

BEFORE THE COMPETITION AND MARKETS AUTHORITY

IN THE MATTER OF AN APPEAL

UNDER ARTICLE 14B OF THE ELECTRICITY (NORTHERN IRELAND) ORDER 1992

B E T W E E N : -

SONI LIMITED

Appellant

and

THE NORTHERN IRELAND AUTHORITY FOR UTILITY REGULATION

Respondent

**RESPONDENT'S REPRESENTATIONS & OBSERVATIONS
ON THE NOTICE OF APPEAL**



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GLOSSARY

In this response, the following terminology is adopted -

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|------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Appellant | SONI Limited |
| CC | Competition Commission |
| CCNI | Consumer Council for Northern Ireland |
| CMA | Competition and Markets Authority |
| Capex | Capital expenditure |
| CEPA | Cambridge Economic Policy Associates |
| DAV | Depreciated Asset Value |
| DB Scheme | Defined Benefit Scheme |
| DC Scheme | Defined Contribution Scheme |
| Decision and Decision Paper | The UR's Decision on the Licence Modifications for the Price Control 2015-2020 for the Electricity System Operator for Northern Ireland (SONI) – 14 March 2017 |
| DIWE | Demonstrably inefficient or wasteful expenditure |
| Draft Determination | The UR's Draft Determination to the Price Control 2015-2020 for the Electricity System Operator for Northern Ireland (SONI) - April 2015 |
| DS3 | Delivering a Secure Sustainable Electricity System |
| EirGrid | EirGrid PLC |
| Electricity Directive | Directive 2009/72/EC of 13 July 2009 concerning common rules for the internal market in electricity |
| Electricity Order | Electricity (Northern Ireland) Order 1992 |
| Energy Order | Energy (Northern Ireland) Order 2003 |
| ENTSOe | European TSO |
| Final Determination | The UR's Final Determination to the Price Control 2015-2020 for the Electricity System Operator for Northern Ireland (SONI) - 22 February |

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| | 2016 |
| FTE | Full time equivalent |
| GB | Great Britain |
| GIS | Geographic Information System |
| I-SEM | Integrated Single Electricity Market for Northern Ireland and the Republic of Ireland |
| IS | Information Systems |
| LIBOR | London Interbank Offered Rate |
| NI | Northern Ireland |
| NIE | Northern Ireland Electricity Networks Limited |
| NIE Determination | The determination of the CC in the Northern Ireland Electricity Limited Price Determination (26 March 2014) |
| NoA | Notice of Appeal |
| Northern Powergrid and British Gas (together the ED1 Determinations) | mean the determinations of the CMA in the respective appeals in Northern Powergrid (Northeast) Limited and Northern Powergrid (Yorkshire) plc v the Gas and Electricity Markets Authority (September 2015) and British Gas Trading Limited v The Gas and Electricity Markets Authority (September 2015). |
| NPV | Net Present Value |
| Ofgem | Office of Gas and Electricity Markets/Gas and Electricity Markets Authority |
| ONS ASHE | Office of National Statistics Annual Survey of Hours and Earnings |
| Opex | Operating expenditure |
| PCG | Parent Company Guarantee |
| PCNP(s) | Pre-construction Network Planning project(s) |
| RAB | Regulatory Asset Base |
| RORE | Return on regulatory equity |

| | |
|----------------------|------------------------------------------------------------------------------------------------------------------------------------------------------|
| RP5 | The 2012-2017 price control for NIE |
| RPI | Retail Price Index |
| SEM | Single Electricity Market for Northern Ireland and the Republic of Ireland |
| SEM Committee | A committee of the UR, the Single Electricity Market Committee |
| SEM Matter | A matter determined by the SEM Committee as a matter that materially affects, or is likely materially to affect, the SEM. |
| SONI | SONI Limited |
| SSS | System Support Services |
| TIA | Transmission Interface Arrangements |
| TSO | Transmission System Operator |
| TSO Licence | The electricity transmission licence held by SONI |
| TUoS | Transmission Use of System |
| TUPE | A reference to the provisions in and/or requirements of the Service Provision Change (Protection of Employment) Regulations (Northern Ireland) 2006. |
| UR | Northern Ireland Authority for Utility Regulation |
| TRV | Total Regulatory Value |
| WACC | Weighted average cost of capital |
| CC | Competition Commission |
| CMA | Competition and Markets Authority |
| Capex | Capital expenditure |
| DAV | Depreciated Asset Value |
| EirGrid | EirGrid PLC |
| Energy Order | Energy (Northern Ireland) Order 2003 |

| | |
|-----------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Electricity Order | Electricity (Northern Ireland) Order 1992 |
| FTE | Full time equivalent |
| GB | Great Britain |
| GIS | Geographic Information System |
| I-SEM | Integrated Single Electricity Market for Northern Ireland and the Republic of Ireland |
| NI | Northern Ireland |
| NIE | Northern Ireland Electricity Networks Limited |
| Northern Powergrid and British Gas (together the ED1 Determinations) | mean the determinations of the CMA in the respective appeals in Northern Powergrid (Northeast) Limited and Northern Powergrid (Yorkshire) plc v the Gas and Electricity Markets Authority (September 2015) and British Gas Trading Limited v The Gas and Electricity Markets Authority (September 2015). |
| Opex | Operating expenditure |
| PCG | Parent Company Guarantee |
| PCNP(s) | Pre-construction transmission network project(s) |
| SEM | Single Electricity Market for Northern Ireland and the Republic of Ireland |
| SONI | SONI Limited |
| UR | Northern Ireland Authority for Utility Regulation |
| TRV | Total Regulatory Value |
| WACC | Weighted average cost of capital |

SECTION A. INTRODUCTION

- A.1 On 14 March 2017, the Northern Ireland Authority for Utility Regulation (the **UR**) published its decision to modify SONI Limited (**SONI**)'s electricity transmission licence to implement its price control determination, setting SONI's price control for its transmission system operator business for the period between 2015 to 2020.
- A.2 On 12 April 2017, SONI sought permission from the Competition & Markets Authority (the **CMA**) under Article 14B(1) and (3) of the Electricity (Northern Ireland) Order 1992 (the **Electricity Order**) to appeal the UR's decision to modify its licence conditions.
- A.3 On 11 May 2017, the CMA granted permission to SONI to bring the appeal set out in its Notice of Appeal (**NoA**).
- A.4 This response contains the UR's representations and observations to the CMA in relation to SONI's appeal, in accordance with paragraph 3(4) of Schedule 5A to the Electricity Order. In so far as they relate to matters which are not the subject of ongoing consultation, the UR resists each of the grounds of appeal and submits that the appeal should fail and that the CMA should confirm the UR's decision
- A.5 In setting SONI's price control the UR –
- (a) adopted an established methodology designed to ensure that all investor capital put into the business is appropriately remunerated,
 - (b) addressed the problem of uncertainty in relation to SONI's expenditure on future projects by using an established methodology – drawn from regulatory precedent including that of the Competition Commission – designed to ensure that the company has certainty as to its expected revenues and the ability to secure debt finance through reliance on 'bankable' regulatory decisions, and
 - (c) made appropriate allowances for individual cost items which are adequate to cover all the expenditure that the company is required to incur and can demonstrate is efficient spend.
- A.1 To succeed in this appeal SONI must demonstrate that the UR's decision is wrong. It does not come close to doing so. Primarily this is because SONI's position is simply that it would have preferred that the UR take a different approach to certain aspects of its price control, while retaining those aspects in which the UR has been generous.
- A.2 In particular, SONI wishes to be able to pass through its costs without appropriate regulatory assessment and scrutiny of the project it undertakes or whether its spending is efficient. It also wants to be remunerated for intangible 'assets' such as the expertise of its staff in a way that no UK regulator has deemed appropriate.
- A.3 SONI's proposals do not stand on their own terms as valid alternatives to the UR's decision. They are unbalanced, disproportionate, and strip away the checks that the

UR has put in place in line with its principal objective of protecting consumers. Its proposals demonstrate a desire on the part of SONI to absent itself from a normal regulatory framework.

- A.4 However, the problems with those alternatives are irrelevant as SONI has not cleared its first hurdle. It cannot establish that the UR's decision is wrong.
- A.5 SONI has developed its case at inordinate and unnecessary length. However, the length of its pleadings, and the weight of the documents which accompany them, cannot conceal the insubstantial nature of its case. Assertion takes the place of argument; repetition replaces evidence.
- A.6 SONI seeks to conceal the insubstantiality of its arguments by dignifying them all with the label of 'financeability'. In doing so, it seeks to conjure breaches of the UR's statutory duties from what are in essence disagreements with decisions that are well within the UR's margin of appreciation.
- A.7 That attempt fails for two reasons. Firstly, SONI cannot establish – by either explanation or evidence – a causal connection between the UR's decision and any negative effects on SONI's financeability.
- A.8 Secondly, the way in which it has constructed its case requires SONI to take a creative approach to legal interpretation. This is shown most starkly in its persistent misquotation of the UR's financing duty – the purported keystone of SONI's appeal.
- A.9 It also leads SONI to invent a new ground of appeal – a failure to follow '*regulatory best practice*'. This is used as a device to allow SONI to argue that its mere preference for alternative solutions should be given more weight than is due under the statutory grounds on which the CMA must determine this appeal. It also allows SONI to seek to make points in relation to the UR's decision-making process, despite its explicit recognition that such points are irrelevant in an appeal of this nature.
- A.10 SONI's pleadings and evidence level a bewildering array of accusations against the UR's decision. Many are simply throwaway statements and most are insufficiently pleaded to admit of a considered response. The UR has not sought to respond to every point made by SONI but has instead confined itself to those points which are more developed and to demonstrating how SONI's case fails on the basis of fundamental principles. However, the fact that the UR has not responded to a particular point does not connote acceptance of it.
- A.11 Neither has the UR responded in detail to the remedies that SONI seeks as it would not be appropriate to do so before the CMA has made its provisional determination. The UR therefore reserves its position on the proposed remedies and will respond to them if and when it becomes relevant to do so.

2 June 2017

SECTION B. STATUTORY FRAMEWORK

- B.1 The framework governing the regulation of electricity transmission activities in Northern Ireland is principally set out in two pieces of legislation: the Energy (Northern Ireland) Order 2003 (the **Energy Order**) and the Electricity Order.
- B.2 The Energy Order establishes the UR¹ and sets out its objectives, powers and duties.
- B.3 SONI is the holder of a transmission licence, issued pursuant to article 10(1)(b) of the Electricity Order. Under article 11 of the Electricity Order, a licence may include conditions and, in the event a licensee fails to comply with a condition of its licence, the UR has a number of enforcement functions².
- B.4 Under article 14 of the Electricity Order, the UR may make modifications to the conditions of a particular licence. An appeal lies to the CMA against a decision by the UR to proceed with a modification of conditions of a licence³. It is the decision of the UR to make modifications to the conditions of SONI's licence (published on 14 March 2017) which is the subject of this appeal.
- B.5 The UR does not set out a full explanation of all relevant aspects of the governing statutory framework in this submission, but instead responds to a number of particular points which were included in the Notice of Appeal. However, the UR will gladly provide any further exposition of the statutory framework should this be of assistance to the CMA.

Grounds of Appeal*The statutory grounds of appeal*

- B.6 This is a statutory appeal, and it must be determined on a statutory basis. Article 14D(4) of the Electricity Order sets out the only circumstances in which the CMA may allow an appeal. Article 14D(4) provides that:

'The CMA may allow the appeal only to the extent that it is satisfied that the decision appealed against was wrong on one or more of the following grounds —

(a) that the [UR] failed properly to have regard to any matter mentioned in paragraph (2);

(b) that the [UR] failed to give the appropriate weight to any matter mentioned in paragraph (2);

(c) that the decision was based, wholly or partly, on an error of fact;

¹ Article 3 of the Energy Order.

² Articles 41 – 51 of the Energy Order.

³ Article 14B of the Electricity Order.

(d) that the modifications fail to achieve, in whole or in part, the effect stated by the [UR] by virtue of Article 14(8)(b);

(e) that the decision was wrong in law'.

- B.7 In accordance with article 14D(5), to the extent that the CMA does not allow the appeal, it must confirm the decision appealed against.

SONI's attempt to generate a non-statutory ground of appeal

- B.8 For the avoidance of doubt, the reason why the CMA has, in SONI's words, '*regarded its function as being to determine whether the relevant decision was wrong in respect of the stated grounds of appeal*'⁴, is because that is its function pursuant to article 14D of the Electricity Order (and the corresponding legislation in Great Britain). It is not a matter of discretion. There is no other approach open to it.

- B.9 In spite of this, SONI states in its Notice of Appeal that:

'There is therefore a distinction to be made between:

- (a) grounds in respect of which the Utility Regulator is found by the CMA to have clearly reached a wrong decision on one or more of the statutory grounds – in such cases, the CMA must allow the appeal; and*
- (b) grounds in respect of which the CMA might itself have reached a decision which differed from that of the Utility Regulator – in such cases, the CMA must consider whether the Utility Regulator's approach in reaching that decision was nevertheless appropriate and reasonable in the circumstances. If the Appellant can demonstrate that the decision was unreasonable and cannot therefore stand, the CMA must allow the appeal*'⁵.

- B.10 This is a very striking submission. SONI is here saying that there are (a) the statutory grounds of appeal, and (b) a set of non-statutory grounds of SONI's own devising.

- B.11 What is wrong with this statement is self-evident. There is no such distinction to be made. The second category of appeal which SONI seeks to introduce has no basis in the Electricity Order and therefore, in a statutory appeal, no basis at all. The appeal may only be allowed to the extent that the CMA is satisfied that the UR's decision is 'wrong' on one or more of the statutory grounds.

- B.12 The attempt to introduce a new ground of appeal is nonetheless revealing, because it speaks to the difficulty SONI has with demonstrating that the UR's decision was 'wrong' on any of the statutory grounds. This draws attention to the fact that this appeal can be properly viewed as an attempt by SONI to invite the CMA simply to

⁴ SONI Notice of Appeal – NOA1 [para. 11.1](#).

⁵ SONI Notice of Appeal – NOA1 [para. 11.5](#).

adopt its preferences, rather than to correct any genuine errors.

The Standard of Review

- B.13 As noted by SONI⁶, the Electricity Order does not set out the standard of review which must be adopted by the CMA in determining whether the decision appealed against is wrong on one of the statutory grounds.
- B.14 Although this is the first appeal against a decision of the UR made under article 14B of the Electricity Order, guidance was given in the CMA's determinations in *British Gas Trading Limited v The Gas and Electricity Markets Authority (British Gas)* and *Northern Powergrid (Northeast) Limited and Northern Powergrid (Yorkshire) plc v the Gas and Electricity Markets Authority (Northern Powergrid)* (together the **ED1 Determinations**).
- B.15 The ED1 Determinations explored the legislative provisions in section 11E(4) of the Electricity Act 1989, which are for all relevant purposes equivalent to those applicable to this appeal.
- B.16 The CMA considered in the ED1 Determinations that it was appropriate to draw on the approach taken (by it and by the Competition Commission (the **CC**), as its predecessor) in other regulatory appeal contexts in determining the appropriate approach for it to adopt in the appeal⁷. A number of important points on the approach to be adopted are set out below.
- B.17 First, in terms of the overall approach to the standard of review:
- (a) The CMA is '*not limited to reviewing the decision on conventional judicial review grounds*'⁸, but must take into account the merits of the decision to the extent this is required for it to determine whether the decision is wrong on one of the prescribed statutory grounds⁹.
 - (b) However, the appeal is not a full merits appeal and the CMA '*is not a second-tier regulator*'¹⁰. It is not the role of the CMA to substitute its judgment for that of the UR '*...solely on the basis that it would have taken a different approach...*'¹¹.
 - (c) The statutory test '*clearly admits of circumstances in which [the CMA] might reach a different view from [the regulator] but in which it cannot be said that*

⁶ SONI Notice of Appeal – NOA1 [para. 11.1](#).

⁷ British Gas, [para. 3.22](#) and Northern Powergrid, [para. 3.21](#).

⁸ British Gas, [para. 3.24](#) and Northern Powergrid, [para. 3.23](#).

⁹ British Gas, [para. 3.43](#) and Northern Powergrid, [paras 3.42](#).

¹⁰ [BT v Ofcom](#) [2014] CAT 14, [para. 67](#).

¹¹ British Gas, [para. 3.43](#) and Northern Powergrid, [paras 3.42](#). See also British Gas, [paras 3.27 to 3.29](#) and Northern Powergrid, [paras 3.26 to 3.28](#) (citing [E.ON UK plc v GEMA: energy code modification](#), [para. 5.11](#)).

*the decision is wrong on one of the statutory grounds*¹². The question is not whether there is a better alternative, but whether the decision was wrong.

- (d) The appeal does not constitute a 're-run' of the 'decision-making process' or a 'de novo re-hearing of all the evidence'¹³. It is not open to the CMA to 'decide matters afresh untrammelled by [the regulator's] decision'¹⁴.
- (e) Decisions of the regulator relating to the modification of licence conditions necessarily require an exercise of judgment. In exercising that judgment, the regulator will have a 'margin of discretion'¹⁵.
- (f) In considering that exercise of judgment, the CMA should 'apply appropriate restraint and should not interfere with [the regulator's] exercise of a judgment unless satisfied that it was wrong'¹⁶.
- (g) '[T]he Tribunal may, depending on the circumstances, be slower to overturn certain decisions where... there may be a number of different approaches which [the regulator] could reasonably adopt'¹⁷.

B.18 In addition, in terms of the approach to be adopted by the CMA:

*'the correct approach is not... to start with an alternative approach and to say that if that approach were considered superior there is an error. In fact... the reverse is true. The first question for the CMA is whether there was an error in [the regulator's] approach. And the question of what alternative approach should be adopted is primarily relevant once an error has been identified'*¹⁸.

B.19 Second, the appeal in relation to which this standard of review is applied is the appeal which has been brought by the appellant. The decision:

*'...is reviewed through the prism of the specific errors that are alleged by the appellant. Where no errors are pleaded, the decision to that extent will not be the subject of specific review. What is intended is an appeal on specific points'*¹⁹.

¹² British Gas, [paras 3.28 to 3.29](#) and Northern Powergrid, [paras 3.27 to 3.28](#) (citing *E.ON UK plc v GEMA*: energy code modification, [para. 5.11](#)).

¹³ British Gas, [para 3.37](#) and Northern Powergrid, [para. 3.36](#).

¹⁴ British Gas, [para 3.36](#) and Northern Powergrid, [para. 3.35](#).

¹⁵ British Gas, [paras 3.32 and 3.42](#) and Northern Powergrid, [paras 3.31 and 3.41](#).

¹⁶ *BT v Ofcom* [2014] EWCA Civ 133, [paras 87 and 88](#).

¹⁷ British Gas, [Footnote 27](#) and Northern Powergrid, [Footnote 26](#) (citing *Vodafone v Ofcom* [2008] CAT 22, [para. 46](#)).

¹⁸ *CityFibre Infrastructure Holdings plc v Ofcom and TalkTalk Telecom Group plc v Ofcom*, [para. 2.25 – 2.26](#) (quoting, with approval, counsel for Ofcom).

¹⁹ British Gas, [para 3.37](#) and Northern Powergrid, [para 3.36](#) (citing *BT v Ofcom* [2010] CAT 17, [para. 76](#)).

- B.20 In other words, the appeal is limited to the grounds of appeal *'to the extent that such grounds are raised by the appellants'*²⁰. The grounds on which the appellant relies in its appeal are required to be set out in the Notice of Appeal²¹ and it is only if the CMA considers that the decision was wrong on one of these grounds that it may allow an appeal²².
- B.21 Third, in relation to the decision to which this standard of review is applied:
- (a) The decision under appeal is the decision to proceed with the modification of licence conditions²³.
 - (b) *'The appeal is against the decision, not the reasons for the decision. It is not enough to identify some error in reasoning; the appeal can only succeed if the decision cannot stand in the light of that error...'*²⁴.
 - (c) *'If the [CMA] concludes that the original decision can be supported on a basis other than that on which [the regulator] relied, then the appellant will not have shown that the original decision is wrong and will fail'*²⁵.
- B.22 An appeal may consider the process followed by the UR in coming to its decision. However, it is the decision and not the process which is being appealed. A deficiency in the regulator's process should not allow an appeal to succeed, unless the appellant has argued, and the CMA is satisfied, that the deficiency has led to the decision itself being wrong on one of the statutory grounds.
- B.23 Fourth, where an appeal relates to an alleged error on a conclusion of fact, there is no margin of discretion for the regulator - it is open to the CMA to determine that a decision is based on a plain error of fact. However, as noted by the CC:

*'...the specialist regulator may well have an advantage over the CC in finding the relevant primary facts. In some respects, the advantage may be less than that which the trial judge has over the Court of Appeal, because [the regulator's] decisions are not based on the evidence and cross examination of witnesses. [The regulator] nevertheless has an advantage of experience, and will often have the benefit of having conducted a consultation with the industry... For these reasons, the CC will be slow to impugn [the regulator's] findings of fact'*²⁶.

- B.24 In addition:

'It is not enough to succeed... for an appellant to demonstrate that some error of fact, whether consequential or inconsequential, has been made...'

²⁰ British Gas, [para. 3.37](#) and Northern Powergrid, [para. 3.36](#).

²¹ [Competition Commission Energy Licence Modification Appeals Rules \(CC14\)](#), [paras 5.1 - 5.3](#).

²² British Gas, [para 3.49](#) and Northern Powergrid, [para. 3.48](#).

²³ Article 14B(1) of the Electricity Order.

²⁴ *Everything Everywhere Ltd v Competition Commission* [2013] EWCA Civ 154, [para. 24](#).

²⁵ *Everything Everywhere Ltd v Competition Commission* [2013] EWCA Civ 154, [para. 24](#).

²⁶ *E.ON UK plc v GEMA: energy code modification*, [para. 5.16](#).

Rather, an appellant will need to demonstrate that the error was material to the outcome of the decision. Only if the error was material in this way will we regard the decision as 'wrong'...¹²⁷.

B.25 The CMA has also adopted²⁸ the position adopted by the Court of Appeal in *Azzicurazioni Generali Spa v Arab Insurance Group*²⁹, which was that:

'...so far as the appeal raises issues of judgment on unchallenged primary findings and inferences, this court ought not to interfere unless it is satisfied that the judge's conclusion lay outside the bounds within which reasonable disagreement is possible...'

B.26 Where an alleged error relates to an evaluation of fact, the CMA should adopt the same margin of discretion as it adopts in relation to exercises of judgment³⁰.

B.27 Fifth, the regulator's assessment of the adequacy of evidence before it cannot lead to a successful appeal unless that assessment is *'outwith the range of reasonable conclusions'*³¹.

B.28 Sixth, where an appeal relates to whether appropriate weight has been given by the regulator to a matter mentioned in article 14D(2) of the Electricity Order, an appeal should not succeed because the CMA considers that there may have been other ways in which various interests could have been balanced³². An appeal should only succeed where *'undue or unsupported weight'* has been given³³.

B.29 Finally, the burden of proof is on the appellant to establish that the decision is wrong on one of the statutory grounds. In particular:

- (a) *'It is for the appellant to marshal and adduce all the evidence and material on which it relies to show that [the regulator's] original decision was wrong'*³⁴.
- (b) *'Where... the appellant contends that [the regulator] ought to have adopted an alternative price control measure, then it is for that appellant to deploy all the evidence and material it considers will support that alternative'*³⁵.
- (c) *'Usually an appellant will succeed by demonstrating the flaws in the original decision and the merits of an alternative solution'*³⁶ (emphasis added).

²⁷ E.ON UK plc v GEMA: energy code modification, [para. 5.17](#).

²⁸ British Gas, [para 3.30](#) and Northern Powergrid, [para. 3.29](#).

²⁹ [2001] 1 WLR 577

³⁰ British Gas, [para 3.31](#) and Northern Powergrid, [para .3.30](#).

³¹ *Everything Everywhere Ltd v Competition Commission* [2013] EWCA Civ 154, [para. 34](#).

³² See *BT v Ofcom* [2014] CAT 14, [para. 67](#).

³³ British Gas, [para. 7.44](#).

³⁴ *Everything Everywhere Ltd v Competition Commission* [2013] EWCA Civ 154, [para. 23](#).

³⁵ *Everything Everywhere Ltd v Competition Commission* [2013] EWCA Civ 154, [para. 23](#).

³⁶ *Everything Everywhere Ltd v Competition Commission* [2013] EWCA Civ 154, [para. 24](#).

- (d) There may be *'the possibility that there could be a case where an appellant succeeds in so undermining the foundations of a decision that it cannot stand, without establishing what the alternative should be'* but such an outcome would be expected to be *'rare'*³⁷.

- B.30 It is only in cases where the appellant can meet the burden of proof that an appeal should succeed.

The Financing Duty

The relevance of the financing duty in this appeal

- B.31 SONI says that this appeal is about its financeability as a regulated company, and in particular about the alleged failure of the UR to comply with its financing duty under Article 12(2)(b) of the Energy Order:

*'This Appeal is primarily founded on the Utility Regulator's failure to secure the Appellant's financeability, in breach of its obligations under Article 12(2) of the Energy Order (the **Financeability Duty**).'*³⁸

- B.32 However, for an appeal which is said to be about the UR's financing duty, which SONI here explicitly equates with its own financeability, it is striking that the duty is almost never quoted fully or accurately anywhere in SONI's documents.

The financing duty

- B.33 The UR invites the CMA to consider the actual wording of the duty –

(2) *The Department and the Authority shall carry out those functions in the manner which it considers is best calculated to further the principal objective, having regard to –*

...

(b) *the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under Part II of the Electricity Order or this Order.*

- B.34 It is important to note both what this does, and does not, say.

What the financing duty means (and does not mean)

- B.35 First, it is a *'have regard to'* duty. Clearly, the thing to which regard must be had is important, as the following words (*'the need to secure'*) indicate. Nonetheless, the statutory wording is not creating an absolute obligation, but identifying something

³⁷ *Everything Everywhere Ltd v Competition Commission* [2013] EWCA Civ 154, paras 25 – 26.

³⁸ SONI Notice of Appeal – NOA1, para. 2.10.

which the UR must take into account when exercising its functions in the consumer interest in accordance with the principal objective.

- B.36 Therefore, when SONI says that the financing duty is '*not a subsidiary consideration to protecting the consumer interest*'³⁹ and is a '*strict test*'⁴⁰, it is not accurately reflecting the location or status of the financing duty within the overall structure of Article 12.
- B.37 This is not to understate the significance of the duty, which the UR considers to be of considerable importance. However, if that duty is to be at the centre of a statutory appeal, it really ought to be quoted accurately and in context. Statements such as '*The Financeability Duty requires the Utility Regulator to secure the Appellant's financeability*'⁴¹ simply fail this test.
- B.38 Second, a key word in the duty is the word 'able' – '*having regard to...the need to secure that licence holder are able to finance*'. The duty is not a duty to secure that a regulated company will in every circumstance, under any possible set of assumptions – regardless of its relative efficiency or the quality of its decision-making – be financially supported. Instead it is a duty to have regard to the need to secure that the company is *capable* of financing its relevant activities.
- B.39 For these purposes, the UR is entitled to act on the basis that a company will act with efficiency and will take reasonable and proportionate decisions, on matters within its own control, to be financeable. It is entitled, for instance, to assume that a company will adopt a reasonable capital structure, with a reasonable level of gearing. Where the company is financeable acting within a reasonable set of parameters, there is no question that the duty has not been discharged.
- B.40 Third, it should be noted that what should be able to be financed is not every activity carried out by the company, but the '*activities which are the subject of obligations*' under the regulatory framework. It is notable how often the underlined words go missing whenever the duty is quoted by SONI⁴².
- B.41 The relevance of the words is that a company may do many things, but the financing duty relates to only those things which it is required to do under statute (including, in the UR's interpretation, under the condition of a licence granted under statute).
- B.42 An activity which is ultimately a matter of choice, because it is not mandated by a regulatory obligation, is not one which falls within the scope of this duty. It may of course be one that the UR agrees should be funded on another basis – e.g. because it is in the interest of consumers – but that brings it within the scope of other parts of the general duties rather than Article 12(2)(b).

³⁹ SONI Notice of Appeal – NOA1, [para. 10.13](#).

⁴⁰ SONI Notice of Appeal – NOA1, [para. 10.20](#).

⁴¹ SONI Notice of Appeal – NOA1, [para. 19.4](#).

⁴² For instance, SONI Notice of Appeal – NOA1, [para. 10.24](#).

- B.43 This distinction has some relevance to this appeal, because a number of the projects which may be funded during the price control period under the D_t mechanism⁴³ will proceed to the extent that they are considered cost-beneficial, and not because of a legal obligation on SONI to complete them.
- B.44 Fourth, the financing duty, properly understood, is addressing something relatively simple – the idea that if a company has an obligation under the statute, the UR must take into account the need for the company to be in a position where it is able to afford to comply with that obligation.
- B.45 It is going much too far to seek to project onto the duty – as KPMG does on behalf of SONI⁴⁴ – complex concepts in finance and economics that there is no evidence the legislator ever intended. For instance, when, exceptionally, a statute wishes to make provision within a financing duty about rates of return, it does so⁴⁵. There is no basis for reading into the duty either words or technical concepts which are not there.
- B.46 Fifth, on the theme of reading in words which are not present, the word ‘standalone’ does not feature in the duty, although SONI⁴⁶ and KPMG⁴⁷ attempt to introduce it. The UR is entitled to have regard to all of the circumstances of a company, including parent company support given under a licence condition which was accepted as part of a corporate acquisition⁴⁸.

Conclusion

- B.47 The financing duty is an important element of the wider set of general duties set out at article 12 of the Energy Order. The UR takes it seriously and is satisfied that it has interpreted it accurately. As the UR will demonstrate below, it has fully complied with that duty. The price control decision made by the UR is designed to, and does, ensure that SONI will financeable on all reasonable assumptions.

⁴³ Explained in detail in Section 2 below.

⁴⁴ KPMG1 – MC1/1, [section 3.1](#).

⁴⁵ For instance, the Water and Sewerage Services (Northern Ireland) Order 2006, Article 6(2)(c).

⁴⁶ SONI Notice of Appeal – NOA1, [para. 4.19](#).

⁴⁷ SONI Notice of Appeal – NOA1, [para. 10.25](#).

⁴⁸ See paragraph 1.79 below.

C

- C.1 The appeal relates to the decision made by the UR in relation to SONI's price control.
- C.2 In relation to each of the purported errors which go to make up its three grounds of appeal, the burden of proof is on SONI to establish both that (i) the UR's decision is wrong on one of the statutory grounds, and (ii) SONI's proposed alternative is appropriate to be adopted⁴⁹.
- C.3 'Wrong' in this context means that the UR's decision is outside the wide margin of discretion which is afforded to judgments made by regulators⁵⁰. It is insufficient to simply point to alternative models or processes that could have been adopted by the UR. The consideration of alternatives arises primarily as part of the consideration of remedies once a decision has been found to be wrong – it is not the focus of the prior question of whether the decision is wrong in the first place.
- C.4 SONI cannot succeed simply by pointing to errors in the reasoning which underlies the decision⁵¹. Nor can it succeed by identifying deficiencies in the process by which it was arrived at, save where that process was so fundamentally flawed as to render the decision wrong on one of the statutory grounds⁵².
- C.5 SONI has not discharged the burden upon it to establish that the UR's decision is wrong. Its appeal cannot therefore succeed.
- C.6 SONI simply disagrees with the decisions that the UR has made with respect to its price control, and attempts to shoehorn that disagreement into the statutory grounds by linking all of its arguments to the concept of financeability. However, it persistently misquotes the UR's financing duty under Article 12(2)(b) of the Energy Order⁵³.
- C.7 To the extent that this concept lies at the heart of SONI's appeal, its attempt to render the financing duty as something which it is not is symptomatic of the wider problems with the case that SONI seeks to present.
- C.8 A brief summary of the UR's response to each of the grounds of SONI's appeal is set out below.

Ground 1 – 'The Financeability Methodology Ground'

- C.9 In this Ground 1, SONI argues that the UR was wrong to have set its price control on a 'RAB-WACC' basis, and should instead have used SONI's preferred margin-based

⁴⁹ See paragraph B.29 above.

⁵⁰ See paragraph B.25 above.

⁵¹ See paragraph B.21 above.

⁵² See paragraph B.22 above.

⁵³ See paragraph B.31 – B.47 above.

approach. It claims that the consequence of the approach taken by the UR is that it is inevitably not financeable.

C.10 In addition, SONI argues that the UR failed in various ways to carry out a suitable and complete financeability assessment.

C.11 In brief, the UR responds that:

(a) The approach it adopted to the price control sought to tie the profits that SONI earns to a fair rate of return on the capital that it needs to take from investors. There is nothing 'wrong' with this approach, which ensures that all investor capital required by SONI is appropriately remunerated.

(b) There are a number of difficulties with SONI's preferred margin x expenditure approach, and the UR was right to reject it.

(c) The UR conducted adequate financeability assessments, and was right to conclude that aligning the marginal rate of return to the cost of capital, and particularly the cost of new equity capital, ought to enable SONI to finance its activities in the 2015-20 regulatory period.

C.12 SONI's submissions on Ground 1 are noteworthy for the way in which they consistently fail to consider the reasons that the UR gave for its decision in the areas of return and financeability. As was the case during the UR's review proper, SONI appears fixated on promoting its preferred margin approach, and particularly its quest for remuneration for 'intangible assets', and does not address directly either the methodology or the specific calculations that underpin the UR's analysis of investor capital requirements and required return.

C.13 As a consequence of this approach, SONI falls well short of demonstrating that the UR's decision was 'wrong'. Indeed, for the most part, SONI has sought to sidestep completely its task of identifying the specific flaws that there are in the UR's decision and focuses on presenting an alternative approach that it happens to prefer.

Ground 2 – 'The Revenue Uncertainty Ground'

C.14 SONI will undertake a number of projects over the period of the price control, the costs for which are radically uncertain. The nature of these projects is such that this uncertainty will exist not only at the outset of the price control, but even during the life of the projects themselves.

C.15 Such costs are therefore subject to a double uncertainty, the effect of which is that they cannot be subject to an ex ante allowance in the normal regulatory manner, either at the commencement of the price control, or upon later application.

C.16 The UR's solution to the problem of double uncertainty is the Dt mechanism contained in paragraph 8 of Annex 1 to SONI's licence. That mechanism is adapted from a similar mechanism which was put in place by the CC in its determination of

NIE's RP5 price control to deal with a similar problem of double uncertainty⁵⁴. Such a mechanism has been used before both for SONI and – with respect to the same PCNP projects for which SONI has taken responsibility – for NIE.

- C.17 To succeed on its Ground 2, as pleaded, SONI must establish not only that one or more of the errors it identifies exists, but that those errors create uncertainty which in turn adversely affects SONI's financeability. That adverse effect must render the decision wrong on one of the statutory grounds that SONI pleads in relation to Ground 2.
- C.18 Each link in this chain of causation must be established, and it is for SONI – as the appellant – to make and to prove its case. It must do so on the basis of clear, consistent and coherent arguments and, where it claims a particular effect, those arguments must be supported by evidence.
- C.19 Each of these elements is missing from SONI's submissions with respect to Ground 2.
- C.20 The UR is satisfied that the mechanism is reasonable, proportionate and well within the margin of appreciation accorded to the UR as a regulator. Indeed it would seem impossible for SONI to succeed in establishing that the UR's decision is wrong in those respects where it adopts provisions created previously by the CC to deal with similar issues.

Error 2 – Failure to provide a cost recovery mechanism for PCNPs

- C.21 From 1 May 2014 SONI has assumed the responsibilities in relation to network planning that previously sat with the Transmission Asset Owner, NIE. Part of SONI's function in this regard is to advance PCNPs⁵⁵ through to the commencement of construction, at which point they pass to NIE for completion.
- C.22 SONI currently expects to invest £15 – 20 million in costs related to PCNPs over the price control period.
- C.23 In its Final Determination, the UR set out a process for dealing with these costs which involves SONI seeking initial approval for its costs prior to the commencement of each project and then recovering costs from NIE for those projects which the latter takes forward to the construction stage. Those costs that do not proceed to construction will be claimed for by SONI using the Dt mechanism.
- C.24 SONI does not accept that mechanism and wishes its costs in relation to PCNPs to be passed through to consumers subject only to an ex post regulatory check which must take place within a short window. It raises a number of points against the UR's proposal. These points range from a passing assertion that the UR had no power to

⁵⁴ NIE Determination, paras 5.246 – 5.270.

⁵⁵ Referred to in UR documents as 'Transmission Load/Capacity Related Projects' and in Annex 1 to SONI's licence as 'Transmission Network Pre-construction Projects'.

impose the mechanism to a suggestion that the lack of detail as to the actual process for applications is having an effect on SONI's ability to finance its activities.

- C.25 None of the points made in relation to Error 2 have merit. The mechanism proposed by the UR is an appropriate response to a set of uncertain costs where there is a need to ensure sufficient regulatory oversight to ensure that those costs are efficiently incurred.

Error 3 – Failure to provide a cost recovery mechanism for additional IS capital investment

- C.26 The UR recognises that IT systems are fundamental to SONI's role as transmission system operator.
- C.27 As part of its price control SONI requested allowances of around £8.9 million in respect of IT capex. In its Final Determination, the UR provided an allowance of £6.6 million – a 45% increase compared to SONI's previous price control – coupled with a 50/50 cost risk sharing mechanism under which SONI will take responsibility for 50% of any spend in excess of its allowances.
- C.28 SONI asserts that the UR's decision is vitiated by specific omissions and errors that it deals with under Error 11.
- C.29 In addition, it suggests that the decision is '*unacceptable*' on the basis that the UR's approach heightens SONI's risk environment which in turn impacts on its financeability.
- C.30 The amount sought by SONI allowed for a substantial degree of contingency reflecting a set of worst case scenarios. Many of those scenarios may not proceed and – if they do – are capable of being managed in other ways. This is because SONI has discretion in how it spends its allowance and can be expected to adjust its spending priorities over the price control period as events unfold.
- C.31 The UR has provided 90% of the amount requested in relation to majority of the projects put forward by SONI, and has deferred the DS3 and Smart Grids project as explained further in section 11. The UR has also confirmed that where some unexpected event does indeed materialise, it will consider and determine an application for further allowances under the D_t mechanism – albeit that, in view of the generous allowance provided, the UR does not expect to receive any such application.
- C.32 SONI does not demonstrate how its '*risk environment*' has been '*heightened*' by the UR's decision⁵⁶. Nor does it provide any explanation as to how its financeability has been impacted.

⁵⁶ SONI Notice of Appeal – NOA1, para. 25.14.

- C.33 SONI simply disagrees with the amount that has been allowed by the UR. However, such disagreement provides no basis for a finding that the UR's decision was wrong on one of the statutory grounds.

Error 4 – Failure to provide a suitable cost recovery mechanism for Significant Projects

- C.34 SONI will undertake a number of large scale projects over the course of the price control period. Together with the PCNPs with a value of over £1 million, such projects also include the following –
- (a) The implementation of I-SEM – A new wholesale electricity market for the island of Ireland that will replace the current SEM.
 - (b) The DS3 Programme – A joint project between the UR, the Commission for Energy Regulation in Ireland, EirGrid (in its role as Republic of Ireland TSO) and SONI to adapt system policies, tools and performance to safely accommodate up to 75% penetration of renewable generation at any one time. This will help achieve the target set by the Northern Ireland Executive that 40% of electricity should come from renewable sources by 2020.
- C.35 The implementation costs of I-SEM will be decided by the SEMC. The implementation costs of DS3 will be considered by the SEMC and, if it decides those costs to be related to a SEM matter, it will set an amount. Where it does not consider DS3 costs to be related to a SEM matter, the UR will still consider whether to approve them.
- C.36 Once decided, both sets of costs will be applied to tariffs through the same mechanism used to recover costs of PCNPs that do not proceed to construction – the D_t mechanism.
- C.37 SONI groups I-SEM, DS3 and high value PCNPs together under the heading of 'Significant Projects' and claims that the D_t mechanism is an unsuitable method of recovery for the costs associated with such projects.
- C.38 The UR considers the use of the D_t mechanism to be an appropriate method for dealing with uncertain costs which balances the need to ensure that SONI can recover its costs for Significant Projects, while providing a sufficient degree of scrutiny to ensure that inefficient costs are not passed through to consumers.
- C.39 The D_t mechanism is adapted from a provision instituted by the CC to deal with a similar problem of uncertainty and has been in use by SONI and NIE for a number of years.
- C.40 The continued use of the D_t mechanism is squarely within the regulator's discretion and there is nothing in the Notice of Appeal that establishes that the decision to adopt it with respect to Significant Projects is wrong.

Error 5 – Failure to provide a suitable right of appeal concerning decisions regarding cost recovery for Significant Projects

- C.41 Under Article 37(11) of the Electricity Directive, member states must ensure that suitable mechanisms exist at national level through which a party affected by a decision of a regulatory authority has a right of appeal to an independent body.
- C.42 In the majority of cases this right is given effect in the UK through the availability of judicial review. However, Parliament has granted a right of appeal to the CMA in respect of a small number of regulatory decisions of a particular type – licence modifications and, in Great Britain, certain code modifications⁵⁷.
- C.43 SONI argues that the use by the UR of the D_t mechanism to make determinations in relation to the financing of Significant Projects is wrong because – as such decisions will not result in modifications to SONI's licence – they will not attract a right of appeal to the CMA.
- C.44 This is a surprising submission as it ignores the fact that the statutory framework is explicitly set up in such a way that appeal to the CMA is not available in respect of decisions made under a licence. It also ignores the fact that judicial review has long been recognised as a valid mechanism to discharge a right of appeal in EU law.
- C.45 SONI is therefore asking the CMA to unilaterally extend its jurisdiction beyond that granted by Parliament by making a finding on the requirements of EU law that goes against a succession of decisions by the European Court of Justice.

Error 6 – Failure to manage uncertainty by creating additional uncertainty through implementing an unworkable two-stage process

- C.46 SONI asserts that the two stage process that comprises the UR's approach to uncertain costs in the price control is '*unworkable*', fails to achieve the intended effect, is '*disproportionate*' and creates uncertainty which will have a negative effect on SONI's financeability.
- C.47 The UR has simply continued with the process which has been adopted previously and which is similar to that adopted by the CC in its determination of NIE's RP5 price control. SONI is well used to working within that process and – although it may disagree with it – SONI has failed to establish that its adoption in this price control is wrong on any of the statutory grounds.

⁵⁷ In Northern Ireland, Article 14B of the Electricity Order makes provision for appeals to the CMA regarding licence modifications; in Great Britain, section 11C of the Electricity Act makes similar provision and, in addition, the Electricity and Gas Appeals (Designation and Exclusion) Order 2014 provides for appeals to the CMA in relation to code modifications where Ofgem has not followed the recommendation of the relevant industry panel.

Error 7 – Unjustified creation of uncertainty through failure to provide guidance on the application of the demonstrably inefficient and wasteful expenditure provision

- C.48 In its determination of NIE's RP5 price control, the CC inserted a provision allowing the UR to adjust NIE's maximum regulated revenue to protect customers from expenditure by NIE that the UR finds to be demonstrably inefficient or wasteful expenditure (**DIWE**)⁵⁸.
- C.49 The UR inserted a similar provision into SONI's price control. In its Draft Licence Modifications the UR originally included a provision – paragraph 9.1 – which allowed it to issue guidance on the interpretation of DIWE. It removed that provision from its Final Licence Modifications.
- C.50 SONI is unhappy with the DIWE provision. On the basis that it cannot reasonably suggest that it should be allowed to pass through expenditure which has been found to be DIWE, SONI seeks to mount a collateral attack on the provision by attacking the fact that the UR has not decided to issue immediate guidance with respect to it.
- C.51 Neither the CC, nor Ofgem, provides guidance on their DIWE terms. Recover under the Dt mechanism in SONI's previous price control was also explicitly linked to the efficiency of its spend. In none of these cases has the lack of guidance led to any issues related to certainty or financeability and it is untenable to suggest that it should do so now.
- C.52 However, although the UR has not included the proposed licence provision with respect to guidance, it has stated in any event that it will issue such guidance at a later date. This is in addition to the reasons that it provides for each decision applying the DIWE provision⁵⁹.

Error 8 – Unjustified creation of uncertainty through the introduction of the Q_t adjustment

- C.53 The UR has introduced a term into SONI's licence – Q_t – the purpose of which is to adjust SONI's allowed revenues for the remaining years of the price control so that the price control has effect across the full five year period from 1 October 2015.
- C.54 SONI objects to this term, arguing that –
- (a) its effect is '*unexpected*',
 - (b) the UR has failed to undertake the necessary statutory consultation, and
 - (c) the effect of the term is contrary to regulatory certainty and creates '*additional financial risks*'.

⁵⁸ NIE Determination, [para. 5.97](#).

⁵⁹ UR Decision on Licence Modifications – NOA1/18, [para. 41](#).

- C.55 None of these submissions have any merit. That the price control would have effect from 1 October 2015 was signalled in a series of documents across a number of years and SONI specifically addressed the point in the statutory consultation which it now seeks to deny took place.
- C.56 As well as being expected, it is clear that the truing-up of the price control to ensure that it has effect from the correct date was appropriate as shown by comments made by the CC in its determination of the NIE price control.

Ground 3 – 'The Inadequate Allowances Ground'

- C.57 SONI's third Ground of Appeal is that the UR has failed to secure SONI's financeability by failing to provide adequate allowances in respect of SONI's costs relating to (i) payroll, (ii) pensions and pensions deficit, and (iii) capital expenditure on Information Systems (**IS**).
- C.58 SONI's case in respect of Ground 3 is fundamentally built on the premise that the UR, and through this appeal the CMA, should accept its word as to its level of costs and permit it to pass through the amount it seeks without adequate justification. It does not submit evidence sufficient to support its contention that allowances granted by the UR are inadequate, or that the amounts it seeks represent its necessary and efficient spend.
- C.59 In essence, SONI's position appears to be that it should get what it asks for without regulatory assessment or scrutiny of its request, and irrespective of whether the allowances sought can be demonstrated to be efficient.
- C.60 The UR's response to each of the errors alleged by SONI under this Ground 3 is set out below.

Error 9 – Failure to provide adequate payroll allowances for network planning staff

- C.61 SONI's contention is that the UR has failed to provide adequate payroll allowances for network planning staff. The claim is made on the basis that in determining payroll allowances the UR failed to take account of the fact that the Service Provision Change (Protection of Employment) Regulations (Northern Ireland) 2006 (referred to here as **TUPE** to align with the Notice of Appeal) apply to eleven network planning staff that transferred from NIE to SONI on 1 May 2014 (the '**transferred staff**')⁶⁰.
- C.62 According to SONI the UR's failure to take account of TUPE is evidenced by the UR applying a benchmarked average salary cost to all staff salary costs⁶¹.
- C.63 The UR does not dispute that TUPE applies to the transferred staff. The transferred staff were allocated by SONI into opex and capex roles. That TUPE was applicable was fully taken into account by the UR in determining the payroll allowance for opex

⁶⁰ SONI Notice of Appeal – NOA1, para. 4.44.

⁶¹ SONI Notice of Appeal – NOA1, para. 36.4.

staff, which includes three transferred staff. In applying a benchmarked assessment of average salary costs for the purposes of determining the opex payroll allowance, the UR did not fail to take account of TUPE.

- C.64 The opex payroll allowance is a single overall allowance which is adequate for SONI's opex salary costs. The overall allowance takes full account of the application of TUPE to opex transferred staff by:
- (a) applying a more generous benchmarking exercise than would otherwise be appropriate;
 - (b) recognising the extent of SONI's TUPE obligations throughout the period of the price control; and
 - (c) recognising that there will be cost efficiencies to be gained within the SONI TSO business from the transfer of the network planning functions.
- C.65 There is no upfront payroll allowance determined for capex staff, including eight transferred staff. The salary costs of the capex transferred staff are to form part of the claim(s) to be made by SONI, under the Dt term, for approval and recovery of costs of PCNPs.
- C.66 The UR will, as it did with opex transferred staff, take full and proper account of the application of TUPE to capex transferred staff when determining the capex staff cost element of claims made by SONI (under the Dt term) for PCNPs.

Error 10 – Failure to provide adequate pension allowances

- C.67 SONI's appeal is brought on the basis that the UR has failed to provide adequate pension allowances. In support of this contention SONI submits that the UR made two errors in respect of pension allowances.
- C.68 SONI's first submission is that the UR applied an inappropriate methodology for determining the pensions allowance for ongoing contributions into the occupational defined benefit scheme which forms part of the SONI Limited Pension Scheme (the **DB Scheme**)⁶².
- C.69 SONI's second submission is that the UR made an error in seeking to put in place a new approach for the recovery of the pension deficit in the DB Scheme⁶³.
- C.70 With regard to this second submission, the position is that in light of representations made by SONI that the UR had not properly consulted on the application of its pension deficit recovery principles to SONI, the UR has not applied the principles to SONI but is consulting further on the matter.

⁶² SONI Notice of Appeal – NOA1, [para. 38.4\(a\)](#).

⁶³ SONI Notice of Appeal – NOA1, [para. 38.4\(b\)](#).

- C.71 It is implicitly recognised by SONI that its appeal with regard to pension deficit recovery is brought in respect of a proposed decision rather than the decision actually made by the UR. The actual decision made by the UR is that the pension deficit principles in question do not presently apply to SONI and the status quo ante remains in place. There is therefore no decision which can be the subject of an appeal on the basis brought by SONI.
- C.72 Having decided to consult further on the pension deficit recovery, the UR considered that, given the connection between pension deficit and ongoing contributions, and given that SONI has also submitted updated information on ongoing contributions relating to the DB Scheme, it was appropriate also to consult on matters relating to the ongoing contributions into the DB Scheme.
- C.73 Given this further consultation the UR chooses not to contest the appeal with regard to the decision on the pensions allowance for ongoing contributions to the DB Scheme. Rather it will proceed to consider its response to the consultation, as it would have done absent SONI's appeal and, having done so, make representations at the remedies stage of the appeal as to the next steps.
- C.74 Accordingly, in responding below to alleged error 10, the UR has reversed the order and responds first to the appeal on the pension deficit recovery aspect and second to the ongoing contributions aspect.

Error 11 – Failure to provide adequate IS capital expenditure allowance

- C.75 SONI states that the IS capex allowance is inadequate because it does not include an amount for costs relating to the DS3 and Smart Grids Project (the **DS3 Project**), and because the UR made an incorrect adjustment to rebase SONI's submitted costs to 2014 prices.
- C.76 The reference to DS3 is a reference to the all-island DS3 (**Delivering a Secure Sustainable System**) programme. The programme is designed to implement measures to support the secure and reliable operation of the all-island transmission system, as level of non-synchronous wind penetration increases across the all-island system, in order to achieve the 40% renewable energy target set by Northern Ireland and the Republic of Ireland respectively.
- C.77 The UR's response is that SONI has not made out a valid case for an allowance in respect of the DS3 Project. It has not provided any tangible evidence or information supporting its request for an allowance of £1.33 million or of the need to incur the level of costs submitted.
- C.78 No detailed breakdown of the submitted costs, other than into three areas of activity which is currently carried out by SONI, has been provided to the UR. Moreover, there is a distinct lack of clarity on the scope of each of the three areas said to fall within the DS3 Project request, and on the difference between each particular area.

- C.79 However, the UR has not discounted entirely the potential need for the DS3 Project and would welcome proposals that can be demonstrated to increase renewable penetration and add value for consumers. It has therefore signalled to SONI that it would be open to SONI to make a Dt claim in respect of the DS3 Project in the event that it is able to demonstrate the need for that investment.
- C.80 In terms of the UR's adjustment of the business plan figures, SONI has not explained to the satisfaction of the UR that, notwithstanding the information provided in its business plan submissions, the IS capex costs within the business plan are in 2014 prices and not in 2015 prices.
- C.81 SONI's arguments for the IS capex allowance to include an amount for the DS3 Project, and its arguments in respect of the UR's adjustment to rebase the submitted costs to 2014 prices, were fully considered and rejected by the UR in the Final Determination and Decision Paper. The UR was right to do so for the reasons given below.

GROUND 1 – 'THE FINANCEABILITY METHODOLOGY GROUND'

1.

Introduction

- 1.1 In this Ground 1, SONI argues that the UR was wrong to have set its price control on a 'RAB-WACC' basis, and should instead have used SONI's preferred margin-based approach. It claims that the consequence of the approach taken by the UR is that it is inevitably not financeable.
- 1.2 In addition, SONI argues that the UR failed in various ways to carry out a suitable and complete financeability assessment.
- 1.3 In brief, the UR responds that:
- (a) The approach it adopted to the price control sought to tie the profits that SONI earns to a fair rate of return on the capital that it needs to take from investors. There is nothing 'wrong' with this approach, which ensures that all investor capital required by SONI is appropriately remunerated.
 - (b) There are a number of difficulties with SONI's preferred margin x expenditure approach, and the UR was right to reject it.
 - (c) The UR conducted adequate financeability assessments, and was right to conclude that aligning the marginal rate of return to the cost of capital, and particularly the cost of new equity capital, ought to enable SONI to finance its activities in the 2015-20 regulatory period.

The UR's approach to returns and financeability

- 1.4 It may be helpful to begin by summarising the UR's approach to returns and financeability. A fuller explanation of these aspects of the UR's decision is set out in paragraphs 272 to 324 and paragraphs 334 to 370 of the UR's Final Determination document⁶⁴.

Returns

- 1.5 SONI is at great pains in its submission to emphasise the asset-light nature of its transmission system operator functions. The UR does not dispute this characterisation. The UR has nonetheless taken the view that the type of business that SONI is does not materially affect the way that a regulator has to view the profit that the regulated firm earns. Broken down into their component parts, the revenues that SONI collects from users consist of:

⁶⁴ UR Final Determination – NOA1/12, pages 56 – 65 and 67 – 73.

- (a) the recovery of efficiently incurred operating expenditure;
 - (b) the recovery, over time, of efficiently incurred capital expenditure; and
 - (c) an additional amount of income which flows ultimately to SONI's shareholder, or, if it chooses to substitute debt for equity capital, to persons that may lend money to SONI.
- 1.6 In the UR's assessment, the quantum of the element of revenues described under (c) cannot be sized without analysing i) the amount of financial capital that SONI requires to support its licensed activities and ii) the cost of that capital.
- 1.7 As part of the price review process, the UR therefore spent a considerable amount of time working with SONI to identify the nature of the financial capital requirements that the transmission system operator business throws up⁶⁵, the likely size of those capital requirements over the 2015-20 control period, and the cost of the various types of capital. In assembling its price control Final Determination, it was the UR's intention that all of the investor capital that SONI would require to run its business should be identified and properly remunerated.
- 1.8 In practical terms, this was achieved as follows.
- 1.9 First, the UR made explicit provision for a baseline amount of financial capital, comprising:
- (a) Baseline investment – SONI's historical and prospective investments in IT and facilities feed into a regulatory asset base (RAB), whose value is tracked over time in the normal way. The investor capital that finances known investments over the 2015-20 period is remunerated in line with an estimate of the opportunity cost of capital or WACC of 5.9% per annum.
 - (b) Contingent capital, bank facility – SONI must also maintain access to additional capital to manage mismatches in the timings of certain payments and receipts it is responsible for as system operator.⁶⁶ SONI has historically elected to use a £12m bank facility for this purpose. SONI informed the UR that it currently pays a fee of [CONFIDENTIAL – REDACTED] per annum⁶⁷ to maintain this facility and this cost was factored directly into the UR's price control calculations.
 - (c) Contingent capital, parent company support – finally, there is a licence requirement that EirGrid undertake to provide the financial support needed

⁶⁵ What matters for these purposes is the capital that needs to be employed given the nature of the business, the licence obligations and the price control framework – the capital that SONI has employed in practice provides relevant information but is not determinative of what is required.

⁶⁶ Specifically, dispatch balancing costs.

⁶⁷ Correspondence relating to Query M, Response to query M – Part B (20 July 2015), [page 5](#) – BT1/34/Tab M.3.

to ensure that SONI may meet its obligations⁶⁸. This is fulfilled by an EirGrid undertaking which agrees to provide support for SONI in future up to the amount of £10m. The UR judged that this undertaking has a cost, but noted that the cost had been recognised in full in the separate SEMO price control.

1.10 On top of the baseline amount of capital, the UR also sought to ensure that SONI would be remunerated for any additional capital calls over the 2015-20 period.⁶⁹

(a) Additional investment – SONI will be taking on a series of additional investments, whose precise costs are not yet known. The UR's decision provides for a D_t adjustment process, in which allowances for such expenditure can be made on a case-by-case basis and in which the costs of financing are capitalised into SONI's RAB at the prevailing WACC.

(b) Additional short-term working capital – when SONI unexpectedly has to make payments as system operator ahead of receipts, it may under-recover against its regulated revenue entitlement. In such circumstances, the cash amounts that SONI needs to finance are recognised in a K-factor adjustment to next year's tariffs, which for regulatory purposes will attract an interest rate of LIBOR plus 2%.⁷⁰

1.11 In addition to the above allowances, the UR was open in principle to covering the cost of any structural, day-to-day working capital requirement that SONI might have owing to the normal profile of payments and receipts over a tariff year. The UR observed, however, that the normal timing of SONI's incomings and outgoings was such that, outwith any investment, SONI has historically had positive month-to-month cash balances. The UR confirmed with SONI that this position was unlikely to change⁷¹ and that SONI would not need to take capital from investors to finance regular day-to-day cash management within the system operator business. Accordingly, the UR judged that it did not need to make any sort of working capital allowance.

1.12 SONI did make claims for remuneration for other intangible 'assets' relating to its staff, competences and expertise. The UR's assessment is that these items do not

⁶⁸ SONI TSO Licence, Condition 3A – NOA1/1, [page 28](#).

⁶⁹ Further provision(s) on top of the items listed here, including additions to SONI's allowed revenue, may be required if the new I-SEM market arrangements impose new working capital requirements on SONI. The impact of I-SEM was not factored into the UR's April 2017 decision, but will be considered separately by the SEM Committee.

⁷⁰ This is a fairly standard allowance in economic regulation and represents an increase on the Danske Bank base rate referenced in SONI's 2010-15 price control, so as to broadly match the [CONFIDENTIAL – REDACTED] per annum interest that SONI told the UR it pays on its bank facility. Source: Correspondence relating to Query M, Response to query M – Part B (20 July 2015), [page 5](#) – BT1/34/Tab M.3.

⁷¹ SONI wrote to the UR in July 2015 stating '*SONI TSO does not have a predictable or seasonal requirement for working capital as it would if it were a supplier (billing cycles and exposure to seasonality in wholesale costs) but rather may require working capital if there are adverse movements in these costs (and/or revenues) relative to that forecast...*' - Correspondence relating to Query M, Response to query M – Part A (20 July 2015), [para 3](#) – BT1 / 34 / Tab M.2.

translate to any sort of investor capital requirement or associated cost and should not therefore require the UR to factor an additional element of financial return into SONI's allowed revenues.

Financeability

- 1.13 The UR's Final Determination anticipates that SONI, as a small company, might need to continue financing all of its RAB investments via equity capital. The UR therefore calculated SONI's cost of capital on the assumption of a 100:0 equity:debt capital structure.⁷² This calculation is set out in the first column of Table 1, below.
- 1.14 The UR also allowed for the possibility that SONI might in future choose to finance some of its investment with debt. A calculation of SONI's cost of capital for a 45:55 equity:debt capital structure is shown in the second column of table 1. Somewhat counter-intuitively, the geared structure gives rise to a higher overall cost of capital, perhaps due to the relatively high cost of debt that has been assumed.⁷³
- 1.15 The return that the UR factored into its price control calculations was 5.9%, at the top end of the range in table 1.

Table 1: The UR's WACC calculations

| | Cost of capital at 0% gearing | Cost of capital at 55% gearing |
|-------------------------|-------------------------------|--------------------------------|
| Gearing | - | 0.55 |
| Risk-free rate | 1.5% | 1.5% |
| Equity-risk premium | 5.0% | 5.0% |
| Asset beta | 0.60 | 0.60 |
| Debt beta | - | 0.10 |
| Equity beta | 0.60 | 1.21 |
| Post-tax cost of equity | 4.4% | 7.61% |
| Tax rate | 20% | 20% |
| Pre-tax cost of equity | 5.5% | 9.51% |
| Cost of debt | - | 2.95% |
| Pre-tax WACC | 5.5% | 5.9% |

⁷² Note that the calculated WACC, and, hence, this 100:0 capital structure, is for the RAB and the investments contained therein. As set out in paragraphs 2.6 and 2.7, the cost of SONI's short-term financing requirements is allowed for separately.

⁷³ SONI is assumed, in effect, to incur relatively high frictional costs/illiquidity premia when it borrows. These costs mean that the weighted average cost of capital increases if SONI takes on more debt.

- 1.16 The UR's assessment is that SONI will be capable of financing its activities in the 2015-20 control period provided that the return factored into its price control is sufficient to cover the business's actual cost of capital. This is to say that if SONI is able to offer a return that at least covers the opportunity cost of capital, there should be no reason why either the existing or any prospective new investors should not be willing to supply the financing that SONI requires in the course of its activities as system operator.
- 1.17 The UR took considerable comfort in this regard from the read-across between its cost of equity calculation and the CMA's calculation of the cost of capital for a GB energy retail business in its recent energy market inquiry. The UR's assessment was that the risks faced by SONI are no greater than the risks faced by the GB energy retail businesses and, hence, the fact that SONI's allowed return can be seen to be in line with the CMA's assessment of the cost of capital (which the UR calculated to be 4.75% to 6.75% on a like-for-like basis)⁷⁴ suggests that one can be confident in SONI as an attractive equity proposition.
- 1.18 For the avoidance of doubt, the UR did not and does not consider that SONI's financeability is dependent on its ability, in practice, to obtain debt financing for its investment, given that the allowed return has been set at a level that covers the cost of 100% equity financing.

The UR's Response to SONI's Notice of Appeal

- 1.19 The standout feature of Ground 1 in SONI's Notice of Appeal is SONI's unwillingness to engage with the analysis set out above. It is noticeable that SONI:
- (a) does not explain what is 'wrong' with an approach that seeks to tie the profits that SONI makes to a fair return on the financial capital that SONI takes from investors;
 - (b) is not claiming that there are any elements of investor capital that the UR has inadvertently overlooked;
 - (c) does not identify any specific fault in the costings that the UR has put forward for each capital type;⁷⁵ and then
 - (d) focuses on the business' ability to finance its investments with debt, ignoring the way in which the UR allowed for the possibility that SONI could finance its investment wholly via equity capital.

⁷⁴ This 4.75% to 6.75% range was obtained from table 1 in appendix 9.12 to the CMA's energy market inquiry report by i) referring to the real-risk-free rate rather than the nominal risk-free rate (to give a range for the real WACC) and ii) adjusting the tax rate to a forward-looking rate of 20%.

⁷⁵ Although SONI does question the treatment of EirGrid's parent company undertaking – see paragraphs 1.78 to 1.89 below.

- 1.20 In the UR's view, SONI's Notice of Appeal strays repeatedly from the statutory question of whether the UR's decision can be said to be 'wrong' and concentrates unduly on how an alternative approach – namely the margin x expenditure method – might be an admissible way of calibrating SONI's allowed revenues.
- 1.21 In order to succeed on Ground 1, SONI must demonstrate that the UR's decision was so flawed that it cannot stand, and then show that an alternative approach should be adopted. It is not sufficient to argue for the merits of an alternative without having cleared the first hurdle of proving that the original decision was 'wrong'.
- 1.22 In setting out its observations on SONI's Notice of Appeal, below, the UR has tried to focus as much as possible on the arguments SONI has made that go directly to the question of whether the UR's approach was 'wrong'. Inevitably, however, it is also necessary to comment from time to time on the weaknesses and inadequacies in SONI's preferred framework.

ALLEGED ERROR 1(a) – The Price Control Framework

- 1.23 The first part of Ground 1 is that the UR failed *'to adopt a price control framework that could secure the Appellant's financeability'*.⁷⁶ The word *'could'* here is central to SONI's case; SONI contends that the approach that the UR took is so unreliable as to render it incapable of producing an appropriate amount of revenue. The claim is that this approach led to the *'inevitable result that the Appellant was not financeable'*.⁷⁷

Why the UR's approach cannot be said to be 'wrong'

- 1.24 In assessing this argument, it is important to be clear what the UR's framework is. The Notice of Appeal often states that the UR applied a *'simple'*⁷⁸ or *'traditional'*⁷⁹ *'RAB-WACC approach'*. This is a considerable over-simplification. A more accurate characterisation of the UR's approach is set out above and in paragraphs 272 to 276 of the Final Determination document; in particular, in the statement that the UR's approach involved:

*'...looking at each of the items [of investor capital] 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.'*⁸⁰

- 1.25 One key element in this assessment was very clearly the value of SONI's RAB, as an objective and transparent measure of the financial capital that SONI has taken and will take from investors to support its investment programme. However, for the avoidance of doubt, and of crucial importance to Alleged Error 1(a), the RAB and the

⁷⁶ SONI Notice of Appeal – NOA1, heading to section 4(b)(i)(A).

⁷⁷ SONI Notice of Appeal – NOA1, para. 4.8.

⁷⁸ SONI Notice of Appeal – NOA1, para. 18.14.

⁷⁹ SONI Notice of Appeal – NOA1, para. 18.15.

⁸⁰ UR Final Determination – NOA1/12, para. 276.

WACC were not the only items that the UR considered, as set out in paragraphs 1.9 to 1.12 above and in paragraphs 275 to 305 of the Final Determination document.

- 1.26 SONI's contention that the UR failed to adopt a framework that could secure SONI's financeability is a contention that a framework which seeks to identify the financial capital that SONI takes from investors and which costs up that capital is not capable of securing SONI's financeability. The UR strongly disagrees with this point of view.
- 1.27 First, as a matter of principle, the UR considers that it is right and proper to view the profit that SONI earns, as distinct and separate from the recovery of efficient opex and capex, through the lens of a return on investor capital. The revenues in question ultimately flow into the pockets of lenders and shareholders and the UR cannot see how it can be said to be 'wrong' to want to be sure that these revenues offer a return that is fair – i.e. neither too low nor too high – in light of the monies that the investors are committing to SONI.
- 1.28 The UR notes that the CMA deployed an identical line of thinking in its recent energy market investigation. Responding to lengthy submissions arguing against an approach which measured the GB energy suppliers' return on capital employed (ROCE), the CMA's final inquiry report stated 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 ...'*⁸¹

- 1.29 The UR employed exactly the same thinking when constructing SONI's price control⁸².
- 1.30 Second, in practical terms, the UR does not consider that there is anything peculiar about SONI that means that it is not practically possible in this specific case to estimate either the financial capital that the business requires or the cost of that capital.
- 1.31 Information on the size of SONI's capital base was provided by SONI in its business plan⁸³ and in responses to the UR's follow-up questions.⁸⁴ In preparing its Final Determination, the UR was able to see:
- (a) the amount of capital that SONI has taken in the past and will require in the future for known investments;
 - (b) the business's day-to-day working capital position;

⁸¹ CMA Energy Market Investigation Final Report, [Appendix 9.10](#), para. 19.

⁸² The UR explicitly referenced the CMA's energy market investigation report in paragraph 275 of its Final Determination document - NOA1/12.

⁸³ SONI Business Plan Submission, 15 October 2014 – BT1/31, [Paper 6](#).

⁸⁴ In particular, Correspondence relating to Query M – BT1/34/Tabs M.1 to M.5.

- (c) the size of SONI's standby bank facilities; and
- (d) the size of EirGrid's contingent parent company support.

1.32 In the case of (c), the UR was able to observe precisely how much SONI pays for its capital. In the cases of (a) and (d), the UR had to arrive at an estimate of the cost of the capital, but the challenges in making these costings were no greater than those which any regulator faces in a price-review setting.

1.33 The UR notes again that SONI is not appealing the UR's decision on the grounds that the regulator inadvertently miscalculated either the scale of investor capital or the cost of that capital. The best argument that SONI and its experts can make is that the business has unobservable '*intangible*' assets, which are likely to be difficult to identify and quantify, and are likely to have been overlooked in the UR's analysis. These '*intangibles*' are said to include things like:

- (a) knowledge;⁸⁵
- (b) expertise;⁸⁶
- (c) human capital;⁸⁷
- (d) talent of employees;⁸⁸
- (e) intellectual property;⁸⁹
- (f) know how and innovation;⁹⁰
- (g) entrepreneurship;⁹¹
- (h) time spent;⁹² and
- (i) reputation and responsibility.⁹³

1.34 The UR explained in paragraphs 298 to 305 of its Final Determination that it does not consider that such 'assets' should factor into deliberations about the amount of profit that SONI should make. None of the items in the above list have involved or will involve lenders or shareholders investing financial capital in SONI; or, to the extent to which they might have involved any such investment, this has already been

⁸⁵ SONI Notice of Appeal – NOA1, para. 14.3(f).

⁸⁶ *ibid.*

⁸⁷ *ibid.*

⁸⁸ Aidan Skelly, First Witness Statement – AS1, para. 15.

⁸⁹ *ibid.*

⁹⁰ KPMG1 – MC1/1, para. 1.7.

⁹¹ Andrew Lilico, First Witness Statement – AL1, para. 3.4.

⁹² Andrew Lilico, First Witness Statement – AL1, para. 4.12.

⁹³ *ibid.*

remunerated and any further reward would be a double recovery. As such, factoring recognition for knowledge, expertise, human capital, etc. into the profits that SONI earns would have the effect of boosting the return that the shareholder takes from SONI to a level that sits well in excess of a market-based return on the shareholder's financial investment. The UR does not consider that this can be justified.

- 1.35 The UR notes that the CMA took a similar line in its energy market investigation when assessing claims for profits related to energy suppliers' brands and skilled workforces.⁹⁴
- 1.36 Notwithstanding SONI's claim that '*this issue is not the subject of this appeal*'⁹⁵, the UR suggests that it is clear that the treatment of '*unobservable intangibles*' is absolutely central to SONI's Alleged Error 1(a). SONI's arguments for an element of return over and above i) the normal WACC plus ii) the costs of committed contingent capital, can all be seen to rest ultimately on the ideas that SONI has intangible assets and that these intangibles should contribute profit. The UR does not agree with this position.

Why Dr Lilico's criticisms of the UR's WACC calculation are ill-founded

- 1.37 As an illustration of the centrality of 'intangibles' to SONI's appeal, one of the arguments that SONI cites in support of its assessment that the UR's framework could not secure SONI's financeability is Dr Lilico's contentions that '*it is implausible that the proposed WACC uplift, offered by Uregni to allow for the effects of thin capitalisation, provides a means to address this issue*'.⁹⁶
- 1.38 On a first read, this might suggest that SONI is offering a direct challenge to one of the component parts in the UR's price control calculation – i.e. the selection of a 0.6 beta as a reflection of the risks that investors in SONI bear. However, this is not the case. Section 9 of Dr Lilico's witness statement can be seen to conflate and confuse:
- (a) the UR's desire to ensure that shareholders are compensated via the WACC for their relatively high exposure to cost shocks, given the relatively small size of SONI's investor capital base relative to ongoing expenditures; and
 - (b) Dr Lilico's belief that SONI should earn enough profit to provide for a return on intangible assets.
- 1.39 For the avoidance of doubt, the UR's selection of a 0.6 asset beta – rather than, say, the 0.38 beta that the UR is currently proposing for NIE Networks in the ongoing review of NIE's transmission price control – is not a back-door way of remunerating 'unobservable intangibles'. The UR's policy on capital remuneration is very clear: the UR wanted to recognise the costs of the actual financial capital that investors have put into the business (plus, separately, the cost of maintaining committed standby

⁹⁴ See, for example, CMA energy market investigation report, [Appendix 9.10](#), paras 62 and 78.

⁹⁵ SONI Notice of Appeal – NOA1, [para. 14.3\(f\)](#).

⁹⁶ SONI Notice of Appeal – NOA1, [para. 18.25](#); Andrew Lilico, First Witness Statement – AL1, [section 9](#).

bank facilities and contingent equity capital), but does not consider that customers should have to pay for 'intangible assets' that do not tie directly to the injection of financial capital into SONI's business.

- 1.40 Accordingly, the selection of a beta of 0.6 should be viewed in the same way as the selection of any other beta estimate in a price review setting. For example, one such parallel might be to the CMA's selection of a beta estimate in the recent Bristol Water case, when the CMA, like the UR, was confronted with a business with a relatively small RAB and had to assess how far the company might be a riskier investment in the eyes of investors. Like the CMA, the UR does not claim that it has a foolproof way of calculating the necessary uplift, but equally the UR does not consider it to be an insurmountable challenge to come up with a reasonable estimate.
- 1.41 There is not, therefore, any sense that it is 'implausible' to think that the UR could correctly calculate SONI's beta and SONI's WACC. Dr Lilico is guilty of attacking a straw man which he alone has set up due to his misreading of the UR's final determination and/or his preoccupation with 'unobservable intangibles'.

Why SONI's preferred approach is flawed

- 1.42 It follows that SONI has failed to clear its first hurdle and demonstrate that the UR's approach to the price control was 'wrong'. In consequence, it is strictly unnecessary to offer observations on SONI's preferred alternative of a profit allowance set in line with margin benchmarking. However, for completeness the UR makes the following points.

SONI's approach is unsound in principle and in practice

- 1.43 First, the idea that profit should vary in proportion to the size of SONI's expenditures rather than investor capital is conceptually unsound.
- 1.44 This can be illustrated with the following example. Consider two companies that have the same annual expenditures, but where company A has required only a small amount of financial capital from its investors and company B, by virtue of the type of business that it is, has required a much larger amount of money. SONI would have it that the two companies should earn the same revenues and profits, whereas common sense would say that company B has a higher cost base and needs to generate additional revenues/profits to service the investor capital that it has taken on. Such distinctions can be picked up in the UR's analytical framework, but are overlooked entirely in SONI's preferred alternative.

1.45 Second, the margin benchmarking that SONI would have the CMA rely on (which, for the record, is notably different to the benchmarking evidence that SONI submitted to the UR during the price control review⁹⁷) is flawed:

- (a) KPMG, on behalf of SONI, makes no real attempt to select companies that are undertaking similar activities to those contained within the transmission system operator business and ends up putting sectors as disparate as real estate and industrial machinery into its comparator set.
- (b) Crucially, there is no attempt to control for variations in the amounts of investor capital that sit behind different types of firms. If profit has to be viewed as a return on investor capital, margin benchmarking only conveys useable information if the companies in the comparator set have taken comparable amounts of equity capital and/or own comparable amounts to lenders, in proportion to their expenditure or annual revenues. Such considerations do not factor anywhere in KPMG's selection criteria.
- (c) Finally, KPMG's benchmarking suffers from numerous issues of selectivity and bias. Companies that earned negative margins are deemed atypical and excluded, but there is no filtering of companies that might have earned atypically high margins.⁹⁸ KPMG claims to select comparators that have high revenues relative to asset values, but in practice identifies only one sector with revenues that noticeably exceeds asset values and has no choice but to include a handful of other sectors in which turnover-to-asset ratios look incomparable to SONI's cost structure.⁹⁹ Then companies from three of KPMG's original ten 'most similar' sectors, including the one sector with a similar turnover-to-asset ratio, are discarded with cursory explanation.¹⁰⁰

1.46 Without selection criteria relating to either investor capital requirements or high turnover to asset value, and without remedying the other issues identified above, KPMG/SONI end up applying a very rough-and-ready rule of thumb – a narrowed-down selection of 53 companies in five quite randomly selected sectors of the UK economy typically make margins worth 10-14% of turnover – to calibrate SONI's profit requirement. The UR submits that this is too approximate and too imprecise a measure for a regulator to rely on in a price control setting.

SONI's expert evidence does not sustain its ground of appeal

1.47 Third, the difficulties with SONI's preferred approach are acknowledged even by its own expert. Dr Lilico says in his witness statement that:

'The margin-based approach has a number of drawbacks, perhaps the most important of which is that, as yet, there is no consensus regarding how to set

⁹⁷ SONI Business Plan Submission – BT1/31, Paper 7 (Section 5.2).

⁹⁸ KPMG1 – MC1/1, para. 9.6.10.

⁹⁹ Compare the statistics for 'asset turnover' in KPMG1 – MC1/1, figures 38 and 39.

¹⁰⁰ KPMG1 – MC1/1, para. 9.6.13.

correct margins nor, in particular, any good mechanism whereby, ex post, a regulatory decision on margins could be deemed to be in error.

...The use of margins should therefore be restricted to situations where it is infeasible or disproportionate to adopt a more robust, theoretically-driven approach.¹⁰¹

- 1.48 Moreover, as SONI notes, Dr Lilico has recently advised the regulator in the Republic of Ireland (CER) on the equivalent price control for SONI's parent company, EirGrid¹⁰². This advice, given in January 2015, also expressed his concerns about a margin-based approach (which '*has many significant drawbacks...*')¹⁰³, and in addition included Dr Lilico's view that there was nothing inherently wrong in CER continuing to employ a RAB-WACC approach:

'When considering the theoretical arguments as to whether a RAB/WACC or a margins approach is appropriate, it is important to bear in mind that EirGrid has in the past been regulated on a RAB/WACC basis, and has remained financeable. Thus, either approach could be viable in practice.'¹⁰⁴

- 1.49 These opinions from SONI's own expert witness provide neither a clear endorsement of its preferred approach nor, more fundamentally, any support for the proposition that the approach adopted by the UR was 'wrong'.

The UR's consideration of the options

- 1.50 Fourth, for the avoidance of doubt, the points made above were put by the UR to SONI during the course of the price control process. The UR's position was very clearly summarised in its Final Determination document, as follows:

*'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 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 capital that SONI's investors put into the business has somehow been missed or is otherwise being under-remunerated.*

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 put into the business in

¹⁰¹ Andrew Lilico, First Witness Statement – AL1, [paras 8.17 – 8.18](#).

¹⁰² SONI Notice of Appeal – NOA1, [para. 18.23](#).

¹⁰³ Europe Economics, [EirGrid: The RAB-WACC Approach and Alternatives](#), [para. 1.5.5](#).

¹⁰⁴ *ibid*, [para. 1.2](#); see also [para. 1.5.1](#) on maintaining the status quo ('*It would therefore be an option simply to continue with the current regime*').

*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 for the financial commitment they make to the regulated business. Any additional reward would therefore constitute excess return and cannot be justified.'*¹⁰⁵

- 1.51 SONI has sought to portray the UR's consideration of its arguments on margin as 'cursory'¹⁰⁶. This is speculation¹⁰⁷, and it is inaccurate. It is also irrelevant to the appeal, since what is under challenge is the decision made by the UR, not the discussions which preceded it. SONI is unable to show that the UR's approach was 'wrong', and the clear explanation given by the UR in its Final Determination shows why it was not wrong.

ALLEGED ERROR 1(b) – The Financeability Assessment

- 1.52 The second part of Ground 1 is SONI's claim that the UR's '*limited and inadequate financeability assessment was subject to material errors*'¹⁰⁸. In particular, SONI contends that the UR '*failed to conduct an adequate assessment of its financeability given its limited focus on applying financial ratio tests to RAB investments*'¹⁰⁹.

Why the UR's approach was not 'wrong' – framework for assessing SONI's ability to finance its activities

- 1.53 SONI's Notice of Appeal again misrepresents of the approach that the UR took in its Final Determination. The key paragraphs in the UR's Final Determination as follows:

'The Utility Regulator considers however, that, limited weight should be placed on [financial ratio tests] given that the amount of debt finance that the business utilises is a matter for SONI alone. In particular, the Utility Regulator considers that at least as much weight should be placed on scenarios in which SONI via investment and has 0% gearing. Provided that the 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.

Therefore the Utility Regulator has placed greater importance on the framework and allowances in the overall price control package providing an

¹⁰⁵ UR Final Determination – NOA1/12, [paras 306 – 307](#).

¹⁰⁶ SONI Notice of Appeal – NOA1, [para. 18.11](#).

¹⁰⁷ SONI Notice of Appeal – NOA1, para 18.23: '*It was therefore entirely reasonable for the Appellant to have expected the Utility Regulator to consider a broad range of precedents, and it is likely that it did not*' (emphasis added).

¹⁰⁸ SONI Notice of Appeal – NOA1, [para. 19](#).

¹⁰⁹ SONI Notice of Appeal – NOA1, [para. 19.1](#).

*appropriate return to investors and put less focus on letting modelled credit ratios drive the calibration of the price control package.*¹¹⁰

- 1.54 The UR remains of the view that SONI's financeability is tied inextricably to the return on capital. In particular, so long as the allowed rate of return is sufficient to cover the marginal cost of financing investment via equity capital, and provided that the UR also covers the cost of committed contingent bank and equity facilities, SONI should be capable of attracting and maintaining the medium- to long-term capital that it requires for its activities.
- 1.55 It is important therefore to note that the UR's 5.9% rate of return sits comfortably against the estimated cost of equity of 5.5% (based on a real risk-free rate of 1.5%, an equity-risk premium of 5.0%, an asset beta of 0.6 and a tax rate of 20%, as set out in table 1). The 5.9% is also positioned logically next to the CMA's energy market inquiry estimate of the cost of capital for GB energy retail companies^{111 112}. Insofar as SONI is not appealing the cost of equity calculation, or the sense check that the UR applied, there ought not to be any dispute that the UR has set the marginal return on new capital at an appropriate level.
- 1.56 Many of the criticisms that SONI makes in its Notice of Appeal are therefore mistakenly directed at the UR's analysis of SONI's financeability in a scenario in which SONI seeks to gear up and finance its investments through a mix of debt and equity capital. This ignores the clear intent in the UR's decision: that there is no imperative for SONI to borrow at all (except perhaps for the purposes of managing short-term volatility in cashflows)¹¹³.
- 1.57 The decision to provide for a 5.9% rate of return, rather than the 5.5% rate of return that SONI needs to make to sustain equity-only financing, can in a sense be viewed as 'headroom' in case SONI wishes to swap some equity for bank financing. However, the price control as a whole does not stand or fall according to whether or not SONI can in reality finance 55% of its investment via debt at a 5.9% overall cost of capital. If lenders do not like the look of SONI's financial ratios at 55% gearing, the implication is that SONI needs instead to replace some debt with equity – i.e. it should target gearing of only 45% or 35% or some other number.
- 1.58 Figure 2 then shows the relationship that there is between gearing and cost of capital in the UR's WACC model. At whatever point SONI finds that lenders are willing to lend against SONI's investment, up to a maximum of 55% gearing, it can be

¹¹⁰ UR Final Determination – NOA1/12, [paras 316 – 317](#).

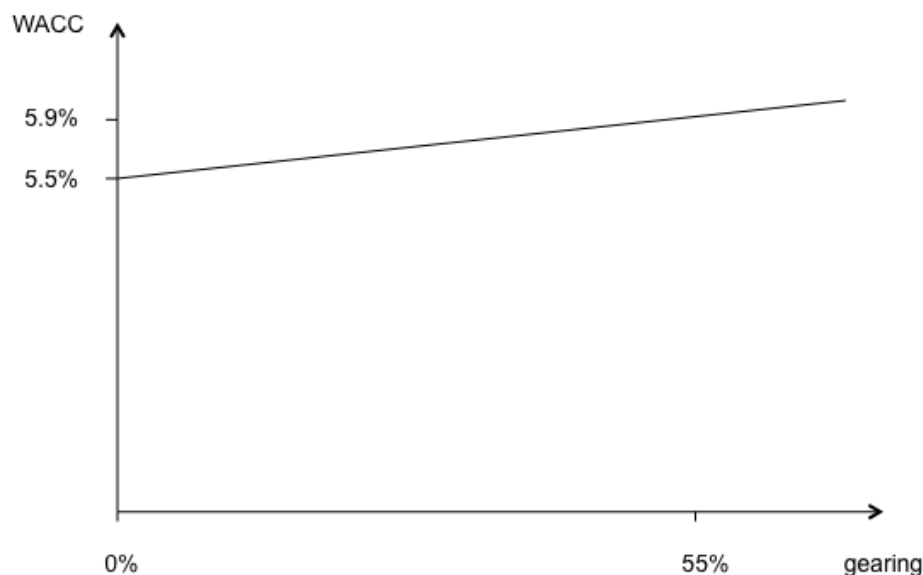
¹¹¹ CMA Energy Market Investigation Final Report, [Appendix 9.12, para. 71](#).

¹¹² Note that the GB energy retailers face systematic demand risk, whereas SONI enjoys a revenue cap. In the UR's eyes, this makes an energy retailer a riskier company and indicates that an estimate of SONI's cost of capital should sit no higher than an estimate of the GB energy retail cost of capital.

¹¹³ The cost of this activity is recognised separately within the UR's price control calculations via the stand-alone allowances for the costs associated with SONI's bank facilities, as set out in paragraphs 1.9(b) and 1.10(b) above.

seen that the cost of capital will not exceed the 5.9% rate of return that is factored into the UR's price control determination.

Figure 2: Ready reckoner for the WACC at different mixes of equity and bank financing



1.59 The UR draws attention here to its submissions in relation to the financing duty¹¹⁴. The aim specified in that duty is that *'licence holders are able to finance the activities which are the subject of obligations...'*¹¹⁵. This aim is met where a WACC is capable of supporting a reasonable range of capital structures, even if that requires some action by the company – for instance, where the company can secure its financeability by reducing its gearing, on the basis that the regulated rate of return will be sufficient to remunerate both equity providers and debt providers at this reduced gearing.

1.60 In relation to SONI, the 5.9% allowed rate of return in its price control ought to be capable of supporting a range of equity:debt mixes, including, crucially, a 100:0 wholly equity-financed capital base.

Why the UR's approach was not 'wrong' – equity financeability tests

1.61 Insofar as SONI gets to grips in its Notice of Appeal with this important principle, SONI's complaint is that the UR *'failed to give more than scant attention to equity financeability tests'*¹¹⁶.

1.62 The first point to make about this contention is that 'equity financeability tests' are not a conventional feature of a regulator's price review analysis. To the best of the

¹¹⁴ See paragraphs B.31 – B.47 above.

¹¹⁵ Article 12(2)(b) of the Energy Order, emphasis added.

¹¹⁶ SONI Notice of Appeal – NOA1, para. 19.16.

UR's knowledge, no UK regulator has ever applied the kind of tests (relating to minimum levels of dividend cover, dividend payout ratio and annual profit)¹¹⁷ that SONI and its expert KPMG insist the UR should have applied.

- 1.63 More fundamentally, the UR does not agree that 'equity financeability' rests on passing such tests. In the UR's assessment, equity will flow freely to a company so long as the net present value of the cashflows arising from equity investment is non-negative. In a regulatory setting, this $NPV \geq 0$ constraint is satisfied when i) the regulator's provisions for opex and capex constitute reasonable allowances for efficient expenditure, ii) there is a reasonable expectation that customers will pay back efficient investments over time, and iii) the allowed rate of return covers the opportunity cost of capital. The UR's view is that all of these conditions are satisfied in SONI's case, and, in particular, that the key to ensuring that the business is able to finance its activities is getting the allowed rate of return right, as set out above.
- 1.64 It is not necessary to layer other elements on top of the $NPV \geq 0$ test, as SONI and KPMG have done in their submissions. What SONI and KPMG are saying, with their focus on dividend cover and dividend payout ratios, is that equity providers require a minimum level of cash return over short time horizons (e.g. five years) even on $NPV \geq 0$ investments. This does not fit easily with the long-term horizon that many equity investors have, especially in the regulated sectors. It does not allow, in particular, for the way in which profits crystallise unevenly over the life of many investments.
- 1.65 The UR notes that the Competition Commission observed in the 2014 NIE price control inquiry that:

*'... if shareholders were able to withdraw large sums in periods with strong cash flow, it was reasonable they should also be willing to supply finance in periods of weaker cash flow. We considered that shareholders had an incentive to supply finance as long as the overall rate of return is in line with the WACC, and that the regulatory regime has appropriate provision for situations where shareholders are unable to, or refuse to, supply finance.'*¹¹⁸

- 1.66 This statement applies just as readily to the present case. SONI has had several years of very strong profits, due in part to the run down of its RAB.¹¹⁹ It is now entering a period which is tilted more towards new investment. In the circumstances, the UR does not consider that it is consistent with its statutory duties to require that the charges that customers pay ensure that SONI generates a strong cash return in every price control period. This is especially the case if the effect of such a requirement is that SONI earns excess returns over the long term.

¹¹⁷ KPMG1 – MC1/1, [sections 7.8 and 7.9](#).

¹¹⁸ CC Northern Ireland Electricity Limited price determination, [para. 17.100](#).

¹¹⁹ SONI has used these profits, in the main, to pay off borrowing which EirGrid took out in 2009 in order to acquire SONI.

Why the UR's approach was not 'wrong' – downside sensitivity analysis

- 1.67 SONI contends that the UR should have performed downside sensitivity tests. As to this, the UR notes two fundamental points.
- 1.68 First, a regulator's duty is not to provide a guarantee to a regulated firm that it will be financeable even in circumstances in which it underperforms significantly against its expenditure allowances. Rather, price controls should be set on the basis of the 'fair bet' principle – i.e. the very nature of a regulated firm's expenditure allowances is that they should be the best estimate of an efficient level of costs, which the firm may outperform, underperform or meet, with consequent impact on financial metrics.
- 1.69 From the UR's perspective, SONI appears to be saying that the UR should have set the allowed return at a premium level so that shareholders are able to earn at least their cost of capital even in downside states of the world. The UR's view is that this finds no support in, and indeed runs contrary, to the UR's statutory duties.
- 1.70 Second, both SONI and KPMG place considerable weight on downside risk that is said to arise in relation to costs falling within the scope of the D_t mechanism. SONI says that in relation to these costs '*outperformance is impossible but underperformance likely*'¹²⁰, which '*implies a significant expected loss to the Appellant*'¹²¹. KPMG assumes that these costs are subject to '*a clear and significant risk for SONI*'¹²².
- 1.71 Neither of these characterisations is accurate. The UR describes below how the D_t mechanism operates¹²³. On a proper understanding of the mechanism it is designed to, and does, de-risk the activities which are the subject of D_t allowances. SONI refers to those activities as if a D_t allowance was set once and the company was then at risk against it, and KPMG appears to share this understanding. But it is a characterisation which the UR does not recognise; in particular it takes no account of SONI's ability to return for additional D_t allowances where its efficient costs turn out to be greater than first estimated and it would otherwise be at risk of exceeding the initial cap.
- 1.72 It was unnecessary for the UR to model downside scenarios that are unrealistic and, with appropriate cost management and use of the D_t mechanism by SONI, should not occur in practice.

¹²⁰ SONI Notice of Appeal – NOA1, [para. 20.22](#).

¹²¹ SONI Notice of Appeal – NOA1, [para. 20.23](#).

¹²² KPMG1 – MC1/1, [para. 8.4.1](#) (in relation to PCNPs); an equivalent statement in relation to I-SEM and DS3 costs is made at [para. 8.3.2](#).

¹²³ See paragraphs 2.12 – 2.26.

Why the UR's approach was not 'wrong' – modelling errors

- 1.73 SONI claims that the financial modelling carried out by the UR was subject to errors in a number of respects¹²⁴.
- 1.74 These allegations have been reviewed by Mr Shankar Rajagopalan of Reckon in his witness statement. In short, the position in relation to each of the matters raised by SONI is as follows:
- (a) SONI's argument that the model did not reflect the projects referred to in the Final Determination misses the point. There are uncertainties about the level of costs to be incurred by SONI in relation to a number of projects during the price control period. That is why the flexible provision of the D_t mechanism is being used. The model was merely a tool to support the assessment of SONI's financial ratios under particular assumptions. It quite properly relied on the best forecasts available at the time when it was being applied.¹²⁵
 - (b) There are no internal inconsistencies of the type KPMG claims.¹²⁶
 - (c) The model did not need to include calculations for the downside scenarios that are identified by SONI – there was no reason to consider that this would have provided information of sufficient value to be worthwhile.¹²⁷ This view is supported by the response to SONI provided above¹²⁸.
 - (d) The alleged formula errors identified by SONI either do not exist or are ultimately not material to the conclusions derived from the modelling.¹²⁹
- 1.75 With regard to those modelling errors that were identified, Mr Rajagopalan has run a revised model resulting in interest cover ratios in the range 1.40 to 1.66, with an average of 1.52. As Mr Rajagopalan observes, these are consistent with target levels typically used by UK regulators for RAB-based utility companies¹³⁰.
- 1.76 Therefore, having corrected for these formula errors and re-run the modelling, there is nothing to suggest that the conclusions reached by the UR in respect of SONI's financeability were 'wrong'.
- 1.77 Moreover, and no less importantly, the UR would refer the CMA to the explanation that the UR gives above in relation to the weight that it placed on the financial ratio analysis. The analysis in question relates exclusively to a scenario in which SONI finances its investment with a 45:55 equity:debt capital structure. For the reasons

¹²⁴ SONI Notice of Appeal – NOA1, [paras 19.28 – 19.31](#).

¹²⁵ Shankar Rajagopalan, First Witness Statement – SR1, [paras 36 – 38](#).

¹²⁶ Shankar Rajagopalan, First Witness Statement – SR1, [paras 39 – 42](#).

¹²⁷ Shankar Rajagopalan, First Witness Statement – SR1, [paras 43 – 47](#).

¹²⁸ See paragraphs 1.67 to 1.72 above.

¹²⁹ Shankar Rajagopalan, First Witness Statement – SR1, [paras 48 – 89](#).

¹³⁰ Shankar Rajagopalan, First Witness Statement – SR1, [para 91\(b\)](#).

set out above, the UR placed greater weight on SONI's ability to finance itself with a 100:0 capital structure. Insofar as the alleged modelling errors are distinct and separate from the latter assessment, this component within SONI's grounds of appeal is incapable of dislodging the main pillar that underpins the UR's evaluation of SONI's financeability.

Parent Company Undertaking

- 1.78 SONI makes a number of complaints under the heading of Alleged Errors 1(b) and 1(c) about the UR's treatment of EirGrid's parent company undertaking.
- 1.79 In reviewing SONI's arguments, the CMA will need first to read the text of EirGrid's letter of undertaking to SONI, dated 11 March 2009. As that document makes clear in its opening words, it was given pursuant to both Condition 3A of the transmission system operator licence and Condition 3A of the market operator licence¹³¹.
- 1.80 In order to assess whether there was any error in the UR's price control calculations, it is necessary to consider two preliminary questions:
- (a) what is the amount of EirGrid's contingent support; and
 - (b) what is the cost of this contingent capital?
- 1.81 The answer to the first question is straightforward. The amount of EirGrid's standby commitment to SONI by virtue of the 11 March 2009 letter in respect of SONI's obligations under both the transmission system operator licence and the market operator licence is £10m – '*a maximum aggregate financial support that shall not exceed in any circumstances stg£10M*'.
- 1.82 The second question cannot be answered so easily. During the price control review, SONI argued that the cost to EirGrid was the full equity cost of capital. The UR did not agree with this assessment. The £10m is not money that SONI has actually taken from the shareholder, thereby depriving the investor of the opportunity to invest in other assets; it is money that the shareholder is obliged to inject into SONI in certain states of the world that may emerge in the future. In the UR's assessment, the contingent nature of this capital gives rise to a lower opportunity cost. Working out exactly what is that cost is admittedly not straightforward. In its decision, the UR opted for a 2.5% costing, which sits just above the 2.0% costing that the CMA put on contingent capital / letters of credit in its recent energy market inquiry¹³².
- 1.83 Again, it is important to note that SONI is not appealing this costing.
- 1.84 What SONI is arguing is that its shareholder should be paid more than the £10m x 2.5% = £250,000 per annum in revenue that would seem to emerge from the answers to questions (a) and (b) above. Specifically, SONI claims that the UR erred

¹³¹ Exhibit TH1/1.

¹³² CMA Energy Market Investigation Final Report, [Appendix 9.10](#), para 139.

when it chose not to include £250,000 of revenue in the system operator price control to add to the £250,000 that is provided for in the separate market operator price control.

- 1.85 The UR does not, however, understand how it can have been 'wrong' for it to have elected not to allow for a total of £500,000 of revenue for a £10m parent company undertaking. SONI's case appears to be that SONI Ltd benefits from the guarantee in two distinct parts of its business – one in relation to its market operator activities and one in relation to its system operator activities – and that the correct regulatory approach is to allow 2 x £10m x 2.5% of remuneration for the risk that EirGrid is taking.
- 1.86 This line of thinking is confused. SONI states that *'the TSO requirement for the PCG is separate from the SEMO requirement, reflects distinct risks as explained in AS1, and should be remunerated separately'*¹³³. However, while it is correct that there are two licence requirements, there is only one 11 March 2009 letter, one parent company undertaking, and one sum of £10m in contingent capital.
- 1.87 The undertaking is clear on its face that it, and the £10m aggregate sum for which it makes provision, represents the entire commitment of EirGrid under both licences¹³⁴.
- 1.88 It follows that if the cost of the contingent capital is 2.5%, the total remuneration that the shareholder requires is £250,000. The argument that EirGrid deserves 2 x £10m x 2.5% would only have any merit if EirGrid was required to provide two distinct and separate undertakings to the value of £10m each; creating, that is, an aggregate equity exposure of £20m. This is not the case.
- 1.89 On the basis that £10m x 2.5% = £250,000 is the right amount of remuneration for the contingent capital that EirGrid is providing, it was unquestionably not 'wrong' that the UR should decide that it was not appropriate to add to the £250,000 of revenue that EirGrid obtains through the SEMO price control. To do otherwise would be to create a double recovery, and hand SONI's shareholder excess return over and above the opportunity cost of capital.

ALLEGED ERROR 1(c) – The Financeability Assessment

- 1.90 The UR has had some difficulty understanding what Alleged Error 1(c) adds over and above the arguments made by SONI under 1(a) and 1(b). From the UR's perspective, Alleged Error 1(c) essentially repeats the points that SONI makes elsewhere about margin x expenditure, financial ratio tests and equitability financeability tests, without adding further clarity or value to its case.

¹³³ SONI Notice of Appeal – NOA1, para. 19.27.

¹³⁴ For these purposes, to put the matter beyond any dispute, it defines the two licences as a single licence – *'We refer to condition 3A of the Transmission System Operator Licence and condition 3A of the Single Electricity Market Operator Licence issued to you (hereinafter collectively referred to as the "Licence")'* (emphasis added).

1.91 Insofar as SONI does seek to adduce new analysis, the UR's response is as follows.

Expected equity returns, 2015-20

- 1.92 SONI and KPMG suggest that expected equity returns under the UR's price control determination will fall short of the identified cost of equity, thus making equity providers unwilling to invest. The key factor driving this expected under-performance is said to be the UR's treatment of network capital spend and other costs that are subject to the D_t mechanism; as SONI notes *'all other aspects of the regulatory framework are assumed to be fully symmetric'*¹³⁵.
- 1.93 The UR's views on the appropriateness of the treatment of network planning costs and other D_t items are set out in full in its response to Ground 2 below. However, in short, the presumption that the UR will exhibit a tendency to disallow efficiently incurred expenditure is a construction of SONI's imagination.
- 1.94 The D_t mechanism is based on a provision put in place by the Competition Commission in its determination of NIE's RP5 price control¹³⁶. It has been successfully used by both NIE and SONI over a number of years, consistently with the continuing financeability of each company¹³⁷.
- 1.95 The inclusion of a specific term allowing the UR to adjust the costs passed through to consumers where the UR can demonstrate that such costs are demonstrably inefficient or wasteful is new to this price control. However, that provision is again drawn from precedent established by the Competition Commission, and previous approvals granted to SONI under the D_t mechanism have specifically stated that only efficient costs will be recoverable¹³⁸.
- 1.96 None of this is new and none of it has previously caused difficulty for the company.
- 1.97 Like all regulators, the UR sets up its price controls so that the expected return on regulatory equity (RORE) is in line with the calculated cost of capital. SONI may, in reality, go on to out- or under-perform, but it is not the case that the 2015-20 price control is biased towards under-remuneration of the efficient costs that SONI will incur in carrying out its licensed activities, inclusive of a fair return on capital.
- 1.98 Rather than show any flaw in the UR's price control decision, KPMG's RORE analysis in fact helps to show why the decision was correct. If the CMA writes back in the deductions that KPMG makes for network planning costs/ D_t items, and the cost of the parent company undertaking (for the reasons set out in paragraphs 1.78 to 1.89

¹³⁵ SONI Notice of Appeal – NOA1, para. 20.24.

¹³⁶ NIE Determination, paras 5.246 – 5.270.

¹³⁷ In relation to SONI see, for example, letter from Robin McCormick to Tanya Hedley, 19 June 2012, TH1/4; Letter from Tanya Hedley to Robin McCormick, 11 December 2012, TH1/5; Letter from Jo Aston to Bill Thompson, 5 June 2013, TH1/5; Letter from Jo Aston to Nick Fullerton, 1 October 2013, TH1/7.

¹³⁸ Letter from Jo Aston to Bill Thompson, 5 June 2013, TH1/6; Letter from Jo Aston to Nick Fullerton, 1 October 2013, TH1/7.

above), it will observe that SONI's shareholder can expect to earn a 7.6% return on equity.

- 1.99 The UR considers that this is the right level of shareholder of return for the type of business SONI is. Alternatively, re-running KPMG's numbers with SONI's preferred 11% profit margin, the UR calculates that SONI's shareholder would make a return on equity of in excess of 13% per annum.¹³⁹ This far outstrips any reasonable estimate of the cost of capital and serves to encapsulate quite neatly how SONI's preferred framework would lead to excess returns.

SONI's alleged inability to secure financing from banks

- 1.100 SONI refers to its alleged inability to secure new bank debt¹⁴⁰.

- 1.101 In the first place, the UR has found it difficult to interpret the evidence that SONI has tabled in support of this claim. Aidan Skelly in his witness statement says that: '*No bank has been willing to lend to SONI on a standalone basis. In order to access debt, lenders require either a cross-guarantee from EirGrid or a letter of comfort from the Utility Regulator. I believe that it is highly unlikely that Utility Regulator would be willing to provide these letters...*'¹⁴¹. However, the suggestion that it is unlikely that the UR would provide a letter of comfort, which is also repeated by EirGrid's financial adviser¹⁴², is surprising because:

- (a) The UR has provided a letter of comfort in the past¹⁴³. That letter makes clear that it was written for disclosure to the banks (*'The Authority is happy for you to provide a copy of this letter to your financiers'*). It was in fact disclosed to [CONFIDENTIAL – REDACTED], as EirGrid's financial advisers confirm ([CONFIDENTIAL – REDACTED] *had previously received such a letter...*)¹⁴⁴. It remains extant and valid.
- (b) The UR has not been asked to provide a further letter of comfort.
- (c) The UR would have been, and it remains, happy to provide an appropriate letter of comfort if requested to do so¹⁴⁵.
- (d) In particular, the UR would be happy to make clear the nature and operation of the D_t term, as to which the banks may not have been fully or accurately

¹³⁹ Assuming the same 45:55 capital structure that underpins SONI's base 7.6% RORE figure.

¹⁴⁰ SONI Notice of Appeal – NOA1, [para. 2.9](#).

¹⁴¹ Aidan Skelly, First Witness Statement – AS1, [para. 31](#).

¹⁴² Letter from Goodbody to SONI, undated [but said to be 8 July 2016] – AS1/6, [page 2](#) (*'Goodbody would have to question whether SONI will be in a position to source such a letter from the Regulator'*).

¹⁴³ Letter from the UR to EirGrid, 26 May 2009 – TH1/2.

¹⁴⁴ Letter from Goodbody to SONI – AS1/6, [page 2](#).

¹⁴⁵ Indeed the UR has provided letters of comfort in relation to specific projects - Letter from Jenny Pyper to Robin McCormick, 19 April 2016, TH1/36; Letter from Jenny Pyper to Robin McCormick, 16 September 2016, TH1/42.

informed, noting that this mechanism was the subject of the UR's previous letter of comfort.

- 1.102 Second, taking into account the existing and prospective letters of comfort, the term sheets provided to SONI by potential lenders appear to indicate that it can obtain additional debt financing¹⁴⁶
- 1.103 Third, the UR notes that SONI has been able to secure the rollover of its existing £12m revolving credit facility¹⁴⁷. The ongoing availability of this important component within SONI's capital base for the whole of the 2015-20 control period should not be in doubt, not least given the existence of EirGrid's Condition 3A parent company undertaking and the UR's letter of comfort.
- 1.104 None of this evidence sustains SONI's contention that '*the banks have refused to lend to the Appellant*'¹⁴⁸.
- 1.105 There may be a question about how much in the way of additional facilities SONI will be able to secure for the purposes of financing investment expenditure. However, in the first place, the UR does not recognise the figure of £30 - £40 million in additional working capital which it is suggested that SONI will require during the price control period¹⁴⁹. In addition, given the manner in which the D_t mechanism operates to provide funding for significant projects through the tariff charges – as more fully outlined below¹⁵⁰ – this statement requires more explanation than it has been given.
- 1.106 Further, the UR reiterates the point made above: the question of whether SONI finances such expenditures through debt or through equity is a matter for SONI alone. The new price control was deliberately set up so to cover the cost of 100% equity funding of new investment and the UR's decision does not stand or fall according to the outcome of SONI's discussions with its banks.
- 1.107 The evidence presented by Mr Skelly has to be looked at in this light. If the banks are reticent to offer SONI £30 – 40 million of facilities, this is perhaps an indication that SONI is seeking to borrow too much. Alternatively, it could be that the shareholder needs to offer more in the way of a parent company guarantee to lenders. The UR notes that the allowed cost of debt (2.9% in real terms, equivalent to around 6.5% in nominal terms¹⁵¹) is high relative to current market rates and appears to offer more than enough revenue to cover the interest payable to lenders and an additional element of parent company support.

¹⁴⁶ AS1/05A-C – EirGrid's financial advisers state that [CONFIDENTIAL – REDACTED] has withdrawn (Letter from Goodbody to SONI – AS1/6, [page 3](#)) but there is no suggestion that [CONFIDENTIAL – REDACTED] do not remain willing to provide new lending.

¹⁴⁷ Aidan Skelly, First Witness Statement – AS1, [para. 41](#).

¹⁴⁸ SONI Notice of Appeal – NOA1, [para. 3.13\(b\)](#).

¹⁴⁹ Aidan Skelly, First Witness Statement – AS1, [para. 29\(c\)](#).

¹⁵⁰ See paragraphs 2.12 to 2.33.

¹⁵¹ The current rate of RPI inflation is 3.5%.

1.108 Ultimately, though, the UR is confident that SONI will be able to finance its activities for the reasons given in its rebuttal to SONI’s arguments on Alleged Error 1(b) above.

Conclusion

1.109 The analysis set out in this section explains:

- (a) why the UR acted appropriately when it sought to tie the profits that SONI earns to a fair rate of return on the capital that it has to take from investors;
- (b) how the alignment of the marginal rate of return to the cost of capital, and particularly the cost of new equity capital, ought to enable SONI to finance its activities in the 2015-20 regulatory period; and
- (c) why the UR was justified in rejecting SONI's margin x expenditure approach.

1.110 For these reasons, the UR respectfully suggests that SONI's Ground 1 challenge to the UR's price control decision should fail.

1.111 As a final observation, the UR highlights again that SONI's submissions on Ground 1 are noteworthy for the way in which they consistently fail to consider the reasons that the UR gave for its decision in the areas of return and financeability. As was the case during the UR's review proper, SONI appears fixated on promoting its preferred margin approach, and particularly its quest for remuneration for 'intangible assets', and does not address directly either the methodology or the specific calculations that underpin the UR's analysis of investor capital requirements and required return.

1.112 As a consequence of this approach, SONI falls well short of demonstrating that the UR's decision was 'wrong'. Indeed, for the most part, SONI has sought to sidestep completely its task of identifying the specific flaws that there are in the UR's decision and focuses on presenting an alternative approach that it happens to prefer.

1.113 For all of the above reasons, SONI's appeal on Ground 1, in respect of alleged errors 1(a) to 1(c), should be dismissed.

GROUND 2 – 'THE REVENUE UNCERTAINTY GROUND'**2.****The problem of uncertainty**

2.1 During the course of the price control period, SONI will undertake a number of projects, the costs for which are at the present time uncertain. Indeed the nature of these projects is such that not only does this uncertainty exist at the point of setting the price control, but it is likely to persist during the life of the projects themselves. The costs associated with those projects are therefore subject to an inherent, and unavoidable, double uncertainty.

2.2 This fact is not in dispute, but is acknowledged by SONI and its experts. For instance, in relation to pre-construction transmission network projects (**PCNPs**), SONI states –

*'As of the date of this Appeal, the Appellant expects to invest approximately £15-20 million in total in these projects over the Price Control Period although the estimates are wide-ranging as both the projects themselves and the project pipeline is continually being re-assessed and updated.'*¹⁵²

2.3 The report by Jacobs which is submitted by SONI in this appeal draws attention to the particular uncertainties that attend PCNPs during their life –

'The preconstruction phase is in itself uncertain – it is the point in the project at which SONI undertakes investigative works, assesses various options and their associated costs and considers alternatives to minimise the unknown elements...

*The projects facing the greatest uncertainty are those for new routes, or extensions to existing routes. These types of projects face a number of challenges outside of the control of SONI which generally result in longer preconstruction phase timescales and increased project costs. Jacobs, experience of these types of developments indicate the cost of the preconstruction phase can easily rise to twice that originally budgeted...'*¹⁵³

2.4 In his witness statement Bill Thompson states –

'Setting out a likely estimate for efficiently incurred pre-construction costs is not straightforward. The experience of the business and its staff (who transferred from NIE) tells us that due to the dependence of the costs on externalities, where the scale and scope of work will be challenging to manage, the probability distribution is unlikely to be in line with a normal distribution given that there is a much greater likelihood of unforeseen or cost volatility driven by the uncertainty in:

¹⁵² SONI Notice of Appeal – NOA1, [para. 3.32\(a\)](#)

¹⁵³ JM1/1, [p. 18](#)

(a) scope and scale of works, e.g. landowner engagement/consultation, environmental impact assessments;

(b) physical location of the investment, e.g. circuit length, sub-station requirements;

(c) technology, e.g. overhead versus underground; and

*(d) planning requirements, e.g. design, environmental planning.'*¹⁵⁴

2.5 Similar points in relation to cost uncertainty are made by SONI in relation to –

(a) The I-SEM¹⁵⁵ –

'The implementation of the I-SEM across the Republic of Ireland and Northern Ireland in 2017 will have implications in terms of the level of uncertainty faced by the Appellant because the SEM Committee's plans for detailed design and implementation work are continually evolving. The decision to invest here, its timing, and the overall design chosen, are all not within the Appellant's control.'

(b) The DS3 programme¹⁵⁶ –

'The delivery of wider DS3 programme raises cost uncertainties owing to the need to ensure that the TSO can securely and safely operate the transmission power system with increasing amounts of variable non-synchronous renewable generation... As in respect of I-SEM, the requirements for detailed implementation of the DS3 System Services element of the programme are continually evolving and is therefore subject to some uncertainty...'

The UR's solution to the problem

2.6 The effect of this uncertainty is that the costs of such projects cannot be subject to an *ex ante* allowance in the normal regulatory manner, either at the commencement of the price control, or upon later application. Decisions may be made within the price control period at the point in time when the amount of costs required has become clearer. However, as the amount of costs actually needed will not fully be known at the point of initial decision, some flexibility is still required – both to allow for cost increases where necessary, and to protect consumers from funding amounts which have not been spent.

2.7 The UR's solution to this problem of uncertainty is the D_t mechanism contained in paragraph 8 of Annex 1 to SONI's licence.

¹⁵⁴ Bill Thompson, First Witness Statement – BT1, [para. 197](#).

¹⁵⁵ SONI Notice of Appeal – NOA1, [para. 3.32\(b\)](#).

¹⁵⁶ SONI Notice of Appeal – NOA1, [para. 3.32\(c\)](#).

- 2.8 Before describing that mechanism two important points must be made at the outset.
- 2.9 First, the D_t mechanism is not new. It is a process that has been used before both for SONI and – with respect to the same PCNP projects for which SONI has taken responsibility – for NIE. Nothing in that previous history of use has established that it is inappropriate. SONI claims that mechanism is unworkable. The history of its usage demonstrates that this is incorrect – it has been working effectively for some years.
- 2.10 Second, the D_t mechanism is adapted from a similar mechanism put in place by the Competition Commission in its determination of NIE's RP5 price control to deal with a similar problem of double uncertainty¹⁵⁷.
- 2.11 The UR is satisfied that the mechanism is reasonable, proportionate and well within the margin of appreciation accorded to the UR as a regulator. It is a rational response to a problem that requires to be addressed, and it resolves uncertainty rather than creating it. It cannot be said to be 'wrong', particularly given its previous adoption by the Competition Commission.

The D_t mechanism

- 2.12 The operation of the D_t mechanism can briefly be described as follows.
- 2.13 Before commencing each project, SONI may make an application to the UR setting out the details of the project and its estimated costs. In relation to I-SEM and elements of DS3, the decisions approving the projects themselves and their high level outputs will already have been made by the SEM Committee. Where such decisions have already been made, the UR's task on receiving a D_t application will simply be to decide on the efficient level expenditure that SONI is likely to require to undertake in order to complete the project.
- 2.14 In relation to other D_t applications, including PCNPs, the UR will first be required to decide whether a particular project should commence or continue before deciding on the allowance that should be set in relation to its costs.
- 2.15 The UR has no legal obligation to approve any particular project for funding. This is because:
- (a) the UR's duty in Article 12(2)(b) of the Energy Order is to have regard to the need to secure that SONI is able to finance the activities which are the subject of SONI's obligations under the Energy Order and the Electricity Order; and
 - (b) SONI does not have legal obligations in respect of (for example) any particular PCNP.
- 2.16 SONI's legal obligations in this respect are confined to broad 'target duties' in its role as TSO, such as the duty¹⁵⁸ –

¹⁵⁷ NIE Determination, paras 5.246 – 5.270.

'(a) to take such steps as are reasonably practicable to –

(i) 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...'

- 2.17 A 'target duty' is an obligation which is essentially goal-focused in nature. Although Article 12 requires SONI to aim to achieve a defined objective, it will be sufficient for it to take *'appropriate steps at a strategic level within available resources'*¹⁵⁹ to achieve that aim. A failure to meet the objective is not, by itself, considered to be a breach of the duty. Nor can the duty be construed as an *'obligation to do anything in any particular case within any particular timescale'*¹⁶⁰ – particularly where the UR has determined that there is no valid cost-benefit case for authorising expenditure (or continued expenditure) on a project.
- 2.18 Where the UR does approve a D_t application it will not grant SONI an allowance which it will be able to recover regardless of what it spends. The uncertainty around these costs is such that SONI will not be able to provide estimates precise enough to make the provision of such an *ex ante* allowance appropriate.
- 2.19 Rather, the UR will allow costs up to a cap. This means that the UR will provide SONI with access to funds, recoverable via its tariffs, upon which it can draw according to its needs.
- 2.20 The UR will expect SONI to build in a prudent and appropriate degree of contingency to its request. For example, in providing assurances with respect to SONI's costs in relation to I-SEM, the UR recognised that SONI had built a 10% contingency into its estimate¹⁶¹.
- 2.21 If during the life of the project SONI realises that its initial estimate appears likely to have been too low, in particular where an unexpected event occurs or further and better information becomes available, it is free to make a further D_t application to request an increase to the initial cap. The ability to do so both recognises and provides an answer to the double uncertainty that will attend a D_t application.
- 2.22 The fact that SONI is granted, in effect, access to a pot on which it can draw rather than a fixed *ex ante* allowance will also mean that SONI passes through to customers what it actually spends. It would not be appropriate to allow SONI to recoup a sum which may build in a substantial contingency which is not in fact required.
- 2.23 During the life of the project, SONI will report to the UR on its actual spend. The UR will then adjust the tariffs charged by SONI using the K_t term contained in paragraph

¹⁵⁸ Article 12(2)(a) of the Electricity Order.

¹⁵⁹ [R \(Morris\) v Rhondda Cynon Taf County Borough Council \[2015\] EWHC 1403 \(Admin\)](#) at [112].

¹⁶⁰ [R \(R and others\) v The Child and Family Court Advisory and Support Service \[2012\] EWCA Civ 853](#) at [70].

¹⁶¹ Letter from Jenny Pyper to Robin McCormick, 19 April 2016, TH1/36.

- 2.2(f) of Annex 1 to allow SONI to pass through its actual costs where these are less than its allowed cap.
- 2.24 Under the K_t term the UR may also disallow any costs that the UR can demonstrate are inefficient or wasteful. Again this is a mechanism to protect consumers, in this case by ensuring that they are not exposed to funding inefficient costs. It is entirely within SONI's control to incur costs in an efficient way and such a provision will pose no threat to a company acting in accordance with good business practice.
- 2.25 Both the D_t mechanism and the provision in respect of demonstrably inefficient or wasteful expenditure (**DIWE**) draw from similar provisions put in place by the Competition Commission as part of its determination of NIE's RP5 price control.
- 2.26 That determination followed a *de novo* consideration of NIE's price control, under the statutory mechanism for price control references which preceded the current system of appeals. Consequently, it was not the case that these were provisions put in place by the UR and the Commission merely considered them not to be 'wrong' (as may now be the case under the present appeal system). Rather, the Commission itself determined upon those mechanisms as it considered them to be the right solution to similar problems relating to uncertain costs.

Decisions made under the D_t mechanism

- 2.27 SONI must use its reasonable endeavours to make D_t applications prior to 1 April in each year – the idea being that, if approved, these costs will then flow through into the new tariffs which commence from 1 October in the same year.
- 2.28 This means that SONI will be able to recoup its money while spending it. It will not need to approach its banks for debt finance to cover the entire cost of a project. At most it will require an appropriate amount of working capital, through a short term credit facility, prior to the commencement of recovery of its costs through tariffs, to to cover any time-lag between spending the money and recovering it.
- 2.29 However, SONI states¹⁶² –
- 'a constant theme in the Appellant's interaction with banks is their perception that there is no clarity on the likely revenue streams on which security they are being asked to lend.'*
- 2.30 It is yet to be demonstrated that SONI has properly explained the operation of the D_t mechanism to its banks, given that it will be able to recover its costs through tariffs during the life of the project.
- 2.31 In addition, it is not clear why SONI would be approaching its banks at this stage to fund projects which may not come to pass. Rather, the more logical approach would

¹⁶² SONI Notice of Appeal – NOA1, [para. 3.28](#).

be to approach its banks to secure whatever short term financing is required once approval for a project has been received from the UR.

- 2.32 In doing so it will be able to present its banks with a regulatory decision by the UR which should provide even greater assurance to a lender than any letter of comfort that the UR might issue¹⁶³. This is because each such decision is an indication that costs incurred up to the cap are presumed to be efficient and can be recovered via tariffs to the extent that those costs are actually incurred. Following approval, SONI will not be required to prove that such costs are indeed efficient, and they will only be disallowed to the extent that the UR can demonstrate that they are inefficient or wasteful.
- 2.33 The effect of the this mechanism is to generate an appropriate degree of certainty at the time at which it is needed, and ensure SONI's financeability in a way that is both reasonable and proportionate. The mechanism strikes a balance between protecting customers from inefficient costs and ensuring that SONI can fund its licence obligations through a flexible process that allows it to seek costs as the need arises in circumstances where these are uncertain at the outset of the price control and remain so during it.
- 2.34 In line with the domestic legal framework and EU law, the decisions made by the UR under the D_t mechanism will be subject to judicial review in the same way as the majority of its other decisions which affect regulated companies.

SONI's appeal

- 2.35 SONI argues that the UR has failed¹⁶⁴ –
- 'to secure the Appellant's financeability by failing to ensure that adequate arrangements were put in place to deal with the significantly uncertainties that the Appellant faces during the Price Control Period. In particular, over 35 per cent of revenues remain uncertain. This has created uncertainty that revenues will not be secured for the Appellant to fulfil its functions and licence obligations which has in turn affected the Appellant's ability to secure finance from investors.'*
- 2.36 SONI alleges that the statutory grounds on which the UR's decision in relation to managing uncertainty was 'wrong' are as follows¹⁶⁵ –
- (a) The UR failed under Article 14D(4)(a) of the Electricity Order to properly have regard to the need to secure that licence holders are able to finance their regulated activities, as required by Article 12(2)(b) of the Energy Order.

¹⁶³ Although it should be noted that in some cases the UR has in fact provided letters of comfort, despite SONI's statements to the contrary (Aidan Skelly, First Witness Statement – AS1, [para. 117](#)).

¹⁶⁴ SONI Notice of Appeal – NOA1, [para 4.3\(b\)](#).

¹⁶⁵ SONI Notice of Appeal – NOA1, [para 22.17](#).

- (b) The UR failed under Article 14D(4)(a) to properly have regard to its duties under Article 12(5)(a) of the Energy Order to promote the efficient use of electricity and efficiency and economy in the generation, distribution, transmission and supply of electricity.
- (c) The UR failed under Article 14(D)(4)(d) in that the modifications fail to achieve, in whole or in part, their stated effect as regards the UR's failure to secure the Appellant's financeability and, specifically, as regards the UR's introduction of a two-stage approval process for recovering uncertain costs.
- (d) The UR is in repeated breach of its obligations relating to best regulatory practice in failing to adopt a suitable approach to managing uncertainty.

What SONI has, and has not, pleaded

- 2.37 It is notable that SONI does not seek to rely on the statutory grounds in relation to errors of fact or law. This is particularly surprising as, in relation to several of the errors in Ground 2, SONI levels criticisms against the UR which, had they any merit, would appear to mean that the UR's decision was wrong in law.
- 2.38 For example, the entirety of SONI's Alleged Error 8 is predicated on a failure by the UR to conduct the consultation required by statute in relation to the Q_t mechanism (despite the fact of SONI having submitted a response to the relevant consultation arguing against that very proposal¹⁶⁶). Under Alleged Error 7, SONI asserts that the UR has failed to comply with a legal obligation to issue guidance (despite failing to identify the source of that obligation – which does not in fact exist). Likewise, in relation to Alleged Errors 1 and 6, SONI questions the UR's *vires*.
- 2.39 The fact that SONI does not seek formally to plead that the UR's decision was wrong in law¹⁶⁷ is indicative of the weakness of its assertions of unlawfulness. They are essentially advocacy points and should be recognised as such.
- 2.40 Nor does SONI suggest that the UR has failed to give appropriate weight – within the meaning of statutory ground 14D(4)(b) – to any of the outputs that SONI is required to deliver over the price control period.
- 2.41 In terms of those grounds on which it does seek to rely, SONI has seen fit to supplement the list of statutory grounds outlined in Article 14D(4) of the Electricity Order with an additional ground of its own devising – failure to meet obligations relating to '*best regulatory practice*'.
- 2.42 What an obligation relating to best practice would be and where it may be found is nowhere explained in the Notice of Appeal¹⁶⁸. Even were such an obligation to exist

¹⁶⁶ SONI Transmission System Operator Licence: Proposed Licence Modifications Consultation Paper, BT1/43.

¹⁶⁷ Article 14D(4)(e) of the Electricity Order.

¹⁶⁸ It may be that SONI's position stems from a conflation of the principles of administrative law with the principles of best regulatory practice based on an erroneous reading of comments made by the Competition

- which it does not – it is not one of the statutory grounds on which the CMA may allow an appeal.
- 2.43 The appeal to best practice – which features in Alleged Errors 2, 5 and 7, and makes up the majority of the submissions on Alleged Error 4 – serves as a means for SONI to introduce the issue that truly lies at the heart of this appeal. That issue is that SONI simply disagrees with some of the decisions that the UR has made as part of its price control and would have preferred different decisions to have been made.
- 2.44 In some cases SONI points to alternative methods and processes that could have been used – as in Alleged Errors 4 and 5. In such cases the simple fact that other regulators have approached an issue differently is taken to mean that those other approaches: (i) are superior to that taken by the UR, and (ii) must be adopted by the UR.
- 2.45 In other cases the best practice point is raised in a more nebulous way. In relation to Alleged Error 2, it relates to certainty. In Alleged Error 7 it is nowhere identified what the best practice alleged to be breached actually is.
- 2.46 However, the mere existence of alternatives to the approach taken by the UR does not mean that the UR's decision is 'wrong'. Indeed in many cases the approach taken by the UR reflects that taken by the Competition Commission in its determination of NIE's RP5 price control.
- 2.47 Even if the CMA disagrees with the UR's approach and would have done something different, it is clear that this by itself does not mean that the regulator's decision will be 'wrong' on one of the statutory grounds¹⁶⁹.
- 2.48 In view of the fact that most of SONI's case in relation to Ground 2 comes down to simple disagreement with the UR, the UR's submission is that the standard of review appropriate to this appeal is fatal to that case.

What SONI must establish in order to succeed and why it fails to do so

- 2.49 To succeed on its Ground 2, as pleaded, SONI must establish not only that one or more of the errors it identifies exists, but that those errors create uncertainty which in turn adversely affects SONI's financeability. That adverse effect must render the decision wrong on one of the (actual) statutory grounds that SONI pleads in relation to Ground 2.
- 2.50 Each link in this chain of causation must be established, and it is for SONI – as the Appellant – to make and to prove its case. It must do so on the basis of clear,

Commission in the Phoenix Natural Gas price control determination (SONI Notice of Appeal – NOA1, paras [10.42 – 10.43](#)). However, those comments are discussed by SONI in relation to the error of law ground of appeal (Article 14D(4)(e) of the Electricity Order) which is not pleaded with respect to Ground 2.

¹⁶⁹ Northern Powergrid, [para. 3.27](#); and see the full analysis of the standard of review in Section B above.

consistent and coherent arguments and, where it claims a particular effect, those arguments must be supported by evidence.

- 2.51 Both of these elements are missing from SONI's submissions with respect to Ground 2.
- 2.52 Indeed it is a very high hurdle for SONI to succeed in establishing that the UR's decision is 'wrong' in those respects in which it adopts provisions created previously by the Competition Commission to deal with similar issues in a related context.
- 2.53 With respect to each alleged error, SONI's case proceeds predominantly by assertion. But an assertion, no matter how many times it is repeated, does not convert itself into evidence. For example, under Alleged Error 2, SONI states that the UR's approach to funding PCNPs '*significantly impacts [SONI's] financeability*'¹⁷⁰. It does not explain how, nor produce evidence from banks or shareholders to support this bald claim. This is so even though financeability is at the core of SONI's claim, and all of the information to support its position should be in its possession.
- 2.54 As will be seen in the following sections, this lack of explanation and evidence is fatal to SONI's submissions with respect to Ground 2. In each case where SONI asserts that the UR has not consulted properly or lacks the *vires* to take a particular decision, the UR is able to point to evidence to the contrary. In each case where SONI asserts that the decision taken by the UR is inappropriate, the UR is able to provide a positive explanation – rooted in its statutory duties – as to why its approach cannot be held to wrong on any of the statutory grounds.

SONI's proposed relief

- 2.55 In order to succeed, not only will SONI need to establish that the UR's decision is wrong on one of the (actual) statutory grounds on which it relies, it will also need to establish that the relief it seeks provides a better alternative to the mechanisms put in place by the UR. It fails to do so.
- 2.56 As noted in relation to Ground 1 above, in circumstances in which SONI has failed to make its case that the UR's decision is wrong, it is not strictly necessary to consider the remedies that it proposes. Again, however, the UR does so for completeness.
- 2.57 It is unusual for an Appellant to present detailed drafting in its Notice of Appeal in relation to the remedy for which it contends. SONI has done so. The UR does not propose at this stage to analyse in detail SONI's suggested remedies unless and until the CMA makes any provisional finding in SONI's favour. Until that time the UR must reserve its position.
- 2.58 However, even the most cursory review of SONI's proposals illustrates that what it seeks is inappropriately and unreasonably balanced in the company's favour. For present purposes the following features may briefly be highlighted –

¹⁷⁰ SONI Notice of Appeal – NOA1, [para. 24.15](#).

- (a) SONI wishes to be able to decide for itself on the PCNP projects that it will undertake, without the need for regulatory approval¹⁷¹.
 - (b) In relation to Significant Projects, any amount SONI proposes for pre-approval (not which has actually been approved) is to be treated as an allowance¹⁷².
 - (c) Unlike other allowances these will not be subject to the 50/50 cost risk sharing mechanism¹⁷³.
- 2.59 The effect of these proposals is that SONI will simply be able to pass through costs which have not been approved and which have been fixed at a point when accurate estimates as to what is needed are not possible.
- 2.60 Where SONI does not spend the money, it has proposed it will keep it. The only check will be the disallowance of costs which are DIWE and even then the UR will be required to make a decision disallowing such costs within a short timeframe – a restriction previously rejected by the Competition Commission.
- 2.61 The UR's approach is balanced, proportionate and in line with both previous practice and that taken by the mechanisms devised by the Competition Commission. It provides certainty and financeability together with appropriate protections for consumers in line with the UR's principal objective.
- 2.62 SONI's proposal is none of these things. It seeks to strip away appropriate regulatory scrutiny of projects and costs, and exposes consumers to the very asymmetric risk of which SONI itself (wrongly) complains.

¹⁷¹ SONI Notice of Appeal – NOA1, paras 46.28 – 46.29.

¹⁷² SONI Notice of Appeal – NOA1, para. 46.35(ii).

¹⁷³ SONI Notice of Appeal – NOA1, para. 46.29(iv).

ALLEGED ERROR 2 – Failure to provide a cost recovery mechanism for PCNPs

Introduction

- 2.63 From 1 May 2014 SONI has assumed the responsibilities in relation to network planning that previously sat with the Transmission Asset Owner, NIE. Part of SONI's function in this regard is to advance PCNPs¹⁷⁴ through to the commencement of construction, at which point they pass to NIE for completion.
- 2.64 SONI currently expects to invest £15 – 20 million in costs related to PCNPs over the price control period.
- 2.65 In its Final Determination, the UR set out a process for dealing with these costs which involves SONI seeking initial approval for its costs prior to the commencement of each project and then recovering costs from NIE for those projects which the latter takes forward to the construction stage. Those costs that do not proceed to construction will be claimed for by SONI using the D_t mechanism.
- 2.66 SONI does not accept that mechanism and wishes its costs in relation to PCNPs to be passed through to consumers subject only to an *ex post* regulatory check which must take place within a short time window. It raises a number of points against the UR's proposal, all of which presumably shelter under the statutory grounds of appeal identified above with respect to Ground 2 generally. These points range from a passing assertion that the UR had no power to impose the mechanism to a suggestion that the lack of detail as to the actual process for applications is having an effect on SONI's ability to finance its activities.
- 2.67 None of the points made in relation to Alleged Error 2 have merit. The mechanism proposed by the UR is an appropriate response to a set of uncertain costs where there is a need for sufficient regulatory oversight to ensure that those costs are efficiently incurred.

The Decision on cost recovery for PCNPs

- 2.68 The UR's decisions in SONI's price control relating to PCNPs are set out in the Final Determination and further explained in the UR's letter to SONI of 30 September 2016¹⁷⁵. In particular –
- (a) SONI will submit a D_t application in respect of each PCNP at the outset of the project. Where appropriate, the UR will approve the project and set a cost cap in relation to the costs associated with it¹⁷⁶.

¹⁷⁴ Referred to in UR documents as 'Transmission Load/Capacity Related Projects' and in Annex 1 to SONI's licence as 'Transmission Network Pre-construction Projects'.

¹⁷⁵ Letter from Tanya Hedley to Leigh McCarthy, 30 September 2016, BT1/66.

¹⁷⁶ UR Final Determination – NOA1/12, para. 77.

- (b) SONI will recover its actual costs through the System Support Services (**SSS**) tariff during the pre-construction phase of the project¹⁷⁷.
 - (c) The value of the project will also accumulate on a separate RAB upon which SONI will earn a rate of return¹⁷⁸.
 - (d) At the end of the pre-construction stage one of two things will happen¹⁷⁹ –
 - (i) Where the project proceeds to construction by NIE, NIE will 'buy' the relevant RAB from SONI. The value will then be removed from SONI's RAB and placed on NIE's. SONI will be reimbursed through the Transmission Interface Arrangements (**TIA**) framework with NIE recovering the cost through the Transmission Use of System (**TUoS**) tariff.
 - (ii) Where the project does not proceed to construction, the value of the RAB will be refunded to SONI through the SSS tariff.
- 2.69 The provision through the price control of an upfront allowance based on estimates would be inappropriate given the uncertain nature of costs in relation to PCNPs. This uncertainty can be illustrated readily by the fact that, in its business plan, SONI had estimated that the costs to be recovered in relation to PCNPs would be around £28 million, but now considers that these costs will be £15 - £20 million.
- 2.70 SONI explains that¹⁸⁰ –
- 'the reason for difference in estimates over time is that both the project pipeline and the projects themselves are assessed, re-assessed and updated on an ongoing basis, often adjusting significantly and mainly due to external factors such as planning applications.'*
- 2.71 It is precisely in view of such uncertainty that a case-by-case approval mechanism is appropriate, which can be supplemented as required through additional applications under the D_t mechanism if costs will unavoidably exceed the approved cap, and which is subject to an *ex post* check to ensure that actual costs are not demonstrably wasteful or inefficient.
- 2.72 This policy position was incorporated in paragraph 8.1(g) of the proposed licence modifications by providing that SONI may, subject to exceptions, make a claim (to the UR) in respect of any reasonable and efficient costs incurred in respect of the electricity transmission network planning associated with a 'Transmission Network Pre-Construction Project' (as defined).

¹⁷⁷ UR Final Determination – NOA1/12, [para. 489](#).

¹⁷⁸ UR Final Determination – NOA1/12, [para. 491](#).

¹⁷⁹ UR Final Determination – NOA1/12, [para. 483](#).

¹⁸⁰ SONI Notice of Appeal – NOA1, [para. 24.3](#).

- 2.73 Any claim made under paragraph 8 may only be made in relation to costs not recovered under the Transmission Owner Licence (see paragraph 8.3(c)).
- 2.74 'Transmission Network Pre-Construction Project' was defined (in paragraph 1.1 of the proposed licence modifications) to include only projects '*approved by the Authority*'. This means that if a project does not have the prior approval of the UR, it cannot be a Transmission Network Pre-Construction Project and SONI may not make a claim under paragraph 8.1(g) in respect of that project.
- 2.75 As stated at paragraph 492 of the Final Determination, the UR will continue to work with both SONI and NIE in relation to network pre-construction projects.
- 2.76 The UR notes that further work is still required to finalise the mechanism within Section N of the TIA framework, under which SONI will be reimbursed for costs it has incurred relating to pre-construction projects which proceed to construction. It is for SONI and NIE to propose changes to the framework for consultation and the UR's approval in line with Condition 18 of SONI's licence. Once that work has been undertaken, SONI will be able to invoice NIE under the TIA framework for costs in relation to projects which proceed to construction.
- 2.77 As with costs incurred relating to pre-construction projects which do not proceed to construction, the UR does not expect to approve costs which are unreasonable or inefficient.
- 2.78 Until such time as a project is transferred to NIE for construction or is abandoned, it will accumulate on a separate RAB with respect to which SONI will earn a rate of return¹⁸¹.

SONI's submissions on Error 2

- 2.79 SONI's section on '*Why the Utility Regulator's Decision is Wrong*' begins by asserting that it is '*unacceptable*' that the UR should '*fail to provide a mechanism*' for SONI to recover the estimated £15 – 20 million costs associated with delivering PCNPs¹⁸².
- 2.80 However, over the course of the succeeding paragraphs, SONI cites a number of concerns with the mechanisms that it complains do not exist. The conclusion to the section returns again to the theme of failure to provide a mechanism.
- 2.81 Properly construed, SONI's complaint is not about the absence of a mechanism, but about disagreement with mechanisms that have in fact been provided.
- 2.82 SONI asserts that the UR's approach –
- (a) is *ultra vires* as it lacks the power to introduce an *ex ante* approval

¹⁸¹ UR Decision on Licence Modifications – NOA1/18, [para. 93](#).

¹⁸² SONI Notice of Appeal – NOA1, [para. 24.10](#).

mechanism¹⁸³,

- (b) exposes SONI to asymmetric risk in respect of the costs of PCNPs as it cannot benefit from efficiency savings but is exposed to loss in a downside scenario¹⁸⁴, which in turn significantly impacts its financeability¹⁸⁵,
- (c) gives rise to a real risk of delay, hindering project efficiency and impeding SONI's ability to fulfil its obligations under the TSO Licence¹⁸⁶, and
- (d) is contrary to '*best regulatory practice*'¹⁸⁷.

2.83 None of these points are pleaded in sufficient detail. For example, despite stating that it has received advice from leading counsel¹⁸⁸, SONI's assertion that the UR is acting *ultra vires* is not supported by any legal analysis and, in particular, does not engage with the legal points made by the UR when SONI first made this assertion as part of the statutory consultation process¹⁸⁹.

2.84 Likewise, and most importantly, no substantive explanation or evidence is provided as to the claimed effect on SONI's financeability beyond the bare claim that such an effect exists.

Response to Alleged Error 2

The UR's vires

2.85 It is noted that despite the assertion that the UR has acted *ultra vires*, SONI has not sought formally to plead that the UR's decision was wrong in law under Article 14D(4)(e) of the Electricity Order.

2.86 This is a telling omission, as is the fact that such a potentially fundamental legal point receives a single line in the Notice of Appeal and two paragraphs in a witness statement¹⁹⁰. Were the point to have any merit it would plainly be front and centre of SONI's case in relation to PCNPs. The fact that it is not shows that SONI and its legal advisors are well aware of its weakness.

2.87 SONI states that it has received advice from leading counsel to the effect that the UR does not have the vires – either in statute or under the TSO Licence – to impose an *ex ante* approval mechanism in respect of PCNP costs.

2.88 It is a surprising assertion that an economic regulator – such as the UR – lacks the

¹⁸³ SONI Notice of Appeal – NOA1, [paras 24.12\(c\) and 24.20](#).

¹⁸⁴ SONI Notice of Appeal – NOA1, [para. 24.12\(b\)](#).

¹⁸⁵ SONI Notice of Appeal – NOA1, [para. 24.15](#).

¹⁸⁶ SONI Notice of Appeal – NOA1, [para. 24.12\(a\)](#).

¹⁸⁷ SONI Notice of Appeal – NOA1, [para. 24.10](#).

¹⁸⁸ Bill Thompson, First Witness Statement – BT1, [para. 192](#).

¹⁸⁹ Letter from Tanya Hedley to Leigh McCarthy, 30 September 2016, BT1/66.

¹⁹⁰ Bill Thompson, First Witness Statement – BT1, [paras 191 – 192](#).

power to impose an *ex ante* approval mechanism to ensure that the costs incurred by a regulated entity are efficient. The UR has not had sight of the advice that SONI has received to the contrary – nor any summary of it, beyond the bare assertion that it exists¹⁹¹.

2.89 Notwithstanding this – and contrary to SONI's assertion¹⁹² – the UR has previously set out its position in this regard in its letter to SONI dated 30 September 2016¹⁹³.

2.90 In terms of the UR's vires to include the relevant conditions in SONI's licence, under Article 11(1)(a) the Electricity Order, a licence may include –

'... such conditions (whether or not relating to the activities authorised by the licence) as appear to the grantor to be requisite or expedient having regard to the duties imposed by Article 12 of the Energy (Northern Ireland) Order 2003'.

2.91 Article 11(3) of the Electricity Order provides that –

'Without prejudice to the generality of paragraph (1)(a), conditions included in a licence by virtue of that sub-paragraph may require the licence holder –

...

(d) to refer for approval by the [UR] such things falling to be done under the licence... as are specified in the licence or are of a description so specified.'

2.92 As outlined above, the D_t term in paragraph 8 of Annex 1 to SONI's licence – together with the definition of 'Transmission Network Pre-Construction Project' – provides the relevant licence mechanism with respect to PCNPs that do not proceed to construction. Article 11 clearly provides the basis for the UR to modify SONI's licence to include a condition of this nature.

2.93 More broadly, the UR has the power to do anything which is calculated to facilitate, or is conducive or incidental to the performance of its functions¹⁹⁴. The UR's principal objective is protecting the interests of consumers¹⁹⁵. It also has a duty to carry out its functions in the way it considers best calculated to promote efficiency and economy on the part of persons licensed to participate in the transmission of electricity¹⁹⁶.

2.94 SONI's costs in relation to PCNPs will ultimately be borne by consumers – whether through SSS or TUoS tariffs. Given the UR's obligations it is clear that it has the vires to require *ex ante* approval of such costs.

¹⁹¹ Bill Thompson, First Witness Statement – BT1, para. 192.

¹⁹² SONI Notice of Appeal – NOA1, para. 24.12(c).

¹⁹³ BT1/66.

¹⁹⁴ Paragraph 11(1) of Schedule 1 of the Energy Order.

¹⁹⁵ Article 12(1) of the Energy Order.

¹⁹⁶ Article 12(5)(a) of the Energy Order.

Asymmetric risk and financeability

- 2.95 The absence of a mechanism through which SONI can benefit by bringing costs in under its approved cap is not ‘wrong’ on any of the statutory grounds of appeal.
- 2.96 Taking its overarching argument as to financeability, as a simple matter of logic, if SONI is granted approval of its costs up to a cap and is then able to complete the necessary work for less, the fact that it cannot retain the difference does not affect its financeability as it is able to recover its costs in full, to the extent that this is not demonstrably inefficient.
- 2.97 In addition, the UR expects SONI to include a prudent measure of contingency into the estimates that it provides for approval.
- 2.98 Where, during the course of a project, SONI comes to the view that its approved costs will be insufficient, the UR has made it clear that SONI can apply for further costs and, where the UR judges these to be appropriate, they will be granted. NIE can take similar steps with respect to projects that proceed to construction¹⁹⁷.
- 2.99 Until a project either proceeds to construction or is abandoned, SONI will benefit from a rate of return earned on the separate RAB under which such projects will sit, fully remunerating its reasonable cost of capital.
- 2.100 The financial risk that SONI points to therefore does not exist and it presents no explanation or evidence of how its financeability has been or will be adversely affected. The assertion in Aidan Skelly's witness statement that two banks have '*expressed concerns about the absence of clarity and codification*'¹⁹⁸ in relation to the funding of PCNPs is far from sufficient evidence – particularly in view of the UR's offer to speak to SONI's banks to provide whatever clarity they required¹⁹⁹.
- 2.101 Where SONI overspends on a particular project without having returned to the UR to ask for further funds, or where it incurs costs that are found to be inefficient, it cannot expect to be able to pass those costs through to consumers.
- 2.102 It is up to SONI (and within its control) to ensure its own spending efficiency, to be alive to any likelihood of cost overruns, and to make the appropriate application to the UR where these are unavoidable. Consumers should not be held liable where SONI fails to do so.
- 2.103 There is no reason why SONI should respond negatively to a regulatory regime which merely requires that it operate in accordance with the prudence, efficiency and foresight to be expected of any business in relation to large scale projects where costs are uncertain. In the UR's submission, this ought to be entirely uncontroversial

¹⁹⁷ UR Decision on Licence Modifications – NOA1/18, [para. 92](#); Letter from Tanya Hedley to Leigh McCarthy, 30 September 2016, BT1/66.

¹⁹⁸ Aidan Skelly, First Witness Statement – AS1, [para. 113](#).

¹⁹⁹ Tanya Hedley, First Witness Statement – TH1, [para. 6.101](#).

regulatory practice.

- 2.104 In view of its statutory duties to protect consumers and promote efficiency and economy on SONI's part, it is difficult to see how the UR's decision in relation to PCNPs can be characterised as 'wrong', or how the position for which SONI contends can have any merit.
- 2.105 The mechanism provided by the UR fulfils these objectives by providing SONI with *ex ante* approval to incur a certain amount of expenditure. To the extent that SONI needs to raise debt finance in relation to a specific project it is difficult to see why it cannot approach its banks in confidence with the UR's *ex ante* approval of its costs. Such a regulatory decision will carry at least as much weight as any letter of comfort provided by the UR.
- 2.106 In addition, the UR has offered to speak to SONI's banks in relation to its price control in order to provide them with any explanation that they require as to how SONI will be remunerated. SONI has not taken the UR up on that offer²⁰⁰.

Delay

- 2.107 SONI has presented no evidence as to how the use by the UR of an *ex ante* approval mechanism will lead to delays and hinder project efficiency. It simply asserts that there is a real risk that this will be the case. The best point that SONI can make in this regard is to point to a comment made by the Competition Commission in its determination in relation to the NIE price control where it stated that the project-by-project approval of NIE's costs in relation to smart grid initiatives '*could bring detailed regulatory micromanagement and administrative burden*' (emphasis added)²⁰¹.
- 2.108 However, SONI fails to point out that in the same determination the Competition Commission itself affirmed project-by-project approval in respect of major transmission network projects when these were still the responsibility of NIE, in spite of the fact that it was alive to the risk of some delay²⁰².
- 2.109 Notwithstanding the lack of substance to SONI's assertions in relation to delay, it is difficult to see how those assertions could in any way establish that the UR was wrong on any of the statutory grounds that SONI identifies in relation to Ground 2, particularly where the Competition Commission has approved a similar mechanism.
- 2.110 Nor has SONI provided any explanation as to how the use of *ex ante* approvals would impede its ability to fulfil its obligations under its licence beyond a bare assertion of a risk in this regard²⁰³.

²⁰⁰ Tanya Hedley, First Witness Statement – TH1, [para. 6.101](#).

²⁰¹ NIE Determination, [para. 5.286](#).

²⁰² NIE Determination, [paras 5.255\(b\) and 5.270](#).

²⁰³ SONI Notice of Appeal – NOA1, [para. 24.12](#); Bill Thompson, First Witness Statement – BT1, [para. 201](#).

Regulatory best practice

- 2.111 As stated in the previous section, compliance with best practice is not a ground of appeal under Article 14D(4) of the Energy Order, nor does it go to any of the actual statutory grounds that SONI relies on in respect of Ground 2 of its appeal.
- 2.112 The best practice which SONI suggests that the UR has ignored is to provide certainty to regulated companies and consumers. The UR considers that it has provided adequate certainty to SONI by the implementation of a mechanism through which it grants *ex ante* approval to SONI prior to the commencement of any work, together with its assurances to SONI that the approved costs will not be disallowed following completion of a project save where they are found to be DIWE.
- 2.113 The UR also considers that mechanism to provide the best protection for consumers in line with its statutory duties.
- 2.114 It is unsustainable for SONI to argue that the approach taken by the UR does not accord with regulatory best practice given that the same approach was adopted by the Competition Commission in respect of NIE. SONI's assertion that '*it cannot be good practice to apply a mix of ex ante and ex post regulation*'²⁰⁴ is particularly surprising.

Relief sought

- 2.115 For the reasons given above, SONI is unable to establish that the UR's approach to PCNPs is wrong. Although it is strictly unnecessary in order to answer SONI's appeal, the UR notes that the alternative mechanism proposed by SONI is flawed in several respects.
- 2.116 The mechanism which SONI proposes to replace the D_t mechanism in relation to PCNPs with a value of over £1 million has already been discussed above.
- 2.117 In summary, SONI wishes to be granted an allowance which it can claim regardless of whether it is spent, subject only to the DIWE mechanism. That allowance will be based on costs which have not been approved and which have been fixed at a point when accurate estimates as to what is needed are not possible.
- 2.118 Although the DIWE mechanism is the only protection afforded to consumers by SONI's proposals, SONI seeks to restrict that protection by imposing a timeframe within which the UR would need to make any adjustments before costs were passed through. However, such a restriction was explicitly rejected by the Competition Commission in its determination of NIE's RP5 price control. In that case, the Commission refused NIE's invitation to implement a specific deadline for amendments by the UR relating to inefficient spend, stating²⁰⁵ –

²⁰⁴ SONI Notice of Appeal – NOA1, [para. 24.11](#).

²⁰⁵ NIE Determination, [para. 5.111](#).

'While we accepted that the behaviour sought from the UR ... would contribute to good administrative practice, we did not consider it necessary or appropriate to put such restrictions in place as part of modifications to NIE's price control Licence conditions. We expect that it would be in the UR's interests to address any concerns promptly because delays would tend to make it more difficult to collect the information necessary to justify any finding of demonstrably inefficient or wasteful expenditure. We did not consider it appropriate for us to give NIE an exemption from the clause if the UR has missed some interpretation of the 'earliest opportunity' or after a particular length of time.'

- 2.119 SONI is therefore asking the CMA to institute a provision mirroring one that the Commission has previously rejected.
- 2.120 SONI's proposal is imbalanced and disproportionate. It seeks to strip away appropriate regulatory scrutiny of projects and costs, and exposes consumers to the asymmetric risk of which SONI seeks to accuse the UR.

The UR Position on Alleged Error 2

- 2.121 The UR has been clear that it does not consider it appropriate that the costs associated with pre-construction activities are recovered on a pass-through basis²⁰⁶.
- 2.122 The UR considers the adoption of an *ex ante* approval mechanism, together with an *ex post* check to ensure that costs have been efficiently incurred to best serve consumer's interests.
- 2.123 The *ex ante* approval will protect consumers by ensuring scrutiny before any detailed work is commenced on a particular network pre-construction project. This will help to ensure not only that the costs incurred on a project are economic and efficient, but also that projects are commenced only where they are likely to be cost-beneficial. The *ex ante* approval process will also give comfort to both SONI and industry on how costs relating to the pre-construction projects will be recovered and where costs will ultimately be passed on to consumers.
- 2.124 At the *ex post* approval stage, whether costs are to be recovered from NIE (where a project proceeds to construction) or through the D_t term in SONI's licence (where it does not), there will be additional scrutiny to ensure that consumer's interests are protected. This will be a fresh assessment of the actual costs incurred and the UR will disallow any costs that are DIWE. As part of this approval process, the UR may carry out a detailed audit of costs if it considers this appropriate in the particular circumstances.
- 2.125 It will produce legally effective decisions which will provide an indication of what the UR presumes to be efficient costs and with which SONI may approach its banks and shareholders.

²⁰⁶ UR Decision on Licence Modifications – NOA1/18, [para. 85](#).

- 2.126 As set out in the Final Determination, the UR recognises that some further work remains to finalise the nature of the submissions that SONI will make to seek approval and the UR has committed to doing so²⁰⁷. However, the UR has also made it clear that it is for NIE and SONI to bring forward amendments to the TIA for approval²⁰⁸.
- 2.127 The fact that some work remains to be done in relation to the administration of the mechanism does not create the level of uncertainty that SONI contends, particularly where responsibility for delivering that work lies primarily with SONI and NIE, not the UR.
- 2.128 There is nothing in SONI's pleaded case that comes close to establishing that the adoption of that mechanism is wrong on one of the statutory grounds. It is within the power of the UR to impose the mechanism and it has done so having had regard to the appropriate matters as set out in Article 12 of the Energy Order.

Conclusion

- 2.129 For all of the above reasons, SONI's appeal on Ground 2, in so far as it relates to Alleged Error 2, should be dismissed.

²⁰⁷ UR Final Determination – NOA1/12, para. 485.

²⁰⁸ Letter from Tanya Hedley to Leigh McCarthy, 30 September 2016, BT1/66, para. 1.9.

**ALLEGED ERROR 3 – Failure to provide a cost recovery mechanism
for additional IS capital investment**

3.**Introduction**

- 3.1 The UR recognises that IT systems are fundamental to SONI's role as transmission system operator.
- 3.2 As part of its price control SONI requested allowances of around £8.9 million in respect of IT capex. In its Final Determination, the UR provided an allowance of £6.6 million – a 45% increase compared to SONI's previous price control – coupled with a 50/50 cost risk sharing mechanism under which SONI will take responsibility for 50% of any spend in excess of its allowances.
- 3.3 SONI asserts that the UR's decision is vitiated by specific omissions and errors that it deals with under the heading of Alleged Error 11.
- 3.4 In addition, it suggests that the decision is '*unacceptable*' on the basis that the UR's approach heightens SONI's risk environment which in turn impacts on its financeability.
- 3.5 The amount sought by SONI allowed for a substantial degree of contingency reflecting a set of worst case scenarios. Many of those scenarios may not proceed and – if they do – are capable of being managed in other ways. This is because SONI has discretion in how it spends its allowance and can be expected to adjust its spending priorities over the price control period as events unfold.
- 3.6 The UR has provided 90% of the amount requested in relation to majority of the projects put forward by SONI and deferred the DS3 and Smart Grids project as discussed in Section 11 below. The UR has also confirmed that where some unexpected event does indeed materialise, the UR will accept and decide on an application for further allowances under the D_t mechanism – albeit that, in view of the generous allowance provided, the UR does not expect to receive any such application.
- 3.7 SONI does not demonstrate how its '*risk environment*' has been '*heightened*' by the UR's decision²⁰⁹. Nor does it provide any explanation as to how its financeability has been impacted.
- 3.8 SONI simply disagrees with the amount that has been allowed by the UR. However, such disagreement provides no basis for a finding that the UR's decision was wrong on one of the statutory grounds.

²⁰⁹ SONI Notice of Appeal – NOA1, [para. 25.14](#).

The Decision on Cost Recovery for IS Capex

- 3.9 On 14 July 2014, the UR made an information request to SONI under Condition 7 of SONI's TSO licence²¹⁰ that SONI provide information to the UR with respect to SONI's business plan for the next five years for the purposes of the price control. As part of this, the UR asked SONI to list the capex items in respect of which it required allowances together with a classification as to whether each item was essential, beneficial or optional. The spreadsheet issued to SONI also contained cells into which SONI was asked to attach a business case and other information with respect to each capex item²¹¹. The purpose of the business cases was to justify the need for each project, its expected benefit and the justification for the proposed allowance.
- 3.10 When SONI returned the spreadsheet, it had deleted the two columns with respect to the priority accorded to capex projects and into which the business cases were to be embedded²¹². Instead of supplying separate business cases, as requested, with respect to each IT capex line, SONI submitted a paper entitled 'Information System Drivers'²¹³. That paper set out – at a very high level – descriptions of the IT capex projects with respect to which it requested funding.
- 3.11 For example, in relation to corporate systems, with respect to which it initially claimed £1 million it provided three paragraphs²¹⁴, IS infrastructure (£1.3 million initially claimed) and generator and trading systems (£1.2 million initially claimed) each received less than 2 pages²¹⁵. Energy Management Systems (EMS) – the most business critical system for SONI, in respect of which £2.5 million was initially claimed – received just over two pages.
- 3.12 In its Draft Determination the UR commented that SONI had provided limited detail on, and justification for, its requests in relation to IT capex allowances²¹⁶. SONI argued that such detail was difficult to provide as its precise IT needs over the next five years could not be known in advance and were subject to change. In its business plan SONI noted²¹⁷ –

'IT capital expenditure is by its very nature lumpy and as a result the profile of the expenditure will vary considerably over the life of the price control. Projects do not ultimately proceed as and when envisaged, some do not proceed at all, some are replacements for erstwhile considered projects and some arise due to new and evolving business requirements to enable SONI to meet its licence obligations...'

²¹⁰ Under Condition 7, SONI is required to provide the UR with information that the UR requires for the purpose of performing any of its statutory functions in relation to electricity.

²¹¹ TH1/52, [tab 3.9](#).

²¹² BT1/31, paper 5, [tab 3.9](#).

²¹³ BT/31, paper 10.

²¹⁴ BT/31, paper 10, [pp. 19 – 20](#).

²¹⁵ BT/31, paper 10, [pp. 18 – 19, 21 – 22](#).

²¹⁶ UR Draft Determination – NOA1/11, [para. 157](#). SONI's submission can be found at BT1/31, paper 10.

²¹⁷ BT1/31, paper 10, [p. 3](#).

- 3.13 However, that does not answer the point that SONI failed to provide adequate explanation and justification for the IT projects in respect of which it was requesting funding.
- 3.14 As part of its consideration of SONI's submissions, the UR engaged external consultants, Gemserv, to review and advise on SONI's IT strategy, including an analysis of the proposed need and estimate cost for each IT capex project in SONI's business case.
- 3.15 Gemserv drew attention to areas of discretionary spend in SONI's business plan, such as in relation to corporate systems which were not business critical²¹⁸. It also highlighted areas which were well provided for in SONI's requests, such as IT infrastructure and Energy Management Systems²¹⁹.
- 3.16 In its Draft Determination, the UR proposed to defer any allowance in respect of the requested DS3 and Smart Grid project costs – for reasons set out in section 11 of this response – and to reduce the amounts requested in respect of the remaining cost lines by 10% in line with Gemserv's recommendation.
- 3.17 The UR also proposed the introduction of a cost risk sharing mechanism through which 50% of SONI's over or under spend would be passed through to customers and 50% borne by SONI itself²²⁰.
- 3.18 A similar mechanism had been introduced by the Competition Commission in its determination of the NIE price control²²¹ and the UR considered that it maintain clear and strong financial incentives for SONI to operate and invest efficiently.
- 3.19 These decisions were confirmed by the UR in its Final Determination²²². The Final Determination stated that, as the UR considered the IT capex allowances it had provided to be sufficient and appropriate, it did not expect to provide further IT capex allowances through the D_t mechanism²²³.

SONI's Submissions on Alleged Error 3

- 3.20 SONI asserts that the adoption of Gemserv's recommendation to reduce allowances by 10% is unreasonable as the UR has failed to consider the context within which that recommendation was provided and in isolation of any consideration of unforeseen IT capex requirements²²⁴.
- 3.21 This is because, firstly, Gemserv had stated in its report that the risk averse approach

²¹⁸ UR Gemserv Report – NOA1/16, p. 14.

²¹⁹ UR Gemserv Report – NOA1/16, pp. 13 and 14.

²²⁰ UR Draft Determination – NOA1/11, paras 337 – 345.

²²¹ NIE Determination, paras 5.93 – 5.96.

²²² UR Final Determination – NOA1/12, paras 213 – 216, 241 – 245 and 456.

²²³ UR Final Determination – NOA1/12, para. 441.

²²⁴ SONI Notice of Appeal – NOA1, para. 25.12.

taken by SONI in its estimates was not unreasonable²²⁵. Secondly, Gemserv had recommended the 10% reduction on the basis that the amounts requested by SONI would not be an appropriate baseline for the 50/50 cost risk sharing mechanism²²⁶, but Gemserv had not recommended any mechanism for claiming in respect of unforeseen outputs not specified in the business plan. SONI noted in this regard that Gemserv has not been requested to make its recommendations '*in the context of ensuring [SONI's] financeability*'²²⁷.

- 3.22 Although it accepts that it is appropriate to apply efficiency mechanisms to incentivise TSO operations in certain circumstances, SONI states that it cannot be expected to deliver the outputs submitted in its business plan and deal with unforeseen developments while being exposed to the risk of bearing 50% of any overspend. This is particularly so in circumstances where the UR does not expect to approve any additional spend under the D_t mechanism²²⁸.
- 3.23 SONI states that the UR has failed to demonstrate that it properly considered the impact of its decision on SONI's financeability and that there were other options available to the UR such as maintaining efficiency targets whilst limiting SONI's exposure to financial risk²²⁹.
- 3.24 Finally, SONI states that²³⁰ –

'the degree of uncertainty in terms of expected outputs, the potential for additional projects to be required and the lack of a coherent cohesive process should this be the case heightens the risk environment for [SONI] which in turn impacts its financeability.'

- 3.25 This assertion is neither further developed nor supported by evidence.

Response to Alleged Error 3

The UR's use of the Gemserv report

- 3.26 SONI asserts that the UR's adoption of the 10% reduction to SONI's requested allowances was '*unreasonable*'. In fact, the UR's adoption of that recommendation was objectively reasonable and well within the scope of its margin of appreciation.
- 3.27 Simply because Gemserv stated that SONI's risk averse approach to its estimates was not unreasonable does not mean that the UR is required to simply allow the sums requested by SONI – and indeed Gemserv itself recommended they be reduced, even in light of its observation.

²²⁵ UR Gemserv Report – NOA1/16, [p. 19](#).

²²⁶ UR Gemserv Report – NOA1/16, [p. 19](#).

²²⁷ SONI Notice of Appeal – NOA1, [para. 25.11](#).

²²⁸ SONI Notice of Appeal – NOA1, [para. 25.12](#).

²²⁹ SONI Notice of Appeal – NOA1, [para. 25.13](#).

²³⁰ SONI Notice of Appeal – NOA1, [para. 25.14](#).

- 3.28 Neither does the fact that Gemserv did not recommend a mechanism through which additional expenditure could be allowed mean that its recommendation as to the 10% reduction could not be followed.
- 3.29 It was for the UR to consider SONI's overall financeability in light of the 10% reduction and the 50/50 cost risk sharing mechanism and it did so²³¹.
- 3.30 The UR considers that its allowance in respect of IT capex are generous, and notes that they represent a 45% increase on the allowances granted in SONI's 2010 price control. The current allowance seeks to reflect SONI's requirements as a standalone TSO, however, in practice SONI will also be able to achieve economies of scale through the use of compatible IT systems with EirGrid where appropriate.
- 3.31 The UR has reduced to some degree the contingency that SONI has built into its requests, but it considers that reduction to be appropriate. This is particularly so in view of the fact that, as SONI itself recognised in its business plan, some of the projects it identifies may not come to fruition. Some are also discretionary and do not need to be pursued if SONI wishes to use its discretion to direct its spend to other, more business critical, projects.
- 3.32 SONI's points come nowhere close to establishing that the UR's adoption of the 10% reduction was 'unreasonable' or outside of the bounds of the UR's regulatory discretion. That decision cannot be said to be wrong on the statutory grounds which SONI pleads.

The 50/50 cost risk sharing mechanism

- 3.33 In his witness statement Bill Thompson describes the risk sharing mechanism as 'novel'²³². It is not, and is based on sound regulatory precedent which SONI extols elsewhere in its Notice of Appeal.
- 3.34 Although it is a new feature of SONI's price control, as highlighted in the Final Determination, the UR has adopted this approach from the Competition Commission's determination in respect of NIE's price control in 2014 which itself drew on Ofgem precedent in relation to efficiency incentive rates (including for National Grid in respect of its transmission operations)²³³.
- 3.35 In that determination the Competition Commission stated²³⁴ –

'5.53 A cost risk-sharing mechanism can help reduce consumers' financial exposure to the risks of:

²³¹ Tanya Hedley, First Witness Statement – TH1, para. 8.32.

²³² Bill Thompson, First Witness Statement – BT1, para. 293.

²³³ NIE Determination, paras 5.85 – 5.86.

²³⁴ NIE Determination, paras 5.53 – 5.54.

(a) deferral or abandonment by NIE of investment projects that are included in the expenditure forecasts used to calculate the price control; and

(b) those regulatory expenditure forecasts being too high for any other reason.

5.54 Likewise such a mechanism can reduce the financial exposure of NIE to the risk that the expenditure forecasts used to calculate its maximum regulated revenue and RAB are too low.'

- 3.36 The UR considers that these points have similar force in the context of SONI's price control. Nowhere does SONI explain why the adoption of this mechanism should be regarded as inappropriate.
- 3.37 SONI states that there were other options available to the UR. However, the fact that other approaches exist does not mean that the one ultimately chosen by the UR is wrong.
- 3.38 The UR notes that SONI overspent by £1.7 million in relation to its capex allowance for 2010 – 2015, including an overspend of £2 million in respect of the current EMS. The UR allowed the recovery of that overspend despite having stated in the 2010 – 2015 Price Control Decision paper that any overspend would have to be absorbed by SONI.
- 3.39 Consumers were required to absorb that previous overspend. The risk sharing mechanism provides a method through which SONI will be incentivised to ensure efficient spend and to ensure that consumers do not continue to bear the totality of significant capex overspend by SONI.

Financeability

- 3.40 SONI suggests that the combination of the 10% reduction as against its requested allowances, the risk sharing mechanism and the UR's signal that it does not expect to allow further costs through the D_t mechanism together have a negative impact on its financeability.
- 3.41 However, this position fails to take account of the fact that SONI has discretion as to how it allocates the allowance it has been granted – it may choose to fund some discretionary projects over others and slim down projects, particularly in light of any unforeseen circumstances.
- 3.42 Where unforeseen circumstances do arise, requiring outputs not considered as part of the price control, the UR has indicated that it will be willing to consider applications under the D_t mechanism where SONI has already spent its existing capex

allowance²³⁵.

- 3.43 Taken together, the risks that SONI identifies – but fails to particularise in any detail – are greatly overstated. As stated in the Gemserv report, SONI's requests were based on a risk averse approach based on worst case scenarios. However, with appropriate scoping and project management, it is inconceivable that the worst case scenario will materialise with respect to all seven projects.
- 3.44 As with any business, where necessary, SONI will be required to prioritise its spending and ensure its efficiency.
- 3.45 As set out in Section 1, UR has had regard to SONI's financeability when setting the price control, as required by Article 12(2)(b) of the Energy Order, including in relation to the allowances for IT capex. Nothing that SONI has said in relation to Alleged Error 3 establishes a breach of that duty.

Relief sought

- 3.46 SONI asks that the ability to request additional funds in respect of IT capex should be included as an additional category under which applications can be made through the D_t mechanism²³⁶.
- 3.47 As explained in the following section, the D_t mechanism contains a catch-all category under which applications can be made for costs which do not fall within the categories that are specifically defined. Together with the UR's confirmation that it will consider and decide upon any application that SONI makes in relation to IT capex, this means that SONI's proposed relief is unnecessary and does not in any way address what it contends to be wrong with the UR's decision.

The UR Position on Alleged Error 3

- 3.48 SONI was asked to provide a list of the IT capex projects for which it requested allowances, with a detailed business plan for each setting out the justification for the project. It was also asked to specify which of those projects were essential, beneficial or optional.
- 3.49 It failed to do either, instead providing a very high level description of its proposed projects. It now objects to the amounts that have been allowed in respect of those projects – even though it has been granted 90% of what it asked for.
- 3.50 SONI disagrees with the UR's decision. It attempts to frame that disagreement within the statutory grounds but struggles to do so. It is left unclear how any suggestion of 'unreasonableness' links to the uncertainty which is the overall basis for Ground 2 or how this in turn supports its central thesis that the UR's decision has left it unfinanceable.

²³⁵ Tanya Hedley, First Witness Statement – TH1, [paras 6.38 and 8.31](#).

²³⁶ SONI Notice of Appeal – NOA1, [para. 46.32](#).

- 3.51 SONI has been granted a 45% increase in allowances in respect of IT capex as compared to its previous price control.
- 3.52 In these circumstances SONI's attempt to suggest that its position is more risky or uncertain is untenable. This is particularly so as SONI's proposed relief would in no way decrease its risk or increase the certainty that it suggests it is lacking.

Conclusion

- 3.53 For all of the above reasons, SONI's appeal on Ground 2, in so far as it relates to Alleged Error 3, should be dismissed.

ALLEGED ERROR 4 – Failure to provide a suitable cost recovery mechanism for Significant Projects

4.

Introduction

- 4.1 SONI will undertake a number of large scale projects over the course of the price control period. Together with the PCNPs with a value of over £1 million, such projects also include the following –
- (a) The implementation of I-SEM – A new wholesale electricity market for the island of Ireland that will replace the current SEM.
 - (b) The DS3 Programme – A joint project between the UR, the Commission for Energy Regulation (**CER**) in Ireland, EirGrid (in its role as Republic of Ireland TSO) and SONI to adapt system policies, tools and performance to safely accommodate up to 75% penetration of renewable generation at any one time. This will help achieve the target set by the Northern Ireland Executive that 40% of electricity should come from renewable sources by 2020.
- 4.2 The implementation costs of I-SEM will be decided by the SEM Committee. The implementation costs of DS3 will be considered by the SEM Committee, and if it decides those costs to be related to a SEM Matter it will set an amount. Where it does not consider DS3 costs to be related to a SEM Matter, the UR will still consider whether to approve them.
- 4.3 Once decided, both sets of costs will be applied to tariffs through the same mechanism used to recover costs of PCNPs that do not proceed to construction – the D_t mechanism that the UR has put in place to facilitate the recovery by SONI of costs that are uncertain at the point of implementation of the price control.
- 4.4 SONI groups I-SEM, DS3 and high value PCNPs together under the heading of 'Significant Projects' and claims that the D_t mechanism is an unsuitable method of recovery for the costs associated with such projects.
- 4.5 The UR considers the use of the D_t mechanism to be an appropriate methodology for dealing with uncertain costs which balances the need to ensure that SONI can recover its costs for Significant Projects, while providing a sufficient degree of scrutiny to ensure that inefficient costs are not passed through to consumers.
- 4.6 The use of the D_t mechanism is squarely within the UR's margin of appreciation and there is nothing in the Notice of Appeal that establishes that the decision to adopt it with respect to Significant Projects is 'wrong'.

The Decision on Cost Recovery for Significant Projects

- 4.7 SONI's licence contained a D_t mechanism prior to the 2015 price control, the purpose of which was to cover unforeseen costs, or costs which were foreseen but with

respect to which the amount required by SONI was uncertain at the beginning of the price control period.

- 4.8 The UR decided to maintain the D_t mechanism as part of the 2015 price control but proposed in its Draft Determination that its use would be limited to certain defined categories of claims²³⁷. As such, the UR proposed removing the general re-opener which had been included in the D_t mechanism.
- 4.9 An adjustment factor – K_t – was also proposed to allow for adjustments to amounts claimed under the D_t mechanism to reflect²³⁸ –
- (a) any over or under recovery against the amounts allowed by the UR,
 - (b) any costs that the UR had found to be DIWE²³⁹, and
 - (c) the proposed 50/50 cost risk sharing mechanism.
- 4.10 In its response to the Draft Determination SONI made a number of points in relation to the use of the D_t mechanism and the K factor. These related mostly to cost items that had been removed from the D_t mechanism – allowances associated with the European TSO (**ENTSOe**) membership and tariffs, and constraints financing costs.
- 4.11 It also argued that the use of the 50/50 cost risk sharing mechanism was inappropriate for PCNPs.
- 4.12 In response to SONI's concerns, the UR agreed in its Final Determination to retain costs in relation to ENTSOe and constraints financing costs within the D_t mechanism and not to apply the 50/50 cost risk sharing mechanism in relation to costs allowed under the mechanism.
- 4.13 The UR also decided to retain the general re-opener within the D_t term. This was to reflect the number of large projects – such as I-SEM and DS3 – that SONI will undertake over the price control period and the fact that these may generate cost items that cannot currently be foreseen. It was also thought prudent to retain a catch-all mechanism that could be used to accommodate other unforeseen cost items, such as any costs associated with Brexit (for example).
- 4.14 In its final form the D_t mechanism contained in paragraph 8 of Annex 1 to SONI's licence allows it to make an application for costs in respect of the following items²⁴⁰
- - (a) Change of law.

²³⁷ UR Draft Determination – NOA1/11, para. 330.

²³⁸ UR Draft Determination – NOA1/11, paras 324 – 345.

²³⁹ Discussed in more detail in Section 7 below.

²⁴⁰ UR Final Licence Modifications – NOA1/17, para. 8.1.

- (b) Compliance with requirements of the Electricity Directive.
 - (c) Additional costs incurred by SONI as transmission system operator in relation to the SEM.
 - (d) Uncollected SSS/TUoS revenue.
 - (e) Financing SEMO working capital requirements.
 - (f) ENTSOe membership and Inter TSO Compensation.
 - (g) Costs associated with PCNPs that do not proceed to construction.
 - (h) Other costs, not already taken into account, costs which cannot reasonably be controlled and the UR determines is appropriate as a D_t (which will include I-SEM and DS3).
- 4.15 SONI must use its best endeavours to make its D_t applications by the 1 April immediately preceding the year in respect of which it wishes the claim to take effect.
- 4.16 In making any claim, SONI is required to take account of and give regard to the Price Control Decision Paper. This is defined in paragraph 1.1 of Annex 1, together with the Final Determination and Decision Paper, the Price Control Decision Paper also includes any further decision paper on the same subject.
- 4.17 The purpose of allowing for further decision papers is that the UR is consulting on relevant aspects of the price control – such as pensions and change of law – which may lead to further decision papers which should be considered for the purposes of D_t claims.
- 4.18 Where the UR allows costs under the D_t mechanism it will do so up to a cap²⁴¹. Costs allowed under the D_t mechanism cannot be equated with *ex ante* allowances granted at the outset of a price control. Rather SONI is granted a notional pot of money from which it is able to draw to the extent that it needs to up to a certain limit. Where it becomes apparent that that limit is insufficient SONI can apply for it to be extended.
- 4.19 SONI will then provide information with respect to its actual costs. These will be checked by the UR and adjusted, where necessary, using the K factor before being passed through to consumers.

SONI's Submissions on Alleged Error 4

- 4.20 SONI's first objection is to the breadth of the cost items that can be the subject of claims under the D_t mechanism. It claims that the UR should have split those cost items into the following three categories, each of which should be dealt with through

²⁴¹ UR Final Determination – NOA1/12, [para. 444](#).

a different mechanism²⁴² –

- (a) Costs which are foreseeable but which cannot be quantified at the outset of the price control as the parameters are not sufficiently known or the estimates are wide ranging, such as the costs associated with Significant Projects.
- (b) Costs which are foreseeable but which SONI cannot quantify as they fall outside of its control, such as pension deficit repair and ENTSOe costs.
- (c) Costs which are genuinely unforeseeable, such as costs associated with changes of law.

4.21 SONI argues that costs in categories (a) and (c) should be dealt with through a re-opener provision resulting in licence modifications whereas costs in category (b) should be dealt with on a simple pass through basis.

4.22 SONI goes on to set out various points made by Cambridge Economic Policy Associates (**CEPA**) in its report which forms part of the evidence submitted by SONI as part of its appeal²⁴³. CEPA was instructed by SONI to identify '*best practice*' in the use of uncertainty mechanisms by other UK regulators and to compare the uncertainty mechanisms put in place by the UR against these.

4.23 The Notice of Appeal draws on CEPA's report to outline a number of alternative uncertainty mechanisms that could have been used by the UR, and the types of considerations that the UR should have borne in mind when addressing the issue of uncertainty in SONI's price control.

4.24 SONI states²⁴⁴ –

'The Utility Regulator's approach in selecting a single inappropriate and illogical uncertainty mechanism and the lack of clarity as to which costs are recoverable and which are not under the Dt mechanism is contrary to best regulatory practice and has resulted in the Appellant facing greater uncertainty than necessary in terms the revenues it is likely to receive from tariffs.'

4.25 Why the approach is '*inappropriate*' or '*illogical*' is nowhere explained.

4.26 SONI states that the degree of uncertainty it faces with respect to its revenues impacts on the willingness of banks to lend to it, which in turn has implications for SONI's ability to '*efficiently deliver in the best interests of the consumer*'²⁴⁵.

4.27 Finally, SONI objects to the definition of a 'Price Control Decision Paper' which it

²⁴² SONI Notice of Appeal – NOA1, para. 26.6.

²⁴³ SONI Notice of Appeal – NOA1, paras 26.8 – 26.14 and 26.20.

²⁴⁴ SONI Notice of Appeal – NOA1, para. 26.20.

²⁴⁵ SONI Notice of Appeal – NOA1, para. 26.22.

claims constitutes²⁴⁶ –

'a form of "Henry VIII clause" in regulation in that the regulator may, simply by publishing further decision papers, radically alter the expectations of all parties as to the use of Dt in the future.'

Response to Alleged Error 4

- 4.28 SONI's Alleged Error 4 seeks to establish that the UR has failed to provide a suitable cost recovery mechanism for Significant Projects. The UR has provided a recovery mechanism for such projects – the D_t mechanism.
- 4.29 The burden is on SONI to establish that this mechanism is '*unsuitable*' in terms of being 'wrong' on one of the statutory grounds of appeal which it pleads. In the UR's submission, it fails to do so.

Best Practice

- 4.30 SONI's points in relation to best practice make up the majority of its submissions on Alleged Error 4. There is no statutory ground on which the CMA could hold that the UR's decision was wrong for failing to follow '*best practice*' – even assuming that the CMA was content that SONI had established what that was and that it should be followed in this case.
- 4.31 The UR does not understand the material benefit to be gained by dealing with the three different types of cost categories identified by SONI through three different mechanisms, or what is wrong with not doing so. Even where the UR is content that a particular category could be passed through to consumers, it would still scrutinise actual costs to ensure that they were not DIWE. The D_t mechanism provides an effective and flexible means for dealing with all three of the categories that SONI identifies and ensuring that all costs receive the appropriate degree of scrutiny.
- 4.32 The UR recognises that there were alternative approaches that it could have adopted in dealing with uncertainty in SONI's price control. However, simply because other regulators have chosen to deal with the issue differently does not mean that the mechanism chosen by the UR is outside of the bounds of its regulatory discretion.
- 4.33 Indeed, the CMA has been clear that its role is not to substitute its judgment for that of the regulator simply because it would have taken a different view with respect to a particular matter²⁴⁷.
- 4.34 It would have been inappropriate for the UR to make an *ex ante* allowance in respect of the Significant Projects to be undertaken by SONI during the price control period as the required costs were unknown at that point (and indeed still are). Likewise, it would have been inappropriate for the UR to simply allow SONI to pass through its

²⁴⁶ SONI Notice of Appeal – NOA1, para. 26.23.

²⁴⁷ Northern Powergrid, paras 3.26 – 3.27.

costs to customers without any check by the regulator.

- 4.35 Once these two options are rejected, the approach adopted by the UR is perfectly reasonable and appropriate – SONI will estimate its costs and apply to the UR for approval of these and the UR will then check the amounts actually spent to ensure that they are efficient. Such scrutiny is entirely appropriate given the UR's principal objective and general duties.
- 4.36 In circumstances where SONI discovers that the cap on allowed costs is too low it can request additional sums through a further D_t application.
- 4.37 The use of *ex ante* approval ensures that SONI sets clear justifications for projects and explains how it has estimated costs. While SONI can ask for further costs under the D_t mechanism, the use of an initial approval ensures that SONI undertakes robust budgeting and scoping at the outset as any increases sought will need to be explained and justified as reasonable. The process also allows SONI some certainty on the views of the UR as to what reasonable costs would look like.
- 4.38 In this way consumers are protected from inefficient costs and SONI is assured that it will be financed with respect to costs that it needs for Significant Projects during the price control period.
- 4.39 Indeed the D_t mechanism will create bankable decisions which will ultimately have a practical value at least as great as that of any letter of comfort. SONI should be able to secure finance on the back of the approval provided by the UR in respect of the costs for a particular project. Such a regulatory decision will assure SONI – and its investors – that it will be able to recover the stipulated amount which the UR has presumed to be efficient unless on an *ex post* review the UR can demonstrate that it is not. It will also allow that recovery to take place through tariffs so SONI will be able to recover the money as it spends it.

Financeability

- 4.40 In view of the above, there should be no uncertainty on SONI's part which would adversely affect its financeability. Where the amount claimed under its original D_t application proves insufficient, the UR has made it clear that SONI can make a further application for additional costs²⁴⁸ and at the end of each project only costs which the UR can demonstrate are inefficient or wasteful will be disallowed.
- 4.41 Notwithstanding that the D_t mechanism will generate bankable decisions, SONI has in fact asked for, and received, letters of comfort with respect to DS3 and I-SEM.
- 4.42 SONI wrote to the UR on 5 April 2016 seeking assurances in relation to its share of the estimated €12 million spend on DS3 and €61 million spend on I-SEM²⁴⁹. The UR replied on 19 April 2016 recognising that the I-SEM costs included a 10% contingency

²⁴⁸ See, for example, letter from Tanya Hedley to Leigh McCarthy, 30 September 2016, BT1/66.

²⁴⁹ Letter from Aidan Skelly to the UR, 5 April 2016, TH1/35.

and providing its assurance that it considered SONI's share of the I-SEM costs to be a 'reasonable overall cost estimate' for the project²⁵⁰.

- 4.43 The UR wrote to SONI on 16 September 2016 again confirming its approval for the I-SEM costs and also approving the estimate in respect of DS3 and stating that additional costs would be allowed 'where they can be demonstrated to be necessary, efficiently incurred' and in accordance with principles set out in the letter²⁵¹. SONI wrote back on 11 November 2016 noting that the proposed costs in relation to DS3 were estimates that could change but welcoming that approval and enquiring what mechanism would be used to facilitate the recovery of its costs²⁵². The UR replied on 20 December 2016 confirming that it would be the D_t mechanism²⁵³.
- 4.44 In view of such assurances, Aidan Skelly's 'firm opinion' that it would not be possible to secure letters of comfort from the Utility Regulator is surprising²⁵⁴ – SONI already has such letters in respect of two of the largest projects that it will undertake during the price control period. Indeed, SONI's letter of 5 April 2016 was written by Mr Skelly himself and the UR's replies were addressed to Robin McCormick. Mr McCormick has also given evidence for SONI and fails to mention this relevant correspondence.

Price Control Decision Papers

- 4.45 The definition of Price Control Decision Papers falls well short of the purported 'Henry VIII clause' that SONI identifies.
- 4.46 A Henry VIII clause, properly construed, is a power which gives the government the right to amend primary legislation through secondary legislation. Henry VIII clauses therefore run against the grain of the principle of Parliamentary sovereignty under which only Parliament can amend primary legislation.
- 4.47 However, the only use to which the definition of a Price Control Decision Paper is put by the UR is the requirement in paragraph 8.2(a) of Annex 1 to SONI's licence which simply requires SONI to take account of and give regard to such papers in making applications under the D_t mechanism.
- 4.48 It is not stated that SONI must adhere to such decision papers in its application, nor that they will bind the UR in its determination of any application.
- 4.49 The obligations imposed by the term are therefore relatively weak, and are intended primarily to ensure that SONI's applications under the D_t mechanism contain all the necessary information that the UR requires to make its decision on the requested allowance and that SONI is aware of the information that it will need to report

²⁵⁰ Letter from Jenny Pyper to Robin McCormick, 19 April 2016, TH1/36.

²⁵¹ Letter from Jenny Pyper to Robin McCormick, 16 September 2016, TH1/42.

²⁵² Letter from Robin McCormick to Jenny Pyper, 11 November 2016, BT1/67.

²⁵³ Letter from Jenny Pyper to Robin McCormick, 20 December 2016, BT1/69.

²⁵⁴ Fintan Slye, First Witness Statement – FS1, [para. 117](#).

following the approval of any costs under the mechanism.

- 4.50 For example, in terms of information to be included in an application, the Final Determination states that with regard to the costs relating to non-system services elements of the wider DS3 programme, SONI should demonstrate that those services do in fact fall within the DS3 programme²⁵⁵.
- 4.51 Likewise, in terms of reporting, SONI would need to be aware of the types of information that it would be required to submit to the UR in relation to its actual spend as against allowed costs using the reporting template at Appendix B to the Final Determination²⁵⁶.

Relief sought

- 4.52 SONI asks the CMA to create a new mechanism to facilitate the recovery of costs for Significant Projects. Whereas the D_t mechanism is balanced and proportionate, the alternative proposed by SONI is inappropriately skewed in favour of the company –
- (a) SONI wishes to be able to itself decide on the Significant Projects that it will undertake, without the need for regulatory approval²⁵⁷.
 - (b) Any amount SONI proposes for pre-approval (not which has actually been approved) is to be treated as an allowance²⁵⁸.
 - (c) Unlike other allowances these will not be subject to the 50/50 cost risk sharing mechanism²⁵⁹.
- 4.53 The effect of these proposals would be that SONI was able to pass through costs which have not been approved and which have been fixed at a point when accurate estimates as to what is needed are not possible. Where SONI does not spend the money it has proposed it will keep it. The only check will be the disallowance of costs which are DIWE and even then the UR will be required to make a decision disallowing such costs within a short timeframe – a restriction previously rejected by the Competition Commission as outlined in response to Error 2.
- 4.54 The UR does not consider that these proposals could possibly be appropriate in the context of the balance it is required to strike under its general duties.

The UR Position on Alleged Error 4

- 4.55 In any price control, a balance must be achieved between providing certainty in relation to cost recovery and allowing flexibility in relation to unknown costs.

²⁵⁵ UR Decision on Licence Modifications – NOA1/18, para. 65.

²⁵⁶ Appendix B to the Final Determination: Cost Outturn and Reporting Template, NOA1/15, Tabs 7 and 8 – D_t Approval List and D_t Entitlement for year.

²⁵⁷ SONI Notice of Appeal – NOA1, paras 46.28 – 46.29.

²⁵⁸ SONI Notice of Appeal – NOA1, para. 46.35(ii).

²⁵⁹ SONI Notice of Appeal – NOA1, para. 46.29(iv).

- 4.56 The UR has chosen to take a particular approach with respect to costs that are uncertain at the beginning of the price control period. That approach serves the twin functions of ensuring that SONI is able to recover its costs with respect to Significant Projects and ensuring that consumers are protected from liability for costs that are demonstrably wasteful or inefficient.
- 4.57 That approach has been used previously for both SONI and NIE, as discussed in section 13. SONI considers that a different process should be used with respect to Significant Projects.
- 4.58 However, it has not established any errors in the UR's approach, much less that the UR's decision is wrong on one or more of the statutory grounds.
- 4.59 The use of the D_t mechanism for Significant Projects is well within the margin of appreciation properly accorded to a regulator and simply because alternative methods exist this does not mean that the UR's decision is wrong – indeed it reflects a substantially similar mechanism created by the Competition Commission.

Conclusion

- 4.60 For all of the above reasons, SONI's appeal on Ground 2, in so far as it relates to Alleged Error 4, should be dismissed.

ALLEGED ERROR 5 – Failure to provide a suitable right of appeal concerning decisions regarding cost recovery for Significant Projects

5.

Introduction

- 5.1 Under Article 37(11) of the Electricity Directive, member states must ensure that suitable mechanisms exist at national level through which a party affected by a decision of a regulatory authority has a right of appeal to an independent body.
- 5.2 In the majority of cases this right is given effect in the UK through the availability of judicial review. However, Parliament has granted a right of appeal to the CMA in respect of a small number of regulatory decisions of a particular type – licence modifications and, in Great Britain, certain code modifications²⁶⁰.
- 5.3 SONI argues that the use by the UR of the D_t mechanism to make determinations in relation to the financing of Significant Projects is wrong because – as such decisions will not result in modifications to SONI's licence – they will not attract a right of appeal to the CMA.
- 5.4 This is a surprising submission as it ignores the fact that the statutory framework is explicitly set up in such a way that appeal to the CMA is not available in respect of decisions made under a licence. It also ignores the fact that judicial review has long been recognised as a valid mechanism to discharge a right of appeal in EU law.
- 5.5 SONI is therefore asking the CMA to unilaterally extend its jurisdiction beyond that granted by Parliament by making a finding on the requirements of EU law that goes against a succession of decisions by the European Court of Justice (ECJ).

The Decision in relation to cost recovery for Significant Projects

- 5.6 The UR's mechanism for cost recovery for Significant Projects is described in Section 4 above.
- 5.7 SONI will make an application for costs under the D_t mechanism which, if appropriate, the UR will allow up to a cap.
- 5.8 SONI will then report on its actual costs to the UR and, before any costs are passed through to consumers through tariffs for the following years, the UR will review those costs and, if necessary, adjust them using the K factor –
- (a) where SONI's actual costs are less than the cap it was allowed under the D_t mechanism, and

²⁶⁰ In Northern Ireland, Article 14B of the Electricity Order makes provision for appeals to the CMA regarding licence modifications; in Great Britain, section 11C of the Electricity Act makes similar provision and, in addition, the Electricity and Gas Appeals (Designation and Exclusion) Order 2014 provides for appeals to the CMA in relation to code modifications where Ofgem has not followed the recommendation of the relevant industry panel.

(b) where the UR finds any element of those costs to be DIWE.

SONI's Submissions on Alleged Error 5

- 5.9 SONI takes issue with the fact that, because decisions made under the D_t mechanism will not involve modifications to its licence, they will not attract a right of appeal to the CMA under Article 14B of the Electricity Order.
- 5.10 SONI states that the lack of such an appeal is '*inappropriate*²⁶¹, contrary to the requirements of the Electricity Directive and '*in breach of natural justice*²⁶². SONI also contends that the lack of an avenue to the CMA will negatively impact its financeability²⁶³ and is out of step with good regulatory practice.
- 5.11 Finally, SONI suggests that the lack of appeal to the CMA means that third parties are deprived of their ability to appeal funding decisions²⁶⁴.
- 5.12 None of these points are fully pleaded nor supported by evidence. SONI does not explain the legal basis on which the requirements of EU law – or '*natural justice*' – have been breached, nor does it identify what good regulatory practice could mean in this context in view of the statutory framework.
- 5.13 Most importantly, with respect to the statutory grounds of appeal on which SONI relies in respect of Ground 2, SONI does not explain or evidence how the availability of judicial review, as opposed to appeal to the CMA, has any negative effect on its financeability in such a way as to render the use of the D_t mechanism 'wrong'.

Response to Alleged Error 5

- 5.14 The suggestion that it is somehow unlawful or inappropriate that decisions made under the D_t mechanism do not attract a right of appeal to the CMA has no merit. Indeed, it is noted that despite its assertion that the absence of such an appeal right is in breach of the UR's obligations under EU law, SONI does rely on the statutory ground in Article 14D(4)(e) of the Electricity Order to the effect that the UR's decision was wrong in law.
- 5.15 This illustrates that SONI itself places little weight on its assertion of unlawfulness, and indeed it does not outline any legal basis for that assertion. No such legal basis exists.

The domestic legal framework

- 5.16 SONI states that the lack of appeal to the CMA in respect of decisions made under the D_t mechanism is '*at variance with the statutory scheme which charges ... the CMA*

²⁶¹ SONI Notice of Appeal – NOA1, [para. 27.7](#).

²⁶² SONI Notice of Appeal – NOA1, [para. 27.12](#).

²⁶³ SONI Notice of Appeal – NOA1, [para. 27.9](#).

²⁶⁴ SONI Notice of Appeal – NOA1, [para. 27.14](#).

*with the particular duty to hear appeals*²⁶⁵. That assertion is simply incorrect.

- 5.17 It is clear from the Electricity Order that the UR can make determinations under the licence. Article 11(3) states –

'Without prejudice to the generality of paragraph (1)(a), conditions included in a licence by virtue of that sub-paragraph may require the licence holder—

(a) to comply with any direction given by the Director as to such matters as are specified in the licence or are of a description so specified;

(b) except in so far as the Director consents to his doing or not doing them, not to do or to do such things as are specified in the licence or are of a description so specified;

(c) to refer for determination by the Director such questions arising under the licence, or under any document referred to in the licence, as are specified in the licence or are of a description so specified; and

(d) to refer for approval by the Director such things falling to be done under the licence, and such contracts or agreements made before the grant of the licence, as are specified in the licence or are of a description so specified.'

- 5.18 Indeed the statutory framework also provides for licence conditions to provide for their own modification (i.e. be self-modifying)²⁶⁶ –

'(5) Conditions included in a licence may contain provision for the conditions—

(a) to have effect or cease to have effect at such times and in such circumstances as may be determined by or under the conditions; or

(b) to be modified in such manner as may be specified in the conditions at such times and in such circumstances as may be so determined.'

- 5.19 The legislation therefore explicitly permits the UR to put in place licence conditions under which it will make further decisions.

- 5.20 It is also clear that Parliament did not intend for a right of appeal to the CMA to attach to such decisions. Had this been the intention of Parliament it would have provided for that. It did not. In Northern Ireland, the right of appeal to the CMA attaches only to licence modifications.

²⁶⁵ Bill Thompson, First Witness Statement – BT1, [para. 335](#).

²⁶⁶ Article 11(5) of the Electricity Order.

Judicial review

- 5.21 SONI is not deprived of a right to challenge UR decisions made by the UR under the D_t mechanism – it can do so, as it has always been able to, by way of judicial review.
- 5.22 The availability of judicial review has long been recognised as capable of discharging a right of appeal in EU law.
- 5.23 For example, in *Upjohn v The Licensing Authority*²⁶⁷ the ECJ was asked to consider whether judicial review was sufficient to discharge a requirement for decisions of the competent authority under Directive 65/65/EEC (which relates to medicinal products) to be subject to legal challenge. It held that, so long as a national court is effectively empowered to apply the principles of EU law, EU law does not require that court to be capable of conducting a merits appeal.
- 5.24 The ECJ has also held that judicial review is sufficient in circumstances where the relevant Directive requires a right of appeal to an independent body similar to that required by Article 37(17) of the Electricity Directive²⁶⁸.
- 5.25 This is unsurprising as Article 37(17) of the Electricity Directive makes no reference to an appeal on the merits. Had a merits appeal been required provision would have been made for this. For example, Article 4(1) of Directive 2002/21/EC explicitly states that in providing a right of appeal in relation to the national regulatory authority dealing with electronic communication networks, '*Member States shall ensure that the merits of the case are duly taken into account*'.
- 5.26 The nature of the appeal envisaged by Article 37(17) is apparent from the preceding Article 37(16) which requires that '*decisions taken by regulatory authorities shall be fully reasoned and justified to allow for judicial review...*' (emphasis added). The requirement that decisions should be fully reasoned is notable as it suggests that the right of appeal does not involve a fresh merits consideration but simply the exercise of a supervisory jurisdiction.
- 5.27 The fundamental plank of SONI's appeal is that the UR has breached its obligations under Article 12(2)(b) of the Energy Order by failing to have regard to SONI's financeability²⁶⁹. Such a failure is essentially a legal point and a court in a judicial review claim would be more than capable of deciding whether or not a breach of that legal obligation had occurred. Therefore, if SONI takes the same issue with respect to any decision made by the UR under the D_t mechanism, there will be no barrier to it airing that grievance by way of judicial review.
- 5.28 In relation to the rights of third parties, it is noted that the test for standing in a judicial review claim is simply that a person has '*a sufficient interest in the matter to*

²⁶⁷ [Case C-120/97 \[1999\] ECR I-223](#), paras 33 – 36.

²⁶⁸ [Case C-55/06 Arcor \[2008\] ECR I-0000](#).

²⁶⁹ SONI Notice of Appeal – NOA1, [para. 2.10](#).

*which the application relates*²⁷⁰. Even without the liberal approach taken by the courts to standing²⁷¹, on its face that test is wider than that contained in Article 14B(2)(b) of the Electricity Order which allows a person to appeal to the CMA in relation to a licence modification only where that person's interests '*are materially affected by the decision*'.

- 5.29 There is therefore no question that a third party who would be entitled to appeal to the CMA under the Electricity Order with respect to a licence modification will have standing to bring a judicial review in relation to a decision made under a licence.
- 5.30 The CEPA report mentions at various points that SONI will have '*no appeal option, except for judicial review*'²⁷². However, although it highlights circumstances in which Ofgem has taken a different approach, nowhere does it explain why judicial review is not sufficient or appropriate in this context. Nor does it explain how the approach taken by the UR falls outside of the range of reasonable decisions it can make in line with its discretion as regulator.

Financeability

- 5.31 SONI states that the '*inability ... to appeal decisions relating to costs of significant projects creates a degree of instability around the price control process, which negatively impacts [SONI's] financeability*'²⁷³. Nowhere does SONI explain how the lack of an appeal to the CMA (rather than an inability to appeal per se) creates instability or uncertainty, or how such effects – if they did exist – have in turn adversely affected its financeability.
- 5.32 Nor does it provide any evidence in this regard. Nowhere in the term sheets it has provided do SONI's banks state that they would wish to see an appeal right to the CMA, for example.
- 5.33 The availability of judicial review ensures that no question of instability or uncertainty will arise. Where the UR makes a decision with respect to SONI's allowances under the D_t mechanism, SONI will be able to challenge that decision by way of judicial review, including on the basis of errors of fact and law, and, in particular, where it considers that the UR has not properly had regard to SONI's financeability as required by Article 12(2)(b) of the Energy Order.

Proposed relief

- 5.34 As discussed in the previous section, SONI asks the CMA to institute a new mechanism with respect to Significant Projects which minimises regulatory oversight and institutes allowances to be passed through to consumers on the basis of

²⁷⁰ Section 31(3)(a) of the Senior Courts Act 1981.

²⁷¹ See, for example, [R \(Feakins\) v Secretary of State for the Environment, Food and Rural Affairs \[2003\] EWCA Civ 1546](#), at [21].

²⁷² For example, IA1-1, p. 33.

²⁷³ SONI Notice of Appeal – NOA1, para. 27.9.

uncertain estimates.

- 5.35 It is difficult to see how SONI's proposal will create any additional certainty that would better secure SONI's financeability as SONI has failed to provide any explanation or evidence to establish that its shareholders or banks would be prepared to provide financing based on the availability of an appeal rather judicial review.
- 5.36 As stated above, SONI is, in effect, inviting the CMA to find that judicial review is insufficient with respect to decisions made under licences and to expand its remit in the face of a statutory scheme which clearly shows that Parliament was satisfied that judicial review is appropriate.

The UR Position on Alleged Error 5

- 5.37 On the basis of the discussion above, it cannot be argued that the use by the UR of the D_t mechanism in relation to Significant Projects is 'wrong' on any of the statutory grounds pleaded by SONI simply because decisions made using that mechanism will not attract a right of appeal to the CMA.
- 5.38 The UR makes a great many decisions – including many that have important consequences for the companies it regulates – the majority of which are not subject to appeal to the CMA. Such appeal is the exception, not the rule, and was provided by Parliament only in relation to particular subsets of regulatory decisions – licence modifications and, in Great Britain, certain code modifications. All other decisions are subject to judicial review.
- 5.39 SONI cannot demonstrate that the lack of an appeal is unlawful as the statutory framework explicitly allows for it and judicial review has long been held to be an effective remedy in EU law.
- 5.40 In such circumstances it is extraordinary that SONI requests the CMA unilaterally to increase its jurisdiction beyond what is clearly enshrined in statute by suggesting that it find that decisions made under a licence must be subject to appeal rather than judicial review.
- 5.41 It cannot be said that the lack of appeal to the CMA is against best practice, particularly as the '*regulatory best practice*' which is supposed to have been breached has not been identified by SONI and the majority of decisions by all regulators are subject to judicial review rather than appeal the CMA. Simply pointing to circumstances in which one other regulator has taken a different approach is insufficient – even were failure to follow best practice one of the statutory grounds of appeal, which it is not.
- 5.42 Nor has SONI shown how the lack of such an appeal would negatively affect its financeability.
- 5.43 At one point, SONI attempts an argument *ad absurdum*, pointing out that were the

UR to manage the entire price control through the D_t mechanism this would remove the entire price control from ambit of the CMA's jurisdiction²⁷⁴. That argument is of no assistance to SONI as it is not the situation that prevails. Only certain aspects of the price control will be dealt with using the D_t mechanism.

- 5.44 For the reasons given elsewhere in this response the use of that mechanism is an entirely reasonable regulatory response to costs which are presently uncertain and to which some regulatory oversight must be applied in line with the UR's statutory duties.
- 5.45 The fact that those decisions will be subject to judicial review, rather than a right of appeal to the CMA, cannot serve as a basis for holding that decision to be wrong on any of the statutory grounds.

Conclusion

- 5.46 For all of the above reasons, SONI's appeal on Ground 2, in so far as it relates to Alleged Error 5, should be dismissed.

²⁷⁴ Bill Thompson, First Witness Statement – BT1, para. 341.

ALLEGED ERROR 6 – Failure to manage uncertainty by creating additional uncertainty through implementing an unworkable two-stage process

6.

Introduction

6.1 SONI asserts that the two stage process that comprises the UR's approach to uncertain costs in the price control is '*unworkable*', fails to achieve the intended effect, is '*disproportionate*' and creates uncertainty which will have a negative effect on SONI's financeability.

6.2 However, the UR has simply continued with the process which has been adopted previously and which is similar to that adopted by the Competition Commission in its determination of NIE's RP5 price control. SONI is well used to working within that process and – although it may disagree with it – SONI has failed to establish that its adoption in this price control is wrong on any of the statutory grounds.

The Decision on the two-stage process

6.3 The 'two stage process' described by SONI is the application of the D_t mechanism and K factor described in sections 2 and 4.

6.4 SONI will make an application for costs under the D_t mechanism which, if appropriate, the UR will allow up to a cap.

6.5 SONI will then report on its actual costs and, if necessary, adjust them using the K factor –

(a) where SONI's actual costs are less than the cap it was allowed under the D_t mechanism, and

(b) where the UR finds any element of those costs to be DIWE.

SONI's Submissions on Alleged Error 6

6.6 SONI states that under its 2010 – 2015 price control, it was required to submit claims to the UR *ex post* to recover unforeseen costs which it occurred above its revenue cap in each year²⁷⁵. This is incorrect as shown below. Rather the current process is, for the most part, a continuation of what has gone before.

6.7 In relation to that process SONI asserts²⁷⁶ –

'The two stage approval process is unworkable. The modifications fail to achieve the effect intended by the Utility Regulator. The approach is inconsistent with good regulatory practice, is disproportionate, and further

²⁷⁵ SONI Notice of Appeal – NOA1, [para. 28.2](#).

²⁷⁶ SONI Notice of Appeal – NOA1, [para. 28.8](#).

hinders the Appellant's ability to recover its efficiently incurred costs, to ensure it is, and is able to demonstrate that it is, financeable for the purposes of funding.'

- 6.8 Why the process is 'unworkable', or why it fails to achieve the UR's intended effect is not explained.
- 6.9 Elsewhere in its Notice of Appeal, SONI outlines the evidence to which the CMA had regard in the BGT Determination in order to determine whether Ofgem's modifications had achieved its stated intentions with respect to its Information Quality Incentive. That evidence included policy statements, explanations of those statements and responses given by Ofgem to consultees²⁷⁷.
- 6.10 However, SONI presents none of the evidence that it suggests might be required to make its case on this point, much less an explanation as to how the policies disclosed by such evidence have failed to be met.
- 6.11 In terms of proportionality, SONI states that there is no need for *ex ante* approval of costs in circumstances where an *ex post* review will be carried out that allows the UR to adjust the amount of costs that are passed through to customers²⁷⁸.
- 6.12 SONI asserts that '*in the absence of clear criteria, a timetable, or appropriate mechanisms for approval*', the two stage process '*is destined to result in uncertainty and delay*²⁷⁹. This '*has the potential to hinder [SONI's] cost recovery, with significant adverse consequences for its financeability*²⁸⁰.
- 6.13 In relation to PCNPs, SONI also repeats the point made under Error 2 with respect to the UR's vires to put in place an *ex ante* approval mechanism²⁸¹.

Response to Alleged Error 6

- 6.14 On the basis of its own characterisation of Alleged Error 6 SONI needs to establish that –
- (a) the two stage process is unworkable,
 - (b) in being unworkable it generates uncertainty, and
 - (c) that uncertainty adversely affects SONI's financeability, such that the UR must be held to have failed to properly have regard to the need to ensure that financeability.
- 6.15 SONI's case as pleaded clears none of these hurdles.

²⁷⁷ SONI Notice of Appeal – NOA1, [para. 10.34](#), referring to BGT Determination, [section 6](#).

²⁷⁸ SONI Notice of Appeal – NOA1, [paras. 28.9 – 28.10](#).

²⁷⁹ SONI Notice of Appeal – NOA1, [para. 28.12](#).

²⁸⁰ SONI Notice of Appeal – NOA1, [para. 28.13](#).

²⁸¹ SONI Notice of Appeal – NOA1, [para. 28.11](#).

6.16 SONI's main contention is that the *ex ante* approval element of the two stage process is unnecessary – not that it is wrong on one of the statutory grounds.

6.17 This position is surprising as in the 'Comments and Queries from SONI Ltd' paper which its letter to the UR dated 16 November 2015, SONI stated²⁸² –

'SONI acknowledges NIAUR's responsibility for ensuring customers receive value for money for investments made in the network, and for ensuring that the costs recovered by SONI are not demonstrably inefficient or wasteful. We agree that, were appropriate, this should include ex-ante approval and incentivisation.'

6.18 It is precisely because of the UR's responsibilities to consumers, which SONI correctly identifies, that *ex ante* approval followed by an *ex post* check on efficiency is required.

6.19 *Ex ante* approval also serves to provide clarity and certainty to SONI as to the costs that it can recover. SONI will be able to secure finance on the back of the approval provided by the UR in respect of the costs for a particular project. Such a regulatory decision will ultimately prove of at least as much value than a letter of comfort from the UR. This is because SONI is assured that it will be able to recover the stipulated amount which the UR has presumed to be efficient unless on an *ex post* review the UR can demonstrate that it is not.

6.20 Properly construed in this way, the process put in place by the UR is not productive of uncertainty. Rather it provides certainty by clearly indicating what the UR considers to be efficient costs at the outset of each project. That assumption on the part of the UR will only be displaced if it is able to demonstrate that the costs actually incurred by SONI were inefficient, even where they are below the cap. That is a high hurdle and the burden would be on the UR to establish that the costs were indeed DIWE.

6.21 As the Competition Commission noted with respect to the same DIWE provision in the NIE RP5 price control *'the UR was not seeking a clause that would penalize NIE for failing to achieve some hypothetical ideal or to make NIE's price control conditional on NIE's proof of its own efficiency'*²⁸³. The same is true with respect to SONI.

6.22 Alleged Error 6 is badged in terms that the process to be adopted is '*unworkable*'. Again, this contention is surprising as the same process is used currently for D_t applications made by SONI and NIE.

6.23 The following examples can be provided –

(a) On 19 June 2012 SONI applied for pre-approval of costs in relation to fuel

²⁸² Letter from Sarah Friedel to Jody O'Boyle, 16 November 2015, TH1/31 and TH1/32.

²⁸³ NIE determination, [para. 5.99](#).

switching arrangements²⁸⁴. That application was granted by the UR in a letter dated 11 December 2012 in which costs were approved on an *ex ante* basis up to £334,480²⁸⁵. The UR's letter went on to state –

'We would ask SONI to be mindful of obtaining the appropriate skills level for the varying aspects of the project in a cost effective manner, as costs incurred that are not deemed efficient, by the Utility Regulator, will not be allowed.'

'As expected with any Dt item an ex-post review may be carried out. Such an ex-post review would be expected to consist of separately identifiable costs together with sufficient, appropriate audit evidence.'

- (b) On 25 June 2012 SONI applied for pre-approval of costs in relation to the auction management platform. This application was granted by the UR in a letter dated 5 June 2013 in which costs were approved on an *ex ante* basis up to £483,000. The UR's letter went on to state²⁸⁶ –

'Please note that this approved amount is a maximum amount, and only actual costs that are efficiently and properly incurred should be recovered in line with the SONI TSO Licence.'

- (c) The same wording was used in the UR's letter of 1 October 2013 which granted *ex ante* approval of an additional £150,000 costs in respect of the EMS System²⁸⁷.

6.24 It is therefore clear that the two-stage process is not new, unexpected or unworkable. The UR has simply retained the current process – which cannot be said to decrease certainty on SONI's part.

6.25 Indeed, the Competition Commission instituted a similar mechanism with respect to investment projects by NIE to increase transmission system capacity²⁸⁸. Under that mechanism, NIE makes applications to the UR in relation to specific projects with any adjustments that the UR makes to NIE's maximum regulated revenue and RAB limited to that necessary to allow for the expected efficient costs of delivery of the project, in light of the UR's review of these costs²⁸⁹.

6.26 The operation of the Commission's mechanism was also subject to the DIWE provision which it put in place with respect to all areas of NIE's expenditure²⁹⁰.

6.27 Mr Slye's comment that SONI will need to spend nearly as much time managing the regulator as managing the business is therefore unwarranted and betrays an

²⁸⁴ Letter from Robin McCormick to Tanya Hedley, 19 June 2012, TH1/4.

²⁸⁵ Letter from Tanya Hedley to Robin McCormick, 11 December 2012, TH1/5.

²⁸⁶ Letter from Jo Aston to Bill Thompson, 5 June 2013, TH1/6.

²⁸⁷ Letter from Jo Aston to Nick Fullerton, 1 October 2013, TH1/7.

²⁸⁸ NIE Determination, paras 5.246 – 5.270.

²⁸⁹ NIE Determination, paras 5.257 – 5.258.

²⁹⁰ NIE Determination, para. 5.104.

unfortunate attitude to regulation on the part of SONI's parent company²⁹¹, and one that was obviously not shared by the Competition Commission when it created substantially the same mechanism as part of its *de novo* price control inquiry in relation to NIE's RP5.

- 6.28 Contrary to SONI's throwaway comment in its Notice of Appeal, the process was indeed consulted on as described in the discussion of Alleged Error 4 above.
- 6.29 SONI's suggestion that the UR does not have the vires to institute an *ex ante* approval mechanism is without merit for the reasons outlined in Section 2 above, and again it is noted that SONI has not sought to plead error of law as one of the statutory grounds of its appeal.

Relief sought

- 6.30 The relief sought by SONI with respect to Error 6 flows from that which it seeks with respect to Alleged Errors 2 and 4. We adopt the points already made with respect to the relief for Errors 2 and 4 in relation to that sought for Error 6.

The UR Position on Alleged Error 6

- 6.31 SONI's contention that the UR's uncertainty mechanism is unworkable is untenable given that it simply formalises the process that has already existed for a number of years and reflects a similar mechanism put in place by the Competition Commission for NIE.
- 6.32 SONI has not explained why the process is unworkable, does not achieve the effect sought by the UR, nor how it impacts on its financeability, much less discharged the burden on it to establish how the UR's decision to adopt that process is wrong on any of the statutory grounds.

Conclusion

- 6.33 For all of the above reasons, SONI's appeal on Ground 2, in so far as it relates to Alleged Error 6, should be dismissed.

²⁹¹ Fintan Slye, First Witness Statement – FS1, para. 43.

ALLEGED ERROR 7 – Unjustified creation of uncertainty through failure to provide guidance on the application of the demonstrably inefficient and wasteful expenditure provision²⁹²

7.

Introduction

- 7.1 In its determination of NIE's RP5 price control, the Competition Commission inserted a provision allowing the UR to adjust NIE's maximum regulated revenue to protect customers from expenditure by NIE that the UR finds to be DIWE²⁹³.
- 7.2 The UR inserted a similar provision into SONI's price control. In its Draft Licence Modifications the UR originally included a provision – paragraph 9.1 – which allowed it to issue guidance on the interpretation of DIWE. It removed that provision from its Final Licence Modifications.
- 7.3 SONI is unhappy with the DIWE provision. On the basis that it cannot reasonably suggest that it should be allowed to pass through expenditure which has been found to be DIWE, SONI seeks to mount a collateral attack on the provision by attacking the fact that the UR has not decided to issue immediate guidance with respect to it.
- 7.4 Neither the Competition Commission, nor Ofgem, provides guidance on their DIWE terms. Recover under the D_t mechanism in SONI's previous price control was also explicitly linked to the efficiency of its spend. In none of these cases has the lack of guidance led to any issues related to certainty or financeability and it is untenable to suggest that it should do so now.
- 7.5 However, although it has not included the proposed licence provision with respect to guidance it has stated in any event that it will issue such guidance at a later date. This is in addition to the reasons that it provides for each decision applying the provision²⁹⁴.

The Decision on Demonstrably Inefficient or Wasteful Expenditure

- 7.6 In its determination of the NIE RP5 price control, the Competition Commission included a provision that allows the UR to disallow claims for costs that the UR finds to be DIWE.
- 7.7 In its Draft Determination the UR proposed to introduce a similar term in SONI's licence. As initially proposed, the DIWE provision would allow the UR to adjust SONI's maximum regulated revenues where costs were found to be DIWE, and would apply across all areas of NIE's expenditure, as did the similar provision imposed in

²⁹² The title of this section follows the wording of SONI's Error 7, however the DIWE provision refers to expenditure which is demonstrably inefficient or wasteful, not 'and wasteful'. SONI repeats this error at several points throughout the Notice of Appeal.

²⁹³ NIE Determination, para. 5.97.

²⁹⁴ UR Decision on Licence Modifications – NOA1/18, para. 41.

NIE's price control by the Competition Commission²⁹⁵.

7.8 That decision was confirmed in the Final Determination and it was stated that the provision would apply '*in respect of System Support Services (ATSOT), price control actual costs, excluded (DTSOT) actual costs, Change of Law actual costs and transmission pre-construction projects*'²⁹⁶.

7.9 In its consultation on the Draft Licence Modifications which was published alongside the Final Determination, the UR proposed the inclusion of the following provision in Annex 1 to SONI's licence²⁹⁷ –

'9.1 For the purposes of the provisions of this Annex in which the term Demonstrably Inefficient or Wasteful Expenditure is used:

(a) the Authority may issue (and from time to time update) guidance as to the manner in which the term is to be interpreted and applied;

(b) the term shall be interpreted and applied in accordance with any such guidance; and

(c) any determination made by the Authority entailing the interpretation and application of the term shall be accompanied by a statement of its reasons.'

7.10 In its response to the consultation, SONI stated that – as some of its costs in relation to A_t are outside of its control – it would be inappropriate to apply the DIWE provision to these. It therefore requested that the DIWE mechanism not be used with respect to A_t ²⁹⁸.

7.11 SONI also took issue with paragraph 9.1 of the Draft Licence Modifications, stating that it was inappropriate for the UR to seek to rely on guidance that it had not yet published²⁹⁹.

7.12 In its Decision Paper, the UR accepted SONI's points in relation to the application of the DIWE mechanism to A_t and removed the DIWE element from the A_t term within paragraph 2.2(a)³⁰⁰.

7.13 The UR also removed its proposed paragraph in relation to guidance, instead confirming that it would issue guidance as to how the DIWE mechanism would be applied in the event of any decision to reduce SONI's costs through application of the mechanism³⁰¹.

²⁹⁵ UR Draft Determination – NOA1/11, [para. 349](#).

²⁹⁶ UR Final Determination – NOA1/12, [paras 462 – 463](#).

²⁹⁷ UR Draft Licence Modifications – NOA1/13.

²⁹⁸ SONI response to UR consultation, RJM1/2, [p. 1 of Annex](#).

²⁹⁹ SONI response to UR consultation, RJM1/2, [p. 10 of Annex](#).

³⁰⁰ UR Decision on Licence Modifications – NOA1/18, [para. 39](#).

³⁰¹ UR Decision on Licence Modifications – NOA1/18, [para. 41](#).

- 7.14 The provision in relation to the giving of reasons in paragraph 9.1(c) was instead inserted into the definition of DIWE, which was amended to as follows³⁰² –

'[DIWE] means expenditure which the Authority has (giving the reasons for its decision) determined to be demonstrably inefficient and/or wasteful, given the information reasonably available to the Licensee at the time that the Licensee made the relevant decision about that expenditure. For the avoidance of doubt, no expenditure is demonstrably inefficient or wasteful expenditure simply by virtue of a statistical or quantitative analysis that compares aggregated measures of the Licensee's costs with the costs of other companies.'

SONI's Submissions on Alleged Error 7

- 7.15 SONI states that the effect of the UR's failure to provide guidance on the application of the DIWE provision means that *'it is entirely within the [UR's] discretion to apply the DIWE provision and reduce or remove funds from [SONI]'*³⁰³.
- 7.16 Such a situation is – SONI claims – contrary to regulatory best practice, particularly in view of limitations that the Competition Commission suggested should apply to the scope of the DIWE clause in the NIE Determination. Those suggestions were that³⁰⁴ –
- (a) the DIWE provision should not be applied with the benefit of hindsight but on the basis of the information reasonably available to the regulated company at the time,
 - (b) high-level econometric models used for benchmarking purposes do not by themselves demonstrate DIWE, and
 - (c) the regulator should undertake a factual investigation to determine whether spend was inefficient and publish a reasoned decision for any adjustment.
- 7.17 In view of those suggestions, SONI states that it was incumbent on the UR, in deciding to introduce the DIWE provision to put in place *'relevant safeguards'*³⁰⁵.
- 7.18 SONI states that it was unacceptable for the UR to *'withdraw its original commitment to provide guidance on the application of the DIWE provision on the basis that it did not have the time to write it'*³⁰⁶.
- 7.19 SONI asserts that the UR *'is required as a matter of law to explain how it intends the provision to apply (given that the application of any DIWE mechanism is not subject to appeal by the CMA)'*³⁰⁷. However, it fails to identify the source of the legal

³⁰² UR Final Licence Modifications – NOA1/17, [para. 1.1](#).

³⁰³ SONI Notice of Appeal – NOA1, [para. 29.8](#).

³⁰⁴ NIE Determination, [paras 5.106 and 5.110](#).

³⁰⁵ SONI Notice of Appeal – NOA1, [para. 29.9](#).

³⁰⁶ SONI Notice of Appeal – NOA1, [para. 29.10](#).

³⁰⁷ SONI Notice of Appeal – NOA1, [para. 29.10](#).

obligation in this regard.

- 7.20 Finally, SONI states that the additional uncertainty created by the failure to issue guidance '*has added even more risk onto [SONI]*'³⁰⁸. Again, however, this bald statement is not explained any further.

Response to Alleged Error 7

The definition of DIWE

- 7.21 Although it frames Alleged Error 7 in terms of an objection to a lack of guidance as to how the DIWE provision will be applied, it is plain that SONI objects to the provision itself, despite its stated acceptance that the objectives behind the provision are reasonable³⁰⁹.
- 7.22 Its most developed set of points therefore relates to the application of the provision by the UR and not to guidance provided to SONI itself. Those points are easily disposed of.
- 7.23 SONI states that it was incumbent on the UR to put in place '*relevant safeguards*' in deciding to introduce the DIWE provision, in light of the Competition Commission's guidance. Even a cursory reading of the definition of DIWE provided in paragraph 1.1 of the Draft Licence Conditions shows that the UR has in fact built the Commission's recommendations into that definition.
- 7.24 By way of illustration, taking each of those recommendations in turn –
- (a) The DIWE provision should not be applied with the benefit of hindsight but on the basis of the information reasonably available to the regulated company at the time –

*Definition – DIWE 'means expenditure which the Authority has ... determined to be that is demonstrably inefficient and/or wasteful, given the information reasonably available to the Licensee at the time that the Licensee it made the relevant decision about incurred that expenditure...'*³¹⁰

- (b) High-level econometric models used for benchmarking purposes do not by themselves demonstrate DIWE –

Definition – 'For the avoidance of doubt, no expenditure is demonstrably inefficient or wasteful expenditure simply by virtue of a statistical or

³⁰⁸ SONI Notice of Appeal – NOA1, [para. 29.11](#).

³⁰⁹ SONI Notice of Appeal – NOA1, [para. 29.3](#).

³¹⁰ UR Final Licence Modifications – NOA1/17, [para. 1.1](#).

*quantitative analysis that compares aggregated measures of the Licensee's costs with the costs of other companies.*³¹¹

- (c) The regulator should undertake a factual investigation to determine whether spend was inefficient and publish a reasoned decision for any adjustment –

*Definition – DIWE 'means expenditure which the Authority has (giving reasons for its decision) determined to be that is demonstrably inefficient and/or wasteful, ...'*³¹²

- 7.25 It is therefore clear that the UR has put in place '*relevant safeguards*' in relation to the DIWE provision and followed '*regulatory best practice*' as outlined by the Competition Commission.

Guidance

- 7.26 In its Draft Licence modifications, the UR did not state that it would issue guidance as to the manner in which the DIWE term would be interpreted and applied. It made no '*commitment*' in this regard. In the form consulted on, the draft version of paragraph 9.1 of Annex 1 to the licence stated that it '*may*' issue such guidance – not that it '*will*' do so – and, where that guidance was issued, the term would be interpreted according to it³¹³.
- 7.27 As the provision was permissive with respect to whether guidance would be issued there can be no possible grounds on which the UR's decision not to enshrine that power in the licence can be said to be wrong.
- 7.28 Nor did the UR fail to provide guidance '*on the basis that it did not have time to write it*', as claimed by SONI³¹⁴.
- 7.29 SONI states that the UR is '*required as a matter of law*' to issue guidance. However, it has failed to identify the source of any such legal obligation. None exists.
- 7.30 There are indeed instances in which the UR is required by statute to issue guidance on how it will act in certain circumstances³¹⁵, however no such statutory duty exists in relation to the DIWE provision. Indeed, if there were a legal obligation to issue guidance there would be no need to mirror that obligation in SONI's licence
- 7.31 As with Errors 3 and 5, had there been any actual breach of a legal obligation on the part of the UR, SONI would have pleaded that the UR's decision was wrong in law³¹⁶. Again, SONI's failure to do underlines the fact that its argument in this regard is

³¹¹ UR Final Licence Modifications – NOA1/17, [para. 1.1.](#)

³¹² UR Final Licence Modifications – NOA1/17, [para. 1.1.](#)

³¹³ NOA1/13, [para. 9.1.](#)

³¹⁴ SONI Notice of Appeal – NOA1, [para. 29.10.](#)

³¹⁵ For example, under Article 46 of the Energy Order the UR is required to issue a policy with respect to the imposition of financial penalties under Article 45 of that Order and the determination of their amount.

³¹⁶ Article 14D(4)(e) of the Electricity Order.

lacking in merit.

- 7.32 The same is true of the suggestion that the absence of guidance somehow creates additional risk for SONI and that – through the torturous process of logic that flows throughout Ground 2 – this creates uncertainty which somehow leads to a breach of the UR's statutory due regard obligation with respect to SONI's financeability.
- 7.33 Although the UR has stated that it will produce guidance on the DIWE term, it is arguable that such guidance is not required. This is because it is clear on its face what the term means. As they are not themselves defined, the words '*inefficient*' and '*wasteful*' are to be given their natural meaning.
- 7.34 In addition, the inclusion of the word '*demonstrably*' serves to reverse the normal burden of proof such that it is not for SONI to show that its actual spend was efficient. SONI will have already established that the amount requested is *prima facie* efficient when it applies to the UR for approval under the D_t mechanism. Costs up to the cap imposed by the UR will thus be presumed to be efficient unless, upon review, the UR can demonstrate that they are not. The high hurdle for the UR's use of the DIWE provision is the trade-off for any risk that SONI might be exposed to in an *ex post* review of its costs.
- 7.35 The Competition Commission agreed with this reversal of the burden relation to the DIWE provision it imposed as part of its determination of the NIE price control³¹⁷ and did not require guidance to be issued with respect to that provision. Indeed, when asked to provide examples of when that clause might bite, the Commission refused to do so stating³¹⁸ –
- 'There is a danger in seeking to define the inefficient spend clause through hypothetical examples which inevitably abstract from many aspects that would be relevant to a factual investigation under this provision.'*
- 7.36 Nor does Ofgem publish guidance in relation to a similar provision in the price control for National Grid's electricity transmission business.
- 7.37 In approvals granted under the D_t term under the previous price control the UR referred to recovery only of '*costs that are efficiently and properly incurred*'³¹⁹. A statement that only efficient costs would be recoverable under the D_t mechanism is also contained in the letter of comfort provided to EirGrid by the UR dated 26 May 2009 to be disclosed to EirGrid's banks³²⁰.
- 7.38 No guidance has been provided in relation to the link between recovery and

³¹⁷ *'The UR was not seeking a clause that would penalize NIE for failing to achieve some hypothetical ideal or to make NIE's price control conditional on NIE's proof of its own efficiency'*³¹⁷ (NIE determination, [para. 5.99](#)).

³¹⁸ NIE Determination, [para. 5.107](#).

³¹⁹ Letter from Jo Aston to Bill Thompson, 5 June 2013, TH1/6; Letter from Jo Aston to Nick Fullerton, 1 October 2013, TH1/7.

³²⁰ Letter to Dermot Byrne from Dermot MacCann, 26 May 2009, TH1/2.

efficiency over the course of the last eight years and yet SONI has remained financeable. The suggestion that its financeability will be impaired now due to a lack of guidance is untenable.

- 7.39 In relation to the DIWE provision itself (rather than the absence of guidance associated with it), the Competition Commission stated³²¹ –

'Whilst NIE might face some 'ex post' financial risk under an inefficient spend clause of this nature, we do not consider NIE's exposure to such risk to be unreasonable in light of NIE's and the UR's duties.'

- 7.40 SONI has provided no basis from departing from that view simply because of a lack of guidance.

Relief sought

- 7.41 SONI asks the CMA to include a provision in its licence which requires the UR to publish guidance on the interpretation and application of the DIWE term within six months of the CMA's determination. The UR must also consult with SONI before publishing such guidance³²².

- 7.42 SONI's proposal therefore goes beyond the provision that it states that the UR should have adopted following consultation as it requires – rather than permits – the UR to publish guidance, and states that such guidance must be the subject of consultation with SONI.

- 7.43 As with its request that the CMA institute a deadline by which the UR must make any adjustment under the DIWE provision, SONI is again asking for something that the Competition Commission has already told NIE is not appropriate. Not only is SONI unable to establish that the UR's decision is wrong in light of the Commission's previous determination, but in fact its proposed relief has already been rejected as described above.

- 7.44 SONI's proposed provision also requires that the UR publish reasons for any determination *'entailing the interpretation and application of the term'*³²³.

- 7.45 The definition of DIWE already contains the requirement to give reasons for any decision which it makes under the DIWE provision. SONI's proposal is narrower than the protections which have already been afforded to it and therefore completely unnecessary.

³²¹ NIE Determination, [para. 5.105](#).

³²² SONI Notice of Appeal – NOA1, [para. 46.42](#).

³²³ SONI Notice of Appeal – NOA1, [para. 46.42](#).

The UR Position on Alleged Error 7

- 7.46 SONI objects to the DIWE provision. However, it cannot object to it directly as to do so would be to suggest that it should be allowed to pass through costs that are DIWE.
- 7.47 It must therefore mount a collateral attack by attempting to take a series of points in relation to best practice regarding safeguards, breach of a legal obligation to provide guidance and the creation of uncertainty which impacts on its financeability.
- 7.48 Even were failure to follow best practice a statutory ground of appeal – which it is not – SONI's point fails as the points made by the Competition Commission have actually been incorporated into the definition of DIWE.
- 7.49 It cannot point to any legal obligation on the UR to produce guidance in relation to the interpretation of DIWE, as none exists.
- 7.50 It is unsustainable to claim that a lack of guidance negatively impacts on SONI's financeability in a way which could allow it to succeed on the statutory grounds of appeal in circumstances where the Competition Commission did not require such guidance when it inserted a similar provision into NIE's price control, Ofgem produces no such guidance and the Competition Commission was clear that any financial risk arising from the provision was not unreasonable.

Conclusion

- 7.51 For all of the above reasons, SONI's appeal on Ground 2, in so far as it relates to Alleged Error 7, should be dismissed.

ALLEGED ERROR 8 – Unjustified creation of uncertainty through the introduction of the Q_t adjustment

Introduction

- 8.1 The UR has introduced a term into SONI's licence – Q_t – the purpose of which is to adjust SONI's allowed revenues for the remaining years of the price control so that the price control has effect across the full five year period from 1 October 2015.
- 8.2 SONI objects to this term, arguing that –
- (a) its effect is '*unexpected*',
 - (b) the UR has failed to undertake the necessary statutory consultation, and
 - (c) the effect of the term is contrary to regulatory certainty and creates '*additional financial risks*'.
- 8.3 None of these submissions have any merit. That the price control would have effect from 1 October 2015 was signalled in a series of documents across a number of years and SONI specifically addressed the point in the statutory consultation which it now seeks to deny took place.
- 8.4 As well as being expected, it is clear that the truing-up of the price control to ensure that it has effect from the correct date was appropriate as shown by comments made by the Competition Commission in its determination of the NIE price control.

The Decision on the Q_t adjustment

- 8.5 The period for SONI's 2010 – 2015 price control ended on 30 September 2015. In its approach document of 9 July 2014³²⁴, its Draft Determination³²⁵, and its Final Determination³²⁶, the UR stated that the 2015 – 2020 price control would start and '*take effect*' from 1 October 2015.
- 8.6 The price control conditions for NIE's RP5 price control were intended to operate only until 31 March 2012. However, after that date the UR adopted a pragmatic approach in which it continued to apply those conditions until the RP5 price control was finally settled. This led to disputes with NIE as to whether those price control conditions had legal effect, particularly because some terms in those licence conditions were not defined for the period after March 2012 and suitable values and restrictions therefore had to be inferred.
- 8.7 In its Final Determination with respect to the RP5 price control the Competition Commission stated that this situation was not compatible with good administration,

³²⁴ UR Approach Paper – NOA1/9, abstract, para. 3.8 and p. 14.

³²⁵ UR Draft Determination – NOA1/11, abstract, p. 1, paras 36 – 37 and 360.

³²⁶ UR Final Determination – NOA1/12, abstract, p. 2, paras 1 and 40.

could give rise to future disputes and exposed NIE to considerable uncertainty³²⁷.

- 8.8 The UR wished to avoid such a scenario following the expiry of SONI's 2010 – 2015 in circumstances where it was apparent that the new price control would not be settled before 1 October 2015.
- 8.9 To this end, on 29 June 2015, the UR consulted on licence modifications which provided for the continuation of the existing licence conditions³²⁸. This had the effect of essentially freezing tariffs at October 2014 levels until a new price control came into force.
- 8.10 The effect of the proposed approach was to grant certainty to SONI, and protections for consumers in terms of the tariffs that would apply until the new price control took effect.
- 8.11 On 26 June 2015, Fintan Slye wrote to Jenny Pyper, the chief executive of the UR, in which he proposed³²⁹ –
- 'that we continue the System Support Services tariff at the existing rate of 0.411p/kWh until such time as the price control process is concluded and the licence updated. This would be without prejudice to the eventual revenue allowance and would be adjusted to reflect that allowance once established.'*
(Emphasis added)
- 8.12 Jenny Pyper responded in a letter dated 6 July 2015 stating that SONI's proposal aligned with that currently being consulted on by the UR and that pending the outcome of that consultation she expected that it was a methodology that the UR could endorse³³⁰.
- 8.13 Neither of these two letters have been included by SONI in the documents submitted together with its appeal.
- 8.14 The UR published its decision confirming its proposed interim modifications on 5 August 2015.
- 8.15 On 22 February 2016 the UR published a notice under Article 14(2) of the Electricity Order for the purposes of its statutory consultation on the licence modifications it proposed to give effect to the Final Determination which it published the same day.
- 8.16 SONI responded to that consultation on 23 March 2016. In that response SONI stated³³¹ –

³²⁷ NIE Determination, paras 3.57 – 3.58.

³²⁸ SONI Transmission System Operator Licence: Proposed Licence Modifications Consultation Paper, BT1/43.

³²⁹ Letter from Fintan Slye to Jenny Pyper, 26 June 2015, TH1/25.

³³⁰ Letter from Jenny Pyper to Fintan Slye, 6 July 2015, TH1/26.

³³¹ SONI response to consultation on draft licence modifications, RMJ1/2, p. 7.

'SONI notes that the Licence Modifications as set out are proposed to apply retrospectively and take effect from 2015...

The Licence Modifications must therefore be amended such that they apply only prospectively...'

8.17 The UR responded to SONI's representations in a letter dated 13 May 2016 in which it noted SONI's concerns about retrospectivity. It agreed that the licence modifications could not be backdated so as to take effect from 1 October 2015, but noted that it had always been agreed by SONI that the price control would be given effect such that it became operational on that date³³².

8.18 On 11 January 2017, the UR shared with SONI a 'preliminary draft' of its proposed licence modifications for the purposes of consultation. That draft included a term – Q_t – which was defined as³³³ –

'an adjustment to be applied to the maximum core SSS/TUoS revenue, which:

(i) in Relevant Year t ending September 2016 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.'

8.19 Despite SONI's misgivings, this term does not have retrospective effect as it does not seek to adjust the tariffs that SONI has already charged. It simply allows adjustments to be made to tariffs for the current year to allow for a truing-up where there has been any over (or under) recovery during the period from 1 October 2015.

8.20 SONI was asked for comments on the preliminary draft modifications and responded on 13 January 2017 questioning the purpose and scope of the Q_t term³³⁴. This was explained in a response from the UR on 17 January 2017 which stated³³⁵ –

'With regards to the Q_t term, as the licence modifications will not be in effect in respect of the relevant year t ending 30 September 2015 and in order to ensure that the maximum revenue for this relevant year t is calculated/assessed on the basis of the price control that should be applied we have included the term (Q_t) which makes the necessary adjustment.'

8.21 In its Decision Paper, the UR stated³³⁶ –

³³² Letter from Brian McHugh to Robin McCormick, 13 May 2016, RJM1/3, p. 6.

³³³ Draft Licence Modifications, BT1/70, para. 2.2(e).

³³⁴ Email from Sarah Friedel to Jody O'Boyle, 13 January 2017, BT1/71.

³³⁵ Email from Jody O'Boyle to Sarah Friedel, 17 January 2017, BT1/72.

³³⁶ UR Decision on Licence Modifications – NOA1/18, paras 19 – 21.

'19. The UR's decision set out in this paper applies in respect of the price control period starting on 1 October 2015. Accordingly, the effective start date of the price control set by the Decision is 1 October 2015. That this is, and always has been, the case is confirmed and clarified not only within and by the Draft Determination and the Final Determination but also within the broader consultation and engagement process undertaken by the UR on the price control and proposed licence modifications, including with SONI individually. The position has not changed – the effective start date of this price control is 1 October 2015.

20. The licence modifications which are made will therefore have the effect of setting the maximum regulated revenue for the five year period from 1 October 2015 to 30 September 2020 (subject to any modifications made following further consultation on the matters noted in this decision paper).

21. Accordingly, as the first year of the price control has passed, in order to ensure that the maximum revenue for that relevant year t is calculated/assessed on the basis of the price control that should apply we have included a new term (Q_t) which makes the adjustment that is required (as determined by the UR).'

SONI's Submissions on Alleged Error 8

- 8.22 The main point made by SONI in relation to the Q_t adjustment is that its effect was 'unexpected'. SONI had not expected that the interim tariffs put in place until the price control took effect would be adjusted by reference to an additional term in the price control³³⁷.
- 8.23 SONI states that the introduction of the Q_t term, and its retrospective effect, is contrary to 'the principle of regulatory certainty' – not least because SONI had submitted and received approval for the interim tariffs³³⁸.
- 8.24 SONI asserts that the UR failed to follow the required consultation process prior to the introduction of the Q_t term and has failed to explain how it intends to apply it. This failure, in view of the wide scope of the term, has led to uncertainty on the part of SONI which has, in turn, created 'additional financial risks'³³⁹.

Response to Alleged Error 8

- 8.25 The UR undertook a consultation in 2015 which proposed that the price control would be applied to revenues from 1 October 2015. SONI responded to that consultation arguing against that proposal. In view of that response it is untenable – simply as a matter of fact – for SONI to deny the existence of the consultation or its knowledge of the proposal.

³³⁷ SONI Notice of Appeal – NOA1, [para 30.7](#).

³³⁸ SONI Notice of Appeal – NOA1, [para 30.8](#).

³³⁹ SONI Notice of Appeal – NOA1, [para 30.8](#).

- 8.26 Nor can it be suggested that the UR's decision to introduce the Q_t term is wrong.
- 8.27 The effect of the Q_t term is simply to 'true-up' the price control such that it essentially has effect from the intended start date of the price control period (i.e. 1 October 2015).
- 8.28 That the new price control was intended to have effect from 1 October 2015 was well signalled in a series of documents over a number of years, including the UR's position paper of 9 July 2014 through the Draft Determination to the Final Determination. It was not unexpected and does not therefore lead to any present uncertainty.
- 8.29 Indeed, it is reflected in SONI's own proposal to the UR for dealing with tariff setting in the interim period before the new price control came into effect, as evidenced in Mr Slye's letter of 26 June 2015. It is unfortunate that this letter is not contained in SONI's appeal bundle as it puts beyond doubt SONI's expectation that its allowed revenue would be trued-up once the new price control came into force.
- 8.30 The Q_t term simply reflects both side's understanding and acceptance of this position.
- 8.31 Without the required truing-up via the Q_t term, the effective start date of the new price control would not be 1 October 2015 (as intended) as no account would be taken of the difference (including in respect of any under and over recoveries) in the allowed and actual revenues for the relevant period from 1 October 2015. That cannot be correct.
- 8.32 Indeed, in its application for suspension, SONI acknowledges that truing-up can be necessary and is appropriate for a price control to take effect from the date that it should have done had the modifications been made in time³⁴⁰.
- 8.33 Such truing-up is standard regulatory practice. In its determination on the NIE price control, the Competition Commission undertook a truing-up to take account of the fact that NIE had been charging tariffs based on the conditions for its previous price control for a period of time before the new price control took effect – a period of around two years, as in this case³⁴¹ –

'17.44 In this determination we set the level of maximum regulated revenues NIE will be able to raise from its customers over the period 1 April 2012 to 30 September 2014. However, NIE will only be able to set tariffs on the basis of this determination from 1 October 2014, the start of the tariff year following the publication of this final determination. Using the calculation of maximum regulated revenues based on this final determination, we estimate that since 1 April 2012 NIE may have billed/will bill more revenue than the maximum regulated revenue that we have determined for that period...'

³⁴⁰ Application for suspension, [para. 13](#).

³⁴¹ NIE Determination, [para. 17.44](#).

8.34 The Commission recognised that one way to deal with any over recovery would be to allow it to feed into a correction factor in NIE's price control conditions³⁴².

8.35 There can therefore be no question that use by the UR of the Q_t term to true-up SONI's allowed revenues to ensure the effect of the price control from the correct date was well signalled by the UR, understood by SONI and is appropriate.

Relief sought

8.36 SONI asks simply that the Q_t term be deleted from its licence. This will mean that the period of the price control will be from 9 May 2017 until 30 September 2020.

8.37 The effect of adopting this suggestion is unknown. Without a truing-up of the price control, SONI will either be granted a windfall – if it has charged tariffs higher than it would have had the price control been in effect from 1 October 2015 – or under recover where it has charged lower tariffs.

8.38 The first option cannot be permitted in light of the UR's principal objective to protect consumers under Article 12(1) of the Energy Order – to which the CMA must also have regard.

8.39 The second option creates risks to SONI's financeability and thereby gives rise to the very problem which SONI states lies at the heart of its appeal.

8.40 A truing-up of the price control is the only way to avoid either scenario.

The UR Position on Alleged Error 8

8.41 SONI asserts that it did not know that the price control would take effect over the full five year period beginning from 1 October 2015. The documentary evidence is clear that it did.

8.42 SONI asserts that the UR did not carry out the necessary statutory consultation on this point. SONI's own response to that consultation, specifically addressing that point, renders that proposition untenable.

8.43 SONI asserts that the fact that the price control will take effect from 1 October 2015 is contrary to the principle of regulatory certainty and creates additional financial risks. Quite apart from the fact that neither of these assertions are backed by either explanation or evidence, truing up is a standard regulatory tool, referenced by SONI itself in its suspension application and applied – through different means – by the Competition Commission in its determination of the NIE price control.

Conclusion

8.44 For all of the above reasons, SONI's appeal on Ground 2, in so far as it relates to

³⁴² NIE Determination, [para. 19.32](#).

Alleged Error 8, should be dismissed.

GROUND 3 – THE INADEQUATE ALLOWANCES GROUND

General Overview

- 9.1 SONI's third Ground of Appeal is that the UR has failed to secure SONI's financeability by failing to provide adequate allowances in respect of SONI's costs relating to (i) payroll, (ii) pensions and pensions deficit, and (iii) capital expenditure on Information Systems (IS).
- 9.2 SONI's case in respect of Ground 3 is fundamentally built on the premise that the UR, and through this appeal the CMA, should accept its word as to its level of costs and permit it to pass through the amount it seeks without adequate justification. It does not submit evidence sufficient to support its contention that allowances granted by the UR are inadequate, or that the amounts it seeks represent its necessary and efficient spend.
- 9.3 In essence, SONI's position appears to be that it should get what it asks for without regulatory assessment or scrutiny of its request, and irrespective of whether the allowances sought can be demonstrated to be efficient.
- 9.4 The UR's response to each of the errors alleged by SONI under this Ground 3 is set out below.

ALLEGED ERROR 9 – Payroll Allowances for Network Planning Staff

Introduction

- 9.5 SONI's contention is that the UR has failed to provide adequate payroll allowances for network planning staff. The claim is made on the basis that in determining payroll allowances the UR failed to take account of the fact that the Service Provision Change (Protection of Employment) Regulations (Northern Ireland) 2006 (referred to here as **TUPE** to align with the Notice of Appeal) apply to eleven network planning staff that transferred from NIE to SONI on 1 May 2014 (the '**transferred staff**')³⁴³.
- 9.6 According to SONI the UR's failure to take account of TUPE is evidenced by the UR applying a benchmarked average salary cost to all staff salary costs³⁴⁴.
- 9.7 The UR does not dispute that TUPE applies to the transferred staff. The transferred staff were allocated by SONI into opex and capex roles. That TUPE was applicable was fully taken into account by the UR in determining the payroll allowance for opex staff, which includes three transferred staff. In applying a benchmarked assessment of average salary costs for the purposes of determining the opex payroll allowance, the UR did not fail to take account of TUPE.

³⁴³ SONI Notice of Appeal – NOA1, [para 4.44](#).

³⁴⁴ SONI Notice of Appeal – NOA1, [para 36.4](#).

- 9.8 The opex payroll allowance is a single overall allowance which is adequate for SONI's opex salary costs. The overall allowance takes full account of the application of TUPE to opex transferred staff by:
- (a) applying a more generous benchmarking exercise than would otherwise be appropriate;
 - (b) recognising the extent of SONI's TUPE obligations throughout the period of the price control; and
 - (c) recognising that there will be cost efficiencies to be gained within the SONI TSO business from the transfer of the network planning functions.
- 9.9 There is no upfront payroll allowance determined for capex staff, including eight transferred staff. The salary costs of the capex transferred staff are to form part of the claim(s) to be made by SONI, under the D_t term, for approval and recovery of costs of Pre-Construction Network Planning (**PCNP**) projects.
- 9.10 The UR will, as it did with opex transferred staff, take full and proper account of the application of TUPE to capex transferred staff when determining the capex staff cost element of claims made by SONI under the D_t term for PCNPs.

Decision on Payroll Allowance

Background (in brief)

- 9.11 Directive 2009/72/EC (the **Directive**) sets out the requirements for ensuring effective separation of electricity networks from electricity production and/or supply activities, known colloquially as the 'unbundling' requirements. One element of the unbundling requirements is the independence and certification of transmission system operators. SONI is the certified transmission system operator for Northern Ireland³⁴⁵.
- 9.12 The Northern Ireland arrangements, under which ownership and operation of the single NI transmission system were within separate legal entities – NIE and SONI respectively – were already largely compliant with the unbundling requirements of the Directive. Nonetheless, in order to ensure ongoing full compliance, the UR considered it appropriate for the functions relating to network planning to be transferred from NIE (the transmission system owner) to SONI (the transmission system operator). The European Commission agreed and accepted the UR's proposals in deciding that SONI shall be certified as the transmission system operator for Northern Ireland³⁴⁶.
- 9.13 The transfer of the network planning functions to SONI was facilitated by a licence

³⁴⁵ European Commission Decision on TSO Certification (12 April 2013) - NOA1/3, Article 1, [page 11](#) and UR Final Decision on TSO Certification - BT1/28, [paras 3.4 and 4.2](#).

³⁴⁶ European Commission Decision on TSO Certification (12 April 2013) - NOA1/3, Article 1, [page 11](#).

modification. The obligation on SONI to undertake activities relating to network planning is set out in paragraph 3(b)(v) of Condition 18 of SONI's TSO Licence³⁴⁷.

- 9.14 This requires SONI to enter into transmission interface arrangements with NIE which, among other things, provide for the transmission system to be developed and maintained by NIE and planned and operated by SONI. The formal transfer of the network planning function was effected on 1 May 2014 when twelve³⁴⁸ NIE employees were transferred to SONI.

Network Planning - Staff Salary Costs: 1 May 2014 -30 September 2015

- 9.15 The transfer of staff took place on 1 May 2014. The costs associated with the transfer therefore first had an impact during the 2010 – 2015 price control period.
- 9.16 Following a submission made by SONI for a revenue adjustment to feed into its 2014/15 tariffs, and having sought further information in respect of the costs submitted by SONI to support that request³⁴⁹, the UR approved an uplift to SONI's opex payroll allowance for the 2010 – 2015 price control for the relevant period, i.e. 1 May 2014 to 30 September 2015.

- 9.17 The uplift reflected the full salary costs of three opex transferred staff and amounted to [CONFIDENTIAL – REDACTED]³⁵⁰.

Network Planning - Staff Salary Costs: 1 October 2015- 30 September 2020

- 9.18 In its business plan submission of October 2014, SONI provided a breakdown of opex payroll costs, for each department (including network planning), in the form of best estimate costs for the 2013/2014 and 2014/2015 relevant years and forecast costs for each of the five relevant years in the 2015-2020 price control period³⁵¹.
- 9.19 At this stage it requested an overall payroll allowance of £44.4 million for the price control period, on the basis of an indicative headcount of 113 employees³⁵².
- 9.20 In its Draft Determination, the UR proposed an overall payroll allowance of £37.6 million in respect of an indicative headcount of 107 employees. The indicative headcount which informed this proposed allowance covered 19 network planning roles (albeit only twelve staff had physically transferred from NIE) but excluded staff working on connections (as these salary costs are recovered through connection

³⁴⁷ SONI TSO Licence - NOA1/1, [page 70](#) (there is an equivalent and corresponding provision in NIE's electricity transmission licence).

³⁴⁸ One of the transferred staff retired in the 2014/2015 financial year and hence only eleven transferred staff were employed by SONI as at 1 October 2015.

³⁴⁹ SONI e-mail to UR on Transfer of Planning Tariff Submission - TH1/20.

³⁵⁰ UR Letter to SONI re Pre-Oct 2015 costs associated with the transfer of planning - TH1/33.

³⁵¹ SONI Business Plan Submission - BT1/31, Paper 5, [Tab 3.3 \(Payroll\)](#).

³⁵² SONI Business Plan Submission - BT1/31, paper 5, [Tab 3.3 \(Payroll\)](#).

charges and are outside the price control revenue)³⁵³.

- 9.21 For the purposes of the Draft Determination proposals, all of the network planning roles, and therefore the payroll costs of the eleven transferred staff, were treated as opex costs. The allowance for salary costs (encompassed within the single overall allowance proposed, but excluding pensions and other non-salary costs) amounted to £29 million.
- 9.22 In responding to the Draft Determination, SONI made representations with regard to the UR's proposal to treat network planning costs as opex costs³⁵⁴. It also revised its payroll submission and increased its requested allowance to £49 million, which represented an indicative headcount of 127 employees³⁵⁵.
- 9.23 Having considered SONI's representations in response to the Draft Determination, and following further engagement with SONI on matters relating to payroll costs, the UR agreed with SONI's proposition that it was appropriate to split the funding of transferred staff between opex and capex.
- 9.24 The UR also accepted SONI's proposed funding split for three transferred staff to be treated as opex staff and eight transferred staff to be treated as capex staff for the purposes of the 2015-2020 price control period.

Opex Staff – Payroll Allowance

- 9.25 To assist in its deliberation of what might constitute efficiently incurred payroll costs, the UR carried out a benchmarking exercise, using the provisional 2014 Office of National Statistics' Annual Survey of Hours and Earnings (**ASHE**), for the purposes of ascertaining the average salary cost that should be reflected within the overall payroll allowance.
- 9.26 SONI accepts that *'it would be inappropriate for the UR to offer a blank cheque on salary costs and that it is correct that, where appropriate, the UR assesses costs to ensure that that are reasonable and efficiently incurred'*³⁵⁶. It would appear therefore that SONI accepts that some form of benchmarking is appropriate to assess the quantum of the reasonable and efficiently incurred salary costs.
- 9.27 The use of ASHE data is deemed to be an appropriate methodology for the purposes of assessing efficient salary costs. It is used by Ofgem, including for example for the purposes of considering labour costs in relation to the RIIO-ED1 price controls for electricity network operators³⁵⁷ (but also other price controlled entities such as the Data Communications Company). It was also used by the CMA's predecessor, the

³⁵³ UR Draft Determination - NOA1/11, [paras 94 and 95](#).

³⁵⁴ SONI Response Appendix to UR Draft Determination - BT1/40B, [page 11](#).

³⁵⁵ UR Final Determination - NOA1/12, [para. 60](#).

³⁵⁶ SONI Notice of Appeal – NOA1 [para. 36.43](#).

³⁵⁷ [RIIO-ED1: Final determinations for the slow-track electricity distribution companies Business plan expenditure assessment](#) (see, for example, [para. 4.12](#)).

Competition Commission, in its final determination on NIE's RP5 price control³⁵⁸.

- 9.28 The benchmarking exercise conducted by the UR focused on the type of roles (within the ASHE methodology) which were akin to the roles to be undertaken within the SONI TSO business, including for example skilled and specialist engineers, IT and project managers and analysts.
- 9.29 Having undertaken the benchmarking exercise and assessed its outputs, the UR considered that an average salary cost (including bonus) of around [CONFIDENTIAL – REDACTED] per FTE was the right figure to feed into its determination of the overall opex payroll allowance.
- 9.30 This figure represented a reasonable (indeed arguably favourable) average salary cost for SONI for all opex staff, including the three transferred staff, having regard in particular to the fact that the UR:
- (a) applied the UK ASHE figures in its assessment, and that these are higher than the corresponding figures for Northern Ireland that the UR could have used. In other words the UR did not make the regional adjustment that might otherwise have been appropriate;
 - (b) applied the cost per full time employee of [CONFIDENTIAL – REDACTED] (in respect of basic salary and bonus) which is close to the 75th percentile for similar roles, when typically the lower median value would be used;
 - (c) did not include the ASHE average salary costs which related to administration staff or to finance administration staff, on the basis that doing so would bring down the average salary cost, even though SONI will of course be employing some staff in these roles;
 - (d) used the gross annual earnings from the ASHE data which also includes shift and overtime pay, but only applied the basic salary assessment; and
 - (e) allowed for a 10% bonus, in each year, for all opex staff.
- 9.31 Having accepted SONI's apportionment of transferred staff between opex and capex, the UR included an indicative headcount of three network planning staff in determining the opex payroll allowance.
- 9.32 This was notwithstanding the fact that the UR was aware that at the number of opex transferred staff would decrease during the price control period through retirement – while there were three opex transferred staff in place on 1 October 2015, it was known that this number would decrease by as early as spring 2017.
- 9.33 The salary costs reflected in the opex payroll allowance determined by the UR for the price control period amount to £27.1 million (which excludes costs relating to

³⁵⁸ [Northern Ireland Electricity Limited price determination, Final Determination](#) (see paras 8.61 -8.69).

national insurance contributions, pensions, agency staff and recharged costs).

- 9.34 As noted above, the UR's benchmarking exercise did not incorporate a number of factors which, had they been incorporated, would ordinarily have produced a lower average salary cost.
- 9.35 The UR has calculated that had it taken full account of the omitted factors in its benchmarking, and applied the resulting lower average salary cost in respect of non-transferred opex staff and actual salary costs³⁵⁹ for the three transferred staff, the salary payroll allowance would be in the region of £21.6 million as opposed to the £27.1 million allowance given. The payroll allowance therefore clearly contains considerable headroom, and should be more than adequate in providing sufficient funding for SONI to meet its TUPE obligations.

Capex Staff – Payroll Allowance

- 9.36 There is no upfront payroll allowance for capex staff. As outlined above, the salary costs of capex staff will form part of the assessment of costs to be allowed in respect of any PCNP claim made by SONI under the D_t term.
- 9.37 This fully accords with the treatment of payroll costs, under the D5 mechanism established by the Competition Commission in its final determination of NIE's RP5 price control³⁶⁰, when PCNP activity was undertaken by NIE.
- 9.38 The payroll costs of capex network planning staff will therefore be considered within the context of the cost approval process in respect of claims, made by SONI under the D_t term, for each approved PCNP.
- 9.39 In assessing each claim made by SONI, the UR will take account of all relevant factors, including the associated payroll costs and the extent of the payroll costs associated with capex transferees. (The UR is aware that a number of the capex transferees are also likely to be retiring during the 2015-2020 price control period.)
- 9.40 The fact that the UR has not determined an upfront allowance for capex staff costs does not equate to a failure to provide adequate payroll allowances for network planning capex staff costs. Such costs will be considered and determined within the D_t process.

³⁵⁹ Based on the uplift in opex salary costs allowed for the period 1 May 2014 – 30 September 2015 (see TH1/33).

³⁶⁰ [Northern Ireland Electricity Limited price determination, Final Determination](#)

The Grounds of Appeal

- 9.41 SONI's challenge under this ground of appeal is brought on the basis that:
- (a) it had a legitimate expectation that it would be funded for the full payroll costs of the transferred staff (Alleged Error 9(a) – the UR breached SONI's legitimate expectation); and
 - (b) further, or alternatively, the UR made an error in setting the payroll allowance by failing to have regard to SONI's legal obligations under TUPE (Alleged Error 9(b) – the UR applied the wrong methodology by failing to have regard to relevant legal obligations).
- 9.42 SONI attributes a value to the alleged failure of almost [CONFIDENTIAL – REDACTED]. The value attributed to opex payroll costs is [CONFIDENTIAL – REDACTED], and to capex payroll costs is [CONFIDENTIAL – REDACTED]³⁶¹.

Response to Alleged Error 9(a) – Legitimate expectation

- 9.43 SONI frames its appeal in respect of this alleged error on the basis that it had a legitimate expectation that it would be funded for the full payroll costs of all transferred staff³⁶².
- 9.44 'Legitimate expectation' is a phrase that has legal meaning and describes certain rights that a person has which are recognised as enforceable in public law.
- 9.45 In order to generate the expectation there are a number of requirements which such a representation must possess. The most fundamental of these, without which no legitimate expectation can be created, is that the representation must be '*clear, unambiguous and devoid of any relevant qualification*'³⁶³.
- 9.46 In support of its legitimate expectation argument, SONI attempts to rely on:
- (a) its own assumptions³⁶⁴;
 - (b) its interpretation of the communications that took place between it and the UR between October 2013 and March 2014³⁶⁵;
 - (c) its understanding of the correspondence exchanged and discussions held

³⁶¹ SONI Notice of Appeal – NOA1 para. 34.6.

³⁶² SONI Notice of Appeal – NOA1 para. 34.4.

³⁶³ See, among others - [R v North and East Devon Health Authority ex p Coughlan \[1999\] EWCA Civ 1871](#); [R \(Bancoult\) v Foreign Secretary \(no 2\) \[2008\] UKHL 61](#) at [28]; [R \(on the application of Cheshire East Borough Council and another\) v Secretary of State for Environment Food and Rural Affairs \[2011\] EWHC 1975 \(Admin\)](#), paragraph 56

³⁶⁴ SONI Notice of Appeal – NOA1 para. 36.1.

³⁶⁵ Bill Thompson, First Witness Statement - BT1, para. 141.

with the UR³⁶⁶; and

- (d) various statements made by the UR in respect of costs associated with the transfer of the network planning functions³⁶⁷.

9.47 None of the above assist SONI to make out a legitimate expectation argument. Whether or not a legitimate expectation has arisen is to be considered objectively, based on what was said and done. The subjective intention of the public authority and the understanding of the person arguing for the expectation are not determinative³⁶⁸.

9.48 The claim does not, in fact, clear the first hurdle.

9.49 SONI has neither drawn the CMA's attention to the legal requirement for a clear and unambiguous statement, nor pointed to any representation made by the UR which is capable of meeting that requirement. The reason for this failure is that no such statement exists.

9.50 None of the statements or representations made by the UR, and relied on by SONI in terms of the assurances it says have been given by the UR, comes close to a promise of the type which creates a legitimate expectation.

9.51 However, and without prejudice to the UR's arguments to the contrary, had it been the case that any such legitimate expectation had been created, the position is that the UR would not have breached that legitimate expectation. This is evident from:

- (a) the UR's decision to allow the full D_t claim made by SONI in respect of the salary costs of the transferred staff for the relevant period, i.e. 1 May 2014 to 30 September, of the 2010-2015 price control period³⁶⁹;
- (b) the amount of the overall opex payroll allowance for the 2015-2020 price control period being more than sufficient to enable SONI to meet its TUPE obligations for opex transferees; and
- (c) the UR's confirmation, following SONI's representations on the capitalisation of certain network planning expenditure³⁷⁰, that salary costs of transferred staff treated as capex staff fall within the costs relating to PCNPs and will be encompassed, following claims made by SONI, within the UR's determination

³⁶⁶ Bill Thompson, First Witness Statement - BT1, para. 142.

³⁶⁷ SEM Committee Preliminary Decision on TSO Certification - NOA1/2, page 42 and SONI Notice of Appeal, paras 36.20, 36.24, and 36.25.

³⁶⁸ *R v Ministry of Agriculture Fisheries and Food ex p Hamble Fisheries (Offshore) Ltd* [1995] 2 All ER 714; *R v Secretary of State for the Home Department ex p Ahmed* [1999] Imm A.R. 22.

³⁶⁹ UR Letter to SONI of 22 February 2016 - TH1/33.

³⁷⁰ SONI Background Note on costs associated with the transfer of network planning to SONI - BT1/25 and SONI Paper on Transmission Planning Cost Transferred to SONI under TSO Certification - TH1/19.

of the relevant costs for each such PCNP³⁷¹.

- 9.52 The opex payroll allowance for 2015-2020 is of an amount that enables SONI to fund the full payroll costs of the opex transferred staff. It is a single allowance which the UR considers to be wholly adequate for SONI's opex payroll costs.
- 9.53 The efficient capex staff costs will be provided for within the specific allowance provided for the network planning capex activities. There is nothing within the UR's decision on payroll costs which has the effect of SONI not being funded for the full payroll costs of the transferred staff.
- 9.54 In engaging with SONI on the price control process and mechanisms the UR has actively encouraged SONI to make claims for PCNPs under the D_t term and does not understand why SONI has not made any such claim to date. The failure to do so is a choice made by the company for reasons which are unclear.
- 9.55 Nothing in SONI's arguments or submitted evidence supports its contention that a legitimate expectation was created or breached by the UR.

Response to Alleged Error 9(b) – Methodology having regard to the relevant legal obligations

- 9.56 SONI's contention in respect of this error is that, notwithstanding its submission that the UR breached SONI's legitimate expectation, the UR failed to have regard to the application of TUPE.
- 9.57 That SONI considers it necessary to plead this alleged error, either in addition or as an alternative to alleged error 9(a), exemplifies the weaknesses in SONI's arguments in respect of the legitimate expectation.
- 9.58 If there were any merit in SONI's claim that it had a legitimate expectation which has been breached by the UR, it would not be necessary for it to argue an additional or alternative error. In doing so SONI tacitly accepts that there is no substance to its arguments in respect of alleged error 9(a).
- 9.59 The contention of SONI in respect of alleged error 9(b) is that the UR erred in setting the payroll allowance by failing to have regard to the fact that SONI is subject to a legal obligation under TUPE in respect of the terms and conditions of employment of the eleven transferred staff, including the level of their pre-existing NIE salaries³⁷².
- 9.60 SONI is wrong in its arguments in respect of this alleged error 9(b) for the same reasons it is wrong in relation to alleged error 9(a).
- 9.61 First, it is evident from the UR's decision to uplift the payroll allowance for 2010-2015 by the full amount requested by SONI that the UR was aware of, and took full

³⁷¹ UR Final Determination - NOA1/12, paras 99 and 487 and UR Decision Paper - NOA1/18, paras 69 and 94.

³⁷² SONI Notice of Appeal – NOA1 para 36.35.

and proper account of the application of TUPE.

- 9.62 SONI's request was for a specific amount which equated to the actual payroll costs to be incurred by SONI in respect of the three individuals treated as opex transferred staff. It accepts that the full salary costs of the three transferred staff treated as opex were allowed in full for this period³⁷³. By doing so it is also accepting that that the UR did not fail to take into account the application of TUPE.
- 9.63 It was appropriate for the UR to allow the full amount requested by SONI for the period 1 May 2014 – 30 September 2015 in light of the timing of the transfer and the period covered by the request. The UR recognised that with regard to the D_t claim made, as the transfer had taken place on 1 May 2014, SONI would not have had the opportunity to consider in any detail the cost efficiencies that can be achieved by full integration of the transferred staff and the associated network planning activities within its business. For this initial period following the transfer, it was appropriate for the UR to uplift the payroll allowance to reflect the full staff costs that SONI would absorb on day one of the transfer, given that the company would have no realistic opportunity to streamline those costs immediately.
- 9.64 The same considerations do not apply going forward from October 2015. During the 2015-2020 price control period, not only will there be changes in the number and make-up of the transferred staff but SONI will have had ample time and opportunity to deliver cost-efficiencies through effective integration of the network planning activities within its business.
- 9.65 This is particularly relevant with regard to opex activities, where the number of opex transferred staff (three) amounts to less than 3% of the total number of opex staff (98) covered by the opex payroll allowance.
- 9.66 Second, the opex payroll allowance determined by the UR for the 2015-2020 price control period is a single overall allowance for all of SONI's opex payroll costs.
- 9.67 Although information on payroll costs is sought by the UR (and provided by SONI) on the basis of a breakdown for each business function/department, the allowance is a single overall allowance for all opex staff costs. The UR does not set a payroll allowance on a department by department basis. Moreover, it does not specify or determine the precise number of staff that are to be employed or engaged by SONI for the purposes of its allocation, or spend, of the payroll allowance.
- 9.68 The headcount figures referred to by the UR in the Final Determination are essentially a useful proxy for considering an 'average per employee' and determining a single overall payroll allowance. There is no obligation on SONI as to its headcount number, whether overall or within each business function/department. How SONI chooses to allocate the payroll allowance is a business management decision for it to take, taking into account its legal obligations.

³⁷³ SONI Notice of Appeal – NOA1 [para 36.38](#).

- 9.69 SONI is empowered to use the allowance as it sees fit in order to meet its legal obligations, including TUPE obligations. The UR does not regulate, dictate or specify how the allowance is to be used – that is a business decision for SONI to take, having regard to the need to comply with its legal obligations.
- 9.70 In making its decision on the correct amount of the upfront opex allowance the UR was fully cognisant of the relevant legal obligations associated with the transfer of staff. This is accepted by SONI in its statement:
- ‘the Utility Regulator on several occasions demonstrated its awareness that the Appellant would be subject to legal obligations resulting from the transfer’ and ‘the UR itself recognised...that its treatment of the costs associated with the transfer must include ‘consideration of any relevant legal obligations resulting from the transfer’.*³⁷⁴
- 9.71 In this context, in determining the single overall opex payroll allowance the UR was also aware of, but did not make any adjustment for, the fact that the number of opex transferred staff could (and indeed would be likely to through retirements) decrease during the price control period.
- 9.72 It is telling that SONI fails completely to mention the changes that either have or may take place in the headcount number of transferred staff, and therefore identify the true extent of its TUPE obligations.
- 9.73 In addition, while it is correct and not in dispute that SONI cannot amend the terms and conditions of the transferred staff without their consent³⁷⁵, this is really no different to the position that applies in respect of non-transferred staff. There are limited cases in which employers can unilaterally amend the terms and conditions of employment contracts.
- 9.74 SONI is not prohibited from amending terms and conditions of transferred staff where the amendments are for an economic, technical or organisational reason which is not connected with the transfer.
- 9.75 Each case will necessarily need to be considered on its merits but the application of TUPE does not prevent SONI from effecting productivity changes in accordance with the ordinary law.
- 9.76 Third, the average salary cost calculated and applied by the UR through the benchmarking exercise is, for the reasons noted in paragraph 9.30 above, more generous than it might otherwise have been.
- 9.77 Having arrived at a fair, reasonable and appropriate average salary cost through the benchmarking exercise, when the UR contemplated the impact and application of TUPE for the purpose of determining the opex payroll allowance it considered there

³⁷⁴ SONI Notice of Appeal – NOA1, [para 36.37](#).

³⁷⁵ SONI Notice of Appeal – NOA1, [para 34.2](#).

to be sufficient headroom for the full salary costs of the three opex transferred staff to be met by SONI, as a company operating on an efficient basis, from within that allowance.

- 9.78 Specifically, the UR considers that the opex payroll allowance ought to have more than sufficient headroom within it to capture the full salary costs of the three opex transferred staff given that the average salary cost is considerably higher than it might otherwise have been and given that the number of opex transferees decreases by as early as spring 2017. There is no question that SONI will be in a position to comply with its legal obligations in respect of the application of TUPE to a small proportion of staff.

The UR's Position on Alleged Error 9

- 9.79 It is evident from the above analysis that the UR did not fail to have regard to the relevant legal obligations.
- 9.80 The opex payroll allowance determined by the UR takes full account of the application of TUPE to opex transferred staff by:
- (a) applying a benchmarking that provides ample headroom for TUPE costs to be met;
 - (b) not factoring into its calculations the decrease in the number of staff to whom TUPE will continue to apply within the price control period; and
 - (c) recognising that over time SONI should be in a position to make cost-efficiencies through the integration of the network planning roles and functions into its business.
- 9.81 With regard to capex staff, the recoverable payroll costs for such staff will be determined through the separate D_t process for pre-constructions network projects.
- 9.82 To date SONI has not, despite having been encouraged to do so by the UR, made a claim for such costs under the available D_t term (for any period from 1 May 2014). Therefore as the UR has not made any decision on payroll costs of capex staff, SONI's claim that the UR has failed to take account of SONI's TUPE obligations in respect of capex staff salary costs is not substantiated.
- 9.83 SONI's case appears to be that the UR should have determined an upfront payroll allowance which reflected the full payroll costs of all eleven transferred staff without taking account of any other relevant factor, including for example the funding split which was requested by SONI itself, the number of transferred staff remaining in position throughout the whole of the 2015-2020 period, and the overall payroll cost efficiencies that may be possible to obtain through productivity changes and/or as a result of the network planning role now sitting within SONI.
- 9.84 With regard to this latter point, while it is accepted that transferred staff have

protected rights under TUPE, the existence of such rights does not prevent SONI from considering how best to integrate, including by way of internal restructuring, the transferred staff into its business and achieving cost efficiencies throughout the business as a result of the transferred activities. It would be entirely possible for SONI, having had the opportunity to review in greater detail the roles and activities involved, to make cost efficiencies in other areas of its business in light of the network planning activities being undertaken by SONI rather than NIE.

- 9.85 In consequence, SONI has not made out a case that the UR was ‘wrong’ to take into account all of these relevant factors in its decision making on the appropriate level of the payroll allowances.

Conclusion

- 9.86 For all of the above reasons, SONI's appeal on Ground 3, in respect of errors 9(a) and 9(b), should be dismissed.

ALLEGED ERROR 10 – Failure to provide adequate pension allowances

Introduction

- 10.1 SONI's appeal is brought on the basis that the UR has failed to provide adequate pension allowances. In support of this contention SONI submits that the UR made two errors in respect of pension allowances.
- 10.2 SONI's first submission is that the UR applied an inappropriate methodology for determining the pensions allowance for ongoing contributions into the occupational defined benefit scheme which forms part of the SONI Limited Pension Scheme (the **DB Scheme**)³⁷⁶.
- 10.3 SONI's second submission is that the UR made an error in seeking to put in place a new approach for the recovery of the pension deficit in the DB Scheme³⁷⁷.
- 10.4 With regard to this second submission, the position is that in light of representations made by SONI that the UR had not properly consulted on the application of its pension deficit recovery principles to SONI, the UR has not applied the principles to SONI but is consulting further on the matter.
- 10.5 It is implicitly recognised by SONI that its appeal with regard to pension deficit recovery is brought in respect of a *proposed* decision rather than the decision actually made by the UR. The actual decision made by the UR is that the pension deficit principles in question do not presently apply to SONI and the *status quo ante* remains in place. There is therefore no decision which can be the subject of an appeal on the basis brought by SONI.
- 10.6 Having decided to consult further on the pension deficit recovery, the UR considered that, given the connection between pension deficit and ongoing contributions, and given that SONI has also submitted updated information on ongoing contributions relating to the DB Scheme, it was appropriate also to consult on matters relating to the ongoing contributions into the DB Scheme.
- 10.7 Given this further consultation the UR chooses not to contest the appeal with regard to the decision on the pensions allowance for ongoing contributions to the DB Scheme. Rather it will proceed to consider its response to the consultation, as it would have done absent SONI's appeal and, having done so, make representations at the remedies stage of the appeal as to the next steps.
- 10.8 Accordingly, in responding below to alleged error 10, the UR has reversed the order and responds first to the appeal on the pension deficit recovery aspect and second to the ongoing contributions aspect.

Pension Deficit Recovery - Background

³⁷⁶ SONI Notice of Appeal – NOA1, [para 38.4\(a\)](#).

³⁷⁷ SONI Notice of Appeal – NOA1, [para 38.4\(b\)](#).

- 10.9 In December 2014, the UR published a position paper which set out its approach to the recovery of pension deficit costs for price controlled energy licensees in Northern Ireland³⁷⁸ (the **Position Paper**).
- 10.10 The Position Paper outlined, with reasons, the UR's position in relation to pension deficit recovery, namely that it had decided that it was appropriate to adopt the pension deficit principles alighted upon by the Competition Commission in its final determination on the RP5 Price Control for NIE³⁷⁹, and to do so for all price controlled energy licensees that sought to recover pension deficit costs from Northern Ireland consumers.
- 10.11 The relevant principles are that a historic pension deficit – that is, a deficit incurred up to a specified 'cut-off' date – would continue to be fully funded by consumers (e.g. through an allowance within the price control) but that any new pension deficit – that is, a deficit occurring from the specified 'cut-off' date – would need to be funded in full by the licensee. A 'cut-off' date of 31 March 2015 was considered by the UR to be appropriate for all price controlled energy licensees³⁸⁰ that sought to recover pension deficit costs from consumers.
- 10.12 As at December 2014 the two energy licensees (other than NIE) recovering pension deficit costs through their respective price control conditions were SONI and Power NI – the latter in respect of pension deficit costs relating to both its electricity supply business and its power procurement business (**PPB**).
- 10.13 The Position Paper noted that, in respect of both the supply business price control and the PPB price control, the UR had previously consulted on and made amendments to Power NI's electricity supply licence which enabled it to determine the amount of the pension deficit that could be recovered from consumers, taking into account the pension deficit principles set out in the paper.
- 10.14 The Position Paper also noted that the UR was minded to apply the same pension deficit principles to SONI and that this would be consulted on as part of the Draft Determination for the 2015-2020 price control.
- 10.15 The Draft Determination outlined the UR's position in respect of the introduction of a 'cut-off' date of 31 March 2015 for SONI³⁸¹.
- 10.16 Based on the information in the actuarial valuation, that as at 31 March 2013 the pension deficit amounted to £1,146,000³⁸², the Draft Determination proposed a recovery period of 10 years for this amount and a pension deficit recovery allowance of £740,000 for the 2015-2020 price control period.

³⁷⁸ UR Final Determination - NOA1/12.

³⁷⁹ [Northern Ireland Electricity Limited price determination, Final Determination](#) (see paras 12.22 to 12.29).

³⁸⁰ Other than NIE for whom a 'cut-off' date of 31 March 2012 had already been specified by the Competition Commission.

³⁸¹ UR Draft Determination - NOA1/11, [para 97](#).

³⁸² SONI Barnett Waddingham Report - AS1/4, [pages 2, 5 and 7](#).

- 10.17 In its response to the Draft Determination, SONI asserted that it did not agree to the UR's proposals with regard to the 31 March 2015 threshold³⁸³. However, its response to the Draft Determination did not assert that the UR had not properly consulted on the application of the pension deficit principles to SONI.
- 10.18 To inform its final proposals for the purposes of the Final Determination the UR had requested SONI to provide an updated actuarial valuation as at 31 March 2015.
- 10.19 SONI provided an actuarial funding update which was dated 11 May 2015³⁸⁴ and estimated the pension deficit as at 31 March 2015 to be £1.885 million.
- 10.20 The UR's final proposals, as set out in the Final Determination, reflected the updated estimated pension deficit amount as at 31 March 2015 and proposed an allowance of £943k for the 2015-2020 price control period³⁸⁵.
- 10.21 In responding, on 23 March 2016, to the Final Determination and the proposed licence modifications published at the same time, SONI raised a concern that the UR had not, as indicated in the Position Paper, consulted on the application of the pension deficit principles to SONI but had '*simply referred to its position paper ...which was never consulted upon...*'³⁸⁶.
- 10.22 Following due consideration of SONI's response of 23 March 2016, the UR provided a detailed reply to all of the matters raised within that response on 13 May 2016³⁸⁷.
- 10.23 That response noted that, notwithstanding that the UR disagreed with SONI's contention that it had not carried out an adequate consultation on the application of the pension deficit principles to SONI, it would consult further on its '*proposed approach for costs arising in respect of any additional pension deficit occurring from 1 April 2015*'³⁸⁸.
- 10.24 The decision to consult further on matters relating to pensions was confirmed in the UR's Decision of 14 March 2017³⁸⁹.
- 10.25 The UR issued its further consultation on 11 April 2017³⁹⁰ (prior to the appeal being brought by SONI). The consultation closed on 26 May 2017, with the UR receiving responses from SONI and from the Consumer Council for Northern Ireland (**CCNI**).

³⁸³ SONI Response Appendix to UR Draft Determination - BT1/40B, [page 20](#).

³⁸⁴ Barnett Waddingham Letter to SONI on SONI Limited Pension Scheme - Funding Update 31 March 2015 - TH1/22.

³⁸⁵ UR Final Determination, NOA1/12, [para 121 and Table 4.5](#).

³⁸⁶ SONI Response (23 March 2016) to UR Consultation - RJM1/2, [page 5](#).

³⁸⁷ UR Letter (13 May 2016) to SONI re consultation on modifications to SONI's TSO Licence - RJM1/3.

³⁸⁸ UR Letter (13 May 2016) to SONI re consultation on modifications to SONI's TSO Licence - RJM1/3, [paras 3.4 and 3.5](#).

³⁸⁹ UR Decision on Licence Modifications - NOA1/18, [paras 135 to 140](#).

³⁹⁰ UR Further Consultation on certain matters relating to 2015-2020 price control for SONI (11 April 2017) - TH1/51.

Response to Pension Deficit Recovery

- 10.26 SONI's submissions in respect of pension deficit recovery are that it was wrong for the UR *'to seek to put in place a new approach for pension deficit recovery...'*³⁹¹ and that the UR *'was wrong to try to impose exactly the same approach to pension deficit recovery...'*³⁹².
- 10.27 However, the UR's position on the pension deficit recovery issue is clear. There is no decision which is or can be the subject of an appeal before the CMA. The Decision on the amount of pension deficit that is recoverable in the 2015-2020 price control period does not incorporate a decision in respect of a 'cut-off' date.
- 10.28 Moreover, the UR has not taken any decision to implement a 'cut-off' date for the recovery of incurred pension deficit. Accordingly it has not decided on a 'cut-off' date of 31 March 2015, or indeed any other date.
- 10.29 The Decision is clear in confirming that the UR did not proceed to make the licence modifications which would otherwise have implemented its proposals on pension deficit cost recovery³⁹³.
- 10.30 The UR has issued a further consultation on the matter. That consultation is now closed and the UR will, having taken due account of consultation responses, consider the matter afresh and with an open mind.
- 10.31 That there is no appealable decision in respect of future treatment of pension deficit costs is clearly evident not only from the UR's published decision on the licence modifications³⁹⁴ in respect of which an appeal can be brought, but also from SONI's submissions in respect of its alleged error 10(b).
- 10.32 SONI's submissions are that the UR was wrong *'to seek to put in place'* and *'to try and impose'* (emphasis added) its proposed approach to future pension deficit costs. Moreover, it unambiguously concedes that the UR has not reached a conclusion as to a 'cut-off' date by averring *'if having conducted a thorough assessment the Utility Regulator does conclude that it is necessary to impose a cut-off date...'*³⁹⁵.
- 10.33 It is difficult to reconcile these statements with any possible mistake by SONI in believing that there was an appealable decision on pension deficit recovery costs.
- 10.34 SONI's attempt to appeal a decision which has not been made is not only premature but also an abuse of process.
- 10.35 The decision made by the UR with regard to pension deficit recovery is to not have a

³⁹¹ SONI Notice of Appeal, [para. 38.4\(b\)](#).

³⁹² SONI Notice of Appeal, [para. 40.59](#).

³⁹³ UR Decision on Licence Modifications - NOA1/18, [paras 136 to 137](#).

³⁹⁴ UR Decision on Licence Modifications - NOA1/18.

³⁹⁵ SONI Notice of Appeal, [para. 40.67](#).

'cut-off' date, but to consult further on the matter.

- 10.36 The UR has provided an allowance to SONI for recovery of the pension deficit existing as at 31 March 2015. The allowance has not been determined by reference to 31 March 2015 because it is the 'cut-off' date (there is no 'cut-off' date) but because it is the last date prior to the start of the price control period for which the UR had the most up-to-date information on the amount of the pension deficit.
- 10.37 It is also relevant to note that even if the UR had concluded on a 'cut-off' date of 31 March 2015 it would have had no impact on the pension deficit allowance determined in respect of the 2015-2020 price control period. That is, had a 'cut-off' date of 31 March 2015 been concluded upon, any such conclusion would only have an impact on the amount of the pension deficit allowance determined for any period from 1 October 2020 onwards.
- 10.38 However, as things stand, there is no 'cut-off' date. The effect of this is that, should SONI be able to evidence that the pension deficit allowance for the 2015-2020 price control period is no longer sufficient (e.g. the deficit has increased substantially in the price control period), it can submit a claim for an additional allowance under the D_t term. Accordingly, as things stand at present, consumers are covering any further accrual of pension deficit, as they have done in the past.
- 10.39 In this respect the UR would wish to clarify that if, following the further consultation, it were to conclude on a 'cut-off' date for the recovery of pension deficit, any such 'cut-off' date will be prospective.
- 10.40 SONI also states that UR has miscalculated the amount that should have been allowed for the pension deficit of £1.88 million as at 31 March 2015³⁹⁶ because it has not taken account of the time value of the money.
- 10.41 The UR notes that the pension deficit allowance of £0.89 million recoverable in each of the five years of the 2015-2020 price control period is expressed in 2014 prices and is subject to RPI uplift. By allowing for an RPI uplift of the allowance stated the UR has taken appropriate account of the time value of the money.

DB Scheme – Ongoing Contributions - Background

- 10.42 The SONI Limited Pension Scheme encompasses two different schemes. One scheme is open to new employees/members (the defined contribution (**DC**) scheme) while the other, the DB Scheme, is not.
- 10.43 In setting the overall opex payroll allowance the UR reviewed SONI's likely costs in respect of the DC Scheme and the DB Scheme separately and decided on a separate amount in respect of each scheme.
- 10.44 In its business plan submission of October 2014, SONI sought an allowance for

³⁹⁶ SONI Notice of Appeal – NOA1, [para. 40.69](#).

ongoing contributions equal to 40.3% of the pensionable pay of the active members of the DB Scheme – at the time of the submission there were 32 active members³⁹⁷ - for the full five year period of the price control.

10.45 The 40.3% employer contribution rate sought by SONI was based on the actuarial valuation as at 31 March 2013 and the schedule of contributions and recovery plan agreed between the Trustees of the DB Scheme and SONI as set out in that actuarial valuation³⁹⁸.

10.46 This was a significant increase from the 28.1% employer contribution rate as at the previous valuation at 31 March 2010 and which had been allowed in full by the UR for the 2010-2015 price control.

10.47 The UR determined an allowance of £2 million for ongoing contribution into the DB Scheme. However, it noted in its decision that in addition to consulting on the pension deficit issue it would also consult further on ongoing contributions³⁹⁹.

Response to Ongoing Contributions

10.48 The UR does not concede SONI's argument that the amount (of £2 million) reflected in the payroll allowance for the ongoing contributions relating to the DB Scheme is inadequate.

10.49 However, as outlined above, having decided to consult further on matters relating to pension deficit recovery, and taking into account (a) the nexus between pension deficit and ongoing contributions and (b) the availability of more up-to-date information on the position of the DB Scheme, the UR considered it appropriate also to consult further on ongoing contributions.

10.50 Given that this is the case, and given that the UR is necessarily keeping an open mind for the purposes of considering the responses to that consultation, the UR chooses not to contest the appeal which is brought in respect of the allowance for ongoing contributions into the DB Scheme.

10.51 However, this does not entail an acceptance by the UR that the remedy proposed by SONI is appropriate. Indeed the appropriate remedy, if one is required at all, will necessarily need to be informed by the UR's proposals following its consideration of the consultation responses.

10.52 The UR envisages that it will be in a position to notify SONI and the CMA on its proposals with regard to ongoing contributions prior to October 2017, the indicative date for remedies hearings (if required) for the appeal⁴⁰⁰.

³⁹⁷ UR Draft Determination - NOA1/11, [para. 108](#).

³⁹⁸ SONI Barnett Waddingham Report - AS1/4.

³⁹⁹ UR Decision on Licence Modifications - NOA/18, [para. 139](#).

⁴⁰⁰ [Energy licence modification appeal: SONI Administrative timetable](#).

10.53 Accordingly, the UR will make submissions on the appropriate remedy, in respect of ongoing contributions, in response to the CMA's invitation on remedies.

Other Observations

10.54 It is clear that SONI understands and accepts that an appealable decision has not been made by the UR in respect of pension deficit recovery.

10.55 Nonetheless, it proceeds to argue that separating the pensions issues impacts on its procedural rights⁴⁰¹. This is on the basis that should the UR make a future decision on the pension deficit recovery SONI would need to make '*a second appeal to the CMA*'⁴⁰². In doing so it fails to appreciate that it need not, indeed should not, have made the appeal that it has made on the issue of pension deficit recovery given that there was no appealable decision.

10.56 In addition, SONI fails to acknowledge that the UR has consulted further on the matter in light of representations made by SONI that, notwithstanding the Draft Determination and Final Determination being consultation documents, the UR had not properly consulted on its proposals to apply a 'cut-off' date for pension deficit recovery.

10.57 It is also surprising that having made submissions that the UR should consult further on the application of the pension deficit recovery principles to SONI, and having urged the UR to formalise the price control without further and undue delay, SONI is now complaining about the fact that the UR has done what SONI wanted it to do.

10.58 The proposition that the UR's further consultation on pension deficit costs '*denies SONI the opportunity to assess the acceptability of the price control package as a whole, and ultimately to determine the impact on SONI's financeability*'⁴⁰³ is wholly without merit.

10.59 The price control package as a whole is that which is reflected in the Decision. SONI has not been denied any opportunity to assess that package. Furthermore given that the UR's decision on pension deficit recovery is to not have a 'cut-off' date it is not obvious how the UR's further consultation denies it the opportunity to consider the impact on its financeability.

10.60 As noted earlier, the UR is not at this stage making any detailed representation and observations in respect of the specific remedies being sought by SONI. It considers it to be more appropriate for it do so at the remedies stage of the appeal.

10.61 However, the UR notes that the relief sought by SONI in respect of alleged error 10(b) is to the effect that the CMA directs the UR that, in the event that the UR determines it necessary to apply a 'cut-off' date for pension deficit recovery, it

⁴⁰¹ SONI Notice of Appeal – NOA1, [para. 40.61](#).

⁴⁰² SONI Notice of Appeal – NOA1, [para. 40.61](#).

⁴⁰³ Bill Thompson, First Witness Statement - BT1, [para. 227](#).

should not do so retrospectively.

10.62 The CMA in fact has no jurisdiction to give such a direction in circumstances where, as requested below, it dismisses the appeal in respect of alleged error 10(b) – which it inevitably must do given that it is brought in respect of a decision that was not made.

Conclusion

10.63 For all of the reasons given above, SONI's appeal in respect of alleged error 10(b) should be dismissed.

ALLEGED ERROR 11 – Failure to provide adequate IS capital expenditure allowances**Introduction**

- 11.1 SONI states that the Information Systems (IS) capex allowance is inadequate because it does not include an amount for costs relating to the DS3 and Smart Grids Project (the **DS3 Project**), and because the UR made an incorrect adjustment to rebase SONI's submitted costs to 2014 prices.
- 11.2 The reference to DS3 is a reference to the all-island DS3 (**Delivering a Secure Sustainable System**) programme. The programme is designed to implement measures to support the secure and reliable operation of the all-island transmission system, as level of non-synchronous wind penetration increases across the all-island system, in order to achieve the 40% renewable energy target set by Northern Ireland and the Republic of Ireland respectively.
- 11.3 The UR's response is that SONI has not made out a valid case for an allowance in respect of the DS3 Project. It has not provided any tangible evidence or information supporting its request for an allowance of £1.33 million or of the need to incur the level of costs submitted.
- 11.4 No detailed breakdown of the submitted costs, other than into three areas of activity which is currently carried out by SONI, has been provided to the UR. Moreover, there is a distinct lack of clarity on the scope of each of the three areas said to fall within the DS3 Project request, and on the difference between each particular area.
- 11.5 However, the UR has not discounted entirely the potential need for the DS3 Project and would welcome proposals that can be demonstrated to increase renewable penetration and add value for consumers. It has therefore signalled to SONI that it would be open to SONI to make a D_t claim in respect of the DS3 Project in the event that it is able to demonstrate the need for that investment.
- 11.6 In terms of the UR's adjustment of the business plan figures, SONI has not explained to the satisfaction of the UR that, notwithstanding the information provided in its business plan submissions, the IS capex costs within the business plan are in 2014 prices and not in 2015 prices.
- 11.7 SONI's arguments for the IS capex allowance to include an amount for the DS3 Project, and its arguments in respect of the UR's adjustment to rebase the submitted costs to 2014 prices, were fully considered and rejected by the UR in the Final Determination and Decision Paper. The UR was right to do so for the reasons given below.

The Decision on IS Capex

- 11.8 In its business plan submission of October 2014, SONI submitted estimated costs for IS capex of £8.927 million⁴⁰⁴.
- 11.9 The submission sought an allowance of £1.333 million in respect of expenditure relating to the DS3 Project. In support of its submission for IS capex, SONI submitted a paper on Information System Drivers⁴⁰⁵. The section relating to the DS3 Project identified three sub-projects falling within it, namely DS3 Performance Monitoring Data, DS3 Tools and Smart Grids, and the requested costs for each sub-project⁴⁰⁶.
- 11.10 In response to SONI's business plan submission on IS capex, the UR asked its consultants (Gemserv) to assess the need for, and estimated costs of, each of the IS capital projects included within SONI's submission.
- 11.11 As described in the witness statement of Tanya Hedley⁴⁰⁷, in undertaking its brief for the UR, Gemserv reviewed SONI's submitted proposals on all IS capex projects and sought further information and explanation, including at tripartite meetings held on 5 February 2015 and 12 February 2015⁴⁰⁸, from SONI on the DS3 Project.
- 11.12 Gemserv reported on its assessment of SONI's IS capex submission in March 2015⁴⁰⁹.
- 11.13 Gemserv's report corroborated the UR's own initial review in relation to the DS3 Project. This is that SONI had not provided sufficient evidence to support its request for costs on the DS3 Project, and that the limited information provided indicated there was potential for overlap and duplication between the DS3 Project, other IS capex projects and the DS3 Programme.
- 11.14 The UR consulted on its proposal to defer the inclusion of an amount for the DS3 Project in the IS capex allowance as part of its Draft Determination on the basis that further work was needed on its interaction with the DS3 Programme⁴¹⁰. Costs relating to the DS3 Programme are a matter for the SEM Committee and approved costs are recoverable through the D_t term.
- 11.15 In its response to the Draft Determination, SONI claimed that only the DS3 System Service costs are a matter for the SEM Committee and that the DS3 Project did not form part of that workstream⁴¹¹.
- 11.16 However, while it may (from a strict viewpoint) have been right for SONI to say that the DS3 Project does not form part of the DS3 System Service workstream, there

⁴⁰⁴ SONI Business Plan Submission - BT1/31, [Paper 5 \(Tab 3.9, Lines 11-19\)](#).

⁴⁰⁵ SONI Business Plan Submission - BT1/31, [Paper 10](#).

⁴⁰⁶ SONI Business Plan Submission - BT1/31, [Paper 10](#) (Section 3.7, [pages 27-28](#) and Table 2, [page 17](#)).

⁴⁰⁷ Tanya Hedley, First Witness Statement - TH1, [para. 9.47](#).

⁴⁰⁸ Tanya Hedley, First Witness Statement - TH1, [para. 9.51](#).

⁴⁰⁹ UR Gemserv Report - NOA1/16.

⁴¹⁰ UR Draft Determination - NOA1/11, [para. 166](#).

⁴¹¹ SONI Response Appendix to UR Draft Determination - BT1/40B, [page 26](#).

nevertheless needs to be a consistent approach to costs which, whether indirectly or implicitly, are associated with or related to the DS3 Programme.

- 11.17 Following the Draft Determination, as described in the witness statement of Tanya Hedley, the UR continued to engage with SONI on its price control proposals including in respect of IS capex⁴¹².
- 11.18 Given the lack of information from SONI in respect of the DS3 Project and the continued uncertainty on the IS requirements for the DS3 Programme, including the parameters of each IS project required to deliver the DS3 Programme, the Final Determination also proposed the deferral of costs of the DS3 Project and noted that it would be considered afresh within the cost recovery framework to be established by the relevant authorities⁴¹³.
- 11.19 In addition, as the costs set out in SONI's business plan submission for IS capex were stated by reference to 2015 prices, in order to ensure a consistent approach across the price control allowances, the UR adjusted SONI's submitted IS capex costs to 2014 prices.
- 11.20 The Decision Paper reflected the Final Determination, with an upfront IS capex allowance of £6.6 million for the 2015-2020 price control period. This is a substantial increase from the IS capex allowance for the last price control.

The Grounds of Appeal

- 11.21 SONI's appeal is brought on the basis that the UR made two specific errors in setting the upfront IS capex allowance for the 2015-2020 price control period.
- 11.22 The errors are stated to be:
- (a) the UR wrongly determined that the DS3 Project should be excluded from the price control as a SEM Matter⁴¹⁴ (Alleged Error 11(a) – Exclusion of DS3 Project); and
 - (b) the UR made an incorrect adjustment for inflation by rebasing SONI's IS capex submission to 2014 prices on the wrong assumption that the submission was in 2015 prices⁴¹⁵ (Alleged Error 11(b) – Incorrect Adjustment for Inflation).
- 11.23 SONI states that the combined effect of the alleged errors in respect of the IS capex allowance was a £1.59 million reduction in the IS capex allowance for the 2015-2020 price control period. This figure has not been explained to the UR.

⁴¹² Tanya Hedley, First Witness Statement - TH1, [para. 9.56](#).

⁴¹³ UR Final Determination - NOA1/12, [para. 218](#).

⁴¹⁴ SONI Notice of Appeal – NOA1, [para. 42.4\(a\)](#).

⁴¹⁵ SONI Notice of Appeal – NOA1, [para. 42.4\(b\)](#).

Response to Exclusion of DS3 Project

- 11.24 SONI argues that the alleged error made by the UR was that it *'wrongly determined that [the DS3 Project] should be excluded from the price control as a SEM Matter'*⁴¹⁶.
- 11.25 There is no evidence submitted by SONI to support its argument that the UR determined that the DS3 Project should be excluded as a SEM Matter. This is not surprising given that the UR did not decide that the DS3 Project should be excluded from the IS capex allowance because it was a SEM Matter.
- 11.26 The UR makes three observations in respect of SONI's claim that the UR made an error in excluding the DS3 amount by effectively treating it as a SEM Matter.
- 11.27 First, a matter is only a SEM Matter where the SEM Committee has determined that it is⁴¹⁷ and, to date, no such determination has been made by the SEM Committee in respect of the DS3 Project.
- 11.28 Second, none of the UR's consultation or decision documents makes any reference to the DS3 Project being a SEM Matter. The UR explains in the Draft Determination that the *'implementation'* of DS3 is determined as a SEM Matter⁴¹⁸ - a different point entirely.
- 11.29 SONI misinterprets the explanation by the UR that *'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'*⁴¹⁹ as the UR stating that the DS3 Project is a SEM Matter.
- 11.30 Third, SONI believes that the UR treated the DS3 Project as a SEM matter because the UR considered the project to be part of the DS3 System Services workstream. It further contends that this *'mistake may have arisen due to a misunderstanding created by [the UR's] consultant Gemserv'* and that the UR *'appeared to rely on Gemserv's incorrect statement as a justification...'*⁴²⁰.
- 11.31 This contention is made on the basis of a single sentence in Gemserv's report which notes that *'if, as implied in the SONI submission, that they will need to make a separate IT submission for this work...'*⁴²¹. SONI has ignored the remainder of Gemserv's assessment on the DS3 Project.
- 11.32 The UR did not treat the DS3 Project to be part of the DS3 System Services workstream and did not make the mistake suggested by SONI whether by reference to the single sentence in Gemserv's report on which SONI focuses or otherwise.

⁴¹⁶ SONI Notice of Appeal – NOA1, para. 42.4(a).

⁴¹⁷ SONI Authorities Bundle - Tab 10, Article 6(3) on page 6.

⁴¹⁸ UR Draft Determination - NOA1/12, para. 25.

⁴¹⁹ UR Final Determination - NOA1/12, para. 218.

⁴²⁰ SONI Notice of Appeal – NOA1, para. 44.13.

⁴²¹ UR Gemserv Report - NOA1/16, page 18.

11.33 SONI states that '*neither the Utility Regulator, nor Gemserv, sought to query or confirm the position*'⁴²². There was no need to query or confirm the position – the UR did not treat the DS3 Project as a SEM Matter.

11.34 Given that the UR did not exclude an amount for the DS3 Project on the basis that it was a SEM Matter, SONI's appeal on the grounds that this was the error made by the UR falls at the first hurdle.

11.35 The IS capex allowance does not include a specific amount for the DS3 Project on the basis that:

- (a) SONI did not provide, and has still not provided through this appeal, any tangible evidence or information on scope or extent of the work falling within each sub-project included within the DS3 Project;
- (b) SONI did not provide, and has still not provided, a breakdown of the costs within each sub-project, set out its methodology or assumptions for the amounts submitted, or distinguished between the type of work outlined in the description of each sub-project and the work included in other IS capex projects;
- (c) SONI has failed to submit a business case, as requested by the UR, in relation to the DS3 Project;
- (d) as described in the witness statement of Tanya Hedley⁴²³, there is a degree of overlap between the IS developments and enhancements falling within the scope of IS projects for which an amount is included in the IS capex allowance, including for the IS project 'Big Data and Data Mining'⁴²⁴ and the DS3 Project; and
- (e) further work is required on the interaction between the IS deliverables within the DS3 Programme and the IS deliverables supporting the DS3 Programme, particularly in terms of identifying areas of overlap and/or duplication.

Lack of supporting information from SONI

11.36 SONI refers to a single sentence in Gemserv's report in an attempt to support its claim that the upfront IS capex allowance is inadequate because it does not include an amount for the DS3 Project, but has nothing to say about Gemserv's assessment in respect of that project.

11.37 Furthermore, it has nothing to say as to the reasons why it deleted, from the IS capex submission, the two columns which asked it to: (i) classify whether the relevant IS capex project was essential, beneficial or optional, and (ii) attach a business case and

⁴²² SONI Notice of Appeal – NOA1, para. 44.14.

⁴²³ Tanya Hedley, First Witness Statement - TH1, para. 9.55.

⁴²⁴ SONI Business Plan Submission - BT1/31, Paper 10 (page 24).

other evidence to justify the need for each project, expected benefit and justification of the proposed allowance.

- 11.38 The simple position is that SONI needs, and fails, to show that the proposed IS investment falling within the DS3 Project is required to the extent stated by SONI, that all of the investment proposed under the DS3 Project is separate and additional to IS investment for which an allowance is provided, and that the proposed investment complements the DS3 Programme.
- 11.39 In its report, Gemserv noted that the DS3 Project seemed to be an area '*where the actual requirements over the next five years are not yet definable*'⁴²⁵.
- 11.40 It also noted that, with regard to the sub-project DS3 Performance Monitoring Data, it was '*unclear to Gemserv what the provision of £417k for IT equipment is actually for*'⁴²⁶ and that although DS3 related tools are definitely required '*the extent to which a separate budget is required is debatable as provisions in other budget lines could include such innovations*'⁴²⁷.
- 11.41 Gemserv's assessment concluded that SONI's '*proposed budgets are not defined enough*'⁴²⁸ and that '*as the costs are not presently definable no provision should be included in the price control*'⁴²⁹.
- 11.42 SONI has failed to provide any information which assists in validating its submission for costs of £1.33 million. As described in the witness statement of Tanya Hedley⁴³⁰, both the UR and Gemserv sought further information and clarification from SONI on the scope of activities and investment falling within the DS3 Project but SONI could not, and has continued to fail to, provide any additional information in support of its submission.

Overlap/Duplication with other IS capex

- 11.43 SONI's DS3 Project submission refers to three sub-projects without setting out any clear delineation between the scope of each sub-project. All of the sub-projects are to a large degree inexplicably intertwined and the dividing line between them is far from self-evident.
- 11.44 It is because of the '*certain commonalities between them*'⁴³¹ that SONI bundled them together for the purposes of seeking a cost allowance in respect of them.
- 11.45 Moreover, there would appear to be a degree of overlap between some of the processes referred to in the brief description of the sub-projects within the DS3

⁴²⁵ UR Gemserv Report - NOA1/16, [page 17](#).

⁴²⁶ UR Gemserv Report - NOA1/16, [page 18](#).

⁴²⁷ Ibid.

⁴²⁸ Ibid.

⁴²⁹ UR Gemserv Report - NOA1/16, [page 19](#).

⁴³⁰ Tanya Hedley, First Witness Statement - TH1, [para. 9.48](#).

⁴³¹ SONI Notice of Appeal – NOA1, [para. 43.5](#).

Project and those described in other IS capex projects.

- 11.46 As described in the witness statement of Tanya Hedley⁴³², SONI has sought investment for a Smart Grids project, but Smart Grid functionality is also included within Big Data and Data Mining IS capex project. There is no clear demarcation between the different IS developments and enhancements that are to be covered by each project or the interaction between the two.

Interaction with the DS3 Programme

- 11.47 The UR did not treat the DS3 Project as a SEM Matter and included within the DS3 System Services workstream.
- 11.48 Nonetheless, it recognised that there will be a need for IS investment to manage the new processes and requirements of any particular DS3 workstream that may already be determined as a SEM Matter and/or to support the relevant DS3 workstream.
- 11.49 In this context it is the case that precise requirements of each different IS workstream, including the deliverables required from that IS investment (whether within the DS3 Programme itself or to support the DS3 Programme), and the interfaces and interactions that will need to be in place between each IS workstream, are not fully scoped out. The IS investment necessary to facilitate and support the implementation of the DS3 Programme will necessarily be informed by the measures being taken within the DS3 Programme itself.
- 11.50 Taking account of the scant information provided by SONI on the DS3 Project and the real potential for overlap and duplication between the IS requirements falling within the DS3 Programme and those supporting the DS3 Programme, the UR does not consider that a case has been made for the IS capex allowance to include an amount for the DS3 Project.

Response to Inflation Adjustment

- 11.51 SONI states that the UR was wrong to assume that the IS capex submission was in 2015 prices. However, the UR did not *assume* that the IS capex submission was in 2015 prices. It is the information set out in SONI's business plan submission which supports the position that the IS capex figures submitted by SONI are in 2015 prices.
- 11.52 Contrary to SONI's assertion, the UR has not made an error of fact. Moreover, the fact that the UR confirmed in the Final Determination that the '*overall capex allowance provided above is adequate*'⁴³³ is not, as claimed by SONI, an indication that the UR '*was aware it had made an error*'⁴³⁴.
- 11.53 SONI's business plan submission of October 2014 included, as requested by the UR,

⁴³² Tanya Hedley, First Witness Statement - TH1, [para. 9.55](#).

⁴³³ UR Final Determination - NOA1/12, [para. 226](#).

⁴³⁴ SONI Notice of Appeal – NOA1, [para. 44.35](#).

business plan information for IS Capex⁴³⁵, for RAB (excluding building)⁴³⁶ and for RAB (Building)⁴³⁷.

11.54 The RAB (excluding building) tab (Tab 3.12) has, for the years within the 2015-2020 price control period, the heading '2014/2015 prices'. In cell N11 of that Tab, SONI has included the comment '*RAB inflated to 2014/2015 prices and adjusted to reflect actual investment*'⁴³⁸.

11.55 The statements and calculations made by SONI in tabs 3.9, 3.12 and 3.13 (of Paper 5 of the October 2014 submission) corroborate the fact that the IS capex costs were expressed in April 2015 prices and not April 2014 prices.

11.56 This is on the basis that:

- (a) The heading of the tables in Tabs 3.12 (RAB: excluding building) and 3.13 (RAB: building) where the depreciation figures are reported is '2014/2015 prices'.
- (b) Each of the RAB Tabs (3.12 and 3.13) contain calculations of the forecast opening and closing RAB for each year in the period 2015 to 2020. The movements in the forecasted RAB must reflect (i) the forecast additions to the RAB, and (ii) the forecast depreciation in the year.
- (c) The opening RAB for the year 2015/16 is calculated in cell N11 of Tab 3.12 and cell J37 of Tab 3.13.
- (d) These figures are calculated by multiplying the closing RAB in 2014/15 (expressed in 2009/10 prices) and uprating it by a factor which is labelled as 'RPI Adjustment'. This factor is reported in cell N1 of Tab 3.12 and in cell K1 of Tab 3.13.
- (e) In both cases, the adjustment factor is calculated as 263.9 divided by 222.8. The value of 222.8 is the RPI for April 2010. The value of 263.9 is consistent with what might have been a reasonable forecast of the RPI for April 2015 at the time of submission of the SONI business plan (October 2014)⁴³⁹. Had SONI's submission been in 2014 prices the formula would have been $255.7/222.8$ as the RPI index for April 2014 is 255.7⁴⁴⁰.
- (f) The RAB additions (for IS capex) for 2015-2020 are set out in:

⁴³⁵ SONI Business Plan Submission - BT1/31, [Paper 5](#) (Tab 3.9).

⁴³⁶ SONI Business Plan Submission - BT1/31, [Paper 5](#) (Tab 3.12).

⁴³⁷ SONI Business Plan Submission - BT1/31, [Paper 5](#) (Tab 3.12).

⁴³⁸ SONI Business Plan Submission - BT1/31, [Paper 5](#) (Tab 3.12, cell N11).

⁴³⁹ SONI's calculations imply a forecast growth in the RPI index of 3.2% from April 2014 to April 2015. This is consistent with the OBRThe's March 2014 RPI forecast for Q2 2015.

⁴⁴⁰ [ONS: RPI All Items Index: Jan 1987 = 100.](#)

- (i) cells N12 to R12 of Tab 3.12 (RAB: excluding building) under the heading '2014/2015 prices'; and
 - (ii) cells J38 to N38 of Tab 3.13 (RAB: building) under the heading '2014/2015 prices' and are updated from 2009/2010 prices by the RPI adjustment factor.
- (g) The total sum of cells N12 to R12 (Tab 3.12) and cells J38 to N38 (Tab 3.13) amounts to the total sum requested by SONI for IS capex (in Tab 3.9), i.e. £9.416 million.

11.57 It is clear from Tab 3.13 that the figures in cells J38 to N38 (of Tab 3.13) are in 2015 prices as they adjust (by 1.18 – the RPI adjustment made by SONI) the figures given in cells J9 and L9 which are in 2010 prices. The RAB additions in Tab 3.13 are for 'concrete repair' and 'facilities improvement' and in J38 and N38 (so the 2015 prices) are of the same amount as in the IS capex submission (Tab 3.9).

11.58 SONI states that RAB additions in Tab 3.12 are not updated to 2015 prices. However, given that these additions are added to other figures that are expressed in 2015 prices, it is difficult to see how the calculations can work as intended if the RAB additions in that Tab 3.12 are not also in 2015 prices. Moreover, SONI states that the total amount in the IS capex submission is in 2014 prices, but as explained above the figures for 'concrete repair' and 'facilities improvement' are definitely in 2015 prices. The total in the IS capex submission cannot be a combination of 2014 prices and 2015 prices – all of the figures must refer to the same base year.

11.59 It was therefore right for the UR to make an adjustment to the costs submitted by SONI for IS capex so that these are expressed in terms of April 2014 prices.

Other Observations

11.60 The position being argued by SONI in relation to this alleged error 11 is essentially that it should be permitted by the UR simply to pass through an amount for IS capex without the need to demonstrate that the amount needs to be incurred or to substantiate the need with a business case.

11.61 The UR has not failed to provide an adequate IS capex allowance for SONI. The upfront allowance of £6.6 million is reflective of the need which has been demonstrated by SONI. It is a 45% increase from the last price control and is sufficient for the level of IS investment required by SONI.

11.62 Notwithstanding this, the UR has said that it is still open for SONI to demonstrate the need for the investment and to substantiate the costs associated with the investment, and that if it were to do so it has the opportunity to make a claim for the DS3 Project under the D_t term.

11.63 That SONI has not yet done so indicates that it is not as yet able to substantiate the need for the investment and that it was not 'wrong' for the UR to decline to include

an amount for the DS3 Project in the IS capex allowance.

Conclusion

11.64 SONI has failed to make out its appeal on any of the statutory grounds stated in paragraph 42.6 of the Notice of Appeal for all the reasons given above.

11.65 SONI's appeal on Alleged Error 11 should be dismissed.

STATEMENT OF TRUTH

The Respondent believes that the facts stated in this Submission are true:

Signature of Authorised Representative

Name of Authorised Representative

JENNIFER PAPER

Date

2 / 6 / 17

for an on behalf of NI Authority for Utility Regulation