

Single Electricity Market

SEMO Revenue and Tariffs
for
October 2010 – September 2013

Decision Paper

10 December 2010

SEM-10-082

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1 EXECUTIVE SUMMARY

The All-Island Single Electricity Market (SEM) commenced operation on 1 November 2007 and is administered by the Single Electricity Market Operator (SEMO) formed through a contractual joint venture between EirGrid and SONI. SEMO needs to recover its operational and capital costs, as well as the imperfection (constraint) costs associated with the balancing of the transmission systems, from market participants.

This paper includes decisions by the SEM Committee (SEMC) on the form of SEMO regulation, the allowed revenue for SEMO and all associated tariffs. The SEM Committee has decided that the new tariff period will run for 3 years from 1 October 2010 to 30 September 2013.

The SEM Committee has decided that the financial requirement for CAPEX should be recovered through a revenue-cap approach similar to that applied to OPEX. Under the revenue-cap approach the revenue requirement will directly reflect the necessity for capital in each year. The total revenue requirement for CAPEX will be subdivided into three allocations corresponding to the revenue requirement within each year of the price control and according to SEMO's planning for projects.

The allowed revenue for CAPEX will be determined by SEMO's choice from a menu of regulatory options representing varying strengths of incentivisation. The options are structured so that SEMO will, acting rationally, choose the option that matches most closely the outcome expenditure expected by them.

The SEM Committee has decided that OPEX will be subject to a revenue-cap regime adjusted by RPI-X. This will provide strong incentives for efficiency, as any savings above the allowed revenue can be kept by SEMO and no provision made for over expenditure.

The SEM Committee has aimed to set SEMO's total allowance for OPEX plus CAPEX at an efficient level and therefore has determined that the X factor should be zero.

	Historical Information		SEMO's Initial Submission			SEMC Decision		
	Actuals 2009/10	Allowed Revenue 2009-10	2010- 2011	2011- 2012	2012- 2013	2010- 2011	2011- 2012	2012- 2013
	EUR ' 000		EUR ' 000			EUR ' 000		
OPEX								
Payroll	4,156	4,262	4,911	5,057	5,161	4,589	4,486	4,383
IT & Communications	1,226	2,139	2,098	2,305	2,448	1,560	1,897	1,910
Facilities and Insurance	1,162	1,304	1,196	1,196	1,196	1,196	1,196	1,196
Professional Fees	436	673	848	885	747	619	661	580
General and Admin.	397	342	368	378	378	368	378	378
Corporate Services	146	49	300	300	300	150	150	150
Total	7,284	8,769	9,721	10,121	10,180	8,482	8,768	8,597
Cost of Capital								
Depreciation	10,660	11,495	12,835	13,927	6,627	12,158	12,624	4,458
WACC	2,079	1,916	1,528	1,066	877	1,373	788	423
Total	12,739	13,411	14,363	14,993	7,504	13,531	13,412	4,881
CAPEX*								
*This values are based on the baseline proposed by the SEM Committee. These values will be updated when SEMO make its decision upon one of the menu options for CAPEX allowance.						3,924	3,278	3,420
K Factor			-1,140			-1,140		
Total Revenue Requirement	20,023	22,180	22,944	25,114	17,684	24,797	25,458	16,898

Table 1 – Summary of SEMO Allowed Revenue

2 INTRODUCTION

THE SINGLE ELECTRICITY MARKET

The Northern Ireland and Republic of Ireland Governments together with the energy regulators, the Northern Ireland Authority for Utility Regulation and the Commission for Energy Regulation (“the RAs”), and industry worked together to create an All-Island Energy Market, as outlined in the All-Island Energy Market Development Framework Paper.¹

The first step in this process was the implementation of an All-Island wholesale electricity market. The development of the Single Electricity Market (SEM) was completed on 1st November 2007 when the market went live.

The SEM is a centralised or gross mandatory pool market, with electricity being bought and sold through the pool under a market clearing mechanism. Generators receive the System Marginal Price (SMP) for their scheduled dispatch quantities, capacity payments for their actual availability, and constraint payments for changes in the market schedule due to system constraints. Suppliers purchasing energy from the pool will pay the SMP for each trading period, capacity costs, and system support charges. The SEM market rules are set out in the Trading and Settlement Code (TSC).

ROLE OF SEMO

The development of the SEM led to the requirement for a Single Electricity Market Operator (SEMO) to administer the market. With this in mind the RAs approved the plans of EirGrid and SONI, the transmission system operators for the Ireland and Northern Ireland respectively, to establish SEMO on a contractual Joint Venture basis.

SEMO’s role in the market is explicitly defined in the TSC which sets out the rules, procedures, terms and conditions to which all parties, including SEMO, must adhere in order to participate in the SEM. In addition, both EirGrid and SONI must comply with the conditions imposed on this activity by their respective Market Operator (MO) Licences

As defined in section 1.3 of the TSC, SEMO’s role can be summarised as ‘to facilitate the efficient, economic and coordinated operation, administration and development of the Single Electricity Market in a financially secure manner’.

¹ All-Island Energy Market: A Development Framework, Nov 2004, www.allislandproject.org
http://www.dcmnr.gov.ie/NR/rdonlyres/BCF98EC4-7321-4E3F8685BFFCA2BF2DF4/0/All_island_Energy_Market_Development_Framework.pdf

SEMO REVENUE & CHARGES

SEMO incurs operational costs while carrying out the above functions and recovers these costs, as well as capital related costs and a rate of return, through Market Operator tariffs and fees, which are levied on market participants. To facilitate this recovery of costs, the Market Operator Licence requires SEMO to submit proposals on its allowed revenue and the charges required to recover this revenue to the RAs.

The current tariff period ended on 30 September 2010 i.e. it covers a 12 month period from 1 October 2009 to 30 September 2010. Therefore, the revenue and tariffs need to be determined for the next tariff periods.

REGULATORY APPROVAL PROCESS

The Regulatory Authorities have carried out an analysis and review of SEMO's submission and associated supporting information. The Regulatory Authorities published a consultation paper on the basis of that review in August 2010, the objective of which was to solicit comments from interested parties (including both members of the public and industry participants) on a range of proposals associated with the allowed revenue for SEMO.

Ten sets of comments were received and these have been published in full by the Regulatory Authorities. Comments were received from:

- | | | | | |
|--------------|---|---------|-----------|--------------|
| 1. Bord Gais | 2. Airtricity | 3. IWEA | 4. Endesa | 5. NIEES |
| 6. SEMO | 7. Consumer
Council for
Northern
Ireland | 8. PPB | 9. ESB | 10. Viridian |

DECISION PAPER

The SEM Committee is now publishing this decision paper in relation to the SEMO revenue and tariffs. This is based on the associated consultation paper and takes into account comments received during the consultation process. Where no comment or response has been received on elements of the consultation, it has been assumed that this reflects agreement.

This paper outlines the SEM Committee's decisions related to the proposals set out in the consultation paper. These decisions are detailed in the following sections and will only apply to the specified tariff periods.

3 REGULATORY PRINCIPLES

This section outlines the principles underpinning the regulatory decisions contained in this paper. These are based on best practice regulation of the so-called natural monopolies which should be characterised as seeking to ensure that tariffs are:

- Sustainable,
- Stable,
- Transparent,
- Predictable,
- Cost-effective.

The SEM Committee's task essentially consists of creating a framework within which, in return for providing monopoly services to an acceptable quality, the regulated business receives a reasonable assurance of a revenue stream in future years that will cover its costs.

Sustainability

The regulated business must be able to finance its operations plus any necessary capital expenditure so that it can continue to operate in the future to the ultimate benefit of consumers. Sustainability in the context of market operations also requires sustainability of market arrangements and the avoidance of barriers to market entry or market exit or any unjustifiable inconsistency or unfairness in the treatment of any participant or class of participants.

Stability

To be stable the framework must also provide some certainty to all the parties affected by it. These include consumers, the Governments and SEM Committee (acting on behalf of consumers), SEMO itself, the TSOs and generators and suppliers. Frequent complaints and disputes could lead to the regime being continually adjusted by the SEM Committee. This could also create uncertainty in the industry and discourage investment and long-term planning. The stability of the regime is particularly important to privately owned businesses if investors are to be encouraged to make long-term investments in the sector.

Transparency & Predictability

The rules that govern the regulatory regime should also be transparent and unambiguous in their interpretation and predictable in the way they are applied. In particular, it should be clear how costs relate to prices. Regulations that are unclear will cause disputes and instability in the regulatory regime and add to the costs of regulation. This would be likely to raise the cost of capital, ultimately to the detriment of consumers in the form of higher

prices. An important corollary is that there should be “no surprises” for participants. This does not imply that the SEM Committee cannot change its view on issues, or revise the regulatory framework as necessary and in response to unforeseen developments, but it does mean that the SEM Committee will endeavour to:

- Avoid, when it is possible, changes that apply retrospectively with adverse consequences for the regulated businesses.
- Take decisions following a due process of consultation and consideration of the relevant issues.
- Publish a full account of the reasoning behind those decisions.

Cost-effectiveness

The costs of monitoring and enforcing compliance need to be low relative to the benefits of regulation. Ideally, the regulatory framework will involve minimum costs of data collection and analysis. The procedure for processing disputes should also be simple, although the more transparent and stable the regulatory system, the less often disputes will arise.

4 FORM OF REGULATION

4.1 SEMC PROPOSALS ON CAPEX REGULATION

- 4.1.1 The SEM Committee has proposed that the revenue requirement for CAPEX should be recovered through a revenue-cap approach in a manner similar to that used for OPEX. Under a revenue-cap the revenue requirement would directly reflect the necessity for capital in each year.
- 4.1.2 There should be no intersection between the CAPEX and OPEX allowances. SEMO has auditable accounts for these two categories of expenditure and they are not interchangeable.
- 4.1.3 The total revenue requirement for CAPEX would be subdivided into three allocations according to the revenue requirement within each year of the price control and according to SEMO's planning for projects.
- 4.1.4 The proposed regulatory framework (revenue-cap) will have implications for the tariffs. The depreciation mechanism built in to the current rate of return regulation smoothes the effects of new expenditure over five years. As a consequence of this SEMO receives a return on the invested capital over an extended period of time which leads to a higher tariff in the long term.
- 4.1.5 The revenue-cap regime would allow SEMO to recover the entire allowance approved for each year within the year of the expenditure. This approach reduces the need for SEMO to act as a financier for the market. The implication is a lower long term revenue requirement as costs would be recovered within year and no rate of return would be applied. However, in the short term (for the first few years) the revenue requirement would increase.
- 4.1.6 In proposing the Revenue-Cap regime the SEM Committee had two main goals:
- First, the SEM Committee appreciates that SEMO has achieved a state of organisational and systems maturity which is admirable given that the company was set up only a few years ago. Therefore the present is an appropriate time to give SEMO a challenging proposal for capital expenditure. The SEM Committee's proposal would produce rewards to SEMO in excess of the current rate of return based mechanism benefiting not only SEMO but also consumers. SEMO would no longer passively receive returns on capital invested but by actively finding gains in efficiency.
- Secondly, the SEM Committee proposal would make the cost of capital projects more visible in terms of their effects on the tariffs (as the current amortization process

masks to some extent this effect). The SEM Committee's aim is to fully involve market participants in the debate on which capital projects proposed by SEMO are relevant for the market. The SEM Committee notes, from the responses from market participants to the consultation paper, that this issue has not attracted as much interest from market participants as might have been expected. In fact just one market participant has questioned the relevance and cost of some of SEMO's proposed projects.

4.2 MARKET PARTICIPANTS RESPONSES AND SEMC COMMENTS ON CAPEX REGULATION

- 4.2.1 Airtricity agrees with the SEM Committee's proposal to move away from rate of return regulation for SEMO's CAPEX. According to Airtricity SEMO's role as a market operator is a service provider function operating on behalf of all market participants on the island. On that basis Airtricity does not see any business rationale for SEMO to earn multi-year returns on capital deployed to provide market services. Rather its costs to serve should be reflected as they are incurred. This will make it much easier to understand the cost drivers.
- 4.2.2 NIEES welcomes the attempt to reduce financing costs incurred by consumers. However they requested that the SEM Committee be mindful of any future high cost projects and potential volatility effects; although it should be noted that the Variable Market Operator Charges (VMOC) accounts for a relatively small proportion of retail tariffs.
- 4.2.3 (ESB, Endesa, PPB, BG, SEMO) Some market participants are concerned that this approach could bring volatility to the tariffs if SEMO's capital's investments are not stable from year to year. It was, for instance, pointed out that projects such as Regional Integration and Global Aggregation could generate lumps of expenditure which could generate a large variance on required revenue between two years.
- 4.2.4 SEM Committee view: Most changes to the market systems will be implemented using the existing pre-approved revenue for IT-Releases which is constant year on year. In the case of exceptional major changes to the market systems, which can not be accommodated within these arrangements, additional IT project revenue may need to be approved separately. The rate at which IT spend can be incurred will be limited to some extent by SEMO's and the market's capacity to absorb and manage system change. Finally, the market operator charge accounts for a relatively small proportion of the retail tariffs and therefore even with moderate variations in IT spend consumers of energy should not be significantly affected.
- 4.2.5 (PPB, SEMO) Concerns were raised over the timing mismatch with recovery of asset costs in a single year while market participants would benefit from the investment throughout the lifetime of the asset. A new entrant although benefiting from the

investment would not have to pay for it as the expenses were already incurred by market participants in the previous years.

- 4.2.6 SEM Committee view: This is a valid point but an unavoidable situation. For instance, the initial investment on market systems will be depreciated in one or two years from now while future market participants are likely to benefit from this investment without incurring any of the initial costs. However the fact that IT costs are not expected to vary enormously from year to year will mean that on average participants will pay in proportion to the benefit they receive.
- 4.2.7 (BG) One market participant pointed out that the proposed approach is not in keeping with the regulatory framework to be applied to the parent companies.
- 4.2.8 SEM Committee view: SEMO is a unique entity in the SEM and regulated independently of its parent companies. Its capital needs are very specific and the price control period shorter than its parents'. For these reasons the adoption of this approach for SEMO is not inconsistent with different approaches being applied by the separate jurisdictional regulators to the separate TSO businesses.
- 4.2.9 (ESB, PPB, BG) Some market participants questioned whether the SEM Committee's proposal would meet financiability criteria. It was argued that SEMO would have to borrow money to finance projects and therefore some return on the invested capital would be required to pay interests.
- 4.2.10 SEM Committee view: The SEM Committee's proposal would actually reduce (if not eliminate) the necessity for SEMO's parent company to finance capital investments as the recovery of revenue would take place within the year of the investment as opposed to over a five year period (through depreciation and rate of return). Nevertheless, it might be the case that SEMO is required to raise capital to cope with the short term imbalance of required revenue (to deliver some projects) and recovered revenue within the year. It is equally likely that revenue will be recovered via tariffs earlier than required within year and SEMO will benefit from the interest earned on the temporary balance.
- 4.2.11 (PPB, SEMO) It was suggested that the analysis presented in the consultation paper, comparing the required revenue under the rate of return regulation against the revenue cap, was overly simplistic and should have considered the cost for consumers associated with the early payment of charges. It was also suggested calculating the Net Present Value (NPV) using a consumer discount rate.
- 4.2.12 SEMO pointed out in their response to the consultation paper that the consumer discount rate of 6% has traditionally been assumed in the HMT Green Book.

4.2.13 **RAs view:** Regarding the 6% consumer discount rate previously used, the HMT, in the most recently published version of the Green Book², reduced its recommended consumer discount rate from 6% to 3.5%. The net cash flow based on SEMO's proposal has an Internal Rate of Return (IRR) of 5.8%. Therefore by adopting 3.5% as a consumer discount rate the Net Present Value (NPV) of SEMO's proposed net cash flow will certainly be negative. The NPV criterion will accept projects that have NPV greater than zero. Therefore given the 3.5% discount rate and the availability of resources to pay for the projects in advance, consumers would be better off by not accepting SEMO's proposal.

4.2.14 (SEMO, Endesa, BG) Finally, it was pointed out by SEMO that recovery of funds in advance of the investment would mean higher taxes applied to SEMO. This increase in taxation should be recognised by the SEM Committee.

4.2.15 **SEM Committee view:** While the SEM Committee, to some extent, accepts that the current approach for CAPEX regulation allows SEMO to optimally allocate their capital tax allowance, this factor alone does not preclude the introduction of a new approach. The minimisation of the tax burden on the business is under the control of SEMO and its parent companies. Furthermore, while only a fraction of the tax allowance for capital spend in any given year can be used within that year (under similar tax law in both jurisdictions), the allowance is not lost and can be utilised in future years. These factors along with the materiality of the effect has led the SEM Committee to decide that this factor should not affect its decision on whether to adopt the approach to CAPEX regulation proposed in the consultation paper and discussed above.

4.3 SEMC FINAL COMMENTS AND DECISION ON CAPEX REGULATION

To summarise, the proposed approach is to regulate SEMO's CAPEX and OPEX ex-ante (providing strong incentives for cost efficiency). The alternative scenario would be the maintenance of the current regulatory format and reliance on ex-post evaluation with a higher regulatory burden and lower degree of flexibility for SEMO. The SEM Committee's proposed framework design is based on three pillars:

- Revenue-cap for CAPEX
- Menu Regulation for determination of CAPEX allowance
- Revenue-cap with RPI-X for OPEX

It is the view of the SEM Committee that the removal of one of the pillars (revenue cap on CAPEX for instance) would have a knock on effect on the other two. In this

² http://www.hm-treasury.gov.uk/d/green_book_complete.pdf

sense, it would be difficult to find a middle ground between a highly incentivised arrangement and a highly regulated one. The alternative arrangement would be:

- OPEX Cost pass through constrained to the separate limits for each category of OPEX with ex-post oversight by the RAs
- CAPEX based on a single regulatory offer (not on a Menu of Options) with the RAs closely monitoring the delivery of each project as specified in SEMOs submission.
- Maintenance of the current rate of return arrangement (RAB, WACC)

It is the SEM Committee's view that, given the scale of their initial proposals for CAPEX costs, SEMO is capable of finding substantial efficiency gains. Therefore, having considered the advantages and disadvantages of the two possible approaches (highly regulated vs. highly incentivised), the SEM Committee has decided that the highly incentivised approach proposed in the consultation paper should be approved. Thus for CAPEX a revenue-cap regime will be adopted with recovery of CAPEX costs via tariffs within the year in which they are incurred.

SEMC DECISION 1.1 CAPEX TO BE REGULATED BY A REVENUE-CAP REGIME

4.4 SEMC PROPOSALS FOR OPEX REGULATION

- 4.4.1 The SEM Committee proposed that OPEX should be subject to RPI-X Regulation under a Revenue-Cap regime. Savings derived from efficiency gains will be retained by SEMO as opposed to being clawed back by the SEM Committee. However any over expenditure would have to be absorbed by SEMO.
- 4.4.2 Given the proposed adjustments on payroll and other areas of OPEX detailed in section 7 below, the SEM Committee is of the view that that SEMO's allowance has been set at an efficient level. Therefore it has been decided that the X factor should be equal to zero.

4.5 MARKET PARTICIPANTS RESPONSES AND SEMC COMMENTS ON OPEX REGULATION

- 4.5.1 Several respondents, including SEMO, have supported the SEM Committee's proposal. However Viridian proposes an X factor of 3% claiming that several items of operational expenditure appear to be excessive in comparison to their own expenditure in these areas.
- 4.5.2 **SEM Committee view:** Given the downward adjustment of several items of the OPEX allowance since the consultation paper, based on more up to date outturn

information, the SEM committee is of the view that the proposed SEMO allowance for OPEX has been set to an efficient level.

4.6 SEMC FINAL COMMENTS AND DECISION ON OPEX REGULATION

4.6.1 Having striven to set the baseline for OPEX at an efficient level, the SEM Committee has decided that an X Factor of zero is appropriate.

SEMC DECISION 1.2: OPEX TO BE REGULATED UNDER A RPI-X REGIME. X FACTOR EQUALS TO ZERO

5 INDEXATION

5.1 SEMC PROPOSALS FOR INDEXATION

5.1.1 The SEM Committee proposed using actual out-turn inflation to correct SEMO's revenue. The permitted tariffs would be set each year based on out-turn inflation during the previous year along with any other necessary adjustments. This is the standard approach to RPI-X price controls and typical of the approach used in SONI's and Eirgrid's price controls.

5.2 MARKET PARTICIPANTS RESPONSES AND SEMC COMMENTS

5.2.1 PPB agrees with the proposal to use out-turn inflation. However, they suggested that it was unclear whether the proposal is to use a lagged out-turn inflation or whether a forecast inflation for the year is used that is then corrected to out-turn with any variance picked up through the K Factor mechanism.

5.2.2 Traditionally a lagged mechanism has been deployed. The SEM Committee would set the correction index to the next year based on the most recent information from the statistic offices. Any deviation from the outturn indexes are picked up by the k-factor determination of each financial year.

5.3 SEMC FINAL COMMENTS AND DECISION ON INDEXATION

5.3.1 SEMO's revenues should be indexed on an annual basis using out-turn figures for actual CPI/RPI inflation in the previous year, in line with standard practice in utility regulation. The decision about which month's CPI/RPI inflation figures should be used in finalising tariffs for the following year will depend on what data is available at the time of year when the SEM Committee has to finalise tariffs for the next year.

SEMC DECISION 2: SEMO'S ALLOWANCE TO BE CORRECTED BY THE OUT-TURN INFLATION FIGURE

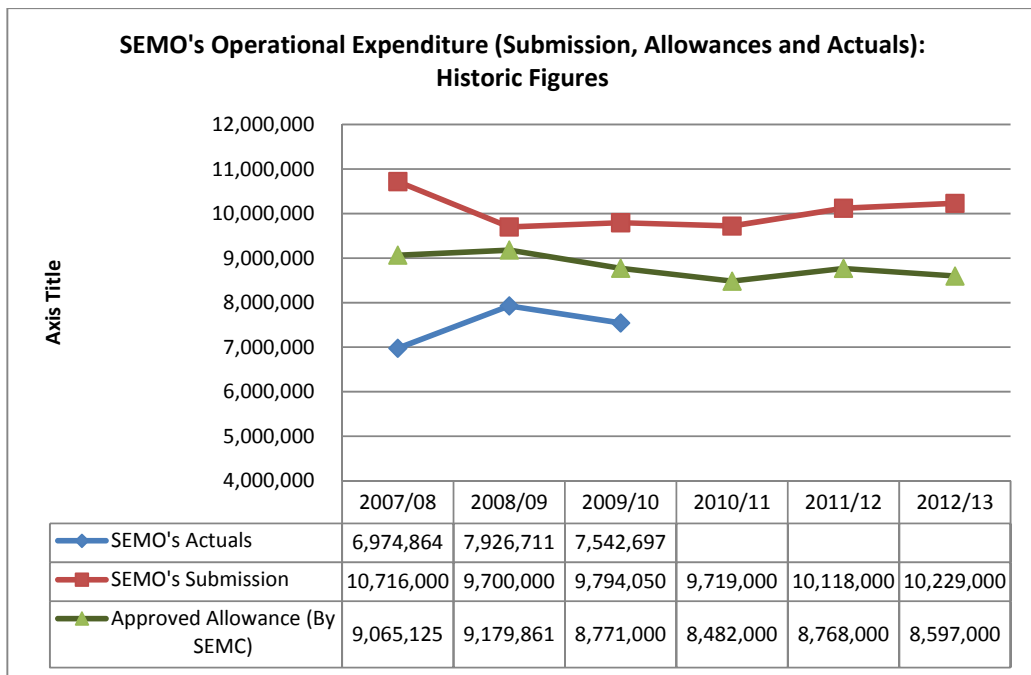
6 OPERATIONAL EXPENDITURE

6.1.1 SEMO’s historic expenditure and proposed payroll allowance for the next three years are as follow:

	Historical Information (€'000)		SEMO's Proposal (€'000)			SEMC Decision (€'000)		
	Allowance	Outturn	2010-2011	2011-2012	2012-2013	2010-2011	2011-2012	2012-2013
Professional Fees	2009-2010	2009-2010						
Payroll	4,264	4,156	4,911	5,057	5,161	4,589	4,486	4,383
IT & Communications	2,139	1,227	2,098	2,304	2,448	1,560	1,897	1,910
Facilities	1,304	1,162	1,196	1,196	1,196	1,196	1,196	1,196
Professional Fees	673	436	847	884	747	619	661	580
General & Administrative	342	397	368	378	378	368	378	378
Corporate Services	49	146	300	300	300	150	150	150
Total	8,771	7,538	9,720	10,119	10,230	8,482	8,768	8,597

Table 2 Operational Expenditure

6.1.2 The following graph compares current costs incurred by SEMO, forecasts made by SEMO in their submission since the market started in 2007 and the allowances approved by the RA. All amounts are presented in nominal terms.



6.2 SEMC PROPOSALS ON PAYROLL

6.2.1 SEMO'S Payroll costs seek to cover all staff costs, including Salaries, Contractors, Bonus, Employer's PRSI/National Insurance, Employer's Pension Contribution, Overtime, On Call/Shift, Car and Other Benefits. The activities of these staff are determined by legislation, licences and the Trading and Settlement Code. SEMO's historical expenditure and proposed payroll allowance for the next three years are as follow:

	Historical Information (€'000)		SEMO's Proposal (€'000)		
	Allowance 2009-2010	Outturn 2009-2010	2010-2011	2011-2012	2012-2013
Payroll	4.264	4156	4911	5057	5161

Table 3: Payroll

6.2.2 The allowance approved by the SEM Committee for the 2009/2010 payroll was €4,264k. This was subsequently increased by an approved amount of €160k for two IT resources to support the new ABB contract. This brought the total approved payroll for 2009/2010 to €4,424k.

6.2.3 As regards the step change from the allowed €4,424K in 2009/10 to the requested €4,911K, an increase of nearly €500K, the RAs requested from SEMO clarification on why the proposed allowance for 2010/2011 is substantially above to the approved expenditure for the current price control (2009/2010). SEMO provided the following explanation:

"The subsequent movement from €4,424k to €4,911k is explained by 4 factors:

- *The 2010/2011 payroll request includes an amount of €201k to cover contributions to pension deficit*
- *An increase in the use of contractors €136k (e.g. to cover for additional controller + analyst for extra resettlement due to mod to extend query time beyond M+13, plus contractors for other specific projects)*
- *One addition to headcount €80k*
- *An increase for real price effect c. €70k"*

6.2.4 This movement is illustrated by the table below:

	EUR '000
Payroll allowed in 2009/2010 SEMO Revenue & Tariffs Decision Paper	4,264
Additional 2 approved by the SEM Committee in November 2009	160
Adjusted 2009/2010 Allowance	4,424
Increase in Pension Deficit Contribution	201
Increase in use of Contractors	136
Additional Headcount (average)	80
RPE 2.75% ROI, 2% NI	70
2010/2011 Payroll	4,911

Table 4: Payroll Expenditure (Breakdown)

6.2.5 So the main decisions to be made by the SEM Committee were:

- 1) Is the baseline of 55 staff appropriate and efficient?
- 2) Are the salaries paid to SEMO staff efficient and necessary?
- 3) Should the increase in pension deficit contributions be allowed within this price control?
- 4) Is the proposed increased use of contractors justified?
- 5) Is the extra one resource requested necessary?
- 6) Is the real price effect claimed something that needs to be allowed for?

The following sections will address each of the questions outlined above:

6.3 BASELINE OF 55 STAFF

6.3.1 **SEM Committee View:** SEMO's organisation is 3 years old. It has grown under close regulatory and market scrutiny with the need for each increase fully assessed and justified on the basis of market need and cost vs. benefit to market participants in particular, and to consumers in general. It is the view of the SEM Committee that this constitutes the basis of an appropriate staffing level for the next price control period.

SEMC DECISION 3: ALLOW THE CURRENT BASELINE OF 55 STAFF

6.4 SALARY BENCHMARK

6.4.1 To assist the SEM Committee in coming to the correct view on this research was commissioned review the staff costs of other similar

companies including benchmarks against similar IT based companies in Ireland and NI and against ELEXON, the market operator for the GB market. The research was carried out by two companies Lane Clark and Peacocks (LCP) and PriceWaterhouseCoopers (PWC).

6.4.2 SEMO is a contractual joint venture by Eirgrid and SONI. Internal staff are employed by the parent companies. SEMO is based in both Dublin and Belfast. Information on payroll costs was provided in an aggregated form. This showed the salary minimum, maximum and average for staff grouped into bands.

6.4.3 As it was presented in the Consultation Paper, the spread of results from the benchmarking exercises are as follows:

	SEMO
PWC Remuneration Database	-4.20%
ELEXON Salaries	4.00%
Salary Surveys	7.00%

Table 5: Summary of Salary Comparisons.

6.4.4 In the table above, a negative figure means that SEMO’s salary level is below the benchmark and a positive figure means that SEMO’s salaries are above the benchmark.

6.4.5 As with any benchmarking exercise the results could be read or used in a number of ways. The broad spread in results is not untypical of such exercises and could be due to factors such as:

- slight differences in timings e.g. surveys are always slightly out of date by the time they are published,
- the broad categories that were provided by SEMO and the challenge of matching these to equivalent posts or ranges in posts in the reference data.

6.4.6 SEMO has offices located in both jurisdictions of the market. The benchmark exercises have provided the SEM Committee with extensive information on the difference of employment costs between NI and ROI

6.4.7 The SEM Committee was of the view that payroll savings are achievable in the range between 7% and 14.26% (5% per year) over 3 years.

6.5 MARKET PARTICIPANTS RESPONSES AND SEMC COMMENTS ON THE SALARY BENCHMARK

- 6.5.1 Airtricity commends the extent of detail undertaken by the SEM Committee in analysing the payroll cost item. However Airtricity does not see the continuity in logic from the inconclusive salary comparison results to the SEM Committee view on payroll savings in the range between 7% and 14.26% (5% per year) over 3 years. Airtricity does not understand the justification for the reduction proposal nor its range and consequently can not see a basis on which to make a determination as to an appropriate target reduction percentage.
- 6.5.2 Bord Gais is of the view that given new developments in the market such as Intra-day Trading, Day-ahead Trading and Market Coupling, SEMO will actually need to recruit more staff. They argued that in this context the proposed decrease in payroll costs are not achievable if the market is to continue its development.
- 6.5.3 SEM Committee view: The proposed decrease in the payroll allowance aims to drive SEMOs salaries to a level of efficiency equivalent to other businesses operating in both jurisdictions of the market. The SEM Committee does not accept the argument that this would preclude SEMO's ability to attract staff.
- 6.5.4 Viridian considers that the salary proposals contained in the document appear reasonable in light of the benchmarking exercise undertaken. Viridian would consider a per annum reduction of 3% to be broadly consistent with the information provided and should be achievable through efficiency and productivity gains.
- 6.5.5 SEM Committee view: 3% per annum would lead to a total reduction of approximately 8.7% i.e. within the range proposed by the SEM Committee.
- 6.5.6 PPB is of the view that the benchmarks show a wide spread and it noted that the Northern Ireland costs are significantly lower and hence the location of the SEMO resources should be considered as a means of reducing the overall costs for consumers. However the main concern for PPB is that SEMO should have adequate resources to efficiently and effectively perform its licensed activities.
- 6.5.7 SEM Committee view: The SEM Committee notes these comments and also the fact that the spread between the costs of labour between the two jurisdictions is correlated with the fluctuations of the exchange rates (Euro v GBP). In the last four years there has been a marked fall of the GBP against the Euro (about 20%). This fluctuation in the exchange rates made the Northern Irish labour market more competitive, notwithstanding that salaries in ROI may suffer a downward adjustment given the current economic climate. The SEM Committee is of the view that short term fluctuations between the two labour markets are not a sustainable basis upon which SEMO should determine its allocation of staff between the two jurisdictions.

While it remains the aim of the SEM Committee to ensure that SEMOs payroll and other allowance elements are set at an efficient level, it is of the view that the optimal allocation of staff in the short term between the two offices should be at SEMO's discretion.

- 6.5.8 SEMO: "The various surveys conducted by the Regulatory Authorities are indicative evidence at best. However, the evidence that they provide is that SEMO is in line with market norms within the two jurisdictions in which it operates. There is therefore no justification for the imposition of further unexplained efficiencies in relation to the payroll provisions and, indeed, there is a disconnection between the surveys and the proposed 7% - 14.26% reduction. Especially recognising the significant real efficiencies imposed last year no reduction is justified."

6.6 SEMC FINAL COMMENTS AND DECISION ON THE SALARY BENCHMARK

- 6.6.1 Considering the benchmark exercise undertaken by the SEM Committee and the responses from market participants the SEM Committee is of the view that a 7% reduction over three years is sufficient to bring SEMO to an efficient level of payroll expenditure.

SEMC DECISION 4: THE TOTAL PAYROLL ALLOWANCE TO BE REDUCED BY 7% OVER THREE YEARS

6.7 INCREASE IN PENSION DEFICIT CONTRIBUTIONS

- 6.7.1 SEMO has included in their submission a provision for pension deficit repair of €201,000 per annum. The SEM Committee view, as stated in the consultation paper, was that the revenue requirement for OPEX should be set at the level that would be possible for a new entrant to undertake SEMO's operational duties.
- 6.7.2 Therefore it was proposed by the SEM Committee that this provision should be disallowed.

6.8 MARKET PARTICIPANTS RESPONSES AND SEMC COMMENTS ON PENSION DEFICIT CONTRIBUTION

- 6.8.1 Viridian welcomes the proposal from the SEM Committee to disallow the pension deficit allowance as no new entrant to the market would have taken the commercial decision to offer a defined benefit entitlement scheme. Such schemes are relics and commercial realities dictate that such schemes should be phased out of all sectors of the economy.

6.8.2 According to SEMO, the proposed approach is at variance with standard regulatory practice (at least in the UK) and takes no account of the circumstances under which the deficit attributable to SEMO, in respect of both EirGrid and SONI, arose.

6.9 SEMC FINAL COMMENTS AND DECISION COMMENTS ON PENSION DEFICIT CONTRIBUTION

6.9.1 The pension deficits currently attributable to Eirgrid and SONI staff currently working for SEMO are historical liabilities that were incurred before SEMO was set up. Therefore the SEM Committee is of the view that this issue should be dealt with by the parent companies.

SEMC DECISION 5: DISALLOW THE PROVISION FOR PENSION DEFICIT REPAIR

6.10 INCREASE IN THE USE OF CONTRACTORS

6.10.1 SEMO has proposed in their submission an increase in their allowance for contractors of € 136k.

The SEM has now been in operation for several years. SEMO has established a structured plan for handling developments to the systems through a series of releases. Both of these suggest that the workload should be more predictable.

6.11 MARKET PARTICIPANTS RESPONSES AND SEMC COMMENTS ON THE INCREASED USE OF CONTRACTORS

6.11.1 PPB do not believe that an allowance for contractors should be built into a three year price control. However they go on to propose that where it is demonstrated that such resources are needed to deliver specific projects that are not part of normal business activity of SEMO, then such costs should be considered and approved as pass through cost.

6.11.2 SEMO: *“It is important that SEMO is adequately resourced to meet the needs of industry. SEMO proposed the use of contractors where the resource requirement was either short term, unpredictable or specialised in nature. However, no provision has been made for this despite the increased workload which is expected as a result of the Regulatory Authorities own work programme and to support a significant business development capital programme.”*

6.12 SEMC FINAL COMMENTS AND DECISION ON THE INCREASED USE OF CONTRACTORS

6.12.1 The SEM Committee accepts that the market there is still a considerable amount of change required to the Trading and Settlement Code and to the market systems and

that this is, if anything, increasing. The SEM Committee also accepts that contractors offer flexibility in dealing with an uncertain workload and in meeting the demand for specialist skills for a short term requirement. Therefore the increased use of contractors is allowed.

SEMC DECISION 6: ALLOW THE PROPOSED INCREASED USE OF CONTRACTORS

6.13 ADDITIONAL RESOURCE

6.13.1 SEMO is proposing to hire a new Administration Assistant at a cost of €80k per annum. The following excerpt was taken from SEMO's submission:

“Currently SEMO does not have an administrative support resource assisting the Managing Director or the business group Managers. Thus, these personnel are responsible for completing their own administrative needs or allocating this work to other staff for whom these are not core duties. Dual site operations, between Belfast and Dublin offices, add an additional requirement to administrative undertakings, which would be best centralised as the responsibility of one core member of staff. “

6.14 MARKET PARTICIPANTS RESPONSES AND SEMC COMMENTS ON THE EXTRA RESOURCE

6.14.1 PPB and Viridian understands that the €80k cost for a new administrative assistant appears to be excessive for such a role.

6.14.2 SEM Committee view: The SEM Committee is of the view that the role seems justified and necessary. The actual allowance to be made for the role is covered by the overall allowance for payroll discussed in section 7.1 above.

SEMC DECISION 7: APPROVE ONE ADDITIONAL HEADCOUNT IN SETTING THE BASELINE FOR THE NEW PRICE CONTROL.

6.15 REAL PRICE EFFECT

6.15.1 The following excerpt was taken from SEMO's submission:

“The nature of the SEMO business means that it will be subject to Real Price Effects to the extent the costs of its inputs are expected to differ from the evolution of RPI/CPI. SEMO's business is largely labour intensive (whether in house or outsourced) and therefore the evolution of real wages represents one of the most important drivers of these real trends. In the medium term real wages within the economy would be expected to increase in line with real labour productivity. Both past real wage trends and future productivity forecasts suggest this is of the order of 1.5% - 2.5% per annum. “

6.15.2 SEMO have argued for a “real price effect” to be applied to the salary costs over and above RPI/CPI. The SEM Committee indicated in the consultation paper that it did not find the case for different elements of this argument to be convincing.

6.16 MARKET PARTICIPANTS RESPONSES AND SEMC COMMENTS ON REAL PRICE EFFECT.

6.16.1 (Airtricity, Viridian) Support the SEM Committee’s proposal to disallow the Real Price Effect allowance. According to them, given the downward trends in inflation and wage growth from broad economic forecasts, they see a weak argument for a real price effect.

6.17 SEMC FINAL COMMENTS AND DECISION ON REAL PRICE EFFECT

6.17.1 SEM Committee View: The Real Price Effects proposed by SEMO are in the context of increasing nominal wages. In the case of SEMO, the payroll benchmarking exercise has indicated that there is a clear case for reducing the nominal wages that SEMO pays; therefore, to the extent that the SEMC enforces a reduced payroll allowance, this argument is irrelevant.

SEMC DECISION 8: DISALLOW THE REAL PRICE EFFECT ALLOWANCE

CONCLUSION ON PAYROLL

The table below summarizes the SEMC Decision for payroll allowance.

	SEMO's Proposal			SEM Committee Proposal		
	2010/ 11	2011/ 12	2012/ 13	2010/ 11	2011/ 12	2012/ 13
Payroll allowed in 2009/2010 SEMO Revenue & Tariffs Decision Paper	4,264			4,264		
Additional 2 approved by the RAs in November 2009	160			160		
Increase in use of Contractors	136			136		
Additional Headcount (average)	80			80		
Grade Increases	-	40				
RPE 2.75% ROI, 2% NI	70	106	104			
				Subtotal	4,640	
Payroll Correction -7% over three years: Year 1: - 1.11%, Year 2: - 2.24% Year 3: - 2.29%.						
Payroll allowance	4,710	4,856	4,960	4,589	4,486	4,383
Increase in Pension Deficit Contribution	201					
Corrected Payroll allowance	4,911	5,057	5,161	4,589	4,486	4,383

Table 6 Payroll Correction

The payroll allowance target by the end of the three year period is €4,315k, 7% lower than 4,640 (4,264+160+136+80=4,640), this allowance should be used as a baseline for the next price control. The table below illustrates the process used to correct the payroll over three year.

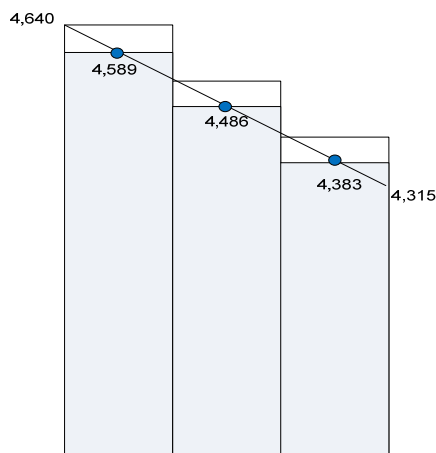


Figure 2 Payroll Correction Process

6.18 SEMC PROPOSALS ON IT & TELECOMMUNICATIONS

6.18.1 Considering the complex IT systems deployed to support the SEM, it is not surprising that a significant cost area within the SEMO operational costs is IT & Communications. Nevertheless this is an area that is critical to the market. The cost components associated with IT & Communications are as follows:

- **Warrant Support & Maintenance: Market Systems** – these costs are largely made up of 3 elements Support contracts for base Vendor maintenance (ABB), third party software and hardware items.
- **Warrant Support & Maintenance: Corporate Systems** – these costs cover requirements such as Outsourcing of network and security IT services, Website Hosting, Hardware Support, Microsoft Licences, Oracle Licences, Antivirus, printers & Networks equipment.
- **Other system maintenance** - This covers the costs associated with the support agreement for Axapta, and other items such as Support works.
- **Telecoms Costs** – This covers the cost of the data links between the SEMO premises in Dublin and Belfast

6.18.2 The historical expenditure and SEMO's proposals for IT & Communications are as follow:

IT & Telecommunication	Historical Information (€'000)		SEMO's Proposal (€'000)		
	Allowance 2009-2010	Outturn 2009-2010	2010- 2011	2011- 2012	2012- 2013
Warranty, Support & Maintenance	1,692	1,006	1,820	2,027	2,010
Telecommunications	447	220	278	278	438
Total IT & Communications	2,139	1,227	2,098	2,304	2,448

Table 7: IT & Telecommunications

6.18.3 SEMO has provided a detailed submission on this area of cost. While the SEM Committee is satisfied with the level of detail contained in SEMO's estimations, the current level of expenditure on IT & Communications has been considered by the SEMC.

6.19 MARKET PARTICIPANTS RESPONSES AND SEMC COMMENTS ON IT & TELECOMMUNICATIONS

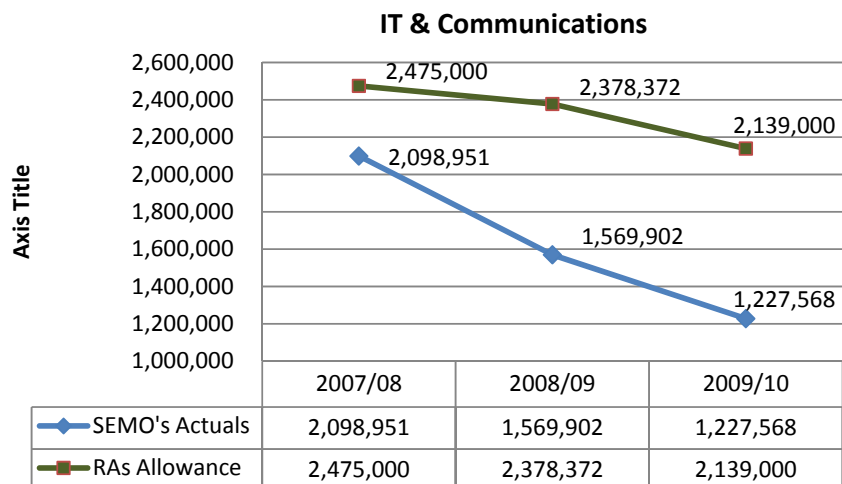
6.19.1 (PPB, SEMO) These participants propose that IT and Telecom costs should be relatively easy to predict and therefore SEMOs proposal should be accepted, otherwise they may not be able to provide their services adequately.

6.20 SEMC FINAL COMMENTS AND DECISION ON IT & TELECOMMUNICATIONS

6.20.1 The approved allowance for IT & Telecommunication for the Current Price Control is €2,139 Million. According to the figures provided by SEMO in their last financial report, the actual expenditure on this area of cost is: €1,227k. The following explanation was provided by SEMO on the discrepancy between allowance and actual expenditure:

“Operational and Maintenance of Systems is 59% of the RA approved allowance for the year. This variance is due to a number of different reasons, including: (1) discounts were negotiated by SEMO with a number of significant IT suppliers which led to valuable savings during the year; (2) some IT projects did not go ahead and (3) some IT costs will now appear in 2010/2011 instead of 2009/2010 (e.g. support costs for new SEMO website).”

6.20.2 Over the last three price controls SEMO has consistently over estimated the revenue requirement for this line item. The graph below illustrates this fact.



6.20.3 To date these discrepancies between SEMO’s proposals and the actual expenditure have not been a major problem because these costs were treated as pass through and any under or over expenditure on OPEX has been captured by the k-factor adjustment. However in the next price control SEMO would be able to retain any savings on OPEX (while any over expenditure would be assumed by SEMO). Therefore it is even more important for the SEMC to set a level of expenditure which is as close as possible to SEMO’s actual required expenditure using outturn expenditure as the most accurate benchmark available.

6.20.4 Considering the historical expenditure and SEMO’s submission, the SEMC decided that the allowance for IT & Communications should be as follows.

SEMC DECISION 9: SEMO’S IT & COMMUNICATIONS BUDGET TO BE LIMITED TO €1,560K, €1,897K AND €1,910K IN YEARS 1, 2 AND 3 RESPECTIVELY.

6.21 SEMC PROPOSALS ON FACILITIES

6.21.1 SEMO has offices in both jurisdictions. This provides operational redundancy and is an important element of the security of market systems. SEMO will continue to co-locate on property provided by both parent companies and will be charged accordingly. Facilities costs cover all shared space and include cleaning services, maintenance, car parking, security, mail service, copy bureau, switch board and catering and canteen services as well as rent, insurance and utilities.

Facilities	Historical Information (€'000)		SEMO's Proposal (€'000)		
	Allowance 2009-2010	Outturn 2009-2010	2010- 2011	2011- 2012	2012- 2013
Rent & Facilities- EirGrid			977	977	977
Rent & Facilities SONI			169	169	169
Subtotal			1,146	1,146	1,146
General Insurance			50	50	50
Total Facilities and Insurance	1.305	1,162	1,196	1,196	1,196

Table 8: Facilities

The proposed overall expenditure on Facilities is somewhat lower than the allowance approved for the current price control €1,304 Million.

6.22 MARKET PARTICIPANTS RESPONSES AND SEMC COMMENTS

6.22.1 Viridian is concerned about SEMO's expenditure on facilities. According to them, SEMO's facilities costs are 70% higher than their own expenditure, even though their costs cover 135 staff and 4 office locations. In light of this they recommend a positive X factor. PPB also expressed concerns over the facilities costs.

SEM Committee view: While the SEM Committee accepts the validity of this point it also understands that SEMO has no ability to manage this expenditure in the short term.

6.23 SEMC FINAL COMMENTS AND DECISION

6.23.1 The SEM Committee is of the view that as SEMO co-locates on property provided by both parent companies it would be more appropriate if the respective price controls for the parent companies deal with the level of facilities costs.

SEMC DECISION 10: SEMO'S PROPOSED BUDGET FOR FACILITIES TO BE APPROVED

6.24 SEMC PROPOSALS ON PROFESSIONAL FEES

6.24.1 Professional fees cover SEMO requirements for external professional services in respect of:

- General Consultant support
- Disputes and Modifications Committee support
- Regulatory and Legal support
- Market Audit
- Corporate Audit
- Communications and Recruitment

Professional Fees	Historical Information (€'000)		SEMO's Proposal (€'000)		
	Allowance 2009-2010	Outturn 2009-2010	2010- 2011	2011- 2012	2012- 2013
Legal			50	50	50
Recruitment			40	40	40
Internal Audit			25	25	30
Market Audit			250	300	300
Committees			53	53	53
Consultancy			411	398	258
RPE @ 2.25%			19	19	16
Total	672	436	848	885	747

Table 9: Professional Fees

6.24.2 The table above presents SEMO's proposals and compares them with the historical expenditure.

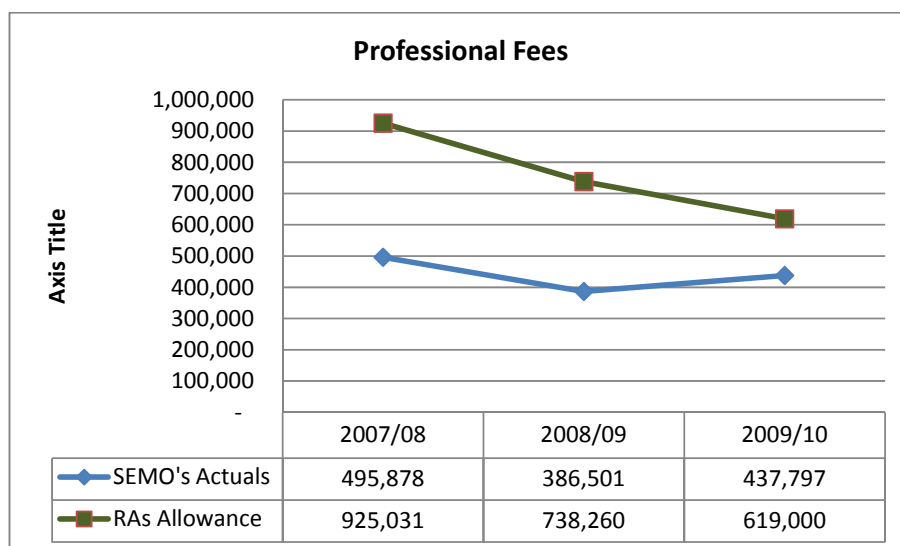
6.25 MARKET PARTICIPANTS RESPONSES AND SEMC COMMENTS ON PROFESSIONAL FEES

6.25.1 PPB do not consider it is appropriate that SEMO should be incurring costs "keeping abreast" of developments that are beyond the scope of its role of delivering the market operator service. According to PPB, It is therefore not clear what ongoing consultancy services are required. Where the scope is unknown, it would not appear to be efficient to build in a level of costs in advance that may turn out to be unnecessary. In circumstances where a particular project requires such a service, that cost should be approved at the time as a pass through cost.

6.25.2 **SEM Committee view:** SEMO has to have some degree of freedom to contract external consultancy without requiring RA approval for every project on an individual basis. Some of the items outlined on SEMO proposal are very predictable (e.g. Committees, Auditing process). Further, SEMO has a number of ongoing market development projects which will require some level of consultancy support.

6.26 SEMC FINAL COMMENTS AND DECISION ON PROFESSIONAL FEES

6.26.1 SEMO's historic expenditure on professional fees has been relatively stable over the last three years. The graph below shows that the allowance determined by the SEM Committee has been to a large margin in excess of SEMO's requirements (the excess has been clawed back by RAs via k-factor).



6.26.2 SEMO has proposed an allowance of €2,480k over three years (average €826k per year). The SEMC, after the evaluation of the future necessities and historical expenditure proposed the following allowance for Professional Fees:

SEMC DECISION 11: SEMO TO BE ALLOWED A BUDGET OF €619K, €661K AND €580K FOR THE YEARS 1, 2 AND 3 RESPECTIVELY.

6.27 SEMC PROPOSALS FOR GENERAL AND ADMINISTRATIVE COSTS

6.27.1 General and Administrative costs cover the remaining expenses expected to be incurred operating the SEMO business. They include Travel and Subsistence, Office Supplies, Bank Charges and Staff Training. The costs associated with each of these areas are detailed below.

	Historical Information (€'000)		SEMO's Proposal (€'000)		
	Allowance 2009-2010	Outturn 2009-2010	2010- 2011	2011- 2012	2012- 2013
General and Administrative					
Travel & Subsistence			168	168	168
Stationery			10	10	10
Bank Charges			35	45	45
Training			124	124	124
Miscellaneous/ Meetings			31	31	31
Total	241	397	368	378	378

Table 10: General and Administrative

6.28 MARKET PARTICIPANTS RESPONSES AND SEMC COMMENTS

6.28.1 Viridian and PPB expressed concern over professional fees and general and administrative costs. According to them SEMO's expenses on travel and subsistence would largely equate to the total cost of Energia business of 135 staff which is highly sales orientated.

6.29 SEMC FINAL COMMENTS AND DECISION

6.29.1 The RAs kept track of the evolution of this expenditure and according to the last financial report submitted by SEMO, incurred General and Administrative costs were €397k. Therefore the SEMC decided SEMO's proposal for this revenue component should be approved.

SEMC DECISION 12: SEMO'S GENERAL AND ADMINISTRATIVE BUDGET TO BE LIMITED TO €368K, €378K AND €378K IN YEARS 1, 2 AND 3 RESPECTIVELY.

6.30 SEMC PROPOSALS ON CORPORATE SERVICES

6.30.1 The SEMO submission made reference to corporate services being charged from the parent companies.

"To date, the SEMO Price Controls have made reference to Group Services being charged from the parent companies. These relate both to services directly provided for SEMO from other business units, for example HR, and to a cost allocation of the overhead associated with the Group activities: Chief Executive, Group Finance, Regulation etc The approach within the EirGrid Group has been to keep general overhead allocated only to costs associated with Group activities, with SEMO retaining separate and separately accountable information services, accounting, and other management functions consistent with its licence. The provision is for €300k per annum consistent with the assumptions made for the other controls within the Group."

	Historical Information (€'000)		SEMO's Proposal (€'000)		
	Allowance 2009-2010	Outturn 2009-2010	2010- 2011	2011- 2012	2012- 2013
Corporate Services					
Group Services (allocated charge)			200	200	200
Activities sourced from within Group			100	100	100
Total Corporate Services	49	146	300	300	300

Table 11: Corporate Services

In the consultation paper the SEM Committee expressed the view that SEMO has not adequately demonstrated that the proposed €300K annually represents the market value of essential business services actually delivered and therefore proposed to not to provide for this line item.

6.31 MARKET PARTICIPANTS RESPONSES AND SEMC COMMENTS ON CORPORATE SERVICES

- 6.31.1 Viridian agrees with the SEM Committee proposal to disallow the corporate services allowance.
- 6.31.2 NIEES notes that SEMO should not be encouraged to outsource these services in isolation at a potentially higher cost if a lower cost internal option is available.
- 6.31.3 PPB is of the view that some provision to corporate services should be allowed and the question is more the appropriate level.
- 6.31.4 According to SEMO the €300k per annum sought in respect of corporate services should be provided; it represents a significantly lower cost to consumers than that which would be necessary were the two MO licensees to operate on a standalone basis.

6.32 SEMC COMMENTS AND DECISION ON CORPORATE SERVICES

- 6.32.1 SEMO is proposing an allowance of €300k per year for corporate services. SEMO's outturn expenditure on corporate services for the period 2009/10 was €146k. The SEMC accepts that some level of allowance should be set for this component of revenue. However SEMO's proposal is inconsistent with the outturn expenditure. Therefore the SEMC decided that SEMO's Corporate Service allowance should be limited to €150k per year.

SEMC DECISION 13: SEMO'S CORPORATE SERVICES ALLOWANCES TO BE LIMITED TO €150K PER YEAR.

7 CAPITAL EXPENDITURE - CAPEX

7.1 SEMC PROPOSALS ON CAPEX

7.1.1 The CAPEX allowance enables SEMO to recover from tariffs the necessary financial resources to finance their capital investments. The following five types of CAPEX have been identified as part of SEMO's submission:

1. Predictable Business CAPEX,
2. Unpredictable Business CAPEX,
3. Biannual IT Market Release CAPEX,
4. Biannual IT Market Release Support CAPEX,
5. Unknown Future Major Market Change CAPEX.

7.1.2 In its submission, SEMO has proposed an allowance for predictable capital expenditure. A **Predictable Business Capex** allowance enables SEMO to plan for hardware and software upgrades and the implementation of additional operational support systems as and when the need arises. The RAs have scrutinised SEMO's CAPEX proposals considering the costs and efficiency gains associated with each project.

7.1.3 SEMO proposes an allowance of €250,000 per annum to cover unplanned spending to meet the day to day needs of SEMO on small investments such as software upgrades and availability of new products on the market that would deliver operational improvements i.e. **Unpredictable Business CAPEX**. The SEM Committee is of the view that SEMO will require and therefore should be allowed to have a level of unplanned expenditure in a given time period.

7.1.4 **Biannual IT Market Release CAPEX**. On 08 September 2009, SEMO presented to the RAs a proposal for a three year agreement on vendor costs and delivery (ABB/Navita). The SEM Committee reviewed the submitted terms and was satisfied that the rate and hours were reasonable and that there was not a large risk of being subject to higher rates for extra work. Therefore the SEM Committee approved the contract

7.1.5 In addition to the above funding for the main vendor contract SEMO proposes in their submission that each release would introduce a series of ancillary costs (to be incurred by SEMO) - **Biannual IT Market Release Support CAPEX**.

7.1.6 **Unknown Future Major Market Change CAPEX**. Finally, Major CAPEX should be derived from major changes to the Trading and Settlement Code and supporting systems. The SEM Committee is of the view that major changes to the TSC will only occur in exceptional circumstances. For any major capital expenditure SEMO are

required to present their expenditure plans to the SEM Committee which in turn will determine the amounts and mechanisms for recovery of the required revenue.

7.1.7 Going forward then SEMO has control over the following CAPEX items:

- Predictable Business CAPEX,
- Unpredictable Business CAPEX,
- Bi-annual IT Market Release Support CAPEX.

7.1.8 The Bi-annual IT Market Release has already been approved by the SEM Committee and there is a contract in place between SEMO and the software vendor, therefore this area of expenditure is out of SEMO's control. The table below presents the remaining amounts involved in the determination of SEMO's CAPEX baseline:

CAPEX item	2010-11	2011-12	2012-13	Amount €
Bi-annual IT Market Release Support	450,000	550,000	550,000	1,550,000
Predictable Business CAPEX	3,430,000	2,650,000	2,800,000	8,880,000
Unpredictable Business CAPEX	250,000	250,000	250,000	750,000
Total	4,130,000	3,450,000	3,600,000	11,180,000

Table 12: CAPEX

7.1.9 Based on the analysis of each CAPEX component the proposed CAPEX of € 11,180k is considered to be reasonable subject to an efficiency stretch of 5%. Therefore the SEM Committee proposes that the baseline for controllable CAPEX to be set at €10,620k.

7.1.10 The SEM Committee considered two different approaches for the CAPEX determination.

1. The first was the traditional one where the SEM Committee presents to SEMO a single option for their allowance, a 'take it or leave it' regulatory offer.
2. The second alternative is to present a menu of regulatory options embodying varying strengths of incentives. The options are structured so that SEMO has an incentive to choose the option that matches most closely the outcome expenditure expected by SEMO.

7.2 MARKET PARTICIPANTS RESPONSES AND SEMC COMMENTS ON CAPEX

7.2.1 (SEMO) Any baseline should be assessed against the costs submitted by SEMO rather than against the unjustified removal of 5% under the guise of an efficiency stretch.

7.2.2 **SEM Committee view:** SEMO's figures were based in their best estimations of what should be the final cost of each project. However the SEM Committee is of the view

that, as over the past year, savings opportunities should emerge throughout the procurement process. Finally given the deterioration of the economy and increased price competition in IT areas in both jurisdictions since the submission of SEMO's proposals a 5% cost reduction target should be viable.

7.2.3 ESB notes the SEM Committee's comments about benefits due to forecast error being clawed back. They point out that forecast error is inevitable with this kind of IT programme. This is because a final price for any project can only be determined from a procurement process and procurement cannot be started until RA approval is received.

7.2.4 **SEM Committee view:** The intention of the SEM Committee is that SEMO would not require approval to go ahead with procurement processes. The intent behind the proposed incentivisation framework is to give SEMO flexibility when investments are necessary. Furthermore, the claw back clause could undermine SEMOs ability to flex between projects. Therefore the SEM Committee has reconsidered this clause.

7.2.5 Viridian believes that many of the submitted costs are excessive, from their experience of similar capital investments. In particular they suggest that the following items appear to be overestimated.

- ABB upgrades
- Testing budget
- Some of the 17 predictable CAPEX items
- 250k for unplanned expenditure.

7.2.6 **SEM Committee view:** In relation to the ABB upgrades and testing budget, these are, to some extent, compatible with the historical expenditure. The SEM Committee is also mindful of the volume of future releases. Regarding the 17 business cases, further to the analysis carried out by the RAs, SEMO will be subject, via menu regulation, to an aggressive incentive scheme to under-expend their allowance. Finally, regarding the €250k for unplanned expenditure, this figure seems to be reasonable since the actual expenditure from SEMO in this area exceeds this figure.

7.2.7 Viridian raised concerns over the possibility of using CAPEX allowance to fund over expenditure on OPEX.

7.2.8 **SEM Committee View:** There will be no intersection between the CAPEX and OPEX allowances. SEMO has auditable accounts for these two categories of expenditure and they are not interchangeable.

7.2.9 ESB and Endesa support the introduction of Menu Regulation as it appears to provide more flexibility while still offering strong incentives to SEMO to complete its programme of works with an appropriate downside where costs are not controlled.

7.2.10 Viridian has concerns that the introduction of menu regulation would unnecessarily complicate the regulatory process. Nonetheless they would be worried if SEMO opts for a riskier option.

7.2.11 **SEM Committee View:** In essence, after the choice of one menu option by SEMO, the regulatory process becomes identical to the single regulatory offer. Regarding the risk involved, SEMO are best placed to manage this.

7.2.12 Bord Gais argued that menu regulation is not appropriate for SEMO as they do not have control over system developments. The type of development implemented by SEMO is decided by the market. Therefore, it is not within the remit of SEMO to diverge from what is determined by the SEM Committee through the Modifications Committee.

7.2.13 **SEM Committee view:** The SEM Committee agrees that SEMO has limited flexibility to influence policies determined by the SEM and Modifications Committee. It is for this reason that the required capital to implement major modifications to the market systems was set outside of the scope of menu regulation (see section 10.3 of the consultation paper). The menu options will comprise only the costs that SEMO has control over which are: Predictable Business CAPEX; Unpredictable Business CAPEX and the Bi-annual IT Market Release Support.

7.2.14 (PPB) One market participant suggested that the SEM Committee's proposal for the determination of the CAPEX allowance is over engineered and would require practically the same level of the regulatory oversight as the present system.

7.2.15 **SEM Committee view:** The SEM Committee accepts that some of the proposed mechanisms to monitor the budget and delivery of the projects (see section 10.6.3 of the consultation paper) could to some extent compromise the intended reduction on the regulatory burden. For this reason and for the reasons discussed in sections 7.2.3 and 7.2.4 above the following conditions proposed in the consultation paper will no longer apply.

- In the event of any of the projects submitted being called off by SEMO, the SEM Committee would revise the baseline and the revenue requirement downward. The same incentive scheme would apply. This mechanism would prevent SEMO from being rewarded simply by not implementing projects,
- SEMO would require SEM Committee approval in order to make any substitution to the list of projects submitted,
- The RAs will monitor the delivery of all projects composing the RAs baseline, Where the SEM Committee deems that benefits gains have been as a result of forecast error rather than efficiency gains, benefits will be clawed back.

Instead SEMO will report in detail, at the end of the price control period, on the extent to which the objectives of their capital programme (all five elements) have been achieved, with appropriate reporting on an annual and quarterly basis in the interim.

7.3 SEMC FINAL COMMENTS AND DECISION

7.3.1 The SEM Committee is of the view that the proposed set of rewards and penalties are sufficient to incentivise SEMO to act economically and efficiently. The table below lists (in the green row) 11 different packages which will be offered to SEMO (in current prices). The dark blue column lists the possible outturn expenditure over three years. Across the table, the reward or penalty associated with each choice of package. SEMO would maximize their reward by selecting the package which matches with their “true” or “best estimate” expenditure expectations for the outturn figure (Dark Blue Column). The figures bellow are in real values and should be inflated (deflated) to September 2013 values (end of this price control).

Allowed Expenditure (Menu Choices) in thousand of Euros											
	Package 1	Package 2	Package 3	Package 4	Package 5	Package 6	Package 7	Package 8	Package 9	Package 10	Package 11
Outturn CAPEX	8,497	9,028	9,559	10,090	10,621	11,152	11,683	12,214	12,745	13,276	13,807
8,497	1,434	1,427	1,407	1,374	1,328	1,268	1,195	1,109	1,009	896	770
9,028	1,115	1,122	1,115	1,095	1,062	1,016	956	883	797	697	584
9,559	797	816	823	816	797	763	717	657	584	498	398
10,090	478	511	531	538	531	511	478	431	372	299	212
10,621	159	206	239	259	266	259	239	206	159	100	27
11,152	-159	-100	-53	-20	0	7	0	-20	-53	-100	-159
11,683	-478	-405	-345	-299	-266	-246	-239	-246	-266	-299	-345
12,214	-797	-710	-637	-578	-531	-498	-478	-471	-478	-498	-531
12,745	-1,115	-1,016	-929	-856	-797	-750	-717	-697	-690	-697	-717
13,276	-1,434	-1,321	-1,221	-1,135	-1,062	-1,002	-956	-923	-903	-896	-903
13,807	-1,752	-1,626	-1,513	-1,414	-1,328	-1,255	-1,195	-1,148	-1,115	-1,095	-1,089

Table 13: Menu Table

7.3.2 In addition to the rewards and penalties outlined in the menu:

- Any under expenditure in relation to the chosen package will be clawed back by the regulatory authorities via k factor.
- Any over expenditure in relation the chosen package will be provided for via k factor, limited to a cap of 13,807. Above this limit SEMO will absorb the deficit.

7.3.3 The ex-post adjustment derived from the package choice will be determined by the following formula.

$$CAPEX k = (\min(13,807, \text{Outturn CAPEX}) - CAPEX \text{ Tariff Revenue}) + (\text{Reward} : \text{Penalty})$$

7.3.4 The SEM Committee will keep the delivery of the proposed projects under close scrutiny. The status of each project will be presented by SEMO to the RAs during their routine meetings. Ultimately, SEMO will furnish the RAs with an End of Year Capital Progress report outlining the progress SEMO has made in the delivery of the proposed seventeen Capital projects.

SEMC DECISION 14: MENU REGULATION WILL BE EMPLOYED TO DETERMINE SEMO'S CAPEX ALLOWANCE.

8 REGULATED ASSET BASE (RAB)

8.1.1 The value of the SEMO RAB at the end of September 2009 was €26,226,287 (based on SEM Establishment €19,827,992 and Day 1+ €6,398,295). The SEM Establishment figure is the Net Book Value based on the Asset Value determined in the 2009-10 Price Control Decision Paper (SEM-09-089). The Day 1+ figure is the Net Book Value based on the Final Regulatory approved amount including interest during construction (IDC) and inflation.

8.1.2 In 2009/10 additional assets were added to the SEMO RAB at an estimated value of €2,859,493 (the final value has yet to be agreed with the RA's). As a result SEMO has used this value in calculations for the Price Control Submission.

Assets going Live in 2009/10	Amount €	Go Live Date	Depreciation to Sep 10	NBV at 01.10.2010
SEMO IT CAGS – Novosco	8,494	Sep-09	1,557	6,937
October Release	135,077	Oct-09	27,015	108,062
Folding Machine	13,700	Apr-10	1,370	12,330
Website	702,044	Jun-10	46,803	655,241
April Release	1,133,125	Apr-10	113,313	1,019,813
Additional Costs April Release (recertification)	13,000	Apr-10	1,300	11,700
SAN	376,431	May-10	31,369	345,062
Sharepoint Infrastructure Upgrade	57,610	May-10	4,801	52,809
Hardware Replacement	13,712	Apr-10	1,371	12,341
Links Upgrade - estimate2	400,000	Aug-10	13,333	386,667
Disks for IBM Servers RCUC	6,300	Apr-10	630	5,670
Total Assets going Live in 2009/10	2,859,493		242,863	2,616,630

Table 14: Status of SEMO's RAB

The value of the Regulatory Asset Base in October 2010 is outlined in the table below

Summary	RAB Value at 01 October 2010
SEM Establishment	19,827,992
Day 1+	6,398,295
Capital Expenditure 2009-10	2,616,630
Opening RAB Value October 2010	28,842,917

9 WEIGHTED AVERAGE COST OF CAPITAL (WACC)

9.1 SEMC PROPOSALS ON WACC

- 9.1.1 Although the current proposal from the SEM Committee is to depart from Rate of Return Regulation the assessment of the appropriate WACC still necessary as SEMO still have many CAPEX items in the depreciation phase. The prevailing RAB will continue to be depreciated according to the rules established in the previous price control.
- 9.1.2 SEMO proposes to continue with the previous approach to the WACC i.e. to blend the WACC values determined by CER and NIAUR in the forthcoming price controls for EirGrid and SONI respectively, in the ratio 3:1. The weights are based on funding for SEMO being supplied in this ratio from EirGrid and SONI respectively.
- 9.1.3 Having commissioned and reviewed the results of expert economic analysis, the SEM Committee has not found any compelling case for using a different WACC figure for SEMO than for the system operators (see section 12 of SEMO Price Control Consultation Paper³). Therefore the SEM Committee is has decided that SEMO's WACC will be determined in accordance with the WACC of SEMO's parent companies (Eirgrid and SONI). The current rate of 3:1 will be kept unchanged as this rate corresponds to the ratio in which SEMO is funded by the parent companies.
- 9.1.4 The table below shows SEMO's estimations of the cost of capital for the next three years.

Summary	2010-11	2011-12	2012-13
WACC	€1,373,782	€ 788,899	€423,986

Table 15: WACC Allowance

9.2 SEMC FINAL COMMENTS AND DECISION

- 9.2.1 Both companies (Eirgrid and SONI) are currently in the process of price control reviews which are being carried out by CER and NIAUR respectively. SEMO's WACC should be adjusted in line with the WACC decisions reached by CER and NIAUR in the forthcoming EirGrid and SONI price controls. Therefore SEMOs WACC will track the prevailing WACC of their parent companies.

SEMC DECISION 15: USE THE PREVALING BLENDED WACC FROM EIRGRID AND SONI WITH THE CURRENT BLEND RATE OF 3:1 TO BE APPLIED.

³ SEMO Price Control (2010-2013) Consultation Paper (<http://www.uregni.gov.uk/uploads/publications/SEM-10-0501.pdf>)

10 DEPRECIATION

10.1 SEMC PROPOSALS ON DEPRECIATION

10.1.1 Depreciation forms the largest single component of SEMO's requested revenue, exceeding both total operational cost and the WACC allowance (although as SEMO notes the proposed allowance for depreciation falls substantially in the final year of the price control period as the SEM Establishment project will have been fully depreciated by 2011-12).

10.1.2 SEMO has proposed to continue to depreciate its assets subject to straight-line depreciation over a five year period. This methodology appears reasonable. Straight-line depreciation is often used by regulators, and five years is a reasonable asset life for IT and related assets. Continuing with a five year period is consistent with previous SEMO price controls.

10.1.3 SEMO's depreciation allowance includes amounts both for depreciation on its existing RAB and for depreciation associated with its proposed CAPEX. As the SEM Committee has decided to departure from the current rate of return regulation for future CAPEX expenditure SEMO's future projects will not be included in the RAB and therefore these will not be depreciated. The only exception will be the IT Release CAPEX as this allowance has already been approved during the current price control.

10.1.4 The table below shows SEMO's proposed depreciation figures. Note that these are based on the assumption that all future capital spend is added to the RAB. It can be seen that depreciation in year 3 drops notability as SEM Establishment project will have been fully depreciated by 2011-12.

Summary	2010-11	2011-12	2012-13
Depreciation Charge	€12,835,000	€ 13,927,000	€ 6,627,000

10.1.5 However by implementing the proposed Revenue-Cap Regulation the depreciation figures will actually be as follow:

Summary	2010-11	2011-12	2012-13
Depreciation Charge	€12,158,000	€ 12,624,000	€ 4,458,000

SEMC DECISION 16: KEEP THE CURRENT STRAIGHT LINE DEPRECIATION MECHANISMS FOR EXISTING IT CAPEX

11 INCENTIVISATION

11.1 SEMC PROPOSALS ON KEY PERFORMANCE INDICATORS

11.1.1 In the current price control (2009 – 2010) the SEM Committee decided that a reward mechanism equivalent to 2.5 per cent of total internal costs would be implemented for out-performing targets for four key performance indicators (KPIs). In its price control submission SEMO has proposed a reward mechanism of 3 per cent of total internal costs (to a maximum of €300,000 per annum).

11.1.2 SEMO also proposed that in terms of assessing the KPIs, a measure be taken at the end of each quarter using the average value of each KPI over that period. Should the KPI be achieved in the given period the reward for that quarter shall be earned. This allows SEMO to continue to be incentivised for the remainder of the year should it fail against a KPI in any particular quarter. This approach represents a relaxation of the prevailing criteria. The following assumptions will be applied:

1. The metric is delivered within one hour of the targeted time;
2. External factors demonstrably outside the Market Operators direct control are excluded e.g. limited communication failure by market participant, late provision of data by System Operators or the Meter Data Provider, Government policy changes, SEM Committee policy changes etc; and
3. The first two weeks after a bi-annual system release are excluded from the annual target.

11.1.3 Finally it was proposed by SEMO the introduction of new targets for the existing KPIs and two new KPIs.

	Weighting		Target		Upper bound	
	Current	Proposed	Current	Proposed	Current	Proposed
Ex-ante pricing report	0.2	0.1	99%	97%	100%	100%
Ex-post initial pricing report	0.2	0.1	99%	97%	100%	100%
Invoicing	0.4	0.2	90%	95%	95%	100%
Credit Cover Increase Notices	0.2	0.1	98%	98%	100%	100%
SEMO related Resettlement queries	-	0.25	-	<30	-	10
General queries	-	0.25	-	97%	-	99%

11.1.4 The SEM Committee is of the view that It is important to continue to provide SEMO with the right incentives to maintain their current good performance. However, as SEMO has suggested to increase the reward pot and change the horizon for the achievement record (quarterly assessment), it may be appropriate to increase the difficulty to achieve SEMO's proposed targets. Therefore the SEM Committee proposed that assumption 3 (first two weeks after a system release) be removed.

11.2 MARKET PARTICIPANTS RESPONSES AND SEMC COMMENTS ON KPIS

11.2.1 ESB agrees with the SEM Committee's proposal to remove the exclusion of the two week period following a release from measurement. We believe this provides the best incentive for consistent service.

11.2.2 ESB maintains that SEMO has proposed an increase in the target level for one KPI (invoicing) and a reduction in two others (ex ante pricing report and ex post initial pricing report) to match the current performance level. Reducing a target level is reasonable where the target was unrealistically high, where the KPI was not of key importance to those receiving the service or where it is proposed to provide the same level of service at lower cost. However ESB believes that these KPIS are of importance to the market and that the targets should not be lowered.

11.2.3 ESB welcomes SEMO's proposals for new incentives for resettlement queries and general queries. In relation to upheld queries resulting in market resettlement, ESB believes that this target should be more stretching and that a target of 15 per quarter (about 1 per week) may be more appropriate, given the investment that SEMO has made in resources and IT systems over the last three years.

11.2.4 ESB proposes that the market resettlement KPI should include queries arising from data provided by TSO it is role as data provider on the basis that SEMO can exert significant pressure on the TSOs as data providers to deliver to the market timetable.

11.2.5 In respect of the General Queries KPI, ESB propose a target of 97% answered within 20 business days (1 month). In this context, closure would mean that the query has been closed in agreement with the participant who raised the query.

11.2.6 According to PPB and NIEES there is no rational for the increase of the KPI incentive pot from 2.5% to 3%.

11.2.7 Airtricity is of the view that, given that the ex-ante pricing report fixes the MIUNS for interconnector units, and consequently forms exposures in BETTA that require execution of trades, timeliness in publication of this report is of high importance, higher than that for the ex-post pricing report. Based on this view of exposures in an external market Airtricity has proposed an adjustment both to the weighting and the target related to this report.

11.2.8 (Airtricity) Regarding SEMO related Resettlement queries, and with the requirement for full collateralisation in SEM and the serious penal consequences for not fulfilling the requirements of these notices, Airtricity are again of the view that the weighting and the target should be higher than proposed.

11.2.9 (Airtricity) Regarding general queries, Airtricity's view is that creating a comprehensive, prominent and well promoted FAQ section (beyond that currently available on the website) would minimise the quantity of general queries that SEMO receives. In other words an alternative, passive mechanism exists that will make a contribution to the management of queries. However given that an FAQ is unlikely to eliminate all queries, as well as in recognition that no T&SC obligation exists to require SEMO to respond to general queries, Airtricity propose that this incentive should remain but a much lower weighting than SEMO has proposed.

11.2.10 NIEES is opposed to the reduction of the target for the ex-ante and ex-post pricing publication reports and views this as a backward step.

11.3 SEMC FINAL COMMENTS AND DECISION

11.3.1 SEM Committee Final Considerations: Taking into account the market participant responses the SEM Committee determines that SEMO should be incentivised for the achievement of the following KPI targets:

	Weighting		Target		Upper bound	
	Current	Decided	Current	Decided	Current	Decided
Ex-ante pricing report	0.2	0.2	99%	99%	100%	100%
Ex-post initial pricing report	0.2	0.1	99%	99%	100%	100%
Invoicing	0.4	0.2	90%	95%	95%	100%
Credit Cover Increase Notices	0.2	0.2	98%	99%	100%	100%
SEMO related Resettlement queries	-	0.2	-	<15¹	-	10²
General queries	-	0.1	-	97%³	-	99%⁴

1. 15 or less Upheld queries incidents per quarter
2. 10 Upheld queries incidents per quarter
3. 97% of Queries answered within 20 Business days
4. 99% of Queries answered within 20 Business days

11.3.2 The following conditions will be applied:

1. The metric is delivered within one hour of the targeted time;

2. External factors demonstrably outside the Market Operator's direct control are excluded e.g. Limited Communication failure by Market Participant, late provision of data by System Operators or the Meter Data Provider, Government policy changes, Regulatory Authorities' policy changes etc.
3. In terms of assessing the KPIs, a measure be taken at the end of each quarter using the average value of each KPI over that period.
4. KPI incentive pot to be set at 3.0% of the total OPEX revenue for each year. The increase (from 2.5%) is justified by the fact that the SEM Committee has increased the targets of several KPIs. In addition the SEM Committee has introduced several measures to reduce SEMO's operational expenditure.

SEMC DECISION 17: SEM COMMITTEE PROPOSALS FOR KEY PERFORMANCE INDICATORS TO BE ADOPTED.

11.4 IT RELEASE SUPPORT CAPEX

- 11.4.1 SEMO has proposed that it be awarded €50,000 for every IT Release delivered on budget and within the scheduled time. Nonetheless, according to SEMO submission, penalties should not be applied on releases delivered with delay.
- 11.4.2 The SEM Committee would favour a mechanism whereby SEMO would receive penalties for late deliveries. However, the SEM Committee is minded of the fact that SEMO outsource a substantial part of the necessary effort to deliver each IT release. Therefore SEMO has limited liability on the achievement of dead lines. For that reason the SEM Committee decided to do not incentivise the IT Release CAPEX.

SEMC DECISION 18: NO PROVISION FOR IT RELEASE CAPEX INCENTIVE

12 K FACTOR

12.1 SEMC PROPOSALS FOR K FACTOR

12.1.1 The SEM Committee has proposed that the k-factor, derived from the OPEX allowance, should adjust allowed revenues each year to take account of any over- or under-recovery of revenue in the previous year compared to the revenue allowance set by the SEM Committee (not compared to actual costs).

12.1.2 For the CAPEX allowance the following conditions should apply:

- Any under expenditure in relation to the chosen package (from the menu of CAPEX choices) will be clawed back by the regulatory authorities via k factor.
- Any over expenditure in relation the chosen package will be provided for via k factor, limited to a cap of 13,807, above this limit SEMO will absorb the deficit.

12.1.3 The ex-post adjustment derived from the package choice will be determined by the following formula.

$$CAPEX\ k = (\min(13,807, Outturn\ CAPEX) - CAPEX\ Tariff\ Revenue) + (Reward : Penalty)$$

12.2 MARKET PARTICIPANTS RESPONSES AND SEMC COMMENTS ON K FACTOR

12.2.1 (PPB) suggested that the current lagged mechanism for the application of the K Factor (e.g. where the 2008/09 “k” is not applied until 2010/11), should be replaced by a mechanism where the best estimates to the “k” factor should be included in the next tariff period.

12.2.2 SEM Committee view: Although the mechanism suggested by PPB would involve estimates and the necessity for future adjustments, the SEM Committee is of the view that the benefits for consumers should outweigh the disadvantages.

12.3 SEMC FINAL COMMENTS AND DECISION ON K FACTOR

12.3.1 The SEM Committee has decided to reinforce its proposals outlined in section 12.1.

12.3.2 In addition, the SEM Committee has decided that the proposed removal of the lagged mechanism for the application of the K Factor should be implemented.

12.3.3 Uncertain costs that cannot be reasonably foreseen by SEMO should be dealt on a cost pass-through basis via K Factor adjustment. These costs could include:

- Changes in legislation or regulation that impose unforeseen costs to SEMO's operations and capital investments.
- Restructuring costs driven by changes in legislation.

12.3.4 In Addition, the K Factor adjustment should cater for the following:

- Any foreign exchange gains or losses will form part of the K Factor calculations as a cost pass through element.
- Depreciation and WACC will require a separate K Factor adjustment. This specific treatment is required given that the timing of the capital expenditure could deviate from the initial expectations and therefore will have a resulting impact on the depreciation and WACC costs.
- KPI rewards will be recovered through adjustment of the K Factor. Eventual penalties for over expenditure on capital projects (as per defined in the menu table for CAPEX incentivisation) will be collected by the SEM Committee via K Factor adjustment.
- Any actual net outturn tax loss that was clearly attributed to the new treatment of CAPEX will be recoverable via the k-factor adjustment – upon proof from SEMO/Eirgrid/SONI that it had been incurred.

SEMC DECISION 19: K-FACTOR TO COMPARE RECOVERY OF REVENUE TO THE REVENUE ALLOWANCE AND NOT ACTUAL EXPENDITURE. THE APPLICATION OF THE K-FACTOR SHOULD NO LONGER BE LAGGED FOR ONE YEAR.

13 FORM AND MAGNITUDE OF CHARGES

13.1.1 This Decision Paper by the SEM Committee includes decisions on the form of SEMO regulation and the allowed revenue for SEMO's OPEX. SEMO has been given a choice of several different CAPEX allowances with specific incentive schemes attached to each choice. The final set of tariffs derived from the SEM Committee approved allowances for OPEX and the SEMO's choice for CAPEX shall be published by SEMO by late December or early January.

13.1.2 The tariffs for the current year (which were already published by SEMO on 24 September) will not be immediately affected by this decision paper. The eventual difference between the allowed revenue for 2010-2011 and the tariff recovered by SEMO within this period will be adjusted via the k factor at the year end.