



SEMO Price Control Submission

Paper 4

Operational Expenditure

16th March 2010

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EXECUTIVE SUMMARY

The Operational Expenditure (Opex) paper contains a set of proposals in support of the Questionnaire which was forwarded to SEMO from the Regulatory Authorities in January 2010.

The paper sets out the key principles applied to Opex for the Revenue period 1st October 2010 to 30th September 2013. In line with this longer Price Control period SEMO has outlined what it believes to be the necessary operational costs going forward allowing for continued operation of the Central Market Systems and with consideration for the future development of the market.

The operational costs outlined herein reflect incremental increases during the period with Payroll costs reflecting a workforce of 55 personnel.

Professional Fees increase in the first two years of the Price Control period and reduces in year three as it is anticipated that by this time key market decisions (requiring additional professional expertise and assistance) will have been taken and initiatives either implemented or in project mode.

It is noted that staff requirements that may result from major initiatives and undertakings which attract capital expenditure will be addressed as part of those decisions going forward.

BACKGROUND

The Single Electricity Market (SEM) is the wholesale electricity market operating across the Republic of Ireland and Northern Ireland. Created through a contractual joint venture between EirGrid and SONI, the Single Electricity Market Operator (SEMO) is responsible for the continuous operation and administration of the SEM.

To date, SEMO has been subject to three Price Controls each covering a duration of one tariff year, with the current Price Control due to expire on 30th September 2010..

This, the fourth SEMO Price Control Submission outlines SEMO's projected requirements for the period encompassing the 2010-2013 tariff years.

OPERATIONAL EXPENDITURE (OPEX) PRICE CONTROL PRINCIPLES

SEMO believes there is now sufficient maturity in both SEM and the Market Operator business to justify the implementation of a revised format for the forthcoming Price Control. The application of multi-annual incentive regulation has the potential to deliver benefits to consumers. On this basis SEMO proposes that the Opex 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 and regulatory reporting regime is to be consistent with a three year Price Control.

3. Exchange Rate risks are catered for on a cost pass through basis.
4. Appropriate cost indexation is to be applied.
5. The Price Control excludes Exceptional Market Changes and Developments.
6. Incentivisation for service delivery in the form of KPIs in addition to Capex (Major Market Changes) for the three year duration.
7. Uncertain costs that cannot be reasonably foreseen by the business should be dealt with on a cost pass-through basis as part of the annual adjustment process.
8. An ability to revert to the Regulatory Authorities, on an annual basis, to provide for requirements which were either unpredictable, or not identified, at the outset of the Control.

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INTRODUCTION

SEMO Vision: to operate and improve energy market services using the best of our talent and expertise in an open manner for the sustainable benefit of society.

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The SEMO Vision is built on a number of key goals that the organisation strives to achieve on a daily basis. These include efficient market operations, the improvement of market services, attracting industry talent and expertise and acting with transparency to achieve ongoing sustainable operations. In fulfilling this vision it is imperative that SEMO be in a position to respond to the challenges facing and opportunities arising in the market. In order to achieve its mission SEMO takes into consideration its customers views and expectations of service, potential future development of the market and the economic climate and forecast when devising a way forward.

The role of SEMO over the past three years has been to settle the market arrangements and processes and to ensure the efficient operation of the electricity market. The systems employed by SEMO have since SEM go live continued to be enhanced to deliver greater reliability, enhanced service and greater functionality in line with the evolving market needs. This development and investment is expected to continue over the 2010 – 2013 period with a replacement capital programme and upgrading required.

SEMO will drive these developments over the next three years and potentially well beyond in order to provide the market with a well maintained operating system capable of providing for the future developments of the market. SEMO has not yet committed to specific longer term projects as these will be developed in association with the Regulatory Authorities.

The Opex allowance, as detailed below, reflects the current thinking of SEMO in its provision of market services for the Price Control period. During this period SEMO will be striving to maintain and develop the systems to take of account of future obligations whilst also improving the quality of services to our customers.

OPERATING COSTS

SEMO operating costs are as attached in the completed Questionnaire – General Principles January 20 as requested by the Regulatory Authorities. The narrative below provides additional explanation to the figures proposed within the Questionnaire.

QUESTIONNAIRE NOTES

The questionnaire issued to SEMO on January 20th consisted of the following four worksheets:

1. **General Principles** – Notes on how to complete the Questionnaire
2. **Opex General** – This covers Professional Fees, IT & Communications, Facilities and General & Administrative costs. SEMO has added Corporate Services as an additional cost category to this worksheet.

3. **Opex Payroll** – Illustrates The Projected Payroll Expenditure for 2010-13, The Projected Staff Expansion and two tables showing the Current Payroll Details.
4. **Capital Expenditure** – Detailing the predictable Capex requirements for the next 3 years.

Worksheets 2 and 3 have been completed as part of the Operational Expenditure Submission due March 16th and the Capital Expenditure detail is due to be submitted April 1st.

SEMO has added five additional worksheets to support the Opex General revenue submission. These extra worksheets give a detailed breakdown of the:

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- 1.1 Professional Fees
- 1.2 IT Support and Maintenance
- 1.2 Telecommunications Requirements
- 1.3 Rent and Facilities and
- 1.4 General and Administrative costs.

Each of these cost categories and sheets are linked through hyperlinks to aid navigation through the worksheets. An appendix has been added to support the business case for the Administration Assistant resource

INTERNAL OPERATIONAL EXPENDITURE

In order to facilitate the ongoing development and the increased work volume in the market, SEMO proposes that its Operational Expenditure accommodate incremental and appropriate growth. Development of the SEM over the past three years has increased transparency for all energy stakeholders. In order to continue to provide efficient services for market participants SEMO believes continued investment in its people, systems and processes to be vital. A reasonable Opex allowance is required to ensure that SEM may continue to facilitate greater market transparency, increased stability of operations and quality of service. The attached table outlines the proposed allowance for the 2010-2013 Price Control periods.

OPERATING COSTS	SEMO Operating Costs		
	2010/11	2011/12	2012/13
	Current Prices €'000		
Payroll	4,911	5,057	5,161
IT & Communications	2,098	2,304	2,448
Facilities	1,196	1,196	1,196
Professional Fees	847	884	747
General & Administrative	367	377	377
Group Services	300	300	300
Total Internal Costs	9,719	10,118	10,229

Summary of the Total Internal Operating Costs

SEMO internal Opex has been divided into the following categories for ease of reference – Payroll, IT and Communications, Facilities, Professional Fees, General and Administrative and Group Services. Included within Payroll costs are all staff costs including Salaries, Contractors, Bonus, Employer’s PRSI/National Insurance, Employer’s Pension Contribution, Overtime, On Call/Shift, Car, and other Benefits. The activities of SEMO staff members are determined by legislation, licenses and the Trading & Settlement Code. Costs for Travel and Subsistence, Office Supplies, Bank Charges and Staff Training are included under General and Administrative costs.

The nature of the SEMO business means that it will be subject to Real Price Effects (RPE) to the extent the costs of its inputs are expected to differ from the evolution of RPI/CPI. SEMO’s business is largely labour intensive (whether in house or outsourced) and therefore the evolution of real wages represents one of the most important drivers of these real trends. In the medium term real wages within the economy would be expected to increase in line with real labour productivity. Both past real wage trends and future productivity forecasts suggest this is of the order of 1.5% - 2.5% per annum. (ESRI, CSO, DETI, ONS)

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SEMO is also subject to two additional factors which will affect the level of real cost pressure it faces. The first relates to the growing demand for labour in the energy sector and short term labour supply inelasticity. This is expected to lead to an upward pressure on wage levels in the energy sector. SEMO believes this is likely to add of the order of 0.5% - 0.7% per annum to its revenue requirements. This is consistent with the 0.7% per annum provided by Ofgem as part of DPCR5¹. Secondly, the nature of SEMO as a start up organisation means that the underlying real marginal value of its primary resource, its human capital, is rapidly increasing and this must be remunerated if SEMO is not to suffer the consequences of high labour turnover and become a training ground for other players in the industry. This effect alone could be expected to add an additional 0.25% - 0.5% per annum to input costs.

SEMO recognises that these effects may not be wholly cumulative, and that they may differ both across the economic cycle and indeed between the two jurisdictions in which SEMO operates:

- SEMO has provided for a Real Price Effect of 2.75% per annum in relation to payroll expenditure in the Republic of Ireland and 2.0% in Northern Ireland;²
- SEMO has provided a real price effect of 2.25% where the labour is outsourced.
- No RPE is to be applied to IT & Communications Facilities, General & Administrative and Group Services cost categories.

PAYROLL

Historically, SEMO’s Payroll costs submissions have reflected a ramping up and maturing of the organisation over the 2007-2010 period. By up-skilling over the course of the previous Price Controls, SEMO’s in-house expertise and capability has been, as it will continue to be, significantly enhanced. The maintenance of an in-

¹ <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=343&refer=Networks/ElecDist/PriceCtrls/DPCR5>

² In Northern Ireland the somewhat lower historical real Average Earnings Index numbers, in combination with the lower projected growth mean the number would be somewhat lower. However, SEMO notes the objective of the Northern Ireland Executive to increase both labour productivity and real wages within Northern Ireland which will, if successful, increase the base cost of the labour pool from which SEMO must source labour.

house skills base becomes increasingly important as SEMO manages a progressively more complex market system, with higher renewables penetration and in determining and overseeing the delivery of a Capex programme of a scale that has yet to be determined.

It is noted that while the staffing level is only increased by one additional position, the increase in Payroll costs for year one also incorporate those posts that have already been approved and are currently in the process of being filled through recruitment (as approved in 2009 / 2010).

(1.5) Projected Payroll Expenditure

	Current Prices €'000		
	2010-2011	2011-2012	2012-2013
Total Payroll Expenditure	4,911	5,057	5,161

Summary of the Total Projected Payroll Costs

The payroll revenue requirement incorporates a provision for both ongoing pensions costs and for legacy past service pension arrangements, and deficit repair. This is provided for on a cash contribution basis in line with the actuarial valuation/recommendation and in accordance with the timing of deficit repair consistent with the pensions regulatory framework pertaining

Due to an increasing administrative workload currently being undertaken by managerial and other specialised staff, included within this submission is a proposal for one Administration Assistant.

SEMO STAFFING STRATEGY (GREATER USE OF CONTRACTORS)

SEMO has experienced a steady increase in staff resourcing over the last three years to the extent that it is generally felt that current staffing arrangements are largely sufficient to meet the existing workload. However, due to increased administrative requirements across the business and between sites (Belfast and Dublin) and as projects progress requiring an increased focus on customer interaction SEMO believes there is a need for a central and permanent administrative resource for 2010/11 and beyond.

To date, the use of contract staff as and where the need has arisen has proved successful, particularly in relation to one off projects and can in certain instances represent the most efficient means of resourcing. In light of this SEMO will continue to retain short and medium term contract staff, as appropriate, for future projects. The Capex paper, to be submitted at the end of March, will outline in greater detail these proposals. The retention of new permanent staff as required by future developments to the market have not been outlined here. SEMO believes that any resources required against new areas of work should be best considered at the appropriate time and in consultation with the Regulatory Authorities as part of the annual adjustment process.

IT & COMMUNICATIONS

A significant operational cost for SEMO is the ongoing support and development of SEM Central Market Systems and its underlying communication links. This is due to complexity, security and resilience required to support a 7-day market. Key investments are planned for the period 2010-2013, including the requirement for additional communications links over the coming months to secure system availability and provide the performance levels that market participants have come to expect (details in the Capital Expenditure paper). A breakdown of the proposed allowance from SEMO is as follows:

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(1.2) IT & Communications			
	Current Prices €'000		
	2010-2011	2011-2012	2012-2013
Warranty, Support & Maintenance	1,820	2,027	2,010
SMO Telecommunications Requirements	278	278	438
Total IT & Communications	2,098	2,304	2,448

Total IT and Telecoms Costs proposed by SEMO

FACILITIES

SEMO has office space in both jurisdictions and will continue to co-locate on property provided by both parent organisations and is charged accordingly. Facilities costs cover all shared space and include cleaning services, maintenance, car parking, security, mail service, copy bureau, switch board, catering and canteen services as well as rent, insurance and utilities. A rent review of the cost of accommodation in EirGrid's offices at the Oval is due in 2012 and this may impact the Facilities charges payable.

(1.3) Facilities			
	Current Prices €'000		
	2010-2011	2011-2012	2012-2013
Rent and Facilities			
Rent & Facilities- EirGrid	977	977	977
Rent & Facilities SONI	169	169	169
Subtotal	1,146	1,146	1,146
Insurance			
General Insurance	50	50	50
Total Facilities and Insurance	1,196	1,196	1,196

Summary of the Facilities Costs

PROFESSIONAL FEES

There exist a number of known major market developments with potentially significant impacts for the SEM that are being considered and consulted upon but which have yet to be finalised. It is important that SEMO remains abreast of such developments in Ireland, UK and also Europe in order to be positioned to take forward any resulting changes that may be required.

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When SEMO reviewed the need for professional advice during the three year period forecast it was felt that an increase in this expenditure is warranted for the first two years as known major initiatives which have yet to be decided upon will be considered in this period. In year three it is expected that decisions will have been made in relation to these known initiatives and, whilst some ongoing provision has been included for further work, it is acknowledged that the need for consultative assistance will be diminishing. This is reflected in the costs provided.

It is also worth noting that the known initiatives currently or soon to be under consultation relate to a wider range of subjects than have been previously considered. The scope of these consultations collectively increases the total allowance requirement compared to previous years. Further, SEMO has not applied any increase to Professional Fees at a rate level.

In addition, the Regulatory Authorities and SEMO are currently considering a number of initiatives for emerging market conditions and improvements to the market. These undertakings will require assessment of the benefits to customers and participants and, upon approval, lead to changes to the market systems, rules, processes and procedures. In order to address this area of work SEMO Market Development requires support to conduct studies, assessments and reviews on emerging issues currently on the agenda of Government and Regulatory Authorities forward work programs. The key areas to be addressed include Interconnectors, Market Coupling, the Impact of Wind Penetration on the SEM, Demand Side Management (DSM) developments and the Review of Capacity Payment Mechanisms. The full range of issues is provided in the questionnaire details.

Professional Fees cover SEMO requirements for external professional services in respect of:

- General Consultant support
- Disputes and Modifications Committee support
- Regulatory and Legal support
- Market Audit
- Internal Audit
- Communications
- Recruitment

The costs associated with Professional Fees, are summarised in the table below.

(1.1) Projected Professional Fees			
	Current Prices €'000		
	2010-2011	2011-2012	2012-2013
Legal	50	50	50
Recruitment	40	40	40
Internal Audit	25	25	30
Market Audit	250	300	300
Committees	53	53	53
Consultancy	411	398	258
Subtotal	829	866	731
RPE @ 2.25%	19	19	16
Total	848	885	747

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Summary of Professional Fees submitted by SEMO

GENERAL & ADMINISTRATIVE

General and Administrative costs cover the remaining expenses expected to be incurred operating the SEMO business. It includes Travel and Subsistence, Office Supplies, Bank Charges and Staff Training. The costs associated with each of these areas are detailed below.

(1.4) General & Administrative & Other			
	Current Prices €'000		
	2010-2011	2011-2012	2012-2013
Travel & Subsistence	168	168	168
Stationery	10	10	10
Bank Charges	35	45	45
Training	124	124	124
Miscellaneous/ Meetings	31	31	31
Total	368	378	378

Summary of General and Administrative Costs

GROUP SERVICES

To date, the SEMO Price Controls have made reference to Group Services being charged from the parent companies. These relate both to services directly provided for SEMO from other business units, for example HR, and to a cost allocation of the overhead associated with the Group activities: Chief Executive, Group Finance, Regulation etc. The approach within the EirGrid Group has been to keep general overhead allocated only to costs associated with Group activities, with SEMO retaining separate and separately accountable information services, accounting, and other management functions consistent with its licence. The provision is for €300k per annum consistent with the assumptions made for the other controls within the Group.

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1.4.1 Group Services

	Current Prices €'000		
	2010-2011	2011-2012	2012-2013
Group Services (allocated charge)	200	200	200
Activities sourced from within Group	100	100	100
Total Corporate Services	300	300	300

Summary of Group Services Costs

SUMMARY OF OPERATING COSTS

The Total Internal Operating costs are summarised in the table below.

OPERATING COSTS	SEMO Operating Costs		
	2010/11	2011/12	2012/13
	Current Prices €'000		
Payroll	4,911	5,057	5,161
IT & Communications	2,098	2,304	2,448
Facilities	1,196	1,196	1,196
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Summary Internal Operational Costs

APPENDIX 1 - SEMO'S RESOURCE REQUIREMENTS

Resource Title	Cost €
SEMO Administration Assistant	
Problem Statement	
<p>Currently SEMO does not have an administrative support resource assisting the Managing Director or the business group Managers. Thus, these personnel are responsible for completing their own administrative needs or allocating this work to other staff for whom these are not core duties.</p> <p>Dual site operations, between Belfast and Dublin offices, add an additional requirement to administrative undertakings, which would be best centralised as the responsibility of one core member of staff.</p>	
Business Need Statement / Objective	
<p>There is sufficient administrative work collectively throughout SEMO to justify the introduction of an Executive Assistant, acting primarily to assist the Managing Director, but also providing a resource that may be utilised across the group Managers and in support to staff where appropriate.</p> <p>In reallocating administrative tasks for inclusion in this resource's core duties the time and efforts of the Managerial staff, or subordinate staff currently undertaking these tasks over an above their own core work, would be made available to focus on their primary workload.</p> <p>Further, in allocating a central resource to address these administrative needs increases accountability and ensures the completion of these tasks which may otherwise be completed on a more ad hoc or as time allows basis if they fall outside of the core business undertakings of other personnel.</p>	
Strategic Benefits	
<p>It is anticipated that the implementation of an exclusively administrative resource to SEMO would achieve the following benefits:</p> <ul style="list-style-type: none"> • Promotion of accountability for these administrative tasks by assigning a single staff member responsibility for them. • Increased productivity through the 'freeing up' the time of other staff members, in particular Management, to allow them to focus on their core duties. • Centralise the point of contact for administrative undertakings across the organisation benefiting both internal and external stakeholders. 	
Risk Analysis	
<p>It is anticipated that the growth experienced by SEMO since its inception will continue over the coming years. Growth in market operations and development is accompanied by an increase in work volume and administrative needs. To date the increased demand in administrative work has been undertaken by highly qualified staff whose skills are best focused elsewhere.</p> <p>Without the addition of a dedicated administrative resource there exists a risk that as the demand on SEMO increases some administrative tasks may be neglected or completed to a lesser quality as those responsible for their completion are otherwise indisposed with their primary duties. It is acknowledged that the completion of these tasks is important to maintain the necessary audit trails and transparency required by a regulated organisation.</p>	

In light of the risks presented it appropriate to employ a dedicated administrative resource to address these requirements rather than appeal for staff with more refined skills which may be less available in the wider marketplace further down the line.