

SONI Qt Adjustment Decision Paper – 2017/18 Tariffs

Decision Document

21/08/2017



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, 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

In Annex 1 of SONI's transmission system operator licence in respect of the 2015-2020 price control, a Q_t term was applied to make an adjustment to the relevant year t ending 30 September 2017.

The Q_t amount will be an amount that reflects the difference (whether positive or negative) between (i) the B_t allowance included within the tariffs set for the relevant years, and (ii) the B_t allowance for the applicable relevant years in the 2015-2020 price control period, namely relevant years $t = 2015/16$ and $2016/17$

The Q_t term will be implemented only once. This will be undertaken in the 2017/18 tariff year. The adjustment will amend prices to take account of what the B_t term should have been in these years if the price control were enacted.

This paper provides the Utility Regulators decision on SONI's Q_t adjustment for the 2017/18 tariff year.

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.

Our Decision is in relation to the Q_t amount for relevant year t ending 30 September 2017 which will impact on the SONI System Support Services (SSS) tariff for 2017/2018.

It will result in an adjustment within the 2017/2018 SSS tariff and put in place the allowances for the 2015-2020 price control period.

Contents

- 1. Introduction 2
- 2. Background 3
- 3. Principles..... 5
- 4. Options..... 6
- 5. Responses 9
- 6. Decision 15

1. Introduction

- 1.1 The Final Determination for SONI's 2015-2020 price control was published in February 2016¹. Licence modifications were consulted upon and the final decision was made in March 2017². The licence modifications changes came into effect on 9 May 2017.
- 1.2 One element of the modifications related to a new licence term (Q_t). The purpose of this term is to 'true-up' the differences between amounts collected through the 2015/16 and 2016/17 tariffs and the amounts allowed under the price control for the same period.
- 1.3 The purpose of this paper is to inform SONI, consumers and stakeholders about the Utility Regulator (UR)'s decision with respect to the application of the term. This is known as the " Q_t adjustment".

¹ <https://www.uregni.gov.uk/publications/decision-2015-2020-price-control-soni>

² <https://www.uregni.gov.uk/publications/soni-price-control-licence-modifications>

2. Background

- 2.1 The UR introduced the Q_t term, by way of licence modifications made to SONI's TSO Licence, in accordance with its decision of 14 March 2017³.
- 2.2 The Q_t term is explained at paragraph 2.2(e) of Annex 1 which reads;
- "means an adjustment to be applied to the maximum core SSS/TUoS revenue, which:*
- (i) in Relevant Year t ending 30 September 2017 shall be the amount which is determined by the Authority and notified to the Licensee in accordance with principles set out in guidance provided to the Licensee and; (ii) in each other Relevant Year shall be equal to zero."*
- 2.3 Since the start of the 2015-2020 price control period, tariffs have been set by 'rolling over' the 2014/15 allowance (in nominal terms) and not by reference to the allowances determined by the UR for the relevant period.
- 2.4 Accordingly, an adjustment needs to be made to ensure that the 2015-2020 price control decisions are given full and proper effect.
- 2.5 The impact of the Q_t term is simply to 'true-up' the price control such that it essentially has effect from the start date of the price control period (1 October 2015).
- 2.6 Correspondence and published papers from the UR has noted the effective date of the price control is 1 October 2015. This has been understood from the outset and the Q_t term simply reflects that understanding.
- 2.7 Without the Q_t adjustment, no account would be taken of the difference (including in respect of any under and over recoveries) in the allowed and actual revenues recovered for the relevant period from 1 October 2015.

³ <https://www.uregni.gov.uk/news-centre/soni-price-control-2015-2020-licence-modifications-published>

Tariff approvals - Post October 2015

2.8 On 18 August 2015, the UR approved £34.3m (nominal terms) for the SSS tariff for 2015/16. This included £18.8m in respect of the B_t term.

2.9 The £18.8m encompassed within it an allowance of £3.1m which (as for 2014/15 allowance) related to pre-construction costs. This was an acknowledgement of the on-going work SONI was required to deliver in relation to pre-construction network projects.

2.10 In approving previous tariffs the UR stated that the formula amounts

*"... will be adjusted to reflect the appropriate allowance once the price control is established."*⁴

2.11 On 31 August 2016, the UR approved £48.8m (nominal terms) for the SSS tariff for 2016/17. This amount again included £18.8m, encompassing pre-construction planning costs of £3.1m (nominal), as the B_t element. In the absence of price control modifications for the 2015-2020 price control, the total B_t element was essentially the same as that which was allocated to the 2015/16 SSS tariff.

2.12 The Q_t term is intended to take account of the difference between the amount of the B_t element allocated within 2015/16 and 2016/17 tariffs and the B_t element allowed for in the price control for these years.

2.13 Without such an adjustment it would be the case that either customers or the licensee (depending on the differential amount) would be subject to some detriment during the price control period.

2.14 As SONI has collected monies through the tariffs, we consider it appropriate to make restitution.

⁴ UR approval of SSS tariff for 2015/16 – Letter dated 18 August 2015; and UR approval of SSS tariff for 2016/17 – Letter dated 31 August 2016.

3. Principles

3.1 On 5 July 2017 we issued our Q_t Adjustment Principles paper to SONI. That paper set out the high level principles we proposed to follow when making the adjustment.

3.2 These principles are detailed below and remain unchanged.

- ❖ **B_t Tariff Correction** – The Q_t amount will be an amount that reflects the difference (whether positive or negative) between (i) the B_t allowance included within the ‘rolled over’ tariffs set for the relevant years, and (ii) the B_t allowance for the applicable relevant years in the 2015-2020 price control period, namely relevant years $t = 2015/16$ and $2016/17$.
- ❖ **Tariff Verification** –The Q_t adjustment will be based on the information provided by SONI and used by the UR (as verified) in the annual tariff verification and approval process.
- ❖ **Other licence terms** – The Q_t adjustment will not take account of actual spend which may result in amendments to other tariff elements (e.g. 50/50 cost share mechanism).
- ❖ **Inflation** – The Q_t adjustment will take full account of inflation for the relevant years and adjust to current (estimated April 2018) prices.
- ❖ **Pre-construction Network Planning (PCNPs)** – Consideration of the PCNP amounts included within tariffs to date.
- ❖ **Timing** – The Q_t adjustment will flow through to the 2017/18 tariffs on a one-off basis.
- ❖ **Financeability & Consumer Impact** – Consideration will be given to the materiality of the adjustment and the impact on the TSO and consumers alike.

4. Options

4.1 Our Q_t Adjustment Principles paper, also set out the potential options for a Q_t adjustment, after considering appropriate application of these principles. The options were :

A: Not make a Q_t adjustment.

B: Make a Q_t adjustment including PCNPs.

C: Make a Q_t adjustment excluding PCNPs.

4.2 **Option A: Not to make a Q_t adjustment** – we considered that if this option were to be taken, it would still be necessary to ensure that customers do not over pay in tariffs what has been allowed in the price control.

4.3 Furthermore some recognition would also have to be given to account for other differences in the B_t term i.e. inflation. We noted that not making a Q_t adjustment would not be in the consumer interest, would not fulfil the purpose of the term in the licence and that adjustments elsewhere within the tariff formula were also likely to be less transparent. We therefore considered Option A not to be a viable option.

4.4 **Option B: Make a Q_t adjustment including PCNPs** – we outlined that under this option all PCNP costs would be included for the purposes of assessing the difference between the B_t amount approved for tariff setting purposes and the B_t allowance for the relevant year in the 2015-2020 price control period.

4.5 We explained that to date we have allocated £18.8m per annum (nominal terms) to the B_t term in tariffs. This includes £3.1m in each year as an acknowledgement of the on-going work SONI was required to deliver in relation to PCNP projects.

4.6 The Q_t adjustment would remove all PCNP costs in the 2017/18 tariff as well as any other differences. However, given that the tariff approvals were on the basis of the PCNP costs being included and having regard to matters relating to SONI's financeability, we considered that Option B was also not a viable option.

4.7 **Option C: Make a Q_t adjustment excluding PCNPs** – under this option all PCNP costs would be excluded for the purposes of assessing the difference

between tariffs and price control allowances.

4.8 We explained that if this option were followed SONI would be able to retain the £6.2m (nominal) PCNP revenue until such times as the appropriate D_t mechanism for these costs is established.

4.9 The Q_t term would therefore only make adjustment for any difference between the B_t allowances for the relevant years in price control period and the £15.7m (excluding PCNP) allowed for in B_t element of the approved tariffs for each relevant year.

4.10 We explained that taking account of inflation, this would result in an overall approximate adjustment of -£1.8m (2017/18 prices), which included a positive adjustment for 2015/16 of £51k and a larger negative adjustment for 2016/17 of -£1,888k).

4.11 We considered that Option C was the right option to follow.

Calculations

4.12 Calculations behind the options are provided in the tables below:

Table 1 - Option B Calculations

	Adjustments	Process Rule	2015-16	2016-17	Totals
A	FD allowance for B_t – April 2014 prices		£15.4m	£13.1m	£28.5m
B	RPI Adjustment – April 2014 to nominal prices		1.022	1.058	
C	FD allowance for B_t – nominal prices	A * B	£15.7m	£13.9m	£29.6m
D	Tariff allowance for B_t – nominal prices		£18.8m	£18.8m	£37.6m
E	Q_t adjustment – nominal prices	C - D	-£3.1m	-£4.9m	-£8.0m
F	RPI Adjustment – nominal to April 2018 prices		1.071	1.035	
G	Q_t adjustment – April 2018 prices	E * F	-£3.3m	-£5.1m	-£8.4m

Table 2 - Option C Calculations

Adjustments		Process Rule	2015-16	2016-17	Totals
A	FD allowance for B_t – April 2014 prices		£15.4m	£13.1m	£28.5m
B	RPI Adjustment – April 2014 to nominal prices		1.022	1.058	
C	FD allowance for B_t – nominal prices	A * B	£15.7m	£13.9m	£29.6m
D	Tariff allowance for B_t – nominal prices		£18.8m	£18.8m	£37.6m
E	PCNP allowance in B_t term – nominal prices		£3.1m	£3.1m	£6.2m
F	Tariff allowance (excl. PCNP) – nominal prices	D – E	£15.7m	£15.7m	£31.4m
G	Q_t adjustment – nominal prices	C – F	£0.05m	-£1.8m	-£1.8m
H	RPI Adjustment – nominal to April 2018 prices		1.071	1.035	
I	Q_t adjustment – April 2018 prices	E * F	£0.1m	-£1.9m	-£1.8m

4.13 After careful consideration and in line with our stated principles, we proposed to determine the Q_t amount, for relevant year t ending 30 September 2017, on the basis of Option C.

4.14 We highlighted this in the Q_t Adjustment Principles paper and invited comments from SONI on our proposal.

4.15 We also confirmed that pre-construction revenue of £6.2m (nominal) recovered to date within the current price control period, and £1.6m recovered by SONI during the previous price control period, would be retained by SONI and that any adjustments that may need to be undertaken in respect of PCNP costs and recovered revenues will be considered within the appropriate PCNP process and recovery mechanism.

5. Responses

5.1 SONI responded to the Qt Adjustment Principles paper on 20 July 2017 and provided further responses to the UR further queries on 27 July 2017.

5.2 Within their reply a variety of issues were raised, namely:

- a) Retrospection;
- b) PCNP disputes;
- c) Factual errors; and
- d) Financeability concerns.

5.3 The various issues, arguments and our responses are detailed below.

Retrospection

5.4 SONI has argued that an 'interim price control' came into effect on the 1 October 2015. The company considers that to make a Q_t adjustment would be retrospective in nature. They further state that

“the Utility Regulator at no point indicated that it intended at some later point to overwrite this control or to put in place alternative revenue entitlements for the period in question.”⁵

5.5 To support this viewpoint, SONI highlight decisions made by the CAA (Civil Aviation Authority) and Ofgem with respect to rollover allowances. They state,

“It should be noted that in all precedent cases of rollover price controls, the subsequent full price control has not sought to retrospectively apply to the rollover period. The introduction of the Q_t term by the Utility Regulator is at variance with this and seeks to amend retrospectively the rollover price control decision reflected in the company licence.”⁶

5.6 We do not consider that any of these arguments have merit given that :

- a) There was no 'interim price control' set by the UR for the period in question.

⁵ SONI response to Q_t Adjustment Principles paper – 20 July 2017, para 4.

⁶ SONI response to Q_t Adjustment Principles paper – 20 July 2017, para 3.

- b) UR price control documents all refer to the effective date of the price control for the period 2015-2020 as 1 October 2015 (see documents references below).⁷
- c) Interim tariffs were approved on the basis that they would be subsequently adjusted when the 2015-2020 price control was established.
- d) The Competition Commission (now the Competition and Markets Authority – the CMA) considered it correct to revise the ‘rolled over’ revenue for their NIE decision.⁸

5.7 We do not believe the TSO can justifiably claim they did not know an adjustment would be undertaken.

5.8 Certain aspects of the UR's decision in relation to the SONI's 2015-2020 price control have been appealed by SONI to the CMA⁹.

5.9 In their Notice of Appeal (NoA)¹⁰, SONI has also asked for remedies covering the full five years from 2015-2020. These remedies therefore include an understanding that an adjustment of the amounts collected from the previous tariffs is required to implement the five years from 2015-2020.

5.10 In contrast to SONI's claim, not all precedent supports their position. The most obvious benchmark in the case of NIE supports revision of ‘rolled over’ revenue decisions.

5.11 We therefore do not consider SONI's arguments to be valid reasons not to proceed with the Q_t adjustment.

PCNP Disputes

5.12 The UR allocated £6.2m (in total) within previous tariffs to the pre-construction activity. SONI has disputed this fact stating:

“In particular, as outlined in the paper of 26 June 2014, the forecast costs of

⁷ [Draft Determination](#) – p12, para 36.

[Final Determination](#) – p15, para 40.

[Proposed licence modifications](#) – p1, point 2.

[Licence modification decision paper](#) – p7, para 19.

⁸ [CC Final Determination on NIE](#) – p4-1, para 4.2.

⁹ <https://www.gov.uk/cma-cases/energy-licence-modification-appeal-soni>

¹⁰ <https://assets.publishing.service.gov.uk/media/5914232940f0b638b000001b/soni-notice-of-appeal-energy-licence-modification.pdf>

£3.1m are not related to the advancement of PCNPs or indeed to any of the capitalised staff associated with the development of projects.”¹¹

“The £3.1m cited relates to the costs of effecting the transfer of the network planning function from NIE to SONI and the enduring cost of fulfilling the additional operational functions up to 1 October 2015 when the price control was originally intended to commence.”¹²

5.13 SONI has claimed that the UR position is an error of fact and therefore not a valid option for the application of Q_t .

5.14 There is no error of fact. The £3.1m which was allocated in approved tariffs for 2014/15 included costs relating to network planning activities and thereby costs relating to pre-construction activities. The same amount has been included in approved tariffs for 2015/16 and 2016/17 for pre-construction activities. However, the B_t amount set out under the price control licence condition does not include any amount for such activities.

5.15 In any event, even if it were the case that the allocation of £3.1m was not in relation to PCNP costs (which it is not the case), the factual position is that an additional £3.1m p.a. has been reflected within the B_t element of the approved tariff amount

5.16 This is clearly demonstrated in the 2015/16 tariff approval letter where £3.1m is allocated to the B_t term for pre-construction planning activities. It therefore needs to be taken into account for the purposes of the amount of the Q_t adjustment.

5.17 We propose to account for this element of tariffs in the PCNP process. We do not consider this to be a barrier to the Q_t adjustment as these monies are excluded from the proposed option.

Factual Errors

5.18 SONI has questioned the relevance of quoting certain correspondence (dated 26 June 2015) which appears to indicate the acceptance of a ‘ Q_t type’ adjustment. They consider this to be no longer relevant as a result of subsequent events¹³.

5.19 We do not consider this objection to be valid. There was no interim price

¹¹ SONI further response to Q_t Adjustment Principles paper – 27 July 2017, para 5.

¹² SONI further response to Q_t Adjustment Principles paper – 27 July 2017, para 6.

¹³ SONI response to Q_t Adjustment Principles paper – 20 July 2017, para 19.

control in place. The tariff amounts were allocated to ensure SONI could still continue its functions with the understanding that the amount would be adjusted in line with the Price Control amounts.

5.20 Furthermore, we do not consider the reference to be out of context. Within this letter SONI specifically ask for tariffs to be maintained at existing levels for the 2015/16 tariff year until such time as the price control is concluded. It further states:

“This would be without prejudice to the eventual revenue allowance and would be adjusted to reflect that allowance once established.”¹⁴

5.21 The letter clearly details SONI’s willingness to accept a revision for the first year of the price control. Whilst it is accepted that the length of the price control process could not be foreseen, the principle of a ‘ Q_t type’ adjustment is evidently accepted.

5.22 If, as SONI claim, the rolled over tariff represented an unchangeable interim price control, no subsequent adjustment would ever be required. This letter cannot therefore mean what SONI is now claiming.

5.23 As no 'interim price control' was in place we see no valid reason why the revision for the first two years of the price control, as proposed, should not be undertaken.

Financeability

5.24 SONI has made the case that, if implemented, the adjustment would have a significant impact on SONI and its financeability.

5.25 The company state that:

“The impact of applying the Q_t alone, without consideration of other elements of the revenue formula, would have very significant impact on SONI’s financeability at a time when it is already without access to debt markets. It would effectively [be] the equivalent of a direct drawing on the equity holder and erosion of the buffer under the PCG. This would be applied when SONI would be separately entitled to additional revenues under other aspects of the formula such as BI_{TSOt} (which cannot be determined at this time and only following the completion of the 2016/17 financial year). The proposed adjustment should not

¹⁴ SONI letter to UR on SSS Tariff 2015/16 – 26 June 2015.

*therefore be made.*¹⁵

- 5.26 The company further state that the K factor could account for any ‘true-ups’ and that the matter is now before the CMA for consideration.
- 5.27 We note SONI’s position however we consider that the Q_t provides a level of transparency against the ‘normal’ K revisions.
- 5.28 The Q_t decision timing is fixed in the current licence and must be completed for the 2017/18 tariff approval. However the CMA will have opportunity to opine on this decision within their determination.
- 5.29 As regards financeability, we do not consider the arguments to be conclusive. We see no reason why these funds should not be returned to consumers as soon as reasonably practical.
- 5.30 It is also unclear why not considering the BI_{TSO_t} element of the formula at the same time should raise concerns. In the event of outperformance SONI would be returning more revenue to consumers.
- 5.31 Additional revenue entitlements would only be provided for overspend, but this would be at a 50% rate on actual costs incurred. Neither scenario indicates additional revenue which would offset the Q_t impact. This element of the revenue formula is therefore unrelated.
- 5.32 We acknowledge that a one-off adjustment to the scale proposed for Option B could potentially create financeability issues. However the proposed adjustment is much lower (-£1.8m) and amounts to less than 4% of the total revenue recoverable by SONI for 2017/18 (£46.4m).
- 5.33 We think it reasonable and prudent that this money should be returned to customers. We do not agree that it has a significant impact on SONI’s financeability.
- 5.34 In SONI’s response (of 27 July 2017) to the Q_t Adjustment Principles paper they confirmed that *“whilst [SONI] disagrees with the application of an adjustment, [SONI] nonetheless understands the basis of the calculations produced by the UR.”*¹⁶
- 5.35 SONI also provided their own Q_t calculations of c£2m and stated that the *“Application of the Q_t on a proportionate basis – i.e. from the commencement*

¹⁵ SONI response to Q_t Adjustment Principles paper – 20 July 2017, para 32.

¹⁶ SONI further response to Q_t Adjustment Principles paper – 27 July 2017, para 9.

of this price control on 9 May 2017 – 30 September 2017 - would result in the £1.982m SONI indicated (using UR's numbers and UR's forecast inflation rate) or a slightly higher £1.998m using SONI's numbers and SONI's slightly different interpretation of the OBR inflation rate.”¹⁷

5.36 We have considered SONI's proposed alternative calculation. However, they do not cover the full 2015-2020 price control period and therefore their calculation does not meet the requirements of the Q_t adjustment.

¹⁷ SONI further response to Q_t Adjustment Principles paper – 27 July 2017, para 10.

6. Decision

- 6.1 After consideration of the various arguments, we remain of the view that a Q_t adjustment is required. Our decision is to apply Option C and that the Q_t amount for relevant year t ending 30 September 2017 to be included in the 2017/18 Tariffs shall be **-£1.8m**.
- 6.2 We consider this correct as it simply gives effect to the 2015-2020 price control decision and consider it to be reasonable and in the consumer interest.
- 6.3 As SONI has been collecting monies through tariffs since 2015, this decision ensures that customers are not paying more than that which SONI needs to carry out its role. The quantum of the correction also aligns with SONI's alternate calculations of a c£2m adjustment.