Revenue Recovery Principles for SEMO and Designated NEMO (SEMOpx) from I-SEM go-live

SEM-17-018

Consultation Paper

A Response by EirGrid plc and SONI Ltd

16 May 2017

EIRGRID SONI

Introduction

1. EirGrid and SONI welcome the opportunity to respond to the SEM Committee's consultation on the revenue recovery principles for SEMO and SEMOpx from I-SEM go-live.
2. Under the new I-SEM arrangements SEMO and SEMOpx will be responsible for the operation of different markets within the I-SEM. SEMO will be responsible for balancing market settlements and capacity market settlement, while SEMOpx will provide a platform for trading electricity in the Day-Ahead and Intra-Day Markets and also settle trades within these markets.
3. Appropriate regulatory revenue recovery frameworks for each should take account of the characteristics of each Market Operator and also the risks inherent in the operation of the businesses. Furthermore, it is important that the framework incentivises each Market Operator to operate in a manner which will allow each to best provide benefit to the electricity customers in the relevant markets.

Revenue Control Arrangements for SEMO

4. EirGrid and SONI support the continuation of a revenue control approach for SEMO in I-SEM. In particular we support the continuation of a regulatory approved tariff and adjustment through the k factor. Ongoing operational costs should be subject to *ex ante* regulatory scrutiny and incentivisation in accordance with revenue cap arrangements. These arrangements have served customers well.
5. If incentive based regulation is to work effectively it must be given time to do so which would suggest a longer revenue control period. However the longer the control the greater the level of uncertainty which must also be managed. EirGrid and SONI support a revenue control which would run from May 2018 to 30 September 2021 (i.e. 3 years and 4 months). This will enable the I-SEM to bed down, information to be derived as to its operation and regulatory burden in terms of ongoing revenue control work to be proportionate.
6. If the control is to be 3 and a half years in length there will however, need to be mechanisms to manage uncertain costs and a level of re-opener and exclusion from the overall revenue cap arrangements. This is particularly the case for capital projects driven by market changes.
7. The *ex ante* revenue cap works through allowing regulated utilities to benefit from any savings/ be exposed to any overspend in the short run whilst re-setting the cap and therefore that paid by consumers in the medium term. The mechanism should be designed such that incentives to make savings are the same regardless of the year within the control in which they are made, with retention being applied on a rolling basis, as the CER has applied in other controls. The savings should be capable of being retained for 5 years, effectively 30% of the

benefit flowing to the regulated utility and 70% to final customers on an NPV basis.

8. It is standard practice that such revenue caps are adjusted for general inflation (RPI/CPI), Real Price Effects (RPEs) and efficiency (X). In the paper it is stated that "*As SEMO's opex is relatively stable over a Price Control period, the RAs are of the view that the scale of SEMO does not justify an RPE approach*." EirGrid and SONI do not follow the logic expressed here. RPEs represent a standard part of the regulatory architecture and are widely applied, including by the Utility Regulator in the context of the SONI price control which faces similar specialised labour costs to SONI in its capacity as SEM Operator. We wish to discuss this point with you further.

9. While the revenue cap framework should be maintained, EirGrid and SONI are of the opinion that other aspects of the underlying regulatory framework for SEMO will need to be revised under I-SEM. This given that, consistent with the letters received from the Regulatory Authorities concerning the recovery of I-SEM project implementation costs, under the arrangements for I-SEM, SEMO will not have an opening Regulatory Asset Base. Further while EirGrid and SONI do not dispute that additional capital expenditure will be recoverable through the MO price control framework, it is believed that any capital expenditure during the price control period would be so small that the business would be incapable of growing a RAB of any significance.

10. SEMO's regulation on a WACC RAB basis would therefore not be likely to secure its financeability as a business. This would certainly be the case were the business to be exposed to any risk as would be suggested under the application of the revenue cap model outlined in the paper and discussed above. It would not therefore represent a sustainable business model.

11. EirGrid and SONI do not therefore understand nor agree with the proposed WACC RAB approach suggested by the Regulatory Authorities and would wish to discuss it further to understand the arrangements and how the Authorities have given consideration to the wider financeability questions.

12. EirGrid and SONI believe a margin based model is likely to be more suited to the Market Operator licensees whereby the predominant capital employed by the business is operating capital and financial metrics considered by investors relate more to turnover and EBIT margin than to WACC returns on regulated assets. It may be a hybrid type model considering working and contingent capital, margin based remuneration of operating costs, performance based incentivisation and WACC returns on limited capital investment driven by regulatory policy decisions is ultimately that which is most appropriate. It is our view that this merits further discussion.

13. The RAs have indicated that their decision is premised on that which has pertained to date; however given the change in circumstances as outlined above, that which previously pertained is not in our view appropriate going forward.

14. We would note a number of factual inaccuracies in the SEM Committee paper which we believe it is important we correct for the record. It may be that some of this misunderstanding is what has led to the position as articulated above.

    a. SEMO is not a joint venture between the TSOs. SEMO is a joint venture between EirGrid plc. in its capacity as a licensee granted under Section 14(1)(e) of the Electricity Regulation Act, 1999 and SONI Ltd in its capacity as licensed SEM Operator in exercise of the powers conferred by Article 10(1)(d) of the Electricity (Northern Ireland) Order 1992.

    b. It is incorrect to state SEMO is not a profit raising entity. Both EirGrid and SONI are standard corporations which are expected to generate profits.

15. Further we have separately received correspondence from you dated 8 May 2017 which suggests that it is the TSOs which hold the ability to finance the MO licensed activity and that financeability of the Market Operator business may be addressed in that fashion. This is not simply the case.

16. In relation to incentives and KPIs, EirGrid and SONI believe it is important that the Market Operator licensees are appropriately incentivised to deliver high quality service levels. Any incentives must however be appropriately calibrated as part of the licensees' ability to bear risk and understood in the context of the overall regulatory framework and regulatory model pertaining.

Revenue Arrangements for SEMOpx

17. In relation to SEMOpx, EirGrid and SONI note the articulation of the Regulatory Authorities need to secure a NEMO to participate in I-SEM from Day 1, particularly given the absence of any alternative route to the day-ahead market. This is also consistent with including the requirements under Article 4 of CACM for Member States to designate at least one NEMO

18. EirGrid and SONI were designated as NEMO in Ireland and Northern Ireland respectively in October 2015. The designation represents a right to provide NEMO services but not an obligation to do so.

19. The RAs have since consulted upon and inserted licence conditions into both EirGrid and SONI's licences concerning the regulation of the provision of NEMO services.

20. EirGrid and SONI support the recovery of the capital costs of Day 1 NEMO establishment, on the same basis as the remainder of the I-SEM implementation costs through TUoS and SSS Tariffs, as all were entered into by them on the same basis.

21. We support the length of period over which the regulatory revenue recovery arrangements for ongoing costs of operation being related to the designation period (i.e. up to October 2019). It will however be important that there is some basis of true up post October 2019 to ensure only appropriate costs are recovered and any excess monies returned to customers.

22. Consistent with the requirement to have a Day 1 NEMO in place we believe the Regulatory Authorities should give consideration to a full regulatory model for NEMO services, akin to a NEMO of last resort, recognising the importance of having NEMO services in place. Any such arrangements would of course, need to be cognisant of and compliant with the requirements of Article 6 of CACM.

23. Should there not be a full regulatory recovery model then it would be necessary to provide tariff flexibility to NEMO providers and would need to facilitate ease of exit from the provision of NEMO services.

General Concluding Comments

24. EirGrid and SONI believe it is important that these issues are considered not for both licensees together but separately in terms of the licence granted to each in accordance with the arrangements pertaining in the relevant jurisdiction. For example it is only SONI Ltd which has in place a Parent Company Guarantee, required under licence, which must be remunerated. However, the management of cashflow imbalances and contingent capital is equally a matter for EirGrid plc. These are areas where the Specified Proportions, applied to date, do not necessarily apply. This is not always clear in the paper.

25. Finally, we would note that the timings as set out in the paper need to be such that they provide for the full completion of the revenue control process, including its codification in respect of SONI in Northern Ireland, prior to implementation

26. An annex is included which seeks to identify and answer the specific questions the RAs asked within the consultation paper.

Annex 1: Questions within the Consultation

SEMO

1. **Does WACC RAB with an appropriate incentive mechanism continue to be appropriate for SEMO under I-SEM? Or is margin based similar to Power NI PPB or DCC more appropriate?**

A. As outlined in points 9-12 of the response document above, EirGrid and SONI do not believe that the WACC RAB approach is appropriate for SEMO under I-SEM. EirGrid and SONI believe a margin based model would be more suited to SEMO, with the possibility of some form of hybrid model adopted. As stated previously it is our view that this merits further discussion.

2. **Should the current allowed revenue RPI-X, with Performance Based incentives, regime continue to apply to SEMO in I-SEM? Alternatives include Price Cap, Benchmarking i.e are the current incentives fit to be carried over?**

A. EirGrid and SONI's views on revenue cap regulation, and its applicability in the case of SEMO under I-SEM, are outlined under points 4, 7 and 8 above. In summary, we believe that these arrangements have served customers well in the past. The mechanism should be designed such that incentives to make savings are equalised throughout the control period and applied on a rolling basis. The savings should be capable of being retained for 5 years, effectively 30% of the benefit flowing to the regulated utility and 70% to final customers on an NPV basis. EirGrid and SONI would like the opportunity to further discuss the RAs rationale around RPEs, as indicated previously.

3. **Should the metrics included in the performance element be revised in light of the changes in roles and responsibilities for SEMO in I-SEM?**

A. In relation to incentives and KPIs, EirGrid and SONI believe it is important that the Market Operator licensees are appropriately incentivised to deliver high quality service levels. Any incentives must however be appropriately calibrated as part of the licensees' ability to bear risk and understood in the context of the overall regulatory framework and regulatory model pertaining.

4. **What length should the Price Control be?**

A. As indicated in point 5 above, EirGrid and SONI support a revenue control which would run from May 2018 to 30 September 2021 (i.e. 3 years and 4 months).

SEMOpx

1. **How should SEMOpx implementation costs be recovered?**

A. As indicated above, EirGrid and SONI support the RAs view that the costs of Day 1 NEMO establishment should be recovered on the same basis as the remainder of the I-SEM implementation costs as all were entered into under the same basis.

2. **Should incremental Capex be considered separately to implementation costs?**

A. Yes, in the event that any incremental Capex is incurred it would likely need to be recovered through the NEMO tariffs.

3. **Should a target revenue (with a cap and floor regime) or an allowed revenue approach to Opex recovery be used?**

A. As specified in point 22 above, EirGrid and SONI would support the consideration of a full regulatory model for NEMO services, akin to a NEMO of last resort, recognising the importance of having NEMO services in place, noting that any such arrangement would of course, need to be cognisant of and compliant with the requirement of Article 6 of CACM. Given this, EirGrid and SONI do not believe a target revenue model would be appropriate, as this is either not representative of a full regulatory model, where an allowed revenue approach would be more appropriate, or restrictive under the conditions of a competitive market, where a less regulated approach would be required.

4. **How best to have a regulated price control for SEMOpx while also facilitating/ encouraging competition?**

A. As indicated under points 22 and 23 above, EirGrid and SONI believe that the RAs should give consideration to a full regulatory model for NEMO services, akin to a NEMO of last resort, recognising the importance of having NEMO services in place. Should the RAs come to the opinion that this is inappropriate, it would be important to provide tariff flexibility to NEMO providers and facilitate ease of exit from the provision of NEMO services.

5. **How to best obligate SEMOpx to be transparent with data and ensure a high standard of service? Can KPIs be used to incentivise this? How?**

A. Similar to point 16 related to incentivisation for SEMO under I-SEM, EirGrid and SONI do believe it is important that a NEMO price control would appropriately incentivise the business to deliver high quality service levels. However, it may be difficult to initially assess appropriate metrics for incentivisation and KPIs given the requirement for a sufficient bedding in period and given the proposed short price control period, May 2018 to October 2019 (i.e. 17 months), it will be challenging to decide on what these should be. Additionally, we should be mindful that it is a competitive market, and maintaining competitiveness would therefore serve as a form of incentivisation.

6. **What is an appropriate balance for charging bases?**

A. EirGrid and SONI believe it should be a priority to first agree on the regulatory revenue recovery arrangements prior to agreeing on an appropriate balance for NEMO charging bases. We would propose to discuss this further once the arrangements are in place.

7. What length should the price control be?

A. EirGrid and SONI support the view that any initial price control should be of the same length as the designation. This is elaborated under point 19 above.