



**Response to Consultation Paper on  
SEMO Revenue and Tariffs  
October 2010 – September 2013  
(SEM-10-050)**

10 September 2010

## Introductory Comments

### *Performance of Service*

Airtricity would like to take this opportunity of responding to the SEMO price control consultation to state that in general it is pleased with the service delivery of SEMO till date. In our involvements in the market both as a SEM Party/Participant and as a continuing member of the Modifications Committee, our dealings with SEMO have been of high professional standards with SEMO being very supportive and a valued partner in efforts to improve the operations of the market. Our hope is that SEMO maintains, and indeed improves its performance of service to the market and its participants.

### *Value of Service*

SEMO performs a service provider function in the SEM of running market operations and from that vantage position, coordinating development of the market. This is a non-competitive activity, and while crucial, the cost implications of its tariffs for delivered electricity are minimal, possibly only a half percent. Given those conditions, it is imperative that the financing structures of SEMO are simple, transparent and easy to analyse. Furthermore, at a snapshot the tariffs attributed to SEMO should be largely reflective of the underlying operational and resource costs incurred in providing that service. Such a cost structure should make it easier to evaluate the value of SEMO's service delivery.

On the basis of these two broad thrusts we make our detailed responses to the consultation on SEMO Revenue and Tariffs for October 2010 – September 2013 on the following pages.

## Detailed Responses to Consultation

### *Form of Regulation*

Airtricity welcomes the intent of the RAs to shift away from the current price control for SEMO where the primary incentive for cost control is based on regulatory oversight and prospects of cost disallowance. Given the specialised nature of market operator functions, knowledge asymmetries between the regulated and the regulators would indicate that costs are best managed by the operator. Furthermore shifting to incentives that enable the operator to gain some benefit from cost reduction efforts ought to encourage it to seek efficiencies and increased productivity.

Airtricity agrees with the proposal by the RAs to move away from rate of return regulation for SEMO's CAPEX. SEMO's role as market operator is a service provider function, "operating on behalf of all market participants on the island". On that basis we do 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 its cost drivers. One benefit of this is that the impact to its resources imposed by external factors, such as policy or legislative changes, are easily identifiable and within reason, prioritisable. While this shifts away from multi-year profiled recovery of capital costs incurred, to potential large single-year charges, in the greater context the impact of this swing to market participants, or ultimately consumers, is minimal. SEMO's costs for recovery of about €24 million for example, pale significantly in comparison to Imperfections costs of about €107 million. Furthermore, the potential for upward swings, giving the rapidly declining residual RAB resulting from SEM implementation, are likely non-existent.

On the change in treatment of OPEX from pass-through to RPI-X regulation, which shields SEMO's revenues from volume risks, our view is that this is reasonable and concurs with the regulatory intent to shift away from intrusive measures.

### *K Factor*

The logic of the incentive-based system as the consultation notes indeed should allow the k-factor to adjust allowed revenues in comparison to the RAs set revenue allowance and not the actual costs. However it is important that actual costs, and their underlying drivers, are analysed and properly understood by the RAs to minimise the natural knowledge asymmetry between them and SEMO as that will form a crucial source of information for future price controls.

One of the caveats to the treatment of the k-factor refers to interest on funding from SEMO's parent companies. Airtricity seeks clarification on how that interest will be determined. Will it, for example, be some weighted average of the parents' aggregate debts incurred in the year, and will it be exclusive of any corporate service charges?

## *Payroll*

Airtricity commends the extent of detail undertaken by the RAs in analysing the payroll cost item. Given its proportional significance within the OPEX and the recent economy-wide downward pressure on wage costs, it is only reasonable to see efforts directed to contain, and even lower payroll costs. However as the analysis shows, significant subjectivity exists in this area of cost. Given the vagaries of determining these costs, to which Airtricity is not privy to all the underlying factors, it will not be in our place to make detailed representations. However one observation that we can make is that we do not see the continuation in logic from the inconclusive salary comparison results to the SEMC view on payroll savings in the range between 7% and 14.26% (5% per year) over 3 years. We do not understand the justification for the reduction proposal nor its range, and consequently we do see a basis on which to make a determination as to an appropriate target reduction percentage.

## *Pension Deficit*

Airtricity agrees with the RAs' views that "costs in excess of that required by an efficient notional company should be borne by SEMO's shareholder", and consequently that the treatment of pension deficits should not be addressed within this price control process. Our view is that this is not a market operations service cost, but costs for the parent co-operates to address.

## *Increased Use of Contractors*

Airtricity agrees that given the operational history of SEMO that the workload should at this stage be largely well understood and hence predictable. Hence the need for contractors, as demonstrated by experience from ELEXON, should be decreasing rather than increasing.

However, again from ELEXON experience, that need is not necessarily eliminated; even after its relatively lengthy operational existence, it still finds needs for a few contractors. As the RAs note in the consultation, staffing at SEMO "has grown under close regulatory and market scrutiny with the need for each increase fully assessed and justified", suggesting a lean operation. While that is the desirable operational structure for a service provider, it may still be reasonable to allow SEMO some use of contractors, at least for a year or two more and perhaps in proportionate numbers to ELEXON. One rationale for this lies with potentials for significant changes arising from current Trading & Settlement Code modification such Intra-day Trading and Global Aggregation, not necessarily to workload of which an argument may be made that existing staff can absorb, but to workflows, which may require some periods of sustained attention along a learning curve before being fully bedded down.

## *Additional Resource*

Airtricity agrees with the view to allow SEMO recruit a full-time staff to deal with administrative matters.

### *Real Price Effect*

Given the downward trends in inflation and wage growth from broad economic forecasts, we see a weak argument for a real price effect. However the specificities of the energy industry may present a counter-argument. While the effect the RAs identify regarding increase in courses in related subjects may be true, this in its own case may be counteracted by two factors: one, a time lag will still exist between the time new students enrol and when they graduate with relevant knowledge to address the labour inelasticity; and two, recent cuts in education funding will limit in the first the number of places available for interested candidates.

While the RAs have indicated the need for a reasoned forecast of broad economic factors for 2011 prior to firming up views on this matter, we would also recommend that further efforts be directed at exploring the effects of labour demand growth and supply inelasticity as alluded to in SEMO submission.

### *Other OPEX Items*

Airtricity has no detailed comments to make on the other OPEX items other than to note that nothing seems unreasonable in the approach taken by the RAs.

### *CAPEX*

The two RAs' proposals for CAPEX determination are interesting propositions. It is a welcome development to see the efforts the RAs are making to adopt techniques that seek to minimise intrusive regulation. On the basis that the menu regulation seems to offer the opportunity for SEMO to self-select its incentive profile, we would tilt towards it. Other than that we do not have a stated preference for either approach. Our recommendation would be for the RAs to leave it up to SEMO to choose between the Single Regulatory Offer and the Menu Regulation approaches.

Irrespective of the decision on that matter we agree with the four monitoring elements listed by the RAs to apply to either approach, with a slight recommendation that on the fourth element, to minimise uncertainty, the claw back of benefits be based on a 'demonstrable' basis rather than a 'deemed' basis.

### *Risk/Reward Balance*

Given the significant change in form of regulation as proposed by the RAs, we would wish the RAs consider in a bit more detail the potential and significance of asymmetric impacts of rewards and penalties on a 'lean' organisation such as SEMO. Given the removal of returns, which we support, the magnitude of penalties may need to be muted in relation to rewards, to prevent foisting a 'debilitating' attitude on SEMO.

## *Incentivisation/KPIs*

### *Ex-ante pricing report*

Given that the ex-ante pricing report fixes the MIUNS for interconnector units, and consequently forms exposures in BETTA that require execution of trades, we are of the view that timeliness in publication of this report is of high importance, higher than that for the ex-post pricing report. Based on this formation of exposures in an external market we have made an adjustment both to the weighting and the target of this report.

### *Ex-post initial pricing report*

No changes.

### *Invoicing*

No changes.

### *Credit Cover Increase Notices*

With the requirement for full collateralisation in SEM and the serious penal consequences attendant on not fulfilling the requirements of these notices, we view that again the weighting and the target should be higher than proposed.

### *SEMO related Resettlement queries*

We applaud the introduction of this measure which is aimed at increasing accuracy in SEMO's processes. While we agree with incentivising accuracy, we do not believe that it warrants the highest weighting proposed by SEMO. Consequently we have reduced it slightly.

### *General queries*

Regarding general queries, our view is that creating a comprehensive, prominent and well promoted FAQ section (beyond that currently available on the website) would minimise the magnitude 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, we view that this incentive should remain, but a much lower weighting than SEMO has proposed.

	<b>Weighting</b>	<b>Target</b>
Ex-ante pricing report	<b>0.2</b> *	<b>99%</b>
Ex-post initial pricing report	0.1	97%
Invoicing	0.2	95%
Credit Cover Increase Notices	<b>0.2</b>	<b>99%</b>
SEMO related Resettlement queries	<b>0.2</b>	<30
General queries	<b>0.1</b>	97%

\* Changes have been **bolded**.

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