



Single Electricity  
Market Operator

MARKET OPERATOR  
SINGLE ELECTRICITY

## SEMO Revenue Control Consultation Response

**Consultation Response**

**Abstract**

*This paper sets out the issues SEMO have identified in the Regulatory Authorities SEM Revenue Control consultation paper.*

**Date – May 24<sup>th</sup> 2013**

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## Introduction

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SEMO welcomes the opportunity to respond to the SEM Committee's consultation on the Single Electricity Market Operator Revenue Requirement from 1 October 2013 (SEM-12-023).

In the consultation paper the Regulatory Authorities espouse five key principles which underpin their proposals: transparency, accountability, proportionality, consistency and targeting. However, in actuality the proposals as set out are often not transparent, at times inconsistent with previous decisions and in many instances not proportionate in terms of their impact on the service which will be received by market participants and consumers relative to the cost of its provision. In this response SEMO sets out:

- Why the levels of efficiency and the revenue cuts proposed are neither warranted nor substantiated and have not been applied consistently
- Why and how seeking to amend principles previously agreed has the potential to undermine regulatory certainty;
- How in determining the appropriate control framework both the nature of the business and specific licence conditions have at best not been addressed and worse than that in a number of cases overlooked and
- How the capex proposals are not supported by evidence and indeed are inconsistent with the expert advice procured by the Regulatory Authorities at customers' expense.

In support of its own proposals SEMO will set out how it has in the past been subject to regulatory imposed efficiencies and how it has responded; how it is now operating at the efficiency frontier, not by reference to its own assessment but by reference to the assessment of the Regulatory Authorities and how the regulatory model must evolve given the changing nature of the SEMO business both in terms of risk profile and in the need for significant standby capital provision.

The paper is structured as follows:

- The next section discusses the regulatory model itself and the nature of the business, risks, incentives and licence obligations;
- The following section discusses inconsistencies in the application of the current framework;
- The Regulatory Authorities capital proposals are then discussed by reference to the Gemserv report provided to SEMO<sup>1</sup> and
- Finally SEMO considers the overall revenue cuts and level of efficiencies proposed to be imposed upon SEMO and why these are unjustified.

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<sup>1</sup> SEMO recognises the Gemserv report has not been published and was provided on a confidential basis to SEMO.

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## Fit for Purpose Regulatory Model

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### The Nature of SEMO's Business

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The prevailing regulatory framework for the SEMO control is formed on the traditional RPI-X based building block approach. This framework has been designed for the traditional utility where the primary focus is on incentivisation and ensuring that the utility delivers physical infrastructure in an efficient manner.

SEMO however is not a typical utility and rather more a business service company operating in the utility sector. SEMO's asset base comprises starkly different assets to that of a traditional network utility. It has a relatively higher proportion of intangible assets such as human capital, intellectual capital, brand and reputation and relatively low levels of physical, or traditional RAB based, assets. These forms of intangible assets are not always recognised on the balance sheet but are nevertheless intrinsic in the ability to provide the necessary service.

Asset light utilities differ greatly to traditional utilities:

- Deliver a fundamentally different form of product/service and value add
- Significantly greater systematic risk (high operational gearing)
  - I. Liquidity Risk
  - II. Recoverability Risk
- Scope to incentivise over and above cost efficiency incentive

### The Nature of Incentivisation of an Asset Light Business

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A traditional infrastructure utility delivers enhanced customer value primarily through deploying physical assets in a more efficient manner i.e. reduction in financial and operational costs. The regulatory framework, in the first instance, rewards the traditional utility for this enhanced value and this benefit is then shared with customers. In order to create enhanced customer value and deliver services asset light utilities combine intangible assets of human capital, intellectual capital, brand and reputation. Combining these assets effectively creates significant NPV positive outcomes. However, in a somewhat unique situation the value created primarily flows to third parties and not the business itself. Recognition of this anomalous situation is required in the regulatory framework.

The regulator must put in place a framework to incentivise the delivery of these NPV positive outcomes; too great an incentive on solely driving down costs can be at the expense of potentially much more valuable continued high quality service provision. In that sense the incentives can become perverse and lead to worse as opposed to better outcomes for consumers. SEMO is concerned that this could in fact be the case under the arrangements proposed by the Regulatory Authorities; firstly the incentives to become more efficient differ dependent upon the year in question when SEMO is faced with the efficiency choice. This is not best practice. Secondly, the

absence of sufficiently powered incentives to deliver continued high quality service quality levels may result in the natural incentive to reduce service quality in order to be able to live within an ever tighter revenue cap. This both diminishes consumer value and increases risks to market participants. There is no evidence that this has been assessed by the Regulatory Authorities and SEMO would urge the Regulatory Authorities to look at this again before putting proposals to the licensees.

Furthermore, in the consultation paper the Regulatory Authorities suggest they are considering the introduction of symmetrical incentives in relation to KPIs. Downside in relation to incentives must be assessed by reference to the underlying return on equity of SEMO. It is clear this has not been done as such analysis would show that given the regulatory model SEMO does not have the ability to absorb downside risk.

### Assessing the Financeability of SEMO's business

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The regulator has two key statutory objectives in relation to the revenue control:

- (a) to protect the interests of customers; and
- (b) to ensure that licensees are able to finance their activities.

These objectives are complementary rather than mutually exclusive. A regulator can assure itself that it meets these objectives through providing an efficient level of revenue which allows a licensee to be financeable by ensuring:

- competitive market forces and outcomes are mimicked.
- that an equivalent to an investment grade credit rating is supported.
- a comparable return to return earned by efficient businesses with similar risk profile.
- return supports and sustains capital for assets and working capital incl. a reasonable buffer to accommodate unanticipated financial shocks.

In this consultation paper there is no evidence that this has in fact been carried out or how the Regulatory Authorities propose to satisfy themselves that this obligation is met by reference to business characteristics, risks faced, investments and service required. Instead there are the following general statements *'given that the current framework has been tried and tested over a number of years .... the RAs are not minded to make any significant changes to the existing framework'* and a further statement that *'work will continue in this area, however it is unlikely that any conclusions will be reached in time for the implementation of the 2013 SEMO price control'*.

The first of these statements is in fact factually incorrect. The declining Regulatory Asset Base (RAB) of the SEMO business means that it is in fact much more highly operationally geared and therefore exposed to greater risk than in the case of previous price controls. Further details in relation to this are set out in [Annex III Operational Gearing and Risk](#).

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The second statement suggests that Regulatory Authorities recognise there is an issue but just haven't had the necessary time to get around to it. SEMO would point out that the need to address issues associated with the regulatory model for asset light businesses was first raised by them some time ago. The absence of time to address what is a fundamental issue as part of the price control does not appear to us to be an argument capable of standing up to scrutiny and these issues must be addressed as part of this control.

### Remunerating SEMO's Licence Obligations: the Parent Company Guarantee

There is as a result of the decision of the SEM Committee (SEM-08-176) a requirement for EirGrid to put and keep in place a Parent Company Guarantee (PCG) in respect of the SONI Market Operator licence. This PCG is entirely unremunerated in the current regulatory structure despite the fact that it is a regulatory requirement to have it in place. This PCG has been put in place by the regulator precisely to manage the sort of risk exposure (some of which is liquidity and some of which is revenue/ credit) that the licensee is exposed to. Yet while the regulator recognises the risk exposure on the one hand it has not remunerated it on the other.

The PCG is in general contingent capital (except where drawn upon) and should therefore be remunerated appropriately consistent with this. Further details on the appropriate remuneration of the PCG are set out in [Annex III Operational Gearing and Risk](#).

This section has set out how if a fit for purpose control is to be put in place the overall regulatory framework will have to evolve. The following sections consider the application of the current framework.

### Inconsistencies in Regulatory Approach

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A stable and certain regulatory regime enables regulated businesses, and ultimately customers, to access low risk sources of finance. Conversely regulatory uncertainty, which results from the amendment of previously agreed or set out regulatory principles, increases costs to regulated businesses and ultimately consumers.

This section sets out:

- Errors in the basis of the application of previous regulatory determined manpower costs;
- Inconsistent application of a roll forward of the previously determined baseline by reference to the requirement for contractor costs;
- Inconsistency in the Treatment of Facilities Costs and;
- The absence of clarity and consistency in the treatment of pension deficit costs.

### Rolling Forward the Previous Determination - Payroll

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In the consultation paper the Regulatory Authorities propose determining payroll costs by virtue of a rollover of their previous decision in respect of efficient average payroll costs made in 2010. However, in so doing they have applied a headcount figure which is not consistent with their previous build up, even having adjusted for a reduction consistent with 1 FTE. As a result the revenue allowance needs to be adjusted in order to apply that which has been stated to have been applied consistently. The detail of this adjustment is set out in [Annex I The basis for the Assessment of Manpower Costs by Reference to Headcount](#).

### Rolling Forward the Previous Determination - Contractors

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The Regulatory Authorities have proposed that in relation to manpower costs that it is their intent to roll forward the previously determined baseline. However, this is not what has been done in all instances. In particular the Regulatory Authorities proposed treatment of contractor costs is not consistent with this and it appears that the level of contractor costs provided for in the previous determination has been inadvertently omitted. In so doing it appears there may have been some confusion between the increased requirement identified by SEMO for the forthcoming period with this underlying requirement which the regulators have previously determined is required and appropriate.

Failure to provide for contractor costs is to provide for no ability for SEMO to manage periodic fluctuations in resource requirements including statutory requirements such as the provision of sickness and maternity cover. A revenue allowance for contractors, consistent with that in the current control must be reinstated.

### Rolling forward the Previous Determination - Facilities Costs

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The previous SEMO price control provided that the costs of facilities faced by SEMO be provided in full. As a joint venture SEMO has no facilities itself but rather receives apportioned costs from both EirGrid plc. and SONI Ltd. on a headcount basis. EirGrid has previously provided its cross charging policy to the Regulatory Authorities and it would in accordance with its licences be required to advise the Regulatory Authorities was it proposed to change this.

In setting out its facilities revenue requirements for the forthcoming period SEMO took the previous apportionment and scaled it for the relative change in SEMO headcount over the period. It is recognised that this is a proxy that does not seek to account for ongoing fluctuations (for example the increased use of contractors by SEMO during the IDT project) nor does it take account of SEMO specific characteristics such as the greater than proportionate use of IT server space by SEMO. Nonetheless it has the virtue of being previously agreed. SEMO does not believe it is appropriate that this somehow be re-considered by the Regulatory Authorities as part of this SEMO control in isolation and without a corresponding amendment in the TSO and other controls which has been neither signaled nor provided for.

In relation to costs associated with SEMO's facilities in Castlereagh House the Regulatory Authorities appear to have previously as part of the SONI control misinterpreted their own position and now appear to be proposing to continue with the perpetuation of this error going forward.

On page 34 of the consultation paper the Regulatory Authorities state that *The decision was taken to include the costs of the SONI Market Operator as being the most appropriate treatment of SONI's overall facility costs*. The assumption being that SEMO's facilities have been catered for in the parent price controls. After reviewing the SEMO 2010 control decision and the SONI 2011 control decision no historical decision on the SEMO or SONI controls supports the assertion made in the consultation paper.

The full cost of facilities has previously been provided for in both jurisdictions in the SEMO control and, rightly, no adjustment was made to the SEMO control following the SONI price control determination as none was warranted given that the SEMO element of cost (apportioned) had been included in the previous SEMO control and was therefore excluded from the SONI control; this is despite an inaccurate statement in the SONI determination stating that it was. The cost of facilities cannot however be excluded now simply by virtue of an inaccurate statement elsewhere. To that end the full facilities costs faced by SEMO under the regulatory arrangements pertaining must be reinstated in the final determination.

### Rolling forward the Previous Determination – Pension Deficits

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The recovery of past pension deficit is a legitimate cost of doing business; in assessing the overall efficient level of revenue then the risk of over/ under recovery on pension liabilities falls to final



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customers. This is widely understood and readily accepted across economic regulators (Utility Regulator, Ofgem, Ofwat, Competition Commission).

While the SONI pension deficit was addressed in the SONI System Operator price control (although at the expense of cross subsidisation from the Market Operator to System Operator) the Regulatory Authorities have not addressed the issues of the EirGrid pensions deficit which has resulted from the carrying out of regulated activities in the past and was largely foisted upon EirGrid at its establishment by virtue of the legislative arrangements pertaining. This is despite a previous commitment to do so.

The Regulatory Authorities and CER in particular, have not outlined an argument as to why it does not now propose to address these matters. The CER has previously indicated it will address the issue of pensions deficits; yet when it has been presented with the opportunity here to finally consider these matters it has not done so nor has it stated why it has not.

SEMO strongly believes the attributed cost of pensions deficits should be provided as part of the revenue allowance. This is both as a general principle but particularly in the case of SEMO given that these largely relate to costs imposed upon it by legislative arrangements. To do otherwise imposes further impediment upon the SEMO balance sheet which it is not in a position to manage by virtue of the legislative constraints which are placed upon it. The revenue associated with the repair of pension deficit costs must be provided or at the very least the CER must provide clarity as to when, and on what basis, they will be assessed.

### Proposals for the Provision of Capital Expenditure

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In the consultation paper the Regulatory Authorities propose a significant reduction on the necessary capital expenditure for the forthcoming period. This is notwithstanding the requirements identified by SEMO were considerably lower than both previous allowances and actual levels of expenditure. Effectively while changes to the market systems are provided for, although with unsubstantiated reductions in support expenditure, capital expenditure associated with the development of the SEMO systems to support its operation are effectively being proposed to be cut by 40% across the board.

### Predictable Capex

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As the Regulatory Authorities note in their consultation they employed expert consultants Gemserv to advise them when it came to capital requirements and level of expenditure. This report has been provided to SEMO on a confidential basis. However, in putting together the consultation proposals the Regulatory Authorities have inexplicably disregarded the consultant's advice.

With the exception of a small number of projects Gemserv believes the capital requirements are well justified and supported. This is welcome. Moreover Gemserv proposed in their report that an allowance based upon 95% of that sought for the projects it believed were supported seemed reasonable or appropriate. However rather than accept this recommendation the Regulatory Authorities have proposed an across the board 35% cut without substantiation other than by reference to previous expenditure against capital project forecasts prepared on an entirely different basis. This is to suggest that on the Regulatory Authorities assessment, that SEMO's estimates are 50% higher than that which is reasonable. In the Gemserv report, Gemserv does recognise that these are forecast *ex ante* provisions and therefore that the outturn will ultimately differ. This it states makes it difficult for them, Gemserv, to be definitive also. However, had Gemserv believed that the estimates as provided by SEMO were overstated by a factor of 50% then it would have been incumbent on them to point this out; rather Gemserv suggested that an allowance of 95% of that forecast by SEMO be provided for the projects it believed to be both worthwhile and justified.

The reality of the allowance proposed, and with the rules as specified, is that SEMO is unlikely to be in a position to carry out any of the projects. This is despite the fact that all parties concerned believe that they are required. Their non delivery would create an unacceptable level of risk for SEMO and the SEM itself. The statement by the Regulatory Authorities in their paper that the Menu provides for where such disagreement between the Regulatory Authorities and SEMO exists as to the cost of delivery is disingenuous; the Menus do not encompass or provide for SEMO's submitted amount or Gemserv's 'up to' amount and if either SEMO's or Gemserv's proposals were delivered would result in a loss making venture under all Menu choices.

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In summary the RA proposed approach is not well supported or evidence based. The scope of the work identified by SEMO is well defined and costed from a bottom up perspective through preliminary discussions with vendors on a more detailed basis than was possible under the previous price control. The predictable capex should be provided for (less any items which require further cost benefit) at a central point on the Menu consistent with Gemserv's 95% recommendation. If SEMO disagrees with this, which it does while recognising that these are all estimates in a world of uncertainty, then SEMO can choose a Menu package, but with a lower reward consistent with its own submission (again adjusted for any projects it is assumed will not proceed) [Annex IV Capital Expenditure](#).

### Unpredictable Capex

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No provision is made in the price control proposals for unpredictable capital expenditure. This appears to be because the Regulatory Authorities maintain that 'all proposals seem well provided for' and it is 'expected that savings will be made' and therefore there is no need to allow for unpredictable capital spend. However, in relation to unpredictable capex Gemserv recognises there will be a need to deal with uncertain capital items as and when they arise and believe the proposed submission appears reasonable. It appears there is some confusion in the Regulatory Authorities as to whether this is contingency against the predictable capex items as opposed to what it is i.e. seeking to deal with unforeseen capital requirements which may/ will arise in the course of any control. We would note that Gemserv believed this provision was reasonable. It should be separately provided for.

## Revenue Cuts and Assessment of Efficiencies

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Overall therefore the paper proposes significant revenue cuts (well in excess of 10%) against SEMO's future identified revenue requirements for the forthcoming period. This is despite the fact that SEMO employed considerable effort and provided substantive material supporting all of its requirements.

In addition to the specific cuts to the baseline level of expenditure, a number of which we have specifically addressed in the section on Inconsistencies in Regulatory Approach above the consultation paper proposes the application of a 1% ongoing X factor: this is neither justified nor supported in the paper.

It is widely accepted that efficient costs will move in real terms by the expected shift in the frontier on the one hand and the movement in input costs in real terms (Real Price Effects) on the other. The Utility Regulator recently commissioned First Economics to consider the rate of frontier shift<sup>2</sup> as part of its analysis for the Northern Ireland Water (NIW) price control. First Economics reported that while annual total factor productivity improvements in utilities was of the order of 1 – 1.7% per annum that for Business Services (effectively akin to SEMO's business) was only 0.3% per annum<sup>3</sup>.

The implication is that there is limited opportunity for ongoing productivity improvements in Business Services firms and that, even before real price effects the costs of efficient business services businesses could be expected to increase in line with or above general inflation. This is not surprising as there is inherently limited scope for capital substitution in these businesses.

In addition Real Price Effects which may pertain do not appear to have been examined. Such an oversight is surprising given the significant effort taken to consider Real Price Effects for other recent control determinations such as Northern Ireland Electricity (NIE) and NIW. Both these determinations forecast significant Real Price Effects for both general and in particular Specialised Labour.<sup>4</sup> The nature of SEMO's business with specialised economic, market modelling and IT skill sets required means that its own labour base is more specialised than most. These Real Price Effects would, if

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<sup>2</sup>First Economics *Water and Sewerage Services Price Control 2013-15: The Rate of Frontier Shift Affecting Water Industry Costs*: December 2012

<sup>3</sup> Moreover this is Total Factor Productivity growth for all firms – efficient and inefficient and as stated in the First Economics report as a result the Competition Commission makes an adjustment of c.0.5% per annum to reflect not frontier shift but Catch Up Efficiencies.

<sup>4</sup> First Economics *Water and Sewerage Services Price Control 2013-15: The Rate of Frontier Shift Affecting Water Industry Costs*: December 2012; First Economics *Real Price Effects: Prepared for the Utility Regulator*, August 2012

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applied appropriately, suggest a trend in revenue requirements greater than RPI/CPI as opposed to the RPI/CPI – 1% proposed.

To suggest that SEMO could achieve a 1% ongoing efficiency (on top of the efficiencies imposed both previously and as part of this control) would be to suggest that other more traditional utilities could achieve ongoing efficiency of 3%+ per annum. This has never been suggested in their case nor could it be as it is not supported empirically; equally neither is the proposed 1% per annum efficiency supported here. Further material responding to the points raised by the Regulatory Authorities in the consultation paper is provided in [Annex II Analysis of RA Statements re. Application of X Factor](#).

## Summary and Conclusion

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In the paper the Regulatory Authorities acknowledge SEMO's good performance to date and the results achieved against stretching targets and efficiencies in the current control.

The cost of SEMO's operation and the associated tariffs will under SEMO's proposals further reduce in the forthcoming period.

The cost of the operation of the market is significantly less than 1% of the total cost of electricity to consumers; yet the value of a well functioning and well managed market, as opposed to one starved of resources and capital, is many many times this.

It is against this background, and in this context, that the SEMO Price Control proposals must be assessed.

In this response to the consultation paper SEMO has set out:

- Why leaving the regulatory model unaltered is not an option and will not ultimately lead to fulfillment of the regulator's statutory obligations;
- Why within the context of the current model there must be consistent application if regulatory principles and regulatory certainty are to be preserved;
- How the capital requirements cannot be delivered against the revenue provided despite the fact that they are agreed by all to be in the customers' interests
- How the level of cuts proposed and ongoing efficiencies imposed are not substantiated and indeed at variance with recent regulatory practice elsewhere.

Ultimately the Regulatory Authorities must ask themselves what is in the interest of consumers? SEMO believes this is very clear. Consumers expect, indeed have a right to demand, a well functioning and efficient Market Operator. Of course it is incumbent upon SEMO, and the Regulatory Authorities that regulate it, to provide for only an efficient level of expenditure; SEMO fully supports this. However, even more importantly than this the Market Operator must deliver a high quality service to market participants and consumers. The Regulatory Authorities themselves recognise this several times in the consultation paper. Unfortunately the proposals themselves as consulted upon do not ultimately fully support the provision of service standards that participants have come to expect and if anything will have an adverse impact on service levels. SEMO urges the Regulatory Authorities to address these matters in its final determination.

## Annex I

### The basis for the Assessment of Manpower Costs by Reference to Headcount

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In the consultation document the RA's have stated that *'In recommending a payroll allowance for SEMO, the RA's have used the agreed baseline which was agreed in the 2010 decision paper, and adjusted this to align with headcount'*

The 2010 decision paper quoted a baseline headcount of 55.

*SEMC Decision 3 – Allow current baseline of 55 staff*

*SEMC Decision 7 – Approve one additional headcount in setting the baseline for new price control*

This therefore equates to an assumed headcount for the purposes of calculating a payroll allowance for the 2010-2013 period of 56. The Intraday Trading and Fuel Mix disclosure numbers were subsequently added to this. The cost of resourcing associated with the Guarantees of Origin are ultimately recovered through Transmission Use of System in Ireland and is included in the payroll numbers but ultimately netted off the Corporate Charges.

### Application of Payroll Baseline Principle

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The Consultation document (Pg27) states *'In recommending a payroll allowance for SEMO, the RA's have used the agreed baseline which was agreed in the 2010 decision paper, and adjusted this to align with headcount'*. If that was the case the amount allowed in the 2010-2013 decision should be adjusted from 56 to 63.

### Adjusting for Headcount

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In table 9 of the Consultation document the Regulatory Authorities proposed a baseline headcount of 63 however the calculations in Table 11 only allow for 62. SEMO has included a headcount of 64, however the consultation suggests a reduction of 1 to 63. Using the other principles adopted by the RA's in their consultation document and applying the baseline adjusted for headcount the payroll allowance should be corrected for an approved headcount of 63.

### Applying the Baseline in the 2010 Control

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There is an inconsistency in the amounts used as an average based on the 2010 decision. The amount applied for the headcount reduction is the corrected average however the average applied for the additional resources is not reflective of the 2010 decision and is therefore inconsistent (it is a lower average). This is not consistent with taking the 2010 decision and adjusting it for headcount as the Regulatory Authorities have stated.

## Annex II

### Analysis of RA Statements re. Application of X Factor

In this annex we outline why the arguments proposed by the Regulatory Authorities for the application of an ongoing 1% efficiency, or 'X' factor, are unsubstantiated.

1. *SEMO have achieved efficiencies in the first two years of the 2010 price control*

This statement is by reference to the past and has no relevance to ongoing efficiencies; the Regulatory Authorities set out their view of a trajectory towards the efficiency frontier as part of the last control and SEMO has had to respond in order to be able to cope within it. This does not point to any evidence of the appropriateness of ongoing real reductions or an ability to deliver further efficiency going forward.

2. *For the foreseeable future pay increases are likely to be below RPI in Northern Ireland and CPI in Ireland*

This point is unsubstantiated and directly contradictory to other recent regulatory reports which have forecast positive Real price Effects for labour costs (see discussion in the general text)

3. *Although an element of SEMO's workforce is specialised many of the IT and business processes within SEMO are relatively generic. It is the RAs view that any leavers during the 2013 price control period can be replaced by staff on lower remuneration packages*

There is no evidence that this is the case and none has been provided. In fact the Regulatory Authorities previously benchmarked remuneration levels in SEMO and applied efficiency targets more stretching than that supported by the benchmarking. Moreover many of the skill sets required within SEMO are specialised and currently in high demand.

4. *SEMO have confirmed 1 FTE is not currently recruited yet their payroll allowance is commensurate with staff levels being at full capacity*

We do not understand the relevance of this which appears to relate to the baseline level of revenue which is appropriate. The Regulatory Authorities have set their view of an efficient baseline; the X factor is about ongoing efficiencies achievable year on year.

5. *All EirGrid staff have membership of a defined benefit pension scheme. Other similar companies have achieved efficiencies in this area.*

EirGrid operates the model defined benefit scheme approved by the Department of Finance. We are not aware of any companies operating under the Department of Finance guidelines which have achieved any such savings as described. Ultimately in any event the RA benchmarking looked at the



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total cost of remuneration and set it at the RA's own assessment of efficient levels (including pension costs)

- 6. Considerable Capex was incurred in the current 3 year price control which should provide opportunity for operational efficiency in the forthcoming years. There is no identified reduction on the Opex allowance with any of the Capex projects.*

As with point 1 this is historical and the efficiencies associated with previous capital projects were taken into account in setting the previous price control and in SEMO's response. Going forward, many of the capex projects relate to hardware refresh and capital equipment replacement and do not generate opex savings. More generally we would note that in the consultation proposals the necessary capital has not been provided for.

- 7. Greater experience of operating the settlement market comes from SEMO's operations having reached a level of maturity. The RAs want to encourage SEMO commitment to effectively operate the market through the continuous improvement of the market process*

The Regulatory Authorities appear to be talking about incentives and revenue cap regulation. These incentives exist regardless of the application or otherwise of an X factor and in no means support it. This statement does not therefore support the ongoing application of efficiency targets.

In the main body of the text we have outlined why it is that the fundamental macroeconomic variables do not support this ongoing 1% X factor. We have also outlined how the overall basket of incentives placed upon SEMO must be such that appropriate outcomes are achieved for consumers and that the proposals as set out risk both the basic operation of the market and the ongoing ability to provide continued high quality service levels. The X factor of 1% should therefore be removed from the final determination proposals.

Annex III

Operational Gearing and Risk

In its submission SEMO set out how it would in the context of the forthcoming control be exposed to significantly increased operational gearing and how this would increase both its liquidity risk in respect of fluctuations to which it is exposed but ultimately remunerated (via the k factor process) and also in respect of credit/ revenue risk relative to unanticipated events which may affect either, or both the revenue cap and the capital programme.

The Regulatory Authorities have asked SEMO to clarify the points raised by SEMO in respect of increased operational gearing. In the table below SEMO sets out the evolution of the SEMO RAB. It is evident that following the write down of the initial investment in SEM that the RAB has declined significantly and will continue to do so for the forthcoming control period. Meanwhile operating cost revenues have remained largely constant or indeed risen slightly in real terms with the Intraday requirements.

Year	Average RAB (€m)	Ratio of Operating Costs: RAB	% Fluctuation in Operating costs which gives rise to variation in equity return of 50%
2010/11	€24m	2.4:1	3.8%
2011/12	€19m	1.9:1	3%
2012/13	€16m	1.6:1	2.5%
2013/14	€13m	1.3:1	2%
2014/15	€11m	1.1:1	1.7%
2015/16	€8m	0.8:1	1.25%

The table above is illustrative of the scale of the effects (this table is not a precise calculation of the RAB and assumes a constant operating cost revenue requirement of €10m)

The equity return is calculated by reference to the notional gearing in the regulatory determined WACC and prior to consideration of the real/ nominal cash squeeze.

Prior to 2010 the ratios would have been even greater. Therefore by 2015/16 an unanticipated fluctuation in operating costs will have three times the impact on the underlying equity return on the business when compared to 2010/11. Without the decision to address future investment through a Regulatory Asset Base the situation would have been significantly worse again. This means the business is by the end of the forthcoming control three times as exposed to such risks relative to the position at the start of the last control; this is equally the case in respect of all other variables which affect the SEMO business (energy demand, unanticipated inflations etc.). An over-forecast of the energy volumes necessary to recover the required revenues of <1% immediately wipes out any equity return on the business for the year in question and requires the business to dip into standby capital or balance sheet reserves to manage it. The arrangements under the k factor are inadequate to deal with this and were never designed with such asset light businesses in mind.

The Regulatory Authorities appear to have made no attempt to consider the level of standby capital that needs to be maintained by the SEMO business, or its parents, to manage such risks<sup>5</sup>. This is notwithstanding that the Regulatory Authorities require such standby capital to be held (see below). To state that interest is provided on under-recoveries when this interest does not even cover the time value of money, or the risk free rate assessed by the Regulatory Authorities themselves does not reflect the cost to the business of financing any such under-recoveries is not a statement which stands up to even the most cursory scrutiny. Rather the Regulatory Authorities have failed to grasp both the credit and liquidity risks involved in the management of the SEMO business.

### Financeability Risk

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SEMO's risk profile differs to that of a traditional utility and the set of circumstances which SEMO now face along with the regulatory rules which the Regulatory Authorities wish to apply has significantly increased the financeability risk of the Market Operator licensees.. The paper states that *'The RAs do not perceive SEMO's risk profile will increase for the current control'* (page 60). As per the facts set out above this statement is factually incorrect. The licensees would contend that:

1. The revenue cap along with the proposed revenue cuts, substantially increase the risk of having insufficient revenue to meet the day to day costs of the business.
2. The risk profile is related to the operational gearing of the business which continues to increase substantively and
3. The level of capital expenditure proposed threatens the ongoing viability/ sustainability of the business much more so than under than previous controls.

### Asset Light

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SEMO would maintain that the Regulatory Authorities have not seriously considered that financeability or otherwise of the MO licensees and no assessment that the business's has the ability to manage risk and unanticipated events (recoverability, credit and liquidity risk) has been carried out.

In relation to providing support for an Asset Light business such as SEMO, the consultation paper states that *'it is unlikely any conclusions will be reached in time for implementation of the 2013 SEMO price control'* (page 12) and *'Given that the current framework has been tried and tested over a number of years without any significant issues'* (page 12).

To take just one such facet of the necessity for standby capital EirGrid plc. is obliged to have in place a Parent Company Guarantee for SONI Ltd. in its capacity as SEM Operator This is a licensed activity

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<sup>5</sup> This was a key facet of our discussions with the Utility Regulator and their consultant First Economics

yet is currently totally unremunerated. This situation cannot be allowed to continue; we do not understand why the Regulatory Authorities have overlooked this in their consultation proposals. At a meeting held with the Utility Regulator on 12<sup>th</sup> March 2013 it was, as we understand it, accepted that given this was a licence requirement that it is necessary this be remunerated in line with the statutory obligations of the regulator to ensure licensees can finance their activities.

### ***Proposal to remunerate the Licence Required, currently unremunerated Parent Company Guarantee***

Specifically SEMO believes:

- The PCG to be treated as being geared consistent with the notional gearing applied by UR in determining the SONI WACC;
- The equity – which must be held as standby capital – to be remunerated as per the return on equity in the SONI WACC (index adjusted recognising that there is no RAB to be indexed)
- The debt to be recognised as a contingent commitment based upon ‘commitment fees’ as are generally incurred in putting in place such facilities.
- Where drawn or required (as a result of liquidity shortfall/ reasons) the cost of debt to be remunerated at the regulatory provided for cost of debt under the SONI WACC rate.
- Where drawn as a result of credit risk no additional specific remuneration of the PCG to be provided (to do otherwise would be to undermine the regulatory revenue cap). The additional risk that this will occur however to be provided for elsewhere within the control architecture for a regulated business of this nature.

This is consistent with the general capital requirements and less costly than having the entirety of such a facility held as standby cash.

This is only one aspect of the overall requirements to deal with SEMO as an Asset Light utility; it is however one which must be addressed in this forthcoming control.

## Annex IV

### Capital Expenditure

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On page 12 of the Consultation Paper it states that *The RAs agree it is important to allow SEMO an adequate CAPEX allowance to ensure the SEM continues to meet stakeholder expectations*. SEMO agree with this sentiment but the current capital provisions proposed are inadequate to deliver the capital needs of the SEM market and participants over the next three years. Without sufficient and sustained capital investment the current service and support expectations which are proving difficult to maintain will be even more challenging. This unsubstantiated 40% cut in capital revenue will have a detrimental effect on the proposed capital programme.

SEMO are currently obliged under the Trading and Settlement Code to deliver:

**Greater Market Transparency** – Market transparency is facilitated through the publication of large volumes of market data in a timely and structured fashion. Participants and potential investors are dependent on the timely provision of this information. The Website project, Corporate Systems and Mobile Apps all support the Code objective of sustaining and potentially improving market transparency. With the current proposed cuts in capital revenue SEMO are in serious risk of breaching the Code and failing to deliver on the Code objectives.

**Capital Project Caveats** - The current capital caveats do not encourage capital savings as the individual implementation of capital project is often more costly. Claw back arrangements are also untenable and a hindrance to consolidated capital investment. How is it proposed under the arrangements proposed to evaluate forecast error v efficiency gains? It is assumed that SEMO can make savings despite an unsupported overall capital revenue cut of 40%. Are SEMO to be compensated for forecast error, and if so how is this compensation to be applied?

**Reporting and Data Storage** - The current website and corporate system infrastructure is obsolete and out of support. Participants, Stakeholders and the Regulatory Authorities require multiple daily reports for the operation of a 3 billion euro market. The current capital proposals require a relatively minor investment to counter the real risk of report or data storage failures.

**Service Levels** - The current proposed capital cuts will have an impact service levels going forward. SEMO require sustained investment in the Corporate Systems, SharePoint and SupportWorks to maintain current service levels. Failure to invest in these systems will have a detrimental impact on service levels.

# SEMO Revenue Control Consultation Response

## Consultation Response

**Security-** Further investment is required in improving the security arrangements of a €3billion market. SEMO would be negligent if adequate security were not provided for such a large volume of financial and energy transactions.

## Annex V

### Incentivisation- Key Performance Indicators

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On page 3 the paper states that *The RAs are of the view that it will be important to continue to provide SEMO with the right incentives to maintain their current good performance.* SEMO agree with this viewpoint but would question the business cost/benefit associated with delivering high performance levels. The Regulatory Authorities also *expect a strong KPI performance and clean market audit reports throughout the duration of the 2013 price control.* Based on the current empirical evidence this is not the case as SEMO's overall performance levels have dropped from 82% to 68%. These outturn performance levels demonstrate four things.

1. The proposed performance targets are too stringent by reference to SEMO's historical performance;
2. SEMO now run a real risk of incurring penalties SEMO can ill afford if the Regulatory Authorities introduce their proposal to penalise poor performance levels;
3. In some cases the incentive offered doesn't compensate sufficiently for the effort required in delivering the KPI;
4. There is no incentive for SEMO to maintain performance over a quarter if the KPI is missed early in the Quarter.

The Regulatory Authorities note that *The reward should reflect the consumers' willingness to pay for an improvement in performance standards.* The corollary of this sentiment is also true i.e. the reward should be sufficient for the company to invest in service improvements. The targets proposed are too high and will prove to be too difficult to attain, therefore any increase in KPI targets could act as a disincentive to invest as the reward (at 4%) is insufficient. The Regulatory Authorities also commented that (for the General Queries KPI) *there has been a notable reduction in performance between 2010-2011 and 2011-2012 (page 54).* SEMO would contend that the reward (approx €28k) for achieving the General Queries Target far outweighs the opex effort required.

