SEMO response to:

SEMO Revenue & Tariffs 2008-2009
Consultation Paper

July 17th 2008

1. Introduction

The Single Electricity Market Operator (SEMO) welcomes the opportunity to comment on the Regulatory Authorities (RAs) Consultation on SEMO Revenue & Tariffs 2008-2009 (SEM-08-079). SEM-08-079 is the Regulatory Authorities consultation based on SEMO's revenue submission. SEMO made its formal submission on its revenue requirement and tariffs to the RAs on 27th March 2008. The formal submission was followed by extensive consultation and clarification by SEMO.

In the preparation of this response SEMO have sought to balance the various needs of the respective parent companies. It should be recognised that some issues are more germane specifically to the Northern Ireland or Republic of Ireland context and may therefore be more applicable to SONI or EirGrid respectively. Equally some issues may be specific to market operation or system operation and any commentary by SEMO in this response should be interpreted accordingly.

2. General comments

In the consultation, the RAs have expressed figures in both mid-2008 terms and April 2009 prices. A more consistent approach would enable direct figure comparison. SEMO would welcome a more consistent methodology (e.g. in mid 2008 terms) in the RAs forthcoming decision paper.

SEMO notes the frequent use of the word "budget" in the content of the consultation: "It is proposed that the allowed budget..." (Reference Proposal 3, 4, 5 etc). We believe this is a revenue submission rather than a budget setting exercise. This consultation and decision process sets the revenue for SEMO, enabling it to propose a set of SEM tariffs for the RAs approval. Separately, but obviously linked to this determination, SEMO develops its own budgets which are approved by the SEMO Governing Committee.

3. Detailed comments

There are some specific items in the RAs consultation which SEMO believe need to be addressed and corrected. Detailed comments are provided in this section of the document.

3.1 Proposal 1 - Length of price control

PROPOSAL 1

It is proposed that the new SEMO tariff period will run for a one year period from:

1st October 2008 to 30th September 2009

We agree with the RAs proposal that the new SEMO tariff period will run for a one year period from: 1st October 2008 to 30th September 2009.

3.2 Proposal 2 - Proposal on forms of Regulation

PROPOSAL 2 SEMO's Operation will be subject to **rate-of-return regulation** (that is, it will receive a rate-of-return on its Regulated Asset Base; RAB). The **energy** and **capacity** cash-flows will be regarded as a **cost pass-through**. The **Imperfections Charges** (Dispatch Balancing Costs + Energy Imbalance + Make Whole Payments) will be regarded as **cost pass-through.**

As set out in the Market Operator Licences, EirGrid and SONI being the licensed operators are charged to "facilitate the efficient, economic and coordinated" operation of the market. The consultation decision will set out a revenue amount which SEMO will utilise to run the business; including return on RAB and pass through of energy, capacity and imperfections charges. This amount should be sufficient to enable us to run our business in an efficient manner.

If the outcome is an over recovery then this needs to be explained in the context of (a) an increase in income over forecasted income or (b) a reduction in expenditure against forecast.

If the outcome is an under recovery then this needs to be explained in the context of (a) reduced income over forecasted income or (b) increase in expenditure against forecast. If there is a proposed increase in expenditure against forecast then this will be subject to regulatory approval before the expense is incurred.

SEMO notes in relation to proposal 2 the following statement in the RAs consultation document "...all SEMO costs which are allowed for the new tariff period, including capital-related costs, will be subject to an ex-post review and determination by the Regulatory Authorities. This determination of efficiently incurred costs may result in an over or under-recovery of revenue being fed through to the subsequent tariff period(s).'

SEMO believes that, having committed to a transparent process, and having efficiently and prudently incurred costs, that the ex-post review performed by the RAs should take the form of an exercise to validate that expenditure claimed for recovery was actually incurred.

With respect to Paragraph 7.2, it is stated, with respect to the ex post review of "all SEMO costs" that:

"This determination [i.e. the ex post review] of <u>efficiently incurred</u> costs may result in an <u>over or under-recovery</u> of revenue being fed through to the subsequent tariff period(s)."

With respect to the portions emphasised, we would ask the RA's to consider:

- As stated earlier in paragraph 7.2, the ex post review relates to "all SEMO costs" not to "efficiently incurred costs".
- The reference to "efficiently incurred costs" and "under-recovery" of revenue is in our view inconsistent with regulatory requirements, for example:
- Under Article 6.1 of the Electricity (Northern Ireland Order) 1992 (applying the duties of the Department under Article 4(2)(b)) NIAUR has a duty "to secure that licence holders are able to finance the activities which they are authorised by their licenses to carry out".

- In the Republic of Ireland, under Section 36A(4)(a) of the Electricity Regulation Act 1999, the charges approved by the Commission should allow recovery of "the costs and expenses directly or indirectly incurred in operating the trading arrangements". This section is referred to in Condition 15 of the Market Operator Licence granted to EirGrid plc.

- The efficient operation of the market (which would include efficiencies in spending and procurement) are matters catered for in the objectives set out in the Market Operator Licences which charges the licensed operator to "facilitate the efficient, economic and coordinated" operation of the market.

Therefore the Market Operator should be able to recover the costs that it has incurred up to the level of the regulatory determination on the revenue amount. If additional costs are identified these will be subject to regulatory approval before they are incurred. Matters related to efficiency are issues of compliance pursuant to the Market Operator Licence and should not in our view be referred to in this way in the context of an ex post review of SEMO costs.

For the avoidance of doubt SEMO does not believe that an ex-post review should result in a disallowance of costs that have been incurred in operating the business up to the level of the regulatory determination on the revenue amount.

3.2 Section 7.3 - K Factor

SEMO notes the RAs expectation that figures will be available from SEMO for analysis and review by the RAs in October 2008. The timing of the ex-post review has not been agreed with SEMO and figures will only be available once accounts are finalised. SEMO will provide "approved" accounts for the analysis.

Whilst we will endeavour to provide accounts as soon as possible it is unlikely that they will be available before November 2008. SEMO would welcome discussion to agree an appropriate date for review.

3.3 Proposal 5 - Facilities

PROPOSAL 5

It is proposed that the allowed budget for Facilities is **€1.336 Million**

SEMO notes that there appears to be an error in the consultation in the proposed facilities figure. The proposed SEMO facilities figure in section 8.3.3 of the consultation is €1,366k. However, €1,006k for EirGrid and €360k for SONI adds up to €1,366k, and not €1,336k as cited in section 8.3.3 of the consultation. SEMO notes however that in the Summary Operating Costs (section 8.3.7) the correct proposed allowed budget is €1,365,856, we assume that the former is a typographical error in the consultation.

3.4 Proposal 9 - Discretionary fund

PROPOSAL 9

It is proposed that a **no discretionary fund** of is allowed. SEMO are required to submit any requests for capital expenditure to the Regulatory Authorities for consideration on a case by case basis.

SEMO is disappointed that the RAs will not allow a small discretionary fund for capital projects which would be prudently and sensibly spent and subject to ex post review. SEMO believes this is a workable method of progressing small changes which may be required at short notice. As stated in the RAs consultation they too believed this to be a practical approach for such spend. Irrespective of this, the RAs now propose that no allocation is allowed in relation to this discretionary fund. SEMO regards this decision as a risk, especially in high impact, low probability situations where equipment fails and has an impact on real time market operation. In such cases, SEMO will be obliged to seek approval from the RAs for spend before it is incurred. SEMO would hope that the RAs will recognise the urgency of such requests and we would welcome discussion on agreement and implementation of a procedure to grant approval at short notice.

3.5 Proposal 11 – Depreciation

PROPOSAL 11 It is proposed that the depreciation to be charged in the new tariff period will be **€10,992,226** The Regulatory Authorities also welcome comments on whether replacement cost methodology or the historical cost methodology is more appropriate in determining the value of SEMO's RAB

The adoption of an Historic Cost Accounting approach and non indexation of the Regulatory Asset Base while providing for the application of real WACC, would not provide for the recovery of capital expended by the licencees in real purchasing power terms and would not be acceptable. Furthermore, the application of a replacement cost methodology would require a write down of the Regulatory Asset Base to ensure the book value continues to equate to market value, an approach which has not been adopted to date. It has been standard regulatory practice in both jurisdictions to index the RAB based on the book value method and subsequently apply WACC in real terms. This has also been applied for SEMO, and is in SEMO's view, the most appropriate method in determining the value of SEMO's RAB.

3.7 Proposal 13 – Interest provisions

PROPOSAL 13 The Regulatory Authorities propose that the same process for interest provisions, as described above, is maintained for the new tariff period.

SEMO notes that the treatment of interest of working capital provided by the parent companies is to be treated in the same manner as interest relating to the under or over recovery of revenue for SONI and Eirgrid. SEMO believes that the treatment of interest provision of working capital provided by SEMO should be considered separately from that of over/under recovery given the different degrees of influence and controllability. The cost of carrying funds and that of the cost of borrowing differs and exceeds the cost of lending for its business. The mechanism for determining the interest rate relating to working capital provided by EirGrid and SONI should include a margin which is reflective of EirGrid and SONI's cost of funding that working capital. This is not the case with the current arrangements and SEMO wish to work with the RAs to develop an appropriate mechanism for this specific provision.

Furthermore, SEMO notes that costs will be paid back in subsequent tariff periods. Whilst the mechanism is correct for Under or Over recovery of revenue it would be incorrect to apply this to working capital provided by the parent companies. Working capital as acknowledged is a short term financing arrangement required to provide SEMO's needs in order to balance the "market accounts". SEMO believes that the return of working capital amounts owed to the parent companies should be made available as soon as possible.

3.9 Proposal 16 – Recovery of Imperfections costs

PROPOSAL 16

The Regulatory Authorities propose that the full estimate provided for the net value of Dispatch Balancing Costs, that is **€121.4 Million** (in March 2009 prices), be recovered through the imperfections charge during the new tariff period.

The Regulatory Authorities propose that the full estimate provided for the Energy Imbalance Costs, that is **€1.98 Million** (in March 2009 prices), be recovered through a new specific charge during the new tariff period.

EirGrid and SONI would like to ensure that all Imperfections costs are recovered. It is unclear whether Dispatch Balancing Costs, Energy Imbalances and Make Whole payments are included in the Imperfections charge. SEMO wish to advise the RAs that some €340k for the first 8 months of the market has been incurred in Make Whole Payments. Hence, it is prudent to provide some provision in the coming tariff period. The RAs mention a new specific charge in Proposal 16 but no detail of this new charge is provided. If the Energy Imbalance costs are no longer being recovered through the Imperfections Charge then it needs to be ensured that this does not impact on the Dispatch Balancing cost recovery.

3.10 Section 9.7.1 - Provision of working capital for imperfection charges

Please see response to Proposal 13 - Interest provisions. The mechanism for determining the interest rate relating to working capital provided by EirGrid and SONI should include a margin which is reflective of EirGrid and SONI's cost of funding that working capital. The parent company should not be carrying a cost with no recovery mechanism for the provision of working capital to SEMO.

3.11 Proposal 17 – Summary of tariffs

PROPOSAL 17

The following Tariffs are proposed for the new tariff period

- Accession fee = €1,500
- Participation fee = €3,500
- Imperfections Charge = €3.264 per MWh
- Market Operator Fixed charge for Generator Units = €124 per MW
- Market Operator Fixed charge for Supplier Units = €385 per Unit
- Market Operator Variable charge for Supplier Units = €0.586 per MWh
- Generator-under-test tariff = N/A (see section 9.4)

It is our understanding that the RAs will determine the revenue amount to be recovered and SEMO will then submit the appropriate tariff figure for approval.

4. Conclusions

There are some specific items in the RAs consultation which SEMO believes need to be addressed, most specifically:

- the "budgetary" language of the consultation, this is neither a tariff nor a budget setting exercise. We believe that the statutory and licensing framework provides for the costs we incur; and
- the presentation of figures in a consistent format.

SEMO look forward to working with the RAs to agree on core financing matters:

- the appropriate cost methodology for determining the value of SEMO's RAB that is consistent with the valuation of the parent company RAB and regulatory precedent;
- the recovery of funding costs for the provision of working capital by the parent companies;
- the context, methodology and timing of the ex-post review;
- the elements that comprise the Imperfections Charge and the new charge envisaged for recovery of Energy Imbalance costs; and
- the implementation of procedures to grant approval for small capital spend at short notice.

In order to address these comments we look forward to meeting with you at your earliest convenience.