SONI Price Control 2007-2010

Decision Paper

4 April 2008

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Executive Summary

The current SONI price control, an extension of the 2004 control, expired at the end of October 2007. The new price control is being introduced at the beginning of a period of change in the Northern Ireland electricity industry with the introduction of full retail market opening and the new wholesale arrangements of the Single Electricity Market (SEM).

This price control proposal deals with one element of the final SSS tariff formula (B_{TSOt} term) and sets the Total Revenue SONI can recover from customers for the duration of the control period. The Allowed Revenue will consist of operating costs and allowances for depreciation on the asset base together with a reasonable return for investors on those and any new assets acquired throughout the price control period.

Duration: 1st November 2007 – 31st March 2010;

Operating Costs: Set at £2.100 million for 1st November 2007 to 31st March 2008, £5.550 million in 2008/09 and £5.529 million in 2009/10;

Capital Expenditure: Approved at £1.952 million from 1st November 2007 to 31st March 2008, £2.659 million in 2008/09 and 0.786 million in 2009/10;

Regulatory Asset Base: Calculated at £12.973 million at 31st October 2007 rising to £14.153 million by 2009/10;

Depreciation: Calculated at £0.622 million from 1st November 2007 to 31st March 2008, £1.758 million in 2008/09 and £1.837 million in 2009/10;

Weighted Average Cost of Capital: 6.3% pre-tax, real giving a return on capital of £0.358 million from 1 November 2007 to 31st March 2008, £0.929 million in 2008/09 and £0.925 million in 2009/10;

Total Allowed Revenue: Set at £2.806 million for 1st November 2007 to 31st October 2008, £7.588 million in 2008/09 and £7.628 million in 2009/10;

X Factor: Set at 0 for duration of price control;

Incentive Mechanism: All-island mechanism to be developed with a view to being operational from June 2009.

Background

SONI is Northern Ireland's Transmission System Operator (TSO) and was established as a regulated business separate from NIE's Supply and Power Procurement businesses in 2000 as a requirement of the European Directive providing for the internal market in Electricity.

SONI's primary responsibility as System Operator is to ensure the safe, secure and economic operation of the transmission system in Northern Ireland which includes the dispatch of generating plant, management of outages, levying System Support Services (SSS) and Transmission Use of System (TUoS) charges, operation of settlements, managing Moyle and North-South interconnector flows and maintenance of operational security standards to meet Northern Ireland's demand for electricity.

Previous Price Controls

SONI's first price control was set on separation of the business from PPB to run from April 2001 to March 2002. The Allowed Revenue was set at £5.95 million (2000/01 prices), to be increased annually by inflation minus 0.5% (RPI-0.5).

The second price control period ran from April 2002 to March 2004 and made little change to the 2001 control other than changing the revenue cap to RPI-0. The rationale for such a short price control was the uncertainty regarding change in the Northern Ireland electricity sector and a separate consultation on the role and ownership of the System Operator in a new market environment and reluctance to cloud that discussion. This price control was extended until March 2006 with revenue allowances remaining on the same terms as before. This was subsequently extended again until SEM Go-Live (1 November 2007), however, a 7.5% reduction in the Allowed Revenue was imposed in order to reduce what the Authority deemed as excessive profits.

To date there has been no mechanism put in place to incentivise SONI to reduce external costs such as ancillary service and constraints costs.

Changing Environment

The advent of the Single Electricity Market (SEM) from 1 November 2007 has brought significant changes to SONI's business. SONI still functions as the System Operator for Northern Ireland but, in a joint venture with Eirgrid, has also taken on additional responsibilities as Single Market Operator (SMO). The SMO function is also subject to price control and this has been done in partnership with CER as part of the all-island work programme. A decision paper was published on 31 August

2007[1] and work has started to put a further price control in place from November 2008; accordingly, this consultation paper deals only with SONI's Transmission System Operator (TSO) role.

It has been determined by NIAUR and DETI that SONI must be divested from Viridian in order for the SEM to be properly implemented. The SONI submission assumed divestment would take place during 2008 and expenditure was forecast on this basis.

The Utility Regulator recognises that the introduction of an all-island wholesale market and divestment of SONI from Viridian will bring additional functions and roles which will lead to increased costs of running the business efficiently. This Price Control Review will consider operating costs, capital expenditure and assets employed including depreciation of these and a return for shareholders.

The Price Control and Tariffs

The maximum regulated SSS revenue is made up of a number of components:

$$\mathbf{M_{TSOt} = A_{TSOt} + B_{TSOt} + D_{TSOt} + K_{TSOt}}$$

Where in year $_t$

> A_{TSOt} is the cost of System Support Services
>
> B_{TSOt} is SONI's Allowed Revenue (excluding System Support Services)
>
> D_{TSOt} encompasses non-typical costs approved by the Utility Regulator including project costs and those associated with SEM and EU Directives

And

> K_{TSOt} is a correction facility whereby under or over-recoveries in the previous year can be collected by the business (under-recovery) or given back to consumers (over-recovery).

This decision paper details the Utility Regulator's decisions with regard to the maximum Allowed Revenue (excluding SSS costs) i.e. B_{TSOt} SONI can recover from market participants and, ultimately electricity consumers across Northern Ireland.

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[1] NIAUR/CER: Single Electricity Market SMO Revenue and Tariffs Decision Paper: AIP/SEM/07/455: 31st August 2007: available at http://www.allislandproject.org/en/single-market-operator-overview.aspx?article=62ebc083-4c00-44b4-9cbc-d74229f542f1)

Approach

The Utility Regulator sent a Business Efficiency Questionnaire (BEQ) to SONI on 30^{th} March 2007 for completion by 30^{th} April. The data was received on 4^{th} May 2007, along with a written submission and the Utility Regulator sent a further data request on 14^{th} May requesting information not supplied in the BEQ by 25^{th} May 2007. The information was supplied on 25^{th} May. The Utility Regulator engaged Deloitte LLP to analyse historical and forecast financial data, identify capital and operational expenditure now and in the future, identify major cost drivers for the business, identify and value the assets of the business, identify key performance indicators and potential new incentives for the business and benchmark costs and performance indicators. Deloitte subsequently reviewed SONI's Business Efficiency Questionnaire, initially with the Utility Regulator, meeting with SONI on 6^{th} June 2007 to discuss the submission and answer outstanding questions. SONI responded to the list of queries arising from the BEQ and subsequent meeting on 13^{th} June 2007 with additional information regarding personnel supplied on 22^{nd} June.

Deloitte presented the first draft report on 26^{th} July 2007 which was released to SONI on 31^{st} July. SONI, Deloitte and the Utility Regulator met to discuss the draft report on 8^{th} August 2007 after which SONI supplied further information regarding salaries and wages. Deloitte presented the final draft report which informed these proposals on 22^{nd} August 2007. We met with SONI on 16^{th} October 2007, having informed them of our main proposals. We met with Deloitte LLP on 26^{th} October 2007 to clarify figures and met again with SONI regarding salaries and payroll on 30^{th} October 2007. SONI re-submitted data on 8^{th} November which was substantially different from its original submission; the Utility Regulator analysed the new data and provided SONI with a list of questions for clarification on 19^{th} November. We then met with SONI on 20^{th} November to discuss the submission; SONI provided a response to most of our questions at the meeting. A further submission of capital expenditure forecasts was presented on 4^{th} December 2007 and, although it was too late to consider these before publication of the consultation paper on 5^{th} December 2007, it has been considered in the intervening period.

The consultation period ended on 11 January 2008; three responses were received from Disability Action, The Consumer Council for Northern Ireland and SONI. Whilst Disability Action had no specific views on the content of the consultation, the Consumer Council for Northern Ireland expressed support for any action that would encourage efficiency and reduce the burden on consumers. We met with SONI on 21^{st} January and submitted queries on their response on 24^{th} January. SONI provided the information agreed at the meeting and in answer to additional queries, as agreed, on Monday 28^{th} January. A further meeting with SONI took place on 19^{th} February 2008 to discuss outstanding issues of the WACC and treatment of Castlereagh House. Our final proposals regarding the WACC were put to SONI on 14^{th} March when we also agreed, in principle, the treatment of Castlereagh House Control Centre. A final meeting between the Utility Regulator and SONI took place on 1^{st} April when the finer detail regarding treatment of Castlereagh House and past service pension liability was agreed. This paper is the final decision of the Utility Regulator.

Decisions

Form and Scope

The previous price control set an Allowed Revenue for SONI to cover operating costs and allowances for necessary capital expenditure; this proposal sets an allowed revenue (excluding System Support Costs) applying RPI-X. The Regulatory Asset Base was rolled forward over the last price control period however, an explicit return on the assets was not determined although the Allowed Revenue was set at a level considered reasonable to recover depreciation on assets along with a return on these.

The Utility Regulator is satisfied that an Allowed Revenue to cover operating costs, allowances for necessary capital expenditure and depreciation on assets should continue. The Regulatory Asset Base has been reviewed and revised and an appropriate return to investors on the assets of the business calculated and added to the other components resulting in a Maximum Allowed Revenue.

Duration

Utility Regulator Proposal

The Utility Regulator understands the rationale for a five year price control which may be desirable for many reasons, not least stability for tariffs, the opportunity for incentive regulation to work effectively, as well as certainty for potential investors. However, the new market arrangements bring uncertainty and a coherent regulatory regime for SONI under the new wholesale market arrangements and the additional functions and responsibilities it will take on and attendant additional costs, will take time to develop. Accordingly, we proposed that the price control period run from November 2007 to March 2010.

SONI Response

SONI proposes that the price control should run from November 2007 until March 2012; 'Given the future changes… which are expected to be on-going until June 2009 and potentially beyond, SONI would experience only a short period before the price control was reset – this does not create a stable environment'.

Decision: Duration

The introduction of SEM has resulted in uncertainties and will do so for some time to come as the market beds down. We have accepted that SONI's costs will increase during the transition period, however there remains much uncertainty with regard to SONI's costs after this period of transition ends. We do not consider a shorter price control period will have a further destabilising effect on the SONI business and therefore we have decided the price control will run from 1st November 2007 until 31st March 2010, allowing sufficient certainty for investors over the transition period while allowing flexibility in the regulatory regime given the underlying future uncertainties.

Operating Costs

SONI's operating costs fall into two broad categories; external costs of providing the services SONI provides and internal costs of running the business. It is accepted that the external costs are variable and forecasting is difficult; these costs are recovered through the A_{TSOt} term of the price control formula on a 100% pass-through basis. Deloitte carried out an analysis of historic internal operating costs, identifying a number of costs that are within SONI's control:

- Payroll
- Data Communications and IT
- Consultancy Costs
- Premises Costs
- Other Costs

Examination of these costs in detail led Deloitte to recommend adjustments to payroll costs only; comparison of the original submission with that submitted in November was carried out by the Utility Regulator and whist there have been minor changes to some of the forecast costs, we have accepted these. SONI's response threw up additional costs which shall be discussed below however, this is a reflection of the uncertainty with regard to SONI's costs over the transition period.

Payroll

Utility Regulator Proposal

The Utility Regulator allowed Payroll costs (including bonuses and car allowances, submitted by SONI in November 2007) however, we have disallowed the proposed incentive payments going forward as we believe these should be paid for by SONI out of any incentive earned through the incentive mechanism outlined later in this paper. We have allowed the bonus element of payroll costs as we have accepted that SONI has had recruitment difficulties, particularly in technical grades, due to a 'tight' labour market and higher salaries in other parts of the industry.

Costs include Payroll (including bonuses and car allowances), Sharesave and SIP share schemes, neither of which is relevant since takeover of Viridian by Arcapita, and other incentive scheme costs.

SONI Response

SONI has requested additional staff costs of £89,000 for 2008/09; this amount of core staff costs was allocated to projects when drawing up the forecasts but SONI has since realised the staff involved are required for core business and any additional projects would require additional personnel.

SONI disagreed with our proposal to disallow incentive payments as opex and 'considers that specific provision for the recovery of the costs of the staff incentive scheme should be included within the opex allowance on the grounds that the staff scheme is intended to reward good performance across the business as a whole, not just in the more limited areas of system support services and constraints'.

Decision: Payroll

It is clear that SONI's workload relating to SEM Day 2 issues is uncertain at this time and thus we have allowed the reallocation of £89,000 to core opex in 2008/09; any additional SEM Day 2 projects, including additional staff requirements will be considered separately to this price control.

Whilst the Utility Regulator understands the requirement to reward staff across the business for good performance, we consider the bonus scheme to be adequate and have disallowed additional incentive payments. Any additional incentives are at the discretion of shareholders.

2006/07 Prices	Nov 07-Mar 08 £000	2009 £'000	2010 £'000
Basic Salaries	1,034	2515	2441
Overtime, bonuses, car payments	65	221	217
On Costs	319	831	867
Total Payroll	**1,418**	**3,567**	**3,525**

Additional Operating Expenditure

SONI Proposal

Besides the reallocation of salary costs, SONI identified increases in two costs: energy and travel. SONI estimates that due to additional IT equipment and increases in energy prices, it will require an additional £10,000 per year from 2007/08 to meet the energy costs of the System Operator function (a portion has already been charged to the Market Operator function).

SONI also revised its estimate of the cost of travel to facilitate joint working with Eirgrid; it estimates an additional £15,000 per annum in 2008/09 and 2009/10.

SONI had also included a cost of £200,000 per annum for rental of Castlereagh House.

Decision: Additional Operating Expenditure

The Utility Regulator will allow the additional costs for energy; the allowance for 2007/08 will be pro rated for the post Go-Live period (5 months) and the full amount allowable from 2008/09 for the duration of the price control.

Additional travel costs will be allowed from 2008/09 for the duration of the price control with the expectation that working practices between SONI and Eirgrid will bed down over this period.

The rental payment has been disallowed as we have now agreed with NIE that Castlereagh House should remain an asset of the SONI business.

Pensions

SONI's pension costs have three elements; Past Service Liability, Current Service Deficit (both arising from IAS 19) and current service costs.

Utility Regulator Proposal

The Utility Regulator had proposed that the past service deficit be recovered through the D_{TSOt} term, (to be reviewed on divestment of SONI from Viridian) with current service deficit and costs recovered through Opex.

SONI Response

At our meeting on 21st January, Viridian's divestment consultants suggested the change be made in one step, that is, the past service liability be transferred now to the Transmission and Distribution business (NIE T&D) as would be expected on divestment. Current service costs would be recovered through Opex.

Decision: Pensions

With regard to SONI's deficit relating to past service liability, a decision has been taken to transfer this to NIE; this is consistent with the liability being that of NIE as opposed to a divested SONI. SONI itself will remain liable for the deficit relating to current employees along with on-going costs.

The deficit relating to current employees will be recoverable through operating costs; current pension costs are included in payroll costs outlined above.

2006/07 Prices	Nov 07-Mar 08 £000	2009 £'000	2010 £'000
Past Service Pension Costs (Current Employees)	101	237	231

Total Operating Costs

Total Operating Costs is the sum of payroll, communications and IT, premises, consultancy, inter-business and other costs. See Appendix 1 for further detail.

Decision: Total Operating Costs

The adjustments detailed above result in the following Total Operating Costs:

2006/07 Prices	Nov 07-Mar 08 £000	2009 £000	2010 £000
Payroll	1,418	3,567	3,525
Communications and IT	486	1,343	1,343
Premises	-59	-20	8
Consultancy	30	143	143
Inter-business Charges	63	0	0
Other Costs	62	280	279
Past Service Pension Costs (Current Employees)	101	237	231
TOTAL OPEX	2,100	5,550	5,529

Capital Expenditure

SONI's submission detailed a number of capital expenses:

- New Energy Management System (EMS);
- Transmission System Operator Readiness;
- Other.

Decision: Capital Expenditure

The Utility Regulator had previously approved £4.437 million expenditure on a new EMS to be phased until 2009/10. TSO Readiness costs are those incurred by SONI in establishing the Single Electricity Market (SEM) including IT system up-grades, other system costs and pertinent refurbishment costs. The costs have previously been approved by the Regulatory Authorities; salary costs are expensed through the D_{TSOt} term during the last and current financial years and other costs are included as capital expenditure.

Other Capex relates to on-going expenditure on hardware for the EMS systems and computer equipment. SONI typically replaces PCs every 3 to 4 years. However, other systems have a longer lifetime including the Generator Dispatch System which is assumed to last 10 years, although the system recently replaced by SONI lasted 15 years.

The Utility Regulator has approved the following capital expenditure between 1st November 2007 and 31st March 2009.

2006/07 prices	Nov 07-Mar 08 £000	2009 £000	2010 £000
EMS Project	1183	2117	559
TSO Readiness	679	0	0
Other	90	542	227
TOTAL CAPEX	**1,952**	**2,659**	**786**

The Utility Regulator is aware that the proposed capital expenditure does not take account of SEM Day Two issues which may yield a requirement for further capital expenditure over the period of the price control; any expenditure additional to that outlined above will require approval by the Utility Regulator outside of this price control.

Regulatory Asset Base

Utility Regulator Proposal

We valued SONI's Transmission System Operator Regulatory Asset Base at April 2007 based on 2006/07 prices at £11.807 million. Going forward, the Forecast Regulatory Asset Base is calculated on the basis of depreciation on April 2007 opening Regulatory Asset Base fixed at 4% per annum on a straight-line basis; other assets were depreciated according to SONI's policy outlined in the consultation paper.

SONI Response

SONI recalculated the Regulatory Asset Base from 2002, depreciating the original asset base and additions between 1st April 2002 and 31st October 2007 (the end of the previous price control period) over 25 years until 31st October 2007 and over 10 years on a straight-line basis thereafter. Post 1st November additions were also depreciated over 10 years.

Decision: Regulatory Asset Base

The Utility Regulator is satisfied that a depreciation period of 10 years is appropriate due to the nature of SONI's assets (mainly IT/systems); any additions after 1st November 2007 will also be depreciated over 10 years. A value of £500,000 for Castlereagh House Control Centre has been included in the Regulatory Asset Base, reflecting the MMC's valuation of the SONI and PPB businesses at the time of its review[2] in 1997 and we are satisfied that a 10 year depreciation period from 1st November 2007 is consistent with the remaining economic life of the asset.

[2] Monopolies and Mergers Commission: Northern Ireland Electricity plc: A Report on a Reference under Article 15 of the Electricity (Northern Ireland) Order 1992: March 1997: TSO: available at http://www.competition-commission.org.uk/rep_pub/reports/1997/397northern.htm#full

Capital additions (other than property or buildings) after 1st November 2007 will be depreciated over 10 years on a straight line basis. In the event of SONI acquiring additional property and buildings, the depreciation period will take account of the longer-term nature of such assets.

Accordingly, the Regulatory Asset Base going forward is:

2006/07 prices £m	Nov 07-Mar 08	2008/09	2009/10
Opening Value	12.973	14.303	15.204
Additions	1.952	2.659	0.786
Depreciation	0.622	1.758	1.837
Closing Regulatory Asset Base	**14.303**	**15.204**	**14.153**
Average Regulatory Asset Base	**13.638**	**14.754**	**14.678**

The full Regulatory Asset Base calculation can be found in Appendix 2.

Depreciation

Depreciation over the price control period is estimated to be:

2006/07 Prices	Nov 07-Mar 08 £000	2009 £000	2010 £000
Depreciation	**622**	**1,758**	**1,837**

The Weighted Average Cost of Capital

A company's assets are financed by either debt or equity. The Weighted Average Cost of Capital (WACC) is the average of the costs of these sources of financing, each of which is weighted by its respective use in the company (denoted by the gearing). By taking a weighted average, we can see how much interest the company has to pay for every pound it finances. The rate of the allowed WACC is important in ensuring SONI can finance investment however, if the WACC is set too high then shareholders may be over-rewarded at the expense of customers who will pay more than they should.

Utility Regulator Proposal

The Utility Regulator had proposed a WACC for SONI of 4.98% (pre-tax, real), including SONI's small company premium of 0.26%, based on the most up-to-date regulatory precedents for each of the elements within the regulatory model used to calculate the WACC:

Pre-Tax Weighted Average Cost of Capital =

[Gearing*cost of debt] + [(1/ (1-corporation tax rate))*cost of equity*(1-gearing)]

Where

Cost of Debt = risk free rate + debt premium

And

Cost of Equity = risk free rate + (market equity risk premium*equity beta)

Component	Utility Regulator Proposal	Precedent	SONI Proposal
Risk Free Rate	2.5	CC Report on BAA Airports September 2007[3]	
Debt Premium	1.05	CC Report on BAA Airports September 2007	
Cost of Debt (pre-tax real)	3.55	Risk Free Rate + Debt Premium	5.37
Gearing	0.575	NIE Licence	0.5
Market Equity Risk Premium	3.5	CC Report on BAA Airports September 2007	
Equity Beta	0.58	Deloitte Report on SONI August 2007	
Tax	0.28	Corporate rate from April 2008	0.28
Cost of equity (post-tax real)	4.53	Risk Free Rate + (Market Risk Premium*Equity Beta)	8.5
Cost of Capital Pre-tax	**4.72**	Cost of Debt + Cost of Equity	8.59
Small Company Premium	0.26	SONI	
Final Cost of Capital Pre-tax	**4.98**	Cost of Capital + Small Company Premium	**8.59**

SONI Response

SONI responded negatively to our proposal citing a pre-tax, real WACC of 8.59% was more appropriate. SONI's methodology for achieving such a return is not robust and relies on small company status.

Decision: Weighted Average Cost of Capital

The Utility Regulator is unconvinced that many characteristics of the company and its cost of capital that SONI attributes to being 'small' are in fact relevant to the SONI business; small business risk is more commonly 'new' business risk and in this regard, we take the view that SONI is an established company with a financial history and operational track record.

[3] Competition Commission: BAA Ltd., A Report on the Economic Regulation of the London Airports Companies (Heathrow Airport Ltd. and Gatwick Airport Ltd.): Presented to the Civil Aviation Authority: 28 September 2007, available from www. competition-commission.org.uk

Risk Free Rate

The risk free rate is the rate at which investors can lend funds without facing any risk. This is exogenous to the characteristics of any individual firm. The Competition Commission report recommends a risk free rate of 2.5% on the basis that 'it strikes a sensible balance between recognition in recent changes in financial markets and avoiding over-cautious view of the long-term implications of investors' attitudes towards risk'. This view was based on analysis of 5 and 10 year index-linked Gilts, forward rates and international government index-linked securities. The Utility Regulator is satisfied that, whilst we appreciate the recent movement in financial markets, the Competition Commission's latest figure is robust and relevant and therefore we will use this most recent regulatory estimate of the risk-free rate.

Debt Premium

The debt premium is the compensation required by lenders in exchange for bearing systematic risk. The premium we use is derived from the Competition Commission report; SONI's suggested WACC, when broken down suggested it has a debt premium of 3% however, the Utility Regulator does not accept this is the case. The debt premium used in the regulatory WACC model allows for systematic risk but eliminates premia for default and illiquid assets. Whilst we accept SONI may pay a higher debt premium in reality, we are unconvinced that the premium is 3% on top of bank lending rates. Accordingly, we are satisfied that 1.05 is a fair premium for the SONI business.

Gearing

A company's gearing is the ratio of its long-term debt to its total capital (debt *plus* equity). We proposed to assume a gearing for SONI equal to that applied to NIE's T&D business however, SONI responded that a gearing of 50 is more appropriate due to it being a small company.

The regulatory model works on an assumed maximum gearing based on the fact that over-indebted companies will incur higher costs of debt. We are unconvinced that SONI's size translates into a debt to equity ratio of 1:1 particularly where, as SONI has stated, the cost of equity (11-12.5% pre-tax) is higher than the cost of debt (5.365%) which makes it more prudent to raise finance by issuing debt as opposed to equity.

Thus, the Utility Regulator is satisfied that the gearing should be assumed to be slightly higher than 50 and therefore we will assume SONI's gearing to be 57.5.

Market Equity Risk Premium

This is an additional premium over the risk free rate that investors expect as compensation for the extra risk associated with investing in the stock market as a whole compared with holding risk-free assets; it is calculated as the difference between the risk free rate and overall return on the equity market. This is also external to the individual company reflecting the state of equity markets, macroeconomic conditions and the market's view of risk of investment in equity over risk-free assets.

In its response to our proposals, SONI's cost of equity breaks down (risk-free rate and equity beta remaining the same) to give a market equity risk premium of 10.3% implying an investor would require 10.3% over and above the risk-free rate to encourage them to invest in equity. We are unconvinced that this is the case and therefore will use the Competition Commission's conclusions which followed comprehensive analysis of available historical market data and forward-looking data relating to investors' current expectations. The Competition Commission concluded a range of 2.5 - 4.5% is appropriate and, due to current market uncertainty, we have revised our figure to 4.5%, the upper end of the range, in our calculations.

Equity Beta

The equity beta (ß) is an indication of systematic risk; it reflects both the operating risk (larger variability of returns) and financial risk (greater leverage; higher debt to value ratio) of a company relative to the risk of the stock market. When broken down, SONI's response to our proposal implies (all other things being equal) SONI has an equity beta of 1.7 that is, the SONI system operator business is 70% more risky than the market average.

The Utility Regulator does not accept this to be the case for SONI; SONI's role in the Northern Ireland electricity industry and in the Single Electricity Market, certainty of future revenues, revenue correction facility (K factor), natural monopoly position and the age and experience of the system operator business make it a less risky investment than the average i.e. ß<1. We have revised our figure to 0.71. This is derived from the lower end asset beta range of 0.30 – 0.6 in the Competition Commission's report and the upper end of the asset beta range (0.09 – 0.31) for Viridian cited in the Smithers' report[4].

SONI was dissatisfied with this stating there was no precedent for such a low equity beta however, our research indicates that an equity beta of less than one is common across Europe:

[4] Wright , S., Mason R., Satchell, S. and Baskaya, M.: Report on the Cost of Capital provided to Ofgem: Smithers and Co Ltd: 1 September 2006 available from http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR4/ConsultantsReports/Documents1/15576-smithers_co.pdf

	Equity Beta	Market Cap (€m)	Total Debt (€m)	Gearing	Asset Beta
National Grid Transco	0.61	23,951.36	19,607.04	0.82	0.42
United Utilities	0.55	7,543.66	6,615.16	0.88	0.32
Viridian	0.47	1,437.65	660.82	0.46	0.21
Scottish Power	0.67	11,883.75	7,506.26	0.63	0.51
Scottish and Southern Energy	0.53	12,162.05	2,839.23	0.23	0.29
RWE	0.73	38,385.58	40,526.84	1.06	0.6
EON	0.65	69,141.04	30,452.48	0.44	0.47
Endessa	0.79	27,531.36	25,985.84	0.94	0.69
Severn Trent	0.42	5,016.81	4,239.31	0.85	0.13
ENEL	0.72	65,574.40	36,470.16	0.56	0.58
Average	**0.61**	**26262.77**	**17490.31**	**0.69**	**0.42**

CER 2006-10 Transmission Price Control Review Decision Paper, September 2005[5]

and that Ofgem have, in the past, been overly generous; Smithers' report concluded:

> *Ofgem's continued policy of setting beta equal to one for all companies appears distinctly generous. It seems safe to conclude that there is only a quite low probability that any of the companies examined (and especially those subject to regulation) have a beta greater than or equal to one.*

Accordingly, we are satisfied that an equity beta of 0.71 is appropriate for the SONI business.

Small Company Premium

Whilst the Utility Regulator does not accept that SONI has the level of risk it associates with being a small business, we are aware that some sources of finance available to larger companies with larger asset bases and capital expenditure may not be available to SONI. Its small IT-based asset base and relatively small amounts of capital expenditure year on year will raise the cost of capital. Accordingly, the Utility Regulator has used Ofwat's precedent[6] in setting the small company premium at 0.9% for companies with an asset base smaller than £70 million. We consider this to be fair recognition of additional costs incurred by an asset-light business.

Revised Weighted Average Cost of Capital

The change to the small business premium will result in a revised WACC for SONI of 6.3% pre-tax real:

[5] CER: 2006-2010 Transmission Price Control Review Transmission Asset Owner (TAO) and Transmission System Operator (TSO) A Decision Paper: CER/05/143: 09 September 2005 available at http://www.cer.ie/en/electricity-transmission-network-decision-documents.aspx?article=8cc19b2c-8d82-4a3d-8721-b47b8671e321

[6] The Utility Regulator is aware that Ofwat has decided that no small company premia will be applied for PR05 and will review this position in future on a case-by-case basis.

Component	Utility Regulator Decision	Precedent
Risk Free Rate	2.50	CC Report on BAA Airports September 2007
Debt Premium	1.05	CC Report on BAA Airports September 2007
Cost of Debt (pre-tax real)	**3.55**	Risk Free Rate + Debt Premium
Gearing	0.575	NIE Licence
Market Equity Risk Premium	4.50	CC Report on BAA Airports September 2007
Equity Beta	0.71	CC Report on BAA Airports September 2007
Tax	0.28	Corporate rate from April 2008
Cost of equity (post-tax real)	**5.70**	Risk Free Rate + (Market Risk Premium*Equity Beta)
Cost of Capital (pre-tax, real)	**5.40**	Cost of Debt + Cost of Equity
Small Company Premium	0.90	Ofwat PR08
Final Cost of Capital Pre-tax, Real	**6.30**	Cost of Capital + Small Company Premium

The cost of capital is used to calculate an allowed return on assets (the average Regulatory Asset Base):

2006/07 Prices	Nov 07-Mar 08 £000	2009 £000	2010 £000
Average Regulatory Asset Base	**13,638**	**14,754**	**14,678**
Cost of Capital		**6.30%**	
Return on Capital	**358**	**929**	**925**

Total Allowed Revenue

The total allowed revenue is the sum of:

- Internal Operating Costs;
- Depreciation;
- Return on Assets.

Decision: Total Allowed Revenue

Adjustments and proposals outlined above result in allowed revenues (excluding SSS costs) as follows:

2006/07 Prices	Nov 07-Mar 08 £000	2009 £000	2010 £000
Total Operating Costs	**2,100**	**5,550**	**5,529**
Depreciation	**622**	**1,758**	**1,837**
Return	**358**	**929**	**925**
Total Allowed Revenue	**3,080**	**8,238**	**8,291**

X Factor

The X factor is a figure by which the inflationary increase in operating costs is reduced to reflect internal efficiencies that can be made to reduce these costs. Efficiency gains are usually achieved by a combination of reducing costs, restructuring, changes in management practices and increasing productivity. The X factor for SONI was set at zero for the last price control period that is, SONI's costs were allowed to rise in line with inflation.

Utility Regulator Proposal

Our analysis for 2008-2010 showed an X Factor of 3 would incentivise SONI, a monopoly business, to seek achievable efficiencies resulting in gains for the business as well as customers.

SONI Response

SONI believes there is no justification to index Opex at RPI-3:

- Recent changes and those to come between now and 2009 leads SONI to expect to continue to be in a state of transition until June 2009 and potentially beyond therefore a period of stability and consolidation is required before the scope for efficiencies can be accurately assessed;

- The changes in RPI already incorporate productivity growth and the X Factor should only reflect expected productivity growth over and above that expected for the economy as a whole.

- Around 60% of SONI's Operating costs are staff costs and almost 30% are third party contracting costs, neither of which is amenable to savings in the short to medium term.

Decision: X Factor

We have accepted that SONI is currently in a period of transition where there is still some uncertainty as to the impact on SONI's costs going forward.

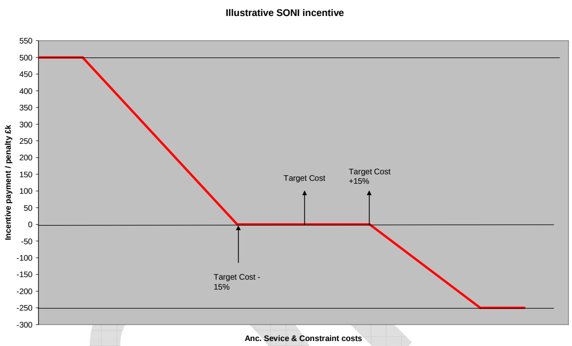
It should be noted however, that the Utility Regulator is not accepting the presumption by SONI and other NIE businesses that the X Factor should only reflect 'expected productivity growth over and above that expected from the economy as a whole'; customarily, the X factor would be a consideration of this and other factors including sharing efficiency gains from the previous price control period with customers.

We have decided that, due to on-going uncertainty about the cost impact of the SEM on SONI through to June 2009 and the shorter duration of this price control, the X factor will be set at zero. Whilst this will not force SONI to reduce costs below those forecast, it will ensure an upper limit to the burden of customers.

Incentive Mechanism

Utility Regulator Proposal

The Utility Regulator proposed to incentivise SONI to reduce both constraints and system support (ancillary services) costs. Limitations of the forecast of constraints and system support costs led us to propose a deadband of +/-15% around a central target whereby any deviation up to +/-15% would neither be rewarded nor penalised. The Utility Regulator proposed to accept SONI's suggested cap of £500,000 however, we proposed a symmetrical mechanism whereby SONI would be penalised for an increase over and above estimated costs. In the context of the proposed total Allowed Revenue outlined, we proposed capping the penalty at £250,000. For simplicity the Utility Regulator proposed a constant 10% gradient whereby SONI could recover £100,000 from customers (up to the proposed cap of £500,000) for every £1 million out-turn costs fall below the deadband and are penalised by £100,000 for every £1 million out-turn costs exceed the deadband, up to a maximum of £250,000.



SONI's Response

SONI states a Northern Ireland-only mechanism on constraints costs is 'not an ideal scenario' and it is 'premature to introduce an incentive until more operational experience has been gained'. However, SONI makes two further points on the proposed mechanism:

- It should be recalibrated, in essence to make the reward payment more easily attainable (10% deadband and £125,000 per £1 million saved which would limit the total amount of savings to be incentivised to £4 million, rather than our proposed £5 million);
- It is inappropriate for a penalty to be introduced within the first year of SEM operation.

Decision: Incentive Mechanism

The Utility Regulator considers it important that any incentive mechanism is symmetrical in that the company faces a penalty where costs are higher than expected as well as a reward when costs are reduced below the forecast figures in order that customers may benefit in the longer-term.

The Regulatory Authorities, through the SEM Committee, have consulted on procurement of ancillary services on an all-island basis including incentivisation of system operators (SONI and Eirgrid); it is expected that an all-island incentive scheme will be in place by the end of 2008. The RAs will also be developing an incentive mechanism to minimize constraints costs to be operational by June 2009.

These mechanisms will be considered separately from the price control process and consulted on through the AIP process in due course to facilitate the 2009 start.

However, at this time, we wish to assure customers and other stakeholders that SONI is obliged under condition 29 of its licence to purchase System Support Services (SSS) economically.

Appendix 1: Operating Costs

Payroll

2006/07 Prices	Nov 07-Mar 08 £000	2009 £000	2010 £000
Basic Salaries	1,034	2515	2441
Overtime, bonuses, car payments	65	221	217
On Costs	319	831	867
Total Payroll	**1,418**	**3,567**	**3,525**

Communications and IT

2006/07 Prices	Nov 07-Mar 08 £000	2009 £000	2010 £000
Data Communication	245	588	588
Contractors	73	176	177
Telephones	20	48	48
SEM Data Links	8	48	48
Generator Dispatch System / EDIL	35	83	83
Generation Metering System	12	29	29
Support costs for Settlement System	1	19	19
SDX Market Interface System	0	19	19
IT Costs	91	167	166
MITS (Moyle Interconnector Trading System) - Formerly in D_t	0	167	167
Total Communications and IT	**486**	**1,343**	**1,343**

Premises

2006/07 Prices	Nov 07-Mar 08 £000	2009 £000	2010 £000
Premises	43	114	114
Facilities recharge to TSO/SEM Readiness (D_t)	-61	-29	0
Facilities Recharge to SMO	-41	-105	-106
Total Premises	**-59**	**-20**	**8**

Consultancy

2006/07 Prices	Nov 07-Mar 08 £000	2009 £000	2010 £000
Consultancy	**30**	**143**	**143**

Inter-business Charges

2006/07 Prices	Nov 07-Mar 08 £000	2009 £000	2010 £000
Inter Business Charge - T&D (NIE)	20	0	0
Inter Business Charge - SX3 (Viridian)	0	0	0
Inter Business Charge - Corporate (NIE)	43	0	0
Total Inter-business Charges	**63**	**0**	**0**

Other

2006/07 Prices	Nov 07-Mar 08 £000	2009 £000	2010 £000
Redundancy / Restructuring Costs	0	0	0
Bank Charges	8	43	43
Other	33	80	80
Insurance and Compensations	5	12	12
Additional On-going Costs related to Divestment	0	106	106
Transport	16	39	38
Total Other Costs	**62**	**280**	**279**

Pensions

2006/07 Prices	Nov 07-Mar 08 £000	2009 £000	2010 £000
Past Service Pension Costs (Current Employees)	**101**	**237**	**231**

Appendix 2: Regulatory Asset Base and Depreciation

2006/07 prices	£m	2002/03	2003/04	2004/05	2005/06	2006/07	2007 / 31.10.07	1.11.07 / 2008	2008/09	2009/10
Opening Value	1st April	13.052	12.530	12.008	11.486	10.964	10.442			
Depreciation	25 years p.a. st.l.	0.522	0.522	0.522	0.522	0.522	0.305			
Closing Value	**31st March**	**12.530**	**12.008**	**11.486**	**10.964**	**10.442**	**10.137**			
Opening Value	1st April							10.637	10.194	9.130
Depreciation	10 years p.a. st.l.							0.443	1.064	1.064
Closing Value	**31st March**							**10.194**	**9.130**	**8.067**
Opening Value	1st April	0.000	0.086	0.230	0.500	0.729	1.368			
Additions	Pre 1st November 2007	0.090	0.153	0.292	0.261	0.698	1.027			
Depreciation	25 years p.a. st.l.	0.004	0.010	0.021	0.032	0.060	0.059			
Closing Value	**31st March**	**0.086**	**0.230**	**0.500**	**0.729**	**1.368**	**2.336**			
Opening Value	1st April							2.336	2.238	2.005
Additions	Pre 1st November 2007							0.000	0.000	0.000
Depreciation	10 years p.a. st.l.							0.097	0.234	0.234
Closing Value	**31st March**							**2.238**	**2.005**	**1.771**
Opening Value	1st April							0.000	1.871	4.069
Additions	Post 1st November 2007							1.952	2.659	0.786
Depreciation	10% p.a. st.l.							0.081	0.461	0.540
Closing Value	**31st March**							**1.871**	**4.069**	**4.315**
Closing Regulatory Asset Base		**12.616**	**12.238**	**11.986**	**11.693**	**11.810**	**12.473**	**14.303**	**15.204**	**14.153**
Average Regulatory Asset Base		**12.834**	**12.427**	**12.112**	**11.840**	**11.751**	**12.141**	**13.638**	**14.754**	**14.678**

Depreciation		2002/03	2003/04	2004/05	2005/06	2006/07	Pre 1 Nov	Post 1 Nov	2008/09	2009/10
2002/03	0.090	0.004	0.004	0.004	0.004	0.004	0.002			
2003/04	0.153		0.006	0.006	0.006	0.006	0.004			
2004/05	0.292			0.012	0.012	0.012	0.007			
2005/06	0.261				0.010	0.010	0.006			
2006/07	0.698					0.028	0.016			
Up to 1 Nov 2007	1.027						0.024			
Total		**0.004**	**0.010**	**0.021**	**0.032**	**0.060**	**0.059**			
Post 1 Nov	1.952							0.081	0.195	0.195
2008/09	2.659								0.266	0.266
2009/10	0.786									0.079
Total								**0.081**	**0.461**	**0.540**

Appendix 3: Costs Remaining in the D_{TSOt} Term

For information, the table below details costs remaining in the D_{TSOt} term going forward. This is the position currently; other costs may be added in future years (with the approval of the Utility Regulator). These costs are excluded from SONI's Total Allowed Revenue.

2006/07 Prices	to 31st Oct 2007 £000	1st Nov-31st Mar £000	2008 £000	2009 £000	2010 £000
SSS Payments: PPB Capacity	5,470	0	5,470	Ends with introduction of SEM	
IPP Capacity	1,245	0	1,245		
SVA	2,566	0	2,566		
Recoverable Salaries and Pensions	484	11	495	0	0
Consultancy	1,918	195	2,113	Ends	
Moyle Interconnector Trading System (MITS)	133	79	212	Moves to Opex	
Market Opening	39	6	45	29	0
Wind Project	51	27	78	Ends	
N/S Project	134	31	165	Ends	
BETTA	192	60	252	Moves to MO	
Other	117	3	120	0	0
Rates	67	48	114	367	367
Total	**12,416**	**460**	**12,875**	**396**	**367**

NB. Licence fees will also be included in the D_t term. These figures are estimates only and will be verified by the Utility Regulator through the annual tariff-setting process.