

SONI Limited v Northern Ireland Authority for Utility Regulation

Summary of final determination

Notified: 10 November 2017

Introduction

1. The Northern Ireland Authority for Utility Regulation (the UR) is responsible for regulating the electricity industry in Northern Ireland (NI), and for licensing electricity suppliers, generators and transmission and distribution companies.
2. SONI Limited (SONI) is the independent electricity Transmission System Operator (TSO) for NI, licensed by the UR. SONI's licence allows it to operate the grid which transfers electricity from generators to local supply networks. SONI also conducts other activities which are not subject to this appeal.
3. On 14 March 2017 the UR published its decision to modify the terms of the electricity transmission licence held by SONI (the Price Control Decision), setting SONI's allowed revenue specific to the SONI system operation business for the five-year period from October 2015 to September 2020 (the Price Control Period). The Price Control Decision was intended to implement the conclusions set out in the UR's [Final Determination](#). The introduction of the 2015-2020 price control had been delayed by 18 months.
4. On 12 April 2017 SONI applied to the Competition and Markets Authority (CMA) for permission to appeal to the CMA to challenge this Price Control Decision. This was granted on 11 May 2017, with a statutory deadline of 10 November 2017 for the CMA to determine whether the appeal should be upheld or dismissed.
5. The CMA has now made its final determination on the appeal and notified SONI and the UR of its findings and the Order to remedy the errors found. This summary provides some background on the role of the CMA in regulatory appeals, outlines the grounds of appeal, and summarises the CMA determination on the alleged errors and, where the appeal has been upheld, the remedies required. The Order regarding remedies has been published on

the CMA [website](#) and the full determination will be published shortly. This document should not be relied upon in place of the full determination, which is the formal document setting out the CMA's reasoning.

6. SONI's Notice of Appeal (NoA) and representations and observations on the NoA from the UR and the Consumer Council of Northern Ireland (CCNI), which was designated an Interested Third Party, have also been published on the CMA [website](#).

Role of the CMA in regulatory appeals

7. In accordance with the Electricity (Northern Ireland) Order 1992 (the Electricity Order), [Article 14D\(4\)](#), the CMA may allow a licence modification appeal only to the extent that it is satisfied that the decision was wrong on one or more of the following grounds:
 - (a) that the UR failed properly to have regard to any matter to which the UR must have regard in carrying out its principal objective under [Article 12](#) of the Energy (Northern Ireland) Order 2003 (the Energy Order) and in the performance of its duties under that [Article](#) and [Article 6B](#) of the Energy Order;
 - (b) that the UR failed to give the appropriate weight to any matter falling within (a) above;
 - (c) that the decision was based, wholly or partly, on an error of fact;
 - (d) that the modifications fail to achieve, in whole or in part, the effect stated by the UR as required by [Article 14\(8\)\(b\)](#) of the Electricity Order;
 - (e) that the decision was wrong in law.
8. To determine whether the Price Control Decision was wrong on one or more of the statutory grounds, we have taken the merits of the decision under appeal into account, considering the specific errors which have been alleged by SONI.
9. [Article 14E\(2\)](#) of the Electricity Order provides that if the CMA allows a price control appeal to any extent, it must do one or more of the following:
 - (a) quash the decision (to the extent that the appeal is allowed);
 - (b) remit the matter back to the Authority for reconsideration and determination in accordance with any directions given by the CMA;

(c) substitute the CMA's decision for that of the Authority (to the extent that the appeal is allowed) and give any directions to the Authority or any other party to the appeal;

and for these purposes a 'party' means 'the appellant; or the Authority'.

Outline of the grounds of appeal

10. SONI sought to challenge the Price Control Decision on three grounds:
 - Ground 1 – the Financeability Methodology Ground, that the UR failed to conduct a proper assessment of SONI's financeability.
 - Ground 2 – the Revenue Uncertainty Ground, that the UR failed to put in place arrangements to secure adequate revenue for SONI.
 - Ground 3 – the Inadequate Allowances Ground, that the UR did not include certain specific costs, which SONI considered it required to fulfil its functions and Licence obligations.
11. Within these grounds, which SONI claimed showed that the UR failed to have regard to its duties under [Article 12](#) of the Energy Order, SONI alleged specific errors, or sub-grounds of appeal. Each was linked with one or more of the statutory grounds listed in paragraph 7 above.
12. SONI's appeal was made against the background of significant changes in the NI electricity market, including the increasing use of renewables, and the planned introduction of the Integrated Single Electricity Market (I-SEM) in the island of Ireland, resulting in increased complexity of the systems operator activity. In addition, the Network Planning Function was transferred from Northern Ireland Electricity Networks Limited (NIE) to SONI in 2014.

CMA findings on the grounds of appeal

13. We have allowed the appeal in relation to Ground 1, part of Ground 2 (Errors 2 and 6) and part of Ground 3 (Errors 10(a), 10(b) and 11(b)) and have allowed the appeal to that extent. For the seven other alleged errors, we have dismissed the appeal.

Ground 1: financeability

14. Ground 1 relates to the ability of SONI to obtain finance for its regulated activities, and the financial framework used by the UR to determine an

assumed profit for SONI at a level consistent with the risks taken by SONI under the price control.

15. SONI submitted that the UR had failed to adopt a price control framework that could secure SONI's financeability, had not remunerated all the layers of capital used in the business, and had failed to assess non-systematic and asymmetric risks.
16. SONI submitted that it has different characteristics as an asset-light company and operates in a very different financial and economic context to other regulated companies. In SONI's view, this implies that the UR should have reflected this in its approach to regulation.
17. We agreed with SONI that the UR's financial framework did not reflect SONI's characteristics. The UR's approach was based on a return to SONI to cover the risks associated with investments in regulated assets, described in regulation as the Regulated Asset Base (RAB). However, SONI said that its RAB was small and fluctuated significantly over time. We agreed with SONI's case that the UR's approach to determining the appropriate return for SONI did not properly remunerate SONI in respect of the risks it faced, and would pose significant risks to SONI's financeability.
18. Specifically, we have found that the UR failed to provide any remuneration to cover the financing costs associated with certain risks faced by SONI. These were:
 - (a) the cost of managing working capital for the industry;
 - (b) the costs of obtaining a Parent Company Guarantee (PCG) from EirGrid plc; and
 - (c) the asymmetric risk associated with the UR's approach to financing of much of SONI's investments, where returns are capped by the UR.
19. These adjustments would materially affect the return required to remunerate SONI for the risks faced by investors. We do not consider that the financial framework used by the UR covers the risks above. We did not find that there were any mitigating factors which would have meant that other aspects of the price control provided returns to cover these risks. We have therefore found that the UR has failed to secure SONI's financeability to the extent that SONI's returns are insufficient to cover the risks it is taking in the current price control period. We therefore found that the UR was wrong on Ground 1.

Ground 2: revenue uncertainty

20. Ground 2 relates to the approach to uncertainty adopted by the UR. SONI claimed that the UR's approach was inappropriate, posing the risk that SONI may not recover significant costs in relation to price control outputs which would have an important bearing on its financeability. Most of the seven errors identified by SONI under Ground 2 relate to the design of uncertainty mechanisms which would enable SONI to apply for and receive funding for various costs that arise during the Price Control Period and for which there is no upfront allowance in the Price Control.
21. The UR approach to uncertain costs in the price control is to agree some allowance up front before the cost is incurred, and then to review the amount of money spent afterwards to ensure SONI was spending efficiently.

No cost recovery for Pre-Construction Network Projects (PCNPs) (Error 2)

22. SONI alleged that the UR had failed to set out a suitable process which permitted it to recover the significant costs that needed to be incurred in order to deliver PCNPs and allows potential funders to assess its creditworthiness. In particular, the UR's framework for recovering its spend on PCNPs is both unclear and inadequately codified, and it should not have applied a two-stage process combining an upfront cap with a review that allowed only actual costs efficiently incurred to be recovered.
23. We found that the UR has now, as part of the appeal process, set out a process through which SONI can recover its efficient PCNP costs. However, the process is not yet specified in sufficient detail in any of the UR's documentation, and important aspects of the process have yet to be codified. This is likely to increase the regulatory risks perceived by SONI and its investors, and will affect SONI's ability to finance its activities. We are satisfied to that extent that the decision was wrong, as the UR failed to codify and specify clearly the mechanisms through which SONI is to recover its efficiently incurred PCNP costs.
24. SONI's argument about the two-stage process is addressed under Error 6.

No cost recovery mechanism for additional information systems capital expenditure (IS capex) requirements (Error 3)

25. SONI claimed that the UR had failed to provide a mechanism in the licence modifications for the recovery of efficiently incurred costs associated with the delivery of any additional information systems information systems capital

expenditure (IS capex) projects over and above those identified in the UR's [Final Determination](#).

26. In our view, the D_t mechanism for dealing with uncertain costs does enable SONI to apply for additional revenue for unexpected IS costs, should they arise. We therefore found that the UR was not wrong in relation to Error 3.

No suitable mechanism for recovering Significant Project costs (Error 4)

27. This error considers whether the D_t mechanism is suitable for the different categories of Significant Project that SONI may have to undertake during the Price Control Period (SONI defined Significant Projects as any materially significant and complex project (including PCNPs) where the costs exceed £1 million).
28. SONI alleged that the UR had materially changed the application of D_t since the previous price control, and it was now the means by which a significantly expanded category of costs was to be recovered. SONI considered that the UR's approach of using a single mechanism to capture both unforeseen costs and certain Significant Projects was not in line with good regulatory practice, and a tailored approach depending on the level of uncertainty was more appropriate.
29. We agreed that the D_t mechanism covers a variety of different categories of costs, with different types of risk and where SONI is able to control costs to a differing extent, and there may be benefits in the UR setting cost recovery mechanisms tailored to these different cost categories. However, while we have concerns relating to how the D_t process may function in practice (which we address in Errors 2 and 6), we do not consider that SONI has demonstrated that the UR was wrong to use the D_t mechanism as the single process for SONI to recover its uncertain costs. We have therefore found that the UR was not wrong with regards to Error 4.

No suitable right of appeal to the CMA (Error 5)

30. SONI has claimed that the UR erred by failing to provide a suitable right of appeal concerning decisions regarding cost recovery for Significant Projects. As Significant Projects are to be recovered through the D_t process, the UR's decision whether to approach such claims does not involve a further modification of SONI's licence, and therefore cannot be appealed to the CMA. SONI considers that this is an abuse of the UR's discretion, that it is contrary to the requirements of the EU, and that it is a breach of natural justice to be prevented from being able to appeal material funding decisions to the CMA.

31. In our view, there is no basis for a claim that the lack of a right of appeal to the CMA against a disputed decision as to the costs of Significant Projects is an abuse of the UR's discretion or contrary to the requirements of EU law. In addition, given that any disputed decisions other than licence modifications would still be subject to judicial review, we do not consider that this is in breach of SONI's right to a fair hearing or the principles of natural justice, nor that it would adversely affect SONI's financeability. We therefore find that SONI does have a suitable appeal mechanism open to it as regards decisions of the UR concerning cost recovery for Significant Projects and PCNPs, and that the UR was not wrong in not providing SONI with an express right of appeal to the CMA.

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

32. SONI submitted that it faced asymmetric risks as a result of the two-stage approval process introduced by the UR for the D_t mechanism, whereby it did not benefit from any efficiency gain should actual costs be under the cap set upfront, but that it was responsible for funding additional costs should actual costs be greater than the cap, even if efficient. SONI also considered the two-stage process created an unnecessary administrative burden, did not reflect the reality of financing arrangements, and was particularly unsuited to PCNPs (argued in Error 2).
33. In our view, the UR was not wrong to implement a framework in which it has to pre-approve each project. However, we agree that SONI faces asymmetric risk to SONI due to the two-stage process introduced by the UR.
34. If asymmetric risks result from a well specified framework, which is designed to incentivise SONI to undertake only efficient expenditure, and SONI can be compensated for the risk in a manner that is not overly costly to consumers, it is unlikely to be wrong. However, in our view there is a significant lack of clarity around the functioning of the two-stage process. We consider that the process as currently set out exposes SONI to material risks of being unable to recover its efficiently incurred costs, particularly if SONI was obliged to carry out expenditure before approval had been granted.
35. The lack of a timeline set out by the UR and the UR's past failure to consider SONI's D_t applications in a timely manner raises significant doubts that the D_t mechanism would function as the UR intends, and investors will justifiably perceive there to be a risk that SONI will not be remunerated fully for its efficient expenditure

36. We therefore find that the D_t mechanism as presently specified results in significant uncertainty for SONI and is sufficiently unworkable that it is not consistent with the UR's duty to secure SONI's financeability, and we therefore find that the decision was wrong.

Unjustified creation of uncertainty through failure to provide guidance on the application of Demonstrably Inefficient and Wasteful Expenditure (DIWE) provision (Error 7)

37. In this price control, the UR introduced a new term, DIWE, into SONI's licence to control 'demonstrably inefficient or wasteful expenditure'. While SONI stated that it did not object to the principle of the UR including the DIWE process in the Price Control, it alleged that the UR had made an error as it had failed to explain how it would apply the DIWE provision in advance of its application. In its view, this left SONI without any certainty as to when, how and why the UR might seek to adjust its revenues downwards to account for DIWE.
38. During the course of the appeal, the UR published guidance on the DIWE provision, but we considered whether the UR was wrong not to publish guidance at the time of the Price Control Decision. In our view, the UR is not under any legal duty to publish guidance on the DIWE mechanism. We therefore find that the UR was not wrong in regard to Error 7.

Unjustified creation of uncertainty through the introduction of the Q_t adjustment (Error 8)

39. This error relates to a truing-up mechanism called the Q_t adjustment that was implemented by the UR to reflect the late completion of the price control review, after tariffs had been approved in the initial years of the Price Control Period.
40. SONI alleged that this was retrospective regulation that allowed the UR to have too much discretion in its implementation, hence it was difficult for SONI to predict its impact, and the uncertainty created additional financial risks.
41. The level of the adjustment is not a specific ground of appeal, but SONI is challenging the existence of a mechanism for making an adjustment to tariffs to reflect the late start of the price control.
42. In our view, while the delays in implementation of the price control are regrettable, consumers should only pay the agreed UR Final Determination settlement. Even though the precise process to apply the Q_t term was not clarified until late, the UR has provided sufficient evidence for us to conclude

that SONI should have expected some adjustment. We therefore find that the UR was not wrong to introduce and implement the Q_t adjustment.

Ground 3: insufficient allowances

43. SONI submitted that the UR had made errors in relation to three categories of allowances: Network Planning staff (Error 9), pensions allowances (Errors 10(a) and 10(b)) and IS capex allowance (Errors 11(a) and 11(b)).

Network Planning staff (Error 9)

44. In Error 9, SONI submitted that the UR had failed to provide SONI with adequate payroll allowances in respect of employees transferred from NIE in connection with the transfer of the Network Planning function in 2014. SONI said that this was a breach of its legitimate expectation that it would be funded in full for these costs, and disregarded the application of relevant legal obligations inherited.
45. We have not seen any clear evidence that the UR provided a clear and unambiguous assurance to SONI that would give rise to a legitimate expectation. We then considered whether the UR was wrong in its choice of regulatory treatment of these costs. SONI has not provided evidence that the approach used by the UR will result in allowances which are below its actual costs, and we do not consider that the approach proposed by SONI, which is effectively a cost pass-through mechanism, would be in consumers' interests. We therefore conclude that the UR did not make an error in its determination of SONI's opex and capex allowances for transferred network planning staff in the Price Control Decision.

Pensions allowances (Error 10)

46. SONI alleged that the UR had made errors on two components of pensions allowances: ongoing contributions (Error 10(a)) and deficit recovery (Error 10(b)).
47. Regarding ongoing contributions, SONI argued that the UR had applied the incorrect contribution rate, and applied it to the wrong level of pensionable salaries, resulting in a substantial funding gap. The UR chose not to contest this error, as it had decided to consult further on ongoing contributions.
48. We agree that the allowance provided by the UR in the Price Control Decision failed to reflect the updated independent actuarial valuation at the time of the UR's [Final Determination](#), and was not a sufficient allowance for ongoing pension contributions.

49. Regarding pension deficit recovery, we note the UR's view that whilst a financial allowance had been made, at the time of the Price Control Decision its position was not concluded and it had issued an open consultation on the policy position. However, we agree with SONI that the UR did make a decision to apply a cut-off date to the pensions deficit in the Price Control Decision, and that this decision failed to take into account the particular circumstances and characteristics of SONI, in particular as regards SONI's financeability.
50. We have therefore found the UR to be wrong on Errors 10(a) and 10(b).

IS capex allowance (Error 11)

51. SONI alleged that the UR had failed to provide adequate IS capex allowances. SONI said that the UR had failed to fund an entire area of SONI's IS capex submission on the mistaken assumption that this area was outside the scope of the Price Control (Error 11(a)), and also that the UR had failed to correct a clear error in its adjustments for inflation (Error 11(b)).
52. We found that it was unclear what specific projects SONI proposed to progress and what they would deliver, and therefore it would not have been appropriate for the UR to provide the upfront allowance which SONI was requesting. We also noted that there was a mechanism for recovering actual spend on projects which are deemed necessary. As the UR has stated that additional IS capital costs can be recovered through this process, we consider that SONI has not demonstrated that the UR was wrong in disallowing a specific upfront allowance (Error 11(a)).
53. Regarding the inflation adjustment, we are satisfied that SONI raised the issue of whether the relevant figures were in 2014 or 2015 prices, that the UR failed to engage sufficiently with SONI on this issue, and that there are errors in the figures. We therefore have found that the UR's decision concerning the IS capex allowance was wrong (Error 11(b)).

CMA remedies

54. Having allowed the appeal in part, as described above, we have determined the appropriate remedies to address the errors found.
55. In respect of Ground 1 we have found that the UR had omitted allowances in the Price Control Decision, as described above. We have remitted the matter back to the UR for reconsideration and determination with directions that the UR should include in the price control additional allowances to reflect:

- the cost of the PCG;
 - the asymmetric risk taken by SONI in respect of D_t and PCNP costs; and
 - the risk taken by SONI in respect of managing revenues for which it has acted as a collection agent.
56. In respect of Ground 2, we have found that the UR failed to provide a codified mechanism for recovery by SONI of efficiently incurred costs associated with PCNPs and D_t claims, as described above. We have remitted the matter back to the UR for reconsideration and determination with directions that the UR:
- include within SONI’s licence a licence condition to allow SONI to recover the ongoing costs of PCNPs under a ‘side-RAB’;
 - put in place codification to provide certainty to SONI on the process it should follow to recover the costs of D_t applications and PCNPs, including guidance on how the UR will apply the process (to be referred to in the Licence) and on what information SONI is required to provide to the UR;
 - confirm to SONI the approach by which its efficient investment in PCNPs to date can be recovered under this process; and
 - put in place a mechanism, whether in the Licence or otherwise, to allow SONI to recover the costs of completed PCNPs from NIE under the TIA.
57. In respect of Ground 3, we found that the UR had omitted allowances as described above and in our Final Determination. We have remitted the matter back to the UR for reconsideration and determination with directions that the UR amends SONI’s licence to reflect amended pension contributions and to reflect the revised investment assumptions. We have quashed the Price Control Decision to the extent that it included a pension cut-off date.
58. In addition, the UR is required to calculate the changes to tariffs required in the Tariff Years 2018/19 and 2019/20 in order that SONI can recover the total changes in tariffs for the five-year price control over those two years.

Impact of our remedies

59. The remedies we have ordered will enable SONI to obtain the finance it requires to continue with its crucial role in the transmission of electricity in NI and the island of Ireland.

60. The effect of the remedies is to provide SONI over the five years of the Price Control with an additional £5.4 million over the Price Control Period. Of this, £1.1 million will reflect amended allowances for pensions and capex and a further £4.3 million for remuneration for risks that it bears while fulfilling its role as TSO, and to provide greater clarity to the process by which it will be able to recover costs of large projects. The CMA remedies of £5.4 million compare to £14.7 million of relief sought by SONI in its Notice of Appeal.
61. We have calculated that the impact of this decision on domestic consumers is approximately 50 pence on average per year over the five years of the price control (representing 0.1% of the average electricity bill in NI).