2 June 2017

Mr Matthew Weighill
Project Manager
Competition & Markets Authority
Victoria House
Southampton Row
London
WC1B 4AD

Dear Mr Weighill,

Re: Energy licence modification SONI TSO price control 2015 - 2020 appeal under article 14B Electricity (Northern Ireland) Order 1992 (as amended)

1.1. The Consumer Council is asking to be formally regarded as an interested third party in this appeal.

1.2. The Consumer Council's principal statutory duty is to promote and safeguard the interests of consumers in Northern Ireland. We have a range of functions, duties and powers in respect of energy which are principally provided for through the Energy Order (Northern Ireland) 2003.

1.3. The Consumer Council has a statutory function within the Electricity (Northern Ireland) Order 1992 (as amended by The Gas and Electricity Licence Modification and Appeals Regulations (Northern Ireland) 2015) (the Order), whereby:

1. Under Article 14B (2)(d) The Consumer Council has the power to appeal a licence modification to the Competition & Markets Authority (CMA) in the capacity of representing consumers whose interests are materially affected by the decision. The Consumer Council is the only non licence holder organisation to have this power; and
2. Under Article 14 (4)(b) the Northern Ireland Authority for Utility Regulation (UR) must send a copy of a notice stating that it intends making modifications to licence conditions to The Consumer Council.

1.4. We understand the grounds upon which the CMA will consider this appeal as laid out in Article 14D of 'the Order' and the three grounds upon which SONI has brought its appeal. In making this submission, and in previous submissions that we have made regarding the SONI Price Control, we are clear that our role is not to assume the role of the Regulator by scrutinising each line of the Price Control. Rather, we seek to help the UR by identifying how the Price Control can deliver consumer benefits and where it may cause consumer detriment.

1.5. In our responses to the UR's Draft Determination to the Price Control 2015 - 2020 for SONI (May 2015) and the UR's "Further Consultation On Certain Matters Relating To The Price Control 2015-2020 for SONI" (May 2017), we identified that the Price Control should:

1. Ensure SONI delivers value for money for consumers;
2. Balance equitably the financial risks in the business between consumers and the company;
3. Deliver a secure and efficient operation of the transmission systems; and
4. Ensure that there is sufficient investment to operate the transmission network.

1.6. In its Notice of Appeal to the CMA, SONI stated that the UR's SONI Price Control Final Determination (FD) was "*in breach of the Utility Regulator's Principal Objective to protect the interests of consumers of electricity in NI*", because it failed to have regard to the need to secure that licence holders are able to finance their licensed activities[1].

1.7. If SONI's appeal is successful it will have a significant material impact on consumers' bills of up to £14.70m[2] (see Table 1). However, we acknowledge that there may be a negative impact on consumers if the FD unfairly underfunds SONI to operate the transmission network.

[1] Financeability Duty (imposed by under Article 12(2) of the Energy Order).
[2] Including expected losses of £1.53m.

Table 1. Relief Sought

Grounds of Appeal	Category	Shortfall between the UR FD and SONI's Appeal (£m)
Ground 1, Error 1A	Margin shortfall	£5.30m
Ground 1, Error 1B	PCG remuneration	£1.55m
Ground 3, Error 9	Network planning staff (opex and capex)	£3.18m
Ground 3, Error 10	Pensions (ongoing contributions)	£1.49m
Ground 3, Error 11	Allowance for DS3/Smart grids and pricing error	£1.62m
All	Expected losses	£1.53m
Total		£14.67m

1.8. As a statutory consultee within the SONI Price Control 2015–2020 process, we have engaged with the UR and SONI. We recognise that SONI has a monopoly role in operating the electricity transmission network system in Northern Ireland.

1.9. In preparing this submission, The Consumer Council contracted SLG Economics Ltd (SLG) to "*scrutinise and provide analysis and a written report of SONI's Notice of Appeal to the CMA in conjunction with the UR Final Determination (FD) of the SONI price control 2015 - 2020 from a* ***consumer perspective***."

1.10. We have included the full SLG report with this response in Annex 3. The key points of SLG's report under each of the Grounds of Appeal are as follows.

1. Appeal Ground 1-Financeability Methodology

The indication that SONI may be unable to raise additional debt without either a parent company guarantee, or a letter of comfort from the UR is a concern. However, SONI must support any claim in this regard with robust evidence.

From the perspective of the suggested remedies, The Consumer Council is concerned that SONI's request for an explicit margin may simply secure higher returns for SONI's investors with no benefit to consumers[3]. For consumers the outcome is more important than the method, and this should be the lowest and most efficient return.

With regards to the £1.55m of additional remuneration for the Parent Company Guarantee, we support the UR principle to prevent double counting.

2. Appeal ground 2-Revenue Uncertainty

SLG's analysis on revenue uncertainty concludes that the UR "*regime is most likely to operate effectively and in the consumers' interests.*" Therefore, The Consumer Council supports the UR approach as being aligned with its statutory duties.

[3] An additional £5.30m over the Price Control.

3. Appeal ground 3-Inadequate Allowances

SLG states that SONI appears to have made "strong arguments" that the UR FD sets inadequate allowances. However, further evidence and detail is needed from both UR and SONI to make a conclusive opinion on behalf of consumers.

1.11. In addition to SLG's report, we have provided a copy of our responses to the UR's "*Draft Determination to the Price Control 2015 - 2020 for SONI*" and the "*Further consultation on certain matters relating to the Price Control 2015-2020 for SONI*". These are enclosed as Annex 1 and 2 respectively of this evidence also.

1.12. We would be willing, if the appeal panel wishes, to give further written or oral evidence on the impact for NI consumers of this appeal.

1.13. Should you have any further queries or wish to obtain clarity on any points raised please do not hesitate to contact me.

Yours sincerely

John French

Chief Executive

Annex 1

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The Consumer Council

Elizabeth House
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Jody O'Boyle and Karen Shiels
Utility Regulator
Queens House
14 Queen Street
Belfast
BT1 6ED

Our Reference: PD20010 2265

12/05/15

Dear Jody and Karen

Re: Consumer Council response to the Utility Regulator Draft Determination to the Price Control 2015 - 2020 for the Electricity System Operation for Northern Ireland (SONI)

The Consumer Council welcomes the opportunity to respond to this consultation.

The Consumer Council notes that the Utility Regulator's (UR) overall objective for the 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 draft determination will increase tariffs for a domestic customer in 2015/16 by approximately £1.50 - £1.80 and the Consumer Council stresses the importance of keeping costs to consumers to the minimum level necessary to achieve the UR objective.

The consultation document explains that the UR takes the view that consumers should not be materially impacted by the transfer of the network planning function from NIE to SONI. The Consumer Council believes it is essential that any increases in the SONI 2015 – 2020 price control to support SONI's new network planning function must be mirrored by an equivalent reduction in the NIE RP6 price control. The Consumer Council also seeks clarification concerning how the UR has ensured consumers do not make a double contribution to funding the network planning function given the overlap in the RP5 price control, which runs until 2017, and the SONI 2015 – 2020 price control periods.

The consultation document notes that delivery of the Strategic Energy Framework (SEF) target for 40% of Northern Ireland's electricity consumption to be met by renewable energy by 2020 will have an impact on SONI during the next price control. It also explains that DS3 will see the redesign of the ancillary services arrangements in order to meet the needs of the system in 2020 as a result of the 40% renewable target. In addition, the consultation document states the 2010 – 2015 price control decision paper was set in the context of government targets for increased renewable generation and SONI therefore requested increased resources to manage the increase in renewable generation and associated connections and to cope with significant infrastructure development. It should also be recognized that DETI is currently assessing responses to its discussion paper *CFD Implementation in NI – Strategic Issues* which sought views on the inclusion of Northern Ireland in the Contracts for Difference (CFD) scheme on a UK wide basis.

In its response to the discussion paper the Consumer Council recommended that given the significant costs to Northern Ireland's consumers and its economy posed by CFD and Department of Energy and Climate Change small scale Feed-In-Tariff (FIT) scheme, Northern Ireland should not be included in either the CFD or FIT schemes. If the Minister for Enterprise, Trade and Investment decides that Northern Ireland will not be included in the CFD scheme this will significantly hamper the ability for the

region to achieve the goal of 40% of energy consumption generated from renewable sources. Conversely, if the Minister decides that Northern Ireland will be included in the CFD scheme there is no guarantee of increased renewable deployment in Northern Ireland on the basis that the CFD scheme will incentivise the most cost effective renewable projects in the UK and if deployment of renewables in Northern Ireland is not competitive in terms of cost effectiveness, renewable generation will deploy elsewhere in the UK.

The Consumer Council recognises that under both the scenarios outlined above, the SEF 40% renewable generation target may not be reached. The Consumer Council is also aware that the target is not a statutory one and therefore DETI is not legally bound to ensuring its delivery. The Consumer Council is therefore concerned that under the SONI price control draft determination consumers will bear the cost of financing phases one and two of transmission capital projects necessary to ensure the transmission network has adequate capacity and facilitates connections to meet the SEF target. The UR explains that SONI estimates that over the next price control period it will spend approximately £20m+ on Phase 2 Capex preconstruction projects which equates to about £5m per annum. The Consumer Council asserts that consideration should be given to how the price control will be modified if the policy environment changes, resulting in the removal of policy drivers and/or financial incentives for delivering 40% of electricity from renewable sources in Northern Ireland. Therefore, on account of these uncertainties the Consumer Council believes the UR should keep the price control under review to ensure consumers do not pay for unnecessary developments to the network.

If further information is required or to discuss this response please contact me on 02890 674 808 or amcclenaghan@consumercouncil.org.uk.

Yours sincerely

Andy McClenaghan
Senior Policy Officer (Energy)

Annex 2

Further consultation on certain matters relating to the Price Control 2015-2020 for the Electricity System Operator for Northern Ireland (SONI)

May 2017

1 Introduction

1.1 The Consumer Council is a non-departmental public body (NDPB) established through the General Consumer Council (NI) Order 1984. Our principal statutory duty is to promote and safeguard the interests of consumers in Northern Ireland (NI).

1.2 The Consumer Council welcomes the opportunity to respond to the Utility Regulator (UR) further consultation on certain matters relating to the Price Control 2015-2020 for the Electricity System Operator for Northern Ireland (SONI).

2 Pensions

2.1 As we stated in our response to the UR RP6 Draft Determination consultation, the Consumer Council remains "of the opinion that regulators ought to minimise where possible allowed revenues in respect of deficits linked to pension schemes."

2.2 Pension deficit is an area of expenditure that has no material benefit to consumers. It is imperative that SONI embraces the principle "to reduce all costs, including pensions in order to become an efficient operator."[1] We echo Manufacturing NI's statement that consumers and businesses in NI should not "be unduly burdened by a very generous scheme."[2]

2.3 We ask the UR to apply the same principle when assessing further its final position in respect of SONI's allowed revenues for pension. Therefore we are disappointed with SONI's opposition to abide by the UR Pension Deficit

[1] Point 35 of the Further consultation on certain matters relation to the Price Control 2015-2020 for SONI, 11 April 2017.

[2] Manufacturing NI response to the Draft Determination to the Price Control 2015-2020 for SONI, 15 May 2015.

Recovery Paper[3], including the introduction of a cut off date of 31 March 2015.

2.4 The document is based on the regulatory precedent set out in the Competition and Markets Authority (CMA) RP5 Final Determination (FD), and therefore we accepted the outcome. However, the Consumer Council remains of the opinion that the pension principles, arrangements and allowances for pension deficits are overly generous to utility companies and work against the interest of consumers. Therefore we oppose strongly any changes to the current policy that increases SONI's allowances.

2.5 The Consumer Council notes the lack of evidence to support SONI's request for an 8% employer Defined Contribution (DC). The company states that this is "necessary to retain/attract workers." We would expect the company to provide a comparison of its staff turnover rates with similar companies in NI, ROI and GB, as well as details of recent recruitment that it may have declared vacant. In the absence of this evidence we support the UR's proposed 6% employer DC allowance.

3 Changes of law

3.1 The Consumer Council recognises the need to have an uncertainty mechanism built into the price control to adjust allowances if this is required as a result of changes of law or regulation. However, this mechanism ought to be operated in a way that provides a more balanced system of appeal or redress between SONI and consumers.

3.2 The current provisions do not work in the interest of consumers in that only the licensee can bring forward a change of law to the UR. This process is outlined in points 77 and 78 of the consultation paper.

[3] https://www.uregni.gov.uk/sites/uregni.gov.uk/files/media-files/UR_Position_Paper_-_Pension_Deficit_Recovery_v1_0.pdf

3.3 We support strongly the new proposed paragraph 6.1 of Annex 1 as it will ensure the interest of consumers are safeguarded if a change of law or regulation decreases SONI's revenue entitlement. From a consumer perspective it is imperative UR implements these changes in the FD.

3.4 We note SONI's objection to a requirement to break down costs information resulting from changes of law into internal and external. The Consumer Council believes that this additional information can only add transparency to the regulatory process and further assist the UR to make decisions that are sound and balanced. Therefore we support the additional requirement.

If you require further information or you wish to discuss any aspect of this response please contact Paulino Garcia on 02890 251645 or Paulino.Garcia@consumercouncil.org.uk.

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Annex 3

SLG Economics Ltd
Economics, Regulation, Competition

A review of SONI's Notice of Appeal in respect of the Utility Regulator's 2015-2020 price control final determination

A report for The Consumer Council for Northern Ireland

SLG Economics Ltd

May 2017

www.SLG-Economics.co.uk

A review of SONI's Notice of Appeal in respect of the Utility Regulator's 2015-2020 price control final determination

1 Background

The Competition and Markets Authority (CMA) has granted the Electricity System Operator for Northern Ireland (SONI) permission to appeal[1] the Utility Regulator's (UR) Final Determination (FD) in respect of SONI's 2015-2020 price control. The Consumer Council has appointed SLG Economics to provide a report which should:

- Provide a critical analysis of each of SONI's grounds of appeal: financeability methodology, revenue uncertainty and inadequate allowances focusing on the costs and outcomes for consumers (business and domestic) in Northern Ireland;
- Assess the impact of SONI's sought relief;
- Be mindful of the UR FD of the SONI Price Control and the Consumer Council response to the same (confirmed to refer to the Consumer Council response to the Draft Determination[2]);
- Assess both the positive and negative impacts on the consumer;
- Use layman's language as far as possible throughout;
- Propose high level recommendations to address any issues identified; and
- Be written in a form which is ready to publish.

SLG Economics is an economics consultancy set up in 2011 by Stephen Gibson providing specialist micro-economic policy advice to regulated companies, regulators and government. Stephen has over 25 years' experience of leading major economic and strategy projects across a broad range of regulated industries as a consultant and working in both economic regulators and regulated companies.

2 Introduction

On 22nd December 2015 the UR published its Final Determination[3] which set SONI's allowed revenue for the five year period 1 October 2015 to 30 September 2020 in relation to its role as Transmission System Operator (TSO). On 12 April 2017 SONI made an application to the CMA for permission to bring an appeal against the UR decision[4] in a notice which sets out

[1] https://www.gov.uk/cma-cases/energy-licence-modification-appeal-soni

[2] http://www.consumercouncil.org.uk/filestore/documents/CCNI_response_to_NIAUR_consultation_on_the_SONI_2015_-_2020_price_control_%282%29.pdf

[3] https://www.uregni.gov.uk/sites/uregni.gov.uk/files/media-files/2016-2-22_SONI_PC_Final_Determination_2015-2020_Final.pdf

[4] https://assets.publishing.service.gov.uk/media/5914232940f0b638b000001b/soni-notice-of-appeal-energy-licence-modification.pdf

the grounds of appeal and relief sought. On 11th May 2017, the CMA granted SONI permission to appeal on each of the grounds sought[5]. The grounds of appeal are:

- **Financeability methodology**: that the UR has failed to secure SONI's financeability, that the financial ratio tests were inadequate and that inadequate revenues were provided for the capital employed given the risks faced by the company.
- **Revenue uncertainty**: that there were inadequate arrangements put in place to deal with significant uncertainty faced by SONI during the price control period which has affected SONI's ability to secure finance from investors.
- **Inadequate allowances**: that the UR failed to allow certain costs which SONI is required to incur to fulfil its functions and licence obligations.

The relief sought by SONI is:

- The introduction of a margin-based approach to secure financeability based on a margin of 11% of controllable costs.
- That SONI be allowed to recover Pre-Construction Transmission Network project (PCNP) costs.
- That additional information system (IS) capex outputs are included as a specific pass-through in the price control.
- To provide a recovery mechanism for significant projects, by requiring the UR to conduct an interim review of the costs of significant projects for which revenue has not already been provided, and make an upward adjustment to the revenue cap via a licence amendment which would give SONI the right to appeal.
- To ensure that costs which are not within SONI's control can be part of the annual revenue submission on a fully cost pass-through basis, and that costs submitted under the pass-through mechanism are on an "as incurred" basis rather than for pre-approval on an individual basis.
- That the UR is required to provide guidance on the demonstrably inefficient and wasteful expenditure (DIWE) mechanism following a consultation on the scope of that guidance.
- That the Qt term which allows for clawback of any overpayment in the first year of the control is removed from the licence.
- That full provision for the costs of the opex and capex TUPE staff is included.
- That the full actuarial costs of ongoing employer pension contributions are included as well as provision for any updated costs from new actuarial reports. If the UR does apply a cut-off date for recovery of pension contributions it should consult first and not do so retrospectively.

[5] https://assets.publishing.service.gov.uk/media/59142282e5274a44cd00001c/soni-decision-on-permission-to-appeal.pdf

- That provision is provided for full forecast expenditure in delivering the DS3/Smart Grid project and reinstate £291,000 expected to be incurred in delivering the full IS capex programme.

3 Analysis of Grounds of Appeal

3.1 Ground 1 of Appeal: The Financeability Methodology

3.1.1 The Price Control Framework fails to secure SONI's financeability

SONI argues that the UR failed to take into account the specific characteristics of and risks faced by its business and so failed to secure its financeability. It argues that given that it is an asset-light business, the Regulatory Asset Base (RAB) * Weighted Average Cost of Capital (WACC) approach is not appropriate and would not secure financeability, and that a margin on controllable costs should be used instead. The UR in its FD argued that an explicit margin was not appropriate, because the RAB*WACC approach fairly rewards investors for the financial commitment that they have made to the business.

Assessment of SONI's arguments

The UR FD discusses this issue purely in terms of the settlement providing a reasonable return to investors, it does not acknowledge the financeability challenge that can be presented by a RAB*WACC approach for an asset-light business which uses the return as a financial buffer against operational risk as well as to generate a return for investors. Given the arguments that SONI has presented, we would have expected the UR to ensure that the level of return provided was sufficient to cover reasonable shocks to the business and we agree with Europe Economics' (EE's) analysis that a small increment to the WACC is unlikely to be an appropriate mechanism to address this problem.

Introducing an 11% EBIT margin on controllable costs as suggested by SONI would be similar to the approach that Ofcom adopted for Royal Mail (RM) (a 5% to 10% EBIT margin on regulated revenue) under its 2012 regulatory framework, recognising the fact that RM (similar to SONI) is an asset-light business with significant operational expenditure and tightly regulated outputs.

There is however a trade-off for consumers between the extra charges which would result from the higher financial return (assessed at approximately £11.7m for an 11% margin compared with a 5.9% WACC * RAB approach), the greater assurance that the company has and strengthened ability to raise capital at a reasonable cost to finance investment. However if the aim is to protect the company against downside shocks rather than provide an additional return to investors, it may be more in customers' interests to provide a regulatory measure that directly addresses this concern (for example an interim review triggered by significant changes in circumstances or the company facing a severe financial shock), rather than allow higher charges than are otherwise necessary.

3.1.2 The financeability assessment was inadequate and subject to material errors

SONI argue that the UR financial assessment was unduly limited and was not sufficient to fully assess SONI's financeability. It lists a number of observations regarding the assessment:

- The inputs appear to be biased upwards
- It lacks focus and analysis of key financial metrics
- The metrics provide an incomplete picture of SONI's position
- There is an absence of robust benchmarks
- The UR does not consider scenarios apart from the base-case
- Other critical factors are not considered

Of these, we consider the lack of downside scenarios which do not allow the financial model to test the company's resilience to down-side shocks to be the most important (in terms of potential downside consequences for consumers). Lack of such an assessment could call into question the adequacy of the UR's analysis.

SONI argues that the UR has incorrectly failed to remunerate it for the Parent Company Guarantee (PCG) provided by EirGrid. The UR suggests that this would be double-counting, since it is already paid for under the SEMO price control. To the extent that extending the PCG to cover SONI increases the cost of the PCG, then such extra costs should be allowed. However just because the PCG covers other independent and separate risks would not be a reason for including it unless there was a clear incremental cost over and above the cost of providing a PCG for SEMO.

SONI argues that the UR incorrectly includes positive incentive payments in the base case for financeability. Whether this is correct depends on the structure of such incentive regimes – if they have a neutral / zero expected value, then payments should not be included; however if they have a positive expected value (for example because payment rates or caps, collars etc are not-symmetrical) then the expected payments should be included. In addition, the potential for incentive payments to be negative (and therefore SONI to receive less funds than expected) should have been considered in the analysis of whether SONI was financeable under various credible downside scenarios.

SONI argues that the UR fails to apply appropriate financial benchmarks by not explicitly comparing them with thresholds for asset-heavy industries. We do not think that this is a material failure in the FD; calculation and consideration of the ratios is generally considered by other UK economic regulators to be sufficient without explicitly comparing them with other thresholds.

SONI also argues that there are errors in the debt financeability assessment, particularly not considering working capital facilities. Working capital is a necessary requirement to run SONI's business, and should be included in the assessment, however to the extent that it is

financed by trade sources rather than investors (as the UR argues) it does not represent an extra call on SONI's debt financeability. The UR argues that any residual can be met by short term financing at low cost and repaid through the K factor (a correction facility in the price control formula), which seems reasonable and is unlikely to make a significant difference to the debt financeability assessment.

Summary of assessment of adequacy and errors in financeability assessment

Overall, there are some areas where further analysis would have provided greater assurance about SONI's financeability (or lack of it) over the control period. SONI raises a further argument, that it is currently unable to raise additional debt without either a parent company guarantee or a letter of comfort from the UR. This is strong evidence (if confirmed by supporting evidence provided by SONI) challenging the UR's conclusion that SONI is financeable under the FD and that the financeability assessment was sufficient to ensure that it remained able to access sources of finance.

3.1.3 The financeability assessment was not complete and so did not demonstrate that SONI is not financeable

SONI sets out analysis conducted by KPMG into its financeability that seeks to demonstrate that the margins in the FD were below thresholds based on benchmarking analysis (10-14% of controllable revenue and 1.5-3% of total revenue). They conclude that investors would face a shortfall of £5.336m (compared to an 11% EBIT margin on controllable costs) and argue that this means that they are not financeable in the sense that it would not be able to meet investors' expected returns for margins given SONI's business characteristics. We see this as a rather circular argument – if investors assume a margin based return, then a RAB*WACC approach that generates a lower margin will be less than investor assumptions, however if investors assume a standard RAB*WACC approach to regulation, then their expectations will be met by the UR's approach.

SONI also argues that the assessment of pre-construction asset costs is likely to underestimate final outturn costs. It argues that the project spend cap means that there is a lack of symmetry in the outturns, where outperformance is impossible while underperformance is likely. It shows that if there were a 25% probability of a 15% shortfall this would equate to a reduction in shareholder returns of £700,000[6] or approximately £150,000 pa. A similar non-recovery of individual pass-through costs could result in a further shortfall of £800,000. KPMG claims that either of these shortfalls would have negative implications for investors' willingness to commit capital to the business. Adding to this, the impact of including the £10m PCG discussed above would have a significant impact on expected investor returns.

[6] Note: paragraph 20.28 of the Notice of Appeal states that the sum is £700,000 million – I presume that this is a type and the intended figure is £700,000

SONI also highlights the exposure to plausible downside shocks: network planning risk, liquidity risk and revenue cap risk and how suck risks might impact on financeability, and suggests that such shocks are likely to pose a significant financeability challenge and affect its ability to raise financing. If these risks are significant then the UR should have considered them in its financeability analysis or ensured that there is a regulatory mechanism (such as an interim review) to appropriately deal with them.

3.2 Ground 2 of Appeal: Revenue Uncertainty

SONI lists seven grounds on which it believes that the UR has erred in managing uncertainty in the FD. It believes that the failure to appropriately manage uncertain costs in the Price Control creates unprecedented levels of uncertainty directly affecting its financeability.

The suggested errors include:

- There being no mechanism to recover the costs of delivering PCNP costs – which amount to £15-20m over the control period.
- No cost recovery mechanism for additional IS capex requirements.
- No suitable cost recovery for significant project costs.
- No suitable right of appeal to the CMA.
- Unworkable two-stage process.
- Disallowing wasteful or inefficient expenditure without providing guidance.
- Potential claw-back of any tariff ‘over-payment’ on a retrospective basis.

The first three suggested errors relate to the clarity and certainty of SONI’s ability to recover extra costs incurred during the control period and a lack of transparency in the process for recovering those costs, rather than a failure to provide in the FD for the costs.

3.2.1 There being no mechanism to recover the costs of delivering PCNP cost

The first suggested error relates to uncertainty over how PCNP costs would feed through to the RAB and the lack of a codified process. The uncertainty however relates to how rather than whether the costs would be recovered. Given the statement in the FD that they will be subject to case-by-case approval and accumulated on a separate RAB (a similar level of assurance as is often given by other UK economic regulators to regulated companies for uncertain future investment), this does not appear to be a material error and it would not be in customers’ interests to have an automatic pass through without some regulatory scrutiny - the detailed process for which does not need to be defined in advance - to give the company assurance that appropriate, efficient costs will be recovered.

3.2.2 No cost recovery mechanism for additional IS capex requirements

This suggested error relates to whether unexpected IS capex requirements should be recovered. The UR is clear that the allowances for the capex spend already includes an

allowance for unexpected events and contingency, and that it is sufficient to cover IT opex and IT capex expenditure. Therefore it would not be in customers' interests to automatically allow higher charges to fund other unforeseen capex requirements. The recently published further consultation on specific matters relating to the Price Control 2015-2020 for SONI[7] suggests that capex TUPE costs could be allowed via an interim review - this would allow the UR to properly review such costs before deciding whether to allow them.

3.2.3 No suitable cost recovery for significant project costs

This relates to the approach to recovering significant projects costs. SONI argues that they should be recovered from as appropriate: re-openers, pass through or additional allowances considered on an individual basis and that it is an error that they are all recovered through the third of these mechanisms which is only supposed to apply to 'unpredictable costs'. Ensuring that significant projects costs are recovered by additional allowances on a case-by-case basis ensures a strong incentive on SONI to ensure that all such project costs are efficient and in customers' interests. While the UR has not explicitly considered other recovery mechanisms, it seems entirely reasonable and in customers' interests to require SONI to justify on a case-by-case basis any additional expenditure that it is seeking to recover from higher customer bills - it would not be in customers' interests to allow SONI to pass through these extra costs without some regulatory check involved.

3.2.4 No suitable right of appeal to the CMA

SONI claims that the significant increase in additional costs subject to additional allowances at the UR's discretion means that SONI should have the right to appeal such decisions to the CMA, or that significant decisions should be submitted as a reopener which involves a licence modification which could be appealed to the CMA (including by the Consumer Council). Any appeal to the CMA would involve significant time and costs; while this might be appropriate for a periodic review decision which involves important questions about the regulatory framework, incentives, outputs, financial allowances, financeability etc, it would be disproportionate for a decision purely on a single or small group of projects (even where they are collectively of significant value). The judgement over a particular project's (or group of projects') costs is much more limited in scope and complexity than that over a periodic review (and would involve stakeholder consultation as part of that process), and therefore we do not think that it is necessary to allow an automatic right to appeal to the CMA on such decisions.

3.2.5 Unworkable two-stage process

This error relates to the creation of a two stage process to evaluate the additional allowance process. This involves pre-approval of claims up to a cap and then reporting actual costs

[7] https://www.uregni.gov.uk/sites/uregni/files/media-files/SONI%20PC%20further%20consultation%20on%20specific%20%20issues%20%202015-2020%2011Apr17.pdf

with any adjustment made as appropriate. SONI argues that it is unworkable, adds extra time, administrative burden and creates a risk to the process. We do not believe that the process proposed by the UR is unworkable; we would expect that most of the information provided for the first stage of the process would be needed for SONI's internal project approval processes (and so would not involve significant additional cost) and that the UR proposal provides some assurance to SONI before it embarks on a project of the maximum budget available for that project, as well as a stronger efficiency incentive to deliver within the cap. We do not think that leaving the entire assessment to an ex post review once the project is already delivered would be in customers' interests.

3.2.6 Disallowing wasteful or inefficient expenditure without providing guidance

SONI also argues that the UR has not provided guidance in advance on the application of the DIWE test. The intention of the DIWE test is clear and is obviously in customers' interests. If SONI undertakes its licenced activities in an efficient manner, delivering outputs that customers want and value, there should be no issue in relation to the DIWE test. We do not think it is in customers' interests to require the UR to specify in advance what activities count as DIWE, so that SONI can potentially undertake other wasteful or inefficient activities that are not picked up by the guidance (for whatever reason) and be remunerated for them. Alternatively, we would expect any guidance from the UR to have a catch-all category such as "or any other demonstrably inefficient or wasteful activity undertaken by SONI" or otherwise allow the UR significant flexibility in determining what activity counts as DIWE, and so we do not believe that such guidance would give SONI the certainty that it is seeking in any case.

3.2.7 Potential claw-back of any tariff 'over-payment' on a retrospective basis

The final suggested error relates to the amount allowed in the first year of the control period (2015-16) given that the year had already passed when the FD was published and the fact that it could amount to retrospective setting of the revenues for 2015-16. We believe that it is in customers' interests that revenues for 2015-16 are set based on an assessed expenditure for that year, rather than a 'roll-over' of the previous year's allowance (which given that they were set in 2009 are likely to include a significant element of forecasting error). While it would be preferable to set revenues ex-ante, in the event that UR has found itself in a position that this could not be achieved, introducing an adjustment for known differences in 2015-16 from the previous year, is a reasonable approach, does not introduce unreasonable uncertainty into the regime and is certainly in customers' interests.

3.2.8 Summary of findings on revenue uncertainty

In summary, we are not persuaded that any of the suggested errors brought by SONI lead to outcomes that operate against consumers' interests. We see there being an advantage in the UR retaining some flexibility and ability to exercise judgement in future decisions, which

the claimed uncertainty would limit or remove. Such judgement and flexibility, exercised in the context of the UR's statutory duties means that the regime is most likely to operate effectively and in customers' interests.

3.3 Ground 3 of Appeal: Inadequate Allowance

3.3.1 Failure to provide adequate payroll allowances for network planning staff

SONI argues that UR failed to provide adequate payroll allowances for 11 employees with protected employment rights who transferred from NIE to SONI as a result of a licence obligation which it legitimately expected to be allowed. SONI argues that given the assurances that they had previously received from the UR at the time of the transfer and subsequently, it had a legitimate claim that the payroll costs associated with the 11 employees would be included in the allowed revenues, rather than staff costs (including for the protected employees) being set via a benchmarking exercise.

If it is indeed the case that the UR provided assurance to SONI that the enduring payroll costs resulting from the transfer of employees would be included in the allowed cost base, then those costs should be allowed as a pass-through, rather than subsumed into wider staff costs and set via a benchmarking exercise. This would mean higher costs to customers, but we think that this is justified in terms of the value of maintaining confidence in regulatory pronouncements and thereby lowering perceived risk to investors.

3.3.2 Failure to provide adequate allowances for ongoing pension contributions

SONI argues that since it has no control over the costs of contributions to its Direct Benefit (DB) pension scheme (since they apply to protected persons whose pension benefits must be maintained at pre-privatisation levels), it should be fully funded for those costs in the FD. Where the costs are not in the control of the regulated company, it is inefficient to place the risk of funding them on that company and not to recognise increases in those costs that the company has no control over. Given that the expected pension contribution costs have risen from 28% to 40% between 2010-15 and 2015-20, it would impact on SONI's ability to finance its activities if this increase was not taken into account in the 2015-20 FD. Unless there are measures that SONI can take to reduce its pension costs to the previous level, it does not seem appropriate not to allow such increased costs. The UR is currently consulting on specific issues relating to the 2015-2020 price control[8], which includes the appropriate allowance for pensionable pay - although it does not make any proposal in the consultation as to potential policy approach to resolve this issue.

3.3.3 Failure to provide adequate allowances for pension deficit recovery

In the FD, the UR decided that the historic pension deficit prior to 31 March 2015 will be 100% funded by consumers, and after that date any incremental deficit will be 100% funded

[8] https://www.uregni.gov.uk/publications/soni-price-control-2015-2020-further-consultation-pensions

by SONI (based on the approach taken for NIE). SONI argue that there was not a proper consultation on this issue (the UR has recently published a consultation paper that consults on this question[9], so this argument may be moot). SONI also argue on the same basis as the previous point, that since it has no control over the size of the pension deficit, it is not appropriate that it bears the risk for funding it. If this is the case, then its argument as in the previous section is sound. Finally, SONI argues that dividing the historic deficit by 10 is not the correct way to fund such a deficit. This is correct, the proper calculation should take account of the Net Present Value (NPV) of the costs and allowances using the WACC as the discount rate.

3.3.4 Failure to provide adequate IS capital allowances

SONI argues that the FD incorrectly excludes funding for DS3/Smart Grids and that the UR incorrectly assumed that it would be recovered as a Single Electricity Market (SEM) matter. However the UR does suggest that IS capex for DS3 might be recovered as an additional allowable cost which would be assessed on an individual basis (via the Dt allowance in the price control formula). While SONI is concerned that this does not give it sufficient comfort that the costs would be recovered, it does provide an alternative mechanism for recovering these costs.

3.3.5 Incorrect adjustment for inflation

SONI argues that the UR incorrectly adjusted figures for IS capex that were already in 2014 prices, to 2014 prices, on the mistaken assumption that they were in 2015 prices. If this is the case, then it is a mistake in the UR's calculations and assessment of SONI's allowed revenue, and should be corrected.

3.4 Conclusions on Grounds of Appeal

Overall, we think that SONI makes some compelling arguments about deficiencies in the UR's FD, in particular it has strong arguments relating to the UR failing to make a sufficient revenue allowance by inappropriately excluding certain costs; we think that its arguments relating to revenue uncertainty and financeability were generally weaker. It is telling that on a number of the points relating to pensions raised by SONI in its appeal, the UR has recently consulted on the identical question to allow further consideration of the issue – this is highly unusual, particularly given that the consultation has been published over a year after the FD.

Overall, while consumers prefer lower charges, there is a benefit to consumers of ensuring that SONI is allowed sufficient funds to finance its activities and secure additional debt to fund investment in its network. The higher charges that consumers would face need to be

[9] Ibids

weighed against the potential downside of SONI being unable to access appropriate sources of finance or being able to finance its activities.

4 Assessment of SONI's sought relief

4.1 Introduction of a margin based on 11% of controllable costs

Introduction of an 11% margin on controllable costs as SONI suggests, would increase the cost to customers by approximately £11.7m compared to a RAB*WACC approach (based on a 5.9% WACC). Under this approach, the appropriate level of margin should be assessed based on scenario analysis of SONI's ability to finance its activities (and in particular raise debt without parent group guarantees) under various significant but not unrealistic downside shocks to the company. Customers would benefit from the lowest margin consistent with SONI being able to withstand such significant but not unrealistic downside shocks. However, as discussed above, it would be in customers' interests (if the UR thinks the risk is significant) for the UR to introduce a measure such as an interim review which allows the company extra revenue in the event of financial distress due to unforeseen financial shocks, but otherwise retains the RAB*WACC approach to minimise the charges to customers.

4.2 SONI is allowed to recover pre-construction transmission network (PCTN) project costs

SONI suggests that it should be given greater certainty over the recovery of PCTN costs through:

- Removing the requirement for ex ante approval;
- Explicitly including in the TSO licence the different potential routes for cost recovery;
- Removing the costs from the 50:50 risk share mechanism;
- Only allowing costs to be adjusted via an ex post assessment which takes place within three months of invoice submission;
- Codification of an 'interim RAB' used during the construction phase in the licence.

Taking away the requirement for the ex ante cap removes an important constraint on SONI's PCTN costs. While there is the opportunity for inefficient PCTN costs to be disallowed through the ex post assessment, this may not provide the same strong cost efficiency incentives. Customers are also likely to value the certainty that an ex ante cap gives them in advance of the PCTN costs being incurred, rather than waiting for the project to be completed before understanding the cost implications.

4.3 Additional information system (IS) capex outputs are included as a specific pass-through in the price control

SONI suggests that reasonable and efficient costs incurred in delivering additional IS capex outputs should be included in the revenue allowance. The UR has determined that the allowance for capex spend is sufficient to cover unexpected expenditure as well as planned expenditure, therefore this relief would imply customers paying for additional expenditure that the UR says they already pay for.

4.4 Providing a recovery mechanism for significant projects

SONI suggests requiring the UR to conduct an interim review of the costs of significant projects for which revenue has not already been provided, and making an upward adjustment to the revenue cap via a licence amendment which would give SONI the right to appeal. The FD already includes a mechanism for SONI to recover significant project costs (the Dt mechanism) and ensure that significant project costs are recovered by an additional allowance on a case-by-case basis ensures strong efficiency incentives. However including this in the licence would give SONI greater certainty and allow it to appeal decisions to the CMA, although the right to such an appeal is much less important for decisions on significant projects (even where collectively they are of significant value) than for the overall periodic review.

4.5 Ensure that costs which are not within SONI’s control are fully passed through on an “as incurred” basis

SONI proposes that costs which are not within its control can be part of the annual revenue submission on a fully cost pass-through basis, and that costs submitted under the pass-through mechanism are on an “as incurred” basis rather than for pre-approval on an individual basis. This proposal could remove some important safeguards for consumers in terms of regulatory scrutiny of costs that are included in the revenue allowance. Customers are also likely to value the certainty that an ex ante cap gives them in advance of the costs being incurred, as well as the potential efficiency incentive if SONI is able to influence, if not control, the costs.

4.6 Requirement to provide guidance on the DIWE mechanism

SONI proposes that the UR is required to provide guidance on the DIWE mechanism following a consultation on the scope of that guidance. The intention of the DIWE test is clear and it is clearly in customers’ interests that such expenditure is disallowed. However, it is not in customers’ interests to have wasteful or inefficient expenditure that is not foreseen in the guidance allowed, therefore we would expect any guidance to include a ‘catch-all clause’ that includes any other demonstrably inefficient or wasteful expenditure undertaken by SONI not specifically recognised in the guidance. Overall we do think providing guidance on DIWE will make a significant difference to the operation of the regime.

4.7 Remove the Qt term from the licence

SONI asks that the Qt term, which allows for clawback of any overpayment in the first year of the control, is removed from the licence. It is in customers' interests that if charges have been higher than necessary in the first year of the control period (due to the periodic review not being completed in time for the start date), that any overpayment as a result of the previous 2010-15 allowance being rolled forward to 2015-16 is returned to customers by way of lower future charges; it is not in customers' interests to allow SONI to keep such a 'windfall'.

4.8 That full provision for the costs of the opex and capex TUPE staff is included

SONI asks that full provision is allowed for three opex network planning staff and eight capex network planning staff that transferred to the company under TUPE and for whom SONI argues the UR gave previous assurances that their enduring payroll costs would be covered. The remedy that SONI proposes would give effect to this and increase overall allowed costs by £3,176,198 across the control period.

4.9 That full provision of actuarial costs of ongoing pension contributions are included

SONI asks that the full actuarial costs of ongoing employer pension contributions are included as well as provision for any updated costs from new actuarial reports, and if the UR does apply a cut-off date for recovery of pension contributions this should be consulted on first and any such date should not be retrospective. The cost of covering the pension shortfall is estimated at £1,489,000 over the control period. Given that the UR has published a consultation paper on pensions cost recovery subsequent to the FD, this appears to provide the consultation on the cut-off date that SONI is seeking.

4.10 That full provision of DS3/Smart Grid and Inflation adjustment are included

SONI also asks that provision is provided for full forecast expenditure in delivering the DS3/Smart Grid project which would amount to £1,333,000 over the price control period. The UR has suggested that IS capex for DS3 should be recovered as an additional allowable cost which would be assessed on an individual basis (via the Dt allowance in the price control formula), therefore it does not appear necessary to include the full forecast expenditure in the allowed revenue. Assessing expenditure on an individual basis would provide consumers with greater assurance that they are not overfunding the project.

SONI also asks for an extra £291,000 to correct an error made by the UR in adjusting the calculations for inflation. If this is an error then it should be corrected in the CMA review.

4.11 Conclusions on relief sought by SONI

Overall, the relief sought seeks to address a number of different concerns:

- That the RAB*WACC approach does not provide a sufficient margin to allow the company to face reasonable down-side shocks (4.1)
    - While we understand the concern expressed by SONI, we believe that alternative measures (such as an interim review that addresses downside financial shocks that might otherwise the company's financeability at risk), are more likely to be in customers' interests.
- Greater certainty is provided that costs incurred will definitely be recovered (4.2, 4.3, 4.4, 4.5, 4.6 and 4.7)
    - While we recognise that limiting the UR's discretion in assessing which costs should be allowed can provide greater certainty of revenues, which may make it easier to raise new debt, the UR has given reasonable assurances of a willingness to include these costs through additional expenditure allowances. It is in customers' interests that the UR has a chance to assess these projects ex ante and provide a cap to the budget for the activity, rather than purely restricting their appraisal to an ex-post efficiency assessment. We would therefore have concerns about the proposals that SONI is making, which do not appear to be in customers' interests.
- Insufficient funds are allowed in the FD compared with the best estimate of the actual costs of those items with the relief of extra revenues being allowed (4.8, 4.9 and 4.10).
    - While increasing the allowed revenue increases the costs to consumers, it is not in customers' long term interests for the determination to deliberately underfund the regulated company for expenditure that it has no option but to incur. This would mean that providers of capital receive (in expectation) a lower return than is justified by the risk faced, meaning that it is difficult (or impossible) for the company to raise new debt or replace existing debt. This can also lead to financial constraints where the company is unable to fund its operations and/or service its debt. We would therefore support an increase, but only where the costs are genuinely required to deliver the regulated outputs during the control period. We note that a number of the points are either subject to further consultation (eg pensions, costs of transferred staff), matters of fact (whether an error was made in adjusting for inflation) or could be dealt with through alternative regulatory mechanisms (such as the Dt allowance).

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