the most efficient investment decision for the consumer and as such it should be remunerated for that cost.
- Para. 211: Reference to SONI mentioning that it 'made considerable profits under revenue cap' mechanism. This quote has been taken entirely out of context. SONI did note that there were a number of fortuitous circumstances (including accelerated regulatory depreciation and savings made as a result of efficient operation) which enabled SONI to finance its activities in the previous period.

3 Network Planning

3.1 Treatment of Network Planning as OpEx

In the DD, NIAUR proposes that the network planning costs be recovered on an operational cost basis, rather than capitalised, which SONI proposed for a number of reasons including that this is most appropriate in terms of best interests for consumers. The NIAUR proposal is:

- Contrary to the treatment of the spend when it was managed by NIE;
- Contrary to standard accounting principles;
- Contrary to the public interest as per the CC determination for NIE (para 10.74);
- Contrary to the SEM Committee determination of the costs which should be allocated to all-island generation through the locational TUoS tariffs, as a corollary to the move to a shallow connection policy in the SEM;
- Inconsistent with the framework as set out in the TIA (Section N) as approved by NIAUR;

Furthermore, it:

- Has customers in Northern Ireland pay for costs previously borne by all island customers;
- Allocates costs associated with network development to users of the system who are actually offsetting the need for network development by shifting their load to off-peak times (contrary to the duties placed on SONI and NIAUR under the Energy Efficiency Directive).

SONI's proposal respected the existing policies and statutory framework, which have been developed through consultation and have been determined to be in the public interest and sought to replicate insofar as possible the arrangements which had been in place prior to the transfer of the planning function.

The CC determination on the NIE referral also considered the treatment of the advancement of transmission works determining '*However, we also saw potential drawbacks with the UR's proposal. Compared with the approach in our provisional determination, there would be additional regulatory burden and risks of project delays from the need for the UR to review any projects before they proceed.' (as per* Paragraph 5.277).

The CC determined '*The RAB is a means of allowing NIE to recover capital investments over a suitable period determined by the regulator. In our view the most appropriate treatment for capital items such as non-network capex is for them to be capitalized and depreciated over a time period which broadly reflects their asset life. Treating capital items in this way should ensure that the balance between current and future tariffs is appropriate (so that, broadly, consumers at any moment are paying a fair share of the costs of capital investments). Expensing non-network capex immediately is at odds with this and risks penalizing current consumers for the benefit of future consumers. For this reason, we found that treating non-network capex as opex was not in the public interest.' (*Paragraph 10.74)

For all these reasons the proposal in the DD is not well thought out and will impose additional burden on customers. SONI wishes to work through a sustainable framework for network project advancement with NIAUR and NIE.

3.2 Proposed Process

NIAUR propose that SONI should submit a Cost Benefit Analysis report to identify project need and that proposed work will only proceed subject to an appropriate regulatory approval and that there should be subsequent annual reporting.

3.2.1 Prior Approval

SONI has a number of concerns over the NIAUR requirement for 'prior approval' of SONI expenditure or indeed as appears to be suggested in the DD that SONI should not undertake works without NIAUR approval.

SONI's concerns stem from SONI's own obligations and requirements to develop an economic and efficient transmission network.

- SONI will in general progress development of the transmission network to ensure compliance with network planning standards. The planning standards are based upon an underlying cost benefit balance and are approved by NIAUR.
- In assessing options to meet identified need SONI undertakes thorough assessment of that which is most appropriate, including that which is ultimately most economically advantageous; this is necessary for SONI to be able to satisfy itself that it has met its licence obligations. The DD appears to suggest that there is a further CBA that is beyond SONI's statutory and licence responsibility? If so could NIAUR explain this?
- NIAUR has an obligation to provide that customers, through tariffs, finance the activities for which SONI is licensed. This should of course be subject to no finding of demonstrable inefficiency or wastefulness. That is all SONI is seeking – a framework that aligns to the various statutory and other obligations of the various parties.
- Introduction of NIAUR approval would lead to an extension of the overall timeline
- It needs to be noted that the level of expenditure committed to at the outset is only the SO costs, not the construction costs. NIE will need to secure NIAUR approval for the much more significant quantum associated with construction.

However, SONI recognises that it would be difficult for NIAUR to agree a revenue control that is based simply on the total £25m envelope of SO costs that SONI has provided as part of its submission, without agreement on further input from SONI prior to individual proposals being taken forward. In addition, and as set out below, SONI could not be exposed to the level of risk as suggested by NIAUR in terms of their advancement.

3.3 Treatment of Risk Sharing arrangements

SONI is fully committed to the efficient discharge of its mandatory planning and project development responsibilities and understands NIAUR's desire to establish regulatory arrangements to incentivise efficiencies, however to operate in the public interest these should focus on optimising the total cost to consumers. In addition to our concerns around the prior approval process, SONI considers that the specific NIAUR 50/50 proposals are impracticable and likely to be counter-productive, for the following reasons:

- Fundamentally, SONI does not consider that the mechanism proposed by NIAUR to incentivise, through a risk sharing mechanism, the quantum of the delivery costs of SONI's planning role will result in the least cost transmission development decision. Indeed, such a mechanism is likely to have the opposite impact.

  This is because the lifetime costs of construction, management and operation clearly far outweigh the costs of SONI's role in determining what is to be constructed and there is a clear risk that defining at the outset, through an incentive mechanism, a limit on SONI pre construction could result in a less than optimum development. For example, such an arrangement could incentivise SONI to pursue the least contentious positioning of infrastructure and technology choice from a landowner/planning perspective resulting however in very significantly increased overall costs, taking into account construction and operation. SONI needs the scope and resources to pursue fully the optimisation of its planning decisions and this would be compromised by the proposed incentive arrangements.

- Due to the increasing resistance to infrastructure development it is an increasingly complex landscape to progress infrastructure development through to the construction stage – the North -South Interconnector is a prime example. There would be very significant risks associated with a simplistic 50/50 risk sharing process – certainly well beyond a level that would reflect SONI's risk profile or the return on regulated equity that it receives.

- Whilst the recent NIE price control has established a 50/50 risk sharing for the construction phase such an arrangement is much less appropriate for the SONI pre construction phase:

    - The pre-construction phase of network infrastructure development is very different from the construction phase, indeed the purpose of the pre-construction work is to achieve a level of definition that is required to confirm the appropriateness of the investment and to enter into construction contracts. Once the project to be constructed is fully defined, the components of costs, particularly materials which make up the largest component of cost can be well understood, and risk can be allocated to the parties best able to manage it, for example through construction contracts. As explained further in this submission, the scope of the activities to be undertaken during the pre-construction phase is much less defined at the time of its initiation;
    - The pre-construction costs make up perhaps 5% to 10% of the total project cost so there is a much lower quantum of cost to be incentivised – this reduces significantly the value of such an initiative to customers;
    - There is much less scope to drive efficiencies in pre-construction than in construction. With construction there is a much greater market for materials and services. Also it is much more possible to define risk sharing with construction contractors because the construction work can be better defined and measured.

- Risk Sharing, which places risk on both SONI and customers, requires at the outset a high level of certainty over an "acceptably efficient" target cost. SONI does not consider that there is adequate certainty over a target cost with respect to pre-construction. Importantly, if one were to seek to define a probability distribution of the likely costs of pre-construction it would not resemble a normal distribution curve. There is a much greater likelihood of unforeseen or underestimated costs than of costs being underspent. As a result the cost probability curve will be highly asymmetric with potential for outturn costs being well in excess of those forecast from an initial bottom up detailed assessment. This uncertainty is not because of any failing on SONI's part; it is for the following reasons:-

    - At the outset there is limited certainty over where infrastructure will be physically located so one cannot for example assess circuit length or S/S locations.
    - Also, at the outset, it would not be appropriate to pre-determine the technology to be employed, for example overhead versus underground.
    - Faced with these uncertainties one is not able to assess with certainty the nature and quantum of:-
        - Landowner engagement
        - Environmental assessment
        - Planning requirements
        - Design input

- Delivering against, and preferably securing improvements on, an acceptably efficient target cost, requires that, as far as possible, the party responsible has a high level of control over the process. Such control is not assured with regard to pre-construction activities due to exposure to a wide range of external pressures and requirements which will arise over the project lifecycle. External aspects, where the scale and scope of work will be challenging to manage with a high degree of control include:

  - Landowner engagement and consultation
  - Environmental requirements
  - Statutory Planning requirements

  These externalities have the potential for significant additional costs extending as far as a need for a public enquiry.

- The establishment of a risk sharing mechanism as proposed also has the potential to stifle innovation in the carrying out by SONI of its role. Innovation, for example, in the selection of the optimal technology and in the approaches to engagement with stakeholders, whist resulting in additional cost for SONI, has the clear potential to result in significant overall cost savings, including for future projects.

- Whilst it may be considered by some that the uncertainties around risk sharing in respect of individual projects would be smoothed out through its application to a portfolio of projects, this would not be the case.
  - There would not be an adequate volume of projects to facilitate the smoothing benefits of a portfolio approach.
  - As explained above, for each project the cost probability distribution will be asymmetric towards cost over-run, so the portfolio would have a similar profile.
  - For each project there would remain an incentive towards constraining cost and an aversion to innovation, to the potential detriment of the individual developments.

- The outworkings of all of the above uncertainties work against an effective “hard and fast” risk sharing incentive arrangement. If implemented, it is likely to lead to SONI legitimately seeking to secure agreement to a target cost that ensures that an extreme range of possible contingencies are catered for, which would undermine the arrangements.

3.4 Network Planning Advancement

The transfer in 2014 of responsibility in network planning, the development of the electricity transmission system, will as would be expected result in additional costs for SONI. If SONI wishes to progress projects at an overall efficient cost including limiting delays in as much as this is possible the foundation investment must be appropriate. The SONI submission included forecasts of <u>operational costs</u> associated with the provision of external technical and communication expert advice. As these costs are not capitalised costs they were not included in the separate project costs submission.

3.4.1 Reduced network planning consultancy/professional fees (-£0.3m)

More complex network planning studies and associated network planning related specialist consultancy support and review are required for the following reasons:

- During the Phase 1 Project Identification Process to ensure a suitable range of feasible solution options for potential new linear/circuit reinforcements (e.g. overhead line, underground cable, HVDC, additional new innovative solutions, etc.) are developed.
- The impact customer equipment has on the grid. The proliferation of smaller intermittent generation connected to the grid remote from larger load centres is an important consideration. Besides the principle need to reinforce corridors to transmit the power from remote locations to load centres, these generators present other technological challenges for which SONI is proactively seeking innovative solutions e.g. reactive power compensation. These technical issues require more complex planning studies and

associated external support and review, particularly related to reactive power compensation, harmonics, dynamics, voltage stability, system stability.

NIAUR states its view that these costs are excessive and further consideration is required and hence have provided for £0.25 of the £0.64m submitted. SONI would caution that limiting costs allowed for network planning will impact on SONI's ability to progress projects it believes are required in order to satisfy its licence obligations and deliver best outcomes for consumers.

3.4.2 Public Affairs Related Consultancy/Professional Fees (-£1.0m)

The new network planning responsibilities means that SONI is and will be in the public spotlight in terms of initiating and proposing network works. As such, SONI submitted a prudent forecast cost of £0.2m p.a. for additional public consultation/stakeholder engagement/media relations/public affairs and other work in NI.

As SONI has now taken on a much more public focussed role, as opposed to its industry focussed role in the past, with responsibility for communication and delivery of the planning and licencing of major projects including North South Interconnector, additional public consultation, stakeholder engagement, media relations and public affairs arise. The work involved includes:

- Explaining, and gaining understanding and support for the vital work of upgrading the transmission system in Northern Ireland, through engagement at national and local level. In line with Government policy, SONI seeks to win support and understanding for its programme of works, to build trust and to consult with the community and landowners.
- Seeking to ensure that there is a broad level of understanding of the drivers of the power system and energy policy insofar as they affect electricity transmission, and of the roles of the various bodies involved, in order to ensure that informed discussion can take place. We must strive to overcome a lack of knowledge about what it is that SONI does, embracing new and modern forms of communications to reach a diverse group of audiences and stakeholders. All of this is in support of the efficient delivery of SONI's projects.

Market research has indicated that there is low awareness of SONI and the work that it is required of it in NI. A dedicated corporate awareness building programme encompassing event management, public affairs, media relations, advertising, stakeholder engagement, digital marketing and sponsorship is required, separate to project communications. NIAUR have referred to other OpEx 'stakeholder events' - £0.1m over 5 years - as providing the funding required to undertake the engagements described above however this is an incorrect assumption. In addition NIAUR refers to an existing dedicated team of in-house advisors however there is no provision for same in the SONI payroll allowances as set by NIAUR. SONI does not have the resources referred to above and nor does it intend to given that it is more efficient to utilise external expertise.

The consequences of not having in place adequate public affairs resources could be detrimental for the efficient development of the SONI Network25 programme and in terms of efficient costs for consumers.

3.5 SONI and NIE cost interactions

NIAUR makes a number of statements in the DD regarding how the SONI allowance for network planning costs will have to be replicated (in reverse) in the NIE allowance. While this is not always necessarily the case in terms of the numbers, it is the framework which SONI sought to use in its submission in respect of the advancement of network projects which appears, for reasons unspecified, not to be accepted by NIAUR.

In addition NIAUR also state that consumers should not have to bear additional costs because of the transfer, due to a change of law requirement. To be clear, SONI does not wish for consumers to bear additional costs

due to the transfer of network planning activities. The benefit of the revised industry structure, and the level of independence of the development of the transmission system (including the absence of 'gold plating' incentives) must be such that it outweighs any additional operational or transactional cost associated with the transfer.

4 Operational Expenditure

NIAUR proposes significant reductions to the SONI Operational costbase despite it demonstrating that its current cost base would be deemed as 'efficient' under the decisions of the last NIAUR decision in 2011.

4.1 Payroll Provisions (4, 5)

In April 2011, NIAUR published its previous determination with regard to setting efficient/allowable costs for the 2011/15 period (2011 Decision). In its submission to NIAUR for the 2015/20 process, SONI set out how its actual operational costs are expected to outturn below the overall approved allowance, as a result of SONI efficiencies achieved, which now transfer to customers in the form of a reduced baseline costbase (Paper 3: Analysis of Outturn & Future Business Drivers). As such, it is reasonable for SONI to consider this baseline costbase is efficient.

The make-up of this costbase has evolved during that time due to the changed organisation structure which is now in place. As such SONI incurs its own costs in addition to a series of group recharges, both positive and negative. SONI advised NIAUR that given this structure, implemented to maximise efficiencies for consumers, it was no longer possible to align operational costs to the cost categories or format applied in the 2011 Decision. Both the pre-submission presentation made to NIAUR and the submission itself detailed the structure emphasising the reason for same was to make efficient use of skills and resources available in order to provide the most efficient service and outputs for consumers. SONI also included in its submission the group 'Cost Allocation and Recharges' procedure which detailed the supporting financial processes in place to ensure that each licensee incurs the appropriate financial costs associated with its own licence activities. NIAUR requested no follow-up information on the arrangements however in its DD, all recharge elements of costs were 'stripped out' of the SONI submission costs even though the 2011 Decision specifically included, and expected, inter group recharging due to the existence of synergies with EirGrid.

Instead, NIAUR is now proposing to disregard its own revenue cap set for 2015, as well as SONI's cost forecasts, and instead provide the payroll allowance based on:

- The 2011 Decision of SONI SO staff requirements (the pure concept of which no longer exists);
- Adding the additional staff network planning roles and 4 (of 13) new resources allowed for 2015/20; and
- Calculating a forecast per person cost based on actual average costs, adjusted by reference to a non-comparative benchmark - hence reducing costs relative to the previous NIAUR allowances by c.20%.

It would seem, contrary to the principles of *ex* ante revenue cap regulation, that NIAUR is proposing to penalise SONI for operating efficiently during 2011/15, absorb an immediate reduction in revenues aligned to a c. 20% cut in staffing costs and to absorb costs associated with contractual and legal obligations (NIE staff transferred under a change in law overseen by NIAUR).

Consistent with NIAUR's 2011 decision, SONI considers it current costs to be efficient. The current value of the NIAUR decision re 2015 costs is c.£10.35m OpEx or £6m for Payroll excluding pensions. SONI has calculated the additional actual costs associated with NIE staff transfer plus the 4 additional staff requirements proposed in the DD accounts for an additional £2.1m. Hence the starting point for this period can only reasonably be assessed at c. £12.5m (OpEx) or £8.1m (Payroll excl. pensions). The NIAUR equivalents, calculated as straight averages, are £10.8m or £6.5m. Hence, the initial delta is at least £8m, over the 5 years, on the payroll excluding pensions element alone.

4.1.1 ASHE Survey

NIAUR proposes comparison of SONI salaries to the UK Annual Survey of Hours and Earnings (ASHE) survey which is published by the Office of National Statistics. NIAUR then draws inference from this as to the appropriate remuneration with which to benchmark SONI.

In the DD, NIAUR made no reference to the independent report, produced by recognised reward service providers, Towers Watson, which was included in the SONI submission, where remuneration levels of the SONI roles have been compared with remuneration survey data from three separate surveys:

- Northern Ireland General Industry Survey 2013 (100+ participant companies)
- UK High-Tech Survey 2013 (250+ participant companies)
- UK Energy Survey 2013 (50+ participant companies)

The process involved extracting comparable pay data that was commensurate with the roles identified by SONI, comparing SONI's median base salary levels against the 'market' by referencing the band and indicative global grades of the roles to ensure that roles are matched against those of a similar size. Overall, SONI's compensation levels were found to be marginally behind the market but found to be in the acceptable range both in terms of base pay and in terms of total cash remuneration. SONI received no queries from NIAUR on this report.

The findings of the Towers Watson report were consistent with NIAUR's own findings in the last determination where the remuneration rates for SONI were examined and found to be reasonable and indeed consistent with benchmarking previously carried out by NIAUR on SONI salary structures, including that undertaken by PWC in 2010.

Given, that the DD claim that SONI staff earn 19% higher than the UK mean for relevant roles, SONI requested the service providers of its benchmarking report to comment on how there could be such a difference. They reverted with the following:

- There is a clear difference in the methodologies ASHE and Towers Watson have applied and as such it is not uncommon for the results of both to be at variance with one another.
- Towers Watson's methodology focuses on a market benchmarking process by which 'market rates' are determined for a representative sample of jobs in a specific talent market, based on data for jobs with similar functions and comparable scope of responsibility. In comparison, the ASHE approach takes a 1% sample of all employee jobs i.e. it does not stipulate the levels within an organisation or the position an individual may hold in the organisation.
- There is an absence of Northern Ireland specific data in the ASHE survey. As a result SONI's roles were compared to all the UK, which does not provide any insight to the specific talent market SONI operate in Northern Ireland.

Overall, therefore, the ASHE survey does not provide a robust approach to undertake a remuneration benchmarking exercise. Specifically it does not consider industry specific circumstances or indeed role attributes and sizing in determining that which is appropriate.

4.2 Real Price Effects (RPE)

NIAUR has stated that it will apply the Retail Price Index (RPI) to index allowances over 2015/20 however RPI is an index designed to reflect the general increases in costs within the economy whereas the underlying costs of a company will not move directly in line with this. As such, it is relatively standard for regulators to include an adjustment for Real Price Effects (RPE) into its revenue regulation frameworks and provision for RPE is

standard practice employed in regulatory regimes throughout Ireland and the UK, including NIAUR e.g. NIW(2014) RP5 (2012), Power NI (2013), Firmus (2015). The CC also confirmed its application in the case of NIE's RP5 referral.

Therefore SONI engaged an independent expert firm to provide it with a clearly justified position as to what adjustment SONI should include in its forecast cost submission to NIAUR. SONI included the full report, prepared by KPMG, in its submission for NIAUR to review and assess. The extensive report outlined the inflationary factors likely to affect the cost base of a company similar to SONI during the 2015/20 period including RPE (outside of RPI) as well as expected productivity improvements. As such, SONI included an explicit provision (c. +1% annualised) in the forecast costs submitted to NIAUR.

However, despite the fact that this is a standard component in frameworks from NIAUR, other UK regulators, up to and including the CC, there is no reference to this report in the DD and no provision for same proposed. In addition, it appears to have been removed in the presentation of forecast costs 'submitted' by SONI. It is imperative that NIAUR revisit this and in so doing that it employs evidence based decision making. The implication is a reduction in SONI's submission of c. £2m over the 5 years that has not been considered, referenced or consulted upon. This increases the minimum delta referred to in 4.1 above to c. £10m.

4.3 Pension Provisions

In its submission, SONI included all pension costs as determined by law or in line with best practise as assessed and confirmed by the Trustees and Scheme Actuary.

4.3.1 Ongoing cost contributions

(i) DB Contributions:

In the DD NIAUR proposes to reduce the 5 year DB contributions allowance by £0.9m. All members of the SONI Focus Scheme are 'protected persons' as defined by the Electricity (Protected Persons) Pensions Regulations (Northern Ireland) 1992 and referenced in the DD (para. 108). SONI inherited these persons by virtue of industry structural changes (divestment and transfer). SONI has received legal advice that the company's ability to amend the pension benefits of such 'protected persons' is extremely limited due to constraints put in place at the time of privatisation. Hence, given the characteristics of the scheme and the legal protection afforded to its participants, SONI cannot 'pass on' reductions in allowance approved by NIAUR.

It is suggested in the DD that 'SONI's protected benefits are considered more generous than average'. This suggestion is unfounded. In fact the benefits of the SONI Scheme are very consistent with typical electricity industry arrangements as set out in the report of the Government Actuary's Department of 2012[1] , a report cited by NIAUR. Indeed unlike a number of other electricity industry schemes SONI was able to secure savings from the move from RPI-based to CPI-based pension indexation.

SONI notes the comment that the actuarial assumptions used in the 2013 Actuarial Valuation are considered more prudent than those applied in the 2010 Valuation. We further note the comment that SONI as the employer has a responsibility to manage and endorse these assumptions. We can confirm that the employer did engage in detailed discussions with the Trustees and Scheme Actuary on the appropriateness of the assumptions adopted. While some modification of the assumptions, such as long term salary growth for scheme members being 0.5% rather than 1% above RPI, was agreed it would have been irresponsible to not recognise the sharp fall in gilt yields between 2010 and 2013. It is this fall in the discount rate that has been

[1] https://www.ofgem.gov.uk/ofgem-publications/42780/gad-peniosn-report-16052012.pdf

the major factor in the increase in the on-going service cost from 28% in 2010 to 40.3% in 2013. It is therefore incorrect to assert that SONI, as the employer, did not challenge the assumptions adopted or furthermore to suggest that the assumptions are more prudent than those applied in 2010.

The key assumption over which the employer had influence: long term pay policy, was in fact less prudent or conservative than the 2010 assumption. A number of other assumptions were also less prudent e.g. the retirement age, cash commutation. Unfortunately the impact of these changed assumptions was over-whelmed by the lower long term discount rate, which was based on observed market data rather than on any factor that could be influenced by the employer.

SONI is strongly of the view that the 2013 assumptions are appropriate. On the basis of these assumptions professional actuaries calculated the employer contribution rate requirement was 40.3%. SONI cannot accept a proposal to reduce the funding rate to 28% based on the cited GAD report which states that at March 2010 “the electricity schemes’ SCRs lie between 24% and 28%”. It should be noted that at March 2010 the SONI employer contribution rate was, at 28%, within that range.

The position paper published by NIAUR in December 2014 has no relevance to SONI, particularly given that the stated base for this position is in the CC 2014 determination made wholly in respect of the NIE referral. SONI is not the same as NIE – scale, asset thinness, impact on consumer, impact on SONI etc. SONI articulated this to the CC at that time. NIAUR proposes to transfer DB pension risk to SONI and its shareholders which is greater than the proposed equity return to the SONI business. This position must be amended.

(ii) DC Contributions:

In addition, NIAUR proposes to reduce the DC contributions (from 8% to 6%) – a reduction of £0.8m. The current rate of employer contribution is in the range 6 - 8%. It should be noted that the additional employer contribution of 1-2% is conditional on the employee also making matching additional contributions. These arrangements were put in place following advice on what was required to be competitive in offering DC benefits to skilled workers in comparator sectors from which SONI is seeking to attract/ retain workers.

4.3.2 Deficit – DB

In February 2015, NIAUR formally requested a March 2015 update and this was provided to NIAUR upon its receipt by SONI. NIAUR have advised that they will assess the March 2015 valuation report, which has since been provided, and will need to be employed to determine the appropriate allowance.

SONI does not agree with the NIAUR proposals regarding the application of the 31 March 2015 threshold to SONI as this was determined solely in an NIE context. Even if it did NIAUR does not appear to have applied it consistently or correctly. In its submission, SONI included all pension costs as determined by law or in line with best practise as assessed and confirmed by the Trustees and Scheme Actuary.

NIAUR is proposing in the above to allow ongoing and deficit costs c. £2.4m lower than the SONI forecast which was based on the latest actuarial report available to it at that time, and hence will have to be updated for the recent March 2015 report. SONI is not in a position to fund that gap, and in particular that associated with legacy regulatory and industry arrangements which it inherited under law.

4.4 Non-provision of future output resource requirements

In section 4.1 SONI has set out that as its costs have been within the overall revenue cap set by and approved by NIAUR in its 2011 Decision, it believes it was, and remains, reasonable to assume the current cost platform as the starting cost point for the 2015/20 period commences at efficient levels.

Under an ex-ante revenue cap regulatory regime, it is important for the regulated entity to examine the additional outputs required during the period and assess if any additional resources are required in order to deliver these outputs. SONI, in its submission, identified additional resource requirements for just two directorates – Operations (10) and IS (3) – due to the additional outputs requirements largely linked with EU legislation requirements, and hence not under SONI control.

Operations:

As stated in the DD, SONI Operations requested an additional 10 staff due to the additional outputs requirements over 2015/20. The DD states that insufficient evidence was received to justify the roles yet SONI is unaware of any outstanding information or queries and provided a detailed paper (Paper 12: Operations Performance & Challenges) which described the new roles in Chapter 3 (Facilitation of Renewables), Chapter 4 (European Network Code Compliance), Chapter 5 (Post I-SEM) and Chapter 6 (UK Electricity Market Reform).

Out of the 10 additional staff requested by SONI, 6 are required for Post I-SEM Control Room operations (50% of two new enduring 24/7 roles) with the remaining 4 to cover all other areas (Renewables/DS3, European Network Code and EMR). As such, SONI assume that the former has been excluded from the allowance and hence the 3 allowed are for the other areas including European Network Codes. It is SONI's understanding that the allocation of costs associated with the ongoing operation of EMR will the subject of discussions and agreements between DECC and DETI, and therefore outside the scope of NIAUR's determination.

Post I-SEM will bring significant change for SONI as SO. The new market design is expected to introduce significant change for Control Room operations with increased requirements to economically manage change across much shorter timescales than at present. In particular, the trading activity across Intra-day will be much higher. The particulars of the 2 roles required on a 24/7 basis (hence 6 persons each) were set out in the Paper referred above. While SONI notes NIAUR wishing to engage further on these requirements these roles are mandatory requirements and given training lead-times will be required from 2016.

IS:

Of the 3 additional requirements included in the SONI submission, the DD is minded to approve just 1 as part of the revenue cap arrangements. The DD states that insufficient evidence was received to justify the roles yet SONI is unaware of any outstanding information or queries and provided a detailed paper in its submission (Paper 10: Information Systems Drivers 2015 - 2020), responded to queries and IS staff attended two meetings with NIAUR and its consultant to discuss the IS submission in detail. In January 2015, in response to a query from NIAUR, SONI outlined examples of IS resources required for European Network Codes and DS3 tools. Both of these major programmes of work are in ongoing development with the full scope of requirements not fully known and hence a conservative estimate of 3 additional IS staff was ascertained by SONI. Requirements are now clearer and the updated position is that this is now expected to be the minimum requirement.

SONI expects the analysis of data will become more and more of a specialisation and that the resource need in this area will grow both in terms of analytics and also in terms of support of the technology. As a consequence of these big data projects, there will be a number of security projects required over the 2015/20 period to manage security around this infrastructure. These would include specific pieces of work to securely collect, deliver and store the high volume of data produced in a smart grid. Protection of the end point is critical for the securing of this infrastructure. Projects would include installation of secure storage structures (SAN upgrades), bandwidth increase work, industry standard encryption for big data in transit, secure options to

deliver an open data platform, advanced two way communication protocols with specific customers as well as granular level sensor reading and management tools. The ever growing sophistication of cyber-attacks would put these structures and technology under constant review for upgrade work.

Should the proposal to disallow 2/3 resources requested remain SONI will have to reassess both current and future requirements with a view to implementing a prioritisation process to ascertain and delays or quality reductions.

4.5 Professional Fees

In addition to the professional fees which fall under the new network planning function requirements (network planning and public affairs discussed earlier in section 3.4) NIAUR is proposing to reduce legal and professional services costs by £0.4m (or 35-40%). The provision allowed by NIAUR is c. 20% below the 2011/15 average and hence the provision proposed is not justifiable or evidence based.

Separately, NIAUR is proposing to not include a provision in relation to submission for DS3 professional fees support within the DD until the further work noted is carried out. SONI is happy to engage with NIAUR in relation to same.

4.6 Other Bt and Dt Cost Reductions

4.6.1 Other Opex

The figures contained with the NIAUR DD, in relation to the SONI submission, with regard to 'Other Opex' cannot be reconciled to the SONI submission. For example, the NIAUR proposed allowance appears to include reductions of £0.3m over the period without any reference in the text. However it is in relation to the CORESO membership fee that SONI has considerable concerns:

4.6.1.1 CORSEO

NIAUR are proposing to exclude this item 'due to lack of justification of both need and cost'. As explained in the SONI submission (Paper 12) and follow-up questions (A14, H3) participation in a Regional Security Coordination Initiative (RSCI) e.g. CORESO, is mandatory for interconnected SOs in Europe, as mandated by ENTSOe. Hence, membership is not *an option* for SONI, the EU certified Transmission System Operator in NI. NIAUR acknowledge that the cost is allowed for National Grid in the UK.

ENTSOe states that consumers will benefit through improved security of supply and lowering costs through increased efficiency in system operation and maximised availability of transmission capacity to market participants.

RSCIs are to deliver the following coordination functions:

- Coordinated Security Analysis (including Remedial Actions-related analysis)
- Short and Medium Term Adequacy Forecasts
- Coordinated Capacity Calculation
- Outage Planning Coordination
- Improved Individual Grid Model / Common Grid Model Delivery.

The submitted cost forecast was based on SONI's understanding of membership of joining an RSCI, and in line with an ex-ante incentive based revenue regulation framework. However SONI will submit for this cost as and when it is advised and invoiced via a Dt.

4.6.2 D_t costs

As per section 2.2.6 SONI does not accept that D_t costs can be limited to a set of known costs and to include only those <£0.2m. In particular, SONI has concerns regarding the following:

4.6.2.1 ENTSOe

SONI cannot accept the NIAUR proposal to remove ENTSOe costs to the revenue capped B_t at the proposed level of £0.6m p.a. given the risk of incurring significant charges in excess of this and which SONI has no control. From the SONI perspective there appear to be no rational reason to treat this charge differently to the CORESO charge above. As such, and given the volatility of the charge, and the lack of a financeable business framework SONI cannot accept this charge being moved to the revenue cap B_t.

4.6.2.2 Constraints financing costs

As per all other cost forecasts included in the SO submission, all costs accorded to the SONI SO are SONI SO costs. As SONI has confirmed, it has an SO licence obligation to incur these costs and as such is entitled to recover the associated costs of same.

5 Capital Expenditure

5.1 Disallowing IS expenditure 2011 – 2015

Section 6.4 of the DD refers to a total non-network CapEx of +£1.7m over the 2011/15 period, including +£2.0m due to the Energy management System (EMS), which is, as per para. 163, 'the most business critical system for SONI'. The 2010 EMS system was significantly upgraded during 2011/15 to ensure that it was fit for purpose – there is no new EMS system being commissioned in September 2015 (as stated by NIAUR in para. 175). Further in para. 177 NIAUR continues 'Consumers are continuing to pay for the 2010 system …..via the depreciation charge ………….. Therefore consumers are continuing to pay for a system which has been made redundant and SONI has assumed …………the consumer will also pay for the new 2015 EMS system in full' which is completely incorrect but given that NIAUR does 'not dispute the need for a new EMS system' (para. 176) also illogical.

SONI, as set out by NIAUR in para. 287 and 290, included the actual investment costs in its Regulated Asset Base (RAB) submission so that the opening RAB 1st October 2015, included that investment going forward as consumers had not paid for it during 2011/15 when the investment occurred, in the interests of consumers. Given that the requirements and investment costs are accepted and SONI can demonstrate that the consumer will benefit by paying back the investment during 2016/20, SONI cannot understand NIAUR's position on this, nor that it is ultimately acting in consumer interest.

The current EMS project (delivery September 2015) is a major upgrade to the existing EMS platform. There is no redundant system. The upgrade was required to build on the investment to date in software licencing, hardware, database development, power system modelling and customisations. In 2012, SONI investigated whether or not, given the imminent requirements of the EMS system in place at that time, if delivery of a new replacement EMS would be more efficient however it was determined, by an independent consultant that a new EMS deployment would cost at least 50% higher than the costs of an upgrade project. Hence, the current investment includes upgrades of hardware and software in order to maintain support arrangements and to deliver new or enhanced functionality, particularly in relation to EMS system resilience, the management of renewable power and the delivery of efficiencies in power system operation in addition to improved planning processes, system stability monitoring and training simulation (developed and implemented for the Dublin EMS).

The project is being managed on a joint basis between EirGrid and SONI which is a more efficient approach compared to the management of separate jurisdictional EMS upgrade projects as originally envisaged. In summary, an integrated EMS platform is a sound investment for the current and future challenges that will be faced and SONI 'did the right thing' in incurring the additional spend required to upgrade to an integrated 'fit for purpose' EMS solution which has "equal capabilities" in each jurisdiction, delivering future efficiencies to Northern Ireland customers in the following ways:

- New European Network codes will mandate greater harmonisation and coordination between TSOs. An integrated all-island EMS system allows this to be delivered more efficiently for end consumers in both jurisdictions. For example, the European Network Code on Operational Security https://www.entsoe.eu/major-projects/network-code-development/operational-security/Pages/default.aspx (Chapter 2 – Operational Security Requirements) requires TSOs to coordinate

in terms of enhancing overall system security. To deliver these requirements, Chapter 3 – Data Exchange describes the legally mandated obligations on information to be transferred to neighbouring TSOs. Having an integrated EMS negates the requirement for certain new IS systems as each jurisdiction "can see" the other.

- For implementation of I-SEM, the European Network Codes require each TSO to produce an "Individual Grid Model" for their Transmission System that feeds into a European "Common Grid Model". The analysis of the EMS system for I-SEM is that it has the capability to deliver an "all-island" grid model. This is a significant saving from each TSO having its own EMS and producing its own separate Individual Grid Models. In addition, an "all-island" approach should ensure the costs of joining a Regional Security Coordination Initiative are also lower for any procurement of services as the integrated platform already "combines" N. Ireland and Ireland data in file creation.
- The latest understanding from ACER/EC is that automatic Frequency Restoration Reserve (aFRR) will be mandated as obligatory subject to a Cost Benefit Analysis (Network Code on Load-Frequency Control and Reserves). In effect this would likely require the implementation of Automatic Generator Control (AGC) across both jurisdictions and having a single EMS platform in place would significantly reduce costs.
- An integrated EMS platform increases system security for both jurisdictions and reduces software licencing costs and optimised hardware infrastructure.
- For SEM and I-SEM, an integrated platform allows efficiencies between Control Centres in terms of roles and staff deployment. While I-SEM is still in detailed design phase, it is evident that Control Centres in each jurisdiction will be dealing with a more complex market design.

In section 8 of the DD, NIAUR notes that SONI added the actual investment from 2011/15 to the Regulated Asset Base (RAB), that SONI overspent on the allowance by £1.3m and hence are 'expecting to claim this overspend from consumers via the depreciation charge'. NIAUR is proposing to exclude this overspend. To be clear, SONI is not expecting to claim an 'overspend' but to be allowed the efficient costs incurred by it in order to ensure that the EMS system is fit for purpose via a depreciation allowance commencing tariff year 2015/16.

The 2011 licence modifications proposed by NIAUR and accepted by SONI only covered the period up to 30 Sept 2015. Hence the licence includes average RAB for each year and the associated depreciation that SONI was entitled to over the period – it does not include closing RAB on 30 Sept 2015 or the opening RAB on 1 October 2015. The 2011 Decision paper did not state that the 100% risk sharing applied to depreciation post 30 Sept 2015. Further, there is no legal restriction on the opening RAB for the next period. Therefore we are unsure on any legal basis to support this proposal.

If NIAUR does not allow SONI to recover this investment cost, then the associated future savings cannot be assumed in setting the revenue requirements for 2015/20 i.e. SONI will assume a separate stand-alone EMS system, with functionality limited to that reflected in NIAUR's 2011 decision paper. SONI will have to submit an increased CapEx and OpEx forecasts for 2015/20 in lieu of the additional functionality. This would be likely to result in additional costs for consumers, due to:

- Post I-SEM operations
- Implementation of other aspects of the network codes (e.g. common network model) would have to assume data being obtained from two separate EMS systems
- Opex to reflect the higher costs associated with separate EMS systems
- EMS upgrades would need be provided for assuming a lower starting functionality

SONI does not believe that this approach would be in the public or consumer interest. Whilst SONI acknowledges that the actual 2011/15 spend was higher than the NIAUR allowance approved in 2011 it did so in the interests of incurring the most efficient spend over time and on the assumption that this being the case it would be allowed the associated depreciation during 2015/20. SONI has no issue with the delayed receipt of

the monies for the EMS system, however it must be received or alternatively the greater monies associated with the higher required opex and capex included.

5.2 Opening RABs

In addition to NIAURs proposals re excluding the actual IS investment costs of 2011/15, NIAUR is also proposing to extend this to the actual investment cost in the SONI building (an additional +£0.4m over allowance). Hence, in total sections 6.4 and 8 NIAUR discusses the additional expenditure of £1.2/£1.3m and £0.4m for Non-Building and Building CapEx costs over 2011/15.

However in section 9 the opening RABs proposed by NIAUR are £1.4m lower and -£0.6m lower respectively. In addition, SONI notes a number of inconsistencies within the NIAUR DD e.g. table 18 states the additional investment at +£1.7m versus whereas the delta between tables 27 & 28 and 29 & 30 is -£2.0m.

5.3 Reductions in IS expenditure 2015 – 2020

NIAUR is proposing to remove the DS3/Smart Grids IT programme in full in addition to reducing the forecast costs of each of the other 7 IS programmes by 10%. In the case of the latter, as per previous SONI comments these IS works are not part of the DS3 System Service workstream which is the only workstream governed by the SEM Committee and for which presently SONI is preparing a submission on a budget for works which were not part of the 2015-20 submission. It should be stressed that the full implementation of DS3 requires all the workstreams to be implemented in order to ensure that expected generation portfolio can be accommodated on the system, in accordance with SONI's duties under the European and National legislation, its licence and the Grid Code. IS CapEx costs for DS3 System Services were not included in the 2015-20 submission however those associated with the other workstreams including Performance Monitoring, new Control Centres Tools etc. were included as these are not part of the System Service workstream. However, if the cost reduction is implemented there are likely to be delays in facilitating the implementation of the DS3 System Service workstream governed by the SEM Committee. Regarding the other IS programmes, the DD further indicates that the SONI cost forecasts for the associated programme of work expected during 2015/20 will be reduced by 10% (excluding Facilities and DS3). It should be noted that this reduction is likely to result in projects being delayed or dropped during the annual prioritisation process. It is not possible at this point to identify which items they will be but it will be kept under constant review. This will be reported to NIAUR during the 2015/20 period with reasons provided.

5.4 Reductions in Buildings expenditure 2015 – 2020

NIAUR is proposing to remove £0.5m from the building CapEx forecast and in the process allowing zero investment in the building. The absence of ongoing capital maintenance, particularly to the parts of the building that will be almost 50 years old in 2020, is expected to result in less than optimal asset management, with negative impacts for the 2020-25 period.

6 Contingent Capital

Section 7 of the DD deals with a number of topics under the heading 'Financeability', which SONI responds to, in the main, separately in this response (Section 7). While the issues of capital adequacy and overall financeability are inextricably linked, in this section SONI is responding on the core issue of capital adequacy and hence, in the main, sections 7.4 Working Capital and 7.7 Contingent Capital of the DD.

6.1 What is Contingent Capital?

Contingent capital is held by SONI in order to enable it to meet unexpected variances which may arise given the nature of its role in the industry. These are variances which will ultimately be corrected through the regulatory model in future periods but which SONI must, under current industry structures, fund pending their recovery. SONI therefore needs to have access to such capital in order to be able to make good such obligations as and when they arise. The capital it has access to should be designed to be at least as great as that which is ever likely to be called upon should such adverse circumstances arise.

The ability of SONI to manage cashflows and have access to appropriate levels of funds is critical, not only to SONI, but to the electricity industry in Northern Ireland and the *all island* SEM market, given that SONI has a:

(a) Custodian role in relation to the collection of various revenues for external parties e.g. NIE, Moyle; and
(b) Funding role in terms of cash deficits due to any unanticipated variances in energy volumes, inflation, exchange rates, Dt costs (timing); and
(c) Funding role in terms of revenue deficits in relation to system balancing (DBC).

SONI has a licence obligation to have funds in place, in part to manage such imbalances.

In the DD NIAUR states that k-factors are remunerated by interest rate. There are two key issues with such a position:

(a) K-factors are year-end positions, they ignore 'intra' year volatilities
(b) Having *access* to funds, and at efficient cost, depends on the financeability of the company. Even if such funds are provided by a parent company they should be remunerated.

No matter how amended, the k factor process will therefore always be inadequate in terms of the requirements. Section 7.4 of the DD concludes with a statement that the provision of a low interest rate on k-factors provides a reasonable answer to the problem. In addition it states that it '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 'represents better value for money for the customer'. Neither the concept nor the statements are correct.

It also represents a departure from other decisions with regard to other regulated utilities where approved remuneration was on the basis of assessing the finance costs of both drawn and undrawn capital requirements, which recognises the cost of the latter. The SONI submission on capital remuneration was made directly referencing that formula. It is disingenuous for NIAUR to infer that SONI has in any way requested customers to pay for something they should not. SONI has requested that customers pay only the reasonable costs, approved elsewhere by NIAUR, of carrying out its business and its NIAUR imposed licence obligations.

Section 7.7 of the DD contains a large number of incorrect, confusing and/or misleading statements which appears to lead NIAUR to come to a view that the SONI price control has no role to play in relation to the funding requirements of DBC. This is despite the fact that the licence obligations are clear that SONI has such responsibilities[2].

NIAUR "has taken the view that 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" (para. 226) the basis of such assumption being the SEMO price control decision paper. NIAUR continues (para. 228) that "Required elements of one price control should not be captured within the submission of a separate price control". SONI wishes to be clear that it did not in its submission include any provision for remuneration of any costs or risks for a separate licence including the MO licence. As SONI has pointed out to NIAUR it is Annex 1 of the SONI SO licence which provides that SONI, acting as SO, make good any shortfall of the SEMO in respect of DBC (a cost managed by the TSOs). Moreover, SONI MO can under Annex 1 of its licence make a call on SONI SO for the necessary financial support. Hence the DD is incorrect in this regard and SONI is correct to include remuneration for the funds it has in place to efficiently deal with financial imbalances[3].

SONI currently holds £22m of contingent capital in the form of £12m debt facilities backed by £10m equity (in the form of a Parent Company Guarantee). This is consistent with the 55% gearing as set out in NIAUR's own WACC formula. This capital is a significant part of SONI's balance sheet. It is not clear why it is not remunerated.

SONI has indicated its willingness, to discuss with NIAUR, what is the most efficient level of capital that should be held, recognising that given the potential increased business risk environment (new balancing markets and system services arrangements bringing an increased financial reliance on the SO) it might be necessary to increase the current funding level. It is clear however that, under the existing industry structure, it must hold some and for periods of up to 27 months, and that holding such capital must be remunerated.

6.2 The Requirement

The remuneration of the SO total contingent capital requirements should reflect the general cost of capital for the business (the regulated WACC) adjusted for:

(a) Nominalisation, as there is no RAB indexation to apply;
(b) There being a probability of it being required to be drawn (therefore for the debt it is akin to a standby facility and on equity deposit interest can be earned); and
(c) Where it is drawn at year end there is a separate stream of remuneration through the k factor which can be taken into account.

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[2] For example, para. 223 notes a £10m PCG is in accordance with the requirements of both the SO and SEMO licences.

[3] Section 7.7 focuses on how one of the various potential contributors - dispatch balancing costs – is not an SO obligation and has some remuneration from the SEMO price control. Neither is the case and reflects a fundamental misunderstanding of the facts. Contingent capital is only in part for the management of DBC – it is also to cover all of the other eventualities as outlined above. The SEMO price control provision is related to the requirements for the SONI SEMO licensed activity including its own exchange rate risk, revenue recovery risk, inflation and increased pass through costs which can arise in SEMO activities (e.g. legal disputes). Contingent capital is separately required by SEMO and hence has a separate required licence obligation. NIAUR's statements and presumptions in the DD are therefore incorrect.

This is precisely the basis on which NIAUR priced such capital for Power NI and hence the basis of the SONI submission. However in the DD NIAUR mistakenly states that SONI is seeking a margin akin to Power NI and that this is not appropriate as Power NI is a competitive business whereas SONI is not. This is not a correct interpretation of the SONI submission. SONI simply stated that the methodology employed by NIAUR to price contingent capital for Power NI by using the relevant WACC (SONI's WACC in SONI's case and Power NI's higher WACC in Power NI's case) should be used to price the contingent capital held by SONI. To do otherwise would be inconsistent and potentially discriminatory.

In the 2011 Decision it was recognised that SONI had to have access to this capital however this DD appears to infer, incorrectly that SONI does not need it and hence incorrectly is minded to not provide remuneration for it. If this is the case then SONI will not be in a position to put such capital in place. Should NIAUR maintain this position in the final determination it would be required in order to render such arrangements consistent:

(a) Amendment of the SONI SO licence to remove the requirement for it to support the Market Operator under Annex 1; and
(b) Amendment of the SONI SO licence to remove the requirement for it to have in place a deed of undertaking in accordance with Condition 3; and
(c) Amendment of the SONI MO licence to remove the ability of it to draw upon the SONI SO licensee in event of shortfall; and
(d) A legally binding undertaking given by NIAUR to SONI that in the event of adverse events under paragraph 1 arising such that SONI is not in receipt of funds through the tariff to enable it to meet its obligations that it would be relieved of its obligation to (i) pay NIE and (ii) pay generators under the T&SC until such times as it receives adequate remuneration through the tariff having paid all of its own costs; and
(e) Written confirmation from the CER and SEM Committee that they understand and have no objection to these arrangements.

Ultimately SONI believes the revised framework as set out above would be inconsistent with the structure of the industry and is not in the public or customer interest.

7 A Sustainable Framework - Financeability

7.1 The SONI Submission

Financeability and the overall regulatory architecture to support a financeable SONi business was a central tenet of SONI's revenue submission for 2015/20. It is SONI's view that NIAUR has misrepresented the basis of the SONI submission with regard to its fundamental concern re financeability. In particular, SONI notes paragraphs 55 & 188 though it is not confined to these, where NIAUR infers that SONI has submitted for a framework composed of a wide variety of separate returns. This is not the case. The SONI submission is centred entirely on establishing a framework to ensure its financeability based on remuneration of costs and capital and an overall return consistent with its financeability requirements. For clarity the following is the basis of the SONI submission.

(a) It should be financeable against an overall benchmark of EBIT margin by reference to comparators. This is the appropriate financeability test as traditional asset based utility financeability tests do not capture the risks and financing challenges to which SONI is exposed.
(b) SONI has applied this financeability test to the SSS tariff revenues only (costs under its control) **not** total revenues as SONI acknowledges that many of the total revenue components are pass-through to SONI with it acting more akin to a collection agent.
(c) However where SONI acts as collection agent (for non SSS tariff revenues) it is still subject to cashflow risks and it must hold capital to mitigate against this risk and to provide cash in the event of it being required. As these revenues were not covered in the EBIT calculations, the efficient cost of holding such capital must be remunerated separately.
(d) The margin (on SSS revenues) is not additive to the WACC*RAB model returns – rather the latter can comprise a component of the overall EBIT margin.

SONI is not seeking explicit remuneration for (i) the Parent Company Guarantee (PCG) which it must have in place under licence or (ii) intangible assets which comprise one aspect of the overall enterprise value of the SONI business. Rather the PCG is one element of the working/contingent capital provided to enable SONI to access capital markets and meet its licence obligations. Further, Intangible assets are one element of the total Enterprise Value against which the EBIT margin should be benchmarked.

The overall inference of SONI submitting for multiple returns is taken a step further in section 7 Financeability, under 7.8 'Other Aspects'. SONI would assume it is reasonable that a regulated business should be able to pay dividends to shareholders and the provision of dividends is a standard part of the overall assessment of a financeable business. SONI does not accept this should be characterised as 'SONI *wishes* to pay EirGrid dividends' (emphasis added).

In addition, in this section NIAUR refers twice, in two separate paragraphs, to the potential for incentives, with respect to the management of constraints without then considering this as part of the overall financeability test. The initial paragraph (233) refers to the potential for financial penalty, a penalty greater than the proposed equity returns, without considering the implications were it to occur yet specifies the potential for c. £1m payments while the next paragraph (234) refers to the potential to provide c. £0.5m annual payment. To clarify, this is the same incentive, one expressed for two years, the other for one.

Section 7.8 concludes with a statement that First Economics in a 2011 paper on the 'Estimate of NIE's T&D's Costs of Capital' concluded 'after considering SONI's arguments' that 'the WACC approach, sufficiently captured SONI's higher operational gearing risk, and remained appropriate for SONI to finance their activities'. SONI does not believe this is an accurate interpretation of either the purpose or comment of the paper

quoted. In any case, SONI would question the relevance of the 2011 paper on estimating NIE T&D's Costs of Capital within which SONI is mentioned amongst several regulated entities but which does not consider the requirements for SONI for the 2015/20 period when operational gearing will have increased and risks increased.

7.2 Key Issue of financeability

SONI identified at the outset of this review that the financeability of SONI over the next 5 years was a critical issue for the business and as such would be the central tenet of SONI's revenue review submission. Therefore SONI asked KPMG to 'benchmark' SONI's financeability to provide an independent expert view which SONI could consider as part of its engagement with NIAUR. In particular SONI requested advice on financeability measurement, given that the current regulatory framework applied to it is one developed for asset based regulated utilities, given SONI is a (tangible) asset light business.

The subsequent SONI submission centred around the output of that analysis, and how this could be applied in the case of SONI. A KPMG report setting out the issues, assessing the options and including a recommendation was included in the submission pack in addition to SONI Papers 2 (Overview & Context) and 6 (Risk & Uncertainty: The Financeability Framework). KPMG determined that SONI:

- As a TSO is atypical in being asset light ;
- Has a thicker and relatively unique set of TSO responsibilities;
- Provides value-add services for industry/society ;
- Is highly geared operationally; and
- Incurs significant financial obligations on behalf of the industry

As such, to ensure actual financeability, it was considered that several revenue building blocks of a new framework needed to be addressed, as follows:

1. Remunerate Contingent Capital (debt & equity); and
2. Maintain WACC*RAB mechanism for tangible asset return; and
3. Introduce a margin, aligned with EBIT, to ensure financeability: and/or
4. Implement an incentives regime (with potential for additional returns in return for value-add).

The EBIT-aligned margin in effect pieces together the revenue building blocks to ensure that the overall outcome satisfied financeability tests. The report detailed the analysis and assessments behind the further determination that EBIT margin benchmark of 10 – 12% for all the relevant components of the return revenue was appropriate, both from the point of view of selecting EBIT as the appropriate measure as well as the selection of the 10-12% value, the latter of which focused on 3 different methodology assessments, as follows:

1. Debt - Ratings agency assessments based on an A grade credit rating (12-16%)
2. Equity - Comparative analyst reports (7 – 13%)
3. Outturns Benchmarking (12-17%)

One of the reasons for both debt and equity assessments was aligned to the fact that debt based financeability tests by themselves cannot be used to assess financeability for SONI. Equity financeability tests are fundamental in addressing the overall financeability question.

The current regulatory revenue model employed by NIAUR includes only one of the three building blocks referred – the WACC*RAB return. Given the small RAB element of same it is not possible for the value of the

return to equal an appropriate EBIT margin. The SONI submission therefore included the missing 2 building blocks:

1. Provision of direct remuneration for the efficient cost of £22m debt & equity capital.
   SONI recommended using the approach adopted by NIAUR in the case of Power NI, adjusted for the lower risk profile and therefore lower WACC of the SONI business; and
2. Introduction of a margin to ensure overall financeability equated to 10% - 12% assessed to have been an appropriate return on SONI's own costs (SSS tariff revenues). This is equivalent to c. 3% on total revenues.

7.3 NIAUR Proposals

In line with the recommendations of the KPMG analysis, SONI made a submission to NIAUR setting out its reasons for requiring a new framework and the component elements of same. The following table provides a high level overview of the actual figures included in the submission, as compared to the DD proposals:

	SONI **2015-2020 £'m**	NIAUR **2015-2020 £'m**	Delta **£'m**	Delta **%**
Bt Costs	75	54	-21	-28%
Dt Costs	7	4	-3	-43%
Network Planning	25	25	0	0%
Depreciation	10	10	0	0%
Contingent Capital	7	0	-7	-100%
Returns	16	1.5	-14.5	-91%

*It should be noted that SONI does not necessarily agree with all of the figures quoted by NIAUR as being representative of SONI's submission.

Hence, based on conservative estimates of total revenues of c. £600m, NIAUR is proposing to allow SONI returns equivalent to <0.3% whereas SONI had requested < 3%. In addition, NIAUR is proposing to allow no provision for remunerating contingent capital.

7.3.1 Margin

Section 7.5.2 of the DD is the NIAUR response to SONI's submission with regard to the overall regulatory model and the application of margin. Para. 212 states that based on '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 the figures presented in the DD itself does not support this observation. The profit margin of 5% earned in 2012/13 is less than half of the required margin suggested by KPMG analysis and is premised on accelerated regulatory depreciation and other factors unique to the 2011/15 period. Also, the margin has exhibited significant fluctuation over the three years included which reflects the profit volatility that is symptomatic of a purely capital-based approach to the allowed return. Moreover, unless recent historical data is assured to being repeated it is essentially meaningless in terms of a 2015/20 review.

NIAUR further state (para. 236) that in their view the 'WACC*RAB approach remains appropriate for SONI as it can ensure that the interests of consumers are protected together with the regulated business being financed and their investors are not unfairly treated'. However, the process that NIAUR has followed to assess

financeability does not appear to follow best practice. Any financeability assessment should clearly set out three groups of considerations:

1. The nature of the test to be carried out;
2. The benchmarks against which the test will be assessed to determine whether the business plan in question is financeable; and
3. The implications of a finding that the business plan is not financeable in the absence of mitigating actions.

NIAUR has not set out any of these considerations in the DD. In particular, it has:

1. Not explained, or justified, the nature of the financeability test it has applied. Importantly, NIAUR has not provided any explanation for why the financial metrics it considers (and it is not clear which it has considered) represent an appropriate or comprehensive basis for the financeability test. As indicated below, there are a number of other factors (including liquidity and cash management) that are relevant considerations in the context of a financeability assessment which have not been adequately considered by NIAUR.
2. Not set out the thresholds on which it has based its conclusion (in Para. 236) that there is no financeability issue. As indicated, the credit metrics presented by NIAUR in the DD appear to indicate the opposite conclusion.
3. Not considered mitigating actions required to ensure financeability, since it has concluded (in our view incorrectly) that there is no financeability issue. In fact, significant mitigating actions would likely be necessary to ensure the financeability of SONI's business plan under the allowance set out in the DD.

Section 7.6 of the DD references the existence of a large intangible, as distinct from tangible, asset base in SONI before concluding that NIAUR does not propose remuneration for this requirement implying that SONI submitted for such remuneration. This is not the case. References to intangible asset returns in the SONI submission were only in relation to the requirement to 'fill the gap' between the tangible asset WACC*RAB return which can only be negligible in the case of SONI (as demonstrated) and the EBIT margin identified as being required in order to secure financeability.

7.4 NIAUR Financeability Model

Following publication of the DD, SONI requested NIAUR to provide it with its financial model and this was provided with NIAUR noting that it remained a working model with a number of corrections required. SONI requested KPMG to provide an independent overview of the model. Based on this SONI has compiled the observations set out overleaf:

Observations on the NIAUR Financial Model

1. Non-balancing balance sheet in any of the modelled years, either on a real or nominal basis.

2. Inflation modelling: All three financial statements are modelled first on a real basis and then converted into a nominal basis using the same indexation factor. This is simplistic and ultimately incorrect approach has been adopted.

   (i) Financial statements expressed on a real basis are meaningless. Interest payments, taxes and working capital movements are all nominal cash flows for the business. Thus, expressing the financial statements on a real basis does not provide useful information (although the conversion between real and nominal has not been done properly – see below). For instance, Ofwat's PR14 Financial Model presents the IS, CF and BS only on a nominal basis. Ofgem's financial models for ED1 and T1 do not include financial statements, although the GD1 model presented the regulatory financial statements purely on a nominal basis.
   (ii) The balance sheet cannot be converted using the 'real x indexation' principle used in the model. Balances are updated over time, and each negative or positive movement to each account has to reflect the inflation for the time period in which that movement was made.
   (iii) Certain accounting frameworks such as current cost accounting (which is not the basis upon which the SONI accounts are presented) update the balance sheet for inflation, however the indexation used would not be the same as that used for the P&L. Also, such accounting frameworks would create special reserves such as the "current cost accounting" reserve and have separate depreciation calculations such as the "current cost depreciation" in order for the financial statements make sense.

   In short, the method adopted neither conforms to historical cost accounting nor any other accounting framework. As such, it is hard to draw conclusions from the financial statements.

3. Price basis used in financial ratios: the model calculates the financial ratios on a real basis, which is not in line with UK regulatory practice. Financial ratios should be calculated on a nominal basis, and if the treatment of inflation were to be corrected, then nominal ratios would give different results from the current ones.
   (i) Given the way the model is built, i.e. the same inflation is used for all financial statements (as described above), the ratios would not yield different figures if they were calculated on a nominal basis. However, as outlined above the inflation assumptions and modelling are incorrect. As such, ratios calculated on an amended nominal basis would be different from those calculated on a real basis.
   (ii) All rating agencies' ratios (e.g. adjusted interest cover ratio, net debt to RAB, FFO to net debt, retained cash flow to debt and S&P's debt to EBITDA) are calculated on a nominal basis.
   (iii) Ofwat calculates all financial ratios on a nominal basis for both PR09 and PR14. Ofgem did not publish ratios within its financial models for T1, G1 and ED1. However, the stated policy closely followed the ratios used by rating agencies, which are all calculated on a nominal basis.

4. Financial ratios mix the notional versus actual basis: there is an inconsistency within the financial ratios in terms of whether they are calculated on a notional or on an actual basis.
   Regulators typically carry out their assessment on a purely notional basis. This notional basis abstracts from companies' actual operational and financing structure but has to be internally consistent in order to be meaningful. The figures taken from a company are typically its opening balance sheet, but the debt (both quantum of debt and the proportion of debt that is index-linked) is flexed by the regulator to reflect the regulator's own assumptions about the notional structure.
   (i) Not doing so would create a wide discrepancy between the gearing assumed in the WACC (and hence the quantum of debt that is being rewarded) and the level of debt (and hence the cost of debt) assumed in the business.
   If a regulator were to assume a different level of gearing in the WACC, any cover and leverage ratios calculated would implicitly assume that the company is under or over-rewarded for its debt and would thereby not be useful in understanding the correct riskiness of the business.
   (ii) Ofwat's PR14 assessment is clear in that respect. All companies are evaluated on a fully notional basis, consistent with the gearing assumed in the WACC.

   In the case of NIAUR model, this principle is ignored e.g. 55% gearing is assumed in the WACC and is also used in calculating interest for the cover ratios, but nil debt is assumed on the balance sheet nor are any

interest payments assumed in the income statement and cash flow statements. This gives erroneous gearing, net gearing, and return on equity figures. The ratios are also inconsistent with each other and do not paint a coherent picture of the business. For example, the leverage ratios are inconsistent with the cover ratios.

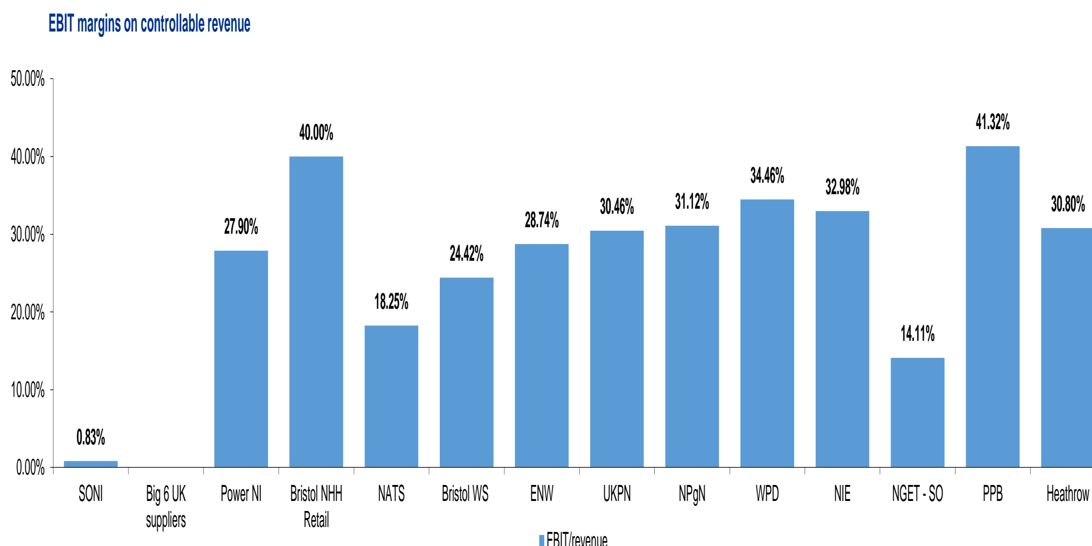
5. Treatment of depreciation: The model equalises the regulatory depreciation to the accounting depreciation, which is not in line with UK regulatory practice. A regulator could set the regulatory depreciation to equal to the statutory depreciation (but not the other way round) when an asset is bought into the business. It could also use its regulatory discretion to change the "RAB depreciation" subsequently, but with no impact on the statutory depreciation when presenting financial statements.
   However, NIAUR has done the opposite by imposing statutory depreciation equal to the regulatory depreciation it has determined. This assumption is unrealistic and incorrect. It distorts the financial ratios by not reflecting the true picture of the company when assessed on both an actual and notional basis.
   (i) Accounting depreciation is governed by IAS 16 (Property, Plant and Equipment), whereby the depreciable amount is allocated on a systematic basis over the useful economic life of the asset, reflecting the pattern of consumption of economic benefits from the use of the asset. Although annual review of the depreciation methododology is allowed, it can only be changed if a change in the pattern of consumption can be identified.
   In contrast, regulatory depreciation is a revenue building block which typically can be altered by the regulator and/or company at each price determination for various reasons, e.g. to solve for financeability issues.
   Given the different purpose and nature of the accouting and regulatory depreciation, the assumption made in the model that they should equal each other is incorrect.
   (ii) Neither Ofgem nor Ofwat assumes that regulatory depreciation and accounting depreciation are the same.
   In Ofgem's three separate Price Control Financial Models for ED1, G1, T1, 'statutory depreciation' and 'RAV depreciation' are calcuated separately and based on different inputs.
   In Ofwat's PR14 Financial Model for each of the 18 WaSCs and WoCs, 'accounting depreciation' is based on asset life and is different from the 'RCV run-off', which is determined as a result of the price control process and incorporates the views of both the company and the regulator.
   (iii) The approach is also inconsistent with how the three main rating agencies would treat depreciation. Moody's, S&P and Fitch typically adopt the method used by Ofgem and Ofwat stipualated above. Although Moody's can (according to its stated policy) amend the regulatory depreciation for the purposes of ratio calculations, it would only do so only if the rate of RAV recovery was excessively rapid compared to useful economic life.

As outlined above KPMG identifies a number of issues with the model as set out, relied upon and provided by the NIAUR. In any event, even if all of the issues identified were to be corrected, such a model remains flawed as it does not consider the further investments SONI will have to make and how it will finance them (e.g. I-SEM, delivery of DS3 System Services) nor the risk based scenarios in terms of the sustainability of the overall framework. The model can only provide one input into the overall financeability test.

7.5 Benchmarking Profits

Ultimately financeability must be assessed against verifiable benchmarks. In its submission SONI set out, based on the KPMG analysis, why EBIT Margin represents the appropriate benchmark. SONI also requested KPMG to carry out some analysis on the financeability of SONI compared to comparable businesses in Northern Ireland and GB. The following charts demonstrate the gap between SONI and other regulated businesses, whether they are asset based or asset light.

In the next chart SONI has adjusted to measure EBIT against controllable revenue as ultimately this is a better measure of that which ought to be financeable by it assuming that separate provision has been made to manage liquidity associated with those revenues it manages on behalf of others. While the SONI numbers increase it remains a notable outlier.



*The chart is based on publicly available data which is not available for the Big 6 which are the subject of the CMA inquiry.

7.6 Benchmarking to PPB

In the past, NIAUR has applied two different regulatory models: WACC * RAB for asset based businesses and Margin for businesses which have modest asset bases. SONI is regulated today under a WACC * RAB approach despite having characteristics (including low physical asset base) much more akin to a Margin type business. At the heart of SONI's submission, supported by independent advice, that the WACC * RAB regulatory model is not fit for purpose and must be amended.

This is already recognised by the NIAUR in other price controls for businesses which have similar characteristics to SONI. On the same day the SONI DD was published NIAUR also published a draft determination for the Power Procurement Business. The control framework for the Power Procurer proposes the application of WACC*RAB for the modest physical assets, a working capital provision to meet unanticipated costs, an allowance for 'profit' and an incentive or gain share provision.

The nature of the regulatory framework which would render SONI financeable has in fact been applied by NIAUR in the case of PPB.