

Final Determination to the Price Control 2015-2020 for the Electricity System Operator for Northern Ireland (SONI)

22 February 2016



About the Utility Regulator

The Utility Regulator is the independent non-ministerial government department responsible for regulating Northern Ireland's electricity, gas, water and sewerage industries and to promote the short and long-term interests of consumers.

We are not a policy-making department of government, but we make sure that the energy and water utility industries in Northern Ireland are regulated and developed within ministerial policy as set out in our statutory duties.

We are governed by a Board of Directors and are accountable to the Northern Ireland Assembly through financial and annual reporting obligations.

We are based at Queens House in the centre of Belfast. The Chief Executive leads a management team of directors representing each of the key functional areas in the organisation: Corporate Affairs; Electricity; Gas; Retail and Social; and Water. The staff team includes economists, engineers, accountants, utility specialists, legal advisors and administration professionals.

Our Mission

Value and sustainability in energy and water.

Our Vision

We will make a difference for consumers by listening, innovating and leading.

Our Values

Be a best practice regulator: transparent, consistent, proportional, accountable, and targeted.

Be a united team.

Be collaborative and co-operative.

Be professional.

Listen and explain.

Make a difference.

Act with integrity.

Abstract

The purpose of this document is to inform stakeholders on the Final Determination (FD) in relation to the next price control for the electricity transmission System Operator for Northern Ireland (SONI). This price control is effective from 1 October 2015.

Audience

Regulated Companies; Consumer Groups; Industry and Statutory Bodies.

Consumer impact

SONI has a pivotal role in terms of 'keeping the lights on'. Both the effectiveness and efficiency of SONI is key to industry and consumers.

Impact on SONI System Support Services (SSS) tariff – the Final Determination results in a reduction of c£7 million (9%) over the 5 year period. This translates to an annual average reduction in tariffs for domestic users of c£0.70 and c£1,600 for Large Energy Users. In comparison SONI submitted a £27 million (35%) increase for the 5 year period, translating to an annual average tariff impact of c£2.60 increase on domestic consumers and an increase of c£6,200 on Large Energy Users.

Executive Summary

SONI Ltd (SONI) is licenced as the Transmission System Operator (TSO) for Northern Ireland and is subject to a regulated price control. The SONI price control takes place in the context of increased renewable electricity generation and European legislative developments. Furthermore, during 2014, as a result of implementing IME3¹, SONI is now responsible for transmission network planning up to the construction phase.

This price control is effective for a five year period from 1 October 2015 to 30 September 2020. The overall objective of this price control is to ensure that SONI can continue to operate the transmission system in Northern Ireland securely and efficiently, and at a reasonable cost to consumers.

The Utility Regulator consulted upon a Draft Determination for which five responses were received, with the most comprehensive response coming from SONI. Throughout this process, there has been considerable engagement, discussions and clarifications between the Utility Regulator and SONI. Summarised below are the key changes from the Draft Determination to this Final Determination:

- Capitalisation of network pre-construction projects
- Pre-tax WACC increased from 5.42% to 5.9%
- Inclusion of debt facility access costs £540k
- Inclusion of Real Price Effects (RPE) at 0.7%
- Inclusion of 2010-2015 capital overspend on Energy Management System (EMS) £1.7million

The overarching regulatory framework has been SONI's greatest concern throughout this process as it directly impacts on their financeability. SONI proposed a new framework comprising a range of revenue streams with the possibility of including a margin. Given the extent of SONI's concerns, the Utility Regulator has further engaged with SONI, has carried out further analysis, considered latest regulatory evidence and sought external advice.

The approach taken within this Final Determination also reflects the focus of regulators recently when considering financeability. Emphasis is on ensuring that the framework and allowances in the overall price control package provide an efficiently managed company with sufficient returns to attract and maintain the financial capital that the business needs in order to carry out its obligations. This has meant less focus on credit metrics and financial ratios than has sometimes been the case in the

¹ EU Third Internal Energy Package (IME3)

past, with choices about capital structure (i.e. the mix of debt and equity) being more explicitly left to the company to determine.

Based on the above, the Utility Regulator has concluded the existing RAB * WACC regulatory framework remains appropriate. Overall, the Utility Regulator has found insufficient grounds, based on its examination of the business's capital requirements, for allowing any additional return, whether in the form of allowances for contingent equity capital, intangible capital or a margin, over and above those elements in the RAB * WACC framework.

However, the Utility Regulator has made a number of amendments including, raising the WACC to 5.9% reflecting SONI's risk profile, providing 2% above LIBOR if SONI under-recover from tariffs and providing costs for accessing a debt facility. The Utility Regulator has determined that this approach will allow SONI to finance its licence activities and serves to protect the interest of consumers. This decision does not fix a precedent and the issue will be fully considered again at the next price control.

Another area of considerable engagement with SONI has been in relation to transmission network planning as it is a new area for consideration within this price control. Following a range of approaches, such as treating all costs as operational costs, the Utility Regulator has decided that SONI will recover the cost from NIE at the point of transfer, with the ultimate cost of pre-construction being borne by NIE and its tariff structure.

Therefore this determination sets out detailed figures only for the day-to-day network planning costs only. In relation to network pre-construction projects SONI has forecast a total of £28 million and this will be dealt with an ongoing approval process upon application by SONI.

Additional incentivisation measures were introduced during the 2010-2015 price control, with the introduction of Dispatch Balancing Cost incentivisation by the SEM Committee. A further incentive is also being considered by the SEM Committee in relation to the DS3 System Services project. This demonstrates the Utility Regulator is supportive of incentive arrangements in the right circumstances. Specifically within this price control there is greater focus on monitoring outputs in terms of Reliability and Availability, Quality of Service, Customer Satisfaction, Customer Connections, Strategic Initiatives and Network Planning. This will assist with informed decisions when further considering incentives.

The Utility Regulator views the key outputs of SONI during this price control as being the successful implementation of the DS3 project, I-SEM implementation and the

commissioning of the North-South Interconnector.

New to this price control is a 50/50 risk share mechanism which has been used recently² by the Competition Markets Authority. This reflects the value of the price control outperformance or underperformance being shared equally between SONI and customers. The introduction of this 50/50 risk share mechanism coincides with the introduction of annual cost and outturn reporting.

Overall SONI's business plan proposed a level of revenue of £132 million. Following analysis the Utility Regulator has determined £97 million to be appropriate. This includes £28 million forecast for specific network pre-construction projects. Table A below provides a comparison between the 2010-2015 price control and this 2015-2020 price control Final Determination.

	2010 - 2015 Allowance £'000	2010 - 2015 SONI Actuals (estimate 2014/15) £'000	2015 - 2020 SONI Submission * £'000	2015 - 2020 UR Draft Determination £'000	2015 - 2020 UR Decision £'000
Payroll (incl ongoing pension)	33,282	31,219	42,881	37,576	36,083
IT and Telecoms	10,559	7,988	9,501	9,501	9,501
Other Operating Costs	7,919	8,624	17,379	6,681	7,056
Pension Deficit	172	391	740	740	943
OPEX Total	51,932	48,222	70,501	54,499	53,583
Depreciation	19,336	9,926	9,761	10,279	11,980
Rate of Return (excl Pre-construction)	4,538	4,115	2,702	1,538	1,768
	75,806	62,263	82,965	66,316	67,330
Innovation Fund			2,625	0	0
Remunerate Contingent Capital (PCG)			6,900	0	0
Margin			13,000	0	0
	75,806	62,263	105,490	66,316	67,330
Network Planning Function**	3,100	3,443	25,100	25,100	28,000
Real Price Effects & Productivity			1,289	0	1,496
Total	78,906	65,706	131,879	91,416	96,826
* Based on the SONI original submission made 21 October 2014					
** SONI responsible for Network Planning from May 2014. Therefore the 2015-2020 UR Decision payroll and network planning function allowances are not directly comparable with the other columns.					

Table A: Summary of SONI TSO Actuals, Submission and UR Allowances (April 2014 prices)

Table A above is shown diagrammatically below in Diagram A.

² Competition Commission Final Determination on NIE 2014

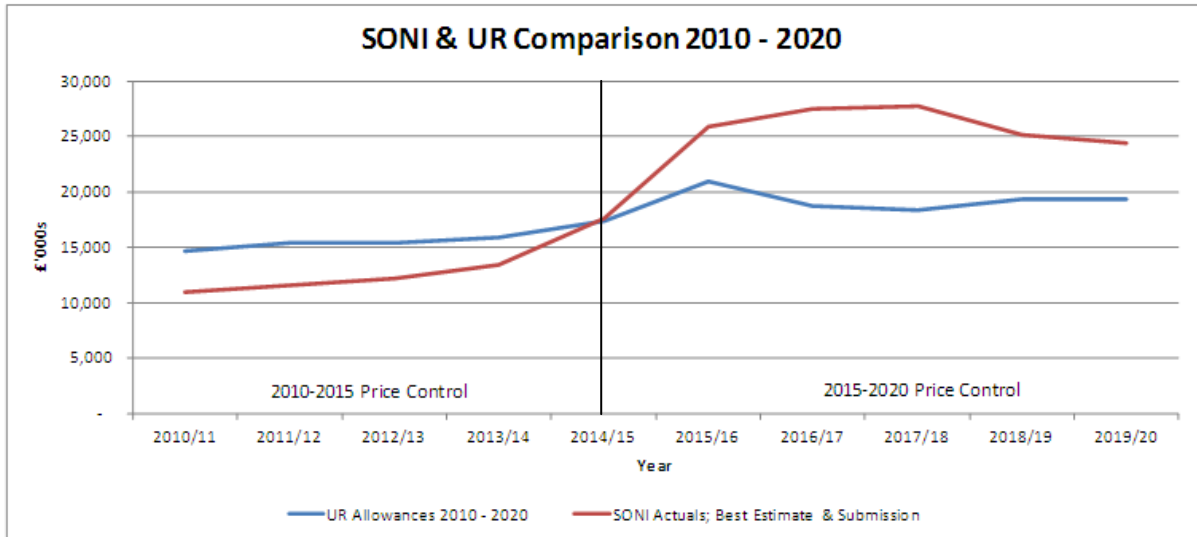


Diagram A: Summary of SONI TSO Actuals, Submission and UR Allowances (April 2014 prices)

As network pre-construction costs (up to £28 million) will be ultimately borne by NIE this amount does not directly impact on the SONI System Support Services (SSS) tariff. Therefore the overall impact of this price control Final Determination on the SONI SSS tariff is a reduction of c£7 million (9%) over the 5 year period. This translates to an annual average reduction in tariffs for domestic users of c£0.70 and c£1,600 for Large Energy Users.

In comparison SONI submitted a £27 million (35%) increase for the 5 year period, translating to an annual average tariff impact of c£2.60 increase on domestic consumers and an increase of c£6,200 on Large Energy Users.

It is important to note that the overall allowance applicable to SONI will increase, during this price control period, once the I-SEM and DS3 implementation costs have been established and approved by the relevant authority.

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1. Introduction

1. The System Operator for Northern Ireland (SONI) is responsible for planning and operating the electricity transmission network in Northern Ireland. SONI is a monopoly and therefore subject to a regulated price control. This Final Determination paper details the Utility Regulator's decision on SONI's allowed revenue specific to the SONI system operation business for the five year period commencing 1 October 2015 to 30 September 2020.
2. References to "SONI" within this paper should be taken to mean SONI in its capacity as Transmission System Operator (TSO) unless otherwise stated.

1.1 Company Overview

3. SONI Ltd holds two licences giving SONI responsibilities as Transmission System Operator (TSO) and Single Electricity Market Operator (SEMO). This paper focuses solely on SONI's role as Transmission System Operator (TSO).
4. As a holder of a transmission licence SONI has a legal³ responsibility to take such steps as are reasonably practicable to –
 - a) ensure the development and maintenance of an efficient, co-ordinated and economical system of electricity transmission which has the long-term ability to meet reasonable demands for the transmission of electricity;
 - b) contribute to security of supply through adequate transmission capacity and system reliability; and
 - c) facilitate competition in the supply and generation of electricity.
5. Core functions of SONI include:
 - operating the transmission network, including both near and real time;
 - balancing the system to achieve the lowest cost of production; and
 - planning the transmission network from identification of need through to obtaining all necessary consents and planning permission before transferring for construction.
6. SONI Ltd was acquired by EirGrid plc, the electricity transmission system operator for the Republic of Ireland, following divestment from Northern Ireland Electricity plc (NIE) in 2009, now known as "NIE Networks". Other businesses within EirGrid Group include EirGrid Interconnector Ltd (licence to own and operate the East West Interconnector (EWIC)) and EirGrid Telecoms Ltd. EirGrid Group structure is shown below in Diagram 1.1.

³ [The Electricity \(Northern Ireland\) Order 1992 Article 12 paragraph 2](#)

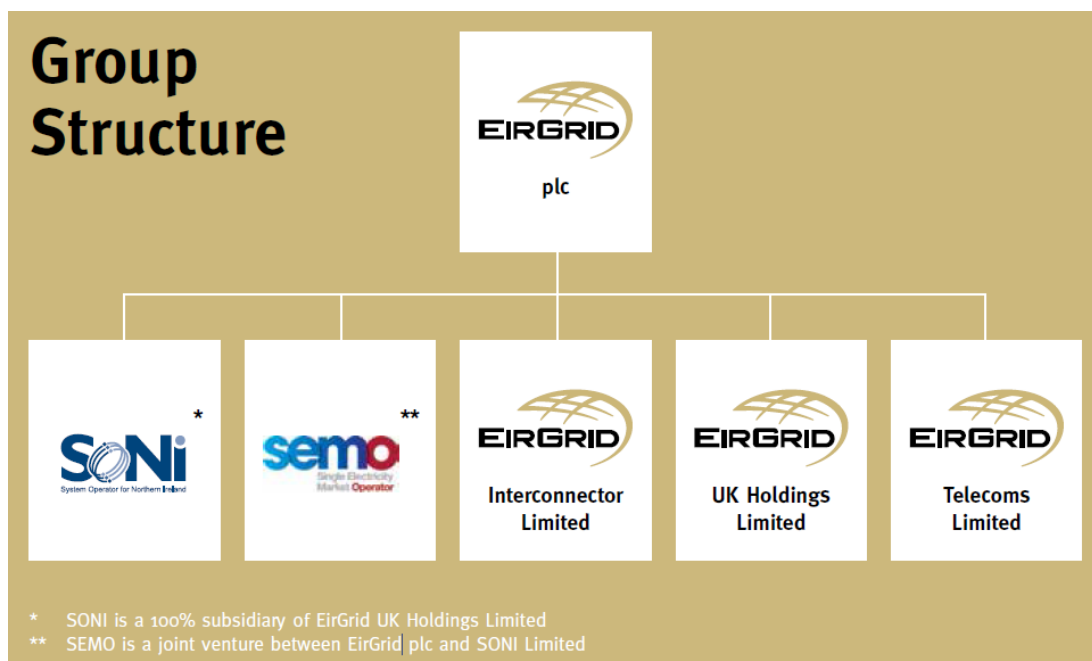


Diagram 1.1: EirGrid Group Structure (Source: EirGrid Annual Report 2014)⁴

7. Within the SONI TSO licence, SONI can perform some duties by acting in conjunction with the Republic of Ireland system operator. These include establishing and operating a merit order system for SEM generation.
8. The role of Transmission System Operator (TSO) in Northern Ireland has evolved in recent years in a number of respects. This includes the implementation of the European Union Third Energy Package involving the European Commission's decision to certify SONI as the Northern Ireland TSO, independent from generation and supply interests, resulting in the transfer of the transmission network planning function from NIE to SONI in May 2014.
9. Furthermore the generation mix SONI manage continues to change due to the increase in renewable energy. Almost 20% of Northern Ireland's electricity demand came from renewable energy sources in 2014.

1.2 Regulatory Framework

10. The role of SONI as TSO is defined in statute, its licence and mandatory codes and agreements. SONI TSO's allowed revenue is determined by the Utility Regulator made up of a number of components as detailed within their licence.
11. In any year SONI is subject to an annual revenue cap denoted by M_{TSO} . A summary of the components is provided below:

⁴ <http://www.eirgrid.com/media/Annual%20Report%20web.pdf>

$$\text{MTSO}_t = \text{ATSO}_t + \text{BTSO}_t + \text{Bl}_t + \text{DTSO}_t + \text{KTSO}_t + \text{INCEN}_t$$

- **A_{TSOt}** includes the total cost estimate relating to Ancillary Services (System Support Services). These costs are treated as pass-through and are considered to be outside of SONI's price control.
 - **B_{TSOt}** is SONI's allowed revenue to cover their operating costs (OPEX), depreciation on the Regulatory Asset Base (RAB) and an appropriate return on those assets. These costs are defined within this price control.
 - **Bl_t** is a new component being proposed within the licence modifications. This captures the risk share mechanism within this price control. This reflects the value of price control outperformance or underperformance being shared equally between SONI TSO and customers.
 - **D_{TSOt}** encompasses price control excluded costs which are considered on an individual basis by the Utility Regulator. These costs are treated as pass-through up to a cap, as they are considered to be outside of SONI's control. Such costs are defined in the annex to SONI's licence and include the cost of implementing changes of law or significant policy changes. **K_{TSOt}** is a correction facility whereby under or over-recoveries in the previous year(s) can be collected by the business (under-recovery) or given back to consumers (over-recovery) adjusted for interest.
 - **INCEN_t** relates to the SONI portion of the all-island Dispatch Balancing Cost Incentive reward/penalty. This reflects the SEM Committee 'Incentivisation of All-island Dispatch Balancing Costs' decision for which licence modifications were published in August 2015⁵.
12. The focus of this Final Determination paper is on the **B_{TSOt}** component for which the Utility Regulator has determined a revenue allowance following an assessment of expected performance and risks. The **D_{TSOt}** and the **K_{TSOt}** is discussed in Chapter 11.

1.3 Consultation Responses

13. The Utility Regulator published a consultation paper on 2 April 2015 which invited interested stakeholders to express a view on any particular aspect of the draft determination paper. The Utility Regulator received five responses to the draft determination paper. The parties who responded were:
- SONI Ltd
 - Manufacturing Northern Ireland
 - The Consumer Council
 - Northern Ireland Renewables Industry Group
 - Prospect Union

⁵ http://www.uregni.gov.uk/news/decision_on_reporting_and_tariff_changes_to_sonis_transmission_licence

14. The Utility Regulator has considered each of the responses received and has been engaging with SONI throughout this price control process. The responses are published along with this final determination paper.
15. This paper addresses the main issues raised in the responses within the relevant chapters.

2. Approach to the price control

2.1 Regulatory Principles

16. The Utility Regulator is responsible for regulating the electricity, gas, water and sewerage industries in Northern Ireland, promoting the short- and long-term interests of consumers. One of the principal objectives of the Utility Regulator is to protect the interests of consumers of electricity in Northern Ireland and where appropriate to do so by promoting effective competition.
17. It was stated in the Draft Determination that the Utility Regulator's task consists of creating a framework within which the regulated business receives a reasonable assurance of a revenue stream in future years that will cover its costs in return for providing monopoly services to an acceptable quality. The Utility Regulator continues to consider this approach to be consistent with the principles of better regulation⁶ which the Utility Regulator continues to apply: transparent, consistent, proportionate, accountable, and targeted.

2.2 Policy Framework

18. There are a number of policies which will have an impact on SONI during this price control period. These include:
 - The Executive's 2010 Strategic Energy Framework target of 40% electricity consumption from renewable sources by 2020;
 - TSO (ENTSO-E) development of Network Codes; and
 - The transfer of the transmission network planning function.
19. While the following may not directly be a part of this price control they will have an overall impact on the SONI system operator business:
 - The implementation of the Integrated Single Electricity Market (I-SEM) across Ireland and Northern Ireland in 2017. This is required to contribute to the implementation of the European Union Target Model which has the objective of harmonising arrangements for the cross-border trading of wholesale energy and balancing services across Europe.
 - DS3 – Delivering a Secure Sustainable Electricity System⁷. This aims to put in place the required changes to system policies, tools and performance to allow the electricity system to operate safely with a high penetration of non-synchronous generation.

⁶ Department for Business Innovation & Skills, *Principles for Economic Regulation*, published April 2011. A copy of this paper is available at:
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31623/11-795-principles-for-economic-regulation.pdf

⁷ <http://www.eirgridgroup.com/how-the-grid-works/ds3-programme/>

- Electricity Market Reform (EMR), which is designed to decarbonise electricity generation across the UK and ensure that the UK consumer pays the lowest cost for renewable generation. The most significant element of EMR for Northern Ireland is the implementation of the Contracts for Differences (CfD) scheme. This was introduced in GB in 2014 and DETI are currently considering whether or not this will be extended to Northern Ireland. In any case, the NIRO will close to new generation on 31 March 2017⁸.

2.3 Approach to Price Control

20. A SONI Price Control Approach Paper⁹ was published by the Utility Regulator in July 2014 together with a Business Plan Information Requirement being issued to SONI outlining both numerical and written information requests.
21. In April 2015 the Utility Regulator published a price control draft determination for consultation. Five responses were subsequently received.
22. The draft determination framework consisted of a number of building blocks which included: operating expenditure (OPEX), capital expenditure (CAPEX), rate of return on investment, incentives, risk sharing mechanism, uncertainty mechanisms and reporting requirements.
23. The Utility Regulator has engaged with SONI throughout this price control process. This has included numerous follow up questions, additional submissions and further meetings which have contributed to informing the decisions taken within this paper.

2.4 Responses to Draft Determination

24. In SONI's view the draft determination, if implemented, would not allow SONI to meet its licence obligations, would be inconsistent with the Utility Regulator's statutory duty to protect the interests of customers and would not be in the public interest. It does not provide a basis for SONI to finance its activities. Therefore the current regulatory model is not fit for purpose and needs amendment.
25. The Consumer Council stressed the importance of keeping costs to consumers to the minimum level necessary to achieve the Utility Regulator's objective. Given policy uncertainties, such as the 40% renewable electricity target, the price control should be kept under review to ensure consumers do not pay for unnecessary development to the network.
26. Manufacturing NI broadly support the Utility Regulator's approach, however they are disappointed that customers appear to be burdened with increasing costs. They welcome the inclusion of items, processes and penalties as applied to NIE in the Final Determination from the Competition Commission on NIE's Price Control.

⁸ <https://www.detini.gov.uk/articles/northern-ireland-renewables-obligation>

⁹ http://www.uregni.gov.uk/news/view/approach_paper_to_the_price_control_for_the_electricity_system_operator_for/

27. Prospect Union's response focused on payroll and pensions. Prospect did not view the Utility Regulator's use of the Office of National Statistics Annual Survey of Hours and Earnings (ASHE) as an appropriate benchmark. Concerns were also made regarding pension benchmarking and the Utility Regulator's proposed employer contribution rate for the defined benefit scheme.
28. NIRIG raised concerns regarding the limited increase in staffing levels, incentives and the transfer of planning process. The importance of capital expenditure on DS3 and the Energy Management System were also highlighted.

2.5 Utility Regulator Decision on Approach

29. In light of SONI's view the Utility Regulator has assessed the current regulatory framework and is of the view the framework remains appropriate for both consumers and SONI at this time.
30. The approach for this SONI price control 2015 – 2020 is outlined below :
 - Operational Expenditure (OPEX): Continue to use the ex-ante revenue cap framework to incentivise SONI to manage and control costs. Where possible, benchmarking has been carried out particularly in relation to payroll and ongoing pension contributions. Consumers have to date funded Northern Ireland regulated companies (those subject to a price control) historic pension deficit costs in full. As from 31 March 2015 any future incremental pension deficit amounts will not be recovered from consumers but will be funded 100% from shareholders¹⁰.
 - Capital Expenditure (CAPEX): The CAPEX allowance will continue to be set on an ex-ante basis with an allowance representing a revenue cap being provided. This will be recovered using a depreciation charge each year.
 - Risk: Appropriate financing to address SONI's risk profile. This risk remuneration allowance is predominantly reflected within the Weighted Average Cost of Capital (WACC) calculation. A risk sharing mechanism is being introduced on a 50:50 basis, between consumers and SONI, and will apply to both positive and negative outturn variances from the cost allowance.
 - Incentives: SONI continues to be incentivised by the ex-ante revenue cap framework, reputational incentives and the SEM Committee dispatch balancing cost incentivisation¹¹. Further incentive arrangements will be put in place as part of work with the SEM Committee including in relation to DS3.

¹⁰ Pension Deficit Recovery – A Utility Regulator Position Paper

http://www.uregni.gov.uk/uploads/publications/UR_Position_Paper_-_Pension_Deficit_Recovery_v1_0.pdf

¹¹ SEM Decision Paper – Incentivisation of All-Island Dispatch Balancing Costs SEM-12-033

http://www.allislandproject.org/en/transmission_decision_documents.aspx?article=40b93d75-e3f6-4eef-b997-3d9209a2b7d8

- Uncertainty Mechanisms: These provide the necessary flexibility to adjust allowances due to change of law/regulation and other specific costs above a materiality threshold. A materiality threshold and a specific pre-defined category of events will be accommodated within mechanisms such as Dt terms and Kt corrections. Enhanced cost reporting will be introduced which will assist with the adjustments necessary.
 - Reporting: Increased reporting will enhance monitoring of SONI and will inform the annual adjustment for the 50:50 risk sharing mechanism. The reporting template, in Appendix B, will be issued with this price control and will be targeted and proportional to the SONI TSO business.
 - Tariffs: The Utility Regulator will continue with a revenue cap approach for SONI's tariffs by setting the maximum regulated revenue to be recovered. The impact on tariffs will continue to be monitored.
31. There is a degree of uncertainty in terms of the workload and policy environment SONI will face over the next five years. This paper details how this will be managed within the price control. For example the implementation of I-SEM and DS3 System Services will require explicit expenditure provisions as the costs involved become better understood. This price control does however provide allowances for SONI operating under I-SEM and DS3, following implementation. There will be an opportunity to review these operational costs once the detail of I-SEM and DS3 emerges.
 32. In respect of EMR, work is continuing with DETI on the mechanism to recover potential set-up costs associated with implementation of the CFD scheme in Northern Ireland. The Utility Regulator will provide the necessary structural flexibility to accommodate these policies and their impact on SONI's costs within this price control, should CfDs be implemented in Northern Ireland.
 33. The Utility Regulator notes DETI's discussion paper on 'CFD Implementation in NI – Strategic issues'. The Utility Regulator will continue to keep abreast of the discussions and any subsequent decision. In the meantime the approach within this price control is to provide additional flexibility for SONI in recognition of further changes in renewable generation.
 34. In April 2014 the Competition Commission (now the Competition Markets Authority (CMA)) published their Final Determination in relation to NIE Transmission and Distribution price control¹².
 35. This CMA determination is relevant to the electricity industry within Northern Ireland and key areas of the Competition Commission Final Determination have been applied to this price control.
 36. The Utility Regulator also received analysis from external consultants on SONI's

¹² <https://www.gov.uk/cma-cases/northern-ireland-electricity-price-determination>

proposed submission. These consultants include CEPA, GEMSERV, RECKON LLP and First Economics.

37. The overall purpose of this price control is to ensure that SONI can continue to plan and operate an efficient, co-ordinated and economical system for the transmission of electricity in Northern Ireland. Therefore SONI's financeability has been assessed from a bottom up perspective in arriving at the sufficient and appropriate cost allowances.
38. The approach and price control design is considered appropriate for SONI for this five year period. The Utility Regulator will again review and consider the appropriateness of both the approach and price control design at the beginning of next price control period.

2.6 Duration

39. The 2010-2015 price control ended on 30 September 2015. A disapplication notice, issued by SONI to the Utility Regulator, was intended to ensure a new price control and subsequent licence modifications were in place and effective from 1 October 2015. SONI withdrew this disapplication notice in May 2015.
40. This price control will be for a five year period from 1 October 2015 to 30 September 2020.

3. SONI Performance to date

41. The 2010 – 2015 price control decision paper¹³ was set in the context of government targets for increased renewable generation. SONI therefore requested increased resources to operate the power system, to manage the increase in renewable generation and associated connections, and to cope with significant infrastructure development.
42. As a response to the 2010 – 2015 price control request the Utility Regulator provided an allowance for 19 additional full time equivalent staff together with sufficient CAPEX to refresh and enhance assets, ensure that it is able to manage and connect renewable generation, manage the impact of European and SEM developments and to respond adequately in emergency situations.
43. An increase of 22%, in real terms, to SONI's allowances was provided as recognition of the need for additional resources required due to the increased level of wind generation on the system to meet the government's target of 40% electricity demand to be met from renewable sources by 2020. In terms of cost management, efficiency gains could be retained by SONI however any over expenditure would conversely have to be absorbed by SONI.
44. The electricity market, within which SONI has operated the transmission system, continued to evolve due to the European Union requirements such as the Third Energy Package; the introduction of intraday trading and changes to the generation mix to include increased renewable generation (almost 20% of Northern Ireland's electricity demand came from renewable energy sources in 2014).
45. SONI has embraced these challenges to maintain a safe and reliable transmission system with 97.35% annual availability during 2014 (97.99% 2013). As a comparison the GB transmission network achieved 94.5%¹⁴ electricity transmission annual availability during 2013/14¹⁵. System security is another key performance measure which captures reported incidents resulting in loss of supplies to consumers.
46. There were no reported events during 2014 which resulted in a loss of supply. During 2013 four reported incidents were experienced which all related to the severe weather conditions experienced in March 2013. Quality of service can be measured by the number of frequency excursions within a year. During 2013 and 2014 there were no voltage excursions exceeding the permitted limits¹⁶. SONI has a high reputation incentive underpinned by their safety and reliability records.
47. A further measure is financial performance and SONI has performed well over the

¹³ http://www.uregni.gov.uk/uploads/publications/SONI_Price_Control_decision_Paper_-_FINAL.pdf

¹⁴ This figure of 94.5% represents a correction to the comparison figure published in the draft determination.

¹⁵ <http://www2.nationalgrid.com/UK/Industry-information/Electricity-transmission-operational-data/Report-explorer/Performance-Reports/>

¹⁶ [THE ELECTRICITY SAFETY, QUALITY AND CONTINUITY REGULATIONS \(NORTHERN IRELAND\) 2012](#)

period. In relation to the SONI TSO licence activity SONI has reported a profit before taxation of £3.9m (4.4% of revenue) in 2014, £4.4m (4.7% of revenue) in 2013, £4.4m (7.1% of revenue) in 2012 and £5.0m (8.5% of revenue) in 2011.

SONI TSO Profitability Summary				
	2010/11	2011/12	2012/13	2013/14
	£'000	£'000	£'000	£'000
Turnover/Revenue	58,917	62,665	92,294	90,782
Operating Profit (EBIT)	5,777	5,588	4,944	4,302
Operating Profit (EBIT) Margin	10%	9%	5%	5%

* Source: Regulatory Accounts

Table 3.1: 2010-2014 SONI TSO Profitability

4. Operational Expenditure (OPEX)

4.1 Overview of OPEX

48. The Operational Expenditure (OPEX) allowance is included within the B_{TSO} component of the SONI allowed revenue to cover their operating costs (OPEX), depreciation on the Regulatory Asset Bases (RABs) and an appropriate return on those assets.
49. This chapter will look at;
- a. Payroll and Headcount
 - b. Pensions
 - c. Telecoms and IT
 - d. Professional Fees
 - e. Facilities, and
 - f. Other OPEX
50. The Utility Regulator analysed the SONI TSO allowed and actual OPEX spend from 2010 - 2015. Each of the above categories is discussed separately within this chapter. The Utility Regulator considered benchmarking information, where available, and also received analysis from external consultants on a number of areas.
51. SONI raised concern regarding the treatment of group recharges within the Draft Determination. SONI's concerns are twofold as it incurs its own costs in addition to a series of group recharges and the 2010 – 2015 price control decision included allowances for group recharges.
52. The Utility Regulator has revised the tables within this paper to reflect SONI's submission including recharges. SONI have included recharge amounts both within payroll and other operating costs. SONI has forecast an increase in net recharges, from EirGrid to SONI, to approximately £5 million over the period 2015 - 2020. The Utility Regulator's decision includes an allowance for shared group services consistent with those provided within the 2010 – 2015 price control and this is outlined in section 4.8.
53. The Utility Regulator has carried out a bottom up approach in setting these OPEX allowances which enable SONI to carry out its duties. Ultimately the management of costs and how they are resourced is a matter for SONI.
54. In relation to costs, once the Utility Regulator has set the allowances, the management of costs is a matter for SONI. Compliance, performance and quality of service provided by SONI should not be compromised in achieving efficiency gains.
55. The Utility Regulator's decision in respect of the OPEX allowances is shown

below in Table 4.1 together with a comparison of actual costs for 2010 – 2015, the SONI submission for 2015 – 2020 and the Draft Determination.

	2010 - 2015 Allowance £'000	2010 - 2015 SONI Actuals (estimate 2014/15) £'000	2015 - 2020 SONI Submission * £'000	2015 - 2020 UR Draft Determination £'000	2015 - 2020 UR Decision £'000
Payroll (incl ongoing pension)*	33,282	31,219	42,881	37,576	36,083
IT and Telecoms	10,559	7,988	9,501	9,501	9,501
Professional Fees	See Other OPEX	1,348	3,997	1,129	1,129
Facilities	See Other OPEX	1,646	2,820	2,820	2,820
Other Operating Costs	7,919	5,630	10,562	2,732	3,107
Pension Deficit	172	391	740	740	943
OPEX Total	51,932	48,222	70,501	54,499	53,583

* 2015-2020 UR Payroll allowance is not directly comparable due to some payroll costs being captured within the network planning function (projects)

Table 4.1: 2015-2020 SONI OPEX Summary

56. Since the Draft Determination the Utility Regulator has given further consideration to the need to reflect Real Price Effects (RPEs) and expected productivity growth of the SONI TSO business during this price control. The Utility Regulator has decided to provide an estimated real increase in operational expenses of 0.7%. This is comprised of a forecast RPE of 1% and expected productivity growth of 0.3%.

4.2 Payroll and Headcount

57. This section discusses the responses, the Utility Regulator's assessment and the final decision. This includes consideration of the revised payroll and headcount costs submitted by SONI following the Draft Determination paper.

4.2.1 Payroll and Headcount in the Draft Determination

58. The SONI submission requested 113 staff at a total cost of £44.4 million for the five year period.
59. The Draft Determination proposed a headcount of 107 staff (excluding connections staff) with a total salary allowance of £37.5 million. Connection staff have been excluded as SONI receive connection charging revenue from connectees. The Draft Determination, consistent with the 2010 – 2015 price control, assumes this to be 5 staff being outside the scope of this price control.
60. Following the Draft Determination SONI provided a revised payroll and headcount submission requesting £49 million for payroll (which included connection staff, CAPEX (pre-construction and IT) staff and additional staff).

4.2.2 Responses to the Draft Determination

61. In general, the respondents concerns were that SONI has adequate resources to facilitate the renewable energy target and the increased workload for I-SEM and DS3.
62. Prospect Union's response did not support the proposals made in relation to payroll and pensions. The reduction in payroll by 5% was viewed as unnecessarily restrictive and the use of ASHE does not provide suitable benchmarking as it is too general and is drawn from a number of different sectors. The reduced payroll is viewed as putting considerable pressure on SONI's ability in the future both in terms of quality and resilience of service.
63. Manufacturing NI stated that whilst they of course want to ensure that the best people are attracted to such an important organisation, they were surprised by the analysis that SONI's payroll grew by 20% whilst its headcount only grew by 2 people. All parts of our economy, including the public sector, have seen wages frozen or indeed shrunk. They do not see the justification for such a large rise in payroll cost and would ask that these excessive costs are controlled or pegged back.
64. NIRIG noted that the Utility Regulator has not allowed the requested increase in staff in operations and IT. However it argued that there will be increasing challenges in accommodating the greater capacity and varying types of renewable energy on the system in the future.

65. SONI commented on the reduced cost base, that the Utility Regulator is proposing to penalise SONI for operating efficiently during 2011-2015 and that they consider their costs to be efficient. Furthermore they commented on the starting point and on the use of the ASHE survey. They also provided additional comments on Real Price Effects (RPE).

4.2.3 Utility Regulators Review of Headcount

66. As indicated in the Draft Determination the detailed headcount information as part of the Business plan request was not provided for by SONI in its initial submission. Following further requests, it was provided in limited form, while SONI highlighted that it was important to note the context that it was supplied in. SONI stated that while the information lists the headcount who are contracted to SONI, it did not cover the full remit of activities which SONI undertakes.

67. SONI comment that the Eirgrid organisational structure detailed in the submission will not align to this schedule and hence to overall revenue requirements, which they state are more correctly assessed on the basis of total labour cost (including allocations).

68. Following the Draft Determination further information was provided by SONI with regard to the headcount and the forecasted heads that SONI deemed would be required for this price control. SONI provided a headcount breakdown for 2013-14 and 2014-15 (i.e. their current headcount).

69. SONI confirmed, following the Draft Determination, that at the end of December 2014 it employed 111 staff (excluding SEMO staff), this was made up of 98 OPEX staff and 13 CAPEX staff. The CAPEX staff relate to the new pre-construction planning function and IT CAPEX. This is shown in Table 4.2 below.

	SONI staff at the end of 2014	Requested amount for 2015-2020
Network Planning Department	3	6
Grid Operations Department - Planning	15	15
Grid Operations Department - Realtime	17	29
Grid Operations Department - Neartime	12	12
Business Support (Internal Audit, Legal, SEMO/SONI GM, Finance, IS, Ops projects, HR & EU Affairs)	51	51
Grid Development CAPEX	9	12
IS CAPEX	4	2
Total	111	127

Table 4.2: SONI Actual Headcount and Forecasted Headcount Submission

70. The Utility Regulator notes that SONI's current staffing level is 10 more than what was allowed for in the 2010-2015 price control.

71. In addition to the current headcount SONI has also requested 16 additional staff for the 2015-2020 price control. This is comprised of 12 additional real-time staff, 3 additional OPEX network planning staff, 3 additional grid development CAPEX staff and a reduction of 2 IS CAPEX staff. Therefore, the total requested for the 2015-2020 period is 127 Full Time Equivalent (FTE) staff. Table 4.2 above shows SONI's allocation of the 127 requested staff.

72. SONI comment the additional staff would oversee the operational headcount required for the implementation of DS3 System Services and to oversee the business process changes associated with the development of European Network Codes.

73. In the Draft Determination the Utility Regulator considered the allowance provided for at the end of the 2010-2015 price control, and adding in the appropriate headcount that SONI would require to fulfil its duties.

74. In the Draft Determination the Utility Regulator proposed a total payroll OPEX allowance based upon headcount of 107 (84 +19 TUPE¹⁷ + 3 additional grid operations + 1 addition IT). The 84 roles are as per the 2010 – 2015 price control and the 19 roles were identified as relating to transfer of planning from NIE to SONI. For comparison with SONI's headcount, the 5 connections staff need included bringing the headcount up to 112, which is similar to SONI's headcount at the time of submission.

75. The Draft Determination considered the proposed headcount of 107 to be appropriate to facilitate all aspects of the network planning function (including projects) and also allow for SONI to operate the system throughout 2015 – 2020 including operating within DS3 and I-SEM.

As per Table 4.2 above, the Utility Regulator notes that the proposed headcount in the Draft Determination is in line with the current headcount in SONI. Furthermore this headcount is currently providing significant support to the I-SEM and DS3 projects and reflects a large increase in resource over the last five years.

76. The Utility Regulator has given further consideration to the treatment and process of the network planning function including the pre-construction projects. With regard to the staff associated with the network planning function, the Utility Regulator has decided to split the funding of these roles between payroll OPEX, as part of this price control, and CAPEX projects via the Dt term.

77. The Utility Regulator has decided to continue providing allowances for specific transmission projects using the Dt mechanism rather the price control. SONI will be requested to submit a pre-pre-construction Transmission Load/Capacity Related

¹⁷ [The Transfer of Undertakings \(Protection of Employment\) Regulations 2006 \(TUPE\)](#)

(TLCR) project, for each specific project, for the Utility Regulator to approve. This is further explained in Chapter 11.

78. With regard to the payroll OPEX aspect of the network planning SONI has proposed that 6 OPEX staff should be included within this price control. However, only 2 of the staff who transferred from NIE were treated as OPEX and SONI currently has 3 staff fulfilling these roles. Furthermore, this is consistent with the analysis of the CMA on the NIE RP5 price control.
79. Therefore the Utility Regulator has provided for 3 FTE OPEX staff (remunerated via the average payroll) within this price control and the remaining network planning staff is assumed to be CAPEX project staff for which project specific allowances will be provided through the pre-construction project approvals.
80. Given the above change and further analysis since the Draft Determination the headcount, upon which the payroll OPEX allowance within this price control will be based, is 98 FTE staff. This reflects a large increase in resource over the last five years. Having considered this and taken into account all submissions the Utility Regulator is content that the headcount of 98 is adequate for this price control.
81. The decision provides for significant support to the I-SEM and DS3 projects through the inclusion within headcount of staff working on these projects. This will be taken into account in determining additional implementation costs. The Utility Regulator considers that the allowance may also cover operational costs of DS3 and I-SEM as implementation ends. However this can be further considered when there is more certainty on these projects. Any additional staff that will be required during the period, for example, for connections or the implementation of DS3 or I-SEM projects, will be remunerated either through connection charges or through the Dt mechanism. Dt submissions will continue to be subject to regulatory review and approval.

	2015-2020
Headcount in the 2010-2015 price control	84
Additional staff employed from the last price control	11
OPEX Network Planning Department	3
OPEX Staff Remunerated through this Price Control	98
Remunerated through connection charging process	5
Remunerated through Transmission Project Dt's	9*
Remunerated through DS3 and I-SEM Dt's	**
Total Headcount including Connection Staff and those within Dts	112

*This number will fluctuate depending on the amount of Transmission project Dt's submitted.

**Unknown at this time, additional staff will be evaluated within each Dt submission, some of SONI's current staff are currently working on these projects.

Table 4.3: Summary of Headcount Analysis

82. Therefore, for this price control period, the OPEX payroll allowance is based upon 98 OPEX staff and the remaining staff will depend on the number of connections and Dt's submitted and approved.

4.2.4 Utility Regulators Review of Payroll

83. Following the Draft Determination, SONI provided updated actuals for 2013-14 and an updated estimate for 2014-15. These now included the CAPEX staff associated with the transfer of planning and had fixed an error in the previous 2014-15 headcount figure. SONI's revised payroll submission is shown in the Table 4.4 below.

SONI Request	ACTUAL				BEST ESTIMATE	FORECAST				
	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	£'000	£'001	£'002	£'004	£'005	£'007	£'008	£'009	£'010	£'011
Basic salaries and wage expense (included Ee's pension contribution)	£3,379	£3,902	£4,428	£5,429	£5,676	£6,501	£6,614	£6,564	£6,578	£6,541
Basic salaries plus Bonus	£3,637	£4,294	£4,838	£5,902	£6,372	£7,239	£7,352	£7,302	£7,316	£7,279
Total Costs+overtime/pensions etc	£4,850	£5,427	£6,041	£7,126	£8,399	£9,628	£9,796	£9,752	£9,770	£10,006
Number of Full Time Equivalents (FTEs) inc plann	75	82	95	111	114	126	127	127	127	127

Table 4.4: SONI Revised Payroll Submission

84. Previously SONI's total payroll has been around £5 million annually. In 2013-14 this increased to over £7 million, following the transfer of NIE network planning staff, with 2014-15 expected to increase above £8 million.

85. The Draft Determination applied an average basic salary (plus bonus) of £52.5k. SONI has since then updated its actual basic salary (plus bonus) for 2013-14 to confirm it is £53k.

86. In relation to the benchmarking carried out by the Utility Regulator SONI did not support the use of the Office of National Statistics (ONS) Annual Survey of Hours and Earnings (ASHE) as a suitable benchmark and also commented that no reference was made to the independent benchmarking report carried out by Tower Watson on behalf of SONI. Both of these are discussed below.

87. In the Draft Determination it was recognised that there was limited benchmarking available for the system operator and the Utility Regulator chose to compare SONI's salaries with the UK ASHE annual earnings survey. SONI comment that the ASHE survey does not provide a robust approach to undertake a remuneration benchmarking exercise.

88. Prospect Union stated that the Utility Regulator focused on certain job roles in ASHE that could be drawn from a number of different sectors and if engineering professionals were excluded, the utility specific section would have a higher mean average salary. They also stated that this is reinforced by the findings of the Engineering Council's 2013 survey of professionally registered engineers and technicians¹⁸ which found that the basic median pay of engineers in the utilities sector was £55k and the mean average was £59k which shows that SONI's salary levels are in line with market pay.

¹⁸ <http://www.engc.org.uk/engcdocuments/internet/Website/2013%20Survey%20of%20Registered%20Engineers%20and%20Technicians.pdf>

89. Following review of the Engineering Council's 2013 survey the Utility Regulator has considered Prospect Union's comments and notes that the report also states that professionally registered engineers and technicians whose primary place of work is based in Northern Ireland had the lowest median basic income of £40k and a mean of £44.6k within its survey.
90. With regard to using ASHE as a benchmark, OFGEM in calculating the direct and contract labour for RIIO-GD1 uses the ASHE data. They also used ASHE methodology within the Data Communications Company (DCC) price control, and therefore the Utility Regulator deems this as an acceptable tool and methodology for use in determining this price control.
91. The Utility Regulator continues to believe that the ASHE survey provides a robust approach to undertake a remuneration benchmarking exercise. As stated in the Draft Determination the Utility Regulator has reviewed the roles in ASHE which are similar to those identified in SONI, these include eg, engineering professionals, electrical engineers, engineering professionals n.e.c., IT specialist managers, IT project and programme managers, IT business analysts, architects and systems designers.
92. The Utility Regulator also reviewed the ASHE Data for more than one year, this was to evaluate if there was any variances in the ASHE Standard Occupational Classification (SOC) codes for different samples in each year, and confirmed that there was no major variation year on year. The possibility of including the ASHE SOC code relating to administration staff and finance administration related staff was also considered. This would have had the effect of reducing the overall average for SONI, but it was decided not to include them so as to ensure that ASHE data appropriately reflected the specialist professional skills required by SONI.
93. With regard to the Tower Watson submission, the Utility Regulator acknowledges the information provided by SONI and its consultants Tower Watson. The body of the report was three pages comprising a summary methodology and a summary table. The summary table provided in the report was of limited use to the Utility Regulator given the desire for more detailed analysis.
94. SONI also raised concern regarding the lack of recognition of the EirGrid Group cost allocation and group recharges within the Draft Determination. EirGrid Group recharges predominantly relate to staff allocations. Having reconsidered, the Utility Regulator has within this Final Determination allowed for recharges consistent with the 2010 – 2015 price control in arriving at an appropriate payroll allowance.
95. SONI also asked the Utility Regulator to reconsider its position on connection staff. SONI included in its submission the headcount associated with connections. However, SONI recover connection costs from connectees through the Transmission and Distribution connection charging process. Therefore the Utility Regulator's position remains unchanged, connections staff should not be provided for within the price control.

96. The Utility Regulator determined that for the start of this price control period SONI staff would have an average salary including bonus of over £52.5k, which is a similar amount that was identified in the Draft Determination and remains close to the 75 percentile on the ASHE banding. The payroll average amount including pension contributions per employee equates to approximately £73.6k per employee. The figure is also not significantly different from the latest actual figures produced by SONI.

4.2.5 The Utility Regulators Decision on Payroll / Headcount

97. Based upon headcount analysis the Utility Regulator will provide a payroll OPEX allowance within this price control on the basis of 98 Full Time Equivalent (FTE) staff. This is in line with the current level of resource which is also providing support for the DS3 and I-SEM projects, and represents a large increase over the last five years. It is recognised SONI may require additional staff for connections and pre-construction projects which are funded by connection charges and the pre-construction project approvals.

98. The Utility Regulator recognises that there are challenges in finding the right benchmark for a company like SONI. Given all the evidence and consideration of responses the use of ASHE data is regarded as the optimum solution in the circumstances. In addition a conservative approach has been applied when using the ASHE data.

99. In the Draft Determination the Utility Regulator had proposed £37.5 million for payroll, which included all staff associated with the network planning function (including pre-construction projects). This proposed amount has reduced as the non-OPEX pre-construction staff will now be remunerated through pre-construction project approvals.

100. The Utility Regulator's decision is to set SONI's OPEX payroll allowance at £36 million for this 2015-2020 price control period. The Utility Regulator's view is this allowance is a reasonable allowance that will ensure SONI can continue to meet its licence obligations. The remaining staff will be remunerated through the connections process and the pre-construction project approvals.

101. The Utility Regulator acknowledges the impact of the I-SEM and DS3 workstreams on headcount and will consider a review of headcount within SONI's Dt submissions following finalization of these workstreams.

4.3 Pensions

4.3.1 Pensions in the Draft Determination Paper

102. During December 2014 the Utility Regulator published a Pension Deficit Recovery Position Paper¹⁹. This paper follows the pension deficit decision made by the Competition Commission's (now the Competition Markets Authority-CMA) final determination on the NIE price control in 2014.
103. In respect of all remaining price controlled businesses with pension deficits, of which SONI Ltd is one, the Utility Regulator's position is the introduction of a "cut-off" date of 31 March 2015. Up to this date a historical pension deficit will be 100% recovered from consumers after which any incremental deficit will be 100% funded by the licensee.
104. SONI perform a full actuarial valuation every three years based upon Trustee's assumptions. SONI advised the 31 March 2013 pension deficit was £1.146 million compared with £0.681 million deficit as at 31 March 2010. The Utility Regulator requested SONI provide an updated actuarial valuation as at 31 March 2015 to inform the price control final determination in light of the Utility Regulator's Pension Deficit Recovery Position Paper.
105. SONI submitted ongoing employer contributions associated with the SONI Ltd Defined Contribution (DC) scheme and the Defined Benefit (DB) scheme to the order of 6-8% and 40% respectively. Benchmarking analysis was carried out by the Utility Regulator together with consideration of the allowances within the current 2010 - 2015 price control to arrive at a draft determination of 6% for the Defined Contribution scheme and 28% for the Defined Benefit scheme. The Utility Regulator also proposed a separate administration fee of 3% for the DC pension scheme.
106. Due to the divestment of SONI from the Viridian Group in 2009 SONI were required to make good a pension deficit under section 75 of the Pensions Act 1995. The Utility Regulator approved this as a 'Dt allowance' recoverable over 15 years. In setting this price control the Utility Regulator proposed to incorporate this approved Dt allowance within SONI's price control allowance for the remaining 10 years.
107. In 2014 SONI took responsibility for planning the transmission network from NIE. The Draft Determination recognised, upon receipt of the 31 March 2015 actuarial valuation, consideration must be given to the NIE price control and the effect the above transfer has on the pension deficit.

4.3.2 Responses to Draft Determination

108. SONI refer to the position paper published by the Utility Regulator in December 2014 as having no relevance to SONI, particularly given that the stated

¹⁹ http://www.uregni.gov.uk/uploads/publications/UR_Position_Paper_-_Pension_Deficit_Recovery_v1_0.pdf

base for this position is in the context of a 2014 Competition Commission determination made wholly in respect of the NIE referral. SONI is not the same as NIE when considering scale, asset thinness, impact on consumer and impact on SONI. The Utility Regulator proposes to transfer Defined Benefit pension risk to SONI and its shareholders which is greater than the proposed equity return to the SONI business. This position must be amended. In its submission, SONI included all pension costs as determined by law or in line with best practice as assessed and confirmed by the Trustees and Scheme Actuary.

109. SONI also state the following in respect of the DB scheme. The Draft Determination

"fails to respect the legal obligations inherited by SONI on divestment and through the NIE transfer. This includes provision for the costs of personnel transferred under TUPE²⁰ legislation and provision for persons who have been accorded 'protected persons' pension status under law. These obligations are absolute and the regulatory framework for SONI must respect them".

110. The 40% employer contribution rate for the DB scheme is based upon an actuarial valuation using appropriate assumptions (relevant to 2013). SONI therefore cannot accept the Utility Regulator's proposal to reduce the funding rate to 28% based on a report which states that at March 2010 'the electricity schemes' employer contribution rates lie between 24% – 28%. SONI note that at March 2010 their contribution rate was 28%, within the range.

111. SONI explain the difference between the 8% employer DC contribution rate and the Utility Regulator's proposal of 6% as being required to be competitive in seeking to attract/retain workers. SONI also note the additional employer contribution of 1-2% is conditional on the employee also making matching additional contributions.

112. Prospect Union represents employees of SONI and views SONI's submission of 22% of basic wage and salary costs as not being excessive. Prospect say the Draft Determination references two wholly different external datasets when benchmarking the SONI DB and DC schemes. Prospect considers the benchmarking of the SONI DB scheme against other GB electricity sector as a reasonable approach, however the use of *all sectors* for benchmarking the DC scheme has the potential to result in lower employer contributions than the electricity sector and goes on to cite specific schemes.

113. Prospect state "the proposed determination's allowance of a level of 28% in respect of future service costs, in the face of the 40% provided for within the independent actuarial valuation, is entirely inadequate (as well as a poor reward for the hard work of the trustees in getting the scheme to the position it is in). Prospect therefore urges the Regulator to re-think its proposal".

²⁰ [Transfer of Undertakings \(Protection of Employment\) Regulations 2006](#)

114. Manufacturing NI was surprised by the payroll and pension analysis outlining SONI staff achieved, *inter alia*, a 40% increase in pension costs. They view SONI's pension proposals as adding significantly to customer bills and are well in excess of similar organisations. In Manufacturing NI's view the Utility Regulator's proposals are still very generous and they request these are reviewed to ensure customers in Northern Ireland are not unduly burdened by a very generous scheme.

4.3.3 Utility Regulator Decision on Pensions

4.3.3.1 Pensions Pension Deficit

115. The Pension Deficit Recovery Position Paper published by the Utility Regulator in 2014 is consistent with both the pension deficit decision made by the Competition Commission in their final determination on the NIE price control and Ofgem's policy for funding pension deficits. The policy aims to protect the interests of existing and future consumers and in doing so, ensures relevant regulated businesses are subject to the same incentive pressures as the broader market.

116. In respect of all remaining price controlled businesses with pension deficits, of which SONI Ltd is one, the Utility Regulator's position is the introduction of a "cut-off" date of **31 March 2015**. Up to this date a historical pension deficit will be 100% recovered from consumers after which any incremental deficit will be 100% funded by the licensee.

117. This approach is consistent with Ofgem's current policy which provides pass-through funding by consumers of deficits up to a specified cut-off date which for system operators in GB is March 2012. Together with the Competition Commission's final determination in 2014 regarding NIE the Utility Regulator cannot accept SONI's assertions that the Pension Deficit Recovery Policy introduced by the Utility Regulator is not relevant to SONI.

118. Each relevant regulated business will provide the Utility Regulator with the relevant pension deficit information, splitting accordingly the historic deficit (assuming a cut-off date of 31 March 2015) and incremental deficit. This information should be in line with the information submitted within GB to Ofgem.

119. Historic pension deficit valuations do not determine how much funding will be needed but do provide estimation for purposes of setting price control allowances. Actual requirements will vary according to outturns including investment performance, longevity and inflation. Ongoing defined benefit pension expenses for scheme member service after the cut-off date have been assessed as part of a benchmarking exercise.

120. In accordance with the Utility Regulator's pension deficit recovery policy an actuarial valuation report for the SONI Ltd defined benefit pension scheme as at 31 March 2015 was requested. SONI provided an actuarial funding update which estimated the pension deficit to be £1,885,000 as at 31 March 2015. The funding level remains at 95% as was the case in the March 2013 valuation.

121. A pension deficit recovery of 10 years will be applied reflecting the average remaining service of active members. Based upon the 31 March 2015 pension deficit of £1,885,000 and a recovery period of 10 years the pension deficit recovery allowance for the duration of this price control is set out in Table 4.5 below:

Pension Deficit Recovery based upon 31 March 2015 Funding Update of £1,885,000. 10 year recovery period applied	URs Decision					
	2015/16	2016/17	2017/18	2018/19	2019/20	Total
	£'000	£'000	£'000	£'000	£'000	£'000
Historic Pension Deficit Recovery	189	189	189	189	189	943

Table 4.5: 2015-2020 UR Decision on Historic Pension Deficit Recover as at cut-off date 31 March 2015

122. Future adjustments will be necessary for this pension deficit recovery allowance to reflect actual historic deficit requirement according to outturns. SONI will provide relevant pension deficit information, splitting it accordingly between the historic deficit (as at 31 March 2015) and any subsequent incremental deficit.

4.3.3.2 Defined Contribution (DC) Scheme

123. The Defined Contribution section of the SONI Ltd Pension Scheme is the only section which remains open to new members. At the time of SONI's submission the DC section had 89 members.

124. The Utility Regulator has reviewed the 6-8% level of employer contributions submitted by SONI Ltd. The most recent Office of National Statistics (ONS) Occupational Pension Schemes Survey²¹ shows the weighted-average employer contribution rate for a private sector pension scheme to be 6%.

125. While SONI's response considers an 8% employer DC contribution rate being necessary to retain/attract workers the Utility Regulator remain of the view the ONS weighted average employer contribution rate is an appropriate benchmark.

126. Prospect Union were concerned with the use of the ONS data for benchmarking the DC scheme on the basis it reflected *all sectors* and was not specific to the electricity sector. In respect of the ongoing employer DC contributions the Utility Regulator view the use of the ONS data as being an appropriate

²¹ [ONS Occupational Pension Schemes Survey 2013 published 25 September 2014](#)

independent benchmark as it represents the broader market.

127. In addition to employer DC pension contributions, SONI Ltd contributes 3% administration fees. The Utility Regulator is encouraged that this represents a 50% reduction in the administration cost for the DC scheme proposed by the company at the last price control review. The Utility Regulator will provide a separate administration fee of 3% for the DC section of the pension scheme.
128. Therefore the Utility Regulator has decided to provide a 6% employer DC pension allowance and a 3% administration fee, unchanged from the Draft Determination.
129. The DC pension scheme allowance will be included within the overall payroll allowance outlined in section 4.2.

4.3.3.3 Defined Benefits (DB) Scheme

130. The Defined Benefit (DB) section of the SONI Ltd Pension Scheme is the more expensive section of the scheme because retirement benefits payable are defined based on salary and length of service.
131. The DB section of the pension scheme was closed to new entrants in 1998, however due to exceptional circumstances was reopened in May 2014 in order to transfer six employees transferring from NIE who were members of a defined benefit section of the NIE Pension Scheme.
132. At the time of submission there were 32 DB active members. All of the DB members have 'protected persons' status outlined in the Electricity (Protected Persons) Pension Regulations (Northern Ireland) 1992. This means that SONI Ltd, as the employer, is limited in its ability to change the pension scheme rules and member benefits which were in place when the industry was privatised.
133. Based upon actuarial advice within SONI's most recent actuarial valuation report as at March 2013, SONI Ltd contribute 40% of pensionable pay to the DB section of the SONI Ltd Pension Scheme. This represents an increase in mid-2014 from 28%. SONI advise the sharp fall in gilt yields between 2010 and 2013 as being the major factor in the increase in the on-going service cost from 28% in 2010 to 40% applied in mid 2014.
134. In assessing an appropriate ongoing employer DB contribution rate the Utility Regulator first considered the same ONS survey as used for the DC analysis. This ONS 2013 Survey shows an *all sector* weighted average employer DB contribution rate of 16% for closed DB schemes.
135. Given the complexity of 'protected persons' status resulting from privatisation

legislation²² within the electricity sector the Utility Regulator also considered employer DB contribution rates for an electricity sector rather than an all sector basis.

136. In doing so, consideration was given to the most recent Government Actuary's Department report to Ofgem on a review of network operators' pension costs²³. Consideration was also given to the number of active DB members within these schemes compared to total staff numbers which suggests that SONI has a particularly high level of DB members.

137. A number of options were considered by the Utility Regulator on balance the Utility Regulator has decided to maintain the 2010 – 2015 provision of 28% throughout the five years of this price control. This is applied to the current level of DB members for the whole price control period. This provides SONI with some flexibility to manage its costs.

138. The DB pension scheme allowance will be included within the overall payroll allowance outlined in section 4.2.

4.3.3.4 Section 75 of the Pensions Act 1995

139. Section 75 of the Pensions Act 1995 sets out certain conditions where an employer is required to immediately make good a pension deficit rather than correcting the deficit over a period of time. The relevant condition is in the circumstances where there is a transfer of ownership and the new owner is no longer a contributor to the pension scheme but the employees remain part of the original scheme: this is the case with SONI as a result of divestment from the Viridian group in 2009. The divestment of SONI from Viridian resulted in a number of members choosing to leave their liability with the Viridian Group Pension Scheme.

140. In 2011 SONI notified the Utility Regulator of a section 75 debt amounting to £1.85m which SONI had already incurred in respect of the SONI Ltd Defined Benefit Pension Scheme. The Utility Regulator approved this section 75 pension liability in 2012 as a 'Dt allowance' on the basis the liability would be recovered from April 2010, over 15 years on an NPV neutral basis calculated by reference to the Bank of England rate plus 1.5%. This allowance will continue to be provided to SONI until 31 March 2025.

²² Electricity (Protected persons) Pension Regulations (Northern Ireland)1992

²³ <https://www.ofgem.gov.uk/ofgem-publications/91593/gadfinalreport-2014reasonablenessreview.pdf>

s75 Crystallised deficit £1.85m	2015/2016	2016/2017	2017/2018	2018/2019	2019/2020
15 years	142,600	142,600	142,600	142,600	142,600
Discount rate	1.126	1.149	1.172	1.195	1.219
	126,625	124,142	121,708	119,321	116,982
Rate applied - base rate + 1.5%	2.00%	2.00%	2.00%	2.00%	2.00%

Table 4.6: Summary of Section 75 Pension Deficit Dt Approval for duration of price control

141.

The Utility Regulator considered incorporating this approved Dt allowance within the SONI price control allowance rather than as a Dt item from September 2015. However, as this particular Dt allowance is provided on an NPV neutral basis based upon the Bank of England rate the Utility Regulator has decided to keep it separate from the price control and continue treating it as a Dt allowance.

142. From a presentational perspective this is no longer being shown within the tables as it is outside of the price control.

4.3.3.5 Transfer of Network planning function from NIE Networks

143. The impact associated with the transfer of the network planning function to SONI in 2014 will be considered within Chapter 12 of this price control. Consideration has also been given to the pension adjustments necessary within the NIE Networks price control as a result of this transfer on the general principle the consumer should not be materially impacted by this transfer of network planning function from NIE Networks to SONI.

4.4 Telecoms and IT

4.4.1 Telecoms and IT in the Draft Determination Paper

144. Within the price control draft determination paper the Utility Regulator recognised the strong correlation between IT CAPEX and IT OPEX. Additional functionality was proposed within IT CAPEX therefore requiring additional support and maintenance within IT OPEX.

4.4.2 Responses to Draft Determination

145. The Utility Regulator did not receive any responses to the draft determination paper specific to the Telecoms and IT allowance proposed.

4.4.3 Utility Regulator Decision on Telecoms and IT

146. As part of this price control the Utility Regulator has carried out a review of SONI's IT requirements. This review was carried out by our consultants Gemserv and provides an assurance report on SONI's IT Strategy Review and related costs; we have provided a copy of the report as an annex to this Determination.

147. This report provided advice and recommendations with a requirement to provide detailed input into the level of system integration with EirGrid given SONI's need to remain operationally independent; Gemserv carried out a document review as well as several meetings and additional written clarification questions. Those questions along with the SONI responses are reproduced in Appendix 2: Questions and Answers of the Gemserv IT report. We have considered the information within this report which informed us of both the OPEX and CAPEX IT allowances to enable SONI to remain operationally independent.

148. Taking into consideration the recommendations of the Gemserv IT report, the Utility Regulator considers that there may be areas of the proposed allowance where cost saving can be achieved but these will not be large. Therefore the SONI proposed allowance for IT OPEX seems appropriate given the business critical nature of the SONI business.

149. The Utility Regulator allows SONI's Telecoms and IT submission in full. Allowances are shown in Table 4.7 below.

OPEX Telecoms & IT	SONI Submission						UR Decision					
	2015/16	2016/17	2017/18	2018/19	2019/20	Total	2015/16	2016/17	2017/18	2018/19	2019/20	Total
	£'000	£'000	£'000	£'000	£'000		£'000	£'000	£'000	£'000	£'000	
Total Telecommunications	£1,005	£1,017	£1,030	£1,030	£1,030	£5,110	£1,005	£1,017	£1,030	£1,030	£1,030	£5,110
Total Hardware and Support	£85	£85	£116	£116	£85	£488	£85	£85	£116	£116	£85	£488
Software Licences and Support	£693	£748	£778	£802	£882	£3,903	£693	£748	£778	£802	£882	£3,903
Total Telecoms & IT	£1,783	£1,850	£1,924	£1,948	£1,997	£9,501	£1,783	£1,850	£1,924	£1,948	£1,997	£9,501

Table 4.7: 2015-2020 SONI Telecoms and IT: Utility Regulator's Decision

4.5 Professional Fees

4.5.1 Professional Fees in the Draft Determination Paper

150. This allowance relates to operational professional fees and includes, *inter alia*, legal costs, audit and accounting services and grid code. SONI submitted three new cost requests relating to network planning consultancy, public affairs and DS3.
151. The Utility Regulator proposed a lower legal cost allowance than that submitted by SONI following a review of actual costs together with the knowledge that SONI has strengthened their internal legal support.
152. The Utility Regulator proposed an allowance for Network Planning Consultancy relating to the ongoing 'business as usual' aspect associated with network planning. This is viewed as a separate allowance from the network planning pre-construction projects.
153. Public affairs cost was a new request sought by SONI and is closely associated with network projects and connections. SONI advised these additional services are to support a dedicated team of in-house public affairs advisors. The additional external services include public consultation, stakeholder engagement and media relations. SONI further comment these resources will only be retained for as long as needed with a submission of over £1m requested for the five year period.
154. The Draft Determination recognised stakeholder engagement to be a key aspect of the Northern Ireland electricity industry. However SONI had submitted forecast costs under Other Opex for stakeholder events which are double historical actual costs. The public affairs costs could be perceived to over-lap with the costs associated with specific pre-construction projects and there is a risk of an allowance being provided in two separate places. The Utility Regulator considered the stakeholder allowance within Other OPEX, together with SONI having access to a dedicated public affairs team as sufficient resource. On this basis the Draft Determination proposed not to include this specific cost request of over £1 million given resources provided elsewhere in the Draft Determination.
155. SONI requested a specific allowance for DS3 professional fees for the three years 2015 – 2018. Elements of DS3 are a specific consideration of the SEM Committee and separate from the price control. The Utility Regulator proposed to not include a provision for this allowance within the Draft Determination. Therefore, implementation costs will be dealt with in the DS3 workstream and accounted for within Dt as appropriate.

4.5.2 Responses to Draft Determination

156. SONI responded primarily in relation to network planning advancement and stated "If SONI wishes to progress projects at an overall efficient cost including limiting delays in as much as this is possible the foundation investment must be appropriate. The SONI submission included forecasts of operational costs associated with the provision of external technical and communication expert advice".
157. In relation to the reduction proposed in network planning consultancy SONI consider "more complex network planning studies and associated network planning related specialist consultancy support and review are required". "SONI would caution that limiting costs allowed for network planning will impact on SONI's ability to progress projects it believes are required in order to satisfy its licence obligations and deliver best outcomes for consumers".
158. SONI also responded specifically to the public affairs related consultancy for network planning advancement. In SONI's view the new network planning responsibilities in Northern Ireland has put SONI firmly in the public spotlight. As such SONI consider they are now under scrutiny by the media and at a political level, which requires careful stakeholder management. SONI require this allowance as they have a more public focused role, with responsibility for communication and delivery of the planning and licensing of major projects including North South Interconnector, additional public consultation, stakeholder engagement, media relations and public affairs.
159. SONI refer to the allowance for stakeholder events within Other OPEX as the Utility Regulator arriving at an incorrect assumption. In addition the Utility Regulator refers to an existing dedicated team of in-house advisors however there is no provision and SONI does not have these resources nor does it intend to given that it is more efficient to utilise external expertise.
160. Overall SONI noted the proposed reduction in professional fees from that proposed by SONI. SONI also noted the proposal to not include a provision for DS3 professional fees which will be subject to further work being carried out.

4.5.3 Utility Regulator Decision on Professional Fees

161. Network Planning Consultancy is new to the SONI allowances following the network planning function being transferred from NIE. The Utility Regulator has further considered the proposed allowance together with the staffing roles which transferred from NIE to conclude the proposed allowance is reasonable for this day to day network planning consultancy. Network pre-construction project consultancy is separate from this allowance and will be allocated to the relevant project cost.
162. SONI play a key role within the electricity industry of Northern Ireland and therefore have been and will continue to come under scrutiny at a political level

and by the media. However additional scrutiny on SONI will relate predominantly to network/grid development upgrade projects.

163. Stakeholder engagement should be an important part of network planning pre-construction projects which will be funded separately and such project specific public affairs will be allocated against the relevant project allowance.

164. The public affairs costs could be perceived to overlap with payroll costs, recharges to EirGrid Group, other operational expenditure and network pre-construction project allowances. The Utility Regulator remains of the view that allowances within the following areas provide SONI with sufficient scope for public affairs support without a further allowance provided within professional fees:

- a) payroll allowances for business support functions;
- b) EirGrid Group also provides a skills and knowledge pool SONI can draw upon i.e. Group recharges;
- c) Stakeholder event allowance within Other OPEX for which the allowance provided is double historical actual costs, and
- d) network pre-construction project specific allowances.

165. As with the Draft Determination costs explicitly relating to the implementation of DS3 are outside of the scope of this price control and therefore a provision for DS3 within professional fees has not been included within this price control. However, a cost recovery framework for DS3 will be established by the relevant authorities.

166. Except for the above the remaining professional fee allowances have been based on actual cost information provided by SONI. On average, the allowance is 11% higher than actual historic costs submitted by SONI.

167. The Utility Regulator's decision, which is unchanged from the Draft Determination, is shown in Table 4.8 below.

Professional Fees	SONI Submission						UR Decision					
	2015/16	2016/17	2017/18	2018/19	2019/20	Total	2015/16	2016/17	2017/18	2018/19	2019/20	Total
	£'000	£'000	£'000	£'000	£'000		£'000	£'000	£'000	£'000	£'000	
Network Planning Consultancy	£121	£121	£121	£121	£80	£564	£50	£50	£50	£50	£50	£250
Grid Code	£46	£46	£46	£46	£46	£228	£46	£46	£46	£46	£46	£229
Legal Costs (excluding Network Planning Function)	£100	£100	£100	£100	£100	£500	£65	£65	£65	£65	£65	£325
Professional Services (excluding Network Planning Function)	£108	£108	£108	£108	£108	£538	£65	£65	£65	£65	£65	£325
Public Affairs	£208	£208	£208	£208	£208	£1,042	£0	£0	£0	£0	£0	£0
DS3	£417	£417	£292	£0	£0	£1,125	£0	£0	£0	£0	£0	£0
Total Telecoms & IT	£999	£999	£874	£583	£542	£3,997	£226	£226	£226	£226	£226	£1,129

Table 4.8: 2015-2020 SONI Professional Fees: Utility Regulator's Decision

4.6 Facilities Fees

4.6.1 Facilities Fees in the Draft Determination Paper

168. The price control draft determination paper consulted upon total facility costs for Castlereagh House. Facility costs include business rates; heat, light and power; security; cleaning services; maintenance; building and contents insurance; mail service and switchboard.

169. In October 2014 SONI completed their building extension and refurbishment of the existing building. As a result costs relating to facilities will increase from 2014 onwards. SONI have advised that the 33,539 square foot building can now accommodate an estimated 148 staff.

4.6.2 Responses to Draft Determination

170. The Utility Regulator did not receive any responses to the draft determination paper specific to the Facilities allowance proposed.

4.6.3 Utility Regulator Decision on Facilities

171. The Utility Regulator has decided to allow within this facilities allowance an amount for business rates as an alternative to the annual Dt process for which business rates have previously been recovered.

172. This allowance is for total facility costs of Castlereagh House reflecting SONI Ltd's role as both system operator and market operator²⁴.

173. The Utility Regulator allows SONI's facilities submission in full. Allowances are shown in Table 4.9 below.

OPEX Facilities Castlereagh House	ACTUAL			BEST ESTIMATE		UR DECISION					Total £'000
	2010/11 £'000	2011/12 £'000	2012/13 £'000	2013/14 £'000	2014/15 £'000	2015/16 £'000	2016/17 £'000	2017/18 £'000	2018/19 £'000	2019/20 £'000	
Building Rates - Castlereagh House	-£410	£79	£81	£84	£147	£147	£147	£147	£147	£147	£735
Heat: Light & Power	£107	£110	£126	£183	£176	£176	£176	£176	£176	£176	£880
Security	£106	£106	£120	£93	£107	£107	£107	£107	£107	£107	£535
Maintenance	£54	£56	£69	£94	£82	£82	£82	£82	£82	£82	£408
Building & Contents Insurance	£24	£26	£22	£40	£50	£50	£50	£50	£50	£50	£250
Mail service/Switchboard	£2	£2	£2	£2	£3	£3	£3	£3	£3	£3	£13
	-£117	£379	£420	£495	£564	£564	£564	£564	£564	£564	£2,821

Table 4.9: 2015-2020 Facilities: Utility Regulator's Decision

²⁴ This is consistent with the approach taken within the current SEMO 2013 – 2016 price control

4.7 Other Opex

4.7.1 Other OPEX in the Draft Determination Paper

174. Other OPEX consists of a wide range of smaller costs associated with staff related costs and general administrative costs. The Utility Regulator excluded EirGrid Group recharges when considering SONI's other OPEX submission.
175. SONI forecast an annual increase of £837k representing a 132% increase from 2016/17 onwards. For the five year period SONI requested £6.5 million of which £3.3 million relates to a European membership (CORESO: a body who proactively helps TSOs to ensure security of supply on a European regional basis).
176. The Utility Regulator did not propose including an allowance for this CORESO membership due to a lack of justification of both need and costs. However it was considered it may be required at a future date and therefore the Dt process may be more appropriate.
177. For each of the remaining cost lines the proposed allowance was considered in terms of actual cost to date and/or assessed on a per employee basis to arrive at an appropriate allowance.

4.7.2 Responses to Draft Determination

178. Manufacturing NI's response gave specific support to the Utility Regulator's view to not include an allowance for the CORESO membership. It is not clear to Manufacturing NI the benefit there is from SONI having membership. Furthermore, Manufacturing NI would expect SONI's parent company EirGrid to share any knowledge and insight internally.
179. SONI's response to other OPEX focused on the CORSEO membership fee to which SONI expressed considerable concerns. In SONI's view their submission (including follow up responses) explained that participation in a Regional Security Coordination Initiative (RSCI) e.g. CORESO, is mandatory for interconnected TSOs in Europe, as mandated by ENTSOe. Hence, membership is not *an option* for SONI, the EU certified TSO in Northern Ireland. However SONI will submit for this cost as and when it is advised and invoiced via the Dt process.
180. SONI disagreed with the exclusion of group recharges from Other OPEX on the basis the corporate structure EirGrid now have in place allows SONI to incur its own costs in addition to a series of group recharges, both positive and negative.

4.7.3 Utility Regulator Decision on Other OPEX

181. The Other OPEX allowance consists of a wide range of smaller costs associated with staff related costs (recruitment costs, subscriptions and membership fees, training, employee welfare), general and administrative costs (debt financing facility charges, weather forecasts, stakeholder engagements and industry events, payroll charges, rent for emergency control centre and water rates).
182. The Utility Regulator understands from ENTSOe that an all-TSO agreement is currently being developed making participation in RSCIs mandatory for an interconnected TSO. Due to the uncertainty as to when this obligation will come into force the Utility Regulator will not provide an allowance within this price control but will consider membership costs to CORESO or other body through the Dt process. Any such Dt request will consider the need to offset other SONI costs/activities.
183. The Utility Regulator reviewed the need to provide an allowance, within this 2015 – 2020 price control, for having access to a debt facility should it be required for SONI TSO working capital purposes. This is further discussed within section 6.6.3 under Financeability. The Utility Regulator has decided to continue to provide for access to a debt facility as was the case with the 2010 – 2015 price control.
184. SONI proposed a higher allowance of £23k for stakeholder and industry events for which the Utility Regulator supports and provides the allowance sought. For each of the remaining cost lines the allowance provided is based on a comparison with actual cost and/or assessed on a per employee basis consistent with the notional headcount provided for within this price control.
185. The Utility Regulator's decision on Other OPEX continues to exclude EirGrid group recharges which are discussed in section 4.8 immediately below.
186. Therefore the allowance being set by the Utility Regulator in respect of Other OPEX is shown in Table 4.10 below.

Other OPEX	SONI Submission						UR Decision					
	2015/16	2016/17	2017/18	2018/19	2019/20	Total	2015/16	2016/17	2017/18	2018/19	2019/20	Total
	£'000	£'000	£'000	£'000	£'000		£'000	£'000	£'000	£'000	£'000	
Stakeholder Events	£23	£23	£23	£23	£23	£115	£23	£23	£23	£23	£23	£115
Debt Financing Access Costs	£0	£0	£0	£0	£0	£0	£108	£108	£108	£108	£108	£540
General & Administrative Costs	£631	£1,468	£1,468	£1,468	£1,468	£6,505	£83	£83	£83	£83	£83	£415
Staff Related Costs	£354	£354	£354	£354	£354	£1,771	£407	£407	£407	£407	£407	£2,036
Total Other OPEX	£354	£354	£354	£354	£354	£1,771	£621	£621	£621	£621	£621	£3,106

Table 4.10: 2015 – 2020 Other Opex: Utility Regulator's Decision

4.8 EirGrid Group Recharges

187. The SONI submission included provisions for the cost of EirGrid group shared

services such as senior management, grid operation, group regulation, treasury, legal, finance, internal audit and procurement. A summary of the actual and forecast EirGrid Group Recharges are shown below in Table 4.11.

EirGrid Group Recharge SONI Submission	ACTUAL					BEST ESTIMATE		FORECAST					Total £'000
	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20			
	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000			
Group Recharge - by SONI TSO				-500	-483	-483	-483	-483	-483	-483	-2,417		
Group Recharge - to SONI TSO	266	389	386	1,567	1,525	1,525	1,525	1,525	1,525	1,525	7,625		
Net Group Recharge from EirGrid to SONI	266	389	386	1,067	1,042	1,042	1,042	1,042	1,042	1,042	5,208		

Table 4.11: 2015 – 2020 Group Recharge submitted by SONI

188. SONI forecast an increase in net recharges, from EirGrid to SONI, to approximately £5 million over the five year period 2015 - 2020. The increase reflects an updated recharge policy introduced by EirGrid in April 2014. The price control submission included this latest EirGrid Group Cost Allocation and Recharge Policy. This policy document is the responsibility of EirGrid and is subject to change at any time without the need for regulatory approval.

189. SONI submitted group recharge information within both payroll and other OPEX costs. However, the Utility Regulator has had difficulty in reconciling the detail provided with the summary recharges show above in Table 4.11. Based on the information submitted it is the Utility Regulator's view the recharge elements could be viewed as being inconsistent across cost lines. These inconsistencies within the SONI submission together with the policy not being subject to regulatory approval has led to the decision both within the Draft Determination and this Final Determination to provide SONI with reasonable cost allowances within which SONI is responsible for managing as they see fit, in order to meet their responsibilities.

190. As EirGrid Group recharges relate predominantly to payroll the total payroll allowance within this paper includes recharges as set out in section 4.2.

4.9 Real Price Effects and Productivity Growth

191. In the Draft Determination the Utility Regulator had not made an allowance for RPEs. Since the Draft Determination the Utility Regulator has given further consideration to the need to reflect Real Price Effects (RPEs) and expected productivity growth of the SONI TSO business during this price control. The Utility Regulator has considered the impact of real price effects and productivity on the SONI TSO business.

192. Payroll costs represent over 50% of the total price control allowance and therefore consideration has been given to the real wage projections for the foreseeable future. Based upon information available the Utility Regulator has

estimated real wages will increase by 1% per annum.

193. The Utility Regulator has also considered the potential for increases in the SONI TSO productivity during this price control and has determined a reasonable estimate would be 0.3%. This is also consistent with the productivity growth expected within the SEMO price control.
194. Combining these two estimates an estimated real increase in operational expenses 0.7% is considered a reasonable assumption for the SONI TSO business for the duration of this price control.
195. The adjustment for RPE will apply to all OPEX costs and will be adjusted for as part of the K factor correction mechanism.

5. Capital Expenditure (CAPEX)

5.1 CAPEX in the Draft Determination Paper

196. The capital expenditure (CAPEX) allowance which will be provided to SONI, through the depreciation charge, will enable SONI to recover the necessary resources to finance their capital investments for the period from tariffs.
197. As Information Technology (IT) is at the heart of SONI's functions their CAPEX submission is predominantly IT related based upon the EirGrid Information Services (IS) Strategy for 2015 – 2017.
198. As stated in the Draft Determination SONI presented their Regulatory Asset Base (RAB) which included CAPEX additions in 2014-15 prices. The Utility Regulator revised SONI's RAB and CAPEX additions to April 2014 prices in order to remain consistent throughout the paper.
199. The CAPEX allowance proposed by the Utility Regulator for the five year period was £6.6 million compared with £9.1million submitted by SONI.
200. The Utility Regulator proposed to scale down the IT CAPEX allowances by 10% with the DS3 allowance being proposed for deferral. In summary the rationale for the 10% reduction is due to SONI submitting prudent estimates which are well provided for and in some cases discretionary. The Utility Regulator therefore proposed to provide a CAPEX allowance of £6.6 million, which relates to IT, representing approximately £2 million more (in real terms) than the IT CAPEX provided for the five year period 2010 – 2015.
201. The consultation paper noted SONI's expenditure within 2010 - 2015 has exceeded the CAPEX allowance by an estimated £1.7 million (19%) with total projected expenditure of £10.3 million. This overspend relates predominantly to the business critical EMS system.
202. The Utility Regulator did not dispute the need for a new EMS system however the Utility Regulator had difficulty with the timing of this project, which is due to be commissioned September 2015, within the 2010 - 2015 control. The Utility Regulator proposed to disallow this CAPEX overspend on the basis consumers are continuing to pay for the 2010 EMS system, via the depreciation charge through to 2018, and SONI's proposal was viewed as inconsistent with the principle outlined in the 2010-2015 price control decision paper.

5.1.1 Responses to Draft Determination

203. SONI's response to the general reduction of 10% for other CAPEX programmes (excluding facilities and DS3) would likely result in projects being delayed or dropped during the annual prioritisation process. It is not possible at

this point to identify which items they will be but it will be kept under constant review. This will be reported to the Utility Regulator during the 2015-20 period with reasons provided.

204. Furthermore, SONI disagree with the deferral of the DS3/Smart Grids IT programme allowance and say that if the Utility Regulator removes this from the allowances the cost reduction, if implemented, is likely to cause delays in facilitating the implementation of the DS3 System Service workstream governed by the SEM Committee.
205. SONI also comment on the reductions in building expenditure for 2015 – 2020 stating that *"the absence of ongoing capital maintenance, particularly the parts of the building that will be almost 50 years old in 2020, is expected to result in less than optimal asset management, with negative impacts for the 2020-2025 period"*.
206. In addition to the above response from SONI they also gave particular emphasis to the disallowed IS expenditure for the 2010 – 2015 price control. SONI state the EMS project is a major upgrade to the existing EMS platform and that there is no redundant system. SONI advise that the new EMS system will deliver future efficiencies in respect of implementing New European Network codes and for the implementation of I-SEM while significantly reducing costs including software licencing costs, hardware infrastructure and efficiencies between Control Centres in terms of roles and staff deployment.
207. In SONI's view they are not expecting to claim an 'overspend' but to be allowed the efficient costs incurred by it in order to ensure that the EMS system is fit for purpose via a depreciation allowance commencing tariff year 2015-2016.
208. SONI do not believe the approach taken by the Utility Regulator would be in the public or consumer interest. SONI elaborate further and state whilst SONI acknowledges that the actual 2011-15 spend did increase the Utility Regulator's allowance approved in 2011 it did so in the interests of incurring the most efficient spend overtime on the assumption that this being the case it would be allowed the associated depreciation during 2015-20. SONI has no issue with the delayed receipt of the monies for the EMS system, however it must be received or alternatively the greater monies associated with the higher required OPEX and CAPEX included.
209. In SONI's view the 2011 price control decision paper did not state that the 100% risk sharing applied to depreciation post 30 September 2015 nor does the licence include a closing RAB value on 30 September 2015 or the opening RAB value on 1 October 2015. Therefore SONI is unsure of any legal basis to support this proposal.
210. NIRIG supports the new EMS allowing all-island control from either SONI or EirGrid bases. While NIRIG noted the DS3 project is outside the scope of the allowances for this price control they emphasised that sufficient resources should

be given to SONI to work alongside EirGrid in the delivery of the DS3 workstreams including the necessary IT systems.

211. Manufacturing NI emphasised the need for customers to be protected from the additional cost burden of a new EMS system whenever customers are already and continuing to pay for the 2010 system. They also believe this incident should have been avoided as SONI should have provided more transparency for customers in this area protecting them from costs.
212. The Consumer Council recommends the price control should have flexibility particularly in relation to facilitating the 40% renewable target given DETI is currently reviewing this target following publication of their discussion paper 'CFD Implementation in NI – Strategic Issues'.

5.1.2 Utility Regulator Decision on CAPEX

5.1.2.1 IT CAPEX (excluding DS3)

213. The Utility Regulator accepted that the costs submitted are provisional, as the procurement process has yet to be carried out. Following review the Utility Regulator views SONI's submission as being well provided for.
214. As was stated in the Gemserv IT report, the SONI cost submission seemed to be well provided for. Many of the costs lines appear to be based on empirical information while others are provisional sums based on assumptions. In relation to the provisional sums the requirements are not adequately defined for an accurate estimate to be determined. For an ex ante allowance SONI appear to include contingency provisions based on worst case scenarios to ameliorate the risk of getting it wrong. In this regard SONI appear to have taken a risk averse approach.
215. The Utility Regulator has decided to maintain the allowance proposed in the draft determination in relation to all IT CAPEX (excluding DS3). This reflects a 10% reduction on SONI's submission. The rationale for the 10% reduction is due to prudent estimates which are well provided for and in some cases discretionary.
216. In summary the IT CAPEX allowance decision of £6.6 million for this price control represents an increase of 45% (c£2 million increase) when compared to the IT CAPEX allowance provided within the 2010-2015 price control. This comparison is illustrated below in Table 5.1.

Comparison of IT CAPEX allowance between price controls	2010-2015	2015 -2020	Increase in IT
	5 year	5 year	CAPEX
	allowance	allowance	allowance
	£'000	£'000	%
EMS	1,360	2,227	64%
IT & Comms	3,194	4,395	38%
Total	4,554	6,622	45%

Table 5.1: Comparison of IT CAPEX allowances

5.1.2.2 IT CAPEX (DS3)

217. With increasing renewable generation the Draft Determination acknowledged delivery of the DS3 project will require investment in big data management and related systems. However, it was recognised that further work was needed within the price control process in terms of how this price control will interact with the DS3 workstream.
218. As with the Draft Determination costs explicitly relating to DS3 are outside of the scope of this price control and therefore an explicit provision for DS3 within CAPEX has been deferred and will be considered afresh within the cost recovery framework to be established by the relevant authorities.
219. While this specific DS3 CAPEX will not be included within this price control allowance, the CAPEX allowance within this price control does provide the IT infrastructure and system capability for operating within the renewable target, I-SEM and DS3.
220. This includes enhanced performance monitoring capabilities within the CAPEX provision for managing 'big data' and data mining. Such performance monitoring capabilities are required for effective monitoring of *inter alia* increased renewable generation and DS3 service providers.

5.1.2.3 Concrete Repair £194,000

221. This relates to the repair to the façade of the original 1970 building. Within the 2010 – 2015 price control submission SONI identified the carbonation of concrete and steel carbonation as major issues at that time and sought building works which included remedial work and re-cladding to the existing concrete façade.
222. SONI were allowed a building extension and refurbishment allowance of £3m within the 2010-2015 price control but have chosen to defer this work. On the basis the Utility Regulator has already provided an allowance for this work the request for £194,000 is disallowed.

5.1.2.4 Facilities Improvements £280,000

223. SONI requested CAPEX for a range of facility improvements, however insufficient business cases or justification were received. Given SONI have just completed, in 2014, extending and refurbishing their existing building the Utility Regulator required strong justification for this request.

224. Insufficient justification has been provided by SONI. The Utility Regulator's expectation was the 2010-2015 £3 million building allowance was provided for the long term facility requirement and so it is surprising that general facility improvements were submitted. On this basis the request for £280,000 is disallowed.

5.1.2.5 Summary of CAPEX Allowances

225. Table 5.2 below summarises the CAPEX allowance provided within this price control against each of the project areas submitted by SONI.

Capital Expenditure Summary		SONI Submission	UR Decision	%
		£'000	£'000	Reduction
Item		Total	Total	
1	IS Infrastructure	1,262	1,135	10%
2	Corporate Systems	987	889	10%
3	Energy Management Systems-All Island Operations	2,475	2,227	10%
4	EDIL/RCUC/AMP	1,201	1,081	10%
5	TUoS/Settlement/Metering	757	681	10%
6	Big Data/Data Mining	475	427	10%
7	DS3/Smart Grids	1,292	0	100%
8	Operation Changes - Network Codes	202	181	10%
9	Concrete Repair	194	0	100%
10	Facilities Improvements	280	0	100%
Total		9,123	6,622	27%

Table 5.2: 2015–2020 SONI CAPEX: Utility Regulator's Decision

226. SONI disagree with the Utility Regulator rebasing their CAPEX additions. Having considered SONI's concerns regarding the price base treatment the Utility Regulator is content that the overall CAPEX allowance provided above is adequate for this price control.

227. SONI submitted an overall CAPEX request for £9.1 million predominantly relating to CAPEX. This compares with a £7.6 million 5 year CAPEX allowance

provided in the 2010-2015 price control with £3 million relating to the building work. The allowance for 2015-2020 of £6.6 million relates to IT CAPEX and represents an increase of 45% on the IT CAPEX allowance provided in the 2010-2015 price control. These figures exclude the 2010-2015 CAPEX overspend which is treated separately in section 5.1.2.6 below.

228. The costs of implementing elements of DS3 and I-SEM will be considered separately by the relevant authorities. However, sufficient CAPEX has been provided within this price control to facilitate SONI operating within DS3 and I-SEM following implementation.

229. The Utility Regulator has considered the outputs associated with this CAPEX allowance which is set out in further detail in section 5.1.4 and Appendix A.

5.1.2.6 Overview of the 2010 – 2015 Price Control Expenditure

230. Table 5.3 below summarises the capital expenditure allowances provided to SONI upon which the annual depreciation charge was calculated.

£ million	Building	EMS	IT & Comms	Other CAPEX	Total
UR 2010 - 2015 Decision Paper	3.0	1.4	4.1	0.2	8.6
SONI Actual Spend	3.4	3.4	3.4	0.2	10.3
Underspend/(Overspend)	(0.4)	(2.0)	0.8	0.0	(1.7)

Table 5.3: SONI CAPEX 5 ½ Year 2010 – 2015 Allowance and Actual Spend Comparison (April 2014 prices)

231. SONI have overspent by £1.7 million on the overall CAPEX allowance within the 2010-2015 price control. This overspend relates to the building extension and refurbishment together with the business critical EMS system. The overspend on the EMS system is approx £2 million. SONI implemented a new EMS system in 2010 and requested and subsequently were provided with upgrade allowances throughout the 5 year period.

232. These allowances were set outside the context of the I-SEM and DS3 projects however the renewable target of 40% was known at that time. SONI have chosen to commission an extensive upgrade of the system creating a new integrated EMS with the EirGrid TSO which has equal capabilities in both jurisdictions and could be operated independently from either location. SONI have allocated costs equally between both jurisdictions.

233. The Utility Regulator does not dispute the need for a new EMS system, with further additional functionality to manage additional renewable generation on the system over the next 5 years. However the Utility Regulator does have difficulty with the timing of this project, which was due to be delivered September 2015, within the 2010 - 2015 price control.

234. Consumers are continuing to pay for the 2010 EMS system and various wind productivity tools via the depreciation charge through to 2018 and in some cases

beyond. Therefore consumers are continuing to pay for this old system and SONI have assumed in their depreciation submission for 2015 – 2020 the consumer will also pay for the new 2015 EMS system in full. SONI committed to overspending on the CAPEX allowance without discussing the need and justification with the Utility Regulator and on the assumption that consumers would fund the overspend from September 2015.

235. The SONI responses to the Draft Determination CAPEX proposals focused primarily on the Utility Regulator's proposal to disallow the 2010-2015 overspend. SONI consider the non provision of the additional spend on the EMS as increasing SONI's risk if they are to absorb the cost of this investment despite it being in the customer best interest. The SONI response refers to the disallowance of the return and depreciation on this investment would result in SONI submitting a claim for costs associated with not having made the investment. SONI 's response acknowledges that the actual 2011-15 spend does increase the Utility Regulator's allowance approved in 2011 it did so in the interests of incurring the most efficient spend over time and on the assumption that this being the case it would be allowed the associated depreciation during 2015-2020. SONI has no issue with the delayed receipt of the monies for the EMS system, however it must be received or alternatively the greater monies associated with the higher required OPEX and CAPEX included.

236. The Utility Regulator has considered this issue at length. SONI advise that the integrated EMS system increases system security together with all-island grid modeling capabilities. SONI advise this will deliver efficiencies in respect of implementing I-SEM, new European network codes, all island data exchanges with Europe and other TSOs while significantly reducing costs including software licencing costs, hardware infrastructure and efficiencies between control centres in terms of roles and staff deployment.

237. The Utility Regulator continues to recognise the additional functionality provides support for SONI when it comes to implement I-SEM, DS3, network codes etc. However the timing of this project continues to cause concern given consumers continue to fund previous extensive upgrades via a depreciation charge until 2018.

238. In an effort to strike the right balance between consumer benefits and cost recovery by SONI the net overspend of up to £1.7 million will be allowed within this 2015-2020 price control but only added to the RAB in 2018-2019, following full depreciation of the 2010 EMS system. This specific addition will be depreciated, and a rate of return applied, over 2 years. This allows for the asset to be fully depreciated aligning with the proposed upgrade due to be commissioned September 2020, as advised by SONI.

239. The value of £1.7 million is an estimated amount for which the actual net overspend will be considered against the 2010-2015 price control and the Utility Regulator reserves the right to adjust the RAB addition to the actual net overspend up to a cap of £1.7 million. Any adjustment necessary will be

considered in 2016 as part of the K factor correction applicable to the 2016/17 tariff.

240. The introduction of enhanced reporting arrangements should ensure the Utility Regulator receives more timely notice of significant variances with the allowances provided.

5.1.3 Regulatory Approach to Monitoring the Delivery of CAPEX Items

241. IT systems are fundamental to the SONI TSO business for which the electricity industry continues to evolve. I-SEM and DS3 are due to be implemented mid price control and it is difficult to predict the SONI CAPEX requirement for the five year period particularly the latter years when operating under I-SEM and DS3. This is evident in the EirGrid IS Strategy which extends to 2017, SONI CAPEX requirements and subsequent cost submission.

242. Under an *ex ante* framework, it is difficult to set defined CAPEX parameters on the works to be undertaken in a given period. While this is challenging the Utility Regulator believes it is important to set out the CAPEX outputs upon which the allowances provided are based. These CAPEX outputs are detailed in Section 5.1.4 below and Appendix A.

243. While these CAPEX outputs are important in setting out the Utility Regulator's CAPEX expectation at the start of the price control, the Utility Regulator will allow SONI the flexibility to move in response to the TSO CAPEX environment.

244. The Utility Regulator views the SONI CAPEX cost submission as being well provided for. SONI appear to have applied a risk-averse approach in relation to the *ex ante* approach. SONI also appears to have included contingency provisions based on worst case scenarios with prudent estimates which are well provided for and in some cases discretionary.

245. Because of this risk averse approach to forecasting CAPEX the Utility Regulator considers the allowances to have sufficient flexibility to facilitate SONI prioritising and managing this CAPEX allowance should other CAPEX requirements arise in order for SONI to meet all its obligations in operating a safe, secure and reliable power system. This will reduce the volume of IT system Dt submissions, however for the avoidance of doubt this requirement excludes the implementation costs associated with the I-SEM and DS3 projects.

246. The Utility Regulator intends to introduce enhanced cost reporting which will include annual reporting in terms of the actual CAPEX. While SONI have been provided with the flexibility to manage the CAPEX allowance as they see fit the Utility Regulator will require SONI to provide transparency in terms of the actual CAPEX, including the annual provision of the SONI asset register. Transparency in terms of the following:

- a) progress of each CAPEX project identified within this price control;
- b) identification of those projects for which the scope has changed;
- c) identification of projects no longer proceeding including project deferral;
- d) identification of new projects not identified at the time of the price control submission.

247. This reporting requirement coincides with the introduction of the 50/50 risk share mechanism for which the difference between the allowance and actual spend flows through the sharing factor with 50% for consumers and 50% for SONI.

5.1.4 CAPEX Outputs for period 2015 - 2020

248. It is challenging to define CAPEX parameters at the outset of a price control given the challenges being faced in the Northern Ireland electricity market during this price control. However the Utility Regulator believes it is important to identify the high level CAPEX outputs thereby providing transparency of the expectation upon which the allowances have been derived.

249. Below is a high level overview of forecast CAPEX outputs. A more extensive list of outputs, collated predominantly from information provided by SONI and their consultation response is provided within Appendix A. These outputs are not fixed and the Utility Regulator expects SONI to use its discretion to allocate allowances in an efficient manner. However it does provide a general forecast for the type and level of output consumers can expect from the price control.

IT CAPEX Outputs

- i. Ensure resilience of control centre management and availability of key systems.
- ii. Enhancements of the mission critical Energy Management System (EMS) system throughout this price control. A further major EMS upgrade project is scheduled for commissioning September 2020 within this price control.
- iii. Maintain enhanced data exchange (Group Data Exchange (GDX)) to ensure transferring a greater increased volume of data. This meets the European Transparency Platform requirements and is used to transfer Group data to ENTSO-E.
- iv. Implement network and system changes associated with European Network Codes to ensure compliance with these Codes.
- v. Integrate SONI Ancillary Services and Other System Charges settlement into the EirGrid Group Settlements & Billing (CSB) system.

- vi. Upgrade the Counterparty Settlements & Billing System (CSB) to facilitate the complexity of settlement calculations.
- vii. Benefit from focus on big data, middleware (data mining) and Business Intelligence (BI) (data analytics) driven by all parts of the business, European obligations and market obligations. This will also greatly benefit DS3 and smart grid data analysis including enhanced performance monitoring.
- viii. Implementation of a Customer Relationship Management System (CRM) with a web portal enabling customers to log, track and view requests online.
- ix. Implementation of a Human Resources Management System (HRMS) to integrate HR process including payroll, performance appraisal, benefits administration, absence management, recruiting and learning management and other information and analytics.
- x. SONI also expect to adopt cloud computing during the period, for which security, availability and confidentiality of data must be preserved.

IT CAPEX Efficiencies Identified by SONI

- xi. Centralising SONI ancillary services and other system charges within the EirGrid Group single settlement system will reduce costs in terms of system support, on-going development and reporting.
 - xii. Centralised meter data will eliminate some licencing and support costs.
 - xiii. Improved data management with the use of big data, middleware and data analytics will improve data quality availability, consistency and accuracy of reporting. Efficiencies expected as fewer people will be responsible for developing and maintaining databases due to the removal of duplication, allowing more resources to focus on functional activities.
 - xiv. The introduction of cloud computing changes the moves costs from CAPEX to OPEX.
250. The above overview of CAPEX outputs and subsequent efficiencies expected provide a range of outputs which go hand in hand with supporting the wider expectations and outputs within this price control as outlined in Chapter 10.

6. Financeability

251. The SONI TSO revenue is comprised of five main components: pass through costs, OPEX, a depreciation allowance, a market return estimated as $RAB * WACC$ and a K factor correction mechanism.

252. SONI must be appropriately financed to fulfill its regulatory activities over the price control period and in doing this the Utility Regulator must protect the interests of current and future customers.

6.1 SONI Submission on Financeability

253. SONI considers it is unable to adequately finance its functions with a conventional $RAB * WACC$ rate of return for the following reasons:

- As a Transmission System Operator, it is 'asset light', i.e. it has a relatively small RAB in comparison to its ongoing costs and revenues.
- It requires 'significant unremunerated standby or contingent capital greater than its remunerated RAB base.'
- The value of intangible business assets is not specifically recognised.
- A financeability assessment should therefore consider the support and reward that SONI receives for the full extent of its physical investment, contingent and working capital intangibles.
- Given this nature of the SONI business a more holistic approach is required to financeability which should target a set of financial metrics consistent with a strong credit rating.

254. SONI proposed the introduction of a new framework with the following characteristics:

- Maintain a $RAB * WACC$ calculation to remunerate capital (tangible) investments.
- Incorporate remuneration of £22 million contingent capital (debt and equity).
- Establish a margin, complementing the current $RAB * WACC$, to ensure overall financeability, equal to a 10-12% margin on EBIT.
- Implement an incentives regime (potential for additional returns in return for value-add).

6.2 Financeability during the 2010-2015 Period

255. Table 6.1 below summarises the SONI TSO operating profit (before interest and tax) reported within their regulatory accounts.

SONI TSO Profitability Summary				
	2010/11	2011/12	2012/13	2013/14
	£'000	£'000	£'000	£'000
Turnover/Revenue	58,917	62,665	92,294	90,782
Operating Profit (EBIT)	5,777	5,588	4,944	4,302
Operating Profit (EBIT) Margin	10%	9%	5%	5%

* Source: Regulatory Accounts

Table 6.1: 2010 – 2014 SONI TSO Profitability

256. As a result of further engagement with SONI they have outlined the following key sources from which their profits (before interest and tax) are derived:

- Regulated returns on the Regulatory Asset Base (RAB) associated with capital investment;
- The difference in regulatory and statutory depreciation – this comprises two parts (i) differences in the timing of the return of capital invested; and (ii) an element of the return on tangible RAB to deal with nominalisation
- Savings/ efficiencies made on OPEX under the revenue cap.

257. The contribution of the various factors in the 2010-2015 period are shown in Table 6.2 below.

Element	Financial Contribution in the 2010 - 2015 Price Control
WACC return on tangible RAB	£4.5m
Difference in regulatory and statutory depreciation	£9.1m
Savings/efficiencies under the revenue cap	£7.4m
Payments/penalties for regulatory incentives	Nil

Table 6.2 : SONI Assessment of Financial Contribution in 2010-2015 Period (Source: SONI)

258. SONI comment that a number of the factors which contributed to SONI profitability, and therefore financeability, in the 2010-2015 period are not expected to be repeated for the forthcoming period, thereby giving rise to the need to address the financeability challenge through more innovative means if the associated public policy objectives are to be met.

6.3 Financeability in the Draft Determination Paper

259. In the Draft Determination, following consideration of SONI's submission and other relevant factors, the Utility Regulator considered that the WACC*RAB approach remained appropriate for SONI as it can ensure that the interests of consumers are protected together with the regulated business being financed

and their investors are not unfairly treated.

260. In terms of working capital the Utility Regulator proposed to amend the K factor mechanism to allow a higher rate of interest of one-year LIBOR plus 2 per cent (currently Danske Bank base rate, (0.5 per cent)) to be recovered by SONI in cases where an under-recovery occurred. Consumers would therefore pay for the reasonable financing costs of such an under-recovery, but only when an under-recovery has actually occurred.

261. Overall, the Utility Regulator found insufficient basis for allowing any additional return, whether in the form of additional return over and above the RAB * WACC calculation, or in the form of a margin, for any working capital, contingent capital or intangible capital. The Utility Regulator did not think that these were necessary or that it would represent value for money for customers.

6.4 Responses to the Draft Determination Paper

262. The only response received which directly addressed the question of financeability came from SONI. However it is noted that other respondents did make comments in relation to the need to control customer prices which indirectly apply to all aspects of the determination.

263. SONI argue that the Draft Determination misrepresented the SONI submission when it referred to "SONI having submitted a regulatory framework which would provide SONI with a rate of return (WACC), margin, contingent capital remuneration, Parent Company Guarantee (PCG) remuneration and intangible asset remuneration." SONI set its arguments out again and each of these areas is discussed in more detail within this chapter.

264. SONI's overarching concern is financeability in that they viewed the Draft Determination as not providing a basis for SONI to finance its activities. SONI's fundamental issue is the RAB * WACC regulatory framework on its own is not sufficient to provide an adequate return. They assert that they need to achieve an overall EBIT margin of 10-12% on SONI (SSS) revenues (not total revenues) and should receive additional allowances to deliver such a return.

265. SONI argues, in particular, that the Draft Determination provides no return on contingent capital, even though a Parent Company Undertaking from EirGrid plc is a licence obligation²⁵, and does not follow best practice in carrying out a financeability assessment. It highlights that its proposed EBIT margins remain significantly below what it views as comparable companies.

266. SONI reviewed the draft financial model linked to the Draft Determination and has highlighted a number of issues to be corrected. However, SONI has highlighted that the financial model is flawed and it is not designed to assess the

²⁵ SONI Ltd Transmission Licence Condition 3A

overall financeability of SONI.

267. SONI also argues that its characteristics mean that an approach to using margins would be similar to the regulatory frameworks for Power NI and PPB.

6.5 Utility Regulator Comments on Financeability

268. The Utility Regulator has reviewed all the comments provided by SONI and engaged in a number of further meetings and correspondence with them to ensure SONI had every opportunity to present its case. In addition, the Utility Regulator has used this engagement to carry out further analysis, consider the latest regulatory evidence and discuss the matters further with consultants.

269. One particular area of focus has been the CMA's initial views on the fair return for asset light energy supply companies, as set out in its Energy Market Investigation provisional findings²⁶. The Utility Regulator considers that there is a good read-across between the questions that the CMA has been considering and the issues that the Utility Regulator has to deal with in this price review, and has therefore sought to draw on the CMA's framework of analysis as much as possible.

270. On the point of misrepresentation the Utility Regulator is confident that it has fully understood the SONI arguments and not misrepresented them. Some slight adjustments have been made to the wording in this paper to take into account SONI's comments and published SONI's response.

271. The following section considers the issues under similar headings to those which appeared in the Draft Determination.

6.6 Overall Approach to Financeability

272. The focus of regulators recently in considering financeability has been to ensure that the framework and allowances in the overall price control package provide an efficiently managed company with sufficient returns to attract and maintain the financial capital that the business needs in order to carry out its obligations. This has meant less focus on credit metrics and financial ratios than has sometimes been the case in the past, with choices about capital structure (i.e. the mix of debt and equity) being more explicitly left to the company to determine. The Competition Commission's determination of NIE's RP5 price control sets out a number of important principles in this regard,²⁷ which have again been reinforced by the CMA in its recent Bristol Water plc price

²⁶ CMA Energy market investigation provisional findings report
<https://www.gov.uk/cma-cases/energy-market-investigation>

²⁷ Competition Commission Northern Ireland Electricity price control determination. See, in particular, paragraphs 17.97 and paragraph 17.100 onwards.
https://assets.digital.cabinet-office.gov.uk/media/535a5768ed915d0fdb000003/NIE_Final_determination.pdf

determination²⁸.

273. The Draft Determination was drafted consistently with this view where less emphasis was placed on the financing ratios which, in the case of SONI, are very difficult to compare with other companies given the very high level of pass through amounts in its turnover and the very different overall risk profile of a monopoly system operator.

274. For its part, SONI's proposals for this price control were built around a target margin of 10-12% of EBIT. The Utility Regulator has considered SONI's perspective very carefully. The Utility Regulator considers that SONI's submissions have been helpful in identifying the capital requirements that the business has, but it has been difficult understanding the link that there is between these capital requirements and SONI's claim for a particular level of EBIT margin. The Utility Regulator notes, in particular, that a top-down margin approach provides no real link between the actual capital that SONI employs and the cost of raising and maintaining that capital.

275. The Utility Regulator would note that the CMA, in its Energy Market Investigation, considered similar matters in the case of GB retail supply companies and concluded that the use of return on capital is the correct lens with which to look at profit for an asset light business. It explained that "*we do not agree that a low level of capital employed, in itself, makes a ROCE analysis less meaningful. Investors expect to earn a return on the actual capital they put at risk, which is limited to their equity or debt holding in a firm with limited liability*".[Appendix 10.3, Paragraph 20²⁹]

276. The Utility Regulator retains the view from its Draft Determination that the approach of simply targeting a particular EBIT margin would be inconsistent with best regulatory practice and is not in the interests of customers. Therefore the Utility Regulator has retained its overall approach of looking at each of the items SONI has identified in its submissions, and of seeking to understand the amount of the business's capital requirement and the fair reward for that capital.

6.6.1 Investment

277. SONI's investors are required to make finance available for capital investments. The RAB provides a well understood mechanism for tracking the amount of that investment and the provision of a return on the RAB (through a RAB * WACC) calculation provides a well understood mechanism for rewarding that capital. The Utility Regulator will therefore continue with a RAB and a RAB-

²⁸ CMA Bristol Water plc Price Determination (Financeability commencing section 11)

https://assets.digital.cabinet-office.gov.uk/media/56279924ed915d194b000001/Bristol_Water_plc_final_determination.pdf

²⁹ CMA Energy Market Investigation provisional findings (Appendix 10.3: Analysis of retail supply profitability – ROCE and economic profit)

https://assets.digital.cabinet-office.gov.uk/media/559fb6bee5274a155900002d/Appendix_10.3_Retail_return_on_capital_employed.pdf

based return in the upcoming price control period.

6.6.2 Working Capital

278. Working capital is critical to any company and SONI TSO has provided examples of when it may be required to draw on its working capital facilities in the next price control period. These examples include a shortfall in TUoS revenues due to actual demand levels being lower than the assumption made in tariffs; shortfall in Dt expenditure for which the K factor process may take more than two years to work through; increased pass-through costs; bad debt from a SONI customer; and liabilities falling due to creditors. None of these things would impact directly on the value of the RAB or, by implication, on the allowed return.
279. The Utility Regulator recognises that there may be circumstances where the structure of working capital within a company requires some level of regular, ongoing access to external financing. This is demonstrated, for example, in the treatment in the Power NI price control where evidence of ongoing working capital requirements was used to arrive at a determination of required returns and where the ongoing cost of such financing was ultimately incorporated into the margin allowed to Power NI.
280. The SONI TSO regulatory balance sheet for SONI's system operator business provides some information about working capital and its sources. For the four most recent years for which data was provided (2010 – 2014) the Utility Regulator concluded in the Draft Determination that a large proportion of SONI's working capital was met through trade sources, not investors.
281. Since the Draft Determination, the Utility Regulator has specifically engaged on this issue with SONI. The Utility Regulator has not seen robust evidence that it is likely to have a day to day financing requirement in the upcoming regulatory period.
282. The Utility Regulator further understands from discussions with SONI that the K factor arrangement proposed in the Draft Determination are sufficient to cover any unexpected future drawn working capital requirements (although it retains its arguments on the cost of maintaining contingent capital which are discussed below).
283. Therefore the Utility Regulator has decided that it is not necessary or appropriate to provide any additional return to SONI TSO in relation to the costs of a day to day external financing requirement in respect of working capital.
284. The Utility Regulator has decided to retain its Draft Determination position on the K factor. Therefore the Utility Regulator has decided to provide within the K

factor an allowance for under-recoveries to attract an interest rate set to one-year LIBOR plus 2 per cent. K factor is explained in further detail in Chapter 11.

285. This reflects that the relevant cost of debt will be relatively low as it is short term borrowing with a high probability of repayment (as SONI is very likely to be able to recover amounts allowed for through the K factor).

6.6.3 Contingent Capital Arrangements

286. SONI Ltd has in place Revolving Credit Facilities of £12 million which acts as a working capital facility. In addition EirGrid plc has provided 'maximum aggregate financial support' in the form of a £10 million Parent Company Guarantee (PCG) for SONI Ltd to have adequate financial and non-financial resources to perform its obligations in accordance with the requirements of both SONI's system operator and market operator licences.

287. SONI argues that its £10 million parent company guarantee and £12 million working capital bank facility should be remunerated for being in place – as opposed to only being rewarded when capital is actually spent.

288. SONI is seeking remuneration of 6.27% on the total value of £22 million for these facilities. This equates to £6.9 million for the 5 years (£1.38 million per annum). Within the SONI response this is referred to as one of a range of revenue building blocks proposed as a means to bringing to effect an EBIT margin of 10-12%.

289. In relation to the bank facilities, the Utility Regulator has reviewed the fixed upfront costs of SONI TSO operating a working capital facility. Given that this is an unavoidable cost of doing business, the Utility Regulator has decided it is appropriate to allow for the costs within SONI's price control. Having decided this, the allowance should be based on the actual cost of the facility which is £108k (0.9% of £12m) per annum. This cost is included within the Other OPEX allowance referenced in section 4.7.

290. The concept of a PCG is not unusual in regulation to ensure adequate financial resources are in place within a licensed business. This is to ensure that in the event of a financial need, e.g. a new IT system, there is a commitment from the owner to provide the regulated business with the funds that it needs to enable the business to deliver its obligations. Once deployed, these funds will be rewarded within the SONI price control, e.g. a new IT system will receive a WACC return.

291. The Utility Regulator has set out above its position that the return on capital should be based on actual capital employed. This does not rule out the potential that some forms of contingent equity capital might be remunerated in some circumstances. For instance, this could be considered where there is a high

probability, in light of the risks that a business faces, that a company will have to draw on contingent equity within a control period.

292. However as was set out in the Draft Determination any argument SONI might make on PCG has been fully dealt with in the SEMO price control.

293. This is because during the SEMO price control SONI Ltd (in their capacity as a market operator licensee) argued that it was not remunerated for the £10 million PCG in the SONI TSO price control and therefore this should be dealt with in the SEMO price control.

294. On the explicit basis that no such allowance was included within the SONI TSO price control the SEM Committee approved an annual allowance of €300k (being £10m x 2.5% converted to Euros) in the SEMO allowance.

295. This is clear in the SEMO price control decision paper which states in relation to the PCG allowance that:

“This amount has been determined based on an assessment of the fair value of the requirement to have in place the Parent Company Guarantee and the likely cost of procuring such a facility for contingent capital.”

296. Furthermore in reaching its determination the SEM Committee also commented that they:

“acknowledge the licence requirement for contingent capital and have decided to remunerate SEMO a fair value for this, having been assured that neither EirGrid nor SONI are remunerated for such a provision in their respective price controls.”[emphasis added]

297. The Utility Regulator has decided that there is no basis for allowing an additional amount within this SONI TSO determination for the upfront cost of contingent equity capital.

6.6.4 Intangible Assets

298. In SONI's view they have significant intangible assets which are their people and their significant knowledge and expertise, i.e. high human and intellectual capital. SONI further explain that these assets form a major element in the ability of the business to carry out its regulatory obligations in the same way that physical assets contribute to traditional utilities' or a Transmission Asset Owner's ability to discharge its obligations. Traditional utilities receive regulated remuneration for their large tangible asset base whereas SONI receive no remuneration for its large intangible asset base.

299. SONI has clarified in its response to the Draft Determination that it is not seeking explicit remuneration for intangible capital. Rather this is one element of the total enterprise value against which the EBIT margin should be benchmarked.

300. Notwithstanding that the Utility Regulator has not accepted the overall SONI approach on financing, it is still reasonable to consider whether 'intangible assets' should be recognised within SONI's new price control.

301. The Utility Regulator agrees that SONI has intangible assets which have been generated internally through its staff knowhow, its business processes and so on. Whilst SONI does not show these assets on its balance sheet, there is acceptance that they never the less have an economic significance.

302. In the Utility Regulator's view SONI is likely to have acquired such intangible assets in the form of:

- purchasing them from external sources e.g. staff training programmes;
- creating intangibles from internal resources e.g. in house staff training;
- recruiting and employing staff who come with relevant knowledge or skills.

303. Investments in tangible or intangible assets would only qualify for remuneration under the price control insofar as they represent investment by investors, rather than an accumulation of value from amounts previously allowed as operating costs or RAB additions through past price controls.

304. Human and intellectual capital, whether internally generated or purchased, whether capitalised or not, would have been paid for out of ordinary price control allowances. In the Utility Regulator's assessment, there is no additional cost here – to SONI's investors or to anyone else – that is left unremunerated within the price control calculation.

305. The Utility Regulator has therefore decided not to include remuneration for intangible assets within the determination.

6.6.5 Margin

306. The Utility Regulator has considered the appropriateness of introducing an explicit margin in addition to or in conjunction with the WACC*RAB return and the allowances for the costs of working capital. The Utility Regulator notes that the application of such a margin would provide SONI's investors with additional return. In order to justify this additional source of profit, the Utility Regulator considers that it would need to see that some element of the capital that SONI's investors put into the business has somehow been missed or is otherwise being under-remunerated.

307. Having reviewed the submissions that SONI has made during the last 12-18 months, the Utility Regulator has not been able to identify any such omission or oversight. The Utility Regulator considers that the capital that SONI's investors have put into the business in the past, and are likely to be put into the business in the future, are fully recognised in the allowances detailed in Chapters 4 to 5 above. Provided that the Utility Regulator accurately estimates SONI's cost of capital – see Chapter 7 below – investors will be receiving fair reward for the

financial commitment that they make to the regulated business. Any additional reward would therefore constitute excess return and cannot be justified.

308. The Utility Regulator has therefore decided not to introduce a margin for SONI for this price control.
309. The Utility Regulator acknowledges that it has previously applied such a margin in the case of Power NI and indeed SONI has cited the Power NI price control in its submission as a comparator. Furthermore, in its response to the Draft Determination, SONI referenced the differential treatment from Power NI.
310. However it is important to note that Power NI's margin was explicitly derived from a capital base * WACC calculation. A key factor in the calibration of Power NI's margin was an examination of the business's expected external financing requirement, supported by very detailed evidence from the company concerned. The cost of this finance was ultimately passed on to customers, using the margin as a delivery mechanism, and not as some sort of separate entitlement over and above the cost of capital.

6.6.6 Incentives

311. Within the SONI submission and response they refer to several building blocks as part of a new financeability framework. One building block mentioned is the implementation of an incentives regime with potential for additional returns in return for value-add. The SONI submission identified they have not received any financial payment (or paid any financial penalty) in respect of regulatory incentives under the 2010 – 2015 price control.
312. While this is true, it does not reflect that since the 2010-2015 price control decision was made the SEM committee introduced a sizeable incentive mechanism in recognition of the 'value add' both SONI and EirGrid can provide. TSOs can contribute to reducing all-island constraint costs. This incentive has been in place for three of the five years of the price control for which SONI had the potential to achieve a cumulative total of c£1.5 million as an incentive payment should they manage constraints to be lower than forecast to the extent set out in the incentive mechanism.

Since the introduction of this incentive in 2012/13 SONI have currently achieved c£0.5 million with the reward/penalty for the 2014/15 year still to be reviewed and determined by the Utility Regulator and the Commission for Energy Regulation. There is a lag between achieving the reward and receiving the reward; for example, the c£0.5 million reward for year 2013/14 is being recovered by SONI within tariff year 2015/16 following review and approval by both regulators. This demonstrates that the Utility Regulator is supportive of incentive arrangements in the right circumstances. Furthermore the Utility Regulator is committed to further work to expand the application of incentives for SONI and this is addressed in section 10.

6.7 Financial Ratios

313. A financial model has been developed in conjunction with this determination using the Utility Regulator's decision on cost allowances and the cost of capital assumption. The model extends beyond the price control and makes assumptions in terms of the overall revenue and costs for the SONI TSO business for the period of this price control.

314. One aspect of the financeability analysis has been a ratio analysis within the model. A selection of modelled ratios relating to profitability, gearing, operational gearing and interest cover are shown in Table 6.3 and Table 6.4 below.

	2010/11	2011/12	2012/13	2013/14	2014/15
Profit Margin (EBIT/revenue)	9.73%	7.76%	6.02%	4.48%	3.76%
Return on equity (Profit after interest costs/Equity)	N/A	168%	131%	52%	31%
Gearing (Debt/RAB)	N/A	69%	48%	32%	28%
Operational gearing ratio 1: (Average RAB/Total revenue)	0.31	0.24	0.19	0.13	0.11
Notional interest cover ratio (based on 55% gearing) (EBIT/Notional interest)	5.88	7.52	8.24	9.34	12.81

Table 6.3: Modelled financial ratios (2010/11 to 2014/15)

	2015/16	2016/17	2017/18	2018/19	2019/20
Profit Margin (EBIT/revenue)	3.36%	0.97%	1.16%	1.84%	1.48%
Return on equity (Profit after interest costs/Equity)	28%	7%	8%	13%	11%
Gearing (Debt/RAB)	28%	36%	55%	56%	48%
Operational gearing ratio 1: (Average RAB/Total revenue)	0.09	0.11	0.14	0.16	0.13
Notional interest cover ratio (based on 55% gearing) (EBIT/Notional interest)	11.38	2.66	2.35	3.39	3.32

Table 6.4: Modelled financial ratios (2015/16 to 2019/20)

315. Overall the ratios have improved since the Draft Determination. Profitability in both profit margin and return on equity are higher due to the application of a

higher WACC, the inclusion of an estimated cost of I-SEM within the RAB (£10 million in 2017) and a return provided on pre-construction Transmission Load/Capacity Related (TLCR) projects. The gearing ratio has changed significantly from the 'no debt' position portrayed by SONI in its submission to a gearing ratio of 55% in 2017/18 when I-SEM is expected to go live. The above mentioned changes since the Draft Determination have improved the forecast operational gearing and interest cover ratios.

316. The Utility Regulator considers, however, that limited weight should be placed on these ratios given that the amount of debt finance that the business utilises is a matter for SONI alone. In particular, the Utility Regulator considers that as least as much weight should be placed on scenarios in which SONI finances investment via equity and has 0% gearing. Provided that the allowed WACC is sufficient to cover the cost of capital for a 100% equity financed business, as set out in Chapter 7 below, the Utility Regulator can be assured that its price control package leaves SONI in a position where it is able to finance its activities. Any decision to depart from such a scenario and draw on debt finance is for SONI.
317. Therefore the Utility Regulator has placed greater importance on the framework and allowances in the overall price control package providing an appropriate return to investors and put less focus on letting modelled credit ratios drive the calibration of the price control package.
318. One issue highlighted above is the high level of operational gearing which SONI experiences. This does have an impact on the overall risk level of the business and is something which was highlighted in the Draft Determination. The allowed rate of return on capital does and will continue to be higher in order to reflect operational gearing. This is addressed in detail in the WACC section below.

6.8 Summary

319. The Utility Regulator will continue to provide for a return set equal to RAB * WACC.
320. In terms of working capital, the Utility Regulator has allowed within the K factor provisions a higher rate of interest of one-year LIBOR plus 2 per cent to be recovered by SONI in cases where an under-recovery has occurred. This ensures that consumers pay for the reasonable financing costs of such an under-recovery, but only when an under-recovery has actually occurred.
321. In addition an amount of £108k per annum has been allowed to cover the fixed upfront costs of a working capital facility.
322. Overall, the Utility Regulator has found insufficient grounds, based on its examination of the business's capital requirements, for allowing any additional return over and above those elements, whether in the form of allowances for

contingent equity capital, intangible capital or a margin. The Utility Regulator recognises that there are issues of operational gearing which are dealt with in consideration of the WACC.

323. The Utility Regulator has determined that its approach will allow SONI to finance its licence activities and serves to protect the interests of customers.

324. This decision has been made based on analysis of the current position of SONI for the purposes of the 2015-2020 period. Further work will be required at the next price control to consider these matters and this decision does not fix a precedent for future price controls.

7. Weighted Average Cost of Capital (WACC)

7.1 Introduction to WACC

325. This section gives consideration of SONI's cost of capital submission and the Utility Regulator's assessment of the appropriate level of WACC to apply. The Utility Regulator, in carrying out this assessment has given regard to the current and future potential activities that SONI will require resource to enable it to fulfil its duties within this price control.

326. In setting price limits the Utility Regulator considered the appropriate WACC that SONI should earn on its Regulated Asset Base (RAB). As prices and RAB are adjusted by outturn inflation, the real cost of capital is relevant.

327. The Weighted Average Cost of Capital (WACC) is the weighted average of two components: the cost of equity (R_e); and the cost of debt (R_d), where the weighting represent the proportions of debt and equity in a firm's capital structure.

328. The WACC is calculated using the following formula:

$$\text{WACC (Vanilla)} = g \times R_d + R_e (1 - g)$$

g is gearing
 R_d is cost of debt
 R_e is cost of equity

The pre-tax WACC calculation amends the above formula to uplift the cost of equity to allow for corporation tax liabilities.

329. The Utility Regulator has monitored regulatory decisions and has considered the cost of equity in greater detail. The Capital Assets Pricing Model (CAPM) was used to calculate the cost of equity. This method relates the cost of equity (R_e) to the risk-free rate (R_f), the expected return on the market portfolio (R_m) and a business specific measure of investors' exposure to systematic risk (Beta or β) using this formula:

$$R_e = R_f + (R_m - R_f) \times \beta$$

7.2 WACC in the Draft Determination paper

330. The Draft Determination considered SONI's specific circumstances in proposing to set the WACC at the pre-tax level of 5.42%. This was reflected in proposing a higher beta value for SONI compared to recent regulatory decisions.

331. A comparison with the WACC for the 2010-2015 control period shows a reduced cost of debt, a lower risk free rate and higher equity beta.

332. Table 7.1 below sets out the proposal in more detail.

Components of the Proposed Rate of Return	Values 2010 - 2015 Decision	Values UR Propose 2015 - 2020
Cost of debt	3.50%	3.20%
Cost of equity	6.17%	6.50%
Gearing	55%	55%
WACC (Vanilla)	4.70%	4.69%
WACC (Pre tax)	5.44%	5.42%
Components of the Cost of Equity:		
Risk-free rate	2.00%	1.50%
Asset beta	0.45	0.45
Equity beta	0.88	1.00
Equity risk premium	4.75%	5.00%
Cost of equity	6.17%	6.50%
Components of the Cost of Debt:		
Risk free rate	2.00%	1.50%
Debt premium	1.50%	1.50%
Issuance costs	Included within Debt Premium	0.20%
Cost of debt	3.50%	3.20%

Table 7.1: UR Proposed WACC for 2015 – 2020 compared with 2010 – 2015 WACC decision

7.3 Responses to Draft Determination on WACC

333. Limited direct response was received to the Draft Determination section on WACC. The Utility Regulator would note that while the Draft Determination WACC matched the SONI submission, this was clearly based on WACC forming part of a suite of building blocks of the appropriate total return. SONI's arguments in response to this aspect of the Draft Determination are set out in the financeability section above.

334. The Utility Regulator noted in the Draft Determination that further consideration would be given to the issue of high operational gearing. This meant the situation where SONI has a small RAB in relation to ongoing expenditures and revenues and therefore sees greater swings in out-turn profit compared to other regulated companies in the face of external shocks.

335. The ratios for SONI's operational gearing are presented in Table 6.4. While difficult to directly compare the Utility Regulator would note that the RAB/totex ratio for a standard UK regulated network would typically be in the range of 5-10 times.

336. In addition it is noted that the SONI operational gearing has increased since the previous price control and this is demonstrated in the operational gearing ratios present in Table 6.3 and 6.4.

337. Further work has now been carried out in considering whether the estimated WACC fully addresses this issue. This also takes into account the overall financing arguments SONI has made in its response to the Draft Determination.

7.4 Recent Cost of Capital Estimates

338. As part of this analysis the Utility Regulator have taken into account the very latest regulatory decisions. The updated Table 7.2 below now includes the CMA determination in the Bristol Water case as well as other recent UK price control decisions:

	Asset base indexation	Gearing	Equity beta	Cost of debt	Cost of equity	Vanilla WACC net of RPI
Bristol Water	RPI	62.5%	0.85	2.61%	5.73%	3.78%
BT Openreach*	None	32%	0.69	5.50%	7.95%	7.20%
BT WBA*	None	32%	1.17	6.00%	10.35%	9.00%
ED1 non-WPD	RPI	65%	0.9	2.60%	6.00%	3.80%
ED1 WPD	RPI	65%	0.9	2.60%	6.40%	3.90%
Gatwick	RPI	55%	1.13	3.20%	8.76%	5.70%
Heathrow	RPI	60%	1.1	3.20%	8.58%	5.40%
NERL	RPI	60%	1.11	2.50%	6.87%	4.20%
NI Water	RPI	50%	0.83	1.41%	5.65%	3.50%
NIE	RPI	45%	0.6–0.7	3.10%	3.4–5.0%	4.10%
Water enhanced	RPI	65%	0.8	2.75%	5.65%	3.90%
Water other	RPI	65%	0.8	2.59%	5.65%	3.70%
Water uplifted	RPI	65%	0.8	2.84%	5.65%	3.90%

*A nominal cost of capital is used for the price control decisions related to BT; the Ofcom statement says that RPI was assumed to grow by 3.2 per cent a year.

Table 7.2: Summary of Regulator Cost of Capital Estimates

7.5 Risk-Free Rate and Equity Risk Premium

339. The Utility Regulator has drawn on evidence from recent market rates for risk-free and market returns.
340. The Utility Regulator has reviewed the risk-free rate assumptions made in recent determinations by Ofgem (gas and electricity), Ofwat (BT), CAA (airports), and the CMA determinations of NIE and Bristol Water. The range of risk-free rates analysed ranged from 0.5% to 2%.
341. The most recent CMA view had a range for the risk-free rate in the Bristol Water plc price determination of 1% - 1.5%, with a point estimate of 1.25%. The Utility Regulator views the CMA position on the current risk free rate as one which a lot of weight should be placed and considers that a risk-free rate (R_f) of 1.25% is an appropriate benchmark.
342. The Utility Regulator also considers that it is appropriate to place weight on the CMA's estimate for the expected market return. This is a figure of 6.5% above RPI.
343. Using the estimated parameters of the risk-free rate (1.25%) and the equity market return of 6.5% the inferred Equity Risk Premium is 5.25%.

7.6 Cost of Debt

344. SONI and the Draft Determination proposed a cost of debt of 3.2% above RPI. This included an allowance for issuance costs which is in line with what has been used in the recent NIE price control. The aggregate cost of debt is higher than Ofgem's recent allowance of approximately 2.6% for the GB energy network companies³⁰.
345. This 3.2%, above RPI, was calculated as the sum of:
- the real risk free rate (1.5%)
 - The spreads between yields on corporate debt issued by comparator companies and the yields on UK government gilts (1.5%)
 - an allowance for issuance costs (0.2%)
346. Given the view expressed above that a risk-free rate of 1.25% is now more appropriate, the Utility Regulator has revised down its estimate of the cost of debt by 25 basis points to 2.95%.

³⁰ <https://www.ofgem.gov.uk/press-releases/equity-market-return-consultation-reducing-cost-capital-electricity-distribution-companies>

347. The Utility Regulator notes that the figure is higher than recent regulatory decisions and does not reflect an element of higher risk within the SONI business. This has been included within Table 7.3 below to provide a range.

7.7 Gearing

348. SONI proposed a gearing ratio of 55%. The Utility Regulator was content in the Draft Determination that this notional level was reasonable and noted that it was consistent with the gearing level adopted in the 2010-2015 price control. It is also consistent with the level of gearing that has been reflected in recent regulatory decisions. The Utility Regulator has retained this figure as one of the values in the range set out in Table 7.3 below.

349. However, since the Draft Determination this is an area the Utility Regulator has given significant further thought. In order to ensure the full range of options were considered, the Utility Regulator has looked at a WACC for a small company that chooses not to raise long-term external debt and instead opts for 100% equity financing. Knowing SONI's WACC at this level of gearing, and being assured that the business has a return that is at least as great as this WACC, plays an important role in securing that the business can finance its activities, as explained in Chapter 6 above.

350. Therefore the Utility Regulator has included within its range set out in Table 7.3 below a scenario of 100% equity financing. This approach also follows that considered by the CMA in its recent Energy Market Investigation in looking at the WACC for an independent energy supplier.³¹

7.8 Equity Beta and Asset Beta

351. A firm's beta is a measure of the riskiness of a firm and may be considered as a measure of the systematic risk that a company has, relative to the market portfolio. Typically company beta values would be obtained by measuring the correlation between movements in a company's share price and movements in the value of the stock market as a whole.

352. As SONI is not listed on the UK stock exchange, the next best alternative is to compare beta values for similar companies and make a judgment based on this comparison.

353. SONI has applied an equity beta of 1 and an implied asset beta of 0.45. This was also the basis for the Utility Regulator Draft Determination decision. This has

³¹ CMA Energy Market Investigation Appendix 10.4 Cost of Capital
https://assets.digital.cabinetoffice.gov.uk/media/559fb6ce40f0b61567000049/Appendix_10.4_The_cost_of_capital.pdf

been retained as part of the range set out in Table 7.3 below.

354. An asset beta, β_a , is a hypothetical measure of the beta that a firm would have if it had no debt and were financed entirely by equity. Therefore in circumstances where there is zero debt the asset and equity beta will be the same.
355. The Utility Regulator noted in the DD that it wished to give further consideration to how the issues of operational gearing should be addressed. In line with regulatory precedent the assessment of beta is regarded as the appropriate place to reflect this issue.
356. The Utility Regulator has concluded that the DD proposals did not fully reflect the increasing operational gearing issues within SONI over recent years which will have an impact on the risk of the company and the appropriate beta figure to apply. Therefore a higher beta figure is regarded as appropriate.
357. While the overall SONI risk has increased somewhat to justify a higher beta the Utility Regulator notes that SONI remains a regulated monopoly with no significant volume or competitive risks. It operates within a flexible regulatory framework where many significant costs are considered using the Dt term. This allows costs to be set with greater certainty and limits risk.
358. Overall the Utility Regulator views SONI as facing greater risk than regulated network companies which do not face the operational gearing challenges as SONI but less risk than other companies which face significant volume risk in a competitive market. Regulated network companies have been given asset betas around a range of 0.3-0.4 recently, whereas the market average firm in the stock market has an asset beta range of 0.7-0.8.
359. Based on this analysis the Utility Regulator has decided to set the asset beta to 0.60. This addresses the increased risk associated with operational gearing.
360. The equity beta at 0% gearing is also 0.60. The equity beta at 55% gearing is calculated to be 1.20, using a debt beta of 0.1 consistent with the CMA final determination on NIE published 2014.

7.9 Taxation

361. SONI suggest making an allowance for corporation tax by using a pre-tax WACC. This effectively amounts to making a tax allowance based on the statutory rate applied to the return on equity.
362. The Utility Regulator will apply the Northern Ireland corporation tax main rate effective at the commencement of each year (1 October) of this price control. This is currently at 20% and expected to reduce to 19% for the years starting

April 2017, 2018 and 2019³². This is reflected within WACC calculations. Any change to corporation tax will be adjusted for under the K factor correction mechanism.

363. The Utility Regulator has given consideration to changing to a Vanilla WACC which would exclude an adjustment for tax. When applying a Vanilla WACC a separate tax allowance should be provided. As the SONI TSO business has a relatively small RAB the Utility Regulator has decided to remain consistent with the approach to date for SONI and therefore will continue to use a pre-tax WACC.

7.10 WACC Range

364. Table 7.3 below sets a range for potential values for the WACC. It includes the Draft Determination figures as well as the updated figures based on the discussions above. It is somewhat unusual in that it includes a very large range for gearing but this reflects the unusual nature of the SONI business where a perfect comparator is difficult to find. However the Utility Regulator finds this range useful in arriving at its final decision.

WACC Comparison	UR final determination range		
	UR Proposal Draft Determination	Zero Debt	55% gearing
Gearing (%)	0.55	-	0.55
tax rate	20%	20%	20%
risk-free rate (%)	1.50	1.25	1.25
Equity-risk Premium (%)	5.00	5.25	5.25
Debt Beta			0.10
Asset Beta	0.45	0.60	0.60
Equity Beta	1.00	0.60	1.21
Post-tax Cost of Equity (%)	6.50	4.40	7.61
Pre-tax Cost of Equity (%)	8.13	5.50	9.51
Cost of Debt (%)	3.20		2.95
Post-tax WACC (%)	4.33	4.40	4.72
Vanilla WACC (%)	4.69	4.40	5.05
Pre-tax WACC (%)	5.42	5.50	5.90

Table 7.3: Range of Potential WACC Values

³² <https://www.gov.uk/government/publications/rates-and-allowances-corporation-tax/rates-and-allowances-corporation-tax>

7.11 Overall WACC Decision

365. The Utility Regulator has taken the time since the Draft Determination to ensure that the particular financing issues faced by the SONI TSO business are given further consideration. The Utility Regulator recognised in the Draft Determination that SONI is an asset light business with a high level of operational gearing and the Utility Regulator has decided that it would add value to consider a wider range of approaches to the WACC from the relatively standard one which featured in the Draft Determination.
366. One further element which the Utility Regulator thought would be useful to consider was a WACC for a company that chooses to rely on 100% equity financing.
367. The range in Table 7.3 is 5.5% to 5.9%. As a cross-check on these calculations, the Utility Regulator has looked at the recent work by the CMA in its Energy Market Investigation on the WACC for a retail energy supply business. As part of this work the assumed 100% equity financing and its range of assumptions produces a pre-tax WACC range of 4.75-6.75%³³.
368. The Utility Regulator notes that the detailed considerations of the CMA in the Energy Market Investigations deal with different companies in different markets with a higher risk profile than SONI and therefore it is important not to over rely on this analysis
369. However, even taking into account this caveat the range produced by the CMA is a useful comparator to the workings for the WACC figures. It also serves to provide an alternative way of considering risk and operational gearing issues through reflection in the gearing assumptions which provides a useful cross check.
370. Having considered the updated analysis considering the CMA work presented above the Utility Regulator has decided to apply a pre-tax WACC of 5.9% (adjusting to changes in the corporation tax rate) for SONI.

³³ https://assets.digital.cabinet-office.gov.uk/media/559fb6ce40f0b61567000049/Appendix_10.4_The_cost_of_capital.pdf). The CMA rate has been converted from nominal to real and updated for 20% corporate tax rate.

8. Regulatory Asset Bases (RABs) & Depreciation

8.1 Regulatory Asset Bases (RABs) & Depreciation in the Draft Determination Paper

371. SONI have two separate RABs, one relating to the building following the recent extension and refurbishment, the other relates to all remaining assets which are predominantly IT related.
372. The SONI RAB submissions, which are based on the allowances provided, increased the opening balance for this price control by the amount overspend on both IT and the building extension. The RAB submissions were also presented in the incorrect price base.
373. Within the Draft Determination the Utility Regulator disallowed the overspend on both the EMS system and the building. The RABs were adjusted accordingly together with an adjustment of the price base to April 2014 for consistency with this price control paper.
374. The Utility Regulator proposed to change the depreciation period on the non-building RAB from eight years to five years while maintaining the 25 years for the building RAB. This change was considered appropriate as the SONI CAPEX proposals assume replacement or upgrade of IT within a five year period and to avoid a situation where consumers are funding assets which are redundant.
375. The Utility Regulator proposed a combined opening RAB value at 1 October 2015 of £8.9 million reducing to £5.2 million at the close of the price control period 30 September 2020.
376. The Draft Determination recognised the I-SEM project, for which the implementation costs are outside of the scope of this price control, is expected to increase the SONI Non-Building RAB in 2017-18 once I-SEM is commissioned. This would be factored into the financial modelling in preparation for the Final Determination.

8.2 Responses to Draft Determination Paper

377. Most of SONI's response on the RAB and depreciation has been captured within the CAPEX Chapter 5 particularly section 5.1.2.6 which details the

treatment of the CAPEX overspend. SONI justifies the inclusion of the overspend within the RAB opening balances for this price control on the basis the licence did not include a closing RAB on 30 September 2015 or the opening RAB on 1 October 2015.

378. It was proposed to change the regulatory depreciation period, for non-building assets, to five years based on the assumption to align depreciation with the useful life of the assets. SONI consider the Utility Regulator is imposing statutory accounting depreciation equal to regulatory depreciation and considers such a proposal as unrealistic and incorrect. SONI consider regulatory depreciation to be a revenue building block which typically can be altered by the regulator and/or company at each price control determination for various reasons including addressing financeability issues.

8.3 Utility Regulator Decision on RABs and Depreciation

379. The Utility Regulator does not agree with the approach taken by SONI to include the overspend of both the EMS system and the building within the respective opening values of the RABs.

380. The 2010-2015 price control decision paper sets out the closing values for both RABs as at 30 September 2015 which the Utility Regulator has indexed and used as the opening values for this price control.

381. Additions to the Non-building RAB include the new CAPEX allowance of £6.6 million together with the £1.7 million relating to the net overspend for the 2010 – 2015 price control. The £1.7m will apply to the RAB in 2018-19 and will be depreciated over two years as explained in section 5.1.2.6.

382. The Utility Regulator has given further consideration to SONI's concerns regarding the change in depreciation period from eight years to five years and remains convinced five years is appropriate. Thereby broadly aligning with the asset life which also reflects the refresh cycle built into SONI's CAPEX submission.

383. Elsewhere within the SONI response (Section 3: Network Planning) SONI refer to the CC Final Determination on NIE which considered this issue and is relevant to repeat here. The CC determined *"The RAB is a means of allowing NIE to recover capital investments over a suitable period determined by the regulator. In our view the most appropriate treatment for capital items such as non-network capex is for them to be capitalized and depreciated over a time period which*

broadly reflects their asset life. Treating capital items in this way should ensure that the balance between current and future tariffs is appropriate (so that, broadly, consumers at any moment are paying a fair share of the costs of capital investment).” (Paragraph 10.74)

384. The building RAB remains unchanged (except for indexation) and will continue to be depreciated over a 25 year period.

385. With the above adjustments applied the RAB values determined by the Utility Regulator are summarised in Tables 8.1 to 8.3 below for the Non-Building RAB, Building RAB and the 2010-2015 overspend RAB.

UR Non - Building RAB Decision	2015/16	2016/17	2017/18	2018/19	2019/20	Total
	£'000	£'000	£'000	£'000	£'000	
Opening RAB Value	6,431	3,713	3,227	2,886	2,928	
Additions	1,365	1,264	1,003	1,327	1,664	6,623
Depreciation 5 yrs SL	4,083	1,750	1,344	1,285	1,236	9,698
Closing RAB Value	3,713	3,227	2,886	2,928	3,356	
Average RAB Value	5,072	3,470	3,056	2,907	3,142	

Table 8.1: UR Decision Non-Building RAB and Depreciation for 2015 – 2020

UR Building RAB Decision	2015/16	2016/17	2017/18	2018/19	2019/20	Total
	£'000	£'000	£'000	£'000	£'000	
Opening RAB Value	2,443	2,327	2,210	2,094	1,978	
Additions	-	-	-	-	-	-
Depreciation 25 yrs SL	116	116	116	116	116	582
Closing RAB Value	2,327	2,210	2,094	1,978	1,861	
Average RAB Value	2,385	2,268	2,152	2,036	1,919	

Table 8.2: UR Decision Building RAB and Depreciation for 2015 – 2020

UR Net Overspend RAB Decision	2015/16	2016/17	2017/18	2018/19	2019/20	Total
	£'000	£'000	£'000	£'000	£'000	
Opening RAB Value	-	-	-	-	850	
Additions	-	-	-	1,700	-	1,700
Depreciation 2 yrs SL	-	-	-	850	850	1,700
Closing RAB Value	-	-	-	850	-	
Average RAB Value	-	-	-	1275	425	

Table 8.3: UR Decision on RAB and Depreciation re 2010 – 2015 net Overspend

386. When these RAB values are combined the opening RAB values at 1 October 2015 are proposed to be £8.9 million reducing to £5.2 million at the close of the

price control period 30 September 2020. Table 8.4 below summarises the above tables and shows the average RAB value which will be used when calculating the return on the RAB as explained in the next Chapter.

UR Total RAB Decision	2015/16	2016/17	2017/18	2018/19	2019/20	Total
	£'000	£'000	£'000	£'000	£'000	
Opening RAB Value	8,874	6,039	5,437	4,980	5,755	
Additions	1,365	1,264	1,003	3,027	1,664	8,323
Depreciation	4,199	1,867	1,460	2,252	2,202	11,980
Closing RAB Value	6,039	5,437	4,980	5,755	5,217	
Average RAB Value	7,456	5,738	5,209	6,218	5,486	

Table 8.4: Summary of UR RABs and Depreciation Decision for 2015 - 2020

387. While the implementation of the I-SEM project is outside of the scope of this price control it is important to bear in mind that SONI's Non – Building RAB is expected to increase further in 2017-18 once I-SEM is commissioned.

388. Costs associated with pre-construction of TLR projects, being planned by SONI, will also accumulate on a separate RAB until such time as the project receives the Utility Regulator's approval to transfer the project to NIE for development or the project is deemed no longer viable. Each of these projects will be subject to case-by-case approval before costs associated with the project can be accumulated on a separate RAB.

389. Within this price control the Utility Regulator is introducing a 50:50 risk share mechanism which will be administered annually with a comparison between the allowance provided and the actual cost. The subsequent adjustment will be shared equally between the consumer and SONI. In order to carry out this assessment the RAB will be adjusted to reflect actual CAPEX which then calculates the actual depreciation charge and actual rate of return. It should be noted the 50:50 risk share mechanism excludes the RAB associated with network pre-construction project assets.

9. Return

9.1 Return in the Draft Determination Paper

390. Based on the submitted RAB and CAPEX additions from SONI, together with SONI's proposed pre-tax WACC of 5.42%, the return requested by SONI was a total of £2.7 million over the 5 year period.

391. The Utility Regulator calculated the return based on CAPEX additions proposed, applying a 5 year depreciation policy and a proposed pre-tax WACC of 5.42%. The total proposed rate of return for the 5 year period was £1.5 million.

392. The Utility Regulator made reference to the potential use of a vanilla WACC within the final determination.

9.2 Responses to Draft Determination

393. SONI's response is primarily focused on the overall financeability of the SONI business. SONI view the proposed financial return of £0.3 million per annum, or <0.3% Earnings Before Interest and Tax (EBIT) to be insufficient return on its own to undertake the activities required to satisfy its licence obligations.

394. The proposal of a return solely being provided through the WACC*RAB framework is insufficient, given the small RAB element, for the value of return to equal an EBIT margin of 10-12% on SONI (SSS) revenues.

9.3 Utility Regulator Decision on Return

395. The Utility Regulator has decided to continue to apply a pre-tax WACC to SONI. As discussed in Chapter 7 the WACC applicable to this price control will be a 5.9% pre-tax WACC, subject to changes in the corporation tax rate throughout the period.

UR WACC Return Decision	2015/16 £'000	2016/17 £'000	2017/18 £'000	2018/19 £'000	2019/20 £'000	Total £'000
Average Non-Building RAB	5,072	3,470	3,056	2,907	3,142	
Average Building RAB	2,385	2,268	2,152	2,036	1,919	
Average Net Overspend	-	-	-	1,275	425	
Total Average RAB Values	7,456	5,738	5,209	6,218	5,486	
Pre-tax WACC	5.9%	5.9%	5.8%	5.8%	5.8%	
Rate of Return	440	339	305	364	321	1,768

Table 9.1: UR Decision on Return

396. It is worth noting that Table 9.1 shows the lowest expected return for SONI during the five year period. Network planning pre-construction projects will also attract a return based on the WACC. Current calculations show this has the potential to provide SONI with a further £0.6 million return per year.

397. The I-SEM and DS3 projects are also expected to be additions to the SONI Non-building RAB. Pre-construction projects, I-SEM and DS3 are all subject to a separate approval process outside of this price control however ultimately they will impact on SONI's RABs and thereby attract a rate of return.

10. Outputs and Incentives

Outputs of SONI for this 2015 – 2020 Price Control Period

398. The Transmission System Operator is required to maintain a continuous balance between electricity supply from generators and demand from consumers while also ensuring the provision of reserves that will allow for sudden contingencies. Given this critical role entrusted to SONI the Utility Regulator expects SONI to fully comply with the SONI Transmission Licence, various codes (e.g. Grid Code), agreements (e.g. Operational and Agency agreement with the Moyle Interconnector) and arrangements (e.g. Transmission Interface Arrangements with NIE) in place. By complying with these requirements SONI would be expected to plan and operate a safe, secure, efficient and reliable transmission network for 2015 – 2020.
399. The critical role SONI have in keeping the lights on places a strong reputation incentive on SONI in relation to their overall performance. SONI is obliged to report annually³⁴ on their performance in maintaining transmission system security, availability and quality of service. The Utility Regulator will continue to monitor SONI's performance on a timely basis as Northern Ireland's electricity environment continues to evolve to comply on a European spectrum together with a greater dependency on renewable generation.
400. In relation to costs, once the Utility Regulator has set the allowances, the management of costs is a matter for SONI. Compliance, performance and quality of service provided by SONI should not be compromised in achieving efficiency gains.
401. Throughout this price control SONI will contribute to security of supply. This relates to operating the transmission network system in a safe and reliable manner with annual system availability expected to be maintained in line with the 97.35% level reported for 2014³⁵.
402. SONI would be expected to focus on contributing to the successful implementation of DS3 (October 2016) and I-SEM (Quarter 4 2017) in conjunction with the Commission for Energy Regulation (CER) and the Utility Regulator.
403. In terms of SONI system operator's ongoing responsibility, SONI have an obligation to manage constraints on the network in an economical and effective

³⁴ SONI Transmission Licence Condition 20 paragraph 11. SONI shall report, to the Authority, performance details within six months after the end of each calendar year.

³⁵ All Island Transmission System Performance Report 2014

<http://www.soni.ltd.uk/media/documents/Operations/All-Island/All-Island%20Transmission%20System%20Performance%20Report%202014.pdf>

manner. This requirement is further incentivised by the SEM Committee's Dispatch Balancing Cost Incentivisation Decision Paper³⁶ which aims to reduce the costs of constraints on an all-island basis for which the market operator (SEMO) is responsible for settling.

404. Based upon data currently available to the Utility Regulator, most of which is published, a set of targets have been produced to quantify some of the outputs the Utility Regulator expects of SONI over the term of this price control. These are shown in Table 10.1 below, focusing on key areas of SONI such as Reliability and Availability, Quality of Service, Customer Satisfaction, Customer Connections and Planning.

UR 2015-2020 Expected Outputs for SONI in relation to Northern Ireland	Target	Source
Reliability and Availability		
Annual Transmission System Availability	97.35%	Annual Performance Report
Total System Minutes Lost (SML)	3.000 SML	Annual Performance Report
System Minutes Lost (SML) attributable to SONI	0.00 SML	Annual Performance Report
Wind Forecast Accuracy (Average Normalised Mean Absolute Error)	6.9%	Monthly Wind Forecast Accuracy Statistics
Annual Wind Constraint & Curtailment	<1.9%	Annual Wind constraint & Curtailment Report
Breakdown of Wind Dispatch- down Curtailment v Constraint	<24% constraint; <76% curtailment	Annual Wind constraint & Curtailment Report
Quality of Service		
Number of Voltage Excursions outside statutory limits	0	Annual Performance Report
Number of Frequency Excursions below 49.6 Hz or above 50.5 Hz	< 13 incidents	Annual Performance Report
Customer Satisfaction		
Overall satisfaction of service provided by SONI	88%	SONI Customer Satisfaction Survey
Satisfaction with Query Handling	68%	SONI Customer Satisfaction Survey
Satisfaction with length of time to resolve query	82%	SONI Customer Satisfaction Survey
Overall satisfaction with communication handling	73%	SONI Customer Satisfaction Survey
Overall satisfaction with staff	88%	SONI Customer Satisfaction Survey
Customer Connections		
Send customer offers within 3 months after receipt of an application containing all such reasonable information	100%	Licence Requirement - Condition 25
Strategic Initiatives		
DS3 Project Go Live (New DS3 System Services Contracts to replace existing HAS contracts)	October 2016	EirGrid/SONI DS3 System Services Project Plan (May 2015)
ISEM Project Go Live	Quarter 4 2017	ISEM ETA Detailed Design Decision Paper (SEM-15-064 Sept 2015)
Planning		
North - South Interconnector Planning Permission obtained	2019	EirGrid/SONI Generation Capacity Statement 2015 - 2024

Table 10.1: Utility Regulator Output Expectations for 2015 – 2020 Period

405. The purpose of the above table is to provide focus and assist the Utility Regulator in monitoring the SONI TSO outputs during 2015 – 2020. This will assist with informed decisions when further considering incentives.

³⁶ http://www.allislandproject.org/en/transmission_decision_documents.aspx?article=40b93d75-e3f6-4eef-b997-3d9209a2b7d8

406. The most recent performance report for SONI relates to the year 2014 and currently does not report on System Minutes Lost. System Minutes Lost (SML) is an international benchmark for transmission system performance and reliability and is often an incentive used by regulators. System Minutes Lost may be incurred due to faults on the transmission system or due to under frequency load shedding events. Some causes of SML are outside of SONI's control; however SONI can contribute to reduced SML through frequency management, developments in the area of generator performance incentivisation and monitoring. The Utility Regulator expects SONI to report on System Minutes Lost within their 2015 Performance Report³⁷ onwards.
407. It is the Utility Regulator's intention to monitor the above outputs using the most recent information available. This will be monitored as part of the annual reporting requirement detailed in Chapter 15.

10.1 Incentives in the Draft Determination Paper

408. In addition to the cost incentive the Draft Determination also recognised the sizeable financial incentive, introduced in 2012 by the SEM Committee, relating to EirGrid and SONI TSO's managing Dispatch Balancing Costs (DBC) in an all-island context.
409. SONI requested an innovation fund of £2.5 million for the duration of the price control. However insufficient detailed information was provided as to how this would be spent and how it supports being in the consumers' interests. The Utility Regulator proposed within the Draft Determination not to provide an additional investment fund for R&D as there was insufficient confidence that such an allowance would be cost-effective for consumers.
410. Given the introduction of the DBC incentivisation by the SEM Committee (since the last price control was put in place), the reputational incentive SONI has within the Northern Ireland electricity industry and an obligation to take reasonable steps to ensure the system is operated in an economical and efficient manner, the Utility Regulator considered that further incentives were not necessary and therefore proposed no additional incentives for this price control period.

³⁷ Part 11 of Condition 20 of the SONI Transmission Licence
http://www.uregni.gov.uk/publications/soni_transmission_system_operator_licence1

10.2 Responses to the Draft Determination Paper

411. Three respondents comment on the incentives that were proposed in the Draft Determination.
412. Manufacturing NI stated that it was their view that constraint costs are over burdening customers and have witnessed excessive rises in the last number of years. This area is largely within the control of SONI and Manufacturing NI would encourage the Utility Regulator to ensure that there is more stretching cost saving targets on the Dispatch Balancing Cost management performance. Manufacturing NI understands the value of incentives in this area but believes that increasing the threshold at which incentives are achieved would be in the interest of all customers.
413. NIRIG stated that the Utility Regulator has made no allowance for innovation despite SONI's request for £2.5 million to support innovation through partnerships with local universities and part-funding of small scale technology trials. They found this very disappointing and indeed potentially short-sighted and would request a review of this Draft Determination position.
414. SONI commented that the Draft Determination provides no incentive for SONI to deliver value for Northern Ireland customers and that the final determination must amend the risk framework to be consistent with the overall control and should ensure that SONI is incentivised to do the right thing for customers. They also stated that investment in system-level R&D in Northern Ireland is critical for SONI to plan, develop and operate a reliable transmission system in line with public policy, for the benefit of all consumers and that this requirement for incentives is recognised under Directive 2009/72/EC and that the proposed approach set out is inconsistent with developing EU regulatory best practice in this area.
415. SONI also state that they should be incentivised to do the right thing for customers.

10.3 The Utility Regulator Decision on Incentives

416. As a Transmission Licence holder, SONI should at all times protect the interests of consumers of electricity in Northern Ireland as per its licensable duties. Should SONI TSO be deemed to not be acting in accordance with their licence (and by not doing the right thing for customers) the Utility Regulator would consider appropriate enforcement action in line with the enforcement policy.
417. In considering the need for a specific innovation fund the Utility Regulator took into account projects which have been developed during the 2010 – 2015 price

control. The Utility Regulator is encouraged by SONI seeking innovation, in conjunction with EirGrid TSO, such as the development and implementation of various system tools such as Wind Stability Assessment Tool (WSAT), Short Circuit and Synchro Phasor.

418. This 2015 – 2020 price control continues to provide allowances which are sufficiently flexible to allow SONI TSO to seek further efficiencies by researching and developing technologies and system tools.
419. In SONI's view the deployment of smart grid technologies can contribute to additional levels of energy efficiency including a reduction in network losses and a reduced requirement for network build. Demand side management is also likely to benefit from smart grid technologies.
420. SONI have not provided additional detailed information on how it proposes to spend the £2.5 million innovation fund and how this expenditure would be in consumers' interests and would lead to lower charges for electricity consumers. Given all of the above the Utility Regulator does not view it appropriate to provide an ex-ante innovation allowance within this price control.
421. In general, the Utility Regulator does not view the purpose of incentives as another means of providing a regulated company with money. Given the existing incentives the Utility Regulator has considered the need for more incentives within this price control.
422. The Utility Regulator has decided to monitor the performance outputs against the targets outlined in Table 10.1 above, which may identify areas to incentivise in the future.
423. Since 2012 a DBC incentive has been placed on both TSOs to manage Dispatch Balancing Costs (DBC) in an all-island context.
424. In financial terms the SONI TSO maximum reward is worth c£0.5 million per annum and maximum penalty of c£0.25 million per annum.
425. Furthermore, the SEM Committee has indicated its intention to introduce a further all-island incentive on both TSOs in relation to the DS3 System Services project. In the SEM Committee's DS3 System Services Procurement Design and Emerging Thinking Decision Paper (SEM-14-108)³⁸ the following commitment was made to TSO incentivisation:

³⁸ SEM-14-108 DS3 System Services Procurement Design and Emerging Thinking Decision Paper published 19 December 2014

http://www.semcommittee.eu/en/transmission_current_consultations.aspx?article=11d55fa2-e9cd-454c-aaa5-d689d434db20&mode=author

"The SEM Committee has decided that an incentive mechanism will be put in place to ensure the economic procurement of system services by the TSO, delivery of an increased level of wind penetration and/or delivering the best overall value for the consumer."

426. The Utility Regulator will continue to work with the SEM Committee and CER to determine if additional appropriate incentives, which are in consumer's interests, will be required, within this period.

427. Where SONI identifies an innovative project which it considers the regulatory framework does not facilitate it is open to make a proposal under the Dt mechanism. For example this could occur on projects which have an impact on the network. In such circumstances the Utility Regulator would expect SONI to engage with NIE Networks to produce a high quality submission to set out why it would benefit NI customers and would welcome evidence of this co-operation in the context of the upcoming RP6 NIE Networks price control.

11. Uncertainty Mechanism and K Factor

11.1 Uncertainty Mechanism and K Factor in the Draft Determination Paper

428. Within the 2010-2015 SONI price control it was recognised that the D_{TSO_t} term would be used to cover unforeseen costs or costs where the scope was not sufficiently defined to enable a reasonable estimation. In the Draft Determination the Utility Regulator proposed to remove some previous Dt requests and incorporate them into the 2015-2020 price control as a price control allowance. For example allowances associated with the European TSO (ENTSOE) membership and tariffs, business rates and section 75 pension liability were proposed to be incorporated into this price control.

429. The Utility Regulator proposed restricting the Dt term by specifying a pre-defined category of events within the SONI TSO licence. This aligns with the approach taken by the Competition Commission (CC) in relation to NIE. The CC removed the general reopener as they viewed it as giving the regulated company insufficient incentive to be efficient and so exposes consumers to the risk of excessive costs.

430. The removal of the general reopener within the Dt term and a proposed increase in the *de minimis* from £20k to £200k for SONI Dt submissions was viewed an effective way in reducing unnecessary regulatory burden going forward.

431. The K factor adjustment (K_{TSO_t}) addresses specific areas of the SONI TSO business which are exposed to risk and therefore is a key component reducing SONI's system operator exposure to risk. The Draft Determination provided a list of adjustment factors including actual demand, inflation, interest and the 50/50 risk sharing mechanism.

432. A key change related to under recoveries representing working capital requirements. It was proposed that such under recoveries would attract an interest rate set to one-year LIBOR plus 2 per cent. This proposal reflects an increase from the current licence which provides for Danske Bank base rate only (currently 0.5%).

11.2 Responses to the Draft Determination Paper

433. SONI encourages and would support efforts to reduce Dt requests under an *ex ante* regulatory revenue framework however SONI consider this can only be achieved if it has the financial resources to underpin the payment of costs incurred in carrying out its licensed activities. Simply listing the items and

introducing a <£0.2m threshold, is not a sustainable solution. Given the Draft Determination proposes an annual return of c£0.3m it is not reasonable to assume that SONI can incur the costs associated with non-qualifying Dt items.

434. SONI has particular concerns regarding the following:

- ENTSOe - SONI cannot accept the proposal to remove ENTSOe costs to the revenue capped Bt at the proposed level of £0.6m p.a. given the risk of incurring significant charges in excess of this and which SONI has no control. From the SONI perspective there appear to be no rational reason to remove this from the Dt process and include in the price control. As such, and given the volatility of the charge, and the lack of a financeable business framework SONI cannot accept this charge being moved to within the price control.
- Constraints financing costs - As per all other cost forecasts included in the SONI submission, all costs accorded to the SONI System Operator are SONI System Operator costs.

11.3 Utility Regulator Decision on Uncertainty Mechanism (Dt) and K Factor

435. The Utility Regulator has considered the SONI response. It is not uncommon for regulators to specify pre-defined categories and set materiality thresholds associated with uncertainty.

436. In relation to SONI's particular concerns, identified above, the Utility Regulator has decided to keep both the ENTSOe costs and constraint financing costs within the Dt process. Therefore the proposed allowance has been removed in order to arrive at the price control allowances. ENTSOe membership and Inter-TSO payment are annual payments made by SONI and represented a recurring Dt submission. This was the rationale for proposing an allowance being provided within the price control. However, it is accepted that particularly the Inter-TSO payment is volatile and therefore **net** ENTSO-e payments will remain as a recurring annual Dt.

437. The Utility Regulator has decided to restrict the Dt term by specifying pre-defined categories thereby reflecting the Competition Commission decision on NIE Networks. Following the Draft Determination pre-construction projects not being transferred to NIE Networks have been added.

438. In response to SONI's concern regarding increasing the de minimis level to £200k the Utility Regulator has decided to set the *de minimis* amount for Dt submissions to £40k applicable annually and for each category of cost.

439. Excluded costs to be treated within the Dt mechanism are set out in Annex 1 of the SONI Ltd Transmission Licence. Such claims for excluded costs will fall into one of the following pre-defined categories:

- Change of Law;
- Compliance with requirements of Directive 2009/72/EC;

- Additional Costs incurred by TSO in relation to the SEM;
- Uncollected SSS/TUoS Revenue;
- Financing SEMO working capital requirements;
- ENTSO-E membership and Inter TSO Compensation;
- Costs associated with Transmission Network Pre-construction Projects;
- Other costs, not already taken into account, costs which cannot reasonably be controlled and the Utility Regulator determines is appropriate as a Dt.

440. Within the coming years the Utility Regulator is aware of number of likely Dt claims by SONI. An example of these are listed below:

- Additional I-SEM SONI TSO implementation related costs;
- Additional DS3 SONI TSO implementation related costs;
- EMR related Costs (DETI to confirm cost recovery);
- Historical Pension Deficit Repair (cut-off date 31 March 2015);
- Moyle Interconnector Administration Costs;
- Mandatory participation in Regional Security Co-ordination Initiative (RSCI);
- Transmission Network Pre-construction Projects (not being transferred to NIE); and
- Contestability.

441. In recent years SONI have claimed annual recurring Dt costs in relation to annual system changes for existing systems. This historically has included Ancillary Services changes for a new tariff year, Intraday system costs, Auction Management Platform costs, France UK Ireland portal costs, EMS priority dispatch costs. The Utility Regulator views the allowances provided under IT OPEX and IT CAPEX to be sufficient and appropriate to enable any such system changes to be captured and therefore do not expect to receive or to provide approval for system change submissions via the Dt mechanism.

442. In general, SONI is encouraged to submit a claim for costs by 1 April immediately preceding the tariff year for which SONI wish the Dt claim to take effect. Such cost submissions must be accompanied by all relevant details of the costs claimed, differentiating between internal and external costs and revenues, to enable the Utility Regulator to determine whether such costs are in the public interest of the consumer and can be recovered by SONI.

443. All Dt submissions require the approval of the Utility Regulator before they become effective within tariffs and/or reported upon. A separate process for network pre-construction Transmission Load/Capacity Related (TLCR) project approval will be put in place.

444. Generally, upon review of a Dt claim submission the Utility Regulator gives approval of an allowance up to a cap. SONI is then obliged, at a later stage, to report the actual cost and any necessary adjustment is made within the K factor mechanism for the variance.

445. This K factor adjustment (K_{TSO}) addresses specific areas of the SONI TSO

business which are exposed to risk and therefore is a key component in reducing SONI's system operator exposure to risk.

446. The specific K factor adjustment factors are listed below:

- Adjustment to allow revenues (including A_{TSO} costs relating to System Support Services) to reflect any over or under recovery of revenue in comparison with the revenue allowance (i.e. adjust for market demand);
- Under recoveries representing working capital requirement will attract an interest rate set to one-year LIBOR plus 2 per cent. This proposal reflects an increase from the Danske Bank base rate (currently 0.5 per cent) currently reflected within SONI's TSO licence.
- Interest received on over-recoveries is assumed to be set at one-year LIBOR plus 1 per cent, until such time as they are repaid to consumers.
- Adjustments for indexation given the PC allowances are set at April 2014 prices.

447. The K factor mechanism will be amended to allow for the introduction of a 'demonstrably inefficient clause' which allows for adjustments should certain costs be determined as demonstrably inefficient or wasteful expenditure. This is outlined further in paragraph 11.6 below.

448. The K factor correction mechanism should relate to the most recent tariff year ended 30 September. For example in setting the tariff in Summer 2016 for year October 2016- September 2017 the most recent tariff year ending 30 September is tariff year 2014/15. The K factor adjustments should be submitted by SONI to the Utility Regulator by 31 March 2016 immediately following the tariff year ending 30 September 2015. The Utility Regulator will subsequently review and approve the K factor with a view to inclusion within the tariff year commencing 1 October 2016.

11.4 Pre-construction Transmission Projects

449. Following the Transfer of Planning SONI will now be working on pre-construction Transmission Projects.

450. The Utility Regulator will continue to work with SONI and NIE Networks in developing the Pre-construction project provisions.

11.5 Cost Risk Sharing Mechanism

451. As stated in the Draft Determination the Utility Regulator wants to ensure that SONI is properly incentivised, given the lessons learned from the interaction with the Competition Commission (CC) and the NIE Final Determination³⁹. The Regulator believed that there is merit in introducing a cost risk-sharing

³⁹ https://assets.digital.cabinet-office.gov.uk/media/535a5768ed915d0fdb000003/NIE_Final_determination.pdf

mechanism under which 50 per cent of any difference between the Final Determination assessment of SONI's expenditure allowances and SONI's outturn expenditure in a particular financial year is passed through to consumers through adjustments to SONI's regulated revenue.

452. The SONI response focused primarily on the impact of this 50/50 risk sharing proposal on network pre-construction projects, for which SONI consider the proposals impractical and likely to be counter-productive as it has the potential to stifle innovation carried out by SONI.
453. The Utility Regulator continues to believe that this 50/50 framework approach does not compromise SONI's ability to fund, develop, provide and receive appropriate returns, and that this approach gives SONI sufficient incentive to be efficient.
454. With regard to the treatment of risk sharing arrangements, the Draft Determination had stated that the amount associated with the transfer of planning projects would be subject to the 50/50 cost risk share mechanism. However, the Utility Regulator has taken the views of SONI on board and has decided that, given the uncertainty around these projects, the costs associated with the pre-construction element of the transmission projects will not be subject to the 50/50 sharing mechanism.
455. The approved amount for a pre-construction Transmission Load/Capacity Related project will be capped at a maximum amount and only actual costs (up to that cap) that are properly and necessarily incurred should be recovered via tariffs. The allocation of actual costs to the projects may also be further audited if it is deemed appropriate to do so.
456. The 50/50 risk share mechanism will be introduced and apply to the price control allowances (B_{TSOI}) only, which includes OPEX, depreciation and WACC. Therefore System Services (A_{TSOI}), price control excluded costs including network pre construction projects (D_{TSOI}) will not be subject to this risk share mechanism.
457. The System Operator Licence is being modified to incorporate the introduction of this risk share mechanism. It comprised an additional component (B_{It}) in calculating the Maximum Regulated SSS/TUoS Revenue recoverable by SONI in any particular year. A comparison will be made between the price control allowance (B_{TSOI}) and the actual expenditure and 50% of the variance is adjusted for when calculating the forthcoming tariff revenue.
458. This risk share mechanism will rely on receiving annual reporting of actual historical cost data from SONI. The Utility has drafted the format of such reporting and this is discussed further within Chapter 15 on cost and outturn reporting and the associated Appendix B.
459. Published with this Final Determination is a financial model detailing the decisions within this price control to aid transparency and accountability. This will

also facilitate the Utility Regulator in managing the adjustments to the SONI TSO regulated revenue.

11.6 Other Arrangements - Demonstrably inefficient or wasteful provision

460. The Utility Regulator recently put tariff restriction arrangements⁴⁰ in place to ensure that some form of price control would apply to SONI TSO after the planned end date, in case of a failure to implement a new price control in time.
461. These licence modifications have the effect that, in the absence of a price control determination the SONI maximum regulated revenue is restricted. The restriction is set at the last agreed tariff set within the last price control, unless the Utility Regulator agrees otherwise, and will remain until such times as a new price control becomes effective. This is similar to the conditions that the Competition Commission placed on NIE in their Final Determination.
462. Having considered the Ofgem and the Competition Commission's terminology of '**demonstrably inefficient or wasteful**' the Utility Regulator will include this provision within the SONI TSO Licence modifications associated with bringing this price control into effect. This would enable the Utility Regulator to determine adjustments to the SONI maximum regulated revenue or RAB to protect consumers from exposure to any costs that the Utility Regulator has found to be demonstrably inefficient or wasteful.
463. This clause originated for the Competition Commission's final determination on NIE and will be applied to SONI TSO in respect of System Support Services (A_{TSO}), price control actual costs, excluded (D_{TSO}) actual costs and Change of Law actual costs.

11.7 Other Arrangements - Condition 12 SONI Independence

464. Condition 12 of the licence requires SONI to maintain the full operational independence of its TSO business. SONI has raised a number of questions regarding the meaning and effect of the condition as it applies to the governance of the company and the management of its operations following its merger with Eirgrid. The Utility Regulator agrees that, in the light of the questions raised, these are matters at which it needs to look again in order to ensure that the obligations under Condition 12 are clear and certain in their application to the present circumstances. It is likely that the outcome of this reconsideration of the condition will be future proposals for licence modifications made to the condition

⁴⁰Decision on reporting and tariff changes to SONI's transmission licence

http://www.uregni.gov.uk/news/decision_on_reporting_and_tariff_changes_to_sonis_transmission_licence

during the early part of the price control period.

465. As part of this price control the Utility Regulator has carried out an independent review of the SONI TSO IT requirements. This report was carried out by Gemserv and is available as an annex to this Final Determination. It concludes that this price control enables SONI TSO to have the flexibility to operate its IT system independently within this jurisdiction. In addition given the significant increases in headcount over recent years the Utility Regulator is of the view that SONI has the resources to operate independently.

466. In addition, within the I-SEM programme, a workstream is currently considering governance and licencing issues arising from changes to the operation of the current Single Electricity Market and the additional roles which have been assigned to the Eirgrid Group. This workstream is seeking to ensure the realisation of synergies within the various roles and responsibilities assigned to the Eirgrid Group while at the same time ensuring that any conflicts of interest (real or perceived) are acknowledged and addressed. This workstream will result in two tranches of licence modifications and public consultations for the various roles assigned within the Eirgrid Group. The first consultation will be in April however it is the second tranche of consultation in Autumn 2016, that will address the conflicts of interest concerns and other licence modifications considered necessary. This second consultation will be relevant to the future of Condition 12. It is therefore envisaged that any future modifications to the condition for policy reasons will be made in conjunction with the deliberations and recommendations of that I-SEM workstream.

467. For these reasons, which give rise to uncertainty as to the future terms and effect of Condition 12, the Utility Regulator considers that it would be inappropriate to attempt to set a final allowance at this stage, covering the whole of the price control period, in respect of the costs of future compliance with that condition. It proposes instead that allowances may be varied by the Dt mechanism, enabling SONI to submit a Dt request to adjust the allowances in light of the reconsideration of the condition, the output of the I-SEM workstream, and any licence modifications that need to be consulted on in the Autumn of 2016.

12. Network Planning Function

12.1 Network Planning in the Draft Determination Paper

468. As part of the implementation of IME3 in Northern Ireland, the SONI⁴¹ and NIE⁴² transmission licences were modified on the 28th March 2014 to transfer the responsibility for planning the network from NIE to SONI.
469. A number of roles have been identified as relating to this function which includes advancing pre-construction projects. SONI estimate that over the next price control period it will spend approximately £25 million on pre-construction network projects alone, equating to c£5 million per annum.
470. Two options were open to the Utility Regulator to deal with the pre-construction project costs within SONI. Either to expense the cost through SONI SSS tariff or replicate the NIE arrangements by capitalising the costs through TUoS tariffs.
471. Within the Draft Determination the Utility Regulator proposed to treat all network planning costs as OPEX rather than CAPEX, or a combination of the two. It was also proposed that the 50/50 risk sharing mechanism would apply.
472. As a general principle the Utility Regulator's view was that the consumer should not be materially impacted by this transfer of network planning function from NIE Networks to SONI.

12.2 Responses to the Draft Determination

473. SONI had a number of concerns over the Utility Regulators requirement for 'prior approval' of SONI expenditure. These concerns are summarised below and include:
- a. progressing compliance with network planning standards,
 - b. the Utility Regulator's obligation to finance the activities for which SONI is licensed, and
 - c. the Utility Regulator's approval would lead to an extension of the overall timeline.
474. SONI commented that the 50/50 cost risk sharing arrangement is much less appropriate for the SONI pre construction phase. SONI stated that there is a

⁴¹ http://www.uregni.gov.uk/uploads/publications/SONI_Transmission_Licence_-_Clean_with_IME3_Modifications_Effective_from_28_March_2014.pdf

⁴² http://www.uregni.gov.uk/uploads/publications/NIE_transmission_Licence_-_IME3_Modifications_-_effective_28_March_2014.pdf

much greater likelihood of unforeseen or underestimated costs than of costs being under spent. They also stated that it has the potential to stifle innovation in the carrying out by SONI of its role. The full extent of SONI's arguments can be seen in SONI's response which is published together with this paper.

475. In relation to all network planning costs being treated as OPEX, SONI were concerned that this would result, *inter alia*, in additional burden on customers and be inconsistent with the Transmission Interface Arrangements (TIA) framework. SONI wishes to work through a sustainable framework with the Utility Regulator and NIE Networks.
476. NIRIG in their response noted concerns around implementation of the 'D5' mechanism requiring SONI to seek pre-construction project approval. NIRIG had not seen any evidence that this mechanism has made the approval process more efficient, timely or effective, and therefore questioned the advisability of introducing this same mechanism for another regulated company without such evidence.

12.3 Treatment of Pre-construction Costs on Tariffs

477. Some of the costs that are incurred to develop a fixed asset could be significant and be developed over a long time frame. In Paper 11 of SONI's price control submission they stated that they will carry the costs on a rolling basis until each project is ready to be developed by NIE Networks. The costs will be collated by SONI and charged to NIE Networks under each Transmission Project Instruction (TPI).
478. In the Draft Determination it was proposed that the network planning costs be recovered on an operational basis, rather than capitalised. In SONI's view this proposal was not well thought out and would impose additional burden on customers. The Utility Regulator had concerns around the capitalisation of the projects (some of which may not materialise) and the arrangements between SONI and NIE Networks to manage the capitalisation process.
479. Previously, when this activity was compiled by NIE Networks, it was allocated through the Transmission Use of System (TUoS) tariffs which are partly paid by all-island generators and Northern Ireland customers. If the activity was processed via the SONI SSS tariff it would be wholly funded by the Northern Ireland customer.
480. There is merit in progressing to capitalise the costs through TUoS, as the generation charge element of TUoS (25%) is billed on an all-island basis. Changing this arrangement for cost recovery would make Northern Ireland consumers slightly worse off by approximately £1 million - £1.5 million per annum, compared with pre-construction projects partially being funded by all island generators over 40 years through the NIE Network's TUoS tariff.

481. Similarly, the Utility Regulator notes that Eirgrid costs are transferred to ESB and applied to TUoS with the same all island apportionment.
482. Given the impact on tariffs, the Utility Regulator has decided to allow the pre-construction costs (works after project identification and project initiation) to be capitalised. SONI are expected to collate the approved costs and then transfer the costs to NIE Networks at the Transmission Project Instruction phase. This will allow SONI to allocate the costs to the TUoS tariff and the appropriate customer share.
483. The Transmission Load/Capacity Related project costs will therefore fall into two categories;
- A: Projects that do not materialize to construction, these costs will be reviewed, approved by the Utility Regulator and if efficiently incurred will be placed on the SSS tariff.
 - B: Projects that materialized to construction, these costs will be reviewed, approved by the Utility Regulator and will be placed on the TUoS tariff, through the Transmission Interface Arrangements (TIA) framework.
484. Further work is required to clarify SONI and NIE Network's role, together with developing the implementation of pre-construction Transmission Load/Capacity Related project submissions by SONI and D5 project submissions by NIE Networks. This will include enhanced stakeholder reporting to provide external stakeholders with annual updates including the major transmission projects both at pre-construction and at construction phases.
485. The Utility Regulator will continue to work with SONI and NIE Networks in developing the pre-construction / construction project provisions and enhanced reporting.

12.4 Utility Regulators Decision on Network Planning

486. The Utility Regulator has decided to split the funding of the network planning function between OPEX and CAPEX.
487. OPEX allowances reflect the day-to-day business as usual cost associated with network planning whereas the pre-construction projects will be treated as CAPEX via the pre-construction Transmission Load/Capacity Related (TLCR) project provision.
488. It has been decided, for this price control, the 50/50 risk share mechanism will not apply to the CAPEX pre-construction project costs.
489. The approved amount for each pre-construction project will be capped at a maximum amount (determined by the Authority) and only actual costs (up to that

cap) that are efficiently incurred should be recovered either via the SSS tariff or the TUoS Tariff, depending on if the project is constructed.

490. The potential use of agreed delivery dates or milestones for the projects, including financial incentives for early delivery and penalties for late delivery could also be considered if appropriate and if it is in the public interest to do so.
491. Costs associated with the pre-construction projects will accumulate on a separate RAB and attract a return until such time as they transfer to NIE Networks for construction or the project does not progress and is remunerated through the SSS tariff.
492. The Utility Regulator will continue to work with both SONI and NIE Networks in relation to pre-construction and D5 construction projects. The inter-relation between both the SONI and NIE Networks price controls requires a high level of cooperation between NIE Networks and SONI and the Utility Regulator will seek to regulate this on the general principle that the consumer should not be materially impacted by this transfer of network planning function from NIE Networks to SONI.

13. Allowed Revenue

493. This decision paper presents the Utility Regulator's final determination on the allowed revenue for the SONI TSO 2015 – 2020 price control of £96.8 million, compared to the SONI TSO submission of £131.9 million.

494. The summary below provides a comparison between the current price control allowance, SONI actual and best estimate, SONI's forecast submission and the Utility Regulator's decision.

	2010 - 2015 Allowance £'000	2010 - 2015 SONI Actuals (estimate 2014/15) £'000	2015 - 2020 SONI Submission * £'000	2015 - 2020 UR Draft Determination £'000	2015 - 2020 UR Decision £'000
Payroll (incl ongoing pension)	33,282	31,219	42,881	37,576	36,083
IT and Telecoms	10,559	7,988	9,501	9,501	9,501
Other Operating Costs	7,919	8,624	17,379	6,681	7,056
Pension Deficit	172	391	740	740	943
OPEX Total	51,932	48,222	70,501	54,499	53,583
Depreciation	19,336	9,926	9,761	10,279	11,980
Rate of Return (excl Pre-construction)	4,538	4,115	2,702	1,538	1,768
	75,806	62,263	82,965	66,316	67,330
Innovation Fund			2,625	0	0
Remunerate Contingent Capital (PCG)			6,900	0	0
Margin			13,000	0	0
	75,806	62,263	105,490	66,316	67,330
Network Planning Function**	3,100	3,443	25,100	25,100	28,000
Real Price Effects & Productivity			1,289	0	1,496
Total	78,906	65,706	131,879	91,416	96,826
* Based on the SONI original submission made 21 October 2014					
** SONI responsible for Network Planning from May 2014. Therefore the 2015-2020 UR Decision payroll and network planning function allowances are not directly comparable with the other columns.					

Table 13.1: Summary of SONI TSO Actuals, Submission and UR Allowances (April 2014 prices)

Table 13.1 above is shown diagrammatically below in Diagram 13.1.

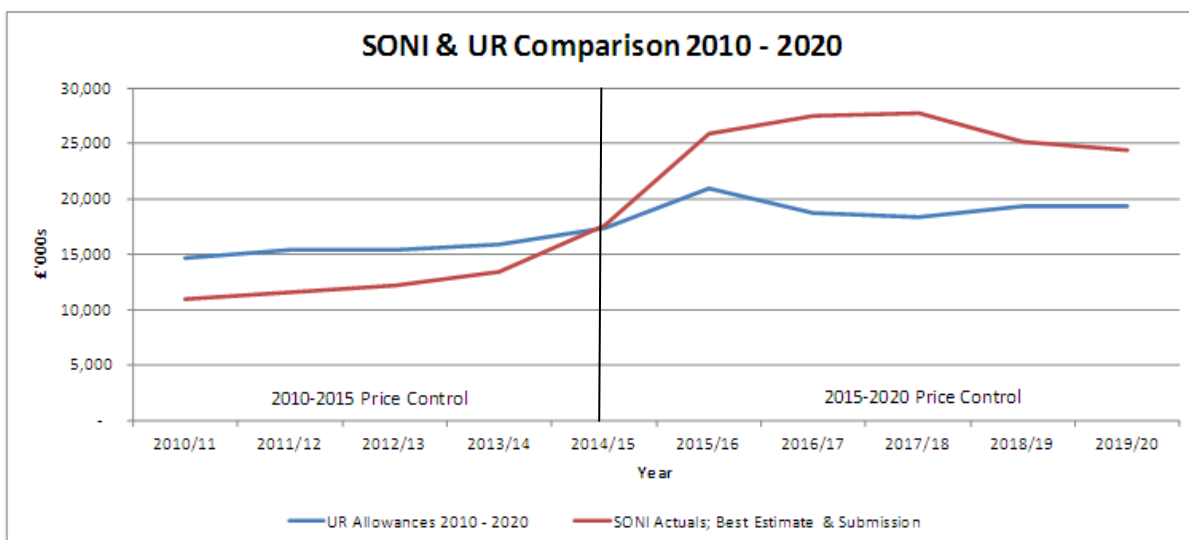


Diagram 13.1: Summary of SONI TSO Actuals, Submission and UR Allowances (April 2014 prices)

495. This Final Determination allowance of £97 million is a 47% increase (£31 million) from the SONI TSO actual spend and best estimate in the last price control. However, this 2015 - 2020 price control includes a forecast amount of £28 million, subject to approval for pre-construction transmission project costs. The overall allowance will also increase within the period once the relevant authorities approve elements of the DS3 and I-SEM project implementation.

496. The focus for SONI TSO should be the successful implementation of DS3 (October 2016), I-SEM (Quarter 4 2017) and the North-South Interconnector (2019) in conjunction with the Commission for Energy Regulation (CER) and the Utility Regulator.

497. The tariff impact is considered in the next chapter. However, with SONI now being responsible for pre-construction transmission projects there is greater complexity when considering the total revenue allowed and the impact on tariffs. Within the allowed revenue is £28 million subject to future regulatory approval, for specific pre-construction projects. However, SONI will recover costs for these projects from NIE Networks rather than from SSS tariffs.

498. Diagram 13.2 below shows SONI's submission both including and excluding pre-construction costs (purple and red lines) compared with the Utility Regulator's final determination on total allowed revenue (including pre-construction projects) and allowed price control revenue (green and blue lines).

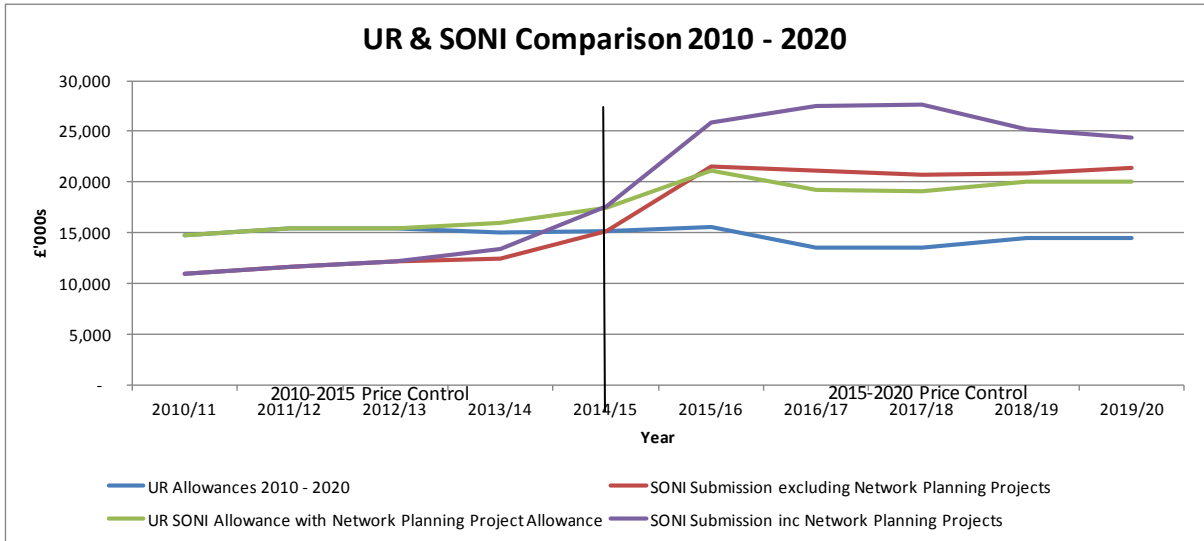


Diagram 13.2: Comparison of SONI TSO Actuals, Submission and UR Allowances both with and with Pre-Construction Network Projects

499. In respect of SONI's tariffs, the Utility Regulator's decision is reflected by the blue line above in Diagram 13.2, compared with SONI's submission (red line).

14. Tariff Impact

500. The overall impact of this price control Final Determination on the SONI SSS tariff is a reduction of c£7 million (9%) over the 5 year period. This translates to an annual average reduction in tariffs for domestic users of c£0.70 and c£1,600 for Large Energy Users.

501. In comparison, SONI submitted a £27 million (35%) increase (excluding pre-construction transmission projects) for the 5 year period, translating to an annual average tariff impact of c£2.60 increase on domestic consumers and an increase of c£6,200 on Large Energy Users.

502. This is depicted in the following diagram which shows a comparison between the SONI submission and the SONI price control allowance. It should be noted, when considering the impact of this price control on the SONI SSS tariff, the costs associated with pre-construction transmission projects should be excluded. This is because the ultimate cost is borne by NIE Networks at the point of project transfer from SONI to NIE Networks for construction.

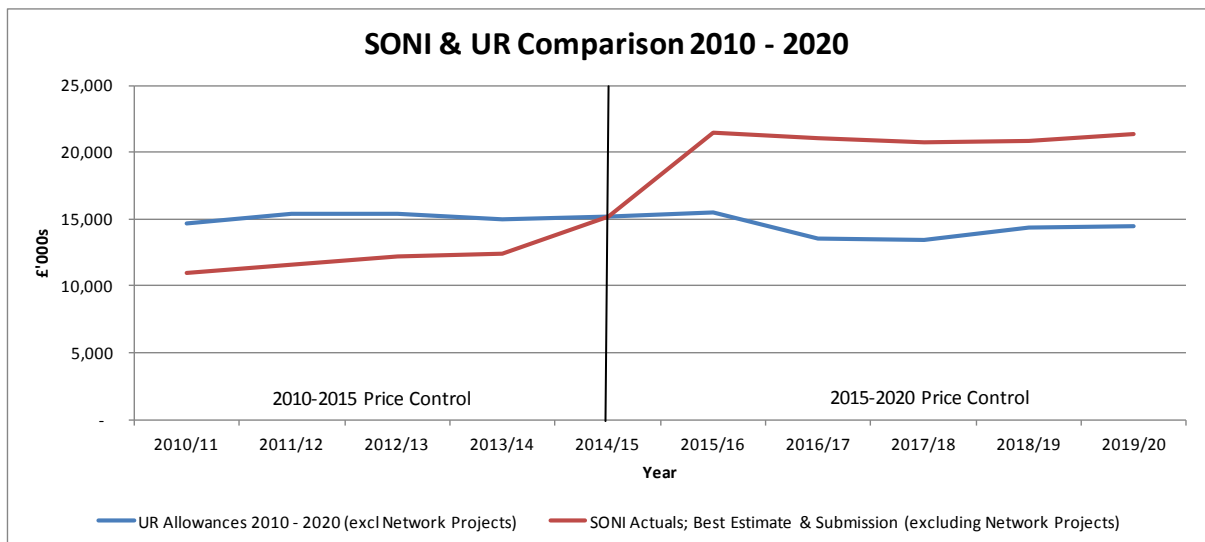


Diagram 14.1: Depicts the SONI Price Control Allowances applicable to SONI SSS Tariff for the 5 year period

503. The drop in the Utility Regulator's allowances in 2016/17 is predominantly due to a c£2 million drop in depreciation as a result of capital investment being fully depreciated.

504. In considering the tariff impact for the forthcoming five years it is important to

bear in mind the following, for which the monies are not directly represented within this price control:

- a) Implementation of the DS3 project which seeks to put in place necessary system policies, tools and performance to facilitate greater reliance on renewable energy. Implementation costs will be decided by the relevant authority and applied to tariff via the D_{TSO} excluded costs mechanism. The actual cost of ancillary services is assumed to continue via the A_{TSO} pass through mechanism. This project is due to be implemented October 2016.
- b) Implementation of the I-SEM project to align with the European Target Model. Implementation costs will be decided by the SEM Committee and applied to tariff via the D_{TSO} excluded costs mechanism. Early indications on the cost impact of implementing I-SEM within the SONI TSO is in the region of £10 million. The first stage of this project is due to be implemented quarter 4 2017.
- c) Costs associated with pre-construction transmission projects. SONI will incur these costs initially, but will then recover the cost from NIE Networks when the project planning is complete and it is transferred to NIE Networks for construction. Therefore the ultimate cost of the pre-construction transmission projects will continue to be funded via the NIE Networks price control.

15. Cost & Outturn Reporting

16.1 Cost Reporting in the Draft Determination Paper

505. There is a need for enhanced monitoring of the SONI TSO business and therefore it is the Utility Regulator's intention to introduce cost reporting measures to cover this price control and beyond.
506. This is expected to take the form of detailed regulatory outturn cost reporting of areas including OPEX, CAPEX and network pre-construction projects. This will then be relied upon to make necessary adjustments from the forecast allowances.
507. Specifically in relation to network pre-construction projects the Draft Determination outlined the need for SONI to report its outturn activities annually on each project to a reporting template in conjunction with NIE. This will enable the Utility Regulator to obtain a complete picture of each D5/transmission project at a pre-construction and a construction level.
508. In preparation for the introduction of this the Utility Regulator recommended SONI maintain appropriate records to facilitate the outturn cost from 1 October 2015.
509. The benefit envisaged is enhanced transparency of the SONI TSO business throughout each year of the 2015 – 2020 price control and beyond.

16.2 Responses to Draft Determination

510. SONI responded that any reporting arrangements must be proportionate to the SONI business. SONI view any substantial increases and/or changes in reporting requirements may require additional systems and/or personnel and will require that the Utility Regulator ensure appropriate provision is made to cover such costs.

16.3 Utility Regulator Decision on Cost & Outturn Reporting

511. The Utility Regulator agrees the reporting arrangements should be proportional to the SONI business. However it is not unreasonable to require timely reporting detailing outturn costs with a view to streamlining the annual tariff process.
512. The overall objective is to bring together in one source actual outturn information (in nominal terms) which draws on the existing requirement of annual audited regulatory accounts, notes and statement, price control information including network pre-construction projects, 'Dt' outturn, Ancillary Services outturn

and other tariff information. This annual information will benefit the Utility Regulator's workstreams including SONI Regulation, Network Projects, Ancillary Services review, Dt cost review and the annual tariff process.

513. This will take the form of detailed regulatory outturn cost reporting of OPEX, CAPEX, network pre-construction projects, Ancillary Services and other D_{TSO} allowances. Annual reporting of the outturn of these areas will improve cost transparency, improve and streamline timelines and is necessary to implement the risk sharing mechanism. This information will benefit the annual tariff process and the K factor correction process.
514. A key function of this cost reporting will inform the adjustment necessary for the implementation of the equal share mechanism detailed in section 11.5.
515. In considering this further, the Utility Regulator is expanding this annual reporting to include outturn reporting in areas such as Reliability and Availability, Quality of Service, Customer Satisfaction, Customer Connections and Network Planning. This extends the focus from purely cost based and is useful for monitoring outputs and future consideration of incentives.
516. The Utility Regulator has issued the reporting templates at the same time as publication of this price control which will be targeted and proportional to the SONI TSO business. The cost and outturn templates are provided in Appendix B for information.
517. As the reporting will be based on information already collated by SONI for the Utility Regulator such as the annual audited SONI TSO regulatory accounts, any additional reporting is not expected to be overly burdensome on SONI.
518. With regard to timelines, year 1 of this price control ends on 30 September 2016. Under current reporting arrangements SONI will submit by 31 December each year an audited statement summarising revenues and costs for the most recent year ending 30 September. By 31 March each year SONI provide annual audited regulatory accounts for the most recent year ending September.
519. The Utility Regulator therefore views the 31 March of each year as the appropriate timeline for SONI to submit the annual cost reporting information for the most recent year ending 30 September. This would provide sufficient time to appropriately review the information for input into tariffs. Based on this the first submission by SONI of the new cost reporting, relating to tariff year 2015/16, would be 31 March 2017.

16. Licence Modifications

520. The SONI Ltd transmission licence Annex 1 requires modification in order to bring this final determination into effect. This also is required to facilitate the appeals process to the Competition Market Authority (CMA).
521. The appeals process changed recently with the implementation of The Gas and Electricity Licence Modification and Appeals Regulations (Northern Ireland) 2015 legislation. This legislation led to requisite and consequential licence modifications to, *inter alia*, SONI Ltd transmission licence for which the Utility Regulator published a decision paper in August 2015 on the Changes to Gas and Electricity Licences with regards to Appeals to the CMA⁴³.
522. The consultation on the proposed licence modifications accompanies the publication of this price control final determination paper. Responses to the licence modification consultation are due by 23rd March 2016.

⁴³ [http://www.uregni.gov.uk/uploads/news/150803_LMA_Decision_paper_\(final\).pdf](http://www.uregni.gov.uk/uploads/news/150803_LMA_Decision_paper_(final).pdf)

A. Appendix A

This appendix sets out in more detail the cost breakdown of each CAPEX category within the SONI CAPEX submission and the Utility Regulator's decision. Furthermore an extensive list of IT CAPEX outputs forecast during the next 5 years has been compiled based upon information provided by SONI within their submissions and the consultation response. This appendix should be read in conjunction with Chapter 5 relating to Capital Expenditure.

Item	Capital Expenditure Summary	SONI's Submission £'000					Total	Utility Regulator's Decision £'000					Total	
		2015-16	2016-17	2017-18	2018-19	2019-20		2015-16	2016-17	2017-18	2018-19	2019-20		
1	IS Infrastructure													
	Common IT Infrastructure	0	0	0	303	101	404	0	0	0	273	91		
	Hardware Replacement	40	0	101	0	0	140	36	0	91	0	0		
	Firewalls	0	242	0	0	0	242	0	218	0	0	0		
	Memory and Storage Expansion	0	101	41	0	0	141	0	91	37	0	0		
	Desktop Infrastructure	41	41	71	140	41	333	37	37	64	126	37		
	Subtotal	80	384	212	444	141	1,262	72	345	191	399	127		1,135
2	Corporate Systems													
	Dynamics	44	44	44	44	44	218	39	39	39	39	39		
	Customer Relationship Management System (CRMS)	203	0	0	0	0	203	182	0	0	0	0		
	Human Resources Management System (HRMS)	0	0	164	0	0	164	0	0	147	0	0		
	SharePoint Migration and Enhancements	50	50	0	0	50	151	45	45	0	0	45		
	Productivity Tools	50	50	50	50	50	252	45	45	45	45	45		
	Subtotal	347	144	258	94	144	987	312	130	232	85	130		889
3	Energy Management Systems-All Island Operations													
	EMS Platform	93	0	0	404	1,211	1,708	84	0	0	364	1,090		
	EMS Enhancements	101	0	0	101	0	202	91	0	0	91	0		
	Wind Dispatch	161	121	121	121	41	565	145	109	109	109	37		
	Subtotal	355	121	121	626	1,252	2,475	319	109	109	563	1,127		2,227
4	EDIL/RCUC/AMP													
	EDIL: Electronic Dispatch Instruction Logger	100	71	41	20	20	252	90	64	37	18	18		
	RCUC: Reserve Constrained Unit Commitment	80	80	80	80	80	402	72	72	72	72	72		
	AMP: Auction Management Platform	109	109	109	109	109	547	99	99	99	99	99		
	Subtotal	290	261	231	210	210	1,201	261	235	208	189	189		1,081
5	TuoS/Settlement/Metering													
	CSB Upgrade	0	0	151	0	0	151	0	0	136	0	0		
	CSB (HAS for NI)	121	0	0	0	0	121	109	0	0	0	0		
	MV90/Converge/MASS	50	50	0	0	0	101	45	45	0	0	0		
	App Enhancements/Consolidations	41	41	101	101	101	384	37	37	91	91	91		
	Subtotal	212	91	252	101	101	757	191	82	227	91	91		681
6	Big Data/Data Mining													
	Data Management	50	0	0	0	0	50	45	0	0	0	0		
	Big Data/Data Analytics	0	101	41	0	0	141	0	91	37	0	0		
	Website	81	0	0	0	0	81	73	0	0	0	0		
	Middleware	101	101	0	0	0	202	91	91	0	0	0		
	Subtotal	233	202	41	0	0	475	209	181	37	0	0		427
7	DS3/Smart Grids													
	DS3	101	151	152	0	0	404	0	0	0	0	0		
	DS3 tools - ramping, voltage management, frequency management	0	101	202	202	101	605	0	0	0	0	0		
	SmartGrids	61	0	101	101	20	283	0	0	0	0	0		
	Subtotal	162	252	454	302	121	1,292	0	0	0	0	0		0
8	Operation Changes - Network Codes	0	202	0	0	0	202	0	181	0	0	0		181
9	Concrete Repair	194	0	0	0	0	194	0	0	0	0	0		0
10	Sterile Zone Lighting	116	0	0	0	0	116	0	0	0	0	0		0
11	Facilities Improvements	0	0	115	0	0	115	0	0	0	0	0		0
12	Fire Protection	48	0	0	0	0	48	0	0	0	0	0		0
	Total	2,037	1,656	1,684	1,777	1,970	9,123	1,365	1,264	1,003	1,327	1,664		6,622

The table below enhances the cost data by focusing on the IT CAPEX outputs associated with the £6.6 million CAPEX allowed. While these outputs have been categorised under relevant headings it is important to understand there are a range of interlinks between the systems both within SONI and the EirGrid Group and therefore the outputs identified may also cross a number of areas. The DS3/Smart

grids will be considered afresh within the cost recovery framework to be established by the relevant authorities.

CAPEX CATEGORY	IT CAPEX Outputs Expected	Estimated Cost
EMS/EDIL/RCUC/AMP	<p>Maintain the 2015 EMS system with power system management capabilities on an all-island basis including monitoring, control, dispatch (including wind dispatch), security/optimisation, forecasting, data logging and data reporting facilities. A programme of EMS enhancements is planned throughout this price control to facilitate new or changing functionality as system operation needs emerge.</p> <p>Ensure resilience of control centre management and availability of key systems e.g. Energy Management System (EMS) and Electronic Dispatch Instruction Logger (EDIL). The EMS is mission critical IT system used for real-time monitoring, control and optimisation of electricity generation and transmission system. EDIL is a secure and robust system for dispatch communication between the control centre and the generation station and archives the information.</p> <p>A further major EMS upgrade project is scheduled to start early 2019 with commissioning planned for September 2020 within this price control.</p> <p>Operate all critical systems and services on fully supported hardware and software while maximizing the lifecycle.</p> <p>Assume the Reserve Constrained Unit Commitment (RCUC), Auction Management Platform (AMP) and All island Electronic Dispatch Instruction Logger (EDIL) will endure throughout this price control given the uncertainty with I-SEM.</p>	£3.3 million
IS Infrastructure	<p>Ensure IT security, cyber security and data security is maintained.</p> <p>SONI also expect to adopt cloud computing during the period, for which security, availability and confidentiality of data must be preserved.</p> <p>Ensure adequate business continuity and disaster recovery.</p> <p>Maintain resilient communication/data links between</p>	£1.1 million

	<p>Dublin and Belfast control centres.</p> <p>Refresh IS Infrastructure including desktops and desktop productivity tools, switches, firewalls, memory and storage expansion and secure mobility tools for remote access.</p> <p><u>IT CAPEX Efficiencies Identified by SONI</u> The introduction of cloud computing changes the way a business manages and supports their IT requirements and costs. It moves costs from CAPEX to OPEX.</p>	
Corporate Systems	<p>Implementation of a Customer Relationship Management System (CRM) with a web portal enabling customers to log, track and view requests online. A further benefit is system level monitoring.</p> <p>Implementation of a Human Resources Management System (HRMS) to integrate HR process including payroll, performance appraisal, benefits administration, absence management, recruiting and learning management and other information and analytics.</p> <p>Continued support of core corporate functions such as Dynamics (financial system), SharePoint (document management etc) and focus on productivity tools.</p>	<p>£0.2 million</p> <p>£0.15 million</p> <p>£0.55 million</p>
TUoS/Settlement/Metering	<p>Integrate SONI Ancillary Services and Other System Charges settlement into the EirGrid Group Settlements & Billing (CSB) system. Thereby creating a single settlement system with centralised view and reporting of all island and jurisdictional data via a centralised secure database.</p> <p>Upgrade the Counterparty Settlements & Billing System (CSB) to facilitate the complexity of settlement calculations within a range of formats reporting meter volumes or financial data. This upgrade will ensure that future strategic objectives for settlement and billing are delivered. Consolidate and simplify the metering data and aggregation function via a single platform for gathering meter information from the generators</p>	£0.7 million

	<p>across the island and feeding the SEM.</p> <p><u>IT CAPEX Efficiencies Identified by SONI</u></p> <p>Centralised settlement processes for SONI Ancillary Services and Other system charges within the EirGrid Group single settlement system will reduce costs in terms of system support and on-going development. Also provides efficient reporting capabilities.</p> <p>Centralised single platform for gathering meter data and submitting it to the SEM will eliminate some licencing costs and also reduce the overhead of supporting multiple different critical systems.</p>	
<p>Big Data/Data Mining</p>	<p>Maintain enhanced data exchange (Group Data Exchange (GDX)) to ensure capability of transferring a greatly increased volume of data. This meets the European Transparency Platform requirements and is used to transfer Group data to ENTSO-E.</p> <p>Benefit from focus on big data, middleware (data mining) and Business Intelligence (BI) (data analytics) driven by all parts of the business, European obligations and market obligations. These elements will enhance SONI's data management including the ability to capture, store, transport and analyse the data for the benefit of our customers given increasing data requirements during the period. A key deliverable of this is the integration of various data sources into a single data source thereby reducing the complexity in integration of EirGrid TSO systems. This will also greatly benefit DS3 and smart grid data analysis including enhanced performance monitoring.</p> <p>The EirGrid website, expected to go live by September 2015, consolidates business critical websites. This will benefit the 2015 – 2020 period as it is expected to include a content management system with website access for stakeholders to an open data download portal thereby allowing Transmission System data for SONI and EirGrid to be viewed and downloaded. A web portal is also expected to enable customers to log, track and view requests online and in real time.</p> <p><u>IT CAPEX Efficiencies Identified by SONI</u></p> <p>Improved data management with the use of big data, middleware and data analytics will improve data quality and availability leading to consistency</p>	<p>£0.4 million</p>

	and accuracy of reports. Efficiencies expected as fewer people will be responsible for developing and maintaining databases due to the removal of duplication, allowing more resources to focus on functional activities. Improved business efficiency and data security with shorter processing times leading to a reduction in response times to queries.	
Operation Changes – Network Codes	Implement network and system changes associated with European Network Codes to ensure compliance with these Codes. These Codes will increase data transparency and require appropriate data links to Europe.	£0.2 million
	Total	£6.6 million

B. Appendix B

This appendix sets out the detailed cost reporting templates which are due to be completed annually by SONI and will inform the Utility Regulator of the annual adjustments for the risk share mechanism.

These templates are published alongside this price control decision paper and are available on the Utility Regulator website.