SONI Revenue Review 2015-2020

SONI Response to:

NIAUR Draft Determination (of 2nd April 2015)

18 May 2015

System Operator for Northern Ireland

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. SONI also holds the licence to act as SEM Operator.

On Friday 3rd April 2015, the Northern Ireland Authority for Utility Regulation (NIAUR) published its Draft Determination to the Price Control 2015-2020 for SONI (Transmission System Operator), requesting responses to same by Thursday 14th May. This forms the main element of the SONI response.

The SONI Draft Determination if implemented would not allow SONI to meet its licence obligations, would be inconsistent with NIAUR's statutory duty to protect the interests of customers and would not be in the public interest. It does not provide a basis for SONI to finance its activities. It is not evidence based. It is at odds with other recent determinations made by NIAUR including those NIAUR is currently consulting on.

Specifically, the draft determination for SONI:

- Fails to respect the legal obligations inherited by SONI on divestment and through the NIE transfer. This includes provision for the costs of personnel transferred under TUPE legislation and provision for persons who have been accorded 'protected persons' pension status under law. These obligations are absolute and the regulatory framework for SONI must respect them.

- Appears to propose over-writing the industry and licence structures put in place and operated since 2007. It does not reflect the licence architecture, as put in place by NIAUR in respect of the management of dispatch balancing ('constraint') costs and seeks to reallocate network costs from TUoS to SSS in contradiction of the SEM Committee's decision in respect of all island TUoS harmonisation and indeed the SEM HLD.

- Is contrary to general principles of *ex ante* regulation including those established in the Competition Commission determination for NIE. The draft does not consider the evolution of SONI costs during the control period (Real Price Effects) even though this is a standard element within the regulatory architecture and is applied by NIAUR elsewhere. Equally the proposed treatment of network project costs is in direct contradiction to the Competition Commission determination on the treatment of capital costs as OpEx in the case of NIE.

- Is at variance with, and contradictory to, the 2011 determination made by NIAUR for SONI. The draft seeks to impose unevidenced, unjustified and undeliverable efficiencies on the SONI business of in excess of 20% in the case of payroll costs and in excess of 10% across the board. It does not address provision for the Energy Management System invested in the current price control even though the rationale for the investment has been accepted by NIAUR and it is vital for the secure operation of the NI transmission system.

- Makes no provision for contingent capital even though it is a licence obligation that such capital be in place and the access to such capital is necessary to enable SONI to pay its bills and meet its obligations. In the absence of such provision SONI will be unable to make payments under the industry structure until such time as it is in receipt of the necessary funds through the tariff.

- Is unclear on how the overall financeability of SONI has been assessed. Whilst a model has been provided (to SONI), this model contains a number of errors and cannot be relied upon. Moreover, even if the model as set out even were to be corrected it is not designed to assess the overall financeability of SONI. The approach adopted is therefore fundamentally flawed.

The final determination for SONI must provide:

- The operating costs associated with the efficient conduct by SONI of those activities it is obliged to carry out;

- Ascribe the management of risks to SONI where SONI is in a position to manage them and support the delivery of value and value adding services to Northern Ireland customers;

- A sustainable framework to enable the necessary investments to be made and the efficient cost of making payments to industry participants to be met; and

- A financeable business, one which ensures consumers pay that which is appropriate, no more and no less.

Against each of these four tests the draft determination falls short:

- It is inadequate in its provision of operating costs, inconsistent with the previous NIAUR price control decision and does not reflect the legal obligations held or inherited by SONI. The final determination must amend the provision to be both consistent with the last control and provide for SONI's legal obligations.

- It provides for a risk framework to SONI around the advancement of network projects which is not sustainable and provides no incentive for SONI to deliver value for Northern Ireland customers. The final determination must amend the risk framework to be consistent with the overall control and should ensure that SONI is incentivised to do the right thing for customers.

- It gives no recognition of the requirement to have access to capital to meet unanticipated variances for example to enable the appropriate TUoS to be paid to NIE and/or Dispatch Balancing Costs to be settled in SEM. The final determination must recognise this requirement and provide for the cost of accessing and drawing this capital.

- It sets out no benchmark of financeability. The final determination must assess SONI financeability on an overall basis and cannot look at each building block in isolation.

NIAUR applies 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 this price control is SONI's assertion, supported by independent analysis and assessment, that the WACC * RAB regulatory model on its own is not the appropriate model for a business with SONI's characteristics and must be replaced with a more suitable model.

This is already recognised by NIAUR in other price controls for businesses which have similar characteristics to SONI. On the same day the SONI draft determination was published NIAUR also published a draft determination for the Power Procurement Business (PPB). The control framework for PPB 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. This framework, appropriately calibrated for SONI, would meet the four tests above. The existing control for Power NI provides for a similar framework.

Ultimately the control framework needs to provide for a sustainable business which will deliver for customers and enable the necessary investments to be delivered; it should promote and incentivise innovation, value-add and total industry value chain cost management. It should be aligned with and enable the fulfilment by NIAUR of its statutory duties.

Looked at in totality the arrangements for SONI as set out in the draft determination:

- Provide total returns to SONI before interest of c.£0.3m per annum, or c.£0.15m per annum after interest costs.

- Provide for operating costs for the forthcoming period over £10m below that implied by NIAUR's last determination without any additional provision for requirements for future challenges.

- Do not address SONI's operational gearing: a 1% variation in OpEx is greater than the underlying equity returns accorded.

- Propose the non remuneration of investments made by SONI in the Energy Management System even though their requirement is not disputed by NIAUR. This non remuneration is equivalent to 10 years' equity return

- Propose to disallow on-going DB pension costs for 'protected persons' which are a legal obligation and as a consequence transfer DB pension risk to SONI and its shareholders which is greater than the equity returns provided for.

- Propose that SONI be responsible for 50% of any additional investment required in relation to network pre-construction activities, the riskiest point in the cycle in terms of infrastructure delivery.

- Expect SONI to finance public policy investments at a time not of its choosing and where the equity required to be injected by SONI could be over the equivalent of 25 years' equity returns.

All of this is in the context of increasing risks for the forthcoming period with the implementation of new system services and the operation of the system, including increased balancing responsibilities, in the context of I-SEM.

The SONI Board met in April 2015, following publication of the Draft Determination, and was unable to make a resolution of the Board to assent to the signing of Directors' Certificates on the Availability of Resources for the forthcoming period, even though this is required under licence, given the Board's concerns as to its adequacy of the draft determination and indeed the degree to which it cast into doubt the wider industry architecture and structure under which SONI has been operating.

Attached as part of this response is an Appendix paper in which SONI has set out a detailed response to the points contained within the draft determination. SONI would welcome the opportunity to discuss its concerns with NIAUR. SONI reserves its position in relation to all such matters.