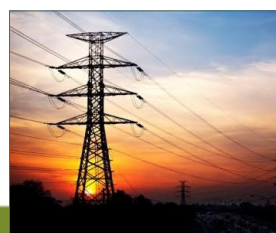


# Approach Paper to the Price Control for Electricity System Operator for Northern Ireland (SONI)

An Information Paper  
July 2014



## About the Utility Regulator

The Utility Regulator is the independent non-ministerial government department responsible for regulating Northern Ireland's electricity, gas, water and sewerage industries, to promote the short and long-term interests of consumers.

We are not a policy-making department of government, but we make sure that the energy and water utility industries in Northern Ireland are regulated and developed within ministerial policy as set out in our statutory duties.

We are governed by a Board of Directors and are accountable to the Northern Ireland Assembly through financial and annual reporting obligations.

We are based at Queens House in the centre of Belfast. The Chief Executive leads a management team of directors representing each of the key functional areas in the organisation: Corporate Affairs; Electricity; Gas; Retail and Social; and Water. The staff team includes economists, engineers, accountants, utility specialists, legal advisors and administration professionals.

### Our Mission

Value and sustainability in energy and water.

### Our Vision

We will make a difference for consumers by listening, innovating and leading.

### Our Values

Be a best practice regulator: transparent, consistent, proportional, accountable, and targeted.

Be a united team.

Be collaborative and co-operative.

Be professional.

Listen and explain.

Make a difference.

Act with integrity.

## Abstract

The purpose of this document is to inform stakeholders on the high level approach which we expect to take in relation to the next price control for the electricity transmission System Operator for Northern Ireland (SONI). This price control is due to be effective from 1 October 2015.

## Audience

Consumer Groups; Industry and Statutory Bodies.

## Consumer impact

SONI has a pivotal role in terms of 'keeping the lights on'. Both the effectiveness and efficiency of SONI are key to industry and consumers.

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# 1 Introduction

- 1.1 Our role is to promote the interests of electricity consumers. Our primary duty, which is defined in law, is to protect the interests of consumers including having regard to securing and meeting demand for electricity and regulated companies being able to finance their activities.
- 1.2 When we carry out our duties we do not operate in isolation but work closely with a range of other stakeholders. Key stakeholders in relation to the operation of the power system in Northern Ireland include:
- System Operator for Northern Ireland (SONI)
  - Government bodies e.g. Department of Enterprise, Trade and Investment (DETI)
  - Market participants e.g. generator units
  - Moyle Interconnector
  - Renewable Groups
  - Consumer Council
  - EirGrid PLC

## Background

- 1.3 SONI Ltd (SONI) is the Transmission System Operator (TSO) for Northern Ireland.
- 1.4 SONI underwent divestment from Northern Ireland Electricity plc (NIE) in 2009 and was acquired by EirGrid, the certified independent Transmission System Operator for the Republic of Ireland. SONI is also a party to a joint venture with EirGrid to form the Single Electricity Market Operator (SEMO) responsible for settling the wholesale electricity market.
- 1.5 This paper relates specifically to SONI as the Transmission System Operator (TSO) and excludes aspects relating to the Market Operator.

## SONI's Statutory Role

1.6 SONI Ltd in their role as Transmission System Operator (TSO) for Northern Ireland operates under licence, which defines its functions as to:-

- a) operate an efficient, co-ordinated and economical system for the transmission of electricity in Northern Ireland;
- b) facilitate the transmission system being made available to persons authorised to supply or generate electricity in Northern Ireland, on terms which neither prevent nor restrict competition in the supply or generation of electricity -; and
- c) promote the security and efficiency of the electricity generation, transmission and distribution system in Northern Ireland.

## 2 Context

### Economic Regulation

- 2.1 Where a natural monopoly exists, there is no scope to change system operator in order to receive better prices or service levels. In the absence of such competitive pressures, natural monopolies may act against consumer interests by:
- Becoming or remaining inefficient, passing higher costs on to consumers than would otherwise be necessary;
  - Accepting poor levels of service rather than seeking innovative or challenging ways to improve performance while reducing costs.
- 2.2 By subjecting monopoly service providers to external benchmarking and challenge, independent economic regulation helps ensure that they continue to act in the consumer interest.
- 2.3 Economic regulators also impose budgetary constraints on the regulated company or companies (while at the same time ensuring efficient companies can finance their licensed activities). These constraints are based on direct challenge of the company's proposals, supported by external benchmarking of cost and service to establish the company's relative efficiency and performance.
- 2.4 The provision of electricity transmission system operator services is a natural monopoly, and in Northern Ireland, is delivered by SONI.
- 2.5 Therefore in respect to SONI a regulatory framework has been put in place to protect the consumers who use its services. In our role as economic regulator, we take action if we consider that the company is performing less

or operates less efficiently than its peers and we set targets for improvement.

- 2.6 To ensure that a strong regulatory framework is in place between us and SONI, we will establish a clearly defined set of outcomes that the System Operator must or will be incentivised to deliver. When selecting these outcomes we aim to strike a balance between outcomes that are clearly defined while allowing the System Operator the flexibility it needs to deliver them in the most effective way.

## Overview of the Price Control Process

- 2.7 The price control process includes a number of distinct stages:
- SONI prepare a business plan (including actual data for previous years), which sets out SONI's assessment of the funding necessary to deliver outcomes;
  - We consider the business plan and performance in order to set appropriate allowances that we consider are necessary to allow the system operator to operate in an efficient manner;
  - We issue a Draft Determination for public consultation. We encourage stakeholders to provide their views by commenting on the draft proposals;
  - We then carefully consider all responses received from the Draft Determination to arrive at a Final Determination of a challenging and achievable level of funding. This process ensures the Final Determination is fair, balanced and proportionate for the system operator.



### 3 Overview of Our Price Controls

#### Previous and Existing SONI Price Controls

3.1 Since divestment from NIE, SONI TSO has been subject to two price controls which are summarised in Table 1 below:

Period	Length of Price Control	Total Allowed Revenue	Average Total Allowance per Year	Average OPEX per year	Average Depreciation and Return per Year
2007 - 2010	2 1/2 years	£20 million	£8 million	£5 million	£3 million
2010 - 2015	5 1/2 years	£72 million	£13 million	£9 million	£4 million

**Table 1: Summary of Previous SONI Price Controls**

3.2 SONI's capital expenditure is reflected within a Regulated Asset Base (RAB) which is a regulatory valuation of the assets of a company. It is calculated as an initial value when the company was formed, plus subsequent investment, less depreciation charges. The RAB value in 2015 is estimated to be £8 million. The RAB relates mainly to the IT system and is depreciated over a period of 8 years. The RAB also includes the building extension estimated to have an initial cost in 2014 of £2.5 million and will be depreciated over 25 years.

3.3 The current price control in place ends, after 5 ½ years, on 30 September 2015.

#### SONI Price Control (Effective 2015)

##### Expectation

3.4 The Utility Regulator is very aware of the key role SONI play within the electricity industry including in relation to security of supply. It is therefore

important that SONI maintain a secure and stable operation of the system whilst also being able to facilitate change in the foreseeable future.

3.5 Throughout the price control process the Utility Regulator will engage with SONI as part of our robust and appropriate arrangements which will continue to be mindful of the principles for best practice regulation:

- transparency,
- consistency,
- proportional,
- accountable and
- targeted.

3.6 The optimum duration of a price control is a matter of judgment that needs to balance the advantage of allowing sufficient time to plan and deliver the service and also take account of the external drivers and constraints that inform the overall level of charging that is possible.

3.7 There are a number of significant factors impacting on SONI's role and costs, some of which will not be sufficiently defined for the commencement of our Price Control work. The factors outlined below are significant in informing and defining our approach to SONI's next price control:

- TSO certification – new requirement on SONI to plan the transmission network
- Market Integration Project scheduled to be implemented by close of 2016
- DETI target of 40% demand being met from renewable energy by 2020
- Delivering a Secure Sustainable Electricity System (DS3 Project), currently expected October 2015.

Due to the uncertainty of the impact the Market Integration Project and DS3 project has on the SONI business a separate submission is expected at a later date when a more reasonable cost assessment can be made.

3.8 In respect of the duration of the price control, a number of options have been considered, particularly in respect of the above list of significant factors impacting SONI's role in the coming years. However, it is expected the price control will be for a five year period ie October 2015 to September 2020.

3.9 Table 2 below provides a summary of the form of regulation applied in previous price controls together with the expected form for the next SONI price control.

	OPEX	CAPEX
<b>Price Control 2007-10</b>	Revenue Cap RPI-X	Rate of Return Regulation
<b>Price Control 2010-15</b>	Revenue Cap RPI-X	Rate of Return Regulation
<b>UR Proposal for 2015-20</b>	Revenue Cap RPI-X	Rate of Return Regulation

**Table 2: Form of Regulation for SONI Price Controls**

## 4 Our Approach to Key Areas

### Operating Expenditure (OPEX)

- 4.1 We are proposing OPEX should continue with RPI-X Regulation under a Revenue-Cap regime. In this ex-ante approach we will agree the revenues that SONI should be allowed to earn. Tariffs will be calculated so as to recover these revenues on the basis of projected energy volumes. However, in the event that out-turn market volumes (demand) differ from these projections, any over- or under-recovery of revenue would be adjusted, via the 'k factor' mechanism, in finalising tariffs for the following year. Savings derived from efficiency gains will be retained by SONI and any over expenditure would have to be absorbed by SONI.
- 4.2 The value of the 'X' factor will be determined by comparison with the Business Service Sector as SONI's asset light structure is more akin to that than a typical network utility company.

### Capital Expenditure (CAPEX)

- 4.3 We propose continuing the Rate of Return Regulation. Under the Rate of Return Regulation the regulated company would include in the Regulatory Asset Base (RAB) the costs of every capital investment. This amount would be recovered through depreciation and a return in the form of a weighted average cost of capital (WACC) would be applied. The WACC has and will continue to reflect the asset light nature of the system operator business. The investments will be depreciated over a specified number of years and a return provided by applying the WACC. This method provides a 'smoothing' effect on tariffs as costs are recovered over a number of years.
- 4.4 SONI's IT assets currently are depreciated over 8 years and buildings over 25 years. The Utility Regulator will assess the most appropriate depreciation period.

- 4.5 The Weighted Average Cost of Capital will be reassessed in full which will take into consideration the Competition Commission's Final Determination in respect of the NIE T&D price control.
- 4.6 SONI's capital requirement is small in comparison to the traditional utility company and therefore in comparison with network companies the risk associated with capital expenditure may be greatly reduced. However operational gearing risk will be considered for companies, such as SONI, which have greater emphasis on operational costs.

## Managing Uncertainty

- 4.7 Within the current SONI price control there are a range of measures in place to manage uncertainty. These include an annual ex-post adjustment mechanism ('k' factor) which accounts for, inter alia, inflation and demand variability. In respect of costs arising during the price control which were not foreseen or could not be appropriately captured at the time of setting the price control there is a 'Dt process' in place. Our expectation is these 'Dt items' should be rare and approval should be sought before expenditure is incurred. In the recent past there has been numerous 'Dt items' relating to a wide range of cost areas which has increased regulatory burden. Currently there is a de minimis of £20,000.
- 4.8 Our intention is to continue with both the K factor adjustment and the Dt process. However we expect to modify the existing Dt process to outline specific principles and timeframes to streamline the process and reduce the regulatory burden. Specific pre-defined costs, to reduce the 'wildcard' aspect of Dt items, will be outlined in the price control together with a materiality threshold.
- 4.9 In terms of risk management we have previously identified a need to address cost fluctuation in the short term until ex-post adjustments, as appropriate, are made to tariffs. This can be lag of up to 2 years. To

bridge this gap SONI's licence currently requires a Parent Company Guarantee to be in place for its System Operator business.

## Asset Light Nature

- 4.10 As with any business there is an element of inherent business risk. The application of a Weighted Average Cost of Capital (WACC) to a Regulated Asset Base (RAB) is a form of remuneration for the exposure to such systematic risk. As a regulated business, the exposure to risk is mitigated to a large extent with an ex-post adjustment mechanism or 'k factor'. The 'k' factor mechanism is a correction facility, for specified adjustments, whereby under or over-recoveries in the previous year can be collected by the business (under-recovery) or given back to consumers (over-recovery).
- 4.11 SONI's structure is more akin to a business service provider than a traditional utility due to their low asset base. As the capital base is relatively low we will consider if the WACC remuneration and 'k' factor mechanism is appropriate to account for the risks of the regulated company.
- 4.12 Some work in this area has been carried out recently in respect of the Power NI price control. However, it must be noted that this was in the context of a competitive supply market. Furthermore, the recent introduction by the SEM Committee of Dispatch Balancing Cost incentivisation has taken account of the asset-light nature of the TSOs. We intend to consider further our approach to a 'fair return' for asset light utilities.

## Incentives

- 4.13 In addition to the RPI-X incentive on OPEX, in which SONI can retain efficiency gains for the duration of the price control we will consider the need to introduce other incentives to this price control. As noted above SONI TSO is currently being incentivised in terms of the Dispatch

Balancing Costs. Dispatch Balancing Costs (DBC), also known as constraint costs, are outside of the scope of this price control and are reflected in the all-island Imperfections tariff. The forecasted value for DBC within the all-island Imperfections tariff is currently €178<sup>1</sup> million for which an estimated €45million (25%) relates to Northern Ireland. Dispatch Balancing Costs are the largest and most variable tariff and therefore an all-island incentive mechanism was introduced<sup>2</sup> to encourage the TSO's to effectively manage constraints with an objective of reducing the all-island Dispatch Balancing Costs.

- 4.14 To date incentives in relation to capital expenditure and overall performance have not been introduced. We will consider the merits of introducing additional incentives to those identified above.

## **TSO Certification – Transfer of Investment Planning Function to SONI**

- 4.15 The European Commission published its decision on 12 April 2013 and concluded that SONI would be certified as the Transmission System Operator for Northern Ireland. To further improve the independence of the system operation in Northern Ireland the responsibility for network investment planning has become the responsibility of SONI rather than NIE. Therefore NIE will be required to develop and maintain the transmission system in accordance with the SONI network development plan.

- 4.16 SONI engaged with NIE to affect the transfer of the investment planning function during April 2014. As a result, SONI will incur additional cost following the transfer. Our expectation, from a consumer's viewpoint, is this will offset against the reduction to NIE T&D's costs for tariff year 2014/15 onwards.

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<sup>1</sup> 2014/15 SEM Committee Imperfections Charge Consultation Paper

<sup>2</sup> SEM Committee Decision Paper on 'Incentivisation of All-island Dispatch Balancing Costs' (SEM-12-033)

- 4.17 There will be a need to assess and include additional costs arising from SONI's certification. As the changes took effect from April 2014 an assessment of efficient costs for this planning function together with consideration of any relevant legal obligations resulting from this transfer will be included as part of the next SONI price control.

## **Licence - General**

- 4.18 Other aspects of SONI's licence are being considered separately and are outside of this price control process. These include SONI Independence, Fuel Switching Agreements, Dispatch Balancing Costs Incentivisation and Accounts. Any proposed modifications will be consulted upon separately by the Utility Regulator.

## **Business Plan Information Requirement**

- 4.19 We expect to issue a Business Plan Information Requirement in July 2014 to SONI. This will outline the financial resource, as identified by SONI, to produce the required outcomes for the next price control period. This request separately captures the 'Business as Usual' costs together with costs in relation to the network planning function which will form part of SONI's duties from May 2014. Due to the uncertainty of the impact the Market Integration Project and DS3 project has on the SONI business a separate submission is expected at a later date when a more reasonable cost assessment can be made. We therefore expect SONI's submission during October 2014.

## **Benchmarking**

- 4.20 Benchmarking is an efficiency comparison with more or less comparable companies which can contribute to the evaluation of specific cost areas e.g. payroll or alternatively contribute to the overall determination of the X-factor in RPI-X regulation. A further advantage is it allows the regulator to refrain



from micro-management by making an assessment based on other firms rather than a stand-alone assessment by the regulator. In arriving at efficient revenue for a Northern Ireland System Operator we expect to benchmark as much as possible.

## Competition Commission

- 4.21 Recently the Competition Commission published their Final Determination in relation to NIE T&D. This determination is relevant to the Electricity Industry within Northern Ireland. This together with the greater involvement SONI now have in terms of planning the transmission network means we will be considering key areas of the Competition Commission Final Determination in respect to SONI's price control.

## 5 Timetable

Phase	Year	Month	Milestone
Planning	2014	9 July	Approach Paper Finalised and issued together with Business Plan Information Requirement
Business Plan Assessment		15 October	SONI submit Business Plan
		October - January 2015	Initial assessment and bilateral meetings
Draft and Final Determinations and Effective Date	2015	27 February	Draft Determination Published
		24 April	Consultation Closes
		31 July	Final Determination Published
		July - September	Drafting and consultation on licence modifications
		1 October	New price control commences