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RE: Revenue Recovery Principles for SEMO and Designated NEMO (SEMOpX) from I-SEM go live, Consultation, SEM-17-018

Dear Gina and Joe,

Bord Gáis Energy (“**BGE**”) welcomes this opportunity to respond to the Consultation on proposed Revenue Recovery Principles for SEMO and SEMOpX from I-SEM go-live (“**the Consultation**”).

In general, BGE accepts the need for both Market Operators to recover their efficiently incurred costs. The overarching principle to designing these revenue recovery principles should be that any costs recoverable are transparent, efficiently incurred, reasonable and proportionate with a view to delivering value for the consumer. Our views on the approaches to deciding the relevant principles for SEMOpX and SEMO are outlined respectively below. A summary and conclusions section is included at the end of this response.

1. Price Regulation of NEMO (SEMOpX) from I-SEM go-live

1.1 Application of Price Control to SEMOpX

BGE agrees with the Regulatory Authorities (“**RAs**”) view that they are at a minimum responsible for reviewing the costs associated with the establishment of NEMO functions for I-SEM.

The overarching principle of the price control should be ensuring value for the consumer. System costs make up a major component of consumer bills at present and it is critical that the “efficiency” criteria for costs incurred is strictly applied pursuant to the Capacity Allocation and Congestion Management regulation (“**CACM**”). In particular, Article 75(1) of CACM requires the RAs to assess particular System Operator (“**SO**”) costs and those that are “reasonable, efficient and proportionate shall be recovered in a timely manner through network tariffs or other appropriate mechanisms as determined by the competent regulatory authorities.” BGE cannot over-emphasise the importance of these assessments and the need for the RAs to provide confidence to market participants as to the approach taken to ensure compliance with CACM in this regard.

Furthermore, it is in the consumer interest that a competitive NEMO market place exists – the more NEMOs in I-SEM, the more competitive prices will be which will have positive impacts for consumers. It is therefore critical that in designing these revenue recovery principles the RAs ensure that they do not ultimately place SEMOpX in a better or worse position compared to other NEMOs. The principles should also not deter the potential market entry of competitive NEMOs.

1.2 SEMOpX Price Regulation Parameters

1.2.1 Capitalised Set Up Costs and Incremental Capex

As regards the three options¹ for recovering establishment costs incurred by SEMOpX BGE supports the final option outlined, whereby the costs are recovered through the TSOs’ RAB and that none of the costs are recovered through SEMOpX tariffs. The concept of efficiency in cost recovery is critical here also. Our main reasons for this view include:

¹ I.e. full recovery through SEMOpX; partial recovery through SEMOpX; no recovery through SEMOpX

- Recovering these costs through SEMOpx tariffs would front-load the costs of I-SEM on consumers. In particular, the depreciation time of 5 years would be compressed into ~18 months and such accelerated depreciation would heighten tariffs for consumers in the early operation of I-SEM;
- The alternative application of a standard 5 year depreciation profile on SEMOpx would reduce the impact of front-loaded tariffs but would go beyond the SEMOpx initial designation period as a NEMO (which expires on 2nd October 2019). Thus on expiration of the term in October 2019, the RAs would have to consider re-calculation of a correction factor at that point in time which would be administratively burdensome;
- Recovery of SEMOpx costs through SEMOpx tariffs could potentially thwart the competitive NEMO playing field;
- Allowing the costs to be allocated to EirGrid and SONI in their capacity as TSOs in line with the established cost sharing mechanism whereby 25% are attributed to SONI and 75% attributed to EirGrid and which is already agreed as part of I-SEM implementation costs, is administratively less complex than seeking to decipher a cost-sharing methodology for the separate SEMOpx function.

With regard to incremental capex, BGE urges the RAs to minimise concentration of costs in a short period of time given the anticipated expiration of SEMOpx designation within 18 months of I-SEM go-live. BGE would also welcome confirmation that SEMOpx is obliged to inform and obtain approval from the RAs before any capital spend occurs that might materially increase costs on consumers? Market participants should also be informed of such spend before its final approval.

BGE requests that should the approach to recovery of these costs through the TSO asset base occur, then these I-SEM costs should be clearly and explicitly explained by line item in the annual tariff updates related to PR4 as these costs will inevitably impact the PR4 cost structure.

Finally, from the consumer perspective, BGE wants to ensure that there is no scope for double counting of revenue recovery by the TSOs. We point to Article 5 of CACM in this regard which should be strongly adhered to by the RAs. NEMO should only recover costs *over those* incurred by the TSOs and they must be incurred in an “efficient” manner. NEMO must keep “separate accounts for MCO functions and other activities in order to prevent cross-subsidisation.” Transparency in the annual tariff updates relating to PR4 will help in this regard and provide confidence to market participants and consumers alike that revenue recovery is occurring in an efficient manner that provides value for the consumer.

1.2.2 Opex

We welcome the RAs commitment to ongoing review of SEMOpx costs and the use of benchmarking in ensuring costs are efficiently incurred and measurable.

Of the two options put forward for Opex recovery, BGE supports the option of a target revenue approach, possibly with a cap and floor option. The latter would enable SEMOpx to react to market conditions and allow for recouping of *efficiently incurred* costs established in the Price Control. A relatively level NEMO playing field would also be made possible with such an approach and should SEMOpx exit the market as a NEMO in October 2019, the burden of re-assessing and applying a correction factor will not fall on the RAs as it would under the “allowed revenue” approach.

BGE is however in favour of incentives tied to obligations placed on NEMO as discussed further below. Consumers should be permitted to share in the benefits of achieved efficiencies where relevant.

1.2.3 Obligations on data transparency and service quality

BGE believes that to ensure compliance with CACM on the efficient recovery of costs by SEMOpx, that explicit obligations and related KPIs for SEMOpx are necessary. Incentives should have the effect of enhancing efficiencies which in turn provide benefits for the end consumer be that through revenues saved and shared, or service delivery for example.

Given the new market design of which market participants have no operating experience, many queries are anticipated to emerge particularly in the early days and satisfaction of these queries within suitable timelines will be critical to the effective operation of the market.

The publication of certain data within particular timelines is also critical to efficient market functioning. This data includes for example early ex-post prices. Other KPIs should include the need for system availability and resolution of queries within usefully narrow timelines. Credit cover and invoicing are also relevant parameters. We understand and request that there will be a further opportunity to put forward our considerations as to appropriate incentives and related weightings in the summer price control consultation.

1.2.4 Tariffs

BGE agrees that no undue barriers to entry should be permitted to arise in I-SEM on foot of the tariff structures applied to participate in the ex ante markets. We believe that an appropriate balance must be struck as between fixed and variable (floating) charges in order that all sizes of market participants can access market timeframes. As a general principle however, the approach to achieving the balance between fixed and floating fees must be such that SEMOpx recovers its efficiently incurred costs in a manner that facilitates all types of market participants to enter the market without discriminating or allowing an uneven playing field between market participants to develop.

In this context BGE is in favour of applying variable fees on a per MWh basis. This in our view best achieves a balance between different market participant sizes and avoids barriers to entry. Payments applied on a per user or per transaction basis would be more likely to have barrier to entry impacts.

The proposed “light” approach to membership seems pragmatic but BGE would welcome more detail on it before agreement. We understand that the actual tariff structures will be decided on through the Price Control consultations. A more informed view on the trade off between the fixed and variable fee structures will be better informed by proposed tariffs in these areas and the cost recovery needs of SEMOpx itself which we will address further in the June consultations.

1.2.5 Length of Price Control

BGE agrees that the length of the SEMOpx price control should continue until the expiration of its initial designation as NEMO, i.e. October 2019. Indeed our views expressed above on principles for revenue recovery for Capex and Opex are made in this context. However, should SEMOpx re-apply for designation (which re-application should occur by October 2018), the RAs should undertake a full review of the extent of price control required in the context of the non-commercial nature of SEMOpx, its status as one entity in a Group of companies some of which are also I-SEM market participants and the need to avoid potential conflict of interests. Ultimately the treatment of SEMOpx now and going forward should not in any way disadvantage other NEMOs or deter their entry to the market so that a competitive NEMO market is facilitated, with a view to keeping costs down for consumers.

2. Price Regulation of SEMO from I-SEM go-live

2.1 Price Regulation Parameters and Capex

It appears pragmatic to continue with the current RAB WACC approach until experience of what costs arise in I-SEM is gained. Transparency is critical however and BGE requests that full, line by line account for the RAB base and related depreciation and WACC is provided for in the Price Control and in subsequent related annual tariff reviews. The Consultation makes reference to possible sizeable Capex investments occurring “sporadically”² in the transition to I-SEM. BGE suggests that such sporadic lumpy investments should be pre-approved and flagged to the market where not covered in the price control given the likely large cost impacts of such investments. In any event, front loading costs on consumers over a short period of time must be avoided.

The alternative margin based approach appears to involve a certain element of subjectivity, for example, in terms of determining reasonable levels of margin which might be considered non-transparent, unpredictable and introduce an element of uncertainty in tariffs. Further, the lack of a competitive market environment and accurate comparator undermines the utility of such an approach.

We also support a straight line 5 year based depreciation and that any RAB additions are subject to the same depreciation policy. Capex developments during the year with any costs that impact on the original Price

² Page 29

Control settings should be simply and transparently reported in annual tariff reviews related to the price control.

Lastly, reference is made in the Consultation to possible k-factors that could arise on foot of the current 2016-2019 Price Control. These corrections should be evident from the year on year tariff reviews related to the price control.

2.2 Opex and Incentive Regulation

BGE is a strong advocate of performance based regulation (“**PBR**”). Performance incentives have a central role to play in encouraging efficiency in company operation with results that work in favour of the customer be that through enhanced service delivery or revenue savings which can be shared with customers.

As previously outlined, the overarching principle of the revenue recovery approach must be to ensure value for the end consumer in how SEMO operates its business. In this regard, a move away from the traditional RPI-X approach towards a more outputs based regulation such as RIIO³ best enables a focus on delivering quality performance to customers. However, BGE urges caution in designing an appropriate RIIO mechanism. Ofgem’s 2015/ 2016 annual reports on the various electricity and gas transmission and distribution system operators evidence certain drawbacks of the RIIO design. The Ofgem experience demonstrates that there are significant calibration issues in that targets have not been set appropriately given that for example all operators’ performance were mostly above average. The incentives must offer good value for the consumer and not be overly generous as appears was the case in the UK. It is evident that more rigour is required in terms of for example stress testing the incentives and ensuring that symmetrical incentives are applied to encourage appropriate performance. Overall, the RIIO is a good approach to regulation in principle but the key is to ensure it works effectively in practice such that it brings benefits for the consumer.

Regarding the current SEMO KPIs or incentives, we do not believe that they all remain fit for purpose. For example BGE considers that more pressing data publication includes for example forecast imbalance, NIV forecast, aggregated Final Physical Notifications, imbalance price by Imbalance Pricing Period, imbalance settlement price by Imbalance Settlement Period. The system availability KPI will remain important and consideration should be given to extending the timelines for availability to cover at least all market timeframe auctions (for example, a potential within-day auction may occur at night-time). Invoicing and credit cover notices remain important also. The timeline for resolving general queries should be gradually reduced as I-SEM progresses. Consideration should also be given to reducing the permitted number of upheld resettlement queries in a quarter considering the critical nature of pricing in I-SEM. An update in KPIs and weightings requires in our view a revision also of the performance metrics in light of the changed roles and responsibilities of SEMO in I-SEM. BGE understands that further consultation on this issue is expected in the imminent Price Control consultation in which we will also put forward views on possible KPI weightings.

Finally, with a view to minimising costs for consumers, BGE believes that should any significant underlying Opex shifts occur, SEMO should furnish the RAs with analysis of such in the annual tariff setting process, before their approval. BGE also supports the use of benchmark regulation as an important tenet of the price regulation process. Comparative market operator costs should be taken into consideration though relevant differences between comparators and SEMO’s business, for example SEMO being a monopoly, should be taken into account also.

2.3 Tariffs

BGE agrees that a revision of tariff structures will need to occur given the changes to SEMO’s role in I-SEM. We would welcome confirmation that this issue will be covered in this June’s Price Control consultation?

2.4 Duration of Price Control

BGE agrees with an initial Price Control duration of 3 years. A duration that provides an element of stability in expected tariffs is required. However after 3 years sufficient experience of the actual costs of SEMO should be ascertainable and it will be appropriate at that time to carry out a full review of the revenue regulation approach in light of the experience that will have been gained at that point.

³ RIIO: Revenues = Incentives + Innovation + Outputs

3. I-SEM Implementation Charges

Reference is made to the Agreed Approach Document which covers the Expenditure Recovery Framework for I-SEM related project costs. These costs that are: a) efficiently incurred; b) demonstrably necessary for progression of I-SEM, and c) incremental to existing price controls and capable of being robustly validated by the RAs are to be recovered via the appropriate tariffs. BGE requests confirmation that the planned document regarding the approach to recovery of such costs will provide insight into the process applied by the RAs under the Expenditure Recovery Framework and that stakeholder review and feedback will be facilitated?

In general, BGE would welcome an indication as to the range of costs that have already been spent by the TSOs related to SEMO and SEMOpx development and whether the full range of costs pre I-SEM go live will have been recovered pre- go- live?⁴ Given the impact of such costs on end consumer bills, we would welcome this information as early as possible.

4. General queries and clarification sought

In addition to our views above, BGE seeks clarity from the RAs on the following additional queries:

- i. This Consultation is stated to refer to the recovery of NEMO “national” costs. BGE would welcome further insight as to the progress on, and timelines as to when we might see sight of, the expected costs related to “common” costs incurred from all NEMOs’ coordinated activities as well as “regional” costs resulting from NEMOs cooperating in a certain region. We would welcome more information on this for tariff certainty reasons and also whether stakeholder input is expected on these costs at some point?
- ii. The Consultation states that a separate decision on the required allowance to facilitate SEM Active (i.e. to May 2018) will be made prior to the new tariff year in October. Does the current price control automatically extend to November 2019 even though it was anticipated to end in March 2019 or is another decision required on this?
- iii. BGE seeks clarity on the Consultation points relating to a need for “a revenue control for the trading facilities offered by the NEMOs (power exchanges, auctions etc.)” and the point that the “same level of revenue regulation will not apply to passport NEMOs, or NEMOs seeking designation in future”.⁵ We would be grateful for further information as to the RAs’ intention with regard to regulation of other NEMOs aside from SEMOpx?
- iv. Lastly, reference is made to the Licence Obligation on SEMOpx to act as an Agent of Last resort (AOLR) which may result in costs which are specific to I-SEM requirements and will require due consideration. Is this referencing the need to consider AOLR costs in the Price Control or some other issue?

5. Summary and Conclusions

By way of conclusion, BGE supports the recovery of efficiently incurred costs that are reasonable, proportionate and transparent. The overarching principle to designing revenue recovery approaches should be to ensure that value to the consumer is attained. In summary, our key comments and suggestions in this response include:

SEMOpx

- i. In light of the legal obligation to appoint a NEMO by December 2015, it is appropriate that establishment costs for SEMOpx are recoverable. These costs should be recovered through the TSO charge base as it will: avoid front-loading costs on consumers; enable SEMOpx to be more competitive as a NEMO; avoid the administrative burden on the RAs to reassess application of a correction factor at the end of the SEMOpx designation period; allow an existing cost-sharing methodology as between the TSOs to be readily utilised for the short duration of the Price Controls;
- ii. Incremental capex should be pre-approved by the RAs before being incurred by SEMOpx;
- iii. Avoidance of double counting of costs as between the SEMOpx and the TSOs must be ensured;
- iv. SEMOpx Opex should be recovered on a target approach with a possible cap and floor regime;

⁴ It is noted in the Consultation (p.4) that these costs are being reviewed on an ongoing basis with the intent that the “costs are recovered by the TSOs for Ireland and Northern Ireland (EirGrid and SONI) through their transmission charges.”

⁵ Page 15-16

- v. KPIs and incentives for SEMOpx should apply with revenue sharing with consumers a possibility; - please see section 1.2.3 for more detail;
- vi. Tariffs should be set such that no barriers to entry exist and in a way that avoids discrimination of any market participant or results in an uneven playing field. Tariffs should be applied on a per MWh basis;
- vii. The price control should expire on expiration of SEMOpx designation as NEMO and a full revenue recovery principles review should occur at that point ensuring for example that conflicts of interest do not arise.

SEMO

- i. The current RAB WACC approach appears pragmatic until experience of I-SEM operation and related costs is gained. Sporadic capex should however be pre-approved and flagged to market participants with reasonable notice given their tariff impacts;
- ii. Performance based regulation is supported for Opex and the RIIO is a possible approach. It is critical however that lessons from Ofgem's experience are applied and that the design of the mechanism in terms of incentives and their metrics are suitable and are not overly generous such that calibration issues manifest;
- iii. KPIs and incentives are critical and must be reviewed in light of SEMO's changing role. Please see further detail in section 2.2 above;
- iv. Changes in underlying Capex and Opex should be outlined simply and transparently in annual tariff reports related to the price control itself;
- v. A price control duration of 3 years is considered practical.

BGE strongly supports the intention of the RAs to consider the RAs' future role in a price control towards the end of the SEMOpx designation period. At that stage the RAs should have an indication as to whether SEMOpx intends to continue to act as a NEMO or not. We believe that our proposals above relating to SEMOpx are appropriate from I-SEM go-live until the end of the SEMOpx designation period but beyond that an altogether different competitive environment may exist.

BGE also outlines a number of issues in sections 3 and 4 above on which we seek clarity from the RAs.

I hope that you find the above comments and suggestions useful. Please do not hesitate to contact me should you have any queries.

Yours sincerely,

Julie-Anne Hannon
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Bord Gáis Energy

{By email}