



**SSE RESPONSE TO
DRAFT CORPORATE STRATEGY 2014 – 2019 AND
DRAFT FORWARD WORK PROGRAMME 2014 – 2015**

FEBRUARY 2014

INTRODUCTION

Thank you for giving SSE the opportunity to comment on the Utility Regulator's Corporate Strategy 2014 – 2019 and Draft Forward Work Programme for 2014 – 2015.

SSE is a utility with both generation and supply interests in Northern Ireland. Our supply business, Airtricity, supplies 300,000 gas and electricity customers in Northern Ireland. We also own and operate over 500MW of wind generation capacity in the Single Electricity Market, over 1000MW of thermal generation capacity, and we are due to commission a new CCGT in Q4 2014.

Our response provides general comments on the Corporate Strategy and briefly covers some of the FWP projects that are relevant to our business. At a very high level, we welcome the organisation's refocusing and restructure, which better reflects the structure of the industries that the organisation regulates. We would hope that the new structure will help to build consistencies across the regulation of both monopolies and markets and drive

OBJECTIVES

The Utility Regulator's Forward Work Programme sets out 3 central objectives. We believe that the structure of these objectives better reflects the structure and operation of the industries that the organisation regulates and the interests of the customers that those industries serve.

We have included some brief comments on each of the individual objectives.

Promoting effective and efficient monopolies

The regulation of natural monopoly activities like gas network operation or electricity network operation shares more than the operation of electricity network operation and electricity wholesale markets. The Key Performance Indicators appear to reflect a focus on assessment of outputs relative to competitors, through increased use of benchmarking against comparable utilities. SSE would welcome this approach – the RIIO model used by Ofgem in GB would require more sophisticated and detailed information on asset management from Licensees, but also provides more freedom for Licensees in determining the best approach to meeting the needs of their

customers (whether those customers are domestic consumers or connecting generators).

One of the key performance indicators is listed as:

“Our regulatory tools have helped ensure regulated utilities drive further effective innovation”

We would note that current monopoly price controls do not effectively incentivise innovation. It is fair to state that Northern Ireland is a small market and to some extent will necessarily follow, rather than lead in technology development and deployment. However, we think that two changes to the approach taken by the Utility Regulator could easily (and cheaply) incentivise effective innovation:

1. Price controls currently assess individual cost items in great detail, rather than looking at the total quantum of costs in an area (or in total). Setting less strictly defined allowances to deliver clearer expected outputs should incentivise effective innovation within the operation of regulated licensees. Some of the RIIO ED1 business plans from GB Distribution Network Operators provide clear examples of how this approach could deliver the same functions at lower cost.
2. Activities that do not naturally sit within natural monopolies should be opened up to competition where possible. A clear example of this is with regard to generation connections. Contestability at distribution **and** transmission level will allow non monopoly companies to deliver their own connection assets, revealing incremental improvements to the connection process and actual costs. Similarly, any ‘Network Innovation Fund’ or similar should be open to wide participation, rather than limited to regulated monopolies.

Finally, we welcome the commitment to deliver gas network extensions by 2019. Northern Ireland’s reliance on Home Heating Oil is the primary reason for differentials in household bills, and the higher levels of fuel poverty relative to Great Britain.

Promoting competitive and efficient markets

SSE would see the delivery of the Integrated SEM as fundamental to this objective for retail and wholesale markets. Suppliers are relatively passive participants in the existing energy trading arrangements, with little opportunity to choose when to procure energy. The options currently being consulted should facilitate better participation for suppliers which should feed through into more competitive retail markets.

However, the new trading arrangements must reflect the characteristics of the Irish system which include indivisibility of generation assets relative to overall demand, level of variable penetration and market power issues. Consistency with the EU target model does not mean strict transposition of a generic continental NWE energy market structure onto the Irish arrangements, more that Ireland can fully utilise the European shared order book functions and take advantage of the liquidity and optimal interconnector flows that should result.

On the effectiveness of competition, we believe that a shift from focusing on the detail of supplier operations to macro market monitoring will be beneficial. This would also fit with Best Practice Regulation – targeted and proportionate actions that deliver better markets for customers.

Protecting the long-term interests of business and domestic consumers

SSE welcomes an explicit objective relating to the long-term interests of business and domestic consumers. However, this objective appears to be split between major interventions to secure physical security of supply or changes in the underlying generation mix and short term interventions to ensure better outcomes for consumers.

Major interventions should only be required when the previous two objectives have not been fulfilled i.e. for the current physical security of supply issue, there has been a monopoly issue in terms of the delivery of the North South Interconnector (albeit one that would have been difficult for the Utility Regulator to address alone), or a market issue in terms of the investment signal the SEM is providing for generators in Northern Ireland.

Smaller interventions should be judged against the targeted and proportionate criteria under Best Practice Regulation. Often, minor interventions to change how energy suppliers have to operate impose costs that have to be recovered over a small customer base. This can restrict competition and market entry, and increase prices for customers. We would suggest that retail market interventions, if judged necessary, should comprehensively consider an area, rather than introducing piecemeal changes to supplier operations.

FORWARD WORK PROGRAMME PROJECTS

In terms of the Forward Work Programme Projects, SSE would have additional comments on a couple of the different projects.

3: Progress the establishment of a single gas transmission operator (TSO) in conjunction with the implementation of European network codes

SSE assumes that this will not entail major ownership changes, but instead agree upon the Contractual Joint Venture approach identified under the CAG project. A single network code and transmission system operator for Northern Ireland would be a significant improvement for operational trading.

We would request that the final project description or outcome includes clarity around the implementation of entry/exit pricing.

15: Deliver contestability for connection to distribution networks

We welcome the Utility Regulator's firm commitment to deliver this project. SSE has already shown that contestability can deliver substantial customer benefits in Northern Ireland, both in terms of cost of connections and timelines for market access.

However, it is not clear why only distribution networks have been included within this project description. Offshore generation connections or any physical solution to security of supply risks (**under Project 26**) would require transmission connections which will be better progressed (both in terms of time and price) under a contestable connection regime.

In fact, it is difficult to see how offshore projects can progress without contestability at transmission level, given the overlaps between planning permissions and the connection assets required to provide market access.

SSE requests that the final project description includes a firm commitment to deliver contestability for connection to transmission and distribution networks. The process design in terms of asset development, construction and transfer would be very similar, and there is no clear benefit in excluding transmission connections from contestability arrangements.

18: Develop enduring arrangements for regional integration of the electricity market, by January 2016

This project will be central to ensuring the effectiveness of competition for consumers in retail and wholesale electricity markets. Rushing the design could lead to structural issues in terms of retail competition,

wholesale competition and the operation of and investment in the physical assets underlying both markets.

We welcome the engagement from the Project Team to date, and request that despite the strict timelines for delivery, market participants will be given adequate opportunity to understand the options available, and share their expertise in the design of the enduring market arrangements.

22: Implement effective market monitoring for intraday trading

SSE would request more clarity around the concerns that appear to have initiated this project. The current intraday trading arrangements for electricity are infrequently used due to their design – it is not clear what material impact intraday trades could have on the market.

24: Consider and develop measures to improve the competitiveness in SEM in advance of the regional integration of the electricity market and;

26: Work with DETI to address security of supply risks in NI beyond 2016

The anticipated project outcome under the first project is stated as:

“Ensure appropriate profitability in wholesale market”

Listed just below is a key project related to the security of supply risk identified for Northern Ireland from 2016 onwards. Delays in the development of transmission infrastructure have led to the specific security of supply risk, but the wholesale market is also not providing any investment signal for generation units in Northern Ireland (whether those would be upgrades to existing plant, lifetime extensions or development of new generation capacity).

Paradoxically, these two projects taken together imply that wholesale profitability is currently both inappropriately high, yet also inadequate to incentivise any investment that would resolve Northern Ireland’s security of supply risk. SSE would question:

- What exactly is meant by the improvement of competitiveness in SEM given that there is a commitment not to make material changes to the trading arrangements given **Project 18** and no changes in ownership or expected market entry.
- How the Utility Regulator would be in a position to define ‘appropriate profitability’ given the existing security of supply risk and the lack of information on how companies actually finance, and make investment decisions on generation capacity. All generation projects are capital intensive projects

which require a positive expectation of the recovery of a WACC that reflects the risk involved in their development, construction and operation.

The existing SEM profitability report gives a very basic and limited snapshot of gross and net margins across various technologies of various vintage, not information on how investment decisions are taken in wholesale markets.

Different types of generation capacity have different characteristics, whether those are high fixed costs, financing arrangements, long development periods or exposure to various different price risks. These can all result in very different levels of accounting 'profitability' in a given year. Simplistic assessments of accounting profitability will lead to a simplistic debate that will not best serve customers, companies or regulators.

A competitive market that incentivises efficient entry and operation is the best way to achieve positive outcomes for all consumers. We would suggest that the Utility Regulator will get substantially more value from a focus on incremental improvements to the market through the development of Integrated SEM arrangements that fit the physical characteristics of the All-Island System and its interactions with Europe.

I hope you find our input helpful to your review, and look forward to seeing the final publication of a Corporate Strategy and Forward Work Programme. If you have any questions regarding our response, please do not hesitate to contact Connor Powell at connor.powell@sserenewables.com