



# SONI Ltd

## Price Control Response

4 March 2011

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# SECTION 1: INTRODUCTION AND KEY ISSUES

## INTRODUCTION

SONI welcomes the opportunity to respond to the Utility Regulator's consultation<sup>1</sup> on the SONI price control for the period 2010 to 2015.

As the Transmission System Operator (TSO) for Northern Ireland, SONI's primary function is to ensure the safe, secure, reliable and economic operation of the transmission system in Northern Ireland. This is an essential and absolutely critical role, and the capability and sustainability of the SONI business is central to the wider Northern Ireland economy and community.

The next 5 to 10 year period will see an unprecedented level of change in the electricity sector including the delivery of the DETI Strategic Energy Framework<sup>2</sup> target of 40% of energy generated from renewable sources by 2020. In order to realise this strategy, the price control reflects a significant ramp up of the SONI business required to meet these challenges, with associated increases to resourcing levels.

SONI will have a central role in delivering the renewable targets and achieving EU policy, government and regulatory objectives. Although this change is significant to the SONI business it adds significant value to Northern Ireland and the overall impact on consumers is relatively small (circa 2.9% of overall bills). SONI is committed to realising the full benefits that can be derived from renewable energy to the benefit of all consumers.

The SONI price control must ensure the right outcomes for Northern Ireland consumers through the provision of:

- Adequate operating revenue to allow SONI to respond flexibly to the needs of the industry
- Sufficient scope to manage and accommodate operational risk
- Adequate capital expenditure investment and return
- Consistency of regulatory practice, for example in the provision for pensions

In this context, SONI has a number of fundamental concerns with the proposals as set out in the Utility Regulator's consultation paper. There are significant gaps in all areas between the SONI submissions and the Utility Regulator's proposals; certain elements of SONI's required revenue have been disallowed or reduced without any or with inadequate justification. The imposition of significant reductions will limit the ability of SONI to deliver a level of service which the industry will expect of it at a time of significant change and development.

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<sup>1</sup> SONI Price Control 2010 – 2015 Consultation Paper, 14<sup>th</sup> January 2011.

<sup>2</sup> Department of Enterprise Trade and Investment, A Strategic Framework for Northern Ireland, September 2010.

SONI must continue to maintain security of supply and operate the system on a 24/7 basis. To achieve this, significant challenges must be addressed by SONI during the price control period. During this period SONI must be able to:

- Maintain the security and integrity of the transmission system
- Balance generation and demand optimally and in an economic manner
- Manage constraints efficiently
- Provide for comprehensive emergency planning and training
- Meet statutory and license obligations and increasing European requirements
- Meet the Government’s renewable generation target
- Facilitate key Executive strategies and plans, including the Regional and Economic Development strategies
- Manage an increasing number of new connections
- Maintain and support business critical IT systems such as the Energy Management System (EMS)
- Support the development of the Single Electricity Market (SEM)
- Provide data to key stakeholders in a timely manner
- Respond effectively to key regulatory and policy issues.

The current proposals as set out in the consultation paper do not provide sufficient revenue, capital and resources to allow SONI to continue to support competition and market liberalisation. SONI has a central role in the connection, facilitation and management of reliable, competitive and sustainable generation which will attract investment and jobs to Northern Ireland.

The final determination must recognise a significant step change and reflect the increasing importance and criticality that SONI has in Northern Ireland.

## RESPONSE STRUCTURE

The format of the response is in two parts:

- **Section 1** is an introduction to the response, and discusses the key issues for SONI
- **Section 2** provides a specific response to the questions contained in the consultation paper.

SONI submitted a number of comprehensive price control documents last year. These were:

1.	6-Month price control Extension Submission	May 2010
2.	Overview and Principles	July 2010
3.	Opportunity Cost of Capital	June 2010
4.	Resource Requirements	August 2010
5.	Capital Expenditure	July 2010
6.	Written Questions	August 2010
7.	Performance Incentives – An initial discussion framework	August 2010
8.	Answers to the formal Utility Regulator’s questionnaire	September 2010

This response supports the papers submitted to the Utility Regulator and the answers to the price control questionnaire.

SONI remains of the view that the level of information provided and the questionnaire responses submitted reflect a proposal that ensures SONI can deliver all of its obligations during the price control period. SONI has continued to engage with the Utility Regulator throughout the period and remains committed to ensuring the best outcome for the business and for consumers in Northern Ireland.

## CHALLENGES 2010-2015

SONI operates within a highly specialised area, in a critical industry sector which faces significant challenges over the next period:

### OPERATING THE SYSTEM WITH INCREASING LEVELS OF WIND GENERATION

There must be sufficient organisational capacity to develop system operational instructions, forecasting and curtailment tools and assessment of planning and real-time scenarios to ensure that wind is optimised on the system and consumers benefit to the maximum extent. Recent system events and TSO studies have demonstrated the impact of system incidents on wind farm output, the insufficiency of current controls to enact curtailment strategies in real time and the need to be able to predict the need for contingency measures to maximise wind output. Each of these items directly impacts on the cost of wholesale electricity.

### ENSURING POWER SYSTEM MANAGEMENT CAPABILITY

There are many factors that will increase the complexity of system operation over the price control period - the introduction of a second interconnector to the GB system (the East-West interconnector), the new North-South tie line, increased levels of wind, increased reliance on special protection schemes and increased pressure to release transmission plant and to facilitate the upgrading of equipment, new substations, and the new lines that will be required to develop the transmission system.

### DELIVERY OF CONNECTIONS - BOTH DISTRIBUTION AND TRANSMISSION

Connections that have been dealt with to date have clearly demonstrated that this is an area of greater complexity and more resource intensive than had been estimated during the previous price control submission. The Strategic Energy Framework has set a target of 40% consumption from renewables by 2020 and the annual rate of connections to be managed will increase year on year to provide the additional 1200-1500MW of renewables to be connected to the NI electricity system over that period.

## DELIVERY OF TRANSMISSION INFRASTRUCTURE TO MEET STRATEGIC ENERGY FRAMEWORK TARGETS

The all island transmission networks will undergo significant development and extension over the next 10-15 years to meet the government targets for renewable penetration. SONI need to be adequately resourced to meet this challenge and, during this price control period, a key focus will be on ensuring the adequacy of the planning and development of the transmission network. It will also be necessary to focus on a more complex operational planning and real time operating environment. SONI will be required to operate the power system whilst managing the increase in renewable generation and a significant infrastructure investment programme. The level of complexity is further compounded as experience has shown that not all project build runs to time and potential delays are inevitable.

## CAPABILITY TO ADEQUATELY RESPOND TO EMERGENCY SITUATIONS

The problems encountered during the recent cold spell in Northern Ireland highlights the need to ensure that all utility companies are adequately resourced to react quickly and appropriately in an emergency situation. This is equally true for the TSO business which needs to be able to react swiftly to emergency situations on the power network, such as a blackout or load shedding, whilst also having the ability to manage a more prolonged period of energy shortfall. Plans must be in place and staff trained to ensure that emergency situations are managed in a real time operational timeframe. SONI must also be able to engage fully with the media and other key stakeholders in an emergency situation. The management and provision of accurate, timely information is of critical importance in an emergency and SONI's systems (e.g. data warehouse and website), processes and resources must be adequate.

## PROVISION OF ACCURATE ROBUST DATA

The Trading & Settlement Code, Inter-TSO Compensation Agreement and Interface Agreements all require that the TSO provides data that is accurate, validated and timely. This is an ever increasing workload due to the level of complexity of data flows, information storage and validation checks, scheduling, query management, disputes, market developments, including modifications, and ENTSO-E requirements.

## KEY ISSUES

SONI is a very different business from that envisaged in preparing the submission for the previous price control in early 2007. Since then SONI has been a principal party in:

- Successfully launching the Single Electricity Market (SEM) in November 2007
- Introducing further SEM developments and associated TSO obligations
- Dealing with a significantly more complex set of processes to meet License obligations in the following areas:

- Connection of generators, demand side units, aggregated generating units and, in particular, wind farms
- Interface arrangements with NIE (TIA), e.g. investment planning
- Interface arrangements with NIE PPB (PSIA)
- Separation of Grid Code and Distribution Code
- The process to complete the divestment of SONI from NIE in March 2009
- The establishment of the European Network of Transmission System Operators - Electricity (ENTSO-E) formed on 1<sup>st</sup> July 2009 and compliance with the Inter-TSO Compensation tariff and data provision requirements of the ENTSO-E Vista platform
- Responding to regulatory requests e.g. to analyse and investigate markets, Use of System Tariffs and the application of Transmission Loss Adjustment Factors
- Increasing requirements to provide responses to regulatory and departmental consultations.

It is important to recognise that the previous price control was agreed on the basis of a submission made prior to the granting of the System Operator and Market Operator Licenses, the TIA, Market Operator Agreement, System Operator Agreement and the Trading & Settlement Code.

In the context of the substantial changes over the last period and the significant challenges ahead given the central role of the TSO, SONI is particularly concerned with four key aspects of the consultation paper:

1. The proposed level of Operating Expenditure (OPEX) in particular the payroll allowance, associated headcount and pension allowances
2. The proposed level of Capital Expenditure (CAPEX)
3. The proposed capital allowance for the Castlereagh House Building
4. The proposed Incentives.

Each aspect is discussed in detail below.

## 1. OPEX

The Utility Regulator has proposed a significant reduction in operating costs compared to the SONI submissions. However, limited supporting evidence is provided to justify the proposed reductions in operating costs. SONI is very concerned that, having undertaken a very substantial business planning process in the formulation of its submissions, the proposed reductions will leave SONI unable to effectively and efficiently deliver against the very real challenges it faces over the price control period.



## PAYROLL ALLOWANCE

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SONI do not agree with the proposed reduction in headcount to 81<sup>3</sup> and associated payroll allowance. Even taking this number as a baseline, SONI calculate that the payroll allowance for the price control period would be £30.4m, leading to a circa £6m shortfall given the Utility Regulator's proposed allowance. The payroll allowance is in fact SONI's HR costs, including payroll, staff related costs, training, recruitment, welfare and transport and travel. SONI's calculation takes into account the full range of costs and the fact that new staff will likely be employed at lower costs. For the full complement of staff as submitted by SONI, the payroll allowance should be £34.4m.

This substantial shortfall in the allowance for labour resourcing will have a significant and detrimental effect across the business in its ability to:

- Maintain the security and integrity of the transmission system
- Balance generation and demand optimally and in an economic manner
- Manage constraints efficiently
- Provide for comprehensive emergency planning and training
- Meet statutory and license obligations and the increasing European requirements
- Meet the Government's renewable generation target
- Facilitate key Executive strategies and plans, including the Regional and Economic Development strategies
- Manage an increasing number of new connections
- Maintain and support business critical IT systems such as the Energy Management System (EMS)
- Support the development of the Single Electricity Market (SEM)
- Provide data to key stakeholders in a timely manner
- Respond effectively to key regulatory and policy issues.

It is critical that revenue is approved commensurate with SONI's increased resource requirements and that further consideration is given to resourcing levels.

## PENSIONS

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SONI strongly disagree with the proposed pension allowance which is contrary to the application of established regulatory precedent. Personnel within the Defined Benefit scheme have "protected persons" status. These costs are not controllable by SONI and are by virtue of historical legacy industry arrangements. SONI divestment required that "mirrored" arrangements were put in place by any acquirer; this has been done.

For the Defined Contribution scheme, the contribution level of 6% of salary is considered to be at market rates.

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<sup>3</sup> The Utility Regulator has proposed a headcount of 81 with 4 additional FTE's funded through connection charges. Therefore SONI have assumed a figure of 81 for the purposes of calculating the payroll allowances.

It is vital that the proposed reduction is reversed and that ongoing pension costs for both scheme members are provided for.

SONI welcomes the continued provision of revenue for the Defined Benefit pension deficit. Provision of the ongoing Defined Benefit contributions will mitigate against future deficits. Consideration should be given to the timeframe over which the deficit repair would take place and the calculation should be consistent with the recovery over that timeframe. The timeframe should take account of the remaining expected service of “active” members and the requirements of the regulatory environment and the Pension’s Regulator. Any calculation of the deficit repair must reflect a consistent Net Present Value calculation to make good the repair over the defined period.

SONI has recently engaged with the Utility Regulator to revise the figures in its original submission in order to reflect both greater assumed efficiencies and revised legislative requirements. The net effect represents a saving in the region £1m compared to SONI’s original submission. The revised numbers must be provided for.

## 2. CAPEX

SONI do not agree with the proposed CAPEX allowance for the price control. In particular, SONI is concerned about the long-term effect on consumers as a result of under-investment in the TSO business. The SONI business needs a CAPEX allowance that is sufficient to ensure that it is able to refresh assets, manage and connect renewable generation, manage the impact of European and SEM developments and to respond adequately in emergency situations. The provision of a sustainable level of CAPEX will increase tariff predictability and also provides certainty for SONI to organise and plan the business more efficiently over the price control period.

The stock of physical assets owned by SONI, in particular IT assets, need to be constantly refreshed over time. The Utility Regulator’s proposed level of CAPEX will defer significant investment to the start of the next price control period with consequential significant impact on consumers at that time.

## 3. CASTLEREAGH HOUSE BUILDING

SONI strongly recommend that the existing building and grounds are brought up to an acceptable standard in compliance with Health and Safety legislation and that the existing building is extended to meet the increasing resource requirements of the business.

SONI has compared the cost of extension and refurbishment of the existing building with alternate rental accommodation in the Greater Belfast area. The annual cost when depreciated over 20-25 years is approximately £130-£150k/annum which compares favourably with rented accommodation.

SONI has investigated other options which are discussed in more detail in the answer to question 9, however the most cost effective and efficient long term solution is to allow the full cost of extending and refurbishing the Castlereagh House premises.

SONI believe that any other option will be more costly to consumers in the long term, dilute SONI's effectiveness, create functional silos, increase security risks and affect SONI's ability to handle major incidents or emergencies.

#### 4. INCENTIVES

SONI agrees that appropriate incentives should be implemented where there are clear benefits. SONI believe that if meaningful incentives are set which are realistic yet challenging, with an appropriate balance between the potential benefit to consumers and potential reward to the business, then both the consumer and business will have the potential to benefit from improved performance.

However, SONI is concerned that the two proposed incentives as set out in Section 12 are inconsistent with the Utility Regulator's decision to exclude other obligations that are license obligations, and will not deliver clear benefits without further development.

The appropriate financial upside and downside associated with the incentives, both individually and as a package, will depend on the overall outcome of the price control review, the specific targets that are set, and the design features of each incentive. SONI propose that for this reason it would be more appropriate to consult separately and agree a package of incentives following agreement of the price control.

## SECTION 2: QUESTION RESPONSES

## QUESTION 1: DO RESPONDENTS AGREE WITH THE PROPOSED APPROACH FOR THE SONI PRICE CONTROL?

***SONI agrees with the regulatory principles underpinning the revenues and resulting tariffs.***

***SONI welcomes the continuation of an RPI-X type price control for operating expenditure (OPEX).***

***SONI also support a capped approach to tariffs and an allowance for OPEX.***

***SONI welcomes the Utility Regulator's statement that it is their intention to minimise the number of areas considered under  $D_{TSO_t}$ , however SONI do not believe that this objective can be realised with the proposed levels of OPEX and CAPEX.***

***SONI agrees with an ex-ante approach to capital expenditure (CAPEX).***

***SONI also agrees that there are some occasions where it is appropriate for SONI to seek further CAPEX and OPEX allowances, on a project by project basis.***

SONI agrees that the regulatory principles underpinning the revenues and resulting tariffs must be sustainable, stable, transparent, predictable and cost-reflective. The overall objective of this price control must be to ensure that SONI can continue to operate the transmission system in Northern Ireland securely, effectively, efficiently, and represents value for money to consumers. It is imperative that this is carried out in a safe manner, with an adequate return so that SONI can operate as a viable business.

Under the policy framework section it was noted that in the event of significant changes relating to the EU 3rd energy package the Utility Regulator proposes to review the parts of the business affected and re-open these aspects of the price control. SONI contend that such significant changes should result in a complete re-opener of the price control as it will likely impact all areas of the business.

SONI welcomes the continuation of an RPI-X type price control for operating expenditure (OPEX) as the most appropriate for the SONI business with an allowance for OPEX which will incentivise SONI to control costs.

SONI support a revenue cap approach to tariffs.

SONI agrees that an ex-ante approach to CAPEX is appropriate, allowing SONI the flexibility needed to plan and invest. SONI would wish to avoid a much higher administrative burden on both SONI and the Utility Regulator to any ex-post evaluation of CAPEX. Moreover an ex-post assessment implies higher risk which would need to be reflected in a higher cost of capital.

SONI very much welcomes the Utility Regulator's statement that it is their intention to minimise the number of areas considered under DTSO<sub>t</sub> approvals for the 2010-2015 price control. Over the last price control period there has been a very considerable overhead in dealing with cost approvals and

recovery for both SONI and the Utility Regulator. Additional cost approvals have been incorporated into the current price control as 'excluded costs' each year and recovered through the System Support Services (SSS) tariff. The process is resource intensive, leads to tariff uncertainty and can restrict SONI's ability to maximise efficiencies and deliver future cost savings for the consumer. To realise the Utility Regulator's stated intention, OPEX and CAPEX must be set at the appropriate levels; SONI do not believe that the proposals set out in the consultation reflect this principle. It is clear that this approach, given the significant challenges ahead, is unsustainable over the next price control period. The regulatory reporting arrangements and regime must be consistent with a 5½ year price control. OPEX and CAPEX levels need to be set at an adequate level for the TSO business to efficiently operate and sufficient resources must be provided if the business is to deliver on key government and regulatory objectives.

There are existing provisions for the recovery of certain known uncontrollable costs and these are provided for in the SONI license. Our assumption therefore is that this will continue and that the following items will be included in the annex to the license as 'pass-through' costs:

- Compliance costs associated with the EU 3<sup>rd</sup> energy package
- Unforeseen Pension costs
- Uncollected TUoS/SSS revenue
- ENTSO-E tariffs
- Moyle administration and associated costs
- SEMO financing costs
- Collection Agency Income Requirement (CAIRt)
- Castlereagh House rates
- License Fees
- Fuel Security Code costs.

SONI acknowledge that there are also occasions where it is appropriate to seek further CAPEX and OPEX allowances, on a project by project basis; for example as and when the Regulatory Authorities make new policy decisions which significantly impact the SONI business and which could not be reasonably foreseen or estimated at the time of the price control submission. As part of the SONI price control submissions an 'Overview and Principles' document was submitted to the Utility Regulator on 2nd July 2010. This paper suggested some of the areas where such approvals may be appropriate. These are listed below; however the list is not exhaustive:

- A decision on the implementation of the EU 3<sup>rd</sup> energy package
- Significant changes due to European Regional Integration initiatives
- Significant changes to the SEM Market e.g. introduction of intra-day trading or use of a SCUC engine
- Significant developments in the area of smart grids and demand side management
- Further NI Supplier TUoS Tariff development or the introduction of all-island Supplier TUoS
- Further all-island Generator TUoS development
- TLA development, particularly if real time dispatch is to be considered
- Changes due to further development of Harmonised Ancillary Services

- Separation (NIE/SONI), updating and development of the NI Planning and Security Standards.

It is important that the Utility Regulator acknowledges that these issues and other policy issues that will inevitably arise over the price control period will be treated as excluded costs. It is expected that approvals for such expenditure will be dealt with on a project by project basis.

**QUESTION 2: WHAT DURATION TO RESPONDENTS DEEM APPROPRIATE FOR THE SONI PRICE CONTROL: FIVE-AND-A-HALF YEARS FROM 1 APRIL 2010 TO 30 SEPTEMBER 2015 OR THREE-AND-A-HALF YEARS 1 APRIL 2010 TO 30 SEPTEMBER 2013?**

***SONI strongly support a five and a half year price control period as the most appropriate duration. A five and a half year period (of which a year has already elapsed) allows for an appropriate balance between costs which can be forecast and are reasonably predictable, whilst at the same time providing greater business stability.***

***In particular, a five and half year period also creates an opportunity to:***

- ***Allow for business efficiencies to be developed and for the incentives regime to work properly***
- ***Deliver the benefits of achieving the government renewables target***
- ***Establish organisational capability and counter anticipated key staff retirements***
- ***Allow increased tariff predictability***
- ***Allow SONI to play a significant part in contributing to the achievement of DETI and the Utility Regulator's aspirations for sustainable and competitive future energy***
- ***Provide a stable financial base to deliver the corporate objectives of SONI.***

The consultation paper suggests that, as the SONI plans submitted for the final two years of the price control are not as detailed and some of the CAPEX costs have not been fully set out in detailed business cases, there is an argument for a shorter price control period. The nature of a five and a half year price control is a level of uncertainty, particularly towards the latter part of the period. However, this is not unusual in a price control and any uncertainty must be balanced against the many efficiency benefits of a longer price control period as outlined above (Ofgem is now introducing an 8 year price control period as part RIIO). As stated in the consultation paper, a five year duration has tended to be the norm for price controls across regulated electricity companies in the UK.

Additionally, as the SONI price control will commence a year late, a reduction in the proposed period will mean that the price control would expire again in two and a half years. That means that, given the detailed level of business analysis required, work on the new price control process would need to commence again within the next 12 months. This would be an inefficient use of resources for both the Utility Regulator and SONI and would not deliver benefits to consumers.



**QUESTION 3: DO RESPONDENTS AGREE WITH THE PROPOSED HEADCOUNT AND PAYROLL ALLOWANCE FOR THE SONI PRICE CONTROL?**

*SONI strongly disagree with the proposed headcount and payroll allowance. The Utility Regulator has proposed an allowance for 81 staff, with an additional 4 staff to be funded by connectees through the Transmission and Distribution connection charging process, leaving a shortfall of 13 positions. Notwithstanding the headcount shortfall, the proposed payroll allowance of £24.9m for 81 staff is insufficient - £30.4m is necessary. The payroll allowance is in fact SONI's HR costs, including payroll, staff related costs, training, recruitment, welfare and transport and travel.*

*SONI's calculation takes into account the full range of costs and the fact that new staff will likely be employed at lower costs. For the full complement of staff as submitted by SONI, the payroll allowance should be £34.4m.*

*This substantial shortfall in the allowance for labour resourcing will have a significant and detrimental effect on the business in its ability to:*

- *Maintain the security and integrity of the transmission system*
- *Balance generation and demand optimally and in an economic manner*
- *Manage constraints efficiently*
- *Provide for comprehensive emergency planning and training*
- *Meet statutory and license obligations and the increasing European requirements*
- *Meet the Government's renewable generation target*
- *Facilitate key Executive strategies and plans, including the Regional and Economic Development strategies*
- *Manage an increasing number of new connections*
- *Maintain and support business critical IT systems such as the Energy Management System (EMS)*
- *Support the development of the Single Electricity Market (SEM)*
- *Provide data to key stakeholders in a timely manner*
- *Respond effectively to key regulatory and policy issues*

*There are significant challenges ahead for SONI during the price control period. SONI is struggling to meet statutory and license obligations at present and will continue to do so without adequate resources.*

*The reality is that the industry will change dramatically over the next few years with an unprecedented 40% renewables target to be met; it is absolutely critical that SONI has the capability to manage the connections efficiently and have the ability to manage the changing portfolio of generation connected to the system in the required operational timeframes.*

*It is therefore critical that revenue is approved commensurate with SONI's increased resource requirements and that further consideration is given to resourcing levels.*

## PROPOSED ALLOWANCE

The payroll costs submitted by SONI include full salary costs, employer's national insurance contributions, overtime and other allowances. (Note that for the purposes of this consultation, pensions are dealt with separately). In addition, the costs include an allowance per head for training, recruitment, welfare and transport and travel.

For the 98 staff as proposed in the SONI submissions, SONI calculated the total payroll cost to be £34.4m.

H2 2010	H1 2011	H2 2011	H1 2012	H2 2012	H1 2013	H2 2013	H1 2014	H2 2014	H1 2015	H2 2015
£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2.40	2.70	2.70	2.73	2.73	2.79	2.79	2.85	2.85	2.91	2.91

SONI do not agree with the proposed reduction in headcount to 81<sup>4</sup> and associated payroll allowance. Even taking this number as a baseline, SONI calculate that the payroll allowance for the price control period would be £30.4m. SONI's calculation takes into account the full range of costs included in the payroll allowance, and the fact that new staff will likely be employed at lower salaries.

The Utility Regulator's proposed payroll allowance does not take into account all of the relevant costs and therefore the proposed allowance would not be sufficient for SONI to retain the current employees under contracted terms and conditions, nor would it allow SONI to increase the headcount to 81 staff.

SONI has provided the Utility Regulator with more detail on the payroll calculation to show that with 81 staff the required payroll allowance is £30.4m.

When determining the final payroll allowance, any increase in the final headcount will correspondingly increase the required allowance.

SONI would therefore urge the Utility Regulator to reconsider the payroll allowance and the proposed headcount.

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<sup>4</sup> The Utility Regulator has proposed a headcount of 81 with 4 additional FTE's funded through connection charges. Therefore SONI have assumed a figure of 81 for the purposes of calculating the payroll allowances.

## CONNECTEES CHARGING – 4 FTE

The Utility Regulator proposes that SONI charge connectees for 4 full time equivalent staff who work on activities directly associated with connecting new generators and ensuring the relevant technical standards are applied. SONI welcomes this suggestion, however it is clear that staff will need to be funded in advance of charging connectees and SONI would seek to have an allowance for the 4 FTE's upfront through the price control and any income would be offset against the revenue recovered through the annual tariff.

## RESOURCE REQUIREMENTS

SONI operates within a highly specialised area in a critical industry sector and staff are its primary resource. SONI has provided the Utility Regulator with a detailed assessment of the resources necessary to ensure that it can continue to meet the needs of consumers, key stakeholders and support the achievement of the Government's renewable targets.

A 'Resource Requirements' paper was submitted to the Utility Regulator on 4<sup>th</sup> August 2010. This paper outlined in some detail the labour resource requirements for the price control period and contained individual business cases for each new post. The key drivers identified that impact SONI's resource requirements are:

- The increased number of transmission and distribution generator connections
- The requirement for increased delivery of transmission infrastructure
- The changing portfolio of generation connected to the system, a second interconnector and, in particular, the increased level of intermittent and asynchronous wind generation
- The increased requirements and workload from ENTSO-E
- The changing scale and shape of the business itself.

These drivers mean an increase in the level of TSO activity and in the complexity of the TSO role. In forecasting the resource requirements looking forward, SONI has undertaken a detailed assessment of the changing level and complexity of activity and how the business will need to be resourced to respond.

The key drivers are further discussed below:

### OPERATING THE SYSTEM WITH INCREASING LEVELS OF WIND GENERATION

The current resource levels do not provide sufficient organisational capacity to develop system operational instructions, forecasting and curtailment tools and the assessment of planning and real-time scenarios to ensure that generation is optimised on the system and the system remains stable.

Recent TSO studies have demonstrated that to reach the levels of wind output required to meet the Strategic Energy Framework targets for renewable generation will require the TSO to devise and implement new strategies and controls for successful real time operation. For example:

- The ability to predict wind curtailment to maintain system security.

- Optimisation of interconnector trading to maximise wind output.
- Determination of the requirement to schedule fast start generation.
- Flexible interconnector trading to manage renewable generation shortfall scenarios.

These measures directly impact system security and affect the cost of wholesale electricity. It is therefore vital that SONI is properly resourced to ensure that they can continue to operate the system optimally with increasing levels of renewable generation.

#### ENSURING POWER SYSTEM MANAGEMENT CAPABILITY

The current resource levels do not provide sufficient organisational capability to deliver the training and development required to sustain the real time control room function. There is a lack of experienced power system engineers in the marketplace. This has resulted in the need to train engineers from within SONI. To facilitate this SONI need to recruit, train and develop staff to backfill and also to accommodate the increased demands on the business. The training requirement is vital and can be provided in part by utilising the Dispatcher Training Simulator (DTS) which is part of the new EMS.

Resources are required to develop and implement a structured training programme to provide the critically important and necessary training in control room operation. Only by fully utilising this DTS facility will performance of the control room be maintained during a period when a number of retirements will take place. In addition, ENTSO-E are advocating Operational Training and Certification which will be used not just for initial training but on an ongoing basis for continuing certification. This will require a dedicated resource. There are also many drivers that will increase the complexity of system operation, for example:

- The introduction of a second interconnector to the GB system (the East-West interconnector)
- Managing increased levels of renewable generation
- Increased operational reliance on special protection schemes
- Increased pressure to release transmission plant and equipment to facilitate line upgrades and restringing required for the development of new transmission infrastructure
- A need to increase the resource required to manage transmission outages
- Assessment of the operational impact of proposed development plans and special protection schemes.

#### DELIVERY OF CONNECTIONS - BOTH DISTRIBUTION AND TRANSMISSION

The current resource levels and the current level of expertise and experience are not capable of delivering the future level of connection requests. The connections that have been dealt with to date have clearly demonstrated that this is an area of greater complexity and more resource intensive than had been estimated during the previous price control submission. The Strategic Energy Framework has set a target of 40% consumption from renewables by 2020 and the annual rate of connections to be managed will increase year on year to provide the additional 1200-1500MW of renewables to be connected to the NI electricity system over that period.

## DELIVERY OF TRANSMISSION INFRASTRUCTURE TO MEET STRATEGIC ENERGY FRAMEWORK TARGETS

The all island transmission networks will undergo significant development and extension over the next 10 -15 years to meet the government targets for renewable penetration. SONI need to be resourced to meet this challenge and, during this price control period, a key focus will be on ensuring the adequacy of the planning and development of the transmission network. It will also be necessary to focus on a more complex operational planning and real time operating environment. SONI will be required to operate the power system whilst managing the increase in renewable generation and a significant infrastructure investment programme. The level of complexity is further compounded as experience has shown that not all project build runs to time and potential delays are inevitable.

Additional resources will be required to manage and participate in the necessary interactions with NIE and EirGrid to ensure that all SONI License, Transmission Interface Agreement (TIA) and System Operator Agreement (SOA) obligations can be met within the prescribed timescales.

## CAPABILITY TO ADEQUATELY RESPOND TO EMERGENCY SITUATIONS

The problems encountered during the recent cold spell in Northern Ireland highlights the need to ensure that all utility companies are adequately resourced to react quickly and appropriately in an emergency situation. This is equally true for the TSO business which needs to be able to react swiftly to emergency situations on the power network, such as a blackout or load shedding, whilst also having the ability to manage a more prolonged period of energy shortfall. Plans must be in place and staff trained to ensure that emergency situations are managed in a real time operational timeframe. SONI must also be able to engage fully with the media and other key stakeholders in an emergency situation. The management and provision of accurate, timely information is of critical importance in an emergency and SONI's systems (e.g. data warehouse and website), processes and resources must be adequate.

## PROVISION OF DATA

SONI operate under a number of licenses and codes and it is imperative that data provided is accurate, validated and timely. This is an increasing burden due to the level of complexity of data flows, information storage and validation checks, scheduling, query management, disputes, market developments including modifications, and ENTSO-E requirements.

It will not be possible to continue to meet license obligations and to respond to these challenges without the associated resources. SONI must also ensure that accurate and timely data is available and provided in emergency situations.

## RESOURCE SHORTFALLS

Having assessed the proposed reduced headcount and associated allowances, there are resource shortfalls in the following departments:

Department	Section	Shortfall
<b>Grid Operations</b>	Real Time	5
<b>Commercial</b>	IT	4
	SCADA and EMS	1
	Regulation and Settlement	1
<b>Finance and Administration</b>	Finance	2
<b>Total FTEs</b>		<b>13</b>

Each department shortfall is discussed in detail below.

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#### GRID OPERATIONS - REAL TIME

Job Role	Shortfall
Balancing Services Engineer	5
<b>Total</b>	<b>5</b>

With an increasing amount of renewable generation being connected to the system there is a need to ensure that the system remains secure and balanced at all times as economically as possible. Day to day operation of the network has become more complex because of the impact of intermittent generation on the real time balance between electricity generation and demand. SONI's role will change as we learn to deal with the fluctuations in electricity generated from renewable sources as well as fluctuations in electricity demand.

Since the establishment of the SONI control room in 1971, there have only been two engineers on each shift, a 'switching' engineer and a 'loading' engineer. The switching engineer has overall responsibility for the safe and secure operation of the transmission system including switching circuits in and out for routine maintenance and emergency repairs and ensuring the system is safe for NIE staff to carry out work. The loading engineer is responsible for the real time dispatch of plant ensuring that there is a continuous balance between demand and supply thus controlling system frequency. The loading engineer also ensures that voltage levels are controlled on the system

The safe, secure, reliable and economic operation of the transmission system remains essential and this responsibility cannot be compromised. By optimising the operation of the system, in parallel with accommodating the substantial level of grid development required to meet the government target of 40% renewable energy by 2020, there will be a direct economic benefit to each electricity consumer. However, this challenge has a significant and immediate impact on the SONI business.

There are two areas where system costs can be potentially reduced by managing the variability of wind in a more concerted and constructive manner:

## 1. Managing excess wind more efficiently

The scope for savings typically occurs during the night when there is excess wind on the system :

- i. For system security reasons there is currently a requirement to keep three conventional generating units connected to the system overnight. As these generating units cannot be dispatched below a minimum level, this can lead to renewable generation being constrained off the system. In turn this can increase costs as wind generation that is constrained off is paid for at the System Marginal Price whilst the plant 'replacing' it may be constrained on at its bid price.

With significantly more wind generation on the system this year and without the ability to trade, there will be significantly more occasions where curtailment of wind generation will be necessary. For example, if there is only one curtailment incident per week in the summer and one curtailment per month in the winter, SONI estimate that with the current levels of wind generation savings would be in the region of £80-£100k and this will increase with additional generation.

- ii. Overnight some generators are 'two-shifted' to allow more wind generation to remain connected to the system. 'Two-shifting' can simply be taking a generator off overnight and restarting it in the morning or it can be more complex when a generator is replaced by a different generator with a lower minimum generation level. SONI estimate that avoiding complex two shifting of generators at night even twice a month during the year could yield savings in the region of £460k per annum.

## 2. Managing a shortfall of wind more efficiently

The scope for savings typically occurs during system peak times when there also may be a shortfall of wind generation on the system. If not properly predicted and planned the shortfall may have to be made up from running more expensive open cycle gas turbines (OCGTs). However, this cost could potentially be partially mitigated by trading or by scheduling another generator that may be 'hot' (or in the future may be held 'hot' under an Ancillary Services contract). SONI estimate that by avoiding the dispatch of an OCGT to cover this shortfall only twice per month could yield savings of approximately £80-100k per annum.

Wind generation has now increased to levels which cause operational problems at night time, not only during the summer, but also during the winter. The problems in managing wind at night can be exacerbated by high import levels on the Moyle interconnector. The uncertainty of managing wind in isolation will be further affected by the potential introduction of Intraday Trading, commissioning of the East West Interconnector and Market Coupling.

The Utility Regulator has asked SONI to explore alternative SO trading options post gate closure for the purposes of system balancing. These options include trading with Moyle capacity holders

and trading with a power exchange. The current resource levels in the control room do not however allow these options to be managed effectively as part of a 24/7 operation.

A Balancing Services Engineer on each shift would enable SONI to manage many of these issues and in terms of investment represents very good value for consumers.

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#### CUSTOMER & OPERATIONAL BENEFITS:

- System security will be enhanced.
- System security will be achieved more economically.
- It will be possible to manage constraints more optimally.
- It will be possible to allow more wind to generate on the system.

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#### CUSTOMER & OPERATIONAL RISK:

If no provision is allowed for Balancing Services Engineers in the control room there is a risk that:

- System security may be compromised.
- More wind will be constrained off than is necessary.
- Constraints cost will increase.
- At times, economic dispatch will not be possible.

### COMMERCIAL - IT

Job Role	Shortfall
Data Integrity Analyst	1
IT Technical Analyst	1
SharePoint Developer	1
Service Delivery Manager	1
<b>Total</b>	<b>4</b>

The IT section manages all of the operational and commercial business critical systems and resources to support the SONI business. These systems are key in the support of the critical infrastructure of Northern Ireland. The systems include the Energy Management System, metering, settlements, market interfacing systems, generation dispatch, event recorder, the Moyle Interconnector Trading System (MITS), infrastructure support and security systems. The provision of timely, accurate and robust data to all stakeholders is critical, and in particular SONI has an obligation to ensure that data is provided to the SEM systems every day.

There are a number of additional projects to be undertaken by SONI during the price control period. Examples include the development of a new website, document management system and data



warehousing to ensure that data is archived, stored and available on demand. The projects not only require resource to undertake implementation but also have significant undertakings for ongoing support and maintenance. The additional resources will not only be key to the implementation of these projects but also vitally important to ensure that SONI has a cost effective mechanism for support and maintenance and that skills in these areas can be shared within the IT section. The IT section also provides front-line 24x7 support of all critical systems.

#### DATA INTEGRITY ANALYST

A key area of the underlying infrastructure is data storage and archiving. Over the last three years there has been substantial change to systems including the introduction of the SEM in 2007, Day One Plus SEM enhancement in 2009, a new Energy Management System commissioned in 2009 and most recently a new system for the management of Harmonised Ancillary Services in 2010.

All of these systems have significant data storage requirements. This needs to be managed in order to ensure that data is accurate and available both for business requirements and to meet statutory obligations. In addition, it is essential that data provision through the business is coherent, consistent and accurate.

A Data Analyst would ensure that:

- Data archives (offline & online archives) are timely and consistent with policy
- Data storage planning and maintenance is carried out
- Timely, accurate data is provided to SEM, ENTSO-E, NIE etc
- Data reorganisation is co-ordinated
- There is provision of Enterprise Data Mining tools and that the tools are maintained
- There is provision for internal and external Ad-hoc data extraction
- There is correction of data inconsistencies and establishment of processes and procedures to permit substitution and estimation as required
- Website data is accurate and up to date
- Data reports are generated and monitored

Given the significant additions outlined above and requirements (statutory and other) to make TSO data available to external bodies this is a key role.

#### IT TECHNICAL ANALYST

The IT Technical Analyst would ensure that the SONI LAN/WAN and IT infrastructure are maintained in order to ensure high availability of systems and also to ensure that systems meet SONI IT Security policies and best practice.

SONI completed IT separation from the Viridian Group in 2010 during which core services (Email, Remote Access, Content Filtering and Anti-Virus scanning) were moved in-house. These services are now an integral part of the SONI infrastructure and require direct support and maintenance by SONI IT staff.

The main responsibilities of this position will include:

- Providing 1<sup>st</sup>, 2<sup>nd</sup> and 3<sup>rd</sup> line support for all infrastructure
- Providing 1<sup>st</sup>, 2<sup>nd</sup> and 3<sup>rd</sup> line support for all SONI applications
- Implementing a patching strategy to ensure system security is kept at a high level
- Monitoring systems in terms performance and capacity
- Supporting and training business users
- Providing fault analysis and reporting.

#### SHAREPOINT DEVELOPER

SONI completed implementation of Microsoft SharePoint in 2009. SharePoint is a core technology which provides a platform that supports data exchange for SEM and also collaboration with the business.

SharePoint will be developed to provide the capability to support business growth over the next five years. This will include Document Management, Centralised information Reporting, Workflow process control and Customer Relationship Management.

The SharePoint Developer would co-ordinate development and integration of SharePoint with other applications and provides a centralised portal for company wide information.

The main responsibilities of this new role position will include:

- Ensuring a suitable development strategy is implemented
- Establishing & configuring collaboration sites for projects
- Developing document management systems
- Developing links to the company Internet
- Monitoring systems in terms performance and capacity
- Supporting and training business users
- Providing fault analysis and reporting.

#### SERVICE DELIVERY MANAGER

SONI has a substantial requirement to co-ordinate service delivery through the business and with external customers. Prioritisation of work throughout the business within an environment where there are numerous and often competing priorities, is essential.

SONI require a Service Delivery Manager to prioritise, manage and co-ordinate the performance of services to clients, both internal and external.(e.g. to new wind farm connectees), within defined Service Levels.

The main responsibilities of this new role position will include:

- Defining of Service Level Agreements (SLAs) for internal and external clients
- Ensuring SLA targets are achieved and client expectations are met (or exceeded)

- Building relationships with clients
- Ensuring consistent, quality services are performed to the agreed SLAs
- Ensure that systems, processes and methodologies as specified are followed to ensure effective monitoring, control and support of service delivery
- Providing reports to an agreed schedule (or on request), including management and performance reports
- Ensuring that SONI provide services in line with best practice
- Maintaining documentation and processes with respect to the role
- Providing centralised co-ordination of service delivery to external clients
- Providing a quality control function on all internal processes.

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#### CUSTOMER & OPERATIONAL BENEFITS:

- Enable SONI to maintain and develop the business critical systems that support and safeguard the Northern Ireland infrastructure
- Enable SONI to be efficient in the delivery of data to SEMO, European bodies and stakeholders
- Provide a reliable and accurate data repository to assist with the efficient response to data requests
- Ensure SONI meets its statutory and license obligations
- Deliver the growth in renewable connections over the price control period.

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#### CUSTOMER & OPERATIONAL RISK:

If no provision is allowed for additional IT resources there is a risk that:

- SONI may not be able to meet statutory and legal obligations to maintain historical records
- Inability to respond to internal and external data requests
- Inability to maintain data to a high-level of accuracy
- Critical Business applications would have a higher risk of failure
- Inability to properly support business critical systems and therefore potentially impact the management of the transmission network
- Impact on 24x7 data provision and flows management to SEM.

### COMMERCIAL - SCADA AND EMS

Job Role	Shortfall
EMS Support Engineer	1
<b>Total</b>	<b>1</b>

The SCADA (Supervisory Control and Data Acquisition) and EMS (Energy Management System) section is responsible for maintaining and supporting the telecommunications infrastructure across Northern Ireland to ensure the provision of real time information. The EMS allows engineers to monitor, control and optimise the NI transmission system in real time.

The new EMS is SONI's most important IT asset and represents a £4.5m investment that delivers benefits to the Northern Ireland consumer. The system is highly complex, enabling real time monitoring and control of the Northern Ireland HV power network. Additional facilities allow data exchanges with other utilities, generation and interconnector applications, safety management, dispatcher training simulation and network analysis tools.

It is fundamental to the operation of the power system and absolutely critical that the EMS is supported and maintained constantly and that it is continually developed and upgraded to make best use of the facilities available. The current core staff complement does not allow adequate resource to maintain and develop the full EMS suite of applications. At the moment, only core functionality can be adequately supported. For example, there are a range of advanced generation and network applications that can be tailored and deployed and there is a huge amount of historical data that can potentially be archived for use in studies and to meet system information requests from stakeholders.

As also outlined in the SONI Capital Expenditure submission, there is a programme of work planned to add new facilities and to upgrade the EMS over the price control period. This will include the development and integration of a wind curtailment block load tool, wind stability assessment tool and keeping the system up to date.

It is therefore absolutely critical that SONI recruit an additional EMS Support Engineer to provide the necessary technical support required to maintain the high availability of the system and its associated applications. If an emergency or operational incident occurs and the EMS had not been maintained adequately, then there would be significant risk to the operation of the transmission system.

The EMS Support Engineer will perform a host of business critical duties including:

- Provision and maintenance of real time data exchange between SONI-EirGrid, SONI-Moyle, and SONI-NIE
- Support and maintenance of "Safety Management" application
- Support and maintenance of the Control Room video wall
- Support and maintenance of DTS Operator training environment
- Support and maintain of the EMS test platform
- Specification, implementation and management of EMS functional enhancements e.g. Wind Dispatch Tool, Economic Dispatch Tool
- Management of system upgrades to facilitate an "evergreen" approach
- Management of internal/external interfaces i.e. SEMO data flows, RCUC/SCUC, load forecast
- Implementation and testing of an EMS "Disaster Recovery Plan".

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#### CUSTOMER & OPERATIONAL BENEFITS:

- Ensure that SONI can continue to operate the NI transmission system in a safe, secure and economic manner, through the utilisation of a stable and robust EMS platform
- Enable SONI to provide the high level of support required to maximise the functional capabilities of the EMS
- Enable SONI to monitor the ongoing performance of EMS ensuring high levels of availability.
- Ensure that SONI can continue to deliver high quality services to all internal/external stakeholders by having suitably trained Control Room Engineers
- Ensure that SONI has technical resource available for system upgrades and enhancements
- Deliver the required telecommunications infrastructure for the delivery of real-time and other data to SONI.

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#### CUSTOMER & OPERATIONAL RISK:

If no provision is allowed for an additional EMS Engineer there is a risk that:

- Management of the NI transmission system may be compromised without a stable, robust and up to date EMS system
- The functional capability of the EMS may not be fully realised
- Regular support and maintenance of the EMS may not be carried out
- The timely provision of accurate EMS data will be affected
- The Disaster Recovery Plan may not be fully tested.

### COMMERCIAL – REGULATION AND SETTLEMENT

Job Role	Shortfall
Senior Commercial Analyst	1
<b>Total</b>	<b>1</b>

The Regulation and Settlement section is responsible for the regulatory, interconnection and settlement functions. This includes management of and compliance with license obligations, liaison with the Utility Regulator and CER, cost recovery and tariff management. The section manages the collection of TUoS revenue and pays NIE for the provision of Transmission Services. In addition, the System Support Services (SSS) tariff is managed and billed monthly. The section has a formal role as Interconnector Administrator for the Moyle Interconnector to Scotland for both the SEM and GB BETTA electricity markets and the settlement function manages the HAS arrangements in Northern Ireland.

The workload of the department will increase during the new price control period. The key and immediate focus over the next period will be in the development of the current Moyle arrangements for the new East-West interconnector, in conjunction with EirGrid, to ensure the value of the increasing amount of interconnection is fully realised for the benefit of participants and Northern Ireland consumers. This will include the introduction of daily capacity auctions which will mean that 7 day-a-week cover will be required. In addition, SONI along with EirGrid are involved in the European Regulators steering group investigating the development of Market Coupling Solutions with the UK and France region. This will be increasingly important to meet EU objectives and to further facilitate renewables.

In relation to cross border congestion management, SONI continue to work with SEMO and EirGrid TSO and the Regulators to ensure that Interconnector Trades in SEM on both current and future interconnectors comply with EU Regulation 1228/2003 and its replacement, EU Regulation 714/2009; this may require SEM rule changes and significant systems and business process changes.

The department currently consists of only 3 full-time members of staff to support the numerous functions. The main purpose of this key role is to ensure that SONI continue to successfully manage all the functions outlined above, but are also able to respond and deal with wider regulatory and policy issues. The main responsibilities of this new position will include;

- Managing the day to day functions of the department
- Detecting and summarising key regulatory and policy issues which are of relevance to SONI
- Reviewing consultation papers and providing responses
- Analysing the impact of regulatory changes on the business
- Understanding and communicating industry changes to the relevant departments within SONI
- Providing analytical support to the business
- Attending industry workgroups and meetings
- Producing clearly presented documents for internal and external communication on regulatory issues and updates.

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#### CUSTOMER & OPERATIONAL BENEFITS:

- Will enable SONI to maintain and develop our organisational capability
- Will assist SONI in being an objective, informed and “authoritative” voice on key industry issues
- Enable SONI to develop strong stakeholder relationships nationally and at a European level
- SONI can continue to deliver high quality services to all stakeholders
- SONI can maintain focus on delivering value to electricity consumers, in particular ensuring that focus is maintained on any cost implications to Northern Ireland consumers.

## CUSTOMER & OPERATIONAL RISK:

If no provision is allowed for a Senior Commercial Analyst there is a risk that:

- SONI may not be fully capable of responding and dealing with key regulatory and policy issues
- Key consultation paper responses may not be submitted
- The impact of regulatory changes may not be fully analysed
- Industry changes may not be communicated within the relevant departments in SONI
- SONI may not be represented at relevant industry workshops and meetings
- Changes to interconnector operational arrangements may not be facilitated easily.

## FINANCE AND ADMINISTRATION

Job Role	Shortfall
Finance Officer	2
<b>Total</b>	<b>2</b>

The Finance and Administration team is responsible for all of SONI's financial, accounting and administrative requirements, preparing statutory and regulatory accounts, monthly management accounts, annual budgets, financial forecasts, business plans and financial information for price control submissions as well as day to day purchasing, payments, invoicing, facilities management and administration.

SONI's Finance and Administration staffing is currently under pressure to cope with the work load. Any further expansion in the business will increase the workload beyond the capabilities of the current resource.

The price control has significant CAPEX and OPEX allowances to manage over the next five years and the Finance and Administration department has a key role in facilitating the financial control and management reporting of expenditure.

As new resource is recruited into SONI there is an increasing requirement to provide administrative support and training. There will also be substantial renewable connections to the system which require significant financial management including provision for recharging costs where appropriate. The overall growth in the business means a corresponding increase in the general workload for Finance and Administration - more purchasing, payments, expenses, salaries and facilities management.

Additionally, given the current focus on good corporate governance across the utility sector, the provision of these additional resources is essential.

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#### CUSTOMER & OPERATIONAL BENEFITS:

- Ensure SONI meets its statutory and license obligations from a financial perspective
- Deliver the growth in renewable connections over the price control period
- Ensure good quality management reports, financial information and support is available to assist key financial and managerial decisions
- SONI will continue to be managed efficiently and effectively
- Facilitate the increased staffing levels and associated costs
- Purchasing is in line with best practice and governance.

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#### CUSTOMER & OPERATIONAL RISK:

If no provision is allowed for additional Finance officers there is a risk that:

- SONI will not be able to carry out basic finance functions such as place orders, receive invoices and ensure prompt payment
- SONI may not meet its statutory and license obligations
- The finance department may not be able to cope with the increased staffing and processing of associated costs
- Key financial decisions may be impaired by poor information and reporting
- Unnecessary delays of approvals and authorisations of key capital projects.



#### QUESTION 4: DO RESPONDENTS AGREE WITH THE PROPOSED IT & COMMS ALLOWANCE FOR THE SONI PRICE CONTROL?

***SONI welcomes the Utility Regulator's recognition that IT and communications are a critical area.***

***However, SONI is concerned that the Utility Regulator proposes to apply a 15% reduction in IT and telecommunications operating costs in year 4 of the price control.***

SONI has had very detailed interaction with the Utility Regulator on the issue of IT and telecommunications support and has provided detail on the areas of support services. From these discussions the Utility Regulator has clearly accepted the importance of IT support services to SONI however SONI is concerned that their ability to drive down prices has been over estimated in the proposed reduction during year 4 of the control.

The systems employed in the TSO business are necessarily niche, complex and bespoke to the industry. Therefore the ongoing support of the software from the suppliers who provide the systems is absolutely critical. The contracts in place currently are for the support of critical infrastructure and systems, and it would therefore also be difficult for suppliers to accept a reduction without a corresponding reduction in services provided.

The support and maintenance contracts are in place with various service providers, most of which come up for renewal during the price control period; in fact most contracts are annual in nature.

SONI recognises the importance of challenging support costs and do so as a matter of course. Aside from the difficulties SONI faces because IT support is critical to the business and the dependency on complex, bespoke systems there are trends throughout the IT industry which make it extremely unlikely that prices will go down at renewal time. In particular:-

- IT companies are now ensuring contract rates can be uplifted each year in line with inflation using RPI or CPI whichever is greater. This has recently crept up to around 4%.
- In addition to inflation, salary costs are also increasing across the industry as the demand for good quality IT staff increases<sup>5</sup>
- The ICT sector is fairly buoyant at the minute and this trend is predicted to increase over the next 24 months. This will again push up support costs due to supply and demand.

As set out in the SONI price control submissions, there is expected to be considerable growth in all areas of the SONI business during the price control period; this will mean that support services will be further broadened to support the increasing demands on the business.

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<sup>5</sup> This is supported by the latest Quarterly Review of the ICT Labour Market (Q3 10) on the e-skills website [www.e-skills.com](http://www.e-skills.com)

## QUESTION 5: DO RESPONDENTS AGREE WITH THE PROPOSED PENSION ALLOWANCE FOR THE SONI PRICE CONTROL?

***SONI strongly disagree with the proposed pension allowance.***

***Personnel within the Defined Benefit scheme have “protected persons” status. These costs are not controllable by SONI and are by virtue of historical legacy industry arrangements. SONI divestment required that “mirrored” arrangements were put in place by any acquirer; this has been done.***

***For the Defined Contribution scheme, the level of contribution of 6% of salary is considered to be at market rates. The high administration cost of the DC scheme (approximately 6% of salary) results from the small size of the scheme. The allowance can be scaled appropriately for the final number of employees.***

***It is vital that the proposed reduction is reversed and that ongoing pension costs for both scheme members are provided for.***

***SONI has recently engaged with the Utility Regulator to revise the figures in its original submission;***

- ***in order to reflect greater assumed efficiencies; and***
- ***taking into account revised legislative requirements.***

***The net effect represents a saving in the region of £1m compared to SONI’s original submission.***

Pensions costs are an important component of the Operating allowance for SONI. As outlined in the Utility Regulator’s paper they reflect the fact that SONI currently has two distinct pension schemes – a Defined Benefit scheme which has been closed since 1998 and a Defined Contribution scheme for new employees since that time.

The Utility Regulator has proposed a reduction in allowable revenue for employer pension costs from £6.1m<sup>6</sup> to £2.4m. The rationale for this reduction is largely unexplained in the paper. It is vital this reduction is reversed and that ongoing pension costs – for both Defined Benefit and Defined Contribution members – are provided for. We address the issues associated with the Defined Benefit and Defined Contribution schemes in turn.

### DEFINED BENEFIT PLAN

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SONI operates a Defined Benefit plan. This plan applies to 32 staff and has been closed since 1998. The personnel within the Defined Benefit (DB) scheme have “protected persons” status conferred

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<sup>6</sup> This figure is prior to SONI’s revised submission.

upon them at the point of privatisation of NIE. These costs are therefore not controllable by SONI and have been thrust upon it by virtue of historical legacy industry arrangements.

It was a requirement of the divestment of SONI that “mirrored”, identical pension arrangements were put in place by any acquirer; this has been done. The level of contribution reflects these “mirrored” arrangements. The level of contribution sought in the SONI submission is also consistent with the summary draft actuarial valuation carried out on behalf of SONI and provided to the Utility Regulator. For all these reasons it must be recognised that the ongoing cost of the Defined Benefit pension scheme represents an uncontrollable cost.

There is considerable and widespread regulatory precedent for the recovery of on-going DB pension costs. For instance, both the Competition Commission<sup>7</sup> and the Civil Aviation Authority<sup>8</sup> have recently provided revenue recovery for these costs.

Indeed it has always been the case in Northern Ireland that these costs are provided for and no reason is proffered to deviate from this precedent; indeed it is not consistent with the decision elsewhere by the Utility Regulator to provide for deficit repair (today’s inadequate contributions represent future deficit). To change the approach would represent a retrograde step and would dilute regulatory certainty with a resulting increase in regulatory risk right across the model.

It is therefore imperative that ongoing Defined Benefit pensions costs are provided for as SONI has no other mechanism to recover these costs.

#### DEFINED CONTRIBUTION PLAN

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SONI also operates a Defined Contribution scheme for those employees who are not members of its Defined Benefit plan. This Defined Contribution scheme also mirrors that in NIE/Viridian. The level of contribution of 6% of salary is considered to be at market rates. Indeed it is well within the 10% suggested by the Utility Regulator as part of the independent benchmarking conducted by PWC under the SEMO control<sup>9</sup>. In any case, the employment cost should be considered as a whole with the pension contribution forming part of the total cost. Again, any benchmarking carried out by the Utility Regulator which we have seen has suggested that SONI unit costs were below those in the market at large for comparable skills; to not provide for an overall market cost will lead to inefficient outcomes.

SONI accept that the cost of administration of the DC scheme – approximately 6% of salary – is high by reference to comparators. However, this results from the small size of the scheme which itself is a feature of the industry structure which required SONI be divested from all other parties. It must therefore be provided for as a feature of the industry.

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<sup>7</sup> Competition Commission, Final Determination, Bristol Water, September 2010

<sup>8</sup> CAA Decision, NATS (En Route) plc CP3 Price Control Review 2011-2014, December 2010

<sup>9</sup> Single Electricity Market SEMO Revenue and Tariffs for October 2010 – September 2013, Decision Paper 10 December 2010

It would have been reasonable that SONI seek a double digit pension contribution for its DC employees consistent with market related benchmarking. This would have represented an *efficient* level. SONI did not submit for this, and simply sought the *cost* of its current contractual arrangements, thus passing the benefit of the competitive contractual arrangements it has entered into to the Northern Ireland consumer. However, it is imperative that the Utility Regulator provide for the 12% Defined Contribution (6% employer contribution, 6% administration) in its final determination. This can be scaled appropriately for the final assumed number of employees.

**QUESTION 6: DO RESPONDENTS AGREE WITH THE PROPOSED PENSION DEFICIT RECOVERY PERIOD AND TREATMENT FOR THE SONI PRICE CONTROL?**

***SONI welcomes the continued provision of revenue for the Defined Benefit pension deficit.***

***Consideration should be given to the timeframe over which the deficit repair would take place and the calculation should be consistent with the recovery over that timeframe.***

***The timeframe should take account of the remaining expected service of “active” members and the requirements of the regulatory environment and the Pension’s Regulator.***

***Any calculation of the deficit repair must reflect a consistent Net Present Value calculation to make good the repair over the defined period.***

SONI welcomes the continued regulatory practice of the provision of revenue for the Defined Benefit pension deficit. This approach is consistent with regulatory precedent elsewhere. This has been treated as an “excluded cost” for the purpose of the license and this should continue. SONI wishes to comment on two aspects of the proposed approach to deficit repair:

1. The timeframe over which the deficit repair would take place;
2. The calculation consistent with the recovery over that timeframe.

In relation to the first, the timeframe over which the deficit should be repaired, SONI believes the following are important considerations:

- a. The remaining expected service of the “active” members over which the cost ought to be made whole; and
- b. The requirements not only of the Utility Regulatory environment but also the Pensions regulatory environment and the requirements of The Pension’s Regulator.

The provision should be consistent with the required cash contributions. It was these factors which led SONI to propose a deficit recovery period of 9 years.

In relation to the second, SONI has been provided with no explanation of the Utility Regulator’s calculation of how the assumed £0.05m per annum to recover the deficit advised as part of our submission. Any calculation of the deficit repair must reflect a consistent Net Present Value calculation to make good the repair over the defined period. This was the basis of the submission made by SONI based upon the summary draft actuarial valuation. It is not clear the Utility Regulator’s approach delivers this.

**QUESTION 7: DO RESPONDENTS AGREE WITH THE PROPOSED OTHER OPEX ALLOWANCE FOR THE SONI PRICE CONTROL?**

***SONI agrees that the costs of facilities should be in line with the headcount and that insurance costs should be in line with CAPEX. SONI also welcomes the recognition that flexibility is required in the provision of professional services. SONI also agrees that the use of the  $D_{TSO_t}$  term should be minimised over the price control period.***

***SONI disagree with the Utility Regulator's proposed headcount of 81<sup>1</sup>; even using this figure we calculate that the required allowance for other OPEX would be £8.45m rather than £7.3m.***

***For the full complement of 98 staff as proposed by SONI this would be £8.6m.***

The majority of the costs in the 'Other OPEX' category are fixed. However, taking the variability of facilities and insurance costs into consideration, SONI estimate that approximately 10% of the costs should 'flex' with staff numbers. Therefore SONI consider that the final number allowed in Other OPEX should be considered on determination of the final headcount based on this assumption.

For the SONI proposed headcount of 98, the total allowance based on this assumption is £8.6m.

For the current proposed headcount by the Utility Regulator of 81<sup>10</sup> staff, the total allowance based on this assumption would be £8.45m.

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<sup>10</sup> The Utility Regulator has proposed a headcount of 81 with 4 additional FTE's funded through connection charges. Therefore SONI have assumed a figure of 81 for the purposes of calculating Other OPEX charges.

## QUESTION 8: DO RESPONDENTS AGREE WITH THE PROPOSED CAPEX ALLOWANCE FOR THE SONI PRICE CONTROL?

***SONI do not agree with the proposed CAPEX allowance for the price control.***

***In particular, SONI is concerned about the long-term effect on consumers as a result of under-investment in the TSO business. The SONI business needs a CAPEX allowance that is sufficient to refresh assets, ensure that it is able to manage and connect renewable generation, manage the impact of European and SEM developments and to respond adequately in emergency situations. The provision of a sustainable level of CAPEX will increase tariff predictability and also provides certainty for SONI to organise and plan the business more efficiently over the price control period.***

***The stock of physical assets owned by SONI, in particular IT assets, need to be constantly refreshed over time. The Utility Regulator's proposed level of CAPEX will defer significant investment to the start of the next price control period.***

The Utility Regulator has taken a particular view that all proposed CAPEX ought to have a fully developed and justifiable business case. However, this approach does not support the principal desire to move away from 'excluded cost' approvals under the  $D_{TSO_t}$  price control term as set out by the Utility Regulator in section 4.3 of the consultation paper and is not feasible in the context of ex-ante incentive based regulation. It also contradicts the recent Utility Regulatory precedent in the SEMO price control decision, where the SEM Committee were of the view that the business required an amount of 'Unpredictable Business CAPEX' and allowed an amount of €250k/annum<sup>11</sup>. This was also in the context of a 3 year price control with well-defined business cases.

SONI has undertaken a comprehensive business planning review to identify major items of CAPEX over the proposed 5-year price control period, with an emphasis on the first two years. The detail of the key CAPEX items, as submitted to the Utility Regulator, was based on the best information available to SONI at the time of submission. However, it is not possible to identify all CAPEX over a five and a half year price control period. There needs to be a recognition that costs will change at the time of project tendering, CAPEX priorities will change and other projects will inevitably commence or be required.

It is important to recognise that all of the CAPEX allowances in the previous price control were fully utilised, with significant additional expenditure recovered via  $D_{TSO_t}$ . The proposed level of CAPEX is less per annum than allowed in the previous price control and it is obvious that this will again lead to an ex-post arrangement of cost approvals which was so prevalent in the last price control and will

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<sup>11</sup> Single Electricity Market SEMO Revenue and Tariffs for October 2010 – September 2013, Decision Paper 10 December 2010

not create effective incentives and the flexibility for SONI to allocate and manage its CAPEX programme.

SONI appreciate the Utility Regulator's support for a number of the business cases submitted however feel that the reduction in the level of the proposed CAPEX where there are business cases and backup is not justified. Each of these are dealt with in turn in Appendix 1 however the overarching principle should be in ensuring a consistent and adequate level of CAPEX over the period, rather than debating individual business cases which will inevitably change.

SONI is also concerned that the proposed level of CAPEX will result in a declining Regulatory Asset Base; this will lead to significant investment at the start of the next price control period, rather than ongoing investment in a planned and controlled fashion. This is further discussed under the response for question 11 on depreciation.

A substantial proportion of the CAPEX is set against the essential refurbishment and extension of the Castlereagh House premises. This is dealt with separately in the answer to question 9.

SONI has reviewed the Utility Regulator's proposed reductions to some of the CAPEX identified in the individual business cases submitted and have provided a response to these in Appendix 1.



## QUESTION 9: WHAT OPINIONS DO RESPONDENTS HAVE REGARDING THE FUTURE BUILDING REQUIREMENTS FOR SONI?

***It is absolutely essential that the existing building and grounds are brought up to an acceptable standard in compliance with Health and Safety legislation. SONI also strongly recommends that the existing building is extended to meet the increasing resource requirements of the business.***

***SONI has compared the cost of extension and refurbishment of the existing building with alternate rental accommodation in the Greater Belfast area. The annual cost when depreciated over 20-25 years is approximately £130 -£150k/annum which compares favourably with rented accommodation.***

***SONI has investigated other options which are discussed below, however the most cost effective and efficient long term solution is to allow the full cost of extending and refurbishing the Castlereagh House premises.***

***SONI believe that any other option will be more costly to consumers in the long term, dilute SONI's effectiveness, create functional silos, increase security risks and affect SONI's ability to handle major incidents or emergencies.***

***It is also SONI's strong opinion that to refurbish the building without the necessary extension works does not address the core issue of space and that continuing to patch and repair the building is unsustainable, costly and inefficient.***

By the end of March 2011 Castlereagh House will be required to accommodate 80 SONI staff. Under the SONI labour resourcing plan for the next 5 years this figure will grow by a further 19. Including the SEMO staff located on site, visitors, consultants and contractors the true capacity figure is 120+. Additional office space is required because the existing building cannot accommodate the current number of people.

An external architect has conducted a feasibility study on the options open to SONI and has recommended the extension and refurbishment of Castlereagh House. The full and comprehensive feasibility study, which investigated alternative options, was supplied to the Utility Regulator on 13<sup>th</sup> December 2010.

There are a number of serious and fundamental issues with the current accommodation which need to be urgently addressed:

- There are ongoing urgent maintenance and repair issues which are becoming more frequent.

- Urgent treatment works are required to deal with the carbonation of concrete on the outer surface of the building. A number of large pieces of concrete have already fallen off the front and rear of the building. These areas have been temporarily repaired.
- The flat roof coverings are showing signs of deterioration and on the first floor minor repair works have already been carried out. SONI is in the process of recovering sections of the roof to prevent further damage to the building fabric.
- The existing heating and ventilation system is not fit for purpose, is performing poorly, with associated high maintenance costs and urgently needs to be replaced.
- Meeting rooms – the number of on-site meeting rooms is insufficient. An old store room with no windows or ventilation has been emptied and is being used as a meeting room.
- Reception Area – this area is out-dated & needs to provide better facilities for arriving guests and customers.
- Car Parking – there is insufficient car parking for the number of staff in the building and for visitors. A number of cars have to park on the grass or at the rear of the building which is a Health and Safety issue.
- Driveway and Entrance – the driveway and car park needs to be resurfaced as there are a number of potholes and it is in need of repair.
- The SONI data centre needs additional civil works for sealing, sound-proofing and equipment segregation.
- Disabled access is a statutory requirement and SONI currently do not comply. For example SONI could not accommodate a disabled member of staff upstairs as there is no lift for access to the upper floor. The proposed extension will ensure full compliance with statutory requirements for disabled access.

The study stated that from a Health and Safety perspective the current premises at Castlereagh House are inadequate. This will lead to Health and Safety issues and a failure to comply with the Workplace (Health, Safety & Welfare) Regulations 1992.

Current space standards for individual and open plan offices are undersized leading to staff welfare issues. Fire Safety requirements may also be compromised. In the short term SONI will accommodate staff in an existing low quality portacabin at the rear of the building. This cannot be considered a sustainable viable option.

SONI has considered a number of alternative options:

1. Extend and refurbish the existing Castlereagh House building – Preferred option
2. Do nothing/minimal repair and refurbishment works
3. Relocate one or more functions to an alternative site

#### 4. Relocate all staff to an alternative site

Each option is considered on merit below:

##### OPTION 1: EXTEND & REFURBISH EXISTING BUILDING – PREFERRED OPTION

The proposal to extend and refurbish Castlereagh House provides the business with the necessary space, meets legislative requirements, maximises the efficiency and effectiveness of the business and is the most cost effective option for the consumer. Therefore the SONI preferred option.

During the divestment process, the Utility Regulator was extremely instrumental in ensuring that the Castlereagh House property was part of the sale. This is because it was a fit-for-purpose control centre building specifically designed for real-time 24x7 secure operations. The current RAB based allowance for Castlereagh House is considerably less than the market value of the premises. Even with the additional CAPEX proposed in the SONI submission this would continue to be the case. If the proposed extension was to be depreciated over 20-25 years then the annual cost would be approximately £130 -£150k/annum, which represents excellent value for money.

The architectural plans accommodate up to 50 additional employees. However, the proposed design is also modular in nature and in no way precludes further extension works. The proposed extension will cover any minor change in responsibilities that may be brought about by a decision on the implementation of the EU 3<sup>rd</sup> energy package.

Investigations into rental and leased accommodation show that there is no significant cost savings. SONI has researched rental and leasing arrangements for office accommodation in the Greater Belfast area (See Appendix 2 for comparative rental costs) and there is no cost saving to be made. Suitable office rental property in Belfast ranges between £141K (Heron Road) to £163K (Lanyon Place); however this excludes any one-off set up costs and additional rental and support costs required for telecommunications, IT and for additional security. This could potentially add another £50-£100k/annum to the cost. This is also in addition to the cost of maintaining the main services at Castlereagh House. There would also be additional inefficiency and expense due to staff travel between the two sites as well as one-off costs for staff relocation.

SONI recently upgraded some of our IT systems including a £4.5M replacement of the Energy Management System. It makes sound business sense to maintain this and other critical systems in the existing secure infrastructure premises at Castlereagh. The business critical data centre remains at Castlereagh House and significant investment would be required in any other rental/lease premises to set up a similar secure environment.

Additional benefits include:

- Having all the SONI services and resources under one roof increases the synergies, improves the business effectiveness and ultimately provides better value to the consumer.

- From a customer perspective, the recent 2010 customer survey confirms that having all the expertise under one roof is one of the benefits customers find helpful. Expertise and assistance is readily at hand and available on site.
- From a staff welfare and functional perspective, having all services under one roof means SONI can maintain high quality of service for customers both internal and external.
- An additional fringe benefit to the wider economy would also be in the local building work in one of the hardest hit sections of the NI economy.

It is SONI's strong opinion that this option will enable us to maintain our current level of service to customers and external businesses whilst future-proofing the business for expansion to facilitate the challenges over the price control period and beyond.

## OPTION 2 – DO NOTHING /MINIMUM REPAIR AND REFURBISHMENT WORKS

As previously outlined, the current building and grounds are no longer adequate for the SONI business.

The SONI annual staff employee survey by “The Great Place To Work Institute” openly criticised the poor accommodation and in particular the heating and office space. This directly affects the morale of staff and in the longer term it can impact on the effectiveness of the business.

The current premises have already been altered a number of times to accommodate increasing number of staff and visitors and various internal partitions have been moved, replaced or relocated to maximise the use of existing space. The ability to continue with this has been exhausted and SONI will have to accommodate staff in an existing low quality portacabin at the rear of the building. This cannot be considered a viable option for the long term.

In the past 12 months alone, SONI has spent over £100K on maintenance to the heating system and recovering parts of the existing roof to prevent further water ingress. It will cost another £75k to seal the building from additional water damage. The problems with the heating system cannot be fully resolved in a piecemeal fashion and there will be other ongoing maintenance costs such as mechanical/electrical work and extending and repairing the car park.

SONI estimate that to maintain the building in its' current form and upgrade it to meet legislative requirements would cost up to £1m over the price control period.

***It is SONI's strong opinion that continuing to patch and repair the building would not be an efficient use of consumer's money and does not provide adequate space for SONI to meet its business obligations.***

### OPTION 3 – RELOCATING ONE OR MORE FUNCTIONS TO ANOTHER ALTERNATIVE SITE

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There is no alternative building available on the Castlereagh House site so accommodation would have to be sought on either a rental or lease arrangement elsewhere. In ruling this option out, SONI has considered the issues around the re-location of each department, as well as the indicative setup costs, ongoing costs and issues.

#### DEPARTMENTAL CONSIDERATIONS

The SONI business is highly complex and there is a very high degree of inter-dependency between the various functions. For example, a new renewable connection involves Planning, Near Time, Real Time, Commercial and Finance departments to work co-operatively. In this example a re-location of any department involved in the process would have an obvious dilution effect and lengthen the connection process, decreasing customer value and satisfaction.

Setting aside the obvious business efficiency benefits of having all staff in the company housed on one site, we have considered the possibility and issues of moving each department of SONI to another location:

Department	Re-location issues
Grid Ops - Real Time	Moving the Real-Time control room function from Castlereagh House would obviously be expensive and logistically prohibitive. All associated systems, including the Energy Management System would have to be made fully available at the new site, with duplicated secure communications established from all power stations and substations in Northern Ireland along with 24x7 security arrangements as currently in place at Castlereagh House. In addition, it would not make sense to move the Real-Time function without Near-Time staff also re-locating and with that, a core element of IT and telecommunications staff required to support the control room function.
Grid Ops -Near Time	The responsibilities of the Near-Time function mean that they are tightly integrated with the Real-Time function and require access to the Real-Time staff and control room on a daily routine basis to discharge their function. For example, Near-Time carry out RCUC <sup>12</sup> runs every few hours and this requires access and input from Real-Time staff.
Grid Ops -Planning	The Grid Operations Planning department have the primary responsibility for ensuring that the connections process is managed efficiently. This requires frequent interaction with all of the other SONI departments for example with the IT department to provide and analyse data or the Near-Time department in relation to outage planning, generation and transmission issues.
IT	The IT support function needs to be located on the site where the primary systems are installed and maintained. The systems are all business critical and high availability and are currently housed in a secure data centre in Castlereagh House. It does not make any sense to relocate the IT support function elsewhere.
SCADA/EMS	The Energy Management System is located in Castlereagh House therefore it doesn't make any sense to house the supporting staff in a separate location. The SCADA signals to all of the power stations and substations also terminate in the EMS.

<sup>12</sup> RCUC – Reserved Constrained Unit Commitment – the TSO scheduling and dispatching system

Regulation & Settlement	The Regulation and Settlement function require access to Real-Time and Near-Time staff in order to manage the Moyle interconnector – for example in managing System Operator trades. In addition, the operation of the Harmonised Ancillary Services arrangements requires access to Near-Time and Real-Time staff e.g. for system log and dispatch queries. The section also interact with the planning department on tariff issues and with the finance department for invoicing TUoS etc.
Finance and administration	As with all businesses, the finance and administration department interacts closely with all other areas of the business and is most effective when located centrally.
Legal	Legal advice is required to all the departments in SONI and it doesn't make sense to locate this function elsewhere. (Additionally there is only 1 full-time lawyer)
HR	The key role of HR is to interface with staff. This will be significantly affected if HR was relocated elsewhere .
General Manager	Needs to be located centrally at Castlereagh House.
SEMO	SEMO was established as a Contractual Joint Venture between EirGrid plc. and SONI Ltd. The structure was proposed by the TSOs and approved by the Regulatory Authorities to ensure that systems were established and personnel employed from both TSO organisations on the existing TSO premises to avail of cost savings and synergies. The SEMO IT infrastructure is located across the two TSO sites at EirGrid and SONI and the staff reside on both premises. Re-location of the SEMO function would mean that any efficiencies resulting from data and information sharing between SEMO and SONI TSO, would also be lost (e.g. data queries, reports, meter data provision queries, D+1, D+3 data feed checks etc).

## SET-UP COSTS

SONI estimate at a high level that establishing secure communications to another site to the same standard currently in place in Castlereagh House would cost in the region of £100-£250k. This includes the provision of secure high availability bandwidth, firewalls, proxy servers and uninterruptible power supplies.

## ON-GOING COSTS AND ISSUES

SONI has researched rental and leasing arrangements for office accommodation in the Greater Belfast area and there is no cost saving to be made: If the proposed extension were to be depreciated over 20-25 years then the annual cost would be approximately £130-£150k/annum. Suitable office rental property in Belfast ranges between £141K (Heron Road) to £183K (Lanyon Place) [please refer to Appendix 2]; however this excludes any additional support costs required for telecommunications, IT and for additional security. This could potentially add another £50-£100k/annum to the cost. This is also in addition to the cost of maintaining the main services at Castlereagh House.

Relocating any staff to another alternative office within Northern Ireland would also have significant drawbacks including:

- Increased IT complexities
- An increase in the IT resource required to manage and support two sites including new firewalls, proxy servers, power supplies and telecommunication links
- Increased administrative and financial overhead in managing two sites
- Security issues – SONI is currently self-contained in remote and discreet premises; moving any department off-site will increase the security risk Increased security costs
- Loss of business efficiencies
- Staff welfare issues.

## OPTION 4 –RELOCATE ALL STAFF TO AN ALTERNATIVE SITE

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It is not commercially viable for SONI to sell Castlereagh House and find cheaper accommodation elsewhere. The Castlereagh House premises were established circa 1971 and designed specifically for control centre operations. The premises are outside the development zone (on a 'Green zone') and therefore no planning permission would be permitted for residential property development. In addition, the TSO function is highly specialised and requires a building designed to be fit-for-purpose to ensure that it is secure and that it has the required communications infrastructure to the Northern Ireland power stations and substations, redundant electricity supplies including diesel backup, data centre requirements etc readily available. Therefore moving from the main Castlereagh site would be a very costly exercise is not a realistic proposition.

The architect has also looked at the cost of a completely new building on the Castlereagh House site. The cost would be in the region of £9-10m for a new building. To maintain the current building with a smaller separate building on site would cost in the region of £4-5m. A new building on another site



would cost in the region of £10-12m. None of these options are realistic nor are they financially viable.

**QUESTION 10: DO RESPONDENTS AGREE WITH THE PROPOSED WACC FOR THE SONI PRICE CONTROL?**

***SONI disagree with the proposed pre tax WACC of 5.45%.***

***The WACC needs to be assessed in the context of the overall price control package. SONI consider a real pre-tax WACC of 6.7% to be appropriate and this is supported by an independent report from CEPA.***

***The debt premium, market return and equity beta components of the calculation are of particular concern. The WACC proposal fails to recognise and reflect SONI's characteristics and is inconsistent with regulatory precedent.***

***Necessary investments, which are to the ultimate benefit of consumers, must be capable of being supported through the provision of adequate return to remunerate both debt and equity holders.***

SONI submitted an 'Opportunity Cost of Capital' paper to the Utility Regulator on 22<sup>nd</sup> June 2010 which recommended a real pre tax WACC of 6.7%. This submission was supported by an independent report from Cambridge Economic Policy Associates (CEPA). The Utility Regulator's proposal for a WACC of 5.45% is not an appropriate regulatory determination of the cost of capital for SONI over the forthcoming price control period. It fails to incorporate a number of key SONI characteristics and is considerably out of line with recent regulatory precedent. Appendix 3 provides a more detailed response to the Utility Regulator's WACC proposal.

The appropriateness of the WACC outcome needs to be assessed in terms of the overall price control package. The reasonableness of each building block, which derive the WACC, needs to be considered in this context, and not in isolation, in order to deliver an efficient outcome. A number of components that derive this WACC outcome are of particular concern; in particular the debt premium, market return and equity beta.

The 1.5% debt premium proposed by the Utility Regulator can only be considered appropriate for a large traditional utility and not for SONI which is more characteristic of a service company within the utility sector. SONI faces a higher cost of debt due to the small packages and short term nature of debt it can avail of. Recognition for such characteristics is now common regulatory practice<sup>13</sup>. It was

<sup>13</sup> See the Competition Commission, Final Determination, Bristol Water, September 2010 and also the Ofwat PR09 determination.

on this basis that SONI submitted for a debt premium of 2.05%, consistent with the Competition Commission determination for Bristol Water.

Regarding the market return component, the Utility Regulator's proposal of 6.75% is an outlier amongst its regulatory peers. Both the Competition Commission in its Bristol Water determination and the Civil Aviation Authority in its NATS determination provided a market return of 7%. Ofwat in its PR09 determination included a rate of 7.4% in its allowed WACC. SONI considers that a minimum market return of 7%, and more likely 7.25% in the current economic climate, represents an appropriate and efficient level reflecting the return an investor demands today and over the forthcoming period.

The consultation paper refers to a framework, provided by First Economics, to assess an appropriate equity beta. SONI believe that this framework is broadly acceptable but the conclusion drawn by First Economics does not fully appreciate SONI's characteristics. Moreover, the proposal and justification made by the Utility Regulator using this information fails to reflect the SONI characteristics to any satisfactory degree.

The framework outlines two key criteria; Exposure to Volume Risk and Operational Gearing. SONI has a high exposure to volume risk in the short run and its operational gearing is very high; indeed, effectively, without equal in terms of regulated utilities. This creates considerable business risk as even a small unanticipated change in the operating cost base can have very significant implications for the level of return achievable. Therefore, it is clear that SONI has a high asset beta and subsequently a high equity beta. The SONI asset beta submission of 0.45 (assuming zero debt beta) or 0.505 (assuming 0.1 debt beta) reflects the systematic risk faced by SONI.

The WACC is one aspect of the price control that supports financeability. Full consideration must be given to how the incentive measures and revenue allowances interact alongside the WACC outcome. The overall price control must provide for SONI's characteristics, e.g. high operational gearing. While the WACC should be adjusted for these it may not be sufficient in and of itself to provide for the risks created by these characteristics. Other elements of the control may also need to be adjusted.

Necessary investments, which are to the ultimate benefit of consumers must be capable of being supported through the provision of adequate return to remunerate both debt and equity holders. The SONI proposal of a real pre tax WACC of 6.7% supports this requirement.

**QUESTION 11: DO RESPONDENTS AGREE WITH THE PROPOSED DEPRECIATION PERIOD OF 10 YEARS (STRAIGHT LINE) SHOULD BE USED FOR THE PRICE CONTROL PERIOD?**

***The SONI business is very highly dependent on IT and the majority of capital projects, excluding building works, are IT related. It is important that the depreciation period reflects the economic life of the assets. On that basis a depreciation period of 5 years, straight-line, rather than 10 years, would better represent the economic life of these assets***

***However, this assumes that the stock of physical assets owned by SONI, in particular IT assets, will be refreshed over the price control period to maintain a relatively constant level of capital investment in the business and this is captured in the regulatory asset base.***

***In consideration of the proposed extension to the Castlereagh House building, SONI would however propose that a depreciation period of 20-25 years is more appropriate reflecting the economic life of that asset.***

The depreciation period of a given asset should reflect its economic life. Correspondingly, the annual depreciation allowance would represent the economic value derived from that asset with the remaining asset value reflecting the value yet to be utilised. This means that an asset becomes less valuable over time. Ultimately a constant asset base level ensures that the same level of service and value is provided by the business.

There is a significant emphasis on IT systems in the SONI RAB and in the CAPEX programme over the price control period. The expected economic life of the SONI IT assets is 3 to 8 years and therefore 5 years would be a reasonable average depreciation period to apply to these assets. However, this is premised upon the assumption that a reasonable refresh in the stock of physical capital is provided for. This is not the case in the Utility Regulator's proposal.

As the SONI business is very IT intensive asset lives are relatively short. It is therefore important that the systems are well maintained and refreshed as the price control period is long in terms of technological development and lifecycle. The CAPEX submission as proposed by SONI provides sufficient capital to replace the assets over the price control period. Failure to allow sufficient capital investment will result in an underinvestment, evident by a declining RAB, leading to a need for significant investment at the start of the next price control period.

Regarding the specific issue of the building extension, a depreciation period of 20-25 years rather than 5 is recommended to reflect its economic life. Again this is deemed an appropriate average depreciation period, consistent with statutory assessment, for the building itself together with the fixture and fittings. This depreciation period would also mean a reduced cost to consumers over the price control period with the annual cost out-weighting options to re-locate some or all staff in rental accommodation. (See answer to question 9)

## QUESTION 12: INCENTIVES

***SONI agrees that appropriate incentives should be implemented where there are clear benefits.***

***SONI believes that if meaningful incentives are set which are realistic yet challenging, with an appropriate balance between the potential benefit to consumers and potential reward to the business, then both the consumer and business will have the potential to benefit from improved performance.***

***However, SONI is concerned that the two proposed incentives as set out in Section 12 are inconsistent with the Utility Regulator's decision to exclude other obligations that are license obligations, and will not deliver clear benefits without further development.***

***The appropriate financial upside and downside associated with the incentives, both individually and as a package, will depend on the overall outcome of the price control review, the specific targets that are set, and the design features of each of the incentives. SONI propose that for this reason it would be more appropriate to consult separately and agree a package of incentives following agreement of the price control.***

SONI has not had performance based incentives applied during its previous price control as there was uncertainty as to the nature of the business post divestment. The increased maturity of the business, the acquisition of the SONI business by EirGrid under a group governance structure, the challenging targets for the integration of renewable generation over the next price control period, combined with the investment which the Northern Ireland consumer is now making in developing SONI to be a separate and fit for purpose business, mean such a framework is not only appropriate, but essential.

Performance incentives are an important component of revenue or price cap regulation. Performance incentives complement the requirement for a regulated business to efficiently manage costs by ensuring that the business also has an incentive to improve on quality and performance. The revenue cap and performance incentives taken together promote the most efficient CAPEX and OPEX by balancing the incentive to reduce actual expenditure with the need to maintain and improve quality and performance.

On the specific incentives proposed in the consultation paper, SONI would make the following comments:

## PROPOSED INCENTIVE 1 – DELIVERY OF KEY INDUSTRY DOCUMENTS

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In the consultation paper, the Utility Regulator states that ‘as SONI receive no benefit from reductions in [sic] other costs, the Utility Regulator consider it important that they are given explicit incentives to manage these in the optimum manner.

However, incentive 1 – delivery of key industry documents, does not provide any benefit to SONI and is therefore a penalty.

Further, in consideration of the delivery of connection offers and use of system offers, the Utility Regulator considered it inappropriate to incentivise SONI as these were license conditions. This is inconsistent with the proposed incentive 1 – the Generation Adequacy Report is a requirement of the SONI License<sup>14</sup> condition 35 and the provision of the Transmission Seven Year Statement is a requirement of SONI License Condition 33. Similarly the Transmission System Performance Report and Grid Code Development Plan are requested from SONI by the Utility Regulator under SONI License Condition 7.

SONI do however think that there is merit in appropriate incentivisation of this area. However, there must be recognition that SONI has very limited ability to absorb downside risk which must be measured against the ‘thinness’ of the business itself and the impact of poor performance on reduced equity returns.

## INCENTIVE 2: WORLD CLASS FORECASTING

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External costs are, by their definition, to a considerable extent outside the direct control of the TSO and the means through which prudent management can exert influence upon their overall level can be limited. However, SONI considers that the introduction of incentives in these areas, when practicable, would be beneficial. Constraints and Ancillary Services are a significant element of electricity costs and their prudent management is of considerable benefit to consumers. It is not, however, appropriate at this time, and following the introduction of a new regime to consider widespread incentives around their management.

Constraint costs are jointly forecast on an all-island basis by EirGrid and SONI and recovered through the SEMO Imperfections Charge. They are treated as pass-through costs reflecting the degree to which the assumptions underpinning the forecast are subject to a number of factors outside the control of the TSOs.

One of the areas where SONI does have some limited ability to directly influence constraint costs is through effective demand forecasting as costs arise to the extent that there are differences between

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<sup>14</sup> SONI License – License to participate in the transmission of electricity granted to SONI Limited by the Department of Enterprise, Trade and Investment

the market schedule of generation and the actual generation dispatch. However, SONI believe that the impact is relatively minor: the demand forecast is only used in the ex-ante schedules in the market software so the effects would principally be found in how the interconnector units are scheduled in the market. Taking account of the MIUN<sup>15</sup> calculations, the schedule is closely aligned with how the interconnector units are dispatched. So there is only limited potential for the quality of the demand forecast to influence the efficiency of dispatch of the interconnector, and thereby impact on dispatch balancing costs.

Foresight of the system conditions, whether it be system demand, or wind penetration, represents only a small proportion of the Dispatch Balancing Costs and the ability to improve upon it, with increasing challenges of greater intermittency, a smaller sub component still. The design of an incentive in this area should take account of the limited potential for improvement as compared to the potential significant downside risk but may nonetheless be important.

From the information provided in the consultation paper, it is not clear whether or not the best measurement is proposed, what the targets are, how they are reviewed, agreed and set and therefore what the downside risk to the SONI business would be.

SONI would therefore urge the Utility Regulator to allow time to develop a more robust and well defined incentive mechanism during the first year of the price control.

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<sup>15</sup> MIUN – Modified Interconnector Unit Nominations as defined under the Trading and Settlement Code.

# APPENDICES



# APPENDIX 1: CAPEX RESPONSE

## Summary

	SONI	Ureg	Diff	Utility Regulator Comments	SONI Response
<b>£M</b>					
<b>6 Month Submission</b>	0.984	0.913	-0.071	Allowance reduced to reflect approved allowance from Utility Regulator	Agreed previously.
<b>Building</b>	3.200	0.400	-2.800	Costs reduced to reflect allowance for refurbishment. Further assessment of Building costs required	See answer to question 9.
<b>EMS</b>	1.385	1.065	-0.320	See Comments Below	See SONI comments below.
<b>IT</b>	2.548	1.663	-0.885	See Comments Below	See SONI comments below.
<b>Telecoms</b>	1.605	0.665	-0.940	See Comments Below	See SONI comments below.
<b>Other</b>	0.100	0.100	0.000	Justification of costs was only provided for 2011. Therefore costs have been allowed in relation to TETRA licencing and Security	Agreed. The SONI submission was only seeking costs for 2011 of £100k.
<b>Non-identified Capex</b>	1.500	0.000	-1.500	Non identified Capex cannot be assessed by the Utility Regulator. The Utility Regulator will consider any innovation ideas with a full CBA during the price control period.	Please see general answer to question 8. The detail of the key CAPEX items, as submitted to the Utility Regulator, was based on the best information available to SONI at the time of submission. However, it is not possible to identify all CAPEX over a five and a half year price control period. There needs to be a recognition that costs will change at the time of project tendering, CAPEX priorities will change, assets will need to be refreshed and other projects will inevitably commence.
<b>Total</b>	<b>11.322</b>	<b>4.806</b>	<b>-6.516</b>		

## EMS

	SONI	Ureg	Diff	Utility Regulator Comments	SONI Response
<b>£M</b>					
Annual Investment	0.200	0.100	-0.100	Annual Investment not fully justified. The Utility Regulator recognise that some level of ongoing investment required but propose a lower value	SONI set out a detailed explanation as to why this amount of annual CAPEX was required in the submissions. The EMS was a £4.5M investment. It is essential that a reasonable amount of annual CAPEX is set aside to enable minor developments and enhancements to utilise the EMS to it's full potential. The downside is that inter-control centre links may not be fully developed or utilised, limited all island data exchange, reduced system visibility, potential stauration of new EMS connections at the EMS front-ends. A £20k/annum allowance is disproportionate to the system investment and will not give sufficient flexibility.

	SONI	Ureg	Diff	Utility Regulator Comments	SONI Response
<b>£M</b>					
EMS Upgrades	0.500	0.400	-0.100	Second upgrade at end of 5 years has been reduced. The Utility Regulator believe SONI will be in a position to negotiate better terms for upgrade as it is part of hardware delivery.	In the submissions, it is explained that the first upgrade proposed in 2011-12 was a more minor upgrade from V2.3 to V2.6. The provision in 2013-14 is for a major upgrade to version 3.x. Although the hardware is to be replaced at this time it will not have any significant impact on the price of this more major software upgrade.
EMS System Hardware Replacement	0.250	0.250	0.000	The Utility Regulator accept that this investment is necessary as equipment nears end of life.	Agreed.
Network Hardware Replacement	0.115	0.115	0.000	The Utility Regulator accept that this investment is necessary as equipment nears end of life.	Agreed.
Wind Curtailment Block Load Tool	0.200	0.200	0.000	The Utility Regulator accepts that investment will reduce costs to consumers (reduced constraints) and expect to see a VFM assessment of this investment	Agreed.
Wind Stability Assessment Tool	0.120	0.000	-0.120	The Utility Regulator do not agree that this investment is necessary. If SONI wish to invest in this area to improve their performance they may gain from the proposed incentive mechanisms	SONI would challenge the basis for the assertion that this investment is unnecessary. As outlined in the submissions, the WSAT tool will highlight the risk of operating the power network in potentially unstable conditions, taking into account the system state and wind forecasts. Without the WSAT tool there is an increased risk that the system could be unstable under certain system and forecast conditions which could otherwise have been avoided. This tool is about system stability and is not related to the Utility Regulator proposed wind forecasting incentive.
<b>Total</b>	<b>1.385</b>	<b>1.065</b>	<b>-0.320</b>		

## IT Software and Hardware

	SONI	Ureg	Diff	Utility Regulator Comments	SONI Response
<b>£M</b>					
Air Conditioning	0.110	0.050	-0.060	The Utility Regulator accepts that the investment in 2011 is required, but have disallowed the 2015 cost. It is expected that a hardware swapout in 2014 will result in more efficient equipment so Air Con requirements should be sufficient or reduced.	As explained in the submissions, the equipment installed in 2011 will be end-of-life by 2014-15. The hardware installed in 2014 may or may not be more efficient; however, air conditioning is still a fundamental requirement for the data centre.
Desktop PC Refresh	0.085	0.085	0.000	The Utility Regulator accepts that the investment is required	Agreed.
System Hardware Replacement	0.423	0.423	0.000	The Utility Regulator accepts that the investment is required to replace end of life equipment	Agreed.
SAN Upgrade	0.370	0.310	-0.060	The Utility Regulator accepts that additional SAN may be needed and an upgrade in 2013. However, the Utility Regulator is disallowing the costs in 2012 as it expects SONI to phase the introduction of the upgrade to ensure storage needs are met efficiently	A cost of £60k in 2012 is provided to allow for increased storage requirements anticipated for the current SAN. SONI estimate that this allowance is required in both 2012 and 2013.

	SONI	Ureg	Diff	Utility Regulator Comments	SONI Response
<b>£M</b>					
Desktop Software Refresh	0.060	0.060	0.000	As this investment is related to the Desktop PC Refresh, the Utility Regulator accepts that this investment is required	<b>Agreed.</b>
Sharepoint Upgrade	0.095	0.070	-0.025	The Utility Regulator has disallowed the 2015 cost as it is not clear if this upgrade will be necessary	<b>SONI agree that it is not clear if the upgrade in 2015 will be necessary however we would contend that it is better to plan for this upgrade.</b>
Virtualisation Upgrade	0.070	0.070	0.000	The Utility Regulator accepts that the investment is required	<b>Agreed.</b>
EDRMS	0.150	0.100	-0.050	The Utility Regulator agrees that SONI need to have good document and record management systems in place. However, it is not clear how this system will interface with the existing Sharepoint. therefore a smaller allowance has been allocated  The Utility Regulator would expect to see efficiencies within the company as a result of this investment. This will be considered in the opex assessment	<b>The SONI estimate assumed utilisation of the existing Sharepoint licenses. Costs were provided by an external advisor for a company of similar size. Therefore SONI would challenge the evidence for the proposed reduction.</b>
Data Warehouse Tools	0.230	0.200	-0.030	The Utility Regulator accepts that this investment is necessary, however disallows one of the costs relating to customising the system within a year of deployment.	<b>SONI accept the proposed reduction in the second year.</b>
IT Standardisation	0.195	0.090	-0.105	The Utility Regulator agrees that SONI should be considering IT standards and best practice. However it is not clear why there is an ongoing investment required. Therefore the Utility Regulator proposed to allow costs for 2 years to ensure the necessary systems are in place	<b>SONI accepts that 2 years of investment should be sufficient CAPEX and that an ongoing OPEX expenditure would be more suitable thereafter.</b>
EDIL	0.045	0.045	0.000	The Utility Regulator acknowledge that this investment would generate an efficiency in terms of resources. The Utility Regulator has considered this allowance in the assesment of opex	<b>Agreed.</b>
SDX	0.150	0.060	-0.090	As this Data Exchange is linked to Sharepoint, the Utility Regulator has made an allowance in the same time frames as the Sharepoint allowances above	<b>The SONI Data Exchange (SDX) is the business critical system for the provision of data to the SEM. In line with bi-annual updates to the SEMO systems the SDX requires ongoing updates and modifications to ensure that it continues to meet operational requirements. SDX is underpinned by Sharepoint but developments are required irrespective of this. The allowance requested of £30k per year is minor compared to the risk that SONI may not be able to fulfill its license and TS&amp;C obligations in complying with TS&amp;C modifications.</b>

	SONI	Ureg	Diff	Utility Regulator Comments	SONI Response
<b>£M</b>					
SONI Website	0.500	0.100	-0.400	The Utility Regulator is concerned about the proposed costs in this area. The Utility Regulator do not agree with the proposed cost and have proposed a much lower cost. The Utility Regulator would require a much more detailed submission to consider a higher cost for a website.	<b>SONI provided a detailed business case for the proposed website and independent benchmarks of similar websites. We were therefore surprised that the Regulator has challenged the level of detail provided. The website is an absolutely critical area of the SONI business and may be the first port of call to consumers in an emergency situation. SONI will undertake a more detailed analysis at tendering time; however all indications and benchmarks indicate that the proposed cost of £500k is entirely reasonable and in line with websites of a similar nature.</b>
Training Records System	0.015	0.000	-0.015	The Utility Regulator do not agree that SONI need a Training Records System for a relatively small company. Therefore this allowance has not been allowed	<b>SONI accept the determination and will develop an in-house application.</b>
Network Modelling	0.050	0.000	-0.050	The Utility Regulator propose that as this tool is in Eirgrid, SONI could avail of that expertise. Therefore no allowance has been included	<b>The assertion that SONI can avail of EirGrid expertise is completely unreasonable, unrealistic and unacceptable. SONI must be able to model and simulate the network independently to evaluate the impact of disturbances, faults and re-configurations on the NI transmission system. The expertise of the NI transmission system resides in SONI, not in EirGrid; SONI must have independent licenses for this software.</b>
<b>Total</b>	<b>2.548</b>	<b>1.663</b>	<b>-0.885</b>		

## Telecoms

	SONI	Ureg	Diff	Utility Regulator Comments	SONI Response
<b>£M</b>					
Telecoms Infrastructure	0.575	0.425	-0.150	The Utility Regulator have made one disallowance in this area in relation to IP Telephony. There is a concern over why the hardware has a 4 year life time. The Utility Regulator proposes that this is an area to consider for the next price control.	<b>The hardware for the IP telephony system is already installed and will be 5 years old in 2014; Hence it was included in the submission.</b>
WAN	0.050	0.050	0.000	The Utility Regulator accepts that the investment is required	<b>Agreed.</b>
UPS	0.190	0.190	0.000	The Utility Regulator accepts that the investment is required	<b>Agreed.</b>
Satellite Comms to Wind farms	0.600	0.000	-0.600	The Utility Regulator disagrees with this cost as it should be covered via connection costs.	<b>SONI are concerned that an opportunity for innovation in the communications to remote wind farm sites will be lost as a result of this disallowance. This one-off capital investment will enable communications to any remote site for a known fee. It would be reasonable to allow such a system to be funded through the SONI price control as it is very difficult to apportion the capital costs across connectees, existing and new.</b>
Electrical Switchboard Replacements	0.150	<b>OMITTED</b>	-0.150	This business case was omitted in the Utility Regulator's analysis.	<b>Business case submitted in CAPEX papers</b>

	SONI	Ureg	Diff	Utility Regulator Comments	SONI Response
<b>£M</b>					
Diesel Generators Refurbishment	0.040	<b>OMITTED</b>	-0.040	This business case was omitted in the Utility Regulator's analysis.	<b>Business case submitted in CAPEX papers</b>
<b>Total</b>	<b>1.605</b>	<b>0.665</b>	<b>-0.940</b>		

APPENDIX 2:  
COMPARATIVE RENTAL COSTS IN THE  
GREATER BELFAST AREA

COMPARATIVE RENTAL COSTS IN THE GREATER BELFAST AREA

Property	Size/sq ft	Annual Rent/£	Rates	Car Parking	Service Charge	Telecoms <sup>16</sup>	Total/£ annum
<b>Avenue House, Royal Avenue</b>	4,000	34,008	19,894	30,000	18,965	50,000	152,867
<b>The Soloist, Lanyon Place</b>	5,794	86,623	29,273	30,000	17,922	50,000	213,817
<b>Pilot's View, Heron Road</b>	8,000	99,000	36,000	Free	5,600	50,000	190,600
<b>The Obel</b>	5,371	67,138	26,855	30,000	18,261	50,000	192,254

<sup>16</sup> An estimated cost of £50k/annum is included for each facility for the provision of secure telecommunications and associated support.



## APPENDIX 3:

# SONI WACC RESPONSE PAPER

## Introduction and Purpose

The opportunity cost of capital, and in particular the overall financeability of the licensed activity, is of particular importance in the overall determination of the price control. This note examines firstly the WACC proposals and suggests some necessary adjustments but concludes that the WACC can only address so much in the SONI context and that this must be supported by broader measures which support financeability across the model.

SONI welcomes the opportunity to respond to the Utility Regulator's proposed WACC as outlined in the consultation paper. This response is made on behalf of both SONI's Transmission System Operator (TSO) and Market Operator (MO) businesses<sup>1</sup>. SONI submitted for a real pre tax WACC of 6.7%. This submission was supported by an independent report from Cambridge Economic Policy Associates (CEPA).

The Utility Regulator's proposal<sup>2</sup> for a WACC of 5.45% is not an appropriate regulatory determination of the cost of capital for SONI over the forthcoming price control period. Indeed it is below that for a traditional asset based utility, below recent regulatory precedent and does not adequately incorporate a number of key SONI characteristics<sup>3</sup> which mean that SONI faces a higher cost of capital than is the case for such traditional utilities. SONI sets out strong arguments which support this position in this paper.

It is important that the WACC outcome, along with other elements of the price control, provide SONI with an efficient level of revenue in order for it to be a financially sustainable business. The cost of this is very low in the short term – a 1% point increase in the allowable WACC would be likely to increase allowable revenues by the order of £100k per annum. However, to neglect this and therefore to put at risk both value adding, and often critical investment, through the absence of a provision of an adequate return to the investor will give rise to much more significant longer term negative cost for consumers.

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<sup>1</sup> It was stated in SEM/10/082 that the WACC rate determined as part of SONI's SO price control would apply to SONI's MO licence.

<sup>2</sup> In the consultation paper reference is made to a report by First Economics. However, this report has not been made public or available to SONI. Therefore, SONI's response is made in the absence of the details of this report and is solely based on the information and references provided by the Utility Regulator in their consultation paper.

<sup>3</sup> Absence of scale, associated absence of access to bond markets, high operational gearing, significant fees as a proportion of finance raised

## Arriving at a WACC estimate

The WACC outcome must not only reflect an assessment of the market conditions for each of the building blocks but more importantly it requires regulatory judgement of whether it underpins and supports the financeability of the overall price control. The appropriateness of the overall outcome needs to be examined in addition to the reasonableness of each of the building blocks in isolation. A pure market assessment for the individual estimates of each component may appear, and may well be, appropriate and reasonable in and of themselves but in aggregate lead to a suboptimal regulatory solution.

This is not to say that regulatory judgement leads to deviations from the market data. Rather it involves the flexibility of utilising the full range of market data available. For instance, when the Competition Commission (CC) ruled on the Bristol Water case (August 2010) they selected the highest point of 7% from their Market Return range of 6% - 7%. Again, regarding the Equity Beta they selected the highest point from their 0.62 – 0.92 range. This reflects the difference in the judgement set when making a regulatory determination from a pure market assessment.

When making a regulatory evaluation of the WACC outcome a step back from the market data is required with due consideration given to the overall role and purpose of the regulatory model and the WACC's place within it. Essentially the regulatory model is one of risk sharing between electricity consumers and the company charged with overseeing the transmission system operator licence. The electricity customer pays an insurance premium, with the WACC return forming part of this premium, to the company in order for it to manage the risk inherent in the licensed activity i.e. operational and investment risk. This means that the company faces the costs when things go wrong rather than the customer. However, the company's ability to manage and survive such costs is limited by the extent of the insurance premium. A low premium can jeopardise the delivery of customer NPV positive investments and activities. In other words, the company will not have a sufficient financial buffer to overcome any difficulties. Therefore, regulators provide some flexibility, either in the WACC itself or the price control more generally, to ensure that a catastrophic event of a utility company failing does not materialise. The 'cost' of aiming somewhat high in the WACC protects the customer from the full upfront cost of such an occurrence.

Arguably it is even more important now than ever to provide headroom within the WACC estimate. The recent market volatility and uncertainty evident in the last few years illustrates that the risks faced by companies in managing their activities is not just a passive or a theoretical risk. To the extent the WACC proposed is not linked to underlying movements in the capital markets then that

risk is effectively passed from consumers to the utility businesses themselves. Regulated companies have faced real costs which were not explicitly provided for in their respective price controls and had to manage such costs from their own resources. Consumers did not have to face these costs as the model shares the risk between both parties. This is the nature of the regulatory model. However, the risk managed by the company must be sufficiently compensated; otherwise the model will break down.

The final determination by the Utility Regulator requires a much fuller consideration, and exploration of these issues. The Utility Regulator has deviated from regulatory precedent which tends to recognise these risks, and indeed that the appropriate choice of point estimate is not necessarily normally distributed within the range, to a choice of estimates which represent midpoint or lower bounds of those advised to it by its consultant. Such an approach is not justified, nor has the Utility Regulator elaborated on why it believes it to be so, in its consultation.

#### *WACC components*

SONI are particularly concerned regarding a number of the individual components chosen by the Utility Regulator which lead to a suboptimal WACC outcome. As mentioned above the concern is centred on the insufficient recognition of the SONI's characteristics and divergence from regulatory precedent. The following components are of particular concern;

- Debt Premium
- Market Return
- Equity Beta

#### *Debt Premium*

In the previous SONI price control a small company premium was added to the WACC by the Utility Regulator recognising the requirements for the provision of a higher cost of capital for a small company such as SONI. The rationale behind the small company premium is largely that due to the small size the costs involved with raising debt or issuing equity are a much greater percentage of the overall costs than for a larger counterpart, as these costs are indivisible. Therefore, it was argued, they must be directly incorporated in the WACC – at the time of the last price control this represented standard regulatory practice.

However, regulatory debate has continued since regarding the appropriateness of applying a small company premium. This debate has led regulators to remove an explicit small company premium on

the cost of equity and rather to incorporate a company's characteristics, and any associated implications for systematic risk, in the cost of equity e.g. equity beta, rather than the direct costs surrounding the raising of equity. This is effectively the approach proposed by First Economics in recognising the importance of operational gearing in a SONI context – see more below.

However, regulators have continued to make provision for a small company premium remains on the cost of debt side, albeit the term no longer tends to be specifically utilised. Smaller companies only have limited access to the bond market and subsequently have a much greater reliance on more expensive bank debt. The CC states that the cost of debt is higher for the Water Only Companies (WoCs) than for Water and Sewage Companies (WaSCs) due to their small size<sup>4</sup>. The CC provided 30 bps to Bristol Water in order to cater for fees related to raising debt. This is consistent with Ofwat stance in PR09 where they added 40 bps to WoCs cost of debt to reflect their higher costs. SONI has a much smaller balance sheet than either Bristol Water, or indeed any of the other WOCs.

SONI's submission sought to reflect such consideration regarding company characteristics. In many respects SONI is less characteristic of a utility and more characteristic of a service company working within the utility sector. The small packages and short term nature of the debt SONI raises means arrangement and financing fees are much greater and frequent than in the case of utilities raising longer term debt in larger packages. The regulatory precedent set by the CC, amongst others, must be reflected in SONI's cost of debt. Indeed it is even more imperative and appropriate to do so given that its RAB is considerably smaller than that of the smallest WoC.

It is for these reasons that SONI submitted for a debt premium of 2.05%, and therefore a total cost of debt of 4.05%; A position consistent with CC's decision to provide a debt premium of 2% for Bristol Water's forward looking debt<sup>5</sup>. The debt premium proposal by the Utility Regulator of 1.5%, which appears to be solely based on bond market evidence for a traditional asset based utility, is out of line with regulatory precedent. Moreover SONI is surprised that solely a single point estimate was presented rather than a range from which a point estimate could be chosen.

The Utility Regulator should therefore adjust the cost of debt to line up with other regulatory precedent and to reflect SONI's characteristics either as a separate line item or as part of the cost of

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<sup>4</sup> Competition Commission, Final Determination, Bristol Water, September 2010 .

<sup>5</sup> This level is inclusive of the provision of 30bps for Bristol Water's specific debt raising characteristics.

debt. SONI believes the 4.05% it originally submitted to represent a reasonable estimate and the 3.95%<sup>6</sup> provided by the CC in the case of Bristol Water to represent a lower bound.

### *Market Return*

In the Utility Regulator's consultation paper it is suggested that a Market Return of 7.25% is not appropriate for a regulated company like SONI in the current economic climate – “this is not considered to be a reasonable expectation for a regulated company in the current economic climate”. SONI would like to clarify that Market Return is not a company specific component as implied in the consultation paper. Rather it is a ‘economy-wide’ component and therefore the consideration of SONI's regulated status is not of relevance. However, consideration of the current economic climate is an important factor when selecting the Market Return. Current macroeconomic circumstances, and financial market turbulence have, in fact, only increased the level of Market Return, or in particular Market premium over and above the risk free rate, required.

There is therefore a need to assess and make a judgement on the extent of the impact and ramifications of the crisis during the forthcoming price control period. This view can then either influence the selected range for the Market Return or the point estimate chosen within this range. Recent work by Europe Economics<sup>7</sup> for CAA outline the view that an Equity Risk Premium of 6% (implied market return of 8%<sup>8</sup>) applies for a crisis period and an Equity Risk Premium of 5% (implied market return of 7%) is more suitable for a non-crisis period. SONI in its submission selected an estimate from the upper end of its range of 6.5% - 7.5%<sup>9</sup> in order to account for the impact of the crisis, providing a Market Return estimate of 7.25% even while recognising the crisis is likely to dissipate to some extent in the forthcoming period, although not to return to pre-crisis levels.

The estimate chosen by the Utility Regulator of 6.75% is an outlier, with it being lower as compared to other recent regulatory precedent. For example, the CC provided a market return of 7% to Bristol Water<sup>10</sup>; the NATS determination<sup>11</sup> was 7% and Ofwat<sup>12</sup> was 7.4%.

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<sup>6</sup> A blend of the CC assessment of backward looking cost of debt on the one hand and 4.0% for forward looking on the other.

<sup>7</sup> Cost of Capital for NATS (En Route) plc for CP3, Europe Economics, May 2010.

<sup>8</sup> Using a Risk Free Rate of 2%.

<sup>9</sup> Consistent with the regulatory precedent where the Equity Risk Premium is typically 4.5% - 5.5% (implied Market Return of 6.5% - 7.5%).

<sup>10</sup> Competition Commission, Final Determination, Bristol Water, September 2010.

<sup>11</sup> CAA Decision, NATS (En Route) plc CP3 Price Control Review 2011-2014, December 2010. For component detail see CAA, NATS (En Route) plc price control: CAA formal proposals for control period 3 (2011-2014): under Section 11 of Transport Act 2000, October 2010.

<sup>12</sup> Ofwat, Future water and sewerage charges 2010-15: final determinations, PR09, July 2009.

A Market Return of 7.25% therefore in our view remains appropriate and efficient level reflecting the return an investor demands today and over the forthcoming period with the 7.0% from the recent CC decision on Bristol Water representing a lower bound.

### *Equity Beta*

The asset beta, and subsequent equity beta, estimate chosen by the Utility Regulator does not reflect the systematic risk faced by SONI. First Economics outline a framework for considering an appropriate asset beta which recognises the operational gearing of the SONI business and its importance in the asset beta calculation. SONI largely subscribes to this framework, although is not certain First Economics have fully appreciated the SONI business characteristics. Given this framework, and the characteristics, it is difficult to ascertain the rationale of the chosen low point estimate, including the largely unsubstantiated assertion by the Utility Regulator that SONI is somehow less exposed to systematic risk than airports.

In examining comparators against which an appropriate asset beta for SONI can be assessed it is important to consider two key variables: Exposure to Volume Risk via Price Control and Operational Gearing. The following table outlines the risks faced by various regulated sectors and regulatory precedent regarding the chosen asset beta.

**Table 1: Asset Beta Sector Comparison**

Sector	Exposure to Volume Risk via Price Control	Operational Gearing (RAB:Revenue/Operational Cost)	Regulatory Precedent*
Electricity/gas transmission (owners)	Low (revenue cap)	Very Low – 5.8	0.27 – 0.36
Airports	Some volumetric exposure	Very low – 4.5	0.47 – 0.61
NATS	Moderate (hybrid price and revenue cap)	High – 1.9	0.60
SONI	<b>Long Run:</b> low (revenue cap) <b>Short Run:</b> Very high (1% shortfall in volume = 50%+ of assumed equity return)	Very High – approximately 1	TBD The Utility Regulator proposal – 0.4

\*The regulatory precedent presented incorporates a non zero debt beta.

It can be seen from examining the two key variables that SONI is not necessarily a low risk business as compared to other regulated sectors. Of significant concern is the high operational gearing (RAB: Revenue) of the order of 1. This high level of operational gearing creates a significant risk as even a small unanticipated change in the operating cost base can have very significant implications for the level of return achievable. This is combined with long run revenue surety in the revenue cap but extremely high volatility in returns, and therefore cashflow and financial ratios, in the short run due to the highly levered exposure to volumetric risk. These are both important determinants in the Asset Beta.

Compare this to the situation in other sectors. Airports, for example, do face some exposure to volumetric risk; however, they also have an operational gearing much more akin to traditional electricity/ gas asset backed utility. This reduces systematic risk. Recent Regulatory determinations have provided for asset betas for airports of 0.47-0.61. NATS, however, have more moderate



volumetric risk but have much higher operational gearing. In their case an asset beta of 0.6 is presented. The Utility Regulator's proposal for SONI is for an asset beta of 0.4. Given the characteristics outlined: the highest operational gearing of all comparators, and, significant intra year volatility in equity return as a result of exposure to volumetric risk, we do not see how this is justified or can be the case.

SONI derived its estimate of an Asset Beta of 0.45 to support the necessary equity return assuming a debt beta of zero; to apply a debt beta of 0.1, while still providing for an appropriate return on equity would result in a correspondingly higher estimate (of the order of 0.505). This would not be out of line with the analysis presented by First Economics, or indeed that provided for to the comparators listed. SONI therefore believes an asset beta of 0.45 premised on a debt beta of zero, or 0.505 premised upon a debt beta of 0.1 should be employed. If a positive debt beta is chosen then a corresponding adjustment should be made to the assumed cost of debt.

### *Conclusion*

The appropriateness of the WACC outcome needs to be assessed in terms of the overall price control package. The WACC proposed in the SONI consultation paper is insufficient to support the cost of capital that will be faced by SONI over the forthcoming period. A number of components that derive this WACC outcome are of particular concern; these have been highlighted. The WACC proposal fails to recognise and reflect SONI's characteristics. In addition, it is inconsistent with regulatory precedent leading the Utility Regulator's proposal to be an outlier amongst its regulatory peers.

A key focus on the choice of appropriate WACC for the SONI price control is the accommodation of small company characteristics and operational gearing/ risk. While the WACC should be adjusted for these it may not be sufficient in and of itself to provide for them. Therefore, full consideration must be given to how the incentive measures and revenue allowances interact alongside the WACC outcome (e.g. to what degree does the revenue cap itself need to provide for "an insurance premium"?; what is the appropriate expected value from the package of output or performance incentives?)

The journey in regulatory thinking has moved from a situation of examining the building blocks in isolation to looking at the package as a whole. The package should be designed to protect electricity consumers by providing an adequate and sustainable insurance premium in exchange for the licensee managing the operational and investment risk – indeed the need to remunerate operational risk through instruments other than a single blunt WACC rate is something highlighted in the recent

First Economics paper on Alternative Financing Models commissioned by the Utility Regulator. There must therefore be flexibility to adjust particular aspects of the price control, e.g. increase the revenue cap to counteract a low WACC figure, to ensure sustainability and to incentivise efficient, and consumer enhancing, behaviour from the licensed business. SONI does not want to impose additional costs on Northern Irish consumers, however, nor does it wish to see those same consumers ultimately lose out. Necessary investments, which are to the ultimate benefit of consumers must be capable of being supported through the provision of adequate return to remunerate both debt and equity holders. The adjustments set out in this response will achieve this; the proposal as in the consultation paper will not.