

BUSINESS ALLIANCE RESPONSE TO THE SONI PRICE CONTROL 2020 - 2025 DRAFT DETERMINATION CONSULTATION

SEPTEMBER 2020

INTRODUCTION

The Business Alliance¹ welcomes the opportunity to respond to the Draft Price Determination for SONI. Northern Ireland is about to embark on a substantial transformation on how and where our electricity is generated, transported, stored and used on the journey to a zero-carbon economy. At the same time our economy is slowly emerging from a Covid led recession with the full impact on employment still to be felt.

Elsewhere in the UK and Europe there is now a focus on encouraging green investment in energy and energy infrastructure as a way to help mitigate the economic impacts of Covid and to re-emerge with a much greener economy as a result.

This Price Control will operate within this environment and therefore by design should facilitate change. We therefore welcome and support Utility Regulator's approach to a Price Control that recognises there is more to be gained in driving the system wide outcomes SONI can directly influence than to concentrate on an exercise in cost control and cost reduction for a business that makes up only 2% of domestic consumers electricity bill.

It is against this backdrop that we consider the Draft Determination and whether we believe it will deliver on its stated aspiration.

TOWARD A ZERO CARBON ECONOMY

A key driver of change going forward will be the environment. It is likely the new NI Energy Strategy will have a strong focus on delivering a road map toward a zero-carbon economy, incorporating the requirements contained within the EU Clean Energy Package that in of itself will drive change. Scotland is already generating enough electricity from renewable sources to meet all its needs and Wales has set a 70% target for renewable electricity by 2030.

The pace at which we embrace change is also important. Northern Ireland has been challenged by the UK Committee on Climate Change for the slow pace at which it is addressing its own carbon footprint. Global warming of 1 degree has already happened and urgent and early action is needed to hold it to 1.5 degrees, according to the Committee

¹ The Business Alliance is a partnership between the Confederation of British Industry Northern Ireland (CBI NI), the Centre for Competitiveness, the Institute of Directors Northern Ireland (IoD NI), and the Northern Ireland Chamber of Commerce and Industry.

on Climate Change.² SONI and the Regulator together will play a pivotal role in driving forward change and the Price Determination will need to set the groundwork for supporting the changes that lie ahead.

SUPPORTING A GREEN ENERGY TRANSITION AS PART OF AN ECONOMIC RECOVERY

Given the foregoing it is a concern that the Utility Regulator (as is the case of his counterpart OFGEM in GB) has failed in the draft determination to address the need to front load investment needed to start the transition. OFGEM has drawn strong criticism from GB businesses for this failure and we are keen to ensure Northern Ireland does not equally fail to live up to its commitments. Thus, the fact the Utility Regulator is open to providing additional allowances if SONI can address some of its information concerns is welcome and we would encourage both parties to work together to resolve those concerns.

However, we remain concerned that much of what needs to be done is likely to be addressed through a process of project approvals during the Price Control that is likely to unnecessarily delay projects at the risk of foregoing consumer and environmental value. DS3 enhancements and Control room investments which are important to enable greater amounts of renewable energy to be managed on the networks are key areas we would like to be supported early in the Price Control.

We would therefore encourage SONI and the Regulator to work closely between now and the Final Determination so that SONI may be in a position to front load significantly more of the Price Control project approvals such that the focus of the Price Control period is on implementation of initiatives, rather than about application for funding. Both parties must strive to ensure that in this period of energy transition, the Transmission Network does not become an unnecessary constraint on wider economic and environmental investments.

One further point that is unclear to us is how well this Price Control will operate to ensure that Northern Ireland is able to match the pace of the South in delivering a transformation of the all-island Transmission Network, such that progress on the Island, North and South, does not get out of step with each other. We therefore limit our comments to asking the Regulator to ensure in the Final Determination takes cognisance of this point when determining the timing and funding of projects that can influence the speed and direction of all island collaborations by the Transmission system operators.

STAKEHOLDER ENGAGEMENT

Understanding the operation of the electricity market requires a unique technical knowledge, often found only inside the regulated utilities. However, the value of that knowledge in guiding and educating the wider business community through the coming transformation will be critical to support early and rapid adoption of new technologies and embracing of opportunities. We acknowledge the lead the Regulator took in encouraging SONI engagement with stakeholders through the creation of the SECG, as SONI sought to develop its Business case for this Price Control. We note plans for better stakeholder engagement and would ask both the Regulator and SONI to ensure adequate resources are

² <https://www.theccc.org.uk/2018/10/08/its-now-or-never-for-one-and-a-half-degrees/>

made available to support focused collaborations with The Executive, NIE Networks and to help educate and inform the wider business community.

INCENTIVISING PERFORMANCE AND OUTCOMES

Two areas of focus we would respond on are the design of the proposed incentive scheme and the weighting applied to incentives/ disincentives for over and under performance.

Mitigating Loss Aversion Bias

It should be recognised that a loss aversion bias is likely to be strong in regulated businesses whose price caps often result in a focus on internal cost reduction and avoidance of any form of risk taking where costs may not subsequently be recovered. This was highlighted in an OFGEM draft determination which stated:

“there could be a case for including relatively more upside than downside for the incentives on medium-term and longer-term roles. We asked whether relatively more upside focus could mitigate the risk of the ESO not stretching itself in more novel areas due to loss aversion bias”³

We note the OFGEM Draft Determination goes on to propose upside incentives at 2.5 times the size of the downside penalties, in order to facilitate an appetite for more novel innovations and we would be supportive of a similar approach in the SONI Price Control.

Proposed Incentives Framework

We note the Utility Regulator’s desire for an evaluative process on assessing performance, as against SONI’s proposals heavily weighted toward “mechanistic” objectives. Whilst we welcome the concept of rewarding actions now that will deliver benefits in future years we would be concerned at the uncertainty risk introduced by switching over entirely to such an untried system, whose success will be dependant on the engagement of sufficient competent experts in a very specialised area, to assess a business that in terms of scale operates in only 3% of the UK energy marketplace.

Further, development of a remuneration mechanism based on 16 qualitative targets, whilst much simplified versus what is proposed in GB, may still struggle to deliver enough clarity to align SONI to the targets or by spreading incentives over so many qualitative targets, to disincentivise targeted outperformance in any one area. It is important to ensure that the final incentive package is both sufficient in quantum to actually incentivise and is not spread over so many targets as to dilute its overall effect.

We believe it is right this Price Control should support a transition to a more evaluative approach but do not believe we should switch over completely within this Price Control to this system but rather apportion the overall incentive between the evaluative approach (and use this Price Control as an opportunity to bed down and refine the evaluative system) whilst also retaining a significant proportion of incentive to apply to delivery of defined outputs. Defined outputs which challenge SONI year on year to deliver increases in network uptime and efficiency, supporting more renewables onto the network and maintaining a strong focus on Grid security, including in these challenging times, cyber security.

³ https://www.ofgem.gov.uk/system/files/docs/2020/07/draft_determinations_-_eso.pdf para 2.66

RISK, UNCERTAINTY AND FINANCIABILITY

The desired outcome of this Price Determination is a business, focused on delivering day to day improvements in value to all consumers, whilst in parallel transitioning toward a zero-carbon network. However, this desired outcome may be put at risk if the Price Control under which it operates contains too much uncertainty, both around how the Enterprise will be rewarded and how well it manages projects whilst trying to live within its allocated operating costs, to the point where SONI may become more focused on managing risk than on delivering outcomes.

How well SONI manages projects depends on what projects are finally to be undertaken, the £20m of the draft determination, or over the course of the Price Control, nearer the SONI submissions of £50m. Greater clarity is needed as the outset as to the level of initiatives to be undertaken, to ensure the business can invest in advance in the staff needed to manage the initiatives and related risks.

If the financial markets perceive there is a mismatch between the staff resources funded and the projects to be managed, they will have a heightened degree of concern around the cost sharing and incentive mechanisms that would penalise poor performance, driving up the risk premium on the funding of Debt during this Price Control.

We note the detailed technical work carried out by the Regulator on the funding of the business (the weighted average cost of capital and the appropriate split between debt and equity) and the intention to remove the need for a Parental Guarantee, which both has a cost but also value. Whilst noting this approach seeks to reduce the overall cost of the SONI business model, we need to reflect on whether the change in gearing and loss of guarantee increases the perception of risk by the markets that in turn determines the price at which SONI can attract finance. A saving in one area that results in an increased cost in the other.

Finally the risk in how well or badly the incentive package performs, the uncertainty around how it will operate and any powers it might or might have on retrospective review to disallow expenditure, are all matters of uncertainty that unless addressed in the Final Determination are likely to impact on the risk rating a financial institution attaches to the financial covenants of the company and therefore the price at which it can access debt. Again, this was recognised OFGEM in its draft determinations recently:

“.... the maximum incentive downside would have to be considered carefully alongside financing considerations for an asset light company.”⁴

CONCLUSION

There is much to welcome in the approach the Regulator has adopted in this Price Control and the engagement brokered between stakeholders and SONI.

SONI is an asset light company that has a major influence on how efficiently the network is run and the resultant levels of network reliability and cost. It is right to focus on the

⁴ https://www.ofgem.gov.uk/system/files/docs/2020/07/draft_determinations_-_eso.pdf 2.67

outcomes needed to manage an energy transition into the future which delivers a highly efficient, secure and carbon efficient network.

Any Price Control Determination is a highly complicated exercise to manage and there will always be a healthy tension between the regulated company seeking more financial headroom and the Regulator seeking value for money. We should not lose sight however of the goal at the outset. The prize of delivering substantial outcomes at a time of change from a regulated business that accounts for 2% of the consumer spend on electricity each year. Ensuring value for money and efficient operations is important, but the sum of the proposed cost adjustments, their consequences on the effective operation of the business, and on creating any perception of heightening of financial risk that in turn negatively affects the price of debt, needs to be weighed against the outcomes being pursued, such that the Final Determination takes a holistic view of this Price Control.