

**NIE Energy Limited
Power Procurement Business (PPB)**

**SEMO Revenue and Tariffs
for
October 2010 – September 2013**

Consultation Paper

SEM-10-050

Response by NIE Energy (PPB)

3 September 2010.



Introduction

NIE Energy – Power Procurement Business (“PPB”) welcomes the opportunity to respond to the consultation paper on the SEMO Revenue and Tariffs for October 2010 – September 2013.

Comments on the Regulatory Framework Proposals (Sections 6-8)

Proposal 1

PPB agree with the proposed regulatory framework in relation to OPEX, particularly where it applies to SEMO’s ongoing and stable work activities. However, it is not clear that this is appropriate where the costs are unpredictable and outside the control of SEMO (e.g. significant changes in systems and work practices arising from approved modifications, which may be more appropriately addressed through a cost passthrough arrangement, rather than building a premium to cover such uncertainty into the regulated allowances.

PPB is not comfortable with the proposal to adopt revenue-cap instead of rate of return regulation for SEMO’s capex. The proposal is likely to result in significant tariff volatility and also results in the recovery of asset costs in a single year while customers will benefit from those assets over the lifetime of the assets. In such circumstances some customers may not be contributing to costs previously incurred but from which they are benefiting which raises significant questions over the equity of the proposal. In addition, the comparative tariff analysis shown in Table 2 seems to ignore two costs associated with the revenue-cap approach.

Firstly, there will inevitably be a mismatch between the timing of any expenditure and recovery through the tariff (where the income will be phased throughout the year). If the expenditure is initially incurred by SEMO in advance of recovery through tariffs, there will be a financing cost for this period or in the alternative, if tariffs are increased in advance of the investment to recover the cost, such an arrangement effectively transfers the funding cost to consumers. Secondly, the advancement of the charges to consumers is not “free” since there is a cost to consumers associated with earlier repayment. A net present value of the tariff revenues using a customer discount rate would show the true cost differential between the rate of return and revenue cap models.

PPB considers the rate of return regulation to be more appropriate except perhaps where the investment is relatively minor (e.g. less than £100k).

Proposal 2

PPB agree with the proposal to use out-turn inflation. However it is unclear whether the proposal is to use a lagged out-turn inflation or whether a forecast inflation for the year is used that is then corrected to outturn with any variance picked up through the “K” Factor mechanism.

Proposal 3

PPB agree with the proposal that the “K” Factor should be determined from the difference between actual revenues and “allowed” revenues. However, PPB does not agree that the lag in this mechanism is appropriate (e.g. where the 2008/09 “K” is not applied until 2010/11). The best estimate of the “K” should be included in the next tariff period thereby reducing the funding period for both SEMO and customers. This is the practice that has historically been used for all regulated tariffs in Northern Ireland.

Comments on the OPEX Proposals (Section 9)

Proposal 4

The provision of an effective performance and level of service by SEMO is essential to the smooth and efficient operation of the SEM and from this perspective SEMO generally continues to perform well although there remains room for improvement particularly in relation to responding qualitatively to market queries and reducing errors in the publication of data. Hence from this perspective, it would not appear that SEMO are under-resourced but it is not possible for PPB to comment on whether SEMO’s current resources are fully utilised or exceed efficient levels.

Proposal 5

The benchmarks show a wide spread and it is noteworthy that the N. Ireland costs are significantly lower and hence the location of the SEMO resources should be considered to reduce the overall costs for customers. It is also unclear how exchange rate risks are managed given the allowances are all Euro based. The main concern for PPB is that SEMO should have adequate resources to efficiently and effectively perform its licenced activities.

Proposal 6

While the consultation paper proposes to disallow the pension deficit cost, it makes a statement that “the treatment of pension deficits will not be dealt with as part of this price control process”. It is not clear whether this means it is to be addressed through some other process. PPB considers that the costs of the repair of pension deficits must be addressed somewhere within the regulatory framework.

Proposal 7

PPB do not believe an allowance for contractors should be built into a 3 year price control but where it is demonstrated that such resources are needed to deliver specific projects that are not part of the “normal” business activity of SEMO, then such costs should be considered and approved as passthrough costs at that time in relation to that specific project.

Proposal 8

It is not possible for PPB to determine whether such an admin/support role could be performed by existing resources or to what extent the existing resources are fully utilised. Additionally, the cost appears high for such a role.

Proposal 9

Unless there are SEMO staff on development arrangements (i.e. with pre-planned salary progression increments) then the proposal seems reasonable.

Proposal 10

Such IT and telecom costs should be relatively predictable and therefore the expected costs should be capable of evidential demonstration. Such costs should be allowed otherwise SEMO would not be able to provide the services required.

Proposal 11

The rent and facility costs payable to SONI seem very high to accommodate 15 staff. The costs payable to Eirgrid for accommodating 38 staff is even higher again on a per head basis. However, on the assumption these payments are deducted under the SONI and Eirgrid price controls then on the basis the overall costs are efficient, the net effect for customers from the allocation would be neutral (although it does result in a change to the customer base over which these underlying TSO cost elements are recovered).

Proposal 12

SEMO's role is to facilitate the efficient, economic, coordinated operation and administration of the SEM. We do not consider it is appropriate that SEMO should be incurring costs "keeping abreast" of developments that are beyond the scope of its role of delivering the market operator service. It is therefore not clear what ongoing consultancy services are required. Where the scope is unknown, it would not appear to be efficient to build in a level of costs in advance that may turn out to be unnecessary. In circumstances where a particular project requires such a service, that cost should be approved at the time as a passthrough cost.

Proposal 13

SEMO's proposed increases appear excessive (e.g. for travel and subsistence, and training) and it is difficult to identify trends with only a single years historic data as a comparator. For example one would expect training costs to be reducing now that the business has been operating for 3 years and more historic data would have made this easier to identify. PPB agree with the proposed approach.

Proposal 14

It appears there is some provision of corporate services and therefore the cost of these should be allowed and the question is more about the appropriate level of cost allocation between SEMO and the TSOs. Again, assuming the overall costs are efficient, the precise allocation between the TSOs and SEMO should not affect the overall cost for customers (although again noting the different customer bases of SEMO and each of the TSOs).

Comments on the CAPEX Proposals (Section 10)

Proposal 15

The proposals set out in section 10.6.3 in respect of monitoring and rebasing the Capex programme, means that the level of oversight required is effectively the same as it would be for approval of all Capex individually and hence it not clear what benefits the proposed approach will deliver for customers. The key principle must be to deliver an efficient and effective service that meets stakeholders' requirements but which is not over-engineered and delivers the requirements at least cost. It is not clear to us how effective the menu based approach would be in the context of the wider structure.

Comments on the RAB and cost of Capital (Sections 11 and 12)

We are surprised to see assets included in the RAB relating to RCUC given that it is a TSO system.

Proposals 16 and 17

PPB agree with the proposals.

Incentivisation (Section 13)

The performance shown against the existing incentives only covers performance in one quarter which is too short to enable any considered assessment of the appropriateness of the target levels.

Proposal 18

It is unclear what additional benefit accrues from increasing the KPI incentive pot and there is no justification provided for increasing the current level. It is also unclear why the reward should change to a quarterly approach. An alternative may be to adopt a range approach whereby differing levels of bonus is obtained across the range.

PPB welcomes the new KPI metrics although the weighting for these appears too high. In addition, the performance measure is not defined and it needs to capture the quality of responses i.e. resolution of queries rather than just acknowledgement.

Proposal 19

PPB agree with the proposal.

Proposal 20

PPB agree with the proposal and suggest that the management of releases could be included as an additional KPI.

General Comments

SEMO operates in two jurisdictions with costs (and investments) that will be incurred in a mixture of Sterling and Euros. However, the price control allowances are set in Euros. In a one year price control, the risk of exchange rate movements may be less significant. However, this must be a much greater risk over the course of a three year price control. It is not clear from the consultation paper how (or if) this is addressed anywhere. For example is there a premium included in the various cost lines to address this risk and if so what premium is being sought and is that the best way to manage the risk?