



Consultation on SEMO Revenue and Tariffs

SEM-10-050

ESB Response

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ESB



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1 EXECUTIVE SUMMARY

ESB welcomes the opportunity to comment on the consultation of the Northern Ireland Authority of Utility Regulation and the Commission for Energy Regulation on the SEMO Revenue and Tariffs October 2010 – September 2013 (SEM-10-050).

The Energy Regulators are seeking to support SEMO in its functions while maintaining and enhancing cost efficiency and incentivising improvements in performance. ESB agrees with this general approach. However SEM is a young organisation operating a developing market that is crucial to the financial livelihood of many businesses and customers in two jurisdictions. We believe that radical departures in regulation mechanism or the pursuit of potentially deep cost cutting in human resources are not the priority at this point in the development of the market.

In this response paper we provide feedback as requested on the specific questions of how performance could best be enhanced as well as supporting the points made above.

2 INTRODUCTION

ESB welcomes the opportunity to provide its comments to the Northern Ireland Authority of Utility Regulation and the Commission for Energy Regulation consultation on the SEMO Revenue and Tariffs October 2010 – September 2013.

This response paper is arranged as follows:

Section 3 – Regulatory Principles

Section 4 – Form of Regulation

This states

Section 5 – Indexation

Section 6 – K Factor

Section 7 – Operating Expenditure

Section 8 – Capital Expenditure

Section 9 – Regulated Asset Base

Section 10 – Weighted Average Cost of Capital

Section 11 – Incentivisation

Section 12 – Form and Magnitude of Charges

3 REGULATORY PRINCIPLES

ESB agrees with the regulatory principles – sustainability, stability, transparency and predictability, cost effectiveness chosen by the RAs in the consultation. In addition to its duties in administering the SEM, SEMO provides services to the market participants. The list of principles omits mention of the requirement for SEMO to carry out its role efficiently. The RAs clearly set out this aspect in the role of SEMO (section 3.2). SEMO's role is summarised here as to 'facilitate the efficient, economic, and coordinated operation, administration and development of the Single Electricity Market in a financially secure manner'.

Efficiency is a crucial element in the effectiveness of SEMO's operations and this omission should be corrected by including efficiency in the list of principles.

4 FORM OF REGULATION

4.1 Operating Expenditure

ESB agrees with the RAs proposal to regulate operational expenditure using an RPI - X approach with revenue cap.

4.2 Capital Expenditure

ESB consider that the proposal to recover Capex via a revenue cap regime is not the most effective means of regulating this expenditure. In outlining the proposal the RAs have not set out their evaluation of the alternative options against the principles set out at the start of the consultation paper. For this reason it is difficult to establish the benefits of such a change or whether any precedents exist. A number of key points stand out:

4.2.1 Stability

As stated by the RAs, SEMO's capex is largely driven by IT projects. Projects take place within a distinct timeframe. Collecting revenue to the current year's Capex may cause the SEMO tariffs to vary strongly from year to year. This would have the opposite effect of the stability principle cited by the RAs. ESB do not agree that all significant IT projects will be driven by changes to the TSC or that changes to the TSC will be infrequent. Certain developments in the market such as global settlement will have impacts. Above all of this, the EU commission has set a deadline for integration of EU electricity markets by 2015. Presumably the work on this will need to commence within this price control or just after it. It is not advisable to abandon the smoothing effect of the current form of regulation when a project of this magnitude is approaching.

4.2.2 Practicality

SEMO does not appear to have a significant source of profits. As a result, it will be necessary for Eirgrid and SONI to borrow money to finance significant IT projects in the future. It is a fact of life that a return on investment is required to repay loans. The RAs may have strong views on what the level of this return should be, but a non-zero return is required. The RAs have not touched on the question of financeability or explained how their proposals meet this business requirement.

We note that the consultation paper refers to 'interest on funding from the parent companies' as part of the K factor calculations. It is not clear from the document that this is meant to

constitute the return. If this is the case, then the proposed arrangements will reduce the transparency of the regulatory control, rather than increasing it as suggested.

In our view, this proposal fails to meet any of the principles identified at the outset. It is also risky. We believe that it needs to be reconsidered and revised.

5 INDEXATION

ESB agree with the RAs proposal to use a blended rate of actual out-turn CPI and the UK equivalent, RPI as the means of indexation for inflation.

6 K FACTOR

ESB agrees with the RAs proposal on the K Factor:

- The k factor should be adjusted each year to take account of out-turn revenue against predicted revenue.
- The k factor should be adjusted each year to take account of out-turn against allowance while taking account of uncontrollable costs.

7 OPERATIONAL EXPENDITURE

SEMO's expenditures are subject to regular and detailed review between SEMO and the RAs. Accordingly, ESB does not propose to comment on the detail of the Opex proposals. We have some general comments on the process from the perspective of supporting SEMO in its service objectives:

- Subject to meeting performance targets, SEMO should be allowed flexibility in how it achieves Opex reductions.
- The ESRI evidence should be used as guidance when establishing the balance between reduction in cost on the one hand and, on the other, the improved performance of the human and IT infrastructure of the electricity market vital to Ireland and Northern Ireland.
- In the consultation paper, the RAs appear to be suggesting that higher staff turnover may be a desirable option for SEMO. This view raises a number of concerns:
 - As the RAs point out, SEMO is a relatively young organisation and one where the market has important development stages still ahead. SEMO's stock of expertise will be undoubtedly tested by these.
 - One of the crucial success factors in successfully completing major IT projects is the expertise of the business people working for the client company with the project. IT failures are very frequent and are expensive. It would be prudent to be wary of false economies.
 - Market operators tend to be repositories of expertise. Other companies in the market, themselves with higher staff turnovers, come to rely on this expertise.
 - SEMO, as a young organisation is still in the process of perfecting its business processes as evidenced by the current scope that exists for further improvement in performance.

For these reasons, a high staff turnover strategy would appear to be unwise at this stage in the development of the SEM.

8 CAPITAL EXPENDITURE

ESB agrees with the RAs proposals on incentivisation of efficiency in Capex expenditure. Menu regulation appears to provide more flexibility while still offering strong incentives to SEMO to complete its programme of works with appropriate downside where costs are not controlled.

ESB notes the RAs comments about benefits due to forecast error being clawed back. We would 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. We suggest that SEMO and the RAs should review the total when the outcome of the procurement processes is known and discount any forecast error between submission and procurement. In this context, we agree with the RAs proposal to assess SEMO's performance against the total IT Capex rather than project by project.

9 REGULATED ASSET BASE

We agree with the proposals in respect of the RAB. However as stated in 4 above, we believe the RAB method should also be retained in respect of future investments.

10 WEIGHTED AVERAGE COST OF CAPITAL

10.1 WACC

ESB agrees that the RAs proposal to use a blend of the WACCs of the parent companies, Eirgrid and SONI.

10.2 Depreciation Method

ESB agrees with the proposal to retain straight line depreciation.

11 INCENTIVISATION

In order to achieve significant change, incentives need to be symmetrical i.e. incorporate penalties as well as receive rewards. It is important also that measurement of performance against target does not exclude factors which are under SEMO's control. Therefore ESB agrees with the RAs 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. However SEMO must be allowed the flexibility to manage its resources including use of contractors in order to ensure that service is unaffected by major releases.

11.1 Proposals for new target and new KPIs

11.1.1 Existing KPIs

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. ESB believes that these KPIs are of importance to the market and that the targets should not be lowered. If the RAs decide to do so, it is crucial that the incentive include a penalty as well in order to avoid service levels dropping in the face of the Opex cuts proposed by the RAs.

11.1.2 Proposed KPIs

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.

ESB proposes that the market resettlement KPI should include queries arising from data provided by TSO in its role as data provider. As part of the Eirgrid group, SEMO can exert significant pressure on the TSOs as data providers to deliver to the market timetable.

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.

11.1.3 Opex Savings

ESB agrees with the RAs proposal that 'X' be set to zero.

11.1.4 IT Release support incentive

ESB agrees with the RAs proposal not to adopt the IT Release Support Incentive, at least in a reward only form.

12 FORM AND MAGNITUDE OF CHARGES

ESB believe the RAs on the form and magnitude of charges is reasonable.

13 CONCLUSION

SEMO has a crucial role to play and many businesses depend on its effectiveness. It has been very successful so far in this early stage of the SEM. ESB believes the focus should be on enabling SEMO to meet the challenges ahead while incentivising improvements in performance. ESB would argue that, at this point in the development of the SEM, these factors are the priority and not deep cost reductions or radical innovations in the regulatory mechanism.

ESB proposes the following

- Realistic reductions in Opex while maintaining the expertise that SEMO has built up.
- Maintenance of the existing system for regulating Capex i.e. use of a RAB
- Symmetrical incentives to support improvement in performance including the new incentives proposed.
- No diminution in target performance levels.