SEMO Price Control Principles

Paper 2

16th March 2010

INTRODUCTION AND SUMMARY

The Single Electricity Market (SEM) has stabilised and matured since it started in November 2007. The Regulatory Authorities and Participants are, by now, familiar with the workings and associated costs of running the SEM. For these reasons, SEMO considers that the implementation of a revised format for the forthcoming Price Control is both timely and justified. In particular, SEMO believes that the application of multi-annual incentive regulation has the potential to deliver benefits to consumers and Participants alike. On this basis SEMO proposes that the Price Control takes the following form:

1. The Price Control period should run for a term of three years (1st October 2010 to 30th September 2013)
2. The regulatory reporting arrangements should be consistent with a three year price control.
3. Appropriate and reasonable cost indexation is to be applied.
4. Exchange Rate risks should be catered for on a cost pass through basis.
5. The Price Control should exclude Exceptional Market Changes and Developments.
6. Energy and capacity cash-flows will be treated on a cost pass-through basis.
7. Incentives on Key Performance Indicators are to be applied on an annual basis for the 3 year duration.
8. A form of incentivisation is to be included for Capex (Major Market Changes) and KPIs
9. Reasonably predictable capital costs are to be provided for over the duration of the Price Control.
10. The cost of capital (WACC) is to remain consistent with the figures agreed in the System Operator controls and is to be blended by a 75:25 weighting consistent with the specified proportions.
11. Uncertain costs which were either too uncertain to be provided for, or not identified, at the outset of the control by the business should be dealt with annually on a cost pass-through basis.
12. Forecasts of the following items will be identified on a yearly basis for the 3 year Price Control:
    - TSO Dispatch Balancing Costs
    - The number of Demand Units, Generator Units and Supplier Units
    - Annual Load Forecasts
    - Energy Imbalances
    - Make Whole Payments
13. Imperfection costs (Constraints to be submitted by the TSOs).

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PRICE CONTROL PRINCIPLES

To date SEMO has engaged with the Regulatory Authorities on an annual basis to identify the revenue requirements associated with the efficient running of the SEM. SEMO has completed three one-year Price Controls and is now sufficiently experienced to move to a multi-annual Price Control. The main reasons for moving to a multi-annual Control are:

- Annual Price Controls tend to be resource intensive (for the Regulatory Authorities and the Market Operator);
- The Regulatory Authorities are familiar and comfortable with SEMO's operations and therefore a multi-annual control brings less uncertainty;
- The Price Control experience has helped SEMO in its ability to more accurately forecast costs over a longer period of time;
- The longer Price Control duration gives SEMO more time to plan strategically for the future.

While SEMO has gained considerable Price Control experience over the past three years the one major lesson learned is that the Operational Expenditure budget needs to be supported by a realistic capital budget in order for SEMO to be effective in its undertakings (see document on SEMO's Capital Expenditure requirements).

PRICE CONTROL DURATION

One year Price Controls require the repeated dedication of significant resources (Regulatory Authorities and SEMO resources) within relatively short timeframes. The absence of any certainty as to the revenue provision beyond a one year time horizon has also prevented SEMO from developing longer term work plans and proposals. It is therefore proposed that for a more effective and sustainable Price Control the 4th SEMO revenue period should run for a duration of three years.

This longer interval will allow SEMO to take a more strategic view when developing the market, delivering IT system changes, controlling operational costs and providing security of investment for capital projects.

Proposal 1 - Price Control Duration
It is proposed that the new SEMO price control will run for a period of 3 years from October 1st 2010 until September 30th 2013.

CAPITAL EXPENDITURE

Capital Expenditure (Capex) is designed to allow SEMO to invest in new and improved systems in order to fulfil its operational and market management requirements. The following four types of Capex have been identified as part of the Price Control:

- Biannual IT Market Release Capex;
- Predictable Business Capex;
- Unpredictable Business Capex;
- Unknown Future Major Market Change Capex.

CAPITAL ALLOWANCES

SEMO is now seeking three capital allowances for:

- Biannual IT Market Release Capex and
- Predictable Business Capex;
- Unpredictable Business Capex;

The Biannual IT Market Release Capex will be used to facilitate the rollout of Central Market System software releases, the content of which will be approved by the Regulatory Authorities.

A Predictable Business Capex allowance enables SEMO to plan for hardware and software upgrades and the implementation of additional operational support systems (which will increase efficiencies, thereby benefiting market participants) as and when the need arises. This business allowance also reduces the administrative burden that has been placed on both SEMO and Regulatory resources for the approval of relatively minor but essential Capex amounts. This will be covered in Document 4 entitled ***'Capital Expenditure'*** which outlines in detail the Business Capex Items sought by SEMO.

Unpredictable Business Capex is required for IT related issues that occur on a daily basis but cannot be accurately budgeted for and yet require immediate attention e.g. hardware failures, additional data storage devices, Digital Certificates etc. It is prudent that SEMO has such a Capex allowance in order to be able to react quickly to system requirements thus reducing the any risk to the operation of the Central Market Systems. This availability will also reduce the approval resource burden on both SEMO and Regulatory Authorities.

Proposal 2 – Predictable Capital Expenditure
It is proposed that SEMO receive three separate allowances for the following Capex categories: **1. Biannual IT Market Release Capex;** **2. Predictable Business Capex.** **3. Unpredictable Business (IT) Capex**

UNKNOWN FUTURE MAJOR MARKET CHANGE CAPITAL

Future major market changes that cannot be accounted for at this time do not form any part of the Revenue Submission. The Market System Development Plan (MSDP) and the Forward Work Programmes of the respective Regulatory Authorities, however, give some indication of the major projects facing SEMO.

SEMO will seek further Capital and Operational allowances as part of the annual adjustment process as and when the Regulatory Authorities make new policy decisions which significantly impact the SEM.

Proposal 3 – Unknown Future Major Market Change Capital Expenditure
Unknown Future Major Market Change capital expenditure is exclusive of this price control and will be addressed on a project by project basis over the duration of the price control through the annual adjustment process.

REGULATORY ASSET BASE

The Regulatory Asset Base (RAB) is a valuation of SEMO's assets and is central to the formulation of Price Control. The value of the RAB now includes the last two biannual releases (October 2009 and April 2010) and the website project. Additional Capex items for Bi-annual Market Releases and Predictable Business Capex are to be added to the Asset Base as and when they are realised but have been provided for on an assumption of the timing of their incurrence. These two Capital amounts have been included in the Revenue Submission and are reflected in the Total Revenue Requirement.

SEMO assets are subject to a straight-line depreciation over a five year period. The valuation of the RAB has been calculated by taking the historic (acquisition cost) value of the assets, revaluing them to nominal values using inflation, and applying straight-line depreciation.

Proposal 4 – Depreciation
SEMO assets are to be depreciated using straight-line depreciation over a five year period

COST OF CAPITAL

The cost of capital determines the allowed return on the Regulatory Asset Base (RAB). SEMO proposes that it continues with the existing Weighted Average Cost of Capital (WACC) mechanism which blends the two System Operator WACC values in a 75:25 ratio when determining the cost of capital. The value of the WACC will be determined by the System Operators., EirGrid and SONI.

Proposal 5 – Cost of Capital

SEMO propose blending the WACC values determined by each of the Regulators in the forthcoming System Operator price controls and applying the blended rate (75% of EirGrid's and 25% of SONI's) value to SEMO's Asset Base.

FLEXIBILITY AND RE-OPENERS

While regulatory certainty is a fundamental underpinning of this Price Control, some flexibility is also required to take account of events which significantly impact the regulated business and which could not have been reasonably foreseen and/or accounted for at the time the Control was set. A significant number of key Market Rules and conditions need to be developed, designed and implemented over the duration of the Price Control. However, SEMO contends that at this time sufficient clarity does not exist to accurately attribute costs to all Operational and/or Capital Expenditure. SEMO therefore believe that it is prudent not to submit for all these costs, but to address these additional requirements when and where the revenue requirements can be accurately quantified.

Proposal 6 – Re-openers

SEMO proposes that for events which significantly impact the SEM regulated business as part of the annual adjustment process. While some events are, whilst foreseeable they are not fully quantifiable at this stage and SEMO believe it is prudent to submit for the revenue requirements once an estimate of the costs is available.

UNCERTAIN COSTS

Uncertain Costs that cannot be reasonably foreseen by the business should be dealt with on a cost pass-through basis. These costs could include

- Changes in legislation or regulation that impose a cost on the company.
- Restructuring costs driven by changes in legislation etc.

Proposal 7 – Uncertain Costs

Uncertain Costs that cannot be reasonably foreseen by the business should be dealt with on a cost pass-through basis

INDEXATION

The use of price indexation (i.e. CPI and RPI blended for SEMO) for regulated businesses is designed to provide a natural hedge for the business against underlying economy-wide changes in the cost of doing business. This works well to the degree that the index reflects the input price changes for the business, however, to the extent that the index is not a good reflection of the changing cost base of the business then any difference must be provided for in the underlying cash flows (as a Real Price Effect). In particular, account must be taken of the difference in the cost structure of the company from the underlying economy as a whole and expected efficiency improvements – over and above the efficiency built in to the CPI calculations. The appropriate real price adjustments are provided by EirGrid and SONI and applied to SEMO.

For consistency with previous Price Controls figures have been calculated in mid-tariff year prices.

Proposal 8 – Indexation

SEMO's revenues are to be indexed by CPI/ RPI blended rate in mid tariff (March) prices.

REAL PRICE EFFECTS

It is important that reasonable and appropriate real price adjustments apply consistent with the Real Price Effects faced by SEMO. These are discussed further in the Operational Expenditure Paper.

K FACTORS

A 'k-factor' is used to accommodate any over, or under, recovery of funds from a previous revenue allowance. This re-balancing of revenue will take account not just of overall income, as against outgoings, but will also take account of any interest earned or payable arising from working capital provisions. Uncertain costs into the future will also be accommodated through this k-factor for SEMO

A second k-factor will apply to the Imperfections Tariff arising from any market imbalances. The k-factor is to be applied on an annual basis.

Proposal 9 – K Factors

A 'k-factor' is to be used annually to accommodate any over, or under, recovery of funds for:

- **Uncertain SEMO costs and**
- **Market Imbalances**

INCENTIVISATION

SEMO is currently rewarded for achieving a number of incentivised outcomes aimed at improving performance, promoting customer service, increasing efficiencies and delivering value to customers. SEMO proposes continuing with this mechanism and implementing the following applied to Key Performance Indicators (KPIs) and Capital Projects.

KEY PERFORMANCE INDICATORS (KPI)

Four Operational Key Performance Indicators have been delivered as part of Price Control 3 (Oct 09-Sept 10). SEMO proposes retaining these four KPIs and adopting an additional two KPIs. These two additional KPIs are aimed at reducing the number of resettlements and improving SEMO's customer service (from MSDP 3 feedback). SEMO proposes an incentive of 3% per annum (approx €300k of Internal Opex) should be applied on an annual basis.

Proposal 10 – Key Performance Indicators

SEMO propose retaining the existing four key performance indicators and adding an additional two performance indicators that will in someway address the issues raised and valued by participants including the number of resettlements and the levels of customer service.

CAPEX SAVINGS

Savings can be made in Capital Expenditure through detailed engagement, good project management/delivery and negotiation (as was evidenced during the ABB IT Release Capex negotiations). It is important the appropriate incentives are in place to ensure such savings can be delivered to customers. The capital costs for which SEMO will seek approval from the Regulatory Authorities during the Control will be for well defined scopes of work consistent with the policy environment. SEMO should therefore be rewarded if further cost reductions can be achieved. SEMO believes that there should be an equal sharing of any savings if it delivers the associated capital project to scope, on time and within the Regulatory approved allowance. SEMO also contends that the threshold for incentivisation on Capex projects should be reduced form its current value of €500k to €100k as this would provide a very strong incentive for SEMO to actively pursue the very best costs for all types of Capital Expenditure.

Proposal 11 – Major Market Change Capex

SEMO propose that an incentive be put in place which provides for an equal sharing of the benefits of any Capital Expenditure savings and reducing the threshold of capital projects to €100k.

EXCHANGE RATES

The SEMO business model does not accommodate the hedging of exchange rates and as such currency variations are to be catered for on a cost pass through basis.

Proposal 12 – Exchange Rates
SEMO will pass through any costs associated with exchange rates.