

# **SONI Limited v Northern Ireland Authority for Utility Regulation**

Final determination

Notified: 10 November 2017

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*Website:* [www.gov.uk/cma](http://www.gov.uk/cma)

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The Competition and Markets Authority has excluded from this published version of the determination information which the Appeal Group considers should be excluded having regard to the considerations set out in Article 14G(2) of the Electricity (Northern Ireland) Order 1992 (Determination of appeal by CMA: supplementary). The omissions are indicated by [✂].

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*Appendix*

A: Chronology of the key steps in the price control consultation process

Glossary



# Final determination

## 1. Introduction

- 1.1 The Northern Ireland Authority for Utility Regulation (the UR) is responsible for regulating the electricity, gas, water and sewerage industries in Northern Ireland (NI). As the regulator of the electricity industry, it is responsible for the licensing of electricity suppliers, generators and transmission and distribution companies. A number of those companies that are licensed are subject to price control regulation by the UR. These include Northern Ireland Electricity Networks Limited (NIE) and SONI Limited (SONI).
- 1.2 SONI is the independent electricity Transmission System Operator (TSO) for NI. SONI is licensed to participate in the transmission of electricity by the Department for the Economy (Northern Ireland), in exercise of the powers conferred by [Article 10\(1\)\(b\)](#) of the Electricity (Northern Ireland) Order 1992 (the Electricity Order). SONI's TSO business is subject to a regulated price control by the UR.
- 1.3 On 14 March 2017, the UR published its decision to modify the terms of the electricity transmission licence (the Licence<sup>1</sup>) held by SONI (the Price Control Decision).<sup>2</sup> These licence modifications set SONI's allowed revenue specific to the SONI transmission system operation business for the five-year period commencing 1 October 2015 to 30 September 2020 (the Price Control Period).
- 1.4 The Price Control Decision is intended to give effect to the arrangements determined by the UR in respect of the 2015–2020 price control for the SONI TSO business (the Price Control), as set out in the UR's Final Determination, published on 24 February 2016 (the Final Determination).<sup>3</sup>
- 1.5 On 12 April 2017, SONI made an application to the Competition and Markets Authority (CMA), under [Article 14B\(3\)](#) of the Electricity Order, for permission to bring an appeal against the Price Control Decision, under [Article 14B\(1\)](#) of the Electricity Order.<sup>4</sup>

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<sup>1</sup> The TSO Licence.

<sup>2</sup> [Decision on the Licence Modifications for the Price Control 2015-2020 of the Electricity System Operator for Northern Ireland \(SONI\) and Modifications to SONI Limited's Electricity Transmission Licence](#), 14 March 2017.

<sup>3</sup> [Final Determination to the Price Control 2015-2020 for the Electricity System Operator for Northern Ireland \(SONI\)](#) (the Final Determination), 22 February 2016.

<sup>4</sup> [SONI's Notice of Appeal \(NoA\)](#), 12 April 2017.

- 1.6 SONI sought to challenge the Price Control Decision on three grounds:
- (a) Ground 1 – the Financeability Methodology Ground, that the UR failed to conduct a proper assessment of SONI’s financeability.
  - (b) Ground 2 – the Revenue Uncertainty Ground, that the UR failed to put in place arrangements to secure adequate revenue for SONI.
  - (c) 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.
- 1.7 At the same time as making an application for permission to bring an appeal against the Price Control Decision, SONI applied to the CMA under [paragraph 2 of Schedule 5A](#) to the Electricity Order for a direction that the Price Control Decision was not to have effect, pending the determination by the CMA of the appeal.<sup>5</sup>
- 1.8 On 28 April 2017, the CMA received representations and observations on the SONI applications from the UR. The UR submitted that SONI had simply identified matters on which it held a different view from the UR and had not identified any errors in the decision.
- 1.9 On 11 May 2017, the CMA granted SONI permission to appeal to the CMA.<sup>6</sup> However, the CMA decided not to make a direction suspending the Price Control Decision and SONI’s application was refused.<sup>7</sup>
- 1.10 In reaching our determination, we have considered SONI’s Notice of Appeal (the [NoA](#)) and related documents, the UR’s representations and observations on the NoA (the [Defence](#)) and related documents and submissions from the Consumer Council (Northern Ireland) (CCNI) in its capacity as an Interested Third Party (ITP). We have also held hearings with SONI and the UR. We issued our provisional determination to the parties on 14 September 2017 and we have taken into account the submissions received in response in reaching our final conclusions.
- 1.11 Under the applicable statutory framework for the appeals process, the CMA must reach its final determination by 10 November 2017.<sup>8</sup>

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<sup>5</sup> [SONI’s application for suspension of the Price Control Decision](#), 12 April 2017.

<sup>6</sup> [CMA decision on permission to appeal](#), 11 May 2017.

<sup>7</sup> [CMA decision on application for suspension of TSO Licence Price Control Decision](#), 11 May 2017.

<sup>8</sup> Paragraph 3.10 of the [Energy Licence Modification Appeals: Competition Commission Guide \(CC15\)](#), September 2012.

## Structure of this document

- 1.12 In this document, we have set out the background to SONI's appeal before considering each ground of appeal in detail. In this introductory chapter, we have described the conduct of the appeal process.
- 1.13 In Chapter 2 of this document, we have briefly summarised the background to SONI's appeal, including information on the electricity supply chain in NI, the parties, the decision under appeal.
- 1.14 Chapter 3 sets out the legal framework for the appeal, including the applicable standard of review.
- 1.15 Chapter 4 provides an overview of SONI's appeal and our approach to the CMA's assessment.
- 1.16 Chapters 5 to 7 address each of SONI's three grounds of appeal in turn, summarising the relevant main submissions and supporting evidence put forward by SONI, the UR and CCNI, before turning to our assessment and determination:
- Ground 3: Inadequate Allowances (Chapter 5).
  - Ground 2: Revenue Uncertainty (Chapter 6).
  - Ground 1: Financeability Methodology (Chapter 7).
- 1.17 Chapter 8 sets out our determination and includes some observations by the CMA on the Price Control process.
- 1.18 Chapters 9 to 12 address the remedies for those grounds in respect of which we have found in favour of SONI, setting out our approach, the relevant submissions and supporting evidence put forward by the parties and our assessment and determination of required remedies.
- 1.19 Chapter 13 sets out the impact of our remedies, and required changes to the level of the Price Control.
- 1.20 Lastly, Chapter 14 describes the process for determining who should bear the costs connected with this appeal.

## Conduct of the appeal

- 1.21 We are conducting this appeal in accordance with the procedure set out in [Schedule 5A to the Electricity Order](#), the [Competition Commission Energy Licence Modification Appeals Rules \(CC14\)](#) as adopted by the CMA ('the

Rules')<sup>9</sup> and the associated [Energy Licence Modification Appeals: Competition Commission Guide \(CC15\)](#) ('the Guidance'),<sup>10</sup>

- 1.22 Throughout this appeal, we have had regard to the overriding objective of the Rules which is to enable the CMA to dispose of appeals 'fairly and efficiently' within the time period prescribed by the applicable sector-specific legislation.<sup>11</sup>

### ***Submissions received, site visit, hearings and our provisional determination***

- 1.23 On 19 May 2017, we held an appeal management conference with SONI and the UR to discuss how the appeal would be conducted and, on 25 May 2017, SONI and the UR made presentations to the CMA staff team to assist us in understanding the factual background to the appeal.
- 1.24 On 2 June 2017, the UR and CCNI submitted their representations and observations on the NoA (the [Defence](#) and [CCNI R&O](#) respectively).
- 1.25 On 21 June 2017, we attended a site visit in NI and held a clarification hearing with SONI and the UR.<sup>12</sup>
- 1.26 On 26 June 2017, SONI submitted its replies to the [Defence](#) and [CCNI R&O](#) (SONI reply to the Defence and SONI reply to CCNI R&O respectively).
- 1.27 On 14 July 2017, in lieu of a hearing, CCNI submitted its response to SONI's reply to CCNI's R&O (CCNI response to SONI reply).
- 1.28 On 18 July 2017 and 2 August 2017, we held main party hearings with SONI and the UR respectively. SONI and the UR attended each other's hearings, and CCNI were observers at these hearings.
- 1.29 We notified SONI, the UR and CCNI of our provisional determination on 14 September 2017.
- 1.30 SONI, the UR and CCNI submitted representations and observations on our provisional determination on 28 September 2017.

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<sup>9</sup> Following a [public consultation](#), the CMA [decided](#) in 2015 that it would use [the Rules](#), adapted as necessary to refer to the relevant NI legislation and decisions of the UR, to govern the procedure for appeals against the UR's energy licence modification decisions.

<sup>10</sup> [CC14](#) and [CC15](#) have now been replaced by the [Energy Licence Modification Appeals: Competition and Markets Authority Rules \(CMA70\)](#) and the associated [Energy Licence Modification Appeals: Competition and Markets Authority Guide \(CMA71\)](#) respectively. However, at the time of these proceedings, the relevant rules and guidance documents were [CC14](#) and [CC15](#).

<sup>11</sup> Rule 4.1 of [CC14](#).

<sup>12</sup> CCNI attended the site visit, technical teach-in and both hearings in an observer capacity.

- 1.31 On 17 October 2017, we held a remedies hearing with SONI and the UR, and on 18 October 2017 we held a roundtable remedies discussion with SONI and the UR.
- 1.32 During the course of the appeal, SONI and the UR have also supplied additional information when requested by the CMA.

### ***Transparency***

- 1.33 Unlike CMA merger inquiries and market investigations, appeals are not a public process. Under the Rules, the CMA is required to publish the administrative timetable and final determination on our [website](#); and has discretion to publish SONI, the UR's and third party submissions.<sup>13</sup> We have therefore published various documents on our [website](#), including the [Price Control Decision](#), the [CMA decision on permission to appeal](#), the non-confidential versions of the [NoA](#), the [Defence](#) and [CCNI R&O](#), and our final determination and Order.

## **2. Background to the appeal**

- 2.1 This chapter provides background relevant to the appeal, including an introduction to the NI electricity supply industry, the parties and the price control under appeal.

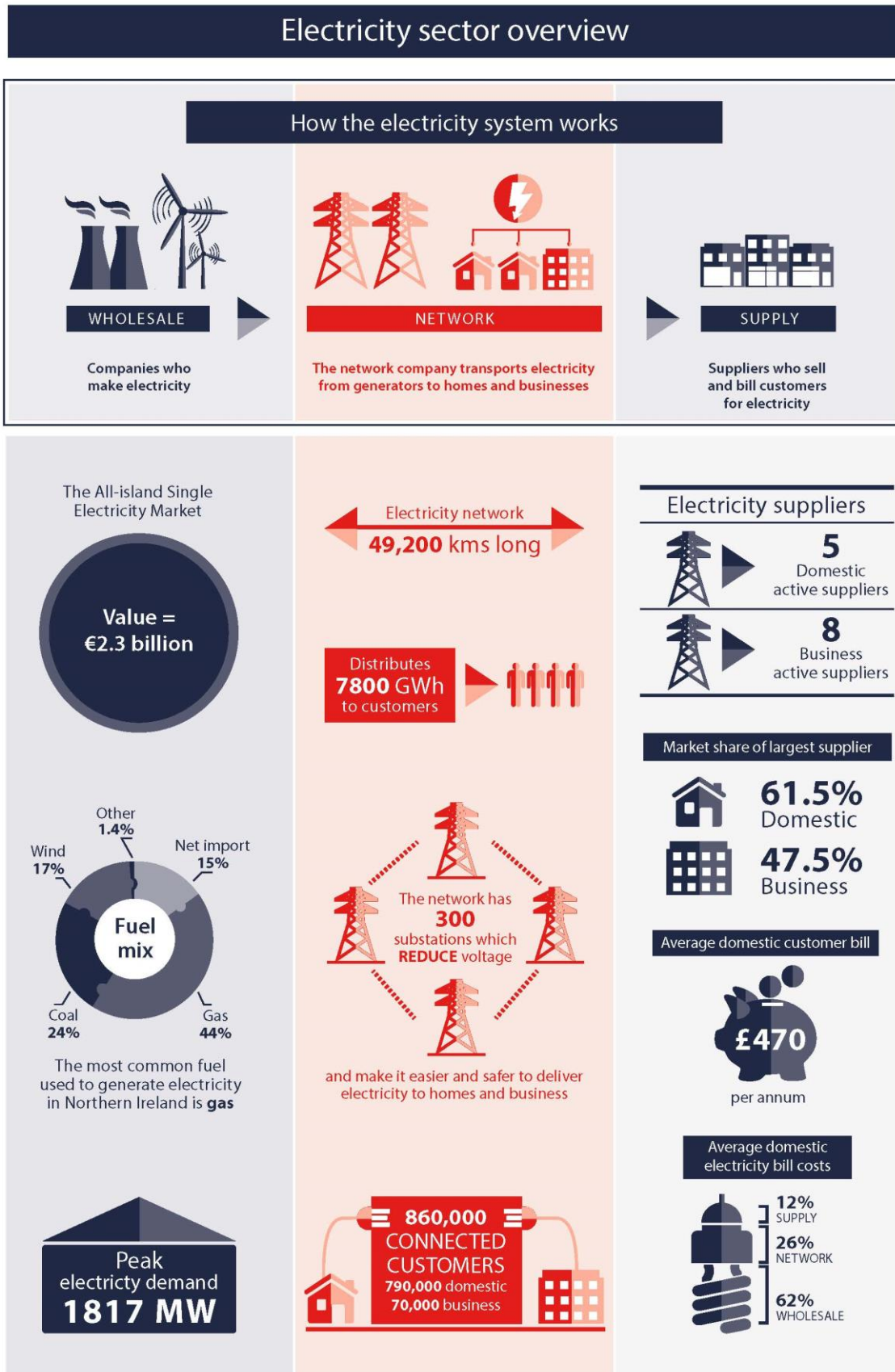
### ***Electricity supply chain in NI***

- 2.2 Figure 2.1 below, reproduced from the UR's website, provides an overview of the electricity sector in NI.

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<sup>13</sup> See [CC14](#), paragraphs 5.5, 9.4, 10.4, 12.1 and 13.5.

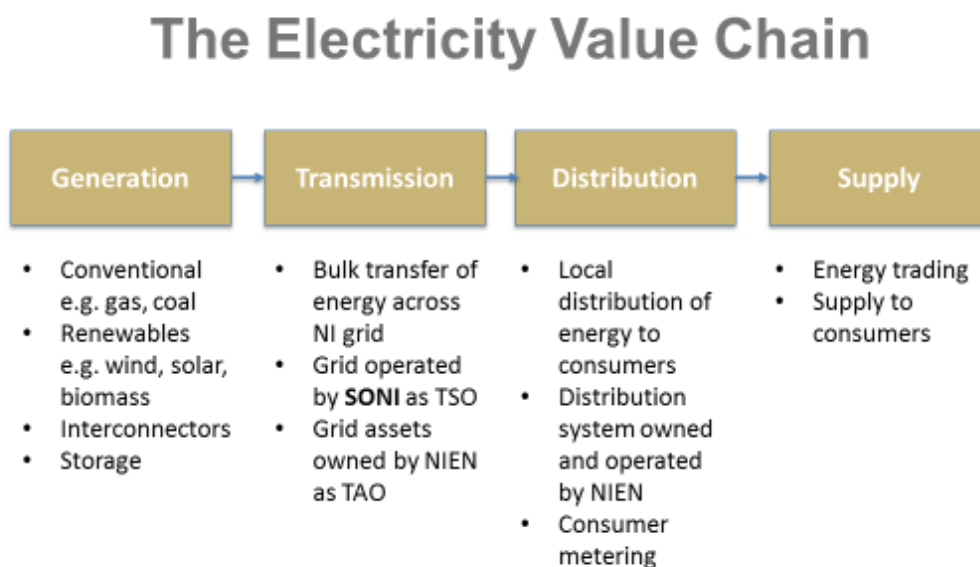
Figure 2.1: Overview of the electricity sector in NI



Source: [UR website](#) (accessed 10 November 2017).

2.3 The structure of the electricity supply value chain is shown in Figure 2.2. The focus of this appeal is the Transmission stage. The transmission grid in NI is owned by NIE (the Transmission Asset Owner, or TAO), while the grid is operated by SONI as the Transmission System Operator (or TSO). Further detail about the TSO role can be found in paragraph 2.29.

Figure 2.2: Electricity Supply Value Chain



Source: SONI staff-level technical teach-in slide presentation, slide 3, 25 May 2017.

### **Single Electricity Market (SEM)**

2.4 One key element of the electricity supply chain in NI, as illustrated in Figure 2.1, is the market for the sale and purchase of wholesale electricity between the wholesale producers of electricity (ie generators) and retailers who supply domestic and business consumers.<sup>14</sup> Since November 2007, the market for the sale and purchase of wholesale electricity in NI has operated through a single wholesale market across the whole of the island of Ireland. This is known as the Single Electricity Market (SEM). All electricity across the island is bought and sold through this single pool. The operation of this single wholesale market requires the physical connection of the NI grid to that in the RoI. The existing connections are proposed to be enhanced by a

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<sup>14</sup> We note that Figure 2.2 does not show the wholesale electricity market as a distinct element of the electricity supply value chain. Within Figure 2.2, the 'wholesale electricity market' element is captured under the term 'energy trading' under the heading "Supply".



new North-South transmission connection which will enable greater flexibility in the flows of electricity.<sup>15</sup>

- 2.5 The single wholesale market is administered by the Single Electricity Market Operator (SEMO). SEMO is a contractual joint venture (the SEMO JV) between SONI in NI (25%) and EirGrid Plc (EirGrid) in the RoI (75%).<sup>16</sup> SEMO facilitates market trading, coordinating financial dealing and ‘owning’ the rule-book. The UR and its counterpart in the RoI, the Commission for Energy Regulation (CER),<sup>17</sup> jointly regulate SEMO through the SEM Committee (SEMC).<sup>18</sup>
- 2.6 The SEMC is responsible for regulating all matters which it decides have a material effect<sup>19</sup> or are likely to have a material effect<sup>20</sup> on the operation of the wholesale electricity market across the island of Ireland. This in practice means that, as well as regulating SEMO, the SEMC also regulates some matters which SONI is responsible for as TSO. Thus, the SEMC has the ability to affect the level of revenues which SONI is able to recover through its TSO price control.

### ***Developments/trends in the electricity supply chain in NI and the island of Ireland***

- 2.7 The electricity sector in NI is in a period of significant transition. The generation of electricity across the island of Ireland is increasingly through renewable energy sources, including wind and solar, and the electricity transmission system is being modernised to improve resilience that enhances security of supply (particularly important given the relatively small size of the electricity network on the island of Ireland). In addition, new wholesale market arrangements for the island of Ireland are being developed.
- 2.8 There are therefore major projects underway to implement these programmes, in which SONI, both in its capacity as TSO and Market Operator (MO), plays a key part, as explained below.

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<sup>15</sup> [UR website](#) (accessed 10 November 2017).

<sup>16</sup> In respect of SEMO, SONI is acting in its capacity as Market Operator (MO) licence holder and not as TSO licence holder.

<sup>17</sup> We note that the CER has recently changed its name to the Commission for Regulation of Utilities (CRU) to better reflect the expanded powers and functions of the organisation (see [CRU website](#)). In this document, we are consistent in our use of the name CER.

<sup>18</sup> Both regulators are represented on the SEMC along with an independent and a deputy independent member.

<sup>19</sup> Remedies Hearing transcript, page 120, lines 8–19.

<sup>20</sup> Defence, First Witness Statement of Tanya Hedley (Defence TH1), paragraph 3.9.



### *Increasing use of renewables*

- 2.9 The generation mix that SONI, as TSO, manages continues to change due to the increase in the supply of renewable energy. Almost 20% of NI's electricity demand was met by renewable energy sources in 2014,<sup>21</sup> and this is expected to increase to 40% by 2020. These changes are likely to increase the complexity of the balancing functions that SONI undertakes. As most renewables are intermittent, this can cause system stability issues.

### *Integrated Single Electricity Market (I-SEM)<sup>22</sup>*

- 2.10 The SEM is undergoing significant change. EU legislation is driving the coming together of energy markets across Europe with the aim of creating a fully liberalised internal electricity market. The SEMC is leading on meeting the requirements of the European legislation by developing and delivering a new wholesale market on the island of Ireland.
- 2.11 The new wholesale market will be known as the Integrated Single Electricity Market (I-SEM) and is scheduled to be in place by May 2018.<sup>23</sup> As well as building on the SEM, according to the SEMC, the I-SEM will deliver increased levels of competition which should help put a downward pressure on prices as well as encouraging greater levels of security of supply and transparency.<sup>24</sup> Broadly, the I-SEM arrangements are intended to:<sup>25</sup>
- (a) enable broad participation in energy markets;
  - (b) increase the opportunities for participants to trade in different timeframes;
  - (c) provide participants with a variety of arbitrage and hedging opportunities;
  - (d) maximise the efficient use of interconnectors in system balancing;
  - (e) provide cost drivers for system balancing; and
  - (f) integrate balancing and system security actions with market operation.
- 2.12 The SEMC oversees the detailed design and implementation work needed to go-live with the new market. This includes detailed design workstreams which include the Energy Trading Arrangements, Capacity Remuneration

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<sup>21</sup> [Final Determination](#), paragraph 9.

<sup>22</sup> See [UR website](#) and [SEMC website](#).

<sup>23</sup> [NoA](#), paragraph 3.32(b).

<sup>24</sup> See [SEMC website](#).

<sup>25</sup> [Quick Guide to the Integrated Single Electricity Market - The I-SEM Project \(Version 1\)](#), page 3.

Mechanism, Forwards and Liquidity, Market Power and Governance and Licensing.

### *Delivering a Secure Sustainable Electricity System (DS3 Programme)<sup>26</sup>*

- 2.13 The 'Delivering a Secure Sustainable Electricity System' (DS3) programme involves developing capabilities to operate the transmission system with increasing amounts of renewable generation. SONI and EirGrid began the multi-year programme in response to binding National and European targets.
- 2.14 The aim of the DS3 Programme is to meet the challenges of operating the electricity system in a secure manner while achieving the 40% renewable electricity targets by 2020.<sup>27</sup> The DS3 Programme is designed to ensure that the power system can be operated securely with increasing amounts of variable non-synchronous renewable generation over the coming years.
- 2.15 The DS3 programme comprises a package of initiatives to deal with these issues: System Services, System Policies and System Tools.
- 2.16 SONI and EirGrid consider each pillar to be fundamental to the success of the DS3 programme and the delivery of the 40% renewable electricity target.

## **Parties to the appeal**

### ***SONI***

#### *Overview*

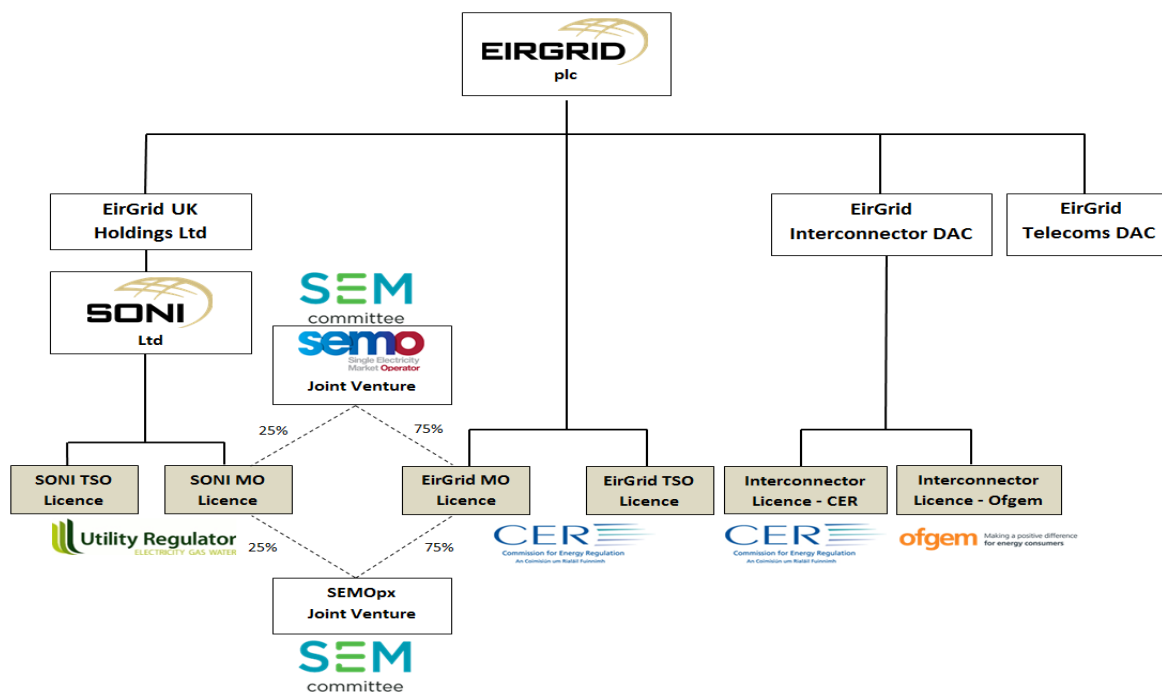
- 2.17 SONI is a subsidiary of the EirGrid Group.
- 2.18 The EirGrid Group is an Irish state-owned corporate group that manages and operates the transmission grid across the island of Ireland. As shown in Figure 2.3 below, the EirGrid Group comprises a number of corporate entities. These are described in more detail in the following paragraphs.

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<sup>26</sup> See [EirGrid website](#).

<sup>27</sup> Directive 2009/28/EC of the European Parliament and of the Council.

Figure 2.3: EirGrid corporate structure and licences



Source: SONI staff-level technical teach-in slide presentation, slide 5, 25 May 2017.

Note: We note that this is a simplification. For example, the SEMC also makes decisions on matters relevant to the SONI TSO licence.

### *EirGrid plc*

- 2.19 EirGrid plc (EirGrid) is an Irish state-owned company and, as the certified electricity TSO in the RoI, is regulated by the CER. It has had responsibility for the operation and development of the national high voltage electricity grid in the RoI since 2006.<sup>28</sup>
- 2.20 EirGrid operates the flow of power on the transmission system and plans for its future, while the Electricity Supply Board, a statutory corporation established in the RoI and which is also owned by the Irish state, and who owns the transmission system, is responsible for carrying out maintenance, repairs and construction in respect of it.<sup>29</sup>

<sup>28</sup> NoA, First Witness Statement of Fintan Slye (NoA FS1), paragraph 15.

<sup>29</sup> NoA FS1, paragraph 16.

## *SONI Ltd*

- 2.21 SONI Ltd (SONI) was established in 2000 and was acquired by EirGrid following divestment from Northern Ireland Electricity plc (NIE) (now known as 'NIE Networks') in March 2009.<sup>30</sup>
- 2.22 SONI acts as the Transmission System Operator (TSO) and Market Operator (MO) for the SEM in NI, for which it holds two separate licences. However, the appeal in question is only concerned with its role as TSO.
- 2.23 Since 2014, SONI has also been responsible for planning for the future of the grid, while NIE, which owns the grid, is responsible for maintenance, repairs and construction of the grid.<sup>31</sup>
- 2.24 SONI currently directly employs 122 personnel shared between its TSO business (around 107 employees) and SEMO business (around 17 employees).<sup>32</sup>
- 2.25 The annual value of SONI's revenues subject to the TSO price control under appeal is approximately £20 million per annum.<sup>33</sup> SONI's average Regulatory Asset Base (RAB) in 2015 was £7.5 million.

## **UR**

- 2.26 The UR is an independent non-ministerial government department and the designated national regulatory authority for electricity in NI. Further details about the UR's powers and duties are set out in Chapter 3.

## **CCNI**

- 2.27 CCNI is a non-departmental public body established through the General Consumer Council (Northern Ireland) Order 1984. Its principal statutory duty is to promote and safeguard the interests of consumers in NI. It has a range of functions, duties and powers in respect of energy which are principally

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<sup>30</sup> In 2007 the TSO activities in NI initially transferred to SONI as a new separately licensed entity within the Viridian group. It was subsequently agreed by the Department for the Economy (Northern Ireland), the UR and NIE that SONI should be divested from NIE. Following a competitive tender process, NIE selected EirGrid as the preferred bidder and the acquisition was subsequently approved by the relevant regulators after a period of consultation (NoA FS1, paragraph 24).

<sup>31</sup> This reflects the relationship and relative responsibilities in the RoI of EirGrid and the Electricity Supply Board, who carry out similar roles to SONI and NIE.

<sup>32</sup> NoA, First Witness Statement of Robin McCormick (NoA RM1), paragraph 21.

<sup>33</sup> SONI's reported revenues are much higher than £20 million, as they include revenue collected on behalf of others.

provided for through the Energy (Northern Ireland) Order 2003 (the Energy Order).<sup>34</sup>

## **Role of SONI as TSO licence holder in NI electricity transmission**

2.28 This section outlines the main roles of SONI as TSO licence holder, and provides a brief outline of SONI's activities relevant to this appeal.

### *Transmission System Operator (TSO)*

2.29 SONI is the electricity system operator for NI and has been certified by the UR as the Transmission System Operator (TSO) for NI. From its control centre in Belfast, SONI ensures that power flows where and when needed. It brings power from those who generate energy, and supplies the distribution network owned and operated by NIE that brings power to homes, farms and businesses in NI.<sup>35</sup>

2.30 The role of TSO in NI has evolved in recent years in a number of respects. This includes the implementation of the European Union Third Energy Package involving the European Commission's decision to certify SONI as the NI TSO, independent from generation and supply interests, resulting in the transfer of the transmission network planning function from NIE to SONI in May 2014 (see paragraphs 2.34 to 2.37 below).<sup>36</sup>

2.31 As a holder of a transmission licence, SONI has a legal<sup>37</sup> responsibility to take such steps as are reasonably practicable to:

- (a) ensure the development and maintenance of an efficient, co-ordinated and economical system of electricity transmission which has the long-term ability to meet reasonable demands for the transmission of electricity;
- (b) contribute to security of supply through adequate transmission capacity and system reliability; and
- (c) facilitate competition in the supply and generation of electricity.<sup>38</sup>

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<sup>34</sup> See [CCNI website](#).

<sup>35</sup> NoA FS1, paragraph 17.

<sup>36</sup> [Final Determination](#), paragraph 8.

<sup>37</sup> [Electricity Order](#), Article 12 paragraph 2.

<sup>38</sup> [Final Determination](#), paragraph 4.

2.32 Core functions of SONI include:

- operating the transmission network, including both near and real time;
- balancing the system to achieve the lowest cost of production; and
- planning the transmission network from identification of need through to obtaining all necessary consents and planning permission before transferring for construction.<sup>39</sup>

2.33 Within the SONI TSO licence, SONI can perform some duties by acting in conjunction with the RoI TSO. These include establishing and operating a merit order system for SEM generation.<sup>40</sup>

### *Network Planner*

2.34 To ensure independence from generation and supply, responsibility for planning the network and obtaining all relevant consents was transferred from NIE to SONI in May 2014.

2.35 SONI is now responsible for:

- the transmission planning and security standards;
- identifying need and economic solutions (to the transmission network);
- obtaining consents, including associated design work; and
- connections to the transmission network.

2.36 Since May 2014, SONI has been responsible for investing in Pre-construction Network Projects (PCNPs). These comprise the pre-construction costs associated with network projects, up to consented stage, and prior to construction by NIE.<sup>41</sup>

2.37 The arrangements governing the interaction of NIE and SONI are defined in the Transmission Interface Arrangements (TIA) (pursuant to the requirements of Condition 18 of SONI's Transmission Licence and Condition 17 of NIE's Transmission Licence).<sup>42</sup>

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<sup>39</sup> [Final Determination](#), paragraph 5.

<sup>40</sup> [Final Determination](#), paragraph 7.

<sup>41</sup> PCNPs are the focus of Error 2 of the appeal – see Chapter 6 for more details.

<sup>42</sup> See paragraphs 2.63 and 2.64 for more information on the TIA.

## *Revenue collection agent*

- 2.38 In addition to its TSO and Network Planning activities, SONI also has a role in collection of revenue for other industry participants. SONI provided us with a description of its role as collection agent and onward distributor of revenues collected, as described below.<sup>43</sup>
- 2.39 In addition to recovering its own costs, SONI levies charges on both generators and suppliers to meet the obligations it has to pay others ie where it acts as a collection agent. In relation to this role, SONI is effectively the custodian of significant industry revenues which it collects on behalf of others and through which it can be exposed to significant cash flow or liquidity risks. These revenues relate to:
- (a) Transmission use of system charges (TUoS) levied by NIE (see paragraph 2.46);
  - (b) System Services Charges – these are for services<sup>44</sup> provided by generators to the TSO which ensure that the technical properties of the electricity system are maintained at all times to the required standard. These services are sometimes referred to as ‘Ancillary Services’;
  - (c) Moyle Interconnector charges (CAIRt)<sup>45</sup> – under current arrangements, SONI levies the charges on behalf of the mutualised Moyle Interconnector Limited (Moyle) and then passes on the money it has collected to Moyle.
- 2.40 In addition, SONI as TSO licence holder is responsible for funding any shortfall<sup>46</sup> in its 25% share of the Imperfections Charges revenues that the SEMO JV levies to finance its activities as MO for the island of Ireland. The principal cost recovered through Imperfections charges are the expected level of Dispatch Balancing Costs (DBC). DBCs are the difference in cost between the constrained and unconstrained market schedules.

## *Market operator (MO)*

- 2.41 SONI also holds a Market Operator (MO) licence for NI. It discharges this role jointly with EirGrid (which holds the MO licence for RoI) through a contractual JV, SEMO. The role of MO involves calculating the price of

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<sup>43</sup> NoA RM1, paragraphs 22–23.

<sup>44</sup> These services are Operating Reserve, Interruptible Load, Reactive Power & Black Start.

<sup>45</sup> The Moyle Interconnector links the electricity grids of NI and Scotland, and is owned by Mutual Energy.

<sup>46</sup> If there is an excess rather than a shortfall, SONI as TSO holds the excess in a separate SEM bank account and it cannot use this temporary excess to finance its other activities.

wholesale electricity for the SEM and settling the market, including constraint costs. The MO licence includes a mechanism for the TSO to fill any funding shortfall. The substantive impact of this licence provision is described in paragraph 2.40.

2.42 The MO licence held by SONI is not subject to this appeal.

## **Some relevant aspects of SONI's operations**

2.43 This section introduces some technical terms which are relevant to the discussion of the appeal grounds in this determination.<sup>47</sup>

### ***System Support Services (SSS)***

2.44 System Support Services (SSS) represent costs covered by SONI's tariff which are paid for by electricity customers in NI on a megawatt per hour (MWh) basis, and which are subject to the price control under appeal. SSS tariffs equate to 1–2% of typical electricity bills.<sup>48</sup>

### ***Dispatch Balancing Costs (DBC)***

2.45 The aim of the TSO is to ensure a stable, secure and economic power supply to customers in real time. This requires dispatching (ie putting on line) power generators out of the market schedule (this could be caused, for example, by constraints or varying availability of renewables). Balancing the difference between scheduled and non-scheduled generation results in DBCs. As described in paragraph 2.40, SONI, as the TSO, has to fund revenue shortfalls in Imperfections Charges, of which DBCs are the dominant element and which can be very volatile with large variations over short periods of time.

### ***Transmission Use of System tariff (TUoS)***

2.46 SONI is responsible for calculating charges for access to the transmission system in line with the methodology approved by the UR. SONI collects this Transmission Use of System tariff (TUoS) from all system users (all-island generators and NI customers) and passes it on to NIE on a regular basis (including fixed minimum payments).<sup>49</sup>

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<sup>47</sup> The source for the background information in this section, unless stated otherwise, is the SONI staff-level technical teach-in slide presentation, 25 May 2017, and CMA analysis.

<sup>48</sup> Note that SSS does not relate to System Services as described in paragraph 2.39(b).

<sup>49</sup> NoA, paragraphs 3.9–3.10.



## **Significant Projects**

2.47 Significant Projects is a term used by SONI to describe any materially significant and complex project where the costs exceed £1 million. During the Price Control Period, SONI expects to complete Significant Projects concerned with a) PCNPs, b) the implementation of I-SEM and c) the DS3 Programme.<sup>50</sup> Some of the capital expenditure on the implementation of the I-SEM and the DS3 programme supports activities that are the responsibility of SONI as a MO.

## **Background to relevant regulation issues**

### ***Regulatory Asset Base (RAB) and side-RAB***

2.48 The Regulatory Asset Base (RAB) has been developed for regulatory purposes and is primarily used in setting price limits. The RAB represents the capital invested in the business. The return on the RAB is considered by regulators when deciding the costs the regulated company should be allowed to recover from customers. The RAB is adjusted each year to reflect inflation and capital additions, less depreciation. The 'side-RAB' is a value which is proposed to be introduced into SONI's regulatory framework, which is calculated in a comparable manner to the RAB, and which reflects the accumulated costs incurred by SONI in respect of PCNPs. This side-RAB is discussed in this document, but is not yet in place.

### ***RAB/WACC framework***

2.49 The RAB/WACC framework is an established approach to determining the level of reasonable profits that a regulated company should be allowed in a price control determination. It is based on calculating the level of assumed return by multiplying the weighted average cost of capital (WACC) by the RAB. The objective is that expected profits for investors in regulated assets reflect the level of capital that has been invested in the business, and the opportunity cost of capital for investors.

### ***Uncertainty mechanisms***

2.50 Regulators often use uncertainty mechanisms to deal with risks and the associated impact on the revenues and costs of companies. Uncertainty mechanisms are intended to provide a regulatory framework in respect of the management of risks and how they are allocated between customers

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<sup>50</sup> NoA, paragraph 3.32.

and regulated companies. Through use of uncertainty mechanisms, it is possible for allowed revenues and hence customer bills to be adjusted during a price control period if specified conditions are met.

### **Interaction between the UR and the SEMC**

- 2.51 The UR is not the only body making decisions which affect the total allowances that SONI as TSO Licence holder is awarded during the Price Control Period. The SEMC, in addition to regulating the operation of the island of Ireland wholesale electricity market, has the power to regulate those TSO matters which it considers affect the operation of the SEM.
- 2.52 Table 2.1 summarizes the features of the current governance arrangements so far as they impact this appeal. It illustrates that there are some activities for which the SEMC has an important decision-making role but where costs are recovered through SONI's TSO tariff.

**Table 2.1: Current division of responsibility for regulatory decision making in the island of Ireland regarding MO and TSO activities**

<i>Features</i>	<i>MO Licence activities</i>	<i>TSO Licence activities</i>	
Decision maker	<b>SEMC</b>		<b>UR (NI) or CER (ROI)</b>
Span of control	MO or TSO activities which the SEMC decides are SEM matters		All other non-SEM matters
Activity types	SEMO JV activities	Non-SEMO JV activities	TSO activities which the UR (or CER) opines on
Mechanism for recovering costs	SEMO JV Imperfections Charges (chiefly expected DBCs)	<b>TSO tariffs</b>	<b>TSO tariffs</b>

Source: CMA analysis.

- 2.53 Where the SEMC regulates matters which are for the benefit of all island of Ireland consumers, and where these costs are incurred by the SEMO JV, the costs are apportioned 75% to EirGrid (TSO) and 25% to SONI (TSO). These TSOs then recover their share of the apportioned costs within the tariffs for their respective jurisdictions.

### **The decision under appeal: TSO price control 2015-2020**

- 2.54 The Price Control Decision<sup>51</sup> under appeal is that for the TSO licence of SONI for 2015-2020, although the licence modifications decision was only made in March 2017 (see paragraphs 3.14 to 3.17 for further details, and Appendix A for a chronology of the key steps in the price control consultation

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<sup>51</sup> The Price Control Decision was stated in the Decision Paper and associated licence modifications published on 14 March 2017, but much of the reasoning was included in the [Final Determination](#) which was published on 24 February 2016.

process). This section outlines the elements of the price control formula which are referred to in our assessment.

- 2.55 The appeal relates to the modification of Condition 32 and Annex 1 of the licence, which require SONI to use its best endeavours to ensure that in each year during the Price Control Period the revenue from SSS and for use of the All-Island Transmission Networks does not exceed the amount calculated (denoted by  $M_{TSO_t}$ ) in accordance with the formula set out at paragraph 2 in Annex 1 of the Licence:<sup>52</sup>

$$M_{TSO_t} = A_{TSO_t} + B_{TSO_t} - B_t + D_{TSO_t} + Q_t + K_{TSO_t} + INCENT_t$$

- 2.56 A summary of the components of the formula is provided below:<sup>53</sup>

- (a)  $A_{TSO_t}$  includes the total cost estimate relating to Ancillary Services. These costs are determined by the SEMC and treated as pass-through.
- (b)  $B_{TSO_t}$  is SONI's allowed revenue to cover its operating costs (opex), depreciation on the RAB and an appropriate return on those assets. These costs are defined within this price control.
- (c)  $B_t$  is a new component in the licence modifications. This captures the risk share mechanism within this price control. This reflects the value of price control outperformance or underperformance being shared equally between SONI TSO and customers.
- (d)  $D_{TSO_t}$  encompasses price control excluded costs which are considered on an individual basis by the UR. This is the mechanism for the advance approval of certain expenditure for certain substantial categories of expenditure which have not been accorded a value in the Price Control and associated licence modifications.<sup>54</sup> These costs are referred to within this determination as 'D<sub>t</sub>' costs.<sup>55,56</sup>
- (e)  $Q_t$  is a new component in the licence modifications, and is an adjustment to be applied to the maximum core SSS/TUoS revenue.<sup>57</sup>

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<sup>52</sup> [SONI Licence Modification](#), 14 March 2017.

<sup>53</sup> [Final Determination](#), paragraph 11.

<sup>54</sup> [NoA](#), paragraph 8.5.

<sup>55</sup> D<sub>t</sub> costs are relevant to several of the alleged errors in this appeal, and in particular Errors 2, 4 and 6.

<sup>56</sup> Some of these costs are determined by SEMC.

<sup>57</sup>  $Q_t$  is the subject of Error 8 in Ground 2.

- (f)  $K_{TSO_t}$  is a correction factor whereby under or over-recoveries in the previous year(s) can be collected by the business (under-recovery) or given back to consumers (over-recovery), adjusted for interest.
- (g)  $INCENT_t$  relates to the SONI portion of the all-island DBC Incentive reward/penalty. This reflects the SEMC 'Incentivisation of All-island DBCs' decision for which licence modifications were published in August 2015.<sup>58</sup>

## Other relevant UR consultations and decisions

- 2.57 The [NoA](#) challenges the Price Control Decision, and not the outcome of subsequent decisions by the UR. However, there are some recent decisions and ongoing consultations by the UR which are relevant to this appeal.

### *Pensions*

- 2.58 Part of the 2015-2020 Price Control concerned the treatment of SONI pension obligations. On 11 April 2017, the UR issued a consultation on matters concerning SONI's defined benefit pension scheme and the change of law provisions in Annex 1 (the price control conditions of the Licence).<sup>59</sup> The UR published its draft decision on these matters on 16 August 2017<sup>60</sup> and its final determination on 19 October 2017.<sup>61</sup>
- 2.59 One of the errors alleged by SONI<sup>62</sup> concerns the allowances provided for SONI's pensions obligations. As such, the recent pensions consultation and decision are relevant to this appeal, and are considered as appropriate later in this determination (see Chapter 5).

### *$Q_t$ adjustment*

- 2.60 One element of the SONI 2015-2020 Price Control related to a new licence term ( $Q_t$ ). The purpose of this term was to 'true-up' the differences between amounts collected through the 2015/16 and 2016/17 tariffs and the amounts allowed under the Price Control for the same period.<sup>63</sup> This was considered

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<sup>58</sup> [SONI TSO Licence, Licence Modification Decision Paper: DBC Incentivisation and SONI SSS/TUoS tariff restriction](#), 5 August 2015.

<sup>59</sup> [Further consultation on certain matters relating to the Price Control 2015-2020 for the Electricity System Operator for Northern Ireland \(SONI\)](#), 11 April 2017.

<sup>60</sup> [SONI: TSO Price Control Changes, Draft Decision](#), 16 August 2017. (SONI responded to the UR's Draft Decision on 18 September 2017.)

<sup>61</sup> [SONI: TSO Price Control Changes, Conclusions on Pensions Allowances and Decision on Change of Law provisions](#), 19 October 2017.

<sup>62</sup> See [NoA](#), Ground 3 Error 10, pages 141–160.

<sup>63</sup> [SONI  \$Q\_t\$  Adjustment Decision Paper – 2017/18 Tariffs, Decision Document](#), 21 August 2017.

necessary because of the delay in deciding and implementing the 2015-2020 Price Control, which did not come into effect until 9 May 2017 although the relevant period of the Price Control was due to start 1 October 2015.

- 2.61 On 5 July 2017 (after permission to bring this appeal had been granted) the UR issued its  $Q_t$  Adjustment Principles paper to SONI setting out the high-level principles it proposed to follow when making the adjustment. Following a consultation period, on 21 August 2017 the UR issued its decision document setting out the UR's decision on SONI's  $Q_t$  adjustment for the 2017/18 tariff year.
- 2.62 One of the errors alleged by SONI<sup>64</sup> concerns the principle of the  $Q_t$  adjustment. As such, the recent  $Q_t$  consultation and decision are relevant to this appeal, and are considered as appropriate later in this determination (see Chapter 6).

### ***Transmission Interface Arrangements (TIA)***

- 2.63 On 23 August 2017, following discussions with SONI and NIE and taking on board concerns with the current TIA, the UR invited suggestions by 8 September 2017 on changes that needed to be made to the TIA, given that the Network Planning function had been transferred from NIE to SONI.
- 2.64 The TIA governs, among other things, the handover of PCNPs from SONI to NIE. It is therefore relevant to the treatment of SONI costs for PCNPs which is the subject of one of the errors alleged by SONI.<sup>65</sup> As such, the recent developments relating to the TIA are considered as appropriate later in this determination (see Chapter 6).

### ***Demonstrably Inefficient or Wasteful Expenditure (DIWE)***

- 2.65 On 27 July 2017, the UR published guidance on the interpretation and application of the new provision in the Price Control on Demonstrably Inefficient or Wasteful Expenditure (DIWE).<sup>66</sup> The guidance applies to the three licences in which the term DIWE is used, including the SONI TSO licence which is the subject of this appeal.
- 2.66 One of the errors alleged by SONI concerns the failure by the UR to issue guidance on the application of the DIWE provision.<sup>67</sup> As such, the recent

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<sup>64</sup> See [NoA](#), Ground 2 Error 8, pages 120–122.

<sup>65</sup> See [NoA](#), Ground 2 Error 2, pages 98–103.

<sup>66</sup> [Guidance on the interpretation and application of the DIWE Provision](#), 27 July 2017.

<sup>67</sup> See [NoA](#), Ground 2 Error 7, pages 118–120.

DIWE guidance from the UR is relevant to this appeal, and is considered as appropriate later in this determination (see Chapter 6).

### ***SEMO price control***

- 2.67 On 28 September 2017, the SEMC published the SEMO Price Control Draft Determination consultation paper.<sup>68</sup> This paper consulted upon the revenue requirements of the MO from the commencement of I-SEM in May 2018 until October 2021 arising from its roles and responsibilities under the Trading & Settlement Code and for Imbalance and Capacity settlement.

## **3. The legal framework for the appeal**

### **The statutory framework**

- 3.1 The legislation relevant to this appeal is the Energy Order<sup>69</sup> and the Electricity Order.<sup>70</sup> Both Orders have been amended to transpose requirements of the EU Third Energy package<sup>71</sup> into domestic legislation. In particular, so far as this appeal is concerned, new provisions relating to appeals against licence modification decisions of the UR were introduced by the Modification and Appeal Regulations in 2015.<sup>72</sup>
- 3.2 [Article 3](#) of the Energy Order establishes the UR for the purpose of carrying out gas and electricity supply functions on behalf of the Crown, and [Article 12](#) of the Order sets out the principal objective and general duties of the UR in relation to electricity. These are considered further at paragraph 3.18 below.
- 3.3 [Part II](#) of the Electricity Order concerns electricity supply. In particular, [Article 10\(1\)\(b\)](#) of the Electricity Order gives the UR power to grant a transmission licence authorising SONI to participate in the transmission of electricity for the purpose of giving, or enabling, a supply of electricity to any premises.
- 3.4 The UR may make modifications under [section 14](#) of the Electricity Order to the conditions of a transmission licence. Such modifications may include, as

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<sup>68</sup> [SEMO Price Control, Draft Determination consultation paper](#), SEM-17-075, 28 September 2017.

<sup>69</sup> [The Energy \(Northern Ireland\) Order](#), SI 2003 No 419 (NI 6).

<sup>70</sup> [The Electricity \(Northern Ireland\) Order](#), SI 1992 No 231(NI 1).

<sup>71</sup> The Third Energy Package comprises two Directives – Directive EC/72/2009 (the Electricity Directive), and Directive EC/73/2009 (the Gas Directive) and three Regulations – Regulation EC No. 713 (the ACER Regulation), Regulation EC No. 714 (the Electricity Regulation), and Regulation EC No. 715 (the Gas Regulation).

<sup>72</sup> The Gas and Electricity Licence Modification and Appeals Regulations (Northern Ireland) 2015, SR 2915 No 1.

here, modifications of the Price Control arrangements in Appendix A of SONI's licence.

- 3.5 A further consequence of implementing the Third Energy Package has been the establishing of a single energy market for the island of Ireland (SEM).<sup>73</sup>
- 3.6 This is relevant to the appeal inasmuch as the UR 'views the key outputs of SONI during this Price Control as being the successful implementation of the DS3 project, I-SEM implementation and the commissioning of the North-South interconnector.'<sup>74</sup>
- 3.7 SEM arrangements are covered in NI by the Electricity (Single Wholesale Market) (Northern Ireland) Order 2007 (the Single Wholesale Market Order). The SEM is jointly regulated by the SEMC, which comprises representatives of the UR in NI, the CER in the RoI and an independent and a deputy independent member.<sup>75</sup>
- 3.8 As far as NI is concerned, the SEMC is deemed to be a committee of the UR and takes decisions on behalf of the UR in relation to SEM matters.<sup>76</sup>
- 3.9 A matter is a SEM matter if the SEMC determines that the exercise of a relevant function of the UR (including a function under [Part II](#) of the Electricity Order) in relation to that matter materially affects, or is likely materially to affect, the SEM.<sup>77</sup>

## Appeals against electricity licence modification decisions

- 3.10 SONI has a right of appeal to the CMA under [Article 14B](#) of the Electricity Order against a licence modification decision by the UR.
- 3.11 [Schedule 5A](#) to the Electricity Order sets out the procedure for licence modification appeals, and these provisions are supplemented by the CMA's Rules.<sup>78</sup>

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<sup>73</sup> Arrangements described in a Memorandum of Understanding relating to the establishment and operation of a single competitive wholesale electricity market in NI and the RoI, which was signed on behalf of the of the RoI on 5 December 2006 and on behalf of the Government of the United Kingdom on 6 December 2006 and a copy of which was presented to Parliament by the Secretary of State by command of her Majesty on 8 December 2006.

<sup>74</sup> [Final Determination](#), pages 3–4.

<sup>75</sup> Single Wholesale Market Order, Schedule 2.

<sup>76</sup> Single Wholesale Market Order, Article 6(1) and (2).

<sup>77</sup> Single Wholesale Market Order, Article 6(3).

<sup>78</sup> Following a [public consultation](#), the CMA [decided](#) in 2015 that it would use [the Rules](#), adapted as necessary to refer to the relevant NI legislation and decisions of the UR, to govern the procedure for appeals against the UR's energy licence modification decisions.



- 3.12 [Article 14B\(2\)](#) of the Electricity Order specifies the persons who may bring an appeal, which include the CCNI in the capacity of representing consumers whose interests are materially affected by the decision.
- 3.13 [Rule 10](#) of the CMA Rules allows ITPs (ie persons who have the capacity under [Article 14B\(2\)](#) to appeal, but are not appellants) to make representations or observations to the CMA about the grounds of appeal. The CCNI (as an ITP) has made representations and observations to the CMA on SONI's grounds of appeal.

## The decision under appeal

- 3.14 On 14 March 2017, the UR published the Price Control Decision which set out the licence modifications required for implementing the Price Control for SONI covering the period from 1 October 2015 to 30 September 2020.<sup>79</sup>
- 3.15 The overall objective of the Price Control was stated to be to ensure that SONI can continue to operate the transmission system in NI securely and efficiently, and at a reasonable cost to consumers.<sup>80</sup>
- 3.16 Prior to issuing the Price Control Decision, on 2 April 2015, the UR consulted on a Draft Determination (the Draft Determination);<sup>81</sup> and on 24 February 2016, the UR published the [Final Determination](#) and consulted on the [proposed licence modifications](#).
- 3.17 The Price Control Decision states that the UR 'will also issue a further consultation on certain individual aspects of the price control, as identified within this decision paper'.<sup>82</sup> As noted at paragraphs 2.57 to 2.66 above, the UR has made certain decisions and issued certain consultations since the Price Control Decision was published. Our assessment has taken these developments into account where relevant, but noting that the appeal is against the Price Control Decision.

## The UR's principal objective, powers and duties

- 3.18 The principal objective and general duties of the UR in relation to electricity are set out in [Article 12](#) of the Energy Order.

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<sup>79</sup> See [Price Control Decision](#).

<sup>80</sup> [Final Determination](#), page 2.

<sup>81</sup> [Draft Determination to the Price Control 2015-2020 for the Electricity System Operator for Northern Ireland \(SONI\)](#) (the Draft Determination), 2 April 2015 (submitted to the CMA as NoA Tab 1/11).

<sup>82</sup> [Price Control Decision](#), page 3.



- 3.19 The principal objective of the UR in carrying out its electricity functions is to protect the interests of consumers of electricity supplied by authorised suppliers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the generation, transmission, distribution or supply of electricity.<sup>83</sup>
- 3.20 The UR has a duty, in carrying out its electricity functions, to do so in the manner which it considers is best calculated to further the principal objective, having regard to the need to secure: (i) that all reasonable demands in NI or RoI for electricity are met; and (ii) that licence holders are able to finance the activities which are the subject of obligations under the regulatory framework.<sup>84</sup> In this document, we refer to this latter duty as the Financeability Duty.
- 3.21 Financeability is a term used by regulators to decide if a firm has the ability to pay off its providers of debt and equity finance. In price controls, it is generally assumed that financeability is achieved when the price control is such that the revenues and therefore cash flows made by the firm are sufficient to pay investors and lenders.
- 3.22 Subject to the duty set out in paragraph 3.20 above, the UR must carry out its electricity functions in the manner which it considers is best calculated to achieve a range of outcomes, including promoting the efficient use of electricity and efficiency and economy in the transmission and supply of electricity.<sup>85</sup>

## The test on appeal

- 3.23 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:<sup>86</sup>
- (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 Order and in the performance of its duties under that [Article](#) and [Article 6B](#) of the Energy Order;<sup>87</sup>

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<sup>83</sup> Energy Order, [Article 12\(1\)](#). The term 'consumers' is defined for these purposes by Article 2(2) of the Order to include both existing consumers and future consumers.

<sup>84</sup> Energy Order, [Article 12\(2\)](#).

<sup>85</sup> Energy Order, [Article 12\(5\)](#).

<sup>86</sup> Electricity Order, [Article 14D\(4\)](#).

<sup>87</sup> [Article 6B](#) of the Energy Order provides that the UR must carry out its functions in the manner it considers is best calculated to implement, or to ensure compliance with, any binding decision of the Agency for the

- (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;<sup>88</sup>
  - (e) that the decision was wrong in law.
- 3.24 In determining an appeal brought under [Article 14B](#) of the Electricity Order, the CMA is required to have regard, to the same extent as is required of the UR, to the matters to which the UR must have regard in carrying out its 'principal objective' and the performance of certain of its duties<sup>89</sup> (ie the duties summarised in paragraphs 3.18 to 3.21 above).
- 3.25 The CMA may have regard to any matter to which the UR was not able to have regard in relation to the decision which is the subject of the appeal, but must not have regard to any matter to which the UR would not have been entitled to have regard in reaching its decision, had it had the opportunity of doing so.<sup>90</sup>

## Standard of review

- 3.26 The question for us to determine is whether the Price Control Decision was wrong on one or more of the statutory grounds and, in order to do that, we have taken the merits of the decision under appeal into account.<sup>91</sup>
- 3.27 As the framework of the Electricity Order in relation to appeals is materially the same as applies to appeals to the CMA brought under the Gas Order,<sup>92</sup> we have adopted an approach similar to that taken by the CMA in the recent Firmus Energy Determination.<sup>93</sup>
- 3.28 Our starting point has been to consider the specific errors which have been alleged by SONI. Where no errors have been alleged, the decision to that

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Cooperation of Energy Regulators or the European Commission made under various instruments of EU legislation including the Electricity Directive and the Electricity Regulation.

<sup>88</sup> [Article 14\(8\)\(b\)](#) of the Electricity Order provides that the UR must state the effect of the modifications.

<sup>89</sup> Electricity Order, [Article 14D\(2\)](#).

<sup>90</sup> Electricity Order, [Article 14D\(3\)](#).

<sup>91</sup> At the time of implementing the EU Third Energy Package, the Government confirmed its intention that 'the proposed grounds for appeal for licence modification decisions ... enable the appeal body to take account of the merits of the case' (see the [Government Response to consultation on Implementation of the EU Third Internal Market Energy Package](#), paragraph 2.24).

<sup>92</sup> [Gas \(Northern Ireland\) Order 1996](#), SI1996 No. 275 (NI 2).

<sup>93</sup> *Firmus Energy (Distribution) Limited v the UR*, [Final determination](#), 26 June 2017.

extent has not been the subject of specific review. We consider that what is intended is an appeal on specific points.

3.29 In particular, we consider that it is not appropriate for the CMA to start by considering an alternative approach and to say that if that approach is considered superior, then there is an error. The first question for the CMA is whether there has been an error in the regulator's approach, not whether an alternative approach might be better. The question of what alternative approach should be adopted is primarily relevant once an error has been identified.

3.30 As regards issues of errors of fact, we have had regard to the principles set out in the decision of the Court of Appeal in *Assicurazioni Generali Spa v Arab Insurance Group*,<sup>94</sup> where the Court held that:

where the correctness of a finding of primary fact or of inference is in issue, it cannot be a matter of simple discretion how an appellate court approaches the matter. Once the appellant has shown a real prospect (justifying permission to appeal) that a finding or inference is wrong, the role of an appellate court is to determine whether or not this is so, giving full weight of course to the advantages enjoyed by any judge of first instance who has heard oral evidence. In the present case, therefore, I consider that (a) it is for us if necessary to make up our own mind about the correctness or otherwise of any findings of primary fact or inference from primary fact that the judge made or drew and which the claimants challenge, while (b) reminding ourselves that, in 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. In relation to (a) we must, as stated, bear in mind the important and well recognised reluctance of this court to interfere with a trial judge on any finding of primary fact based on the credibility or reliability of oral evidence.

3.31 We have also taken into account the view of the Competition Commission (CC) in the E.ON decision that:

...the specialist regulator may well have an advantage over the CC in finding the relevant primary facts. In some respects, the

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<sup>94</sup> [2003] 1 WLR 577.

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<sup>95</sup>

- 3.32 As regards the exercise of discretion, we have taken into account that the CC and CMA have consistently applied the principle in regulatory appeals that the statutory test admits of circumstances in which we might reach a different view from the regulator, but in which it cannot be said that the regulator's decision was wrong on one of the statutory grounds. It is not the CMA's role to substitute our judgment for that of the regulator simply on the basis that we would have taken a different view of the matter, had we been the regulator.
- 3.33 SONI took a passage from the CC's decision in E.ON<sup>96</sup> – an energy code modification appeal brought under [section 173](#) of the Energy Act 2004 – as the basis for a submission as regards the standard of review that:

There is a distinction to be made between:

(a) grounds in respect of which the UR 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 UR – in such cases, the CMA must consider whether the UR'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.<sup>97</sup>

- 3.34 The UR strongly disagreed with this submission, stating that:

There is no such distinction to be made. The second category of appeal which SONI seeks to introduce has no basis in the

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<sup>95</sup> *E.ON UK plc v GEMA*, [Decision and Order of the CC](#), 10 July 2017, paragraph 5.16.

<sup>96</sup> *E.ON UK plc v GEMA*, [Decision and Order of the CC](#), 10 July 2017.

<sup>97</sup> *NoA*, paragraph 11.5.

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.<sup>98</sup>

- 3.35 We consider that the UR is correct to say that the test is not whether the decision under appeal was 'unreasonable'. The test is whether the CMA is satisfied the regulator's decision was wrong on one or more of the statutory grounds and that the error was material. It appeared to us that SONI's submission was directed at the question of materiality in our assessment of the UR's decisions, and was not seeking to introduce a non-statutory basis for its claim.
- 3.36 In accordance with the principles set out in the *Assicurazioni Generali Spa* judgment mentioned above, when applying the five statutory tests in [Article 14D](#) of the Electricity Order we consider that there is an important difference between the CMA making up our own mind about the correctness or otherwise of any findings of primary fact, or inference from primary fact, made in the Price Control Decision, which is permissible, and the CMA substituting our judgment for that of the regulator simply on the basis that we would have taken a different view of the matter, had we been the regulator, which is not permissible.

## Materiality

- 3.37 SONI stated that it had limited its grounds of appeal to those errors which have a material effect on the Price Control<sup>99</sup> and cited the following passage from the CMA's determination of British Gas Trading's appeal:

Whether an error is material must be decided on a case-by-case basis taking into account the particular circumstances of each case. Relevant factors would include the impact of the error on the overall price control, whether the cost of addressing the error would be disproportionate to the value of the error, whether the error is likely to have an effect on future price controls, and whether the error relates to a matter of economic or regulatory principle. This list is not intended to be exhaustive.<sup>100</sup>

- 3.38 The UR cited<sup>101</sup> a passage from the CC's decision in E.ON that:

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<sup>98</sup> [Defence](#), paragraph B.11.

<sup>99</sup> [NoA](#), paragraphs 12.1–12.2.

<sup>100</sup> *British Gas Trading v GEMA*, [Final determination](#), 29 September 2015, paragraph 3.61.

<sup>101</sup> [Defence](#), paragraph B.24.

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

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' ...<sup>102</sup>

but did not make any submissions as to the meaning of 'material'.

- 3.39 For the purposes of this appeal, we have agreed with SONI and the UR that the CMA should only interfere with a decision of the UR if the error identified was material. Consistent with other CMA and CC decisions we have considered that an error will not be a material error where it only has an insignificant or negligible impact in relative terms on the overall level of price control that has been set by the regulator.<sup>103</sup>

### **CMA's powers when allowing an appeal**

- 3.40 [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'.<sup>104</sup>

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<sup>102</sup> *E.ON UK plc v GEMA*, [Decision and Order of the CC](#), 10 July 2017, paragraph 5.17.

<sup>103</sup> See *Northern Powergrid (Northeast) Limited and Northern Powergrid (Yorkshire) plc v GEMA*, [Final determination](#), 29 September 2015, paragraph 3.58 and *British Gas Trading v GEMA*, [Final determination](#), 29 September 2015, paragraph 3.60.

<sup>104</sup> Electricity Order, [Article 14E\(9\)](#) and [Schedule 5A](#), paragraph 13(2).

## 4. Overview of appeal and CMA assessment

### Outline of Grounds as pleaded (ie errors)

4.1 In the NoA,<sup>105</sup> SONI sets out the grounds of appeal in terms of a number of errors alleged by SONI:

- **Ground 1 – The Financeability Methodology Ground**
  - Error 1(a): The UR failed to adopt a price control framework that could secure the Appellant’s [SONI’s] financeability.
  - Error 1(b): The UR’s limited and inadequate financeability assessment was subject to material errors.
  - Error 1(c): The UR failed to undertake a complete financeability assessment which, if it had done so, would have demonstrated that the Appellant [SONI] is not financeable.
- **Ground 2 – The Revenue Uncertainty Ground**
  - Error 2: Failure to provide a cost recovery mechanism for PCNPs.
  - Error 3: Failure to provide a cost recovery mechanism for additional IS capital investment.
  - Error 4: Failure to provide a suitable cost recovery mechanism for Significant Projects.
  - Error 5: Failure to provide a suitable right of appeal concerning decisions regarding cost recovery for Significant Projects.
  - Error 6: Failure to manage uncertainty by creating additional uncertainty through implementing an unworkable two-stage approval process.
  - Error 7: Unjustified creation of uncertainty through failure to provide guidance on the application of the DIWE provision.
  - Error 8: Unjustified creation of uncertainty through the introduction of the  $Q_t$  adjustment.

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<sup>105</sup> See [NoA](#), paragraphs 4.1–4.46.

- **Ground 3 – the Inadequate Allowances Ground**

- Error 9: Failure to provide adequate payroll allowances for network planning staff.
- Error 10: Failure to provide adequate pensions allowances.
- Error 11: Failure to provide an adequate IS capex allowance.

4.2 SONI submitted that the cumulative impact of all these errors was that it was required to find additional funding to the value of £14.7 million to meet its obligations. It also submitted that the UR had failed to secure SONI’s ability to finance its activities under the Price Control, as SONI had not been able to secure financing from debt or equity providers based on the Price Control Decision.<sup>106</sup>

## **Statutory grounds of appeal**

4.3 SONI linked the errors listed above to the statutory grounds of appeal (see paragraph 3.23 above). The statutory grounds for each error are outlined in the relevant chapters.

## **Structure of the determination**

4.4 To some extent, the grounds of appeal and alleged errors are interrelated. We found it helpful to assess Ground 3 first (considering specific allowances), then Ground 2 (considering the use of the uncertainty mechanism) and lastly Ground 1 (which included an overarching view of financeability). Our determination is therefore structured in that order.

4.5 We have not addressed every point made by SONI and the UR, but have focused our analysis on those points which we considered to be material to our analysis. Where we have judged pleadings not to be material to reaching our decisions, we have not provided explanations as to whether or not we agree with the arguments made by SONI and the UR.

4.6 We have, throughout our determination, commented on the price control process where relevant either in our assessment of the alleged errors or in sections entitled Observations on Process. We also provide overarching observations after our determination in Chapter 8.

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<sup>106</sup> NoA, paragraph 4.47.



## 5. Ground 3: Inadequate Allowances

### Introduction

5.1 SONI's third Ground of Appeal concerns the UR's decision on the ex-ante allowances for operating expenditure (opex) and for capital expenditure (capex) that SONI is allowed to recover over the Price Control Period.

### *Outline of Ground 3*

5.2 This Ground, referred to in the [NoA](#) as 'the Inadequate Allowances Ground', concerns what SONI described as the unjustified failure by the UR to provide certain specific allowances. SONI submitted that the UR had made a number of clear errors concerning allowances which will result in known costs being subject to non-recovery or under-recovery across the Price Control Period.<sup>107</sup>

5.3 SONI submitted that the UR had made errors in relation to three categories of allowances:

- **Error 9: Network Planning staff** – 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.<sup>108</sup> 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 under the applicable transfer of undertakings (protection of employment) regulations.<sup>109</sup>
- **Error 10: pensions allowances** – SONI submitted that the UR had failed to provide it with adequate pensions allowances, by taking a decision to fund SONI for significantly less than the full costs of its contributions to its defined benefit scheme (including costs which it is legally obliged to meet as a result of the transfer of the Network Planning function from NIE). SONI argued that this risked creating a significant funding deficit for the current Price Control Period and beyond.<sup>110</sup>

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<sup>107</sup> [NoA](#), paragraph 4.41.

<sup>108</sup> The network planning function formally transferred from NIE to SONI on 1 May 2014 at the direction of the UR.

<sup>109</sup> [NoA](#), paragraph 4.44.

<sup>110</sup> [NoA](#), paragraph 4.45.

- **Error 11: IS capex allowance** – SONI submitted that the UR had failed to provide adequate information systems (IS) capex allowances. SONI said that the UR had failed to fund an entire area of SONI’s IS capex submission (DS3/Smart Grids) on the mistaken assumption that this area was outside the scope of the Price Control, and also that the UR had failed to correct a clear error in its adjustments for inflation. In SONI’s view, this error threatened the ability of SONI to deliver a significant regulatory project relating to Smart Grid development.<sup>111</sup>

5.4 SONI said that the errors made by the UR were not cured by the statements in the Price Control Decision that the UR intended to consult further on pension costs or that it would consider a D<sub>t</sub> submission at a later point in time, but after the costs have been incurred.<sup>112</sup> SONI said that these points would not satisfy providers of capital,<sup>113</sup> ie its parent company, EirGrid, or banks as a potential source of debt finance.<sup>114</sup>

5.5 The combined value of these areas where SONI alleged that the UR excluded costs and/or provided insufficient ex-ante cost allowances was £6,289,190 (2014 prices).<sup>115</sup>

### ***Statutory grounds of appeal***

5.6 SONI submitted that the alleged errors (as outlined above) resulted in the Price Control Decision being wrong on the following statutory grounds:<sup>116</sup>

- Error 9: failure to provide adequate payroll allowances for Network Planning staff<sup>117</sup>
  - (i) The UR failed properly to have regard to the Financeability Duty.
  - (ii) The UR failed properly to have regard to its duty to promote efficiency and economy.
  - (iii) Error of fact in assumptions regarding employees with protected rights.

<sup>111</sup> NoA, paragraph 4.46. This project was intended to facilitate greater use of renewable energy, which when implemented was expected to provide significant benefits for consumers in NI.

<sup>112</sup> NoA, paragraph 4.42.

<sup>113</sup> NoA, paragraph 4.42.

<sup>114</sup> SONI Hearing transcript, page 8, lines 3–11.

<sup>115</sup> This comprises Error 9: £3,176,190, Error 10: £1,489,000, Error 11(a): £1,333,000, Error 11(b): £291,000. They are values from SONI’s NoA, not accounting for subsequent amendments made by SONI.

<sup>116</sup> SONI Clarification Hearing follow-up written response of 28 June 2017, Annex 1, page 11.

<sup>117</sup> NoA, paragraph 34.7.

- (iv) Wrong in law by failing to take into account TUPE (the Transfer of Undertakings (Protection of Employment) Regulations 2006 and the Service Provision Change (Protection of Employment) Regulations (Northern Ireland) 2006).
- (v) Wrong in law by breaching SONI's legitimate expectations.
- Error 10: Failure to provide adequate pension allowances<sup>118</sup>
  - (i) The UR failed properly to have regard to the Financeability Duty.
  - (ii) Error of fact in assumptions regarding employees with protected rights.
  - (iii) Wrong in law by failing to consult and provide clear reasons for its decisions.
- Error 11: Failure to provide an adequate IS capex allowance<sup>119</sup>
  - (i) The UR failed properly to have regard to the Financeability Duty.
  - (ii) The UR failed properly to have regard to its duty to promote efficiency and economy.
  - (iii) Error of fact in exclusion of DS3/Smart Grids and incorrect adjustment for inflation.
  - (iv) Wrong in law by failing to properly consider the case for funding the DS3/Smart Grids Project and failing to take account of SONI's request to correct the incorrect adjustment for inflation.

### ***Our approach to assessment of Ground 3***

5.7 We consider each alleged error and sub-error in turn, outlining SONI and the UR's views and our assessment, before concluding whether the UR was wrong in this Ground.

5.8 We note that there have been further developments in terms of pension costs since the Price Control Decision:

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<sup>118</sup> NoA, paragraph 38.6.

<sup>119</sup> NoA, paragraph 42.6.

- (a) On 11 April 2017, prior to SONI submitting its [NoA](#), the UR published a consultation document on the treatment of SONI's pension costs.<sup>120</sup>
- (b) On 16 August 2017, the UR published a draft decision in which it proposed certain changes to SONI's Price Control in relation to pension costs.<sup>121</sup>
- (c) On 19 October 2017, the UR published its final conclusions on pensions.<sup>122</sup>

5.9 This appeal focuses on the treatment of pension costs in the Price Control Decision under appeal. However, the subsequent developments are relevant to remedies.

## **Error 9: Allowances for Network Planning staff**

5.10 SONI describes this error as two sub-errors:

- Error 9a: the UR breached SONI's legitimate expectation, and
- Error 9b: in any event, or alternatively, the UR applied the wrong methodology by failing to have regard to relevant legal obligations.

5.11 We have considered both sub-errors together since the issues raised are closely related.

5.12 SONI's Error 9 relates to the ex-ante allowance for the Network Planning staff functions that transferred from NIE to SONI in 2014. SONI's valuation of the excluded costs was £3,176,190 for the five-year Price Control Period (2014 prices), split between capex (£[~~3~~]) and opex (£[~~3~~]).<sup>123</sup>

### ***UR's Decision***

5.13 In May 2014, the Network Planning functions were transferred to SONI from NIE. Eleven employees transferred from NIE to SONI, of whom three were treated as opex. The remaining eight employees were involved in capex

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<sup>120</sup> [Further consultation on certain matters relating to the Price Control 2015-2020 for the Electricity System Operator for Northern Ireland \(SONI\)](#), 11 April 2017.

<sup>121</sup> [SONI: TSO Price Control Changes, Draft Decision](#), 16 August 2017.

<sup>122</sup> [SONI: TSO Price Control Changes, Conclusions on Pensions Allowances and Decision on Change of Law provisions](#), 19 October 2017.

<sup>123</sup> [NoA](#), paragraph 34.6.

projects, including PCNPs, and therefore the costs of these employees were included in SONI's capital cost projections.<sup>124</sup>

- 5.14 Under the relevant legislation (referred to here as TUPE),<sup>125</sup> the employees transferring retained their rights to their existing terms and conditions of employment.
- 5.15 Since the transfer of the Network Planning function occurred during the previous price control period (2010-2015), the UR made an allowance of £3.1 million<sup>126</sup> to fund the activity for the remainder of the price control. Based on this allowance, the UR amended the level of the applicable tariffs for the period to 1 October 2015.
- 5.16 In the [Draft Determination](#), the UR proposed an ex-ante allowance for all PCNP costs (with all costs to be treated as opex). SONI argued against this approach and this proposal was subsequently changed in the [Final Determination](#).<sup>127</sup>
- 5.17 In the [Final Determination](#), the UR therefore made no ex-ante allowance for the PCNP staff allocated to capex. Instead, in respect of the recovery of the capex costs of SONI's Network Planning staff, the UR decided that these would now form part of any PCNP claim submitted by SONI under the D<sub>t</sub> term.<sup>128</sup>
- 5.18 In the [Final Determination](#), an ex-ante allowance for 2015-20 was assumed as part of the overall payroll opex allowance for all SONI's employees. This included the Network Planning staff who were treated as opex. There was no separate or ring-fenced allowance for the three opex staff who had transferred from NIE.
- 5.19 The overall payroll allowance was determined by the UR through benchmarking of efficient salary costs. It did this benchmarking using provisional 2014 Office for National Statistics (ONS) data relating to the Annual Survey of Hours and Earnings,<sup>129</sup> with adjustments made to reflect the types of roles and skills at SONI and estimated bonus levels.<sup>130</sup>

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<sup>124</sup> [NoA](#), paragraph 35.3.

<sup>125</sup> The Service Provision Change (Protection of Employment) Regulations (Northern Ireland) 2006.

<sup>126</sup> [NoA](#), paragraph 35.8.

<sup>127</sup> [Defence](#), paragraphs 9.21–9.23 and UR Hearing transcript, page 20, lines 1–4.

<sup>128</sup> [Defence](#), paragraph 9.36.

<sup>129</sup> [Defence](#), paragraph 9.25.

<sup>130</sup> The benchmarking exercise led to an overall opex payroll allowance of £27.1 million in the [Final Determination](#) ([Defence](#), paragraph 9.33), equivalent to £53,000 per full-time equivalent (FTE) ([Defence](#), paragraph 9.29).

## **SONI's views**

- 5.20 SONI said it expected full cost recovery through the adoption of an ex-ante, transparent cost allowance specifically for the Network Planning activities that had been transferred from NIE in 2014.<sup>131</sup>
- 5.21 SONI stated that, from October 2013, it had dialogue and correspondence with the UR to gain assurances that the costs of the transfer of the Network Planning function would be recoverable. It referred to various assurances it was given by the UR and said that this led to a legitimate expectation of full cost recovery.<sup>132</sup> SONI argued that the UR failed to honour its assurances that the costs associated with the TUPE transfer would be recovered. In its response to our provisional determination, SONI noted that the UR had referred to “efficient enduring costs associated with the transfer” and that this, in SONI’s view, was evidence of an assurance. SONI considered that the UR’s statement was a firm guarantee of reimbursement.<sup>133</sup>
- 5.22 SONI submitted that an up-front capex allowance had been made in the previous price control for the final year once the transfer from NIE was undertaken.<sup>134</sup>
- 5.23 SONI considered that the capex costs arising from the Network Planning transfer were certain, so there was no need for recovery through the D<sub>t</sub> mechanism, which was a mechanism for dealing with uncertain costs.<sup>135</sup>
- 5.24 SONI argued that due to the TUPE obligations, which restricted its ability to control these costs, the UR’s benchmarking of efficient opex costs was not appropriate.<sup>136</sup>

## **UR's views**

- 5.25 The UR stated that it did not give any specific assurances to SONI that it would recover its costs in full, and that it did not in advance of the [Final Determination](#) for this Price Control confirm the precise approach that it would adopt for allowances relevant to the Network Planning functions that were transferred to SONI.<sup>137</sup>

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<sup>131</sup> [NoA](#), paragraph 36.1.

<sup>132</sup> [NoA](#), paragraph 36.25.

<sup>133</sup> SONI response to CMA provisional determination, paragraph 4.8.

<sup>134</sup> [NoA](#), paragraphs 35.8 & 36.27.

<sup>135</sup> [NoA](#), paragraph 46.9.

<sup>136</sup> [NoA](#), paragraph 36.5 and 36.42.

<sup>137</sup> [Defence](#), paragraph 9.50.

- 5.26 The UR stated that full cost recovery was possible, using the  $D_t$  process whereby SONI submits claims for costs incurred relating to PCNPs.<sup>138,139</sup>
- 5.27 The UR said that an upfront allowance was appropriate for the circumstances of the last price control period, as it related to the final year only. There would therefore have been limitations on submitting a relevant ex-post claim, in the form of the  $D_t$  mechanism, to recover the costs incurred in this period.<sup>140</sup>
- 5.28 The UR told us that SONI's Business Plan did not actually request an upfront capex allowance for these Network Planning costs.<sup>141</sup> The UR also said that SONI, in response to the [Draft Determination](#), had argued against the UR's proposal for an upfront allowance for PCNP costs and so this was not adopted in the [Final Determination](#). The UR considered that both these points meant that SONI's previous submissions were 'at odds' with SONI's appeal ground.
- 5.29 The UR stated that it was fully aware of SONI's TUPE obligations and that these had been taken into account when it undertook the benchmarking exercise to determine efficient payroll opex allowances.<sup>142</sup> The UR considered that it was in consumers' interests for the regulator to only allow efficient costs to be paid through tariffs, and the UR disagreed with SONI's preferred approach which it described as a request for cost pass-through.
- 5.30 The UR considered it had adopted a generous opex benchmarking allowance, due to factors such as the reduced ability of SONI to control the costs of transferred staff from NIE, who were subject to TUPE protection.<sup>143</sup> The UR considered it was proportionate to adopt a single overall opex allowance and it was not necessary for a specific separate allowance for just three opex staff that were undertaking the Network Planning functions. The UR acknowledged that benchmarking was less relevant in considering a suitable approach to determining costs for capex staff.<sup>144</sup>

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<sup>138</sup> [Defence](#), paragraph 9.81.

<sup>139</sup> The UR said it had encouraged SONI to progress this, but to date no such claims had been submitted ([Defence](#), paragraph 9.82).

<sup>140</sup> [Defence](#), paragraph 9.63.

<sup>141</sup> UR Hearing transcript, page 18, line 11 to page 19 line 5.

<sup>142</sup> [Defence](#), paragraph 9.80.

<sup>143</sup> [Defence](#), paragraph 9.78.

<sup>144</sup> UR Hearing transcript, page 20, lines 7–8.

## **CCNI's views**

- 5.31 SLG Economics Ltd (SLG), on behalf of CCNI, submitted that SONI had strong arguments relating to the UR failing to make a sufficient revenue allowance by inappropriately excluding certain costs, but that the CCNI would only support an increase where the costs were genuinely required to deliver the regulated outputs during the Price Control Period.<sup>145,146</sup>
- 5.32 In terms of the costs associated with the transfer of Network Planning staff, SLG submitted that if assurances from the UR had been made, then costs should be allowed as a pass-through, rather than subsumed into wider staff costs and set via a benchmarking exercise. This would mean higher costs to customers, but SLG submitted that this was justified in terms of the value of maintaining confidence in regulatory pronouncements and thereby lowering perceived risk to investors.<sup>147</sup>

## **Our assessment of Error 9**

- 5.33 The basis of Error 9 is that the UR was wrong not to honour assurances of cost recovery by failing to include an ex-ante allowance for the Network Planning capex staff that were transferred from NIE in 2014, and by setting an ex-ante allowance for the opex staff that were transferred at the same time that was insufficient.
- 5.34 In this appeal, both the UR and SONI agreed with the apportionment of numbers of transferred staff between opex and capex,<sup>148</sup> and that TUPE was applicable. We have considered SONI's appeal in that context, as to whether the UR was wrong not to make an ex-ante allowance, where it is agreed that SONI was under TUPE obligations in respect of the relevant costs.
- 5.35 SONI's first argument is that it had a legitimate expectation that the UR would set an allowance based on the actual costs for Network Planning staff.
- 5.36 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. Although the UR told SONI that a cost recovery approach for the transferred Network Planning staff would be devised, it did not specify the detail of this and did not specify that this would be in the form of an ex-ante allowance. We do not consider that reference to 'enduring costs'

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<sup>145</sup> CCNI R&O, Annex 3 (SLG Economics Ltd Report), paragraph 3.4.

<sup>146</sup> CCNI R&O, Annex 3 (SLG Economics Ltd Report), paragraph 4.11.

<sup>147</sup> CCNI R&O, Annex 3 (SLG Economics Ltd Report), paragraph 3.3.1.

<sup>148</sup> Defence, paragraph 9.31.



constitutes a firm commitment to the specific cost recovery approach to be adopted.

- 5.37 In the absence of clear evidence of a legitimate expectation, SONI's appeal is whether the UR was wrong in its choice of regulatory treatment. In the case of both opex and capex, the UR followed the same approach to these costs as other parts of SONI's Network Planning costs.
- 5.38 Even with TUPE applying, this does not as a matter of law prevent SONI entirely from being able to manage the efficiency of some of the costs associated with the staff that were transferred. SONI has not provided sufficient evidence that this approach will result in allowances which are below its actual costs over the price control period. In its response to our provisional determination, SONI stated that in the first two completed years of the Price Control, the [Final Determination](#) allowances were below actual costs.<sup>149</sup> However, in the remedies hearing, SONI acknowledged that there are scope for cost efficiencies to be made.<sup>150</sup> SONI's appeal is that the allowances may be below actual costs due to the assurances from the UR not being fulfilled. SONI considers that this risk is not reasonable given that SONI has no choice but to incur these costs.
- 5.39 We agree with the UR that the approach proposed by SONI is effectively a cost pass-through mechanism. We do not consider that SONI has shown that a mechanism which is equivalent to a cost pass-through would be in consumers' interests. Whilst the legal obligations associated with TUPE are a relevant consideration, we do not consider that this automatically means that cost pass-through should be applied.
- 5.40 The use of pass-through mechanisms can dampen incentives to act efficiently, and in cases such as this, could create perverse incentives. A pass-through which applies to one category of Network Planning costs could affect SONI's incentives on how it chooses to allocate staff with different regulatory treatment to different projects or to different areas of SONI's activities. There would be different incentives on SONI in respect of the approach it would take to managing the costs associated with different staff. Whilst we agree with CCNI that some form of assurance to SONI may be appropriate in the context of a situation such as a TUPE transfer of staff, to go beyond this and to create a cost pass-through for one element of Network Planning staff would not be in consumer interests. Whilst we recognise that, in this specific case, the transfer of Network Planning staff was a policy

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<sup>149</sup> SONI response to CMA provisional determination, paragraph 4.4.

<sup>150</sup> Remedies Hearing transcript, page 76, lines 1–9.

decision outside SONI's control, we are not convinced that this is sufficient to warrant a cost pass-through approach.

- 5.41 We have noted that there is a link to Error 2 within Ground 2 of this appeal, which relates to the UR's alleged failure to provide an adequate cost recovery mechanism for PCNPs. The concerns SONI raises about the recovery of the costs of Network Planning staff cost recovery process are consistent with its view that the 'D<sub>t</sub> mechanism' or 'D<sub>t</sub> process' is ill-defined and, in its current form, unworkable. We do not consider that this means an ex-ante allowance should instead have been applied, rather, we agree with SONI that the process to recover costs through the D<sub>t</sub> mechanism needs to be effective.
- 5.42 One of the advantages of using the D<sub>t</sub> process for cost recovery is that it provides an opportunity to ensure that consumers only pay for efficiently incurred costs. Even with TUPE applying, there may still be opportunities for SONI to manage some of the costs arising from the Network Planning transfer. For example, SONI would still negotiate annual wage adjustments and some costs may reduce should any of the eleven employees retire, leave or take on other responsibilities if a lower level of PCNP work allows this, during the Price Control Period. This suggests that costs are less certain than SONI has suggested in its [NoA](#). If an upfront allowance had been made then predicting such efficiencies would have been problematic and hence unlikely to have been applied to the allowance, leading to a potential windfall for SONI and higher charges for consumers.

### ***Our view on Error 9***

- 5.43 For the reasons given above, our view is 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.

### ***Observations on process***

- 5.44 In our view, neither party articulated its position clearly during the Price Control process. SONI's Business Plan (as submitted to the UR on 21 October 2014) did not clearly explain how it considered the cost recovery for the capex element of the Network Planning function would apply. The [Final Determination](#) did not fully explain how TUPE had been taken into account, nor why the UR had changed its approach to capex recovery from the previous price control. The UR also failed to provide much detail on the operation of the D<sub>t</sub> process, a point we have considered within Ground 2 (see Chapter 6).

- 5.45 If SONI is concerned that the lack of an upfront capex allowance has implications for its financeability, we would expect SONI to be prompt in submitting  $D_t$  claims in order to secure upfront approval from the UR as required in the two-stage process. However, we recognise that SONI may have hesitated to do this, due to its concerns over the current  $D_t$  process. We consider that financeability concerns should diminish once  $D_t$  claims are approved, since, subject to resolving the issues raised under Ground 2 of SONI's appeal:
- (a) the side-RAB applicable to PCNPs would reflect the capex incurred and hence would be subject to allowable returns;
  - (b) there would be more certainty once the allowed expenditure up to the cap set by the UR was known;
  - (c) through progressing and settling  $D_t$  claims, this should reassure providers of finance that a reasonable cost recovery approach is available.
- 5.46 We have identified an approach as part of our remedies on Ground 2 which should help resolve SONI's concerns in respect of the use of this mechanism for recovering the costs of the Network Planning staff.

## **Error 10: Pension allowances**

- 5.47 Error 10 relates to excluded pension cost allowances, covering two components: (i) ongoing contributions (Error 10(a)); and (ii) deficit recovery (Error 10(b)).
- 5.48 SONI's valuation of the excluded costs for ongoing pension contributions was £1,489,000.<sup>151</sup> SONI did not quantify the alleged under-funding arising from the UR's approach to pension deficit recovery.
- 5.49 As discussed above (see paragraph 5.8), there have been developments since the Price Control Decision, which is the subject of this appeal. In this section, we have noted references to these developments to the extent they have been part of the submissions to this appeal.

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<sup>151</sup> NoA, paragraph 40.7.

## **Background: SONI's Pension Schemes**

- 5.50 SONI operates a Defined Benefits (DB) scheme, which is now closed to new members.<sup>152</sup> The existing members are subject to protected rights.
- 5.51 The DB scheme was established in 2009 when EirGrid acquired SONI from NIE. Although the DB scheme is closed to new members, the staff that transferred from NIE for the Network Planning function in 2014 did join the DB scheme.
- 5.52 As with other private sector pension schemes, there is a requirement to undertake a full actuarial valuation of the DB scheme every three years. A full valuation was conducted in March 2010 and March 2013. SONI's Business Plan, submitted in October 2014, for the 2015-2020 Price Control process was based on the March 2013 valuation. The UR also asked SONI to update its 2013 valuation in March 2015.<sup>153</sup> Subsequent to the Business Plan submission, an updated full re-valuation was carried out in March 2016.

## **UR's Decision**

### *Ongoing contributions*

- 5.53 For the Price Control Period, SONI requested an allowance of 40.4% of pensionable salaries based on the March 2013 valuation. The UR set the allowance in the [Final Determination](#) at 28.1% of pensionable salaries, which was also the basis of the provision made in the previous 2010-15 price control.
- 5.54 The UR referred to benchmarking analysis using data from an ONS Survey and Government Actuary's Department (GAD) report as comparators to assess efficient levels of pension allowances.
- 5.55 At the time of the [Final Determination](#), the UR said it considered SONI has some flexibility to manage its pension costs.

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<sup>152</sup> SONI operates a separate scheme for other staff, including new starters, based on Defined Contribution (DC) arrangements. The DC scheme is not subject to this appeal.

<sup>153</sup> [Final Determination](#), paragraph 120.

## *Deficit recovery*

- 5.56 In December 2014, the UR published a position paper,<sup>154</sup> in which it stated that it had decided to apply a cut-off date<sup>155</sup> of 31 March 2015 for pension deficit contributions in all price controls in the future. It stated that this was consistent with the approach taken by the CC in the re-determination of NIE's price control in 2014.<sup>156</sup> In the [Final Determination](#), the UR stated that it would apply this cut-off date in the case of SONI's price control for 2015-2020.
- 5.57 The UR's approach was based on the following principles:
- (a) all deficits existing at the cut-off date would be treated as 'historic' and would be 100% recovered from customers; and
  - (b) deficits after the cut-off date would be 'incremental' and would be 100% funded by the licensee (therefore shareholders).<sup>157</sup>
- 5.58 The UR made an allowance of £943,000 for pension deficit recovery in the [Final Determination](#), based on SONI's 2015 update to its 2013 actuarial valuation.<sup>158</sup>

## *Subsequent developments*

- 5.59 As noted in paragraph 2.58 above, since the Price Control Decision, but after the [NoA](#) was submitted to the CMA, the UR has conducted a further consultation<sup>159</sup> on the treatment of pension costs. In August 2017, the UR issued a draft decision,<sup>160</sup> in which it proposed changing the allowance for ongoing contributions to 38.4%. Changing the allowance from 28.1% to 38.4% would mean that the five-year allowance for ongoing contributions would change from £2.0 million to £2.9 million. In October 2017, the UR issued its final conclusions, correcting an error in the draft decision relating

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<sup>154</sup> [Pension Deficit Recovery – A Utility Regulator Position Paper](#), 22 December 2014.

<sup>155</sup> The cut-off date is a date after which the costs associated with pension deficit funding will be, at least in part, funded by shareholders.

<sup>156</sup> NIE price determination, [CC Final determination](#), 26 March 2014.

<sup>157</sup> Our understanding of how this would work in practice, which was confirmed at its hearing, is that SONI would be required to calculate the portion of any deficit which related to the accruals to the scheme after the 'cut-off date'. If there was a deficit both on the scheme as a whole and on that portion of the deficit, then SONI would be required to exclude this prospective deficit from its price controlled costs (see SONI Hearing transcript, page 24, lines 7-24).

<sup>158</sup> [Defence](#), paragraph 10.20.

<sup>159</sup> [Further consultation on certain matters relating to the Price Control 2015-2020 for the Electricity System Operator for Northern Ireland \(SONI\)](#), 11 April 2017.

<sup>160</sup> [SONI: TSO Price Control Changes, Draft Decision](#), 16 August 2017.

to expenses, with the overall position for ongoing contributions being £3.2 million.<sup>161</sup>

- 5.60 In this draft decision on pensions, the UR also provisionally decided to change the cut-off date to 31 March 2019<sup>162</sup> and changed its calculation of the contributions required. Its updated position is based on the 2016 full re-valuation and this has a lower allowance at £550,000<sup>163</sup> for pension deficit recovery in the Price Control Period, which is £395,000 lower than in the [Final Determination](#). This position was maintained by the UR in its final conclusions paper.<sup>164</sup>

## **SONI's views**

### *Error 10(a) (ongoing contributions)*

- 5.61 SONI said that the UR's ongoing contributions pension allowance of 28.1%, compared to its requested level of 40.3%, had created a £1.5 million funding gap. It said that this funding gap was substantial given the scale of allowed returns in the [Final Determination](#).<sup>165</sup>
- 5.62 SONI told us that the UR had not only applied the incorrect contribution rate, it had also applied this to the wrong level of pensionable salaries, therefore further increasing the level of expenditure that was disallowed.<sup>166</sup>
- 5.63 SONI explained the steps it had taken to control prudently and, where possible, reduce the costs of the DB scheme. It said that its ability to further manage costs down was very limited, due to factors such as the protected rights that the pensionable employees had retained.<sup>167</sup> SONI criticised the UR for assuming that SONI had wide scope to manage its costs, but not investigating what action had been taken and the extent of SONI's limitations.<sup>168</sup>
- 5.64 SONI argued that the benchmarking exercises used by the UR, reviewing pensions data from sources at the GAD and ONS, were not appropriate. SONI considered that the comparators were not relevant and provided a

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<sup>161</sup> [SONI: TSO Price Control Changes, Conclusions on Pensions Allowances and Decision on Change of Law provisions](#), 19 October 2017.

<sup>162</sup> [SONI: TSO Price Control Changes, Draft Decision](#), 16 August 2017, paragraph 39.

<sup>163</sup> [SONI: TSO Price Control Changes, Draft Decision](#), 16 August 2017, Table 2.

<sup>164</sup> [SONI: TSO Price Control Changes, Conclusions on Pensions Allowances and Decision on Change of Law provisions](#), 19 October 2017.

<sup>165</sup> [NoA](#), paragraph 40.7.

<sup>166</sup> [NoA](#), paragraph 40.30 and SONI Hearing transcript, page 32, lines 6–12.

<sup>167</sup> [NoA](#), paragraph 40.27.

<sup>168</sup> [NoA](#), paragraph 40.29.

variety of explanations for why it considered SONI's circumstances to differ from those of the comparators.<sup>169</sup> SONI said that the UR had relied on the comparators at the expense of taking into consideration SONI's actuarial valuation.<sup>170</sup>

5.65 SONI also argued that the UR had departed from its pensions policy used at the previous price control for 2010-15 and when tariffs were adjusted to reflect the NIE staff that transferred in 2014. SONI said that the UR had not explained the basis of this decision to adopt a revised approach.<sup>171</sup>

5.66 On 17 October 2017 SONI provided the UR and the CMA with evidence of its actual contributions paid in 2015/16. These were £842,000.<sup>172</sup>

#### *Error 10(b) (deficit recovery)*

5.67 SONI stated that, notwithstanding the fact that the UR had decided to re-consult on its approach to pensions, the UR had made a decision on its approach to pension deficit recovery in the Price Control Decision and hence SONI was at liberty to submit an appeal to the CMA regarding this matter.<sup>173</sup>

5.68 SONI said that it was not appropriate in principle to mirror the approach used for NIE and other regulated utilities in applying a cut-off date.<sup>174</sup> It also argued that the proposed cut-off date of 31 March 2015 was not appropriate. SONI referenced the lack of consultation by the UR in reaching a decision on its approach.

5.69 SONI said that a cut-off date for pension deficit recovery was not appropriate due to the specific characteristics of its DB scheme, which the UR had failed to recognise. SONI argued that simply applying regulatory precedent, that it described<sup>175</sup> as a one size fits all approach, was not valid. SONI's pension scheme is relatively small and so already has relatively high administration costs. SONI said that adopting a cut-off date would increase administration costs significantly and was not appropriate given the specific circumstances of SONI, such as:

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<sup>169</sup> NoA, paragraphs 40.13–40.15.

<sup>170</sup> NoA, paragraph 40.24.

<sup>171</sup> NoA, paragraph 40.31.

<sup>172</sup> This is £861,000 in 2016 prices, but the price base for this price control is 2014 prices. (Letter from SONI's actuaries (Barnett Waddingham LLP) confirming pension contributions paid for year ended 30 September 2016, 17 October 2017.)

<sup>173</sup> SONI reply to the Defence, paragraphs 5.12–5.13.

<sup>174</sup> NoA, paragraph 40.59.

<sup>175</sup> NoA, paragraph 40.66.



- (a) it was a public policy decision by Government and regulators that led to the transfer of staff from NIE for Network Planning, and these employees had protected rights;
  - (b) there would be high administration costs in monitoring separate schemes;
  - (c) there would be a very small effect on customer bills; and
  - (d) there was a significant risk for shareholders given that the scheme had a high proportion of active members and it received low returns due to its relatively low RAB.
- 5.70 In response to the [UR's draft decision on pensions](#), SONI stated the UR has not confirmed the new cut-off date of 31 March 2019 as a decision.<sup>176</sup> In its response to our provisional determination, SONI suggested that the CMA should direct the UR to not progress any subsequent action to set a cut-off date during the Price Control Period.<sup>177</sup>
- 5.71 In the terms of the allowances for pension deficit recovery, SONI submitted that the deficit repair payments paid by SONI in 2016/17 were in fact £75,000, rather than the £268,000 requested in its [NoA](#). Hence SONI clarified that it no longer wished to contest this element of the remedy within Error 10.<sup>178</sup>

### **UR's views**

#### *Error 10(a) (ongoing contributions)*

- 5.72 The UR chose not to contest Error 10(a) relating to the amount allowed in the Price Control Decision for SONI's ongoing contributions to the DB pensions scheme, as it had decided to consult further on ongoing contributions.<sup>179</sup>
- 5.73 The UR considered that the availability of more up-to-date information in the form of SONI's actual contributions and SONI's 2016 actuarial valuation was relevant to the choice of pension contribution rate. The UR decided to re-

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<sup>176</sup> [SONI Ltd response to Notice of Modifications proposed to Annex 1 of the SONI Ltd TSO Licence – Pensions and Change of Law](#), 18 September 2017, page 10 and SONI response to CMA provisional determination, paragraph 4.19.

<sup>177</sup> SONI response to CMA provisional determination, paragraph 4.20.

<sup>178</sup> SONI post-provisional determination written response of 12 October 2017 to CMA clarification requests, paragraphs 9.1–9.2.

<sup>179</sup> [Defence](#), paragraph 10.7.



consult<sup>180</sup> on its position after the Price Control Decision had been issued, and submitted that any new decision should be considered at the remedies stage of this appeal.<sup>181</sup>

- 5.74 The UR clarified that whilst it was not contesting the allowance for ongoing contributions into the DB scheme, in doing so it was not signalling its full acceptance of SONI's proposed remedy.<sup>182</sup>

*Error 10(b) (deficit recovery)*

- 5.75 The UR submitted that SONI's appeal was premature<sup>183</sup> since the UR had not yet made a decision in respect of a 'cut-off' date.<sup>184</sup> The UR said that it had not decided whether it would implement a cut-off date, nor the date of this should the approach be adopted.<sup>185</sup>
- 5.76 The UR considered that whilst a financial allowance had been made, its regulatory approach to pension deficit recovery was not progressed in the relevant licence modifications.<sup>186</sup> The UR stated that at the time of Price Control Decision, its position was not concluded and it had issued an open consultation<sup>187</sup> on the policy position.

**CCNI's views**

- 5.77 As stated in paragraph 5.31 above, SLG, on behalf of CCNI, submitted that SONI had strong arguments relating to the UR failing to make a sufficient revenue allowance by inappropriately excluding certain costs,<sup>188</sup> but that it would only support an increase where the costs were genuinely required to deliver the regulated outputs during the Price Control Period.<sup>189</sup>
- 5.78 In terms of ongoing pension costs (Error 10(a)), SLG noted that the expected pension contribution costs have risen from 28% to 40% between 2010-15 and 2015-20. It said that unless there were measures that SONI

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<sup>180</sup> [Further consultation on certain matters relating to the Price Control 2015-2020 for the Electricity System Operator for Northern Ireland \(SONI\)](#), 11 April 2017.

<sup>181</sup> [Defence](#), paragraph 10.53.

<sup>182</sup> [Defence](#), paragraph 10.51.

<sup>183</sup> [Defence](#), paragraph 10.34.

<sup>184</sup> [Defence](#), paragraph 10.27.

<sup>185</sup> [Defence](#), paragraph 10.28.

<sup>186</sup> [Defence](#), paragraph 10.29.

<sup>187</sup> [Further consultation on certain matters relating to the Price Control 2015-2020 for the Electricity System Operator for Northern Ireland \(SONI\)](#), 11 April 2017.

<sup>188</sup> [CCNI R&O](#), Annex 3 (SLG Economics Ltd Report), paragraph 3.4.

<sup>189</sup> [CCNI R&O](#), Annex 3 (SLG Economics Ltd Report), paragraph 4.11.

could take to reduce its pension costs to the previous level, it seemed inappropriate not to allow such increased costs.<sup>190</sup>

- 5.79 In terms of the pension deficit recovery costs (Error 10(b)), SLG submitted that if SONI had no control over the size of the pension deficit, it was not appropriate that it bore the risk of funding it.<sup>191</sup> SLG suggested that the UR had incorrectly calculated the allowance based on net present values by using an inappropriate discount rate.<sup>192</sup> SLG suggested the weighted average cost of capital (WACC) should be used as the discount rate, rather than inflation.

### ***Our assessment of Error 10***

#### *Error 10a (ongoing contributions)*

- 5.80 The UR is not contesting Error 10(a). The UR decided to include an allowance based on a 28% contribution rate in the Price Control Decision, but also to re-consult on changing the level of the contribution rate. We interpret the UR's submissions on Error 10(a) as being that the allowance in the [Final Determination](#), which was based on the 28% contribution rate carried forward from the previous price control period, was set at a level which did not reflect prevailing circumstances at the time of the Price Control Decision.
- 5.81 We agree with SONI that this allowance fails to reflect the updated independent actuarial valuation data available at the time of the [Final Determination](#). Given the restrictions on SONI in renegotiating its pension agreements, we agree with SONI that 28% is not a sufficient allowance for ongoing pension contributions.

#### *Error 10(b) (deficit recovery)*

- 5.82 Given that the dispute under Error 10(b) relates to the pension deficit cut-off date, the starting point in Error 10(b) is whether the UR made a decision to apply a cut-off date of 31 March 2015 in respect of the pension deficit. The UR argued that in the [Final Determination](#), its decision was to consider a cut-off date, rather than to apply a cut-off date. Although the UR made an

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<sup>190</sup> [CCNI R&O](#), Annex 3 (SLG Economics Ltd Report), paragraph 3.3.2.

<sup>191</sup> [CCNI R&O](#), Annex 3 (SLG Economics Ltd Report), paragraph 3.3.3.

<sup>192</sup> [CCNI R&O](#), Annex 3 (SLG Economics Ltd Report), paragraph 3.3.3.

allowance for the pension deficit, it nevertheless argued that the cut-off date decision was deferred until after the Price Control Decision.

- 5.83 Whilst the UR did say that it would keep the pension deficit approach under review,<sup>193</sup> we consider that, effectively, the UR did make a decision to apply a cut-off date of 31 March 2015 in the Price Control Decision. The UR included a specific allowance for pension deficit contributions in the Price Control Decision which was based on the pension deficit as at 31 March 2015. This was consistent with the policy statement published by the UR in December 2015 stating that the UR would apply such an approach in all future price controls.
- 5.84 Although the UR decided to conduct a further consultation on whether to change its approach, we do not agree that this means that no appealable decision has been taken. The UR made a decision on an approach to pensions in the Price Control Decision, including the use of a 31 March 2015 date for valuation of the liabilities. This decision was implemented by the relevant changes to the Licence. We consider that SONI has the right to appeal any material aspects of that decision, including the use of a cut-off date. As such, our assessment under this appeal is whether SONI has shown that the decision to adopt a cut-off date of 31 March 2015 and to set pension deficit allowances on that basis in the Price Control Decision was wrong.
- 5.85 We are aware that the adoption of a cut-off date is an approach used by other regulators as a mechanism to ensure that the future risks are shared between customers and shareholders. In many cases this may be the right way to allocate risk, but it is not necessarily the same for all regulated companies regardless of the broader characteristics of the relevant company and the pension scheme under consideration.
- 5.86 In this case SONI has made a credible and coherent case as to why it may be inappropriate to follow this approach for a small company such as SONI. From the evidence presented to us, in our view the UR failed at the [Final Determination](#) stage to give sufficient weight in its pensions analysis to the specific circumstances of SONI.
- 5.87 We agree with SONI that it has different characteristics which need to be properly considered when considering if a cut-off date is appropriate:

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<sup>193</sup> [Decision on the Licence Modifications for the Price Control 2015-2020 of the Electricity System Operator for Northern Ireland \(SONI\)](#), 14 March 2017, paragraphs 135–136.

- (a) staff who transferred from NIE in 2014 are subject to protected rights; this suggests it is more difficult for SONI than other companies to manage the costs of future accruals;
  - (b) SONI's financeability could be more significantly affected than others as it has many active scheme members and a very high proportion of opex staff as ratio to RAB. SONI has a relatively low RAB and hence low allowed returns, meaning it is less able to absorb financial shocks; and
  - (c) the administrative costs of monitoring and enforcing a cut-off mechanism are likely to be relatively large in this case compared to the benefits given the small size of the SONI scheme.
- 5.88 We agree with SONI that these points are all important and relevant to whether it is appropriate to apply this approach to SONI in its current form. We do not consider that the approach taken by the UR in the [Final Determination](#) was sufficient to demonstrate that the cut-off approach was appropriate for SONI.
- 5.89 By conducting a further consultation after the Price Control Decision was issued, which included consideration of these issues, in our view the UR has implicitly accepted that further analysis of SONI's position was required. By failing to give sufficient consideration to the specific characteristics of SONI when determining the appropriate approach to pension deficit recovery, we consider that the UR made an error.
- 5.90 In summary, we consider that the Price Control Decision included a decision in relation to pension deficit funding based on a valuation and cut-off date of 31 March 2015. We consider that the evidence provided to this appeal demonstrates that this decision failed to take properly into account SONI's particular circumstances and so was wrong. We note that the UR itself has decided that the decision should be revisited. As with Error 10(a) above, we are aware that the UR has consulted on a revised approach to pension deficit funding, and its final conclusions on pensions has been considered as part of the remedies process.
- 5.91 For the avoidance of doubt, in this decision as to whether the UR was wrong, we have not considered whether the UR would be wrong to apply a cut-off date at all, and specifically, whether the UR would be wrong to apply the revised cut-off date of 31 March 2019 proposed in its August 2017 draft decision document and confirmed as an intended approach in its October

2017 final conclusions paper.<sup>194</sup> We note that this intended policy has no implications on the financial allowance for this price control. Furthermore, if a cut-off date is to be introduced, the final decision on this will be made at the next Price Control, which will be subject to consultation and is a decision that is appealable at that point.

### ***Our view on Error 10***

- 5.92 For the reasons given above, we agree with SONI that the UR's decision to not take into account the updated valuation, and to set an allowance in the [Final Determination](#), which was taken from the previous price control period, was wrong, as it failed properly to have regard to the Financeability Duty and was based wholly or partly on an error of fact.
- 5.93 We also agree with SONI that the UR did make a decision to apply a cut-off date of 31 March 2015 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. We are therefore satisfied that this decision was wrong as the UR failed properly to have regard to the Financeability Duty.
- 5.94 We discuss our approach to designing an appropriate remedy in Chapter 10.

### ***Observations on process***

- 5.95 Whilst we welcome the recent activity by the UR to obtain and scrutinise the latest pensions information from SONI and its actuarial advisors, this was not progressed before the start of the Price Control Period. Not only was the Price Control Decision announced many months after the start of the price control in October 2015, this pensions issue has been delayed even further. We also note that the UR did not clearly explain its reasons for the delay. Some of the UR's explanations of its position and reasoning in the [Final Determination](#) and in the Price Control Decision are far from comprehensive.
- 5.96 We welcome the UR's recent consultation and that it has now progressed further in its consideration of these issues, which we recognise are complex and not straightforward. However, in our view, the timing of this should have been earlier.

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<sup>194</sup> SONI: TSO Price Control Changes, Conclusions on Pensions Allowances and Decision on Change of Law provisions, 19 October 2017.

5.97 We were concerned that SONI had to change its ongoing pension contributions request for 2015/16; this was not notified to the CMA until 17 October 2017.<sup>195</sup> SONI also withdrew its appeal with respect to the deficit recovery allowance for 2016/17 when it realised at a very late stage, again in October 2017, that it had not actually made the additional payment and had instead paid an amount in line with the UR's assumptions. While we understand that errors might be made in these complex areas, parties need to be scrupulously careful in their claims and to ensure that any errors are rectified at the earliest opportunity.

## Error 11: IS capex allowance

5.98 Error 11 relates to the excluded DS3/Smart Grid IS capex allowance (Error 11(a)) and to an inflation adjustment to the IS capex (Error 11(b)). SONI's valuation in the NoA of the under-funded costs was £1,333,000 for DS3/Smart Grid IS costs and £291,000 for the inflation adjustment.

### **UR's Decision**

#### *Error 11(a) (exclusion of DS3/Smart Grid expenditure)*

5.99 In its role as TSO, SONI maintains and enhances the IS capabilities required to operate the network, and much of this IS expenditure is recorded as capex.

5.100 In its Business Plan, SONI requested £8.9 million for IS spend in the period 2015-20 whereas the UR allowed £6.6 million in the [Final Determination](#).<sup>196,197</sup> The difference between SONI's Business Plan and the UR's allowances included £1.33 million of IS capex relating to DS3 System Services which the UR decided not to allow.<sup>198</sup> The expenditure for the projects that was not allowed is shown in Table 5.1.

**Table 5.1: Proposed IS expenditure disallowed in Price Control Decision**

IS Project	£
DS3 performance monitoring data	417,000
DS3 tools	625,000
Smart Grids	292,000

Source: [NoA](#), paragraph 43.5.

<sup>195</sup> Letter from SONI's actuaries (Barnett Waddingham LLP) confirming pension contributions paid for year ended 30 September 2016, 17 October 2017.

<sup>196</sup> [NoA](#), paragraph 43.3.

<sup>197</sup> [Final Determination](#), paragraph 227.

<sup>198</sup> The remainder of the difference between what was requested and allowed was due to a 10% reduction in allowances for other IS projects. This reduction has not been appealed by SONI.

- 5.101 In support of its decision, the UR employed consultants, Gemserv, to review the evidence and justification in SONI's capex submissions, including IS capex and this specific component for DS3 costs.
- 5.102 The UR has provided an explanation for the reasons for the exclusion. In the [Final Determination](#), the UR stated the capex had been deferred, rather than completely disallowed.<sup>199</sup> It referred to the potential cost recovery route through the D<sub>t</sub> term. It continued to suggest that some of the costs may be outside this Price Control, noting that some DS3 budget provision may arise from the SEMO price control, depending on decisions of the SEMC.

*Error 11(b) (inflation adjustment)*

- 5.103 The UR's business plan template required SONI to submit its Business Plan, including its projected IS capex costs, in 2014 prices for the 2015-2020 Price Control Period. In February 2015, the UR approached SONI stating it had assumed that a 2015 price base had been used. SONI responded and disagreed with this assumption. In both the [Draft Determination](#) and the [Final Determination](#), the UR adjusted the IS capex amount from 2015 to 2014 prices. Throughout the Price Control process, SONI maintained its position that the costs were already in 2014 prices, whereas the UR maintained its position that an adjustment was necessary.

**SONI's views**

*Error 11(a) (exclusion of DS3/Smart Grid expenditure)*

- 5.104 SONI told us that the projects to develop DS3 and Smart Grid capabilities were part of the drive for use of more renewable energy. This would lead to cost savings that would benefit consumers and was a key output of this price control review. In light of this, SONI submitted that the UR was therefore wrong not to make ex-ante allowances for these projects.<sup>200</sup>
- 5.105 SONI said that the UR and its consultant, Gemserv, had incorrectly made assumptions that the spend was a SEMC decision, and therefore that the funding was not within this Price Control Decision.<sup>201</sup>
- 5.106 The DS3/Smart Grids project was focused on developing capabilities for extending renewable energy usage<sup>202</sup> across the island of Ireland. SONI

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<sup>199</sup> [Final Determination](#), paragraph 218.

<sup>200</sup> [NoA](#), paragraphs 43.6 & 44.12.

<sup>201</sup> [NoA](#), paragraph 44.9.

<sup>202</sup> A 40% renewable energy target by 2020 has been set.



noted that the CER had allowed EirGrid its 75% proportional allocation in its corresponding price control determination (€5 million).<sup>203</sup> Given that the CER had allowed full funding for EirGrid, SONI considered it should have had its equivalent 25% allocation allowed as part of the Price Control allowances.

5.107 SONI said that the alternative mechanisms of using the  $D_t$  process did not represent a clear mechanism for cost recovery. It argued that the UR had failed to explain why the uncertainty mechanism was appropriate in these circumstances given that, in SONI's view, the Business Plan had quantified the costs that would be incurred.<sup>204</sup>

5.108 In its reply to the Defence, SONI said that the UR was late to claim that SONI's submission lacked clarity. SONI suggested that the first time the UR referenced this poor clarity was in the [Defence](#) to this appeal. Due to this timing, SONI said it was not given the opportunity to provide further justification and clarity.<sup>205</sup>

#### *Error 11(b) (inflation adjustment)*

5.109 In accordance with the instructions provided with the UR's business plan template, SONI said that its cost estimates for IS projects were made in 2014 prices and at no point did SONI forecast and amend these to 2015 prices.

5.110 SONI provided us with correspondence which demonstrated that, following the [Draft Determination](#), it had identified the error and provided a full explanation to the UR. SONI told us that it made repeated attempts to resolve the issue following its identification in February 2015. Copies of relevant letters and emails to the UR were provided to the CMA as evidence of SONI's efforts to encourage the UR to re-visit this re-basing adjustment.

5.111 SONI told us that the UR failed to respond to SONI's submissions on this issue or seek to clarify or resolve any misunderstanding. SONI said it suspected that the UR was aware of the error but considered the value to be inconsequential so not necessary to address.<sup>206</sup>

5.112 SONI acknowledged that it had made one error in its submission relating to the price base; this was equivalent to £30,000. SONI said it believed that this

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<sup>203</sup> [NoA](#), paragraph 44.19.

<sup>204</sup> [NoA](#), paragraph 44.22.

<sup>205</sup> SONI reply to the Defence, paragraph 5.18.

<sup>206</sup> [NoA](#), paragraphs 44.34–44.35.



had possibly led or contributed to the UR's decision to progress an overall adjustment for inflation, that it calculated to have an effect of £291,000.<sup>207</sup>

- 5.113 During the course of the appeal we asked SONI for further evidence that its costs were prepared in 2014 prices. A witness statement was provided that noted that the cost estimates were prepared internally in 2014 and that these internal estimates were verified by discussions with relevant IT providers.<sup>208</sup>
- 5.114 In the remedies hearing, SONI informed us that the UR's approach had already included a 10% reduction following advice from GemServ. The alleged error of 3.2% for inflation was in addition to this.<sup>209</sup>

### **UR's views**

- 5.115 As overall context, the UR said that SONI's Error 11 amounted to a request by SONI for pass-through of its projected costs. It said that SONI should have had better justification for the spend it projected and that there remained opportunities for future funding claims through the D<sub>t</sub> term, if SONI substantiated the need for the spend through a business case. The UR noted that this appeal ground should be considered in light of the 45% increase in the allowed IS capex compared to the previous price control period.<sup>210</sup>

#### *Error 11(a) (exclusion of DS3/Smart Grid expenditure)*

- 5.116 The UR said that its decision to exclude the DS3 project was not because it was a SEM matter.<sup>211</sup> The UR stated that the [NoA](#) was misguided in making this assertion.
- 5.117 According to the UR, its actual reason for not making an allowance for the DS3 project was because it considered that SONI's business case was weak in that it failed to provide a breakdown of the costs, set out its methodology or assumptions for the amounts, and failed to provide any reassurance there would not be a potential overlap and/or duplication with other IS workstreams that did receive a funding allowance in the Price Control.<sup>212</sup>

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<sup>207</sup> [NoA](#), paragraph 44.32 and SONI reply to the Defence, paragraph 5.22.

<sup>208</sup> SONI post-provisional determination written response of 6 October 2017 to CMA clarification requests, First Witness Statement of Margaret Hayden.

<sup>209</sup> Remedies Hearing transcript, page 83 line 24 to page 84 line 8.

<sup>210</sup> [Defence](#), paragraphs 11.60–11.63.

<sup>211</sup> [Defence](#), paragraph 11.25.

<sup>212</sup> [Defence](#), paragraph 11.35.

- 5.118 The UR noted that it received advice from its consultants, Gemserv, who had reviewed SONI's evidence base. Gemserv had advised there was insufficient supporting evidence and a high risk of duplication.<sup>213</sup>
- 5.119 The UR stated that it was open to receiving  $D_t$  claims once the business justification was more comprehensive and cost certainty was improved. This would provide an opportunity for SONI to secure the necessary funding allowance.<sup>214</sup>

*Error 11(b) (inflation adjustment)*

- 5.120 The UR stated that it had not assumed that the IS capex submission it received was in 2015 prices, as suggested by SONI.<sup>215</sup> Rather, the UR said that it had based this on information set out in SONI's business plan submissions which supported the position that the figures were in 2015 prices.<sup>216</sup>
- 5.121 The UR said that it undertook cross-checks when reviewing SONI's spreadsheet submissions and it argued that these all suggested that SONI's figures were presented to the UR in 2015 prices. It said that if this was not the case, the calculations in the IS capex submission would have been illogical.<sup>217</sup>
- 5.122 In the UR's view, it deliberately and correctly applied the re-basing adjustment.<sup>218</sup>
- 5.123 In its response to our provisional determination, the UR noted that the value of the potential remedy adjustment was £212,000. This is lower than the £291,000 estimate provided by SONI. The UR stated that SONI had incorrectly included two spend categories in the re-basing calculation that had not been allowed in the [Final Determination](#).<sup>219</sup>
- 5.124 In the remedies hearing, the UR stated that they relied on SONI to provide the evidence of what price base was used.<sup>220</sup> The UR confirmed in the remedies hearing that the evidence that they had relied upon was from

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<sup>213</sup> [Defence](#), paragraphs 11.39 & 11.42.

<sup>214</sup> [Defence](#), paragraph 11.62.

<sup>215</sup> [Defence](#), paragraph 11.51.

<sup>216</sup> [Defence](#), paragraphs 11.51 & 11.55.

<sup>217</sup> [Defence](#), paragraphs 11.53 & 11.57.

<sup>218</sup> [Defence](#), paragraph 11.59.

<sup>219</sup> UR response to CMA provisional determination, paragraphs 3.53–3.58. The UR refers to two cost categories excluded in the [Final Determination](#): DS3/Smart grid capex and buildings capex.

<sup>220</sup> Remedies Hearing transcript, page 148 lines 2-8, and page 149 lines 7–18.

SONI's Business Plan; the UR had not raised further queries with SONI to investigate this matter.

### **CCNI's views**

- 5.125 In terms of the allowance for DS3/Smart Grids spend, SLG, on behalf of CCNI, submitted that it recognised the UR had proposed an alternative cost recovery approach using the  $D_t$  mechanism that allows costs to be recovered on an individual basis, whereas SONI had not provided an alternative mechanism for recovering these costs. SLG, on behalf of CCNI, was not supportive of SONI's request for a full ex-ante cost allowance, noting that individual project reviews were more likely to ensure consumers did not over-fund the costs needed.<sup>221</sup>
- 5.126 In terms of the inflation rebasing adjustment, SLG said that if a genuine mistake had been made, then this should be corrected.<sup>222</sup>

### **Our assessment of Error 11**

#### *Error 11(a) (exclusion of DS3/Smart Grid expenditure)*

- 5.127 The dispute in respect of Error 11(a) relates to whether the relevant costs should form part of an ex-ante allowance, as alleged by SONI, or form part of the costs which are included in tariffs through an ex-post mechanism, as set out in the [Final Determination](#).
- 5.128 SONI's Price Control includes both ex-ante mechanisms and ex-post mechanisms, reflecting that many of SONI's outputs are uncertain and not suitable for an ex-ante price control. As a result, the key question in dispute is whether these costs are sufficiently well-defined in respect of outputs that the UR was wrong not to include them in the ex-ante allowance.
- 5.129 Whilst we note that the DS3/Smart Grid activities are key outputs expected from this review, it remains unclear what specific projects SONI proposes to progress and what these will deliver. In particular, the distinction from other IS projects within the £6.6 million IS allowance made in the [Final Determination](#) is not clear. We invited SONI to provide further clarity, but its submissions still left uncertainty over the timeline, the outputs and whether

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<sup>221</sup> CCNI R&O, Annex 3 (SLG Economics Ltd Report), paragraph 3.34.

<sup>222</sup> CCNI R&O, Annex 3 (SLG Economics Ltd Report), paragraph 3.35.

there was duplication. SONI's updated evidence of the justification of this IS expenditure remains unconvincing.<sup>223</sup>

- 5.130 In the absence of clearly defined outputs for ex-ante allowances, and given that there is an ex-post mechanism for recovering actual spend on projects which are deemed necessary, there is a real risk of double counting. Where SONI has an ex-ante allowance and where it is insufficiently clear which outputs or outcomes are to be delivered with the spend associated with that allowance, SONI may underspend on such ex-ante allowances and still be able to justify a separate allowance for spend on DS3 or other projects which it implements with well-defined outputs.
- 5.131 SONI has suggested that the UR should follow the decision of the CER in allowing an upfront allowance for EirGrid for similar activities in the RoI. We note that the CER's approach still allows for an ex-post review of the level of actual spend. In any case, in our view the existence of an alternative treatment does not necessarily mean that the UR's decision not to give an upfront allowance was wrong – consistent regulatory treatment is not always appropriate. Given the interactions between the UR and CER in respect of the SEM, in our view the UR could have explained more clearly why its regulatory approach differed from that taken by the CER. However, the two approaches need not be identical.
- 5.132 On balance, given the UR has stated that additional IS capital costs can be recovered through the  $D_t$  process if necessary, we consider that SONI has not demonstrated that the UR was wrong in disallowing a specific ex-ante allowance. We also consider that if the UR had done so, it would have resulted in a risk of double counting.

*Error 11(b) (inflation adjustment)*

- 5.133 In respect of Error 11(b), we are being asked to consider whether the price control was wrong due to the use of an inflation adjustment which assumed prices were in a 2015 rather than a 2014 base. We have first assessed whether the actual values used were in 2014 or 2015 prices, and then considered whether the UR had taken the appropriate steps to resolve this issue once raised in the price control process.
- 5.134 We note that SONI's submission to the UR was in made in October 2014. We accept that it is more likely than not that for a business plan submitted in 2014, the cost base price index for the estimated projects costs submitted

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<sup>223</sup> SONI written response of 17 July 2017 to CMA clarification requests, paragraphs 8.1–8.13.

would have been in 2014 prices, rather than uplifted for anticipated inflation in 2015. SONI's statement that, in the absence of any specification to the contrary, it should be assumed that 2014 submissions would be calculated in 2014 prices, is credible, even if supported by relatively limited evidence. It is also consistent with our analysis of the Business Plan spreadsheets provided by SONI. The UR template made it clear that 2014 prices should be used, so we consider SONI would have done this.

- 5.135 We then considered whether the UR acted appropriately once SONI had raised this issue.
- 5.136 Our review of the spreadsheet submissions from SONI revealed some poor practice and errors. The template provided by UR was amended by SONI, and some labelling of the price base was inconsistent. We also found errors in the spreadsheet submissions indicating that neither SONI nor UR carried out adequate steps to check the basis of the submission.
- 5.137 SONI recognised that some figures in its Business Plan spreadsheet were incorrectly uplifted in 2015 prices, but it re-asserted that the capex 'additions' were in 2014 prices.
- 5.138 In our view, once SONI had highlighted this issue to the UR in its response to the [Draft Determination](#), the UR should have engaged properly with SONI to clarify the position at that point, but it failed to do this. The UR acknowledged in the remedies hearing that it had relied on the Business Plan submission and it had not followed this up with SONI, despite concerns being raised.<sup>224</sup> We consider that the UR should have sought further evidence of the actual price base used.
- 5.139 We have reviewed the UR's submissions on why it considered that the submissions were in 2015 prices, even after SONI had raised the issue in response to the [Draft Determination](#). Whilst the UR's submissions were consistent with the starting point that SONI had made errors in its original spreadsheet, we do not consider that the UR responded sufficiently to SONI's revised submissions following the [Draft Determination](#).
- 5.140 Although we accept that the existence of an error in the inflation adjustment may have resulted in part from inconsistent presentation on SONI's part, we are required for the purposes of this appeal to consider whether the Price Control is wrong for the reasons stated by SONI in this appeal. In respect of

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<sup>224</sup> Remedies Hearing transcript, page 148 lines 2-8, and page 149 lines 7-18.

the inflation adjustment, SONI has made submissions that the calculations were in error and therefore the price control has the wrong outcome.

- 5.141 We consider on the balance of probabilities that SONI's prices in its Business Plan were in 2014 prices. We therefore have concluded that the UR was wrong to make an inflation adjustment and, to this extent, the Price Control was wrong.
- 5.142 The Price Control was based on a Business Plan model which included errors, both in terms of how SONI described its input assumptions, and also other errors, including those identified by the UR. However, for the purpose of this appeal, we are considering whether the end of this process, whether or not flawed at the early stages, resulted in the wrong capex allowance for the Price Control.
- 5.143 We have concluded, based on a review of the evidence, that the Price Control applied, based on the UR's original assessment of SONI's business plan model, includes errors. SONI provided us with contemporaneous documentation that was consistent with its statement that the submission was compiled in 2014 prices, and a subsequent witness statement confirming the basis on which this submission was prepared.<sup>225</sup> UR's decision based on the Business Plan was wrong and should be corrected. The UR could therefore have corrected the errors prior to the [Final Determination](#). We therefore find that the UR was wrong and that the Business Plan inputs and resultant ex-ante allowance should be revised. The error comprised the use of wrong data, which would be straightforward to correct, rather than the exercise of regulatory judgment where we would ordinarily apply appropriate restraint.

### ***Our view on Error 11***

- 5.144 In terms of Error 11(a) (DS3/Smart Grids allowance), for the reasons given above, we conclude that the UR did not make an error in its determination of SONI's capex allowances for the DS3/Smart Grids projects in the Price Control Decision.
- 5.145 As regards Error 11(b) (inflation adjustment), for the reasons given above, 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 with SONI on this issue after the Business Plan submission, and that there are errors in the figures. Accordingly, for the purposes of [Article 14D\(4\)](#) of the Electricity

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<sup>225</sup> SONI post-provisional determination written response of 6 October 2017 to CMA clarification requests, First Witness Statement of Margaret Hayden.

Order, we are satisfied that the decision of the UR was to this extent wrong, as the UR failed properly to have regard to the Financeability Duty. We are also satisfied that the relevant decision was based, wholly or partly, on an error of fact.

### **Observations on process**

5.146 In terms of Error 11(a), we note that:

- (a) The UR, during the course of this appeal, appears to have changed its position and has not been able to present clarity on whether DS3 spend is a SEMC decision.<sup>226</sup>
- (b) We consider that SONI should have been given opportunity earlier to improve its justification of the DS3 spend and address the UR's/Gemserv's concerns about duplication.
- (c) We also consider that, where the UR is adopting a different regulatory approach to the issues which are common to SONI and EirGrid, there would be benefits in greater transparency of the reasons for taking a different approach compared to CER's allowance for EirGrid.

5.147 However, based on the information provided to this appeal, we also recommend that SONI improves the clarity and justification of its projects, showing that they are distinct from those already allowed in the [Final Determination](#) and are in consumer interests to be progressed. Once this improved justification is available, SONI should be able to recover the necessary funding through the D<sub>t</sub> process, and it is feasible that an ex-ante approach could be appropriate in future reviews.

5.148 In terms of Error 11(b), we consider that both parties have contributed to the uncertainty over which price base data was used by SONI. In our view, neither party articulated its position clearly during the Price Control process. SONI should have been able to provide comprehensive evidence that its Business Plan submissions were prepared in 2014 prices, but it failed to do this. The spreadsheet tables that SONI submitted within its Business Plan in October 2014 to the UR contained errors and the structure of the tables specified by the UR was amended by SONI. No such amendments should have been made and SONI should have had audit arrangements in place to

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<sup>226</sup> In paragraph 11.27 of the [Defence](#), the UR said it had not decided if the DS3 costs were a SEM matter. Hence these were not the reason for their exclusion. But later, at its hearing, the UR Chairman said the DS3 costs were outside of the scope of this Price Control (see UR Hearing transcript, page 14, lines 2–3).

avoid errors. We also consider the UR should have explored the issue further with SONI to seek a resolution.

### **Conclusion on Ground 3**

5.149 We have concluded that the UR did not err in its determination of SONI's allowances for:

- (a) Network Planning staff (opex and capex), which formed Error 9.
- (b) IS expenditure, where it is alleged that DS3/Smart Grid expenditure was excluded (Error 11(a)).

5.150 For the reasons set out above, we have concluded that the UR was wrong in its determination of SONI's allowances for:

- (a) Pensions (both ongoing allowances and the pension deficit recovery allowance), which formed Error 10.
- (b) IS capex in respect of the re-basing adjustment made for inflation (Error 11(b)).

as the UR failed properly to have regard to the Financeability Duty and the determination was based wholly or partly on an error of fact.

## **6. Ground 2: Revenue Uncertainty**

### **Introduction**

6.1 Ground 2 of SONI's appeal 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.<sup>227</sup>

6.2 In this chapter, we briefly outline SONI's alleged errors and our approach to the assessment of Ground 2. We then consider each of SONI's alleged errors in turn.

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<sup>227</sup> NoA, paragraph 4.30.



## **Outline of Ground 2**

- 6.3 Most of the alleged 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. SONI has identified six separate alleged errors relating to these uncertainty mechanisms:
- (a) Error 2: No cost recovery mechanism for PCNPs;<sup>228</sup>
  - (b) Error 3: No cost recovery mechanism for additional IS capex requirements;
  - (c) Error 4: No suitable mechanism for recovering Significant Project<sup>229</sup> costs;
  - (d) Error 5: No suitable right of appeal to the CMA;
  - (e) Error 6: Failure to manage uncertainty by creating additional uncertainty through implementing unworkable two-stage process; and
  - (f) Error 7: Unjustified creation of uncertainty through failure to provide guidance on the application of DIWE provision.
- 6.4 SONI has claimed that the UR had created uncertainty that revenues would not be secured for SONI to fulfil its functions and licence obligations.<sup>230</sup> In particular, SONI set out that for over 35% of its expected revenues it had not been granted an allowance but instead had to recover these costs via the UR's uncertainty mechanism.<sup>231</sup> SONI submitted that the nature of the UR's approach meant that it remained unclear if it would be able to recover this revenue.<sup>232</sup>
- 6.5 Table 6.1 below sets out SONI's expected level of expenditure under different categories of cost that it would have to recover via the  $D_t$  mechanism.

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<sup>228</sup> PCNPs are described in Chapter 2 of this document.

<sup>229</sup> SONI defines Significant Projects in this context as any materially significant and complex project (including PCNPs) where the costs exceed £1 million. See [NoA](#), paragraph 4.35.

<sup>230</sup> [NoA](#), paragraph 4.3(b).

<sup>231</sup> [NoA](#), paragraph 3.27.

<sup>232</sup> [NoA](#), paragraphs 4.3(b) & 22.1.

**Table 6.1: Expected scale of SONI’s expenditure under different cost categories subject to the uncertainty mechanism during the 2015-20 price control period**

Type of expenditure	£ million	
	Amount	
PCNPs	17	
I-SEM	11	
DS3	2	
Other	6	

Source: SONI written response of 17 July 2017 to CMA clarification requests, Annex 1 workbook (Tab Question 1).

6.6 SONI has also alleged a separate error in relation to the adjustment of revenues resulting from the delay in implementing the price control (the ‘ $Q_t$ ’ term):

- (a) Error 8: Unjustified creation of uncertainty through the introduction of the  $Q_t$  adjustment

### **Statutory grounds of appeal**

6.7 SONI submitted that the alleged errors resulted in the Price Control Decision being wrong on the following statutory grounds:<sup>233</sup>

- Error 2: Failure to provide a cost recovery mechanism for PCNPs
  - (i) The UR failed properly to have regard to the Financeability Duty: the UR failed to provide a recovery mechanism for potentially £15–20 million of costs associated with PCNPs.
  - (ii) The UR failed properly to have regard to its duty to promote efficiency and economy: the proposed approach to PCNPs gives rise to a real risk of delay, hindering project efficiency and impeding SONI’s ability to fulfil its obligations under the TSO licence.
  - (iii) The modifications fail to achieve, in whole or in part, the effect stated by the UR: the UR’s attempt to codify the two-stage process in the Licence is an insufficient basis for imposing a two-stage process.
  - (iv) Wrong in law: contrary to best regulatory practice which is to provide certainty for regulated companies and for consumers who benefit through the efficient development of the transmission system.

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<sup>233</sup> NoA, paragraph 22.17; SONI Clarification Hearing follow-up written response of 28 June 2017, Annex 1, page 11.

- Error 3: Failure to provide a cost recovery mechanism for additional IS capital investment
  - (i) The UR failed properly to have regard to the Financeability Duty.
  - (ii) The UR failed properly to have regard to its duty to promote efficiency and economy: SONI cannot be expected to deliver the required outputs when obliged to take responsibility for 50% of any expenditure in excess of the IS capex allowance, when the UR has stated it does not expect to approve additional IS capex submissions.
  - (iii) The modifications fail to achieve, in whole or in part, the effect stated by the UR: the [Final Determination](#) contains a number of conflicting statements, and it is unclear how costs incurred in respect of additional IS capex requirements can be recovered by SONI.
  - (iv) Wrong in law: the UR's approach to the IS capex allowance lacks justification and is unreasonable, and therefore breached the UR's obligations to exercise best regulatory practice.
- Error 4: Failure to provide a suitable cost recovery mechanism for Significant Projects
  - (i) The UR failed properly to have regard to the Financeability Duty.
  - (ii) The UR failed properly to have regard to its duty to promote efficiency and economy: the lack of certainty compromises efficiency, as it hinders SONI's ability to plan and ensure the ongoing development of the transmission system in NI.
  - (iii) Wrong in law: the UR's approach of using a single mechanism to capture both unforeseen costs and certain Significant Projects constitutes a failure to exercise its responsibility to SONI to provide for the most appropriate mechanism in each case.
- Error 5: Failure to provide a suitable right of appeal concerning decisions regarding cost recovery for Significant Projects
  - (i) The UR failed properly to have regard to the Financeability Duty: the inability of SONI or third parties to appeal decisions relating to the costs of Significant Projects creates a degree of instability around the price control process, negatively impacting SONI's financeability.

- (ii) Wrong in law: The UR's decision is inappropriate and contrary to the requirements of IME3,<sup>234</sup> as well as being out of step with best regulatory practice and in breach of natural justice.
- Error 6: Failure to manage uncertainty by creating additional uncertainty through implementing an unworkable two-stage process
  - (i) The UR failed properly to have regard to the Financeability Duty: the two-stage approach imposes asymmetric risk on SONI, which the UR has failed to take account of when assessing the level of returns, and hinders SONI's ability to recover its efficiently incurred costs.
  - (ii) The UR failed properly to have regard to its duty to promote efficiency and economy: the two-stage approach creates an unnecessary administrative burden and is likely to result in uncertainty and delay.
  - (iii) The modifications fail to achieve, in whole or in part, the effect stated by the UR: it is not clear how the UR has sought to implement the two-stage process in the TSO Licence, and the result is an unworkable mechanism.
  - (iv) Wrong in law: the two-stage process is evidence of an overly intrusive and disproportionate approach to regulation, contrary to best regulatory practice.
- Error 7: Unjustified creation of uncertainty through failure to provide guidance on the application of the DIWE provision
  - (i) The UR failed properly to have regard to the Financeability Duty.
  - (ii) The modifications fail to achieve, in whole or in part, the effect stated by the UR: the UR created additional uncertainty through failure to provide guidance on the application of the DIWE provision.
  - (iii) Wrong in law: the UR's ability to reduce or remove funds from SONI entirely at its discretion is contrary to regulatory best practice, and it was unacceptable for the UR to withdraw its original commitment to provide guidance on the application of the provision.
- Error 8: Unjustified creation of uncertainty through the introduction of the  $Q_t$  adjustment

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<sup>234</sup> Third Internal Market in Electricity Directive.

- (i) The UR failed properly to have regard to the Financeability Duty: the UR has discretion to retrospectively adjust tariffs and to reduce or remove funds from SONI, thus adding to uncertainty over cost recovery and creating additional financial risks.
- (ii) The modifications fail to achieve, in whole or in part, the effect stated by the UR: rather than appropriately managing uncertain costs, the UR created unjustified additional uncertainty through the introduction of the  $Q_t$  adjustment.
- (iii) Wrong in law: it is contrary to the principle of regulatory certainty for the UR to now seek to introduce a  $Q_t$  term with retrospective application, and the UR failed to consult on either the intent or precise codification of the term.

### ***Our approach to assessment of Ground 2***

- 6.8 As set out above, Errors 2 to 7 all relate to aspects of the use of uncertainty mechanisms by the UR. There are significant overlaps in the arguments put forward by SONI in support of each of the alleged errors. In particular:
- (a) Errors 2 and 3 concern whether a mechanism exists for recovering particular costs – namely PCNP costs and certain IS capital costs.
  - (b) Error 4 concerns whether the mechanism proposed for Significant Projects (the ‘D<sub>t</sub>’ term) is appropriate.
  - (c) Errors 5 to 7 relate to the design of the mechanisms put in place by the UR and whether SONI has appropriate rights of challenge against the UR’s decisions.
- 6.9 In our analysis, we have assessed each error in turn. We have also taken account of the overlaps in SONI’s reasoning where appropriate. This is described in more detail at the start of each section of the analysis.
- 6.10 We consider that Error 8, relating to the  $Q_t$  term, raises different issues which are separate from our analysis of Errors 2 to 7. We set out our analysis of Error 8 at the end of this section, having reached a conclusion on the other errors under Ground 2.

## Error 2: No cost recovery mechanism for PCNPs

### *Our approach to Error 2*

- 6.11 SONI's fundamental concern under Error 2 is that the UR has failed to set out a suitable process which would permit it to recover the significant costs that need to be incurred in order to deliver PCNPs and allow potential funders to assess its creditworthiness.<sup>235</sup>
- 6.12 The concerns outlined by SONI under Error 2 can be split into two broad objections:
- (a) the framework for recovering its spend on PCNPs is both unclear and inadequately codified; and
  - (b) the UR should not have applied an approach that imposed an ex-ante cap on how much SONI could spend on PCNPs, when combined with an ex-post review that allowed SONI only to recover actual costs that are efficiently incurred.
- 6.13 As the arguments presented under paragraph 6.12(b) above are essentially that the 'two-stage process' gives rise to asymmetric risk, there is significant overlap with Error 6 (which alleges that the two-stage process applied to the D<sub>i</sub> mechanism more generally also gives rise to asymmetric risk). As such we have addressed the arguments made in relation to paragraph 6.12(b) in addressing Error 6 below (see paragraphs 6.210 to 6.242 below). This section therefore focuses only on the question of whether the framework for recovering PCNP costs is sufficiently clear and codified.

### ***UR's Decision***

- 6.14 In the [Draft Determination](#), the UR proposed that PCNP costs would be treated as an opex allowance, with the UR giving approval on a project by project basis. The approved amount would be subject to a 50:50 risk sharing mechanism.<sup>236</sup>
- 6.15 In response to the [Draft Determination](#), SONI raised a concern that if the PCNP activity was processed via the System Support Services (SSS) tariff<sup>237</sup> it would be entirely funded by NI consumers. In the [Final Determination](#), the UR decided to allow pre-construction costs to be

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<sup>235</sup> [NoA](#), paragraph 24.21.

<sup>236</sup> [Draft Determination](#), paragraph 377.

<sup>237</sup> The SSS tariff is described in Chapter 2 of this document.

recovered from NIE so they could be capitalised through the Transmission Use of System (TUoS)<sup>238</sup> tariff paid to NIE. This change ensured that some of the costs would be shared with customers in the RoI, as the generation charge element of the TUoS (25%) is billed on an all-island basis.<sup>239</sup>

- 6.16 SONI also raised concerns in response to the [Draft Determination](#) that a 50:50 risk share mechanism was not appropriate for PCNP spend given the likelihood of unforeseen costs. In the [Final Determination](#), the UR determined that a 50:50 risk share should not apply to PCNP spend.
- 6.17 The UR stated in the [Final Determination](#) that PCNP costs would fall into two categories:<sup>240</sup>
- (a) Projects that do not proceed to construction: these costs would be reviewed, approved by the UR and if efficiently incurred would be placed on the SSS tariff.
  - (b) Projects that proceed to construction: these costs would be reviewed, approved by the UR and would be placed on the TUoS tariff, through the Transmission Interface Arrangements (TIA) framework.
- 6.18 The UR stated that costs associated with PCNPs would accumulate on a separate RAB (a side-RAB) and attract a return until such time as they transfer to NIE for construction or the project does not progress and is remunerated through the SSS tariff.<sup>241</sup>
- 6.19 In the [Final Determination](#), the UR also stated that it would continue to work with SONI and NIE in developing the pre-construction / construction projects provisions and enhanced reporting.<sup>242</sup>
- 6.20 The UR stated that SONI would need to make a submission in a similar format and process to when NIE had made pre-construction requests for transmission projects, including providing an initial high-level pre-construction cost benefit analysis.<sup>243</sup>
- 6.21 The UR also stated that SONI had the ability to submit additional D<sub>t</sub> claims if unexpected costs developed beyond the upper cap. As with any other claim

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<sup>238</sup> The TUoS is described in Chapter 2 of this document.

<sup>239</sup> [Final Determination](#), paragraph 479.

<sup>240</sup> [Final Determination](#), paragraph 483.

<sup>241</sup> [Final Determination](#), paragraph 491.

<sup>242</sup> [Final Determination](#), paragraph 485.

<sup>243</sup> [Price Control Decision](#), paragraph 90.

under the  $D_t$  provisions, the UR would assess the claim to determine if it was in customers' interests.<sup>244</sup>

### **SONI's views**

- 6.22 SONI set out that its fundamental concern was that the UR had failed to prescribe a suitable process which permitted SONI to recover the significant costs that needed to be incurred in order to deliver PCNPs, and enabled potential funders to assess its creditworthiness.<sup>245</sup>
- 6.23 SONI submitted that in its Licence, the UR included costs associated with PCNPs in its list of pre-defined categories of costs in respect of which any claims made would be processed under the  $D_t$  process and carried through into the SSS tariff.<sup>246</sup> SONI then noted that in the [Final Determination](#), the UR set out that only costs associated with PCNPs which were not transferred onto the construction phase (because the project was not deemed to be viable to continue) could be recovered using this process.<sup>247</sup> SONI set out its concerns that this left open the question as to how the costs of PCNPs that were transferred onto the construction phase were to be recovered.<sup>248</sup>
- 6.24 SONI submitted that the UR had suggested that SONI's PCNP costs would be recovered through the TIA, but that there was no procedure set out in the TIA for it to recover its costs.<sup>249</sup>
- 6.25 SONI then noted that it and NIE had received a letter from the UR in November 2014 specifically prohibiting them from exchanging money in relation to network planning costs.<sup>250</sup>
- 6.26 SONI noted that the UR had stated in the [Final Determination](#) that it would continue to work with SONI and NIE in developing the pre-construction and construction project provisions.<sup>251</sup> However, SONI stated that the process of recovering revenues was still not clear.<sup>252</sup>

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<sup>244</sup> [Price Control Decision](#), paragraph 92.

<sup>245</sup> [NoA](#), paragraph 24.21.

<sup>246</sup> [NoA](#), paragraph 24.4.

<sup>247</sup> [NoA](#), paragraph 24.4.

<sup>248</sup> [NoA](#), paragraph 24.4.

<sup>249</sup> [NoA](#), paragraph 24.4.

<sup>250</sup> [NoA](#), paragraph 24.5.

<sup>251</sup> [NoA](#), paragraph 24.6

<sup>252</sup> [NoA](#), paragraph 24.6



- 6.27 SONI submitted that there were four possible scenarios for PCNPs, and that each of them should be addressed in cost recovery mechanisms in its Licence:<sup>253</sup>
- (a) the PCNP does not proceed to construction;
  - (b) the PCNP proceeds to construction by NIE;
  - (c) the PCNP proceeds to construction by another entity; and
  - (d) the PCNP proceeds to construction by SONI, where it has exercised its 'step-in rights'<sup>254</sup> in accordance with provisions in the TIA.
- 6.28 SONI noted that in the Price Control Decision, the UR provided no further assurance that all such costs would be recoverable.<sup>255</sup> Furthermore, it noted that there was no provision in the Licence that codified the recovery of the costs of any PCNPs that are transferred to another non-NIE entity or in circumstances where SONI might invoke its step-in rights.<sup>256</sup> SONI set out that the absence of any cohesive codified process being put in place has created further unnecessary uncertainty.<sup>257</sup> It noted that it has been three years since it took over responsibility for network planning from NIE and there is no justification for the persistent delay.<sup>258</sup>
- 6.29 SONI set out that the UR had explained in the Price Control Decision that costs associated with PCNPs being planned by SONI will accumulate on a side-RAB until such time as the project receives the UR's approval to transfer the project to NIE for development.<sup>259</sup> However, SONI stated that there was nothing in the [Final Determination](#) or in the licence modifications which provided a framework for this side-RAB.<sup>260</sup>
- 6.30 SONI submitted that it was unacceptable that the UR should fail to provide a mechanism for it to recover the estimated £15-20 million of costs associated with delivering PCNPs.<sup>261</sup> It noted that it had no visibility as to how it was supposed to recover these costs and was required to carry out work on

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<sup>253</sup> [NoA](#), paragraph 24.7

<sup>254</sup> Under its step-in rights, SONI can take a PCNP to the construction phase. See [NoA](#), paragraph 24.7(d).

<sup>255</sup> [NoA](#), paragraph 24.8.

<sup>256</sup> [NoA](#), paragraph 24.9.

<sup>257</sup> [NoA](#), paragraph 24.9.

<sup>258</sup> [NoA](#), paragraph 24.9.

<sup>259</sup> [NoA](#), paragraph 24.8.

<sup>260</sup> SONI reply to the Defence, paragraph 4.14.

<sup>261</sup> [NoA](#), paragraph 24.10.

PCNPs and incur significant costs in circumstances where the recoverability of such costs and the applicable mechanism remained uncertain.<sup>262</sup>

- 6.31 SONI submitted that it was not in the interests of consumers for it to suspend work on PCNPs so it had progressed work.<sup>263</sup> However, it noted that the continuing uncertainty surrounding delivery of these projects could hamper this work given its negative effect on cost recovery assurance and the lack of visibility concerning the financeability of the business.<sup>264</sup>
- 6.32 SONI explained that this lack of codification contributed to its claim that the uncertainty mechanism does not ensure it can finance its business, as that would require having a clear codified provision.<sup>265</sup> SONI noted that banks require effective visibility of the process and approach, and having this in the Licence is key as this is a document that financiers recognise as something on which they can rely.<sup>266</sup>
- 6.33 In addition to a lack of codification, SONI submitted that certain key aspects of the process that the UR had described remained unclear. First, it noted that in its [Defence](#) the UR claimed that the first stage of the PCNP process would involve SONI submitting a 'D<sub>t</sub> application' in respect of each PCNP at the outset of the project.<sup>267</sup> However, SONI stated that the part of the [Final Determination](#) which the UR cited as authority for this claim made little sense, and, indeed, was immediately contradicted in a later part of the document. In SONI's view, rather than confirming that it had to submit a D<sub>t</sub> application at the outset to recover costs incurred in respect of each PCNP, the relevant paragraph of the [Final Determination](#) stated that the UR would put in place a separate process for PCNPs.<sup>268</sup> SONI also noted that the suggestion that it was required to submit a D<sub>t</sub> application in the case of projects which transferred to NIE was also contradicted by Ms Headley (Director, Compliance and Network Operations) in her letter of 30 September 2016 in which she stated:<sup>269</sup>

It is only if the project is granted initial approval that SONI will subsequently be able to make a claim under the D<sub>t</sub> term in respect of that project (with any such claim being made at the

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<sup>262</sup> [NoA](#), paragraph 24.10.

<sup>263</sup> [NoA](#), paragraph 24.11.

<sup>264</sup> [NoA](#), paragraph 24.11.

<sup>265</sup> Clarification Hearing transcript, pages 53–54.

<sup>266</sup> SONI Hearing transcript, page 82.

<sup>267</sup> SONI reply to the Defence, paragraph 4.6.

<sup>268</sup> SONI reply to the Defence, paragraph 4.7.

<sup>269</sup> SONI reply to the Defence, paragraph 4.8.

point that it becomes clear that the project will not materialise to construction).<sup>270</sup>

- 6.34 Second, the UR confirmed its intention to impose a cap on SONI's spending at the point it gives upfront approval for the project. However, SONI considered that the UR's proposal that SONI could submit additional  $D_t$  claims if unexpected costs develop beyond the upper cap made no sense, as only projects that did not proceed to construction were intended to be claimed for under the  $D_t$  process.<sup>271</sup>
- 6.35 In SONI's view, the UR could not now intend that SONI recovered costs in excess of any cap it imposed through  $D_t$  (and therefore via the SSS tariff) while costs incurred up to the cap were recoverable direct from NIE. SONI submitted that this suggested it might need to utilise two different mechanisms to recover the costs of the same project, which was unworkable and burdensome.<sup>272</sup> In SONI's view, recovering costs via the SSS tariff would also have the effect of the wrong customer base paying in respect of the advancement of the pre-construction costs, since current NI customers would pay, as opposed to future all-island customers.<sup>273</sup>
- 6.36 Third, SONI highlighted that the UR had stated during the course of the appeal that upon gaining approval to proceed with a PCNP, SONI would increase SSS tariffs during the pre-construction phase of the project.<sup>274</sup> SONI suggested that this adjustment to SSS tariffs would appear to be stated in error by UR, given that the costs of PCNP projects are carried by SONI before being recovered from either the TUoS or SSS charges. SONI submitted that this added still further confusion to an already confused set of arrangements.<sup>275</sup>
- 6.37 SONI set out that it is important that we note the distinction between the process that the UR means to apply for recovery of PCNP costs and that for those other costs that it wishes to consider under the  $D_t$  mechanism. It noted that there is some confusion because the UR frequently talks about  $D_t$  claims being made in respect of PCNPs, but that SONI's understanding is that the UR does not intend PCNP costs to be recoverable under the  $D_t$  mechanism.<sup>276</sup>

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<sup>270</sup> NoA, First Witness Statement of Bill Thompson (NoA BT1), supporting document BT1/66, page 2.

<sup>271</sup> NoA, paragraph 24.17.

<sup>272</sup> NoA, paragraphs 24.17–24.18.

<sup>273</sup> SONI Clarification Hearing follow-up written response of 28 June 2017, Annex 2, paragraph 3.5.

<sup>274</sup> SONI reply to the Defence, paragraph 4.12.

<sup>275</sup> SONI Clarification Hearing follow-up written response of 28 June 2017, Annex 2, paragraph 3.7.

<sup>276</sup> SONI response to CMA provisional determination, paragraph 5.8.

- 6.38 SONI also responded to the point made by the UR in its hearing that the methodology that the UR set out to comply with the Trans-European Energy Infrastructure Regulation stated that SONI and NIE should work together to produce submissions to the UR on PCNPs. SONI noted that it was not consulted prior to publication of the paper to which the UR referred. It also noted that the paper was drafted specifically to address NIE's Licence obligations, and did not take account of SONI's specific circumstances.<sup>277</sup> SONI also set out that prior to the hearing with the UR, it was not aware that the UR considered SONI's PCNP work to be within the scope of the processes set out in that paper.<sup>278</sup>
- 6.39 SONI submitted that the UR had erred by failing to reach a decision setting out how SONI will recover costs incurred, including by failing to include a modification in the Licence that confirmed that such costs were recoverable, as required by lenders.<sup>279</sup> SONI submitted that this was in breach of the UR's Financeability Duty and was contrary to the interests of consumers.<sup>280</sup>

### **UR's views**

- 6.40 The UR stated that the process for dealing with PCNP costs had been set out in the [Final Determination](#). This involved 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 took forward to the construction stage. Those costs of projects that do not proceed to construction would be claimed for by SONI using the  $D_t$  mechanism.<sup>281</sup> In the view of the UR, properly construed, SONI's complaint was not about the absence of a mechanism, but disagreement with the mechanisms that have in fact been provided.<sup>282</sup>
- 6.41 The UR stated that this process was set out in the [Final Determination](#) and also in a letter to SONI on 30 September 2016:<sup>283</sup>
- (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 it;<sup>284</sup>

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<sup>277</sup> SONI response to CMA provisional determination, paragraph 5.9.

<sup>278</sup> SONI response to CMA provisional determination, paragraph 5.10.

<sup>279</sup> [NoA](#), paragraph 24.22.

<sup>280</sup> [NoA](#), paragraph 24.22.

<sup>281</sup> [Defence](#), paragraph 2.65.

<sup>282</sup> [Defence](#), paragraph 2.81.

<sup>283</sup> [Defence](#), paragraph 2.68.

<sup>284</sup> [Defence](#), paragraph 2.68(a).

- (b) the costs of the project will accumulate on a side-RAB upon which SONI will earn a rate of return;<sup>285</sup> and
- (c) at the end of the pre-construction stage, one of two things will happen:
  - (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 TIA framework with NIE recovering the cost through the TUoS tariff.<sup>286</sup>
  - (ii) Where the project does not proceed to construction, SONI will recover the value of the RAB through the SSS tariff.<sup>287,288</sup>

6.42 The UR stated that this position was incorporated in paragraph 8.1(g) of the proposed licence modifications which provided that SONI may 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 PCNP.<sup>289</sup>

6.43 In its [Defence](#) the UR said that it recognised that further work was still required to finalise the mechanism within Section N of the TIA framework, under which SONI would be reimbursed for costs it has incurred relating to PCNPs which proceed to construction. However, the UR stated that it was 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 had been undertaken, SONI would be able to invoice NIE under the TIA framework for costs in relation to projects which proceeded to construction.<sup>290,291</sup>

### **CCNI's views**

6.44 SLG, on behalf of CCNI, noted that the uncertainty appeared to relate to how, rather than whether, PCNP costs would be recovered. SLG stated that,

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<sup>285</sup> [Defence](#), paragraph 2.68(c).

<sup>286</sup> [Defence](#), paragraph 2.68(d(i)).

<sup>287</sup> [Defence](#), paragraph 2.68(d(ii)).

<sup>288</sup> We also note that the UR stated that 'SONI will recover its actual costs through the SSS tariff during the pre-construction phase of the project' – see [Defence](#), paragraph 2.68(b). This appears to be at odds with the UR's description of the process, whereby PCNP costs are recovered only at the end of the project (either via the SSS tariff or from NIE via the TIA), and SONI will receive only a return on the side-RAB during the pre-construction phase.

<sup>289</sup> [Defence](#), paragraph 2.72.

<sup>290</sup> [Defence](#), paragraph 2.76

<sup>291</sup> We note that the UR is currently consulting on the appropriate arrangements for the TIA. (See UR letter of 23 August 2017 to SONI and NIE.)

given the statement in the [Final Determination](#) that PCNP costs would be subject to case-by-case approval and accumulated on a side-RAB (a similar level of assurance as is often given by other UK economic regulators to regulated companies for uncertain future investment), this did not appear to be a material error. SLG noted that it would not be in customers' interests to have an automatic pass through without some regulatory scrutiny to give the company assurance that appropriate, efficient costs will be recovered.<sup>292</sup>

### ***Our assessment of Error 2***

- 6.45 At the heart of SONI's concern is its view that the framework for recovering its spend on PCNPs is unclear and inadequately codified. We note that for any regulated business, a clear path for recovering its efficiently incurred costs is a central aspect of the regulatory settlement. Where costs are taken outside the standard price control framework, clarity between all parties around the processes for recovering these costs is particularly important.
- 6.46 We also note that there are specific reasons why clarity of the arrangements for SONI to recover its PCNP costs may be particularly important:
- (a) This is the first full price control during which SONI has undertaken this activity,<sup>293</sup> and as we understand it, has not previously had to recover its PCNP costs; and
  - (b) SONI estimates that PCNPs will account for approximately £15 million to £20 million of its expenditure over the price control period, making it one of SONI's most sizeable activities and a material proportion of SONI's overall expected expenditure of £102–110 million.<sup>294</sup>
- 6.47 We first assess whether the UR has set out a coherent process for recovering PCNP costs, and then assess whether any mechanism that exists is properly codified.<sup>295</sup>

#### *Has the UR set out a coherent process for recovering PCNP costs?*

- 6.48 In the [Final Determination](#), the UR set out that costs associated with the pre-construction projects will accumulate on a side-RAB and attract a return until such time as they transfer to NIE for construction or the project does not progress and is remunerated through the SSS tariff.<sup>296</sup> While this sets out

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<sup>292</sup> CCNI R&O, Annex 3 (SLG Economics Ltd Report), paragraph 3.2.1.

<sup>293</sup> SONI took over responsibility for PCNPs from NIE in May 2014. See [NoA](#), paragraph 3.32(a).

<sup>294</sup> [NoA](#), paragraph 3.27

<sup>295</sup> In our view, codification entails the UR providing sufficient detail, whether it is in the Licence or elsewhere.

<sup>296</sup> [Final Determination](#), paragraph 491.

the broad principles relating to how SONI can recover its PCNP costs, it does not give detail of how this process should work in practice.

- 6.49 During the course of this appeal, the UR has further clarified the process by which SONI can make a claim to the UR and then recover any reasonable and efficient costs incurred in respect of PCNPs (see paragraph 6.41 above).
- 6.50 In its hearing, SONI submitted that it had to piece together its understanding of the process from various different sources, including letters from the UR, the TIA, the Licence and other UR decision documents.<sup>297</sup> This is similar to our experience during this appeal of trying to understand how the PCNP framework is intended to function.
- 6.51 We note that there has been genuine confusion on SONI's part around aspects of the process, that seem to have been clarified only during the course of this appeal.
- 6.52 Overall, while the UR has now set out a relatively clear process through which SONI can recover its efficient PCNP costs, we find it unsatisfactory that the process was not set out in a manner that was easily understandable by parties from the outset, and that this process has been clarified only during the course of this appeal. Also, as discussed below, the PCNP process is not yet specified in sufficient detail in any of the UR's documentation. In addition, important aspects of the process, such as how the relationship between the SSS tariff and the side-RAB will work in practice, have yet to be set out by the UR. This is consistent with SONI's case that, at the point of the Price Control Decision, so many aspects remained to be resolved that it had significant uncertainty when trying to raise finance for PCNPs, and that it faced significant regulatory risk in incurring costs associated with PCNPs.

*Is the mechanism properly codified?*

- 6.53 Notwithstanding the fact that the UR has set out the process through which SONI can recover its PCNP costs in some detail during this appeal, we agree with SONI that the framework underpinning it lacks legal clarity.
- 6.54 In our view, aspects of this framework have not been set out in sufficient detail and, crucially, key aspects that we would expect to see codified

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<sup>297</sup> SONI Hearing transcript, page 51.



remain uncodified, as set out below.<sup>298</sup> This is likely to increase the regulatory risks perceived by SONI and its investors, and will affect SONI's ability to finance its activities, both in respect of PCNPs specifically, and also in terms of the views of providers of finance as to SONI's overall financial risk. We now set out the areas in relation to PCNPs where we consider the UR's process is insufficiently codified.

#### *Existence of the side-RAB*

- 6.55 As noted above (see paragraph 6.41(c)), SONI's expenditure on PCNP projects will accrue in a 'side-RAB', on which SONI will earn a return, and will eventually recover its costs either from NIE or via the SSS tariff.<sup>299</sup>
- 6.56 However, the UR has not set out anywhere precisely how the process for transferring PCNP costs to the side-RAB will work. In our view, it is important that this is set out in a manner that gives sufficient regulatory certainty to SONI that it will be allowed to recoup its efficiently incurred costs. We note that SONI did not disagree with the concept of using a side-RAB for recovery of PCNP costs; rather it submitted that the side-RAB was insufficiently codified.

#### *Return on the side-RAB while undertaking PCNP projects*

- 6.57 SONI's Licence does not provide any mechanism by which SONI would receive a return on this side-RAB via the SSS tariff. This is despite the UR stating in the [Final Determination](#) that SONI would receive a return on its side-RAB during the period before the project is either cancelled or transferred to NIE.
- 6.58 Codifying these provisions clearly would have provided assurance to SONI and its external funders that although SONI will carry the costs of PCNPs until each project is ready to be transferred to NIE or cancelled, it will be assured of earning a return on its capital invested in the meantime.
- 6.59 We note that Annex 1 paragraph 2.3 of the Licence codifies three other SONI RABs and specifies how the rate of return SONI can earn is calculated, which is then provided for under the B<sub>TSO</sub> term of the tariff (see paragraph 2.56). In our view, since SONI is entitled to earn a return on its

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<sup>298</sup> Whether this be in SONI's Licence, in the [Final Determination](#) and/or Final Decision, and/or in supporting documents.

<sup>299</sup> Unless a third party takes on the project. We note that this is an unlikely outcome in practice.



side-RAB, and this will be reflected in its allowed revenues, it should have been codified in the Licence in a similar manner.

*Recovery of the side-RAB following completion of the PCNP project*

- 6.60 Paragraph 8 of Annex 1 of the Licence sets out the details of how SONI can recover the costs of projects approved under the  $D_t$  mechanism.<sup>300</sup> Any costs approved in accordance with paragraph 8 are recoverable under the 'D<sub>Tsot</sub>' term in the SSS tariff (see paragraph 2.56).
- 6.61 While this framework is suitable for those categories of  $D_t$  claim where SONI will make a claim for and then recover its costs in the following year via the SSS tariff, in our view it is undeveloped for the more complex process the UR envisages in the event that SONI recovers its PCNP project costs from NIE.
- 6.62 As noted above, for projects that are transferred to NIE following the planning process, SONI will recoup the value of its side-RAB from NIE. Under the framework that the UR describes, SONI would seek approval from the UR at the start of the process, the expenditure would be logged on a side-RAB, and at the end of the process the value of the side-RAB would be recovered from NIE.
- 6.63 Although the UR stated that SONI will recover its costs via the TIA if a PCNP transfers to NIE, we note that there is no reference to this anywhere in the Licence. Condition 18 of the Licence sets out specific matters that the TIA should capture, including 'arrangements, as between the Licensee and the Transmission Owner, for the planning and development of the transmission system', but there is no specific reference to construction projects transferred from SONI to NIE and the funding of these.
- 6.64 In addition, the aspect of the TIA which governs the transfer of the side-RAB to NIE has not been finalised. Indeed, the UR has stated that no money is currently allowed to transfer between the NIE and SONI pursuant to the TIA. This is highly likely to create material uncertainty for SONI and its investors regarding the likelihood of it being able to recover its efficiently incurred costs for PCNPs that transfer to NIE.

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<sup>300</sup> This sets out that SONI can make a claim to the UR for 'any reasonable and efficient costs incurred in Relevant Year t in undertaking electricity transmission network planning activities associated with a Transmission Network Pre-construction Project'. This would then be treated as 'excluded TUoS/SSS costs in Relevant Year t'.

- 6.65 The UR submitted that Condition 18 of the Licence sets out that SONI and NIE should agree the terms of the TIA between themselves.<sup>301</sup> SONI submitted that ‘it is entirely disingenuous for the UR to suggest it has no responsibility for making provision for SONI to recover its costs’.<sup>302</sup> We note that as the parties have not reached agreement, the UR is currently consulting on the appropriate arrangements for the TIA.<sup>303</sup>
- 6.66 Regardless of the approach the UR takes to ensure there is a functioning TIA between SONI and NIE,<sup>304</sup> it is essential that there is a workable process in place that enables SONI to recover its PCNP costs for projects that are transferred to NIE. However, there is currently no functioning arrangement for PCNPs to transfer from SONI to NIE, despite SONI taking on the PCNP process more than three years ago.
- 6.67 In our view, without such arrangements in place, the current process is not fit for purpose, and this in itself is likely to affect SONI’s ability to finance its activities.
- 6.68 In addition, as noted in paragraph 6.28 above, the UR has not set out the mechanism through which SONI would recover its costs if it exercises its step-in rights with regards to a PCNP, or if a PCNP is transferred to another non-NIE entity. We agree with SONI that codification should also address this possibility to avoid further uncertainty.

### ***Our view on Error 2***

- 6.69 Overall, while we recognise that the UR has set out the broad process by which SONI can recover its PCNP costs, we consider that the UR has not provided sufficient clarity around the functioning of this process.
- 6.70 In our view, it is important that the mechanisms through which SONI is expected to recover its efficiently incurred costs are set out clearly, in a manner that allows SONI’s investors to assess the risks of investing in the company. Failing to do so is likely to introduce regulatory risk, and is likely to affect SONI’s ability to finance its activities. PCNPs are material to SONI: SONI estimates that the level of investment in PCNPs over the Price Control Period (approximately £17 million, as set out in Table 6.1 above) is considerably higher than the value of SONI’s opening RAB. In that context,

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<sup>301</sup> UR Hearing transcript, page 54.

<sup>302</sup> SONI response to CMA provisional determination, paragraph 5.13.

<sup>303</sup> Letter from UR to SONI, 23 August 2017.

<sup>304</sup> That is, whether the process is agreed between SONI and NIE, or is imposed by the UR.

we agree with SONI that greater certainty is required for it to be able to finance its activities.

- 6.71 We note that the UR has clarified what it meant by the process for remuneration of PCNPs, and that its clarified approach is consistent with the Price Control Decision. In our view, the process as now clarified is feasible. However, it has not been documented and there are many areas to be resolved.
- 6.72 PCNPs are projects which require timely and ongoing investment, and the UR has not specified timelines or a practical approach to ensuring that the approval decisions envisaged in its process are made in a timely manner. We also note, as discussed below in paragraph 6.228 regarding Error 6, that the UR has taken a considerable amount of time to respond to previous D<sub>t</sub> requests.<sup>305</sup> As a result, we consider that there is a material risk that the approach set out by the UR will not deliver the stated outcomes without further codification and specification.
- 6.73 Further, the UR has yet to agree an approach to remuneration of projects under the TIA. Whilst we appreciate that the UR's initial intention was that a revised approach would be agreed between SONI and NIE, the UR indicated in its November 2014 letter to SONI an intention to resolve this issue. It has not done so. We understand that the PCNP process cannot work without this being in place and therefore this needs to be resolved urgently.
- 6.74 We agree with SONI that, in light of the above, the approach the UR has taken is likely to make it difficult to demonstrate to investors that its efficient expenditure will be recovered. In our view, the UR should have specified the formal framework in more detail, and in a manner that enables SONI to approach investors for finance. The UR should have codified key aspects that are necessary to provide certainty to investors that SONI's efficiently incurred costs will be recovered.
- 6.75 In view of the foregoing, we are satisfied that this decision was wrong, as the UR failed to codify and specify clearly the mechanisms through which SONI is to recover its efficiently incurred PNCP costs, including under the TIA, notwithstanding this may adversely affect SONI's ability to finance its statutory activities. We are satisfied that the UR has therefore failed to properly have regard to the Financeability Duty, and that the modifications fail to achieve, in whole or in part, the effect stated by the UR.

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<sup>305</sup> SONI set out that the UR took an average of seven and a half months to approve D<sub>t</sub> requests during the period 2011-2015, with the Auction Management Platform D<sub>t</sub> request taking 13 months.

## **Error 3: No cost recovery mechanism for additional IS capex requirements**

6.76 Error 3 relates to the question of whether or not there is a mechanism in place for SONI to recover unexpected IS capex. This is separate to the question of whether SONI was awarded sufficient allowance in the price control to cover its expected IS costs (which is considered in Error 11).<sup>306</sup> We note that both parties set out concerns relating to the level of IS capex allowed in the Price Control in their submissions on Error 3. We do not address these arguments here, since we consider them in detail in our assessment of Error 11 in Chapter 5 above.

### ***UR's Decision***

6.77 In the [Final Determination](#), the UR made certain allowances for IS capex based on SONI's submissions during the price control review. In line with the recommendations of its external consultants, Gemserv, the UR reduced SONI's allowance for IS capital costs by 10% compared with SONI's Business Plan submission. The UR also deferred any allowance in respect of DS3 and Smart Grid project cost because it considered that SONI had not properly justified its proposed expenditure in these areas.

6.78 The [Final Determination](#) stated that, as the UR considered the IS capex allowances it had provided to be sufficient and appropriate, it did not expect to provide further IS capex allowances through the D<sub>t</sub> mechanism.<sup>307</sup>

### ***SONI's views***

6.79 SONI claimed that the UR had failed to provide a mechanism in the Final Licence Modifications for the recovery of efficiently incurred costs associated with the delivery of any additional IS capex projects over and above those identified in the [Final Determination](#).<sup>308</sup>

6.80 SONI submitted that the UR had recognised that SONI was likely to need to provide additional investment in IS capex over and above that set out in the Business Plan and identified in the [Final Determination](#).<sup>309</sup>

6.81 SONI stated that the UR had refused to provide any mechanism for recovering such costs on the basis that it considered the allowance in the

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<sup>306</sup> See Chapter 5.

<sup>307</sup> [Final Determination](#), paragraph 441.

<sup>308</sup> NoA, paragraph 25.1.

<sup>309</sup> NoA, paragraph 25.2.

price control to be sufficient.<sup>310</sup> SONI noted that the UR had stated that it therefore did not expect to receive or to provide approval for IS capex via the D<sub>t</sub> mechanism.<sup>311</sup>

- 6.82 SONI submitted that it was therefore currently unclear how costs incurred in respect of these additional requirements can be recovered. SONI noted that the UR seemed to anticipate that the approved allowance would have to cover the costs of additional and unforeseen IS capex outputs. SONI noted that this was despite the fact that the allowance had been calculated only in respect of the outputs listed in the Price Control Decision and without making provision for unforeseen requirements. SONI submitted that this raised significant concern in terms of its ability to absorb any additional costs associated with these outputs.<sup>312</sup>
- 6.83 SONI outlined that the UR's decision was unacceptable in circumstances where:
- (a) the UR had already reduced the allowances sought in SONI's Business Plan for seven out of eight key IS capex projects;<sup>313</sup>
  - (b) SONI would be exposed to the costs of any spend over the allowance limit pursuant to the new 50:50 risk share mechanism;<sup>314</sup> and
  - (c) the UR had specifically stated that it did not expect to provide approval in respect of additional costs associated with system change submissions via the D<sub>t</sub> mechanism.<sup>315</sup>
- 6.84 SONI submitted that this left it facing unnecessary financial risk in terms of non-recoverability of efficiently incurred costs arising from discharging its statutory and Licence requirements.<sup>316</sup>
- 6.85 SONI submitted that 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 heightened its risk environment, which in turn impacted its financeability.<sup>317</sup>

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<sup>310</sup> NoA, paragraph 25.5.

<sup>311</sup> NoA, paragraph 25.5.

<sup>312</sup> NoA, paragraph 25.6.

<sup>313</sup> NoA, paragraph 25.7(a).

<sup>314</sup> NoA, paragraph 25.7(b).

<sup>315</sup> NoA, paragraph 25.7(c).

<sup>316</sup> NoA, paragraph 25.12.

<sup>317</sup> NoA, paragraph 25.14.

- 6.86 In its hearing, SONI emphasised that although the UR had included a ‘catch-all’ term within the D<sub>t</sub> term of the Licence, which could in principle cover unexpected IS spend, the Licence also stated that the application would only be accepted if SONI had regard to what the UR stated in the [Final Determination](#). Given that the [Final Determination](#) said that such an application for IS spend was not to be expected, SONI did not consider that the UR had provided such a mechanism in practice.<sup>318</sup>
- 6.87 In response to our provisional determination, SONI reiterated its view that its Licence precluded the UR from utilising the D<sub>t</sub> mechanism to provide for recovery of any additional IS capex requirements. It set out that under the Licence, SONI had to take account of and give regard to the [Final Determination](#) in making any D<sub>t</sub> applications, and the [Final Determination](#) stated that the UR would be unlikely to approve D<sub>t</sub> applications for further IS capex.<sup>319</sup>
- 6.88 As such, SONI considered that Annex 1 of the Licence should be modified to include additional IS capex outputs as an additional category for recovery via the D<sub>t</sub> mechanism.<sup>320</sup>

### ***UR’s views***

- 6.89 The UR stated that the allowances in respect of IS capex were generous.<sup>321</sup> The UR emphasised that it provided 90% of the amount requested by SONI in relation to the majority of projects put forward (the deferral of DS3 and Smart Grids is the subject of Error 11 in this appeal (see Chapter 5 above)).<sup>322</sup> The UR proposed to reduce the amounts requested by 10% in line with Gemserv’s recommendation. Gemserv did not consider the amounts requested by SONI would be an appropriate baseline for the 50:50 cost share mechanism.<sup>323</sup>
- 6.90 The UR stated that its adoption of Gemserv’s recommendation was objectively reasonable and within the scope of its margin of appreciation.<sup>324</sup> The amount sought by SONI allowed for a substantial degree of contingency reflecting a set of worst case scenarios. Many of the scenarios might not occur and – if they did – were capable of being managed in other ways. This is because SONI had discretion in how it spent its allowance and could be

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<sup>318</sup> SONI Hearing transcript, page 67.

<sup>319</sup> SONI response to CMA provisional determination, paragraph 5.15.

<sup>320</sup> [NoA](#), paragraph 32.3.

<sup>321</sup> [Defence](#), paragraph 3.30.

<sup>322</sup> [Defence](#), paragraph 3.6.

<sup>323</sup> [Defence](#), paragraph 3.21.

<sup>324</sup> [Defence](#), paragraph 3.26.

expected to adjust its spending priorities over the price control period as events unfolded.<sup>325</sup>

- 6.91 The UR also rejected SONI's assertion that financeability was affected by the combination of the 10% reduction, the risk sharing mechanism and the UR's signal that it did not expect to allow further costs through the  $D_t$ .<sup>326</sup> In the UR's view, this position failed to take account of the fact that SONI has the discretion as to how it allocates the allowance it has been granted – it may choose to fund some discretionary projects and slim down others, particularly in light of any unforeseen circumstances.<sup>327</sup>
- 6.92 The UR stated that it was unnecessary to introduce an additional category within the licence under which SONI could submit  $D_t$  claims for additional IS capex. The  $D_t$  mechanism already contained a catch-all category under which applications can be made for costs which do not fall within the categories that are specifically defined.<sup>328</sup> The UR has confirmed that if an unexpected event did indeed materialise, it would decide on an application for further allowances under the  $D_t$  mechanism – albeit that, in view of the generous allowance provided, the UR did not expect to receive any such application.<sup>329</sup>

### **CCNI's views**

- 6.93 SLG, on behalf of CCNI, noted that the UR was clear that allowances for the capex spend already included an allowance for unexpected events and contingency, and that this was sufficient to cover IT opex and IT capex expenditure. SLG stated that it would not be in customers' interests to automatically allow higher charges to fund other unforeseen capex requirements. It further noted that the further consultation on specific matters relating to the Price Control for SONI<sup>330</sup> suggested that capex TUPE costs could be allowed via an interim review, and this would allow the UR to review such costs properly before deciding whether to allow them.<sup>331</sup>

### **Our assessment of Error 3**

- 6.94 SONI argued that the UR had failed to provide a mechanism by which it could recover unexpected IS capex should unexpected costs arise during

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<sup>325</sup> [Defence](#), paragraph 3.5.

<sup>326</sup> [Defence](#), paragraph 3.40.

<sup>327</sup> [Defence](#), paragraph 3.41.

<sup>328</sup> [Defence](#), paragraph 3.47.

<sup>329</sup> [Defence](#), paragraph 3.6.

<sup>330</sup> For example, pensions and 'change of law'. See [Further consultation on certain matters relating to the Price Control 2015-2020 for the Electricity System Operator for Northern Ireland \(SONI\)](#), 11 April 2017.

<sup>331</sup> [CCNI R&O](#), Annex 3 (SLG Economics Ltd Report), paragraph 3.2.2.

the course of the Price Control. Its proposed remedy is that the UR should be directed to include a specific category of spend under the D<sub>t</sub> mechanism to capture unexpected IS spend.

- 6.95 We consider it surprising that the UR indicated that it did not expect to receive D<sub>t</sub> applications for further IS capex, since applications under the D<sub>t</sub> are by their nature unexpected.
- 6.96 However, in our view, the D<sub>t</sub> mechanism does enable SONI to apply for additional revenue for unexpected IS costs, should they arise. The Licence does not prevent SONI from recovering costs associated with any specific category of project (such as IS costs) under the D<sub>t</sub> mechanism. The Licence includes a catch-all term, under which SONI can make a D<sub>t</sub> application for ‘any other reasonable and efficient costs incurred (or likely to be incurred)’ in relation to its activities.<sup>332</sup> As a result, we do not agree with SONI that the UR failed to provide a mechanism for recovery of efficiently incurred costs relating to IS capex.
- 6.97 SONI disagrees with the position the UR set out in the [Final Determination](#) that it does not expect to provide additional revenue for IS capex via the D<sub>t</sub> mechanism.<sup>333</sup> However, this does not constitute a decision on whether or not to allow revenue for additional IS capex via the D<sub>t</sub> mechanism; rather it is the UR signalling its view that it is unlikely that SONI will require further revenue to finance this activity. Furthermore, we note, as set out above in paragraph 6.92, that the UR confirmed that if an unexpected event does materialise, it will decide on an application for further allowances under the D<sub>t</sub> mechanism.
- 6.98 We also note that, were we to implement SONI’s preferred remedy, it would not make any material difference – SONI would be able to make D<sub>t</sub> applications for additional IS capex (as it can now), and the UR would be able to approve or reject these applications, depending on the details of SONI’s case (as it can now).

### ***Our view on Error 3***

- 6.99 In view of the foregoing, we have reached the view that the UR was not wrong in relation to Error 3.

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<sup>332</sup> Paragraph 8.1(i) of the Annex to the Licence.

<sup>333</sup> [NoA](#), paragraph 25.7(c).



## **Error 4: No suitable mechanism for recovering Significant Project costs**

6.100 This error considers whether the  $D_t$  mechanism is suitable for the various different categories of Significant Project that SONI may have to undertake during the Price Control Period. SONI defines Significant Projects in this context as any materially significant and complex project (including PCNPs) where the costs exceed £1 million.<sup>334</sup>

### ***UR's Decision***

- 6.101 In its [Final Determination](#), the UR decided to maintain the  $D_t$  mechanism included in SONI's previous licence, the purpose of which was to cover unforeseen costs, or costs which were foreseen but where the amount required by SONI was uncertain at the beginning of the price control period.<sup>335</sup>
- 6.102 The UR also decided to retain a 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 but where there is uncertainty over costs.<sup>336</sup>
- 6.103 The [Final Determination](#) set out the process by which SONI would have to make a claim under the  $D_t$  mechanism. The UR stated that SONI must use its best endeavours to make its  $D_t$  applications by 1 April immediately preceding the year in which it wished the claim to take effect.<sup>337</sup>
- 6.104 The UR noted that, in making a claim under the  $D_t$  mechanism, SONI would be required to take account of and give regard to the 'Price Control Decision Paper'. This term is defined in Annex 1 of SONI's licence, and includes not only the [Final Determination](#) and the licence modifications, but also any further decision papers that the UR might subsequently issue.<sup>338</sup>

### ***SONI's views***

6.105 SONI submitted that the UR had materially changed the application of the  $D_t$  mechanism since the previous price control.<sup>339</sup> It noted that the  $D_t$

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<sup>334</sup> [NoA](#), paragraph 4.35.

<sup>335</sup> [Defence](#), paragraphs 4.7–4.8.

<sup>336</sup> [Defence](#), 4.13.

<sup>337</sup> [Defence](#), 4.15.

<sup>338</sup> [Defence](#), 4.16.

<sup>339</sup> [NoA](#), paragraph 26.2.

mechanism was now the chosen means by which a significantly expanded category of costs, representing significant output requirements which were in principle predictable, was to be recovered.<sup>340</sup>

6.106 SONI submitted that its anticipated uncertain costs could be grouped into three categories:

(a) Reopeners: costs which were foreseeable but which SONI could not quantify because the parameters were not sufficiently known or the estimates were wide-ranging.<sup>341</sup>

(b) Pass throughs: costs which were foreseeable but which SONI could not quantify as they fell outside of its control.<sup>342</sup>

(c) Appropriate D<sub>ts</sub>: costs which were genuinely unforeseeable.<sup>343</sup>

6.107 SONI set out its view that, had the UR sought to categorise the various uncertain costs, it would have realised that it was not appropriate to group them all together.<sup>344</sup>

6.108 SONI submitted that the UR's approach of using a single mechanism to capture both unforeseen costs and certain Significant Projects constituted a failure to exercise its responsibility to SONI.<sup>345</sup> Namely, SONI considered that this was not in line with good regulatory practice; that is, to consider each category of uncertainty individually and provide for the most appropriate mechanism in each case.<sup>346</sup>

6.109 In SONI's view, good regulatory practice would involve the UR:

(a) balancing the benefits of using uncertainty mechanisms alongside the impact they have on overall financeability;<sup>347</sup>

(b) tailoring the design of any uncertainty mechanism to the specific uncertainty faced by the regulated company;<sup>348</sup>

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<sup>340</sup> NoA, paragraph 26.2.

<sup>341</sup> NoA, paragraph 26.5(a).

<sup>342</sup> NoA, paragraph 26.5(b).

<sup>343</sup> NoA, paragraph 26.5(c).

<sup>344</sup> NoA, paragraph 26.6.

<sup>345</sup> NoA, paragraph 26.7.

<sup>346</sup> NoA, paragraph 26.7.

<sup>347</sup> NoA, paragraph 26.8(a).

<sup>348</sup> NoA, paragraph 26.8(b).

- (c) developing detailed guidance for the regulated company and its customers as to the way the mechanism will be implemented;<sup>349</sup> and
  - (d) ensuring the robustness of the mechanism by including an appeal process for the regulated company and affected parties to challenge the application of the mechanism within the price review period.<sup>350</sup>
- 6.110 SONI considered that in formulating the Price Control, for each element of expected cost subject to uncertainty, the UR should have:
- (a) assessed whether it was appropriate to have employed an uncertainty mechanism;<sup>351</sup>
  - (b) identified the different types of uncertainty faced by SONI;<sup>352</sup>
  - (c) identified suitable mechanisms to deal with each circumstance;<sup>353</sup> and
  - (d) selected the most appropriate mechanism for each taking account of the individual nature of the uncertainties involved.<sup>354</sup>
- 6.111 SONI submitted evidence from an expert report from Cambridge Economic Policy Associates (CEPA), which highlighted that, in general, the greater the proportion of allowed revenue expected to fall under the scope of an uncertainty mechanism, the more specific and tailored should be the design of that regulatory mechanism.<sup>355</sup>
- 6.112 SONI submitted that in the 2010-15 Price Control Period, D<sub>t</sub> claims accounted for approximately 10% of its Price Control revenues.<sup>356</sup> In contrast, SONI submitted that the proportion of ‘uncertain’ revenues which were not funded under the Price Control Decision had increased to 35%.<sup>357</sup>
- 6.113 SONI submitted that the high proportion of uncertain revenue which was only recoverable under the D<sub>t</sub> or other unknown mechanisms directly affected SONI’s ability to obtain finance.<sup>358</sup> It submitted that there was also a lack of visibility for customers and other stakeholders in respect of these

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<sup>349</sup> NoA, paragraph 26.8(c).

<sup>350</sup> NoA, paragraph 26.8(d).

<sup>351</sup> NoA, paragraph 26.9(a).

<sup>352</sup> NoA, paragraph 26.9(b).

<sup>353</sup> NoA, paragraph 26.9(c).

<sup>354</sup> NoA, paragraph 26.9(d).

<sup>355</sup> NoA, paragraph 26.14.

<sup>356</sup> NoA, paragraph 26.11.

<sup>357</sup> NoA, paragraph 26.11.

<sup>358</sup> NoA, paragraph 26.13.

material funding decisions, contrary to the UR's principal objective and the key principle of transparency in regulation.<sup>359</sup>

- 6.114 SONI said that it saw no reason why the UR could not have provided for interim modifications of the Price Control to address cost uncertainty for the Significant Projects it is required to undertake (ie not only I-SEM and DS3, but also large scale PCNPs).<sup>360</sup>
- 6.115 In addition, SONI submitted that it saw no reason why the UR could not have made provision under a separate licence mechanism for the recovery of costs which were outside SONI's control.<sup>361</sup> SONI noted that such costs were suitable to be approved on a pass-through basis, rather than subject to an assessment within the D<sub>t</sub> framework.<sup>362</sup> It submitted that this would ensure that such costs were recovered pursuant to a more efficient and streamlined process.<sup>363</sup>
- 6.116 SONI said that using a single, inappropriate uncertainty mechanism was contrary to best practice and had resulted in SONI facing more uncertainty than was necessary in terms of the revenues it was likely to receive from tariffs.<sup>364</sup> It submitted that this uncertainty – in particular the high proportion of revenue which was only recoverable under the D<sub>t</sub> mechanism – affected the willingness of banks to lend to it, impacting on its financeability.<sup>365</sup>
- 6.117 Moreover, according to SONI, this lack of certainty over whether it would recover its costs hindered its ability to plan and ensure the ongoing development of the transmission system, contrary to UR's statutory duty to protect the interests of consumers and to promote economy and efficiency in the generation, transmission and supply of electricity.<sup>366</sup>
- 6.118 In addition to its concern that UR was taking a 'one size fits all' approach, SONI also argued that UR was leaving itself too much discretion to alter the use of the D<sub>t</sub> mechanism in future. SONI said that UR was unjustifiably introducing a form of 'Henry VIII clause' because changes could be made to the D<sub>t</sub> mechanism outside a formal price control or licence modification.<sup>367</sup>
- 6.119 SONI objected to what it saw as the ability of the UR, simply by publishing further decision papers, to radically alter the expectations of all parties about

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<sup>359</sup> NoA, paragraph 26.13.

<sup>360</sup> NoA, paragraph 26.14.

<sup>361</sup> NoA, paragraph 26.17.

<sup>362</sup> NoA, paragraph 26.17.

<sup>363</sup> NoA, paragraph 26.17.

<sup>364</sup> NoA, paragraph 26.20.

<sup>365</sup> NoA, paragraph 26.22.

<sup>366</sup> NoA, paragraph 26.21.

<sup>367</sup> NoA, paragraph 26.23.

the use of  $D_t$  in the future. Under paragraph 8.2(a) of the Annex to SONI's Licence, SONI stated that it was required to ensure that it took account of and gave regard to the 'Price Control Decision Paper' when making a  $D_t$  claim. The definition of 'Price Control Decision Paper' included the [Final Determination](#) and the Price Control Decision 'as supplemented or amended by any further decision paper on the same subject'.

6.120 In response to our provisional determination, SONI set out that its primary concern was that the  $D_t$  mechanism is not suitable for Significant Projects due to the effects on SONI's financeability. It submitted that this results from the lack of codification and certainty, and that the  $D_t$  mechanism therefore does not provide certainty for recovery of efficiently-incurred costs.<sup>368</sup> It also submitted that the asymmetric risk SONI faces under the  $D_t$  mechanism makes SONI unable to raise funding for large scale projects.<sup>369</sup>

### ***UR's views***

6.121 In response to SONI's arguments, the UR stated that there was no statutory basis on which the CMA could find it wrong for not following 'best practice', even if the CMA was content that SONI had established what that was and that it should be followed in this case.<sup>370</sup>

6.122 The UR said that it did not agree that there would be a material benefit in dealing with the three different cost categories identified by SONI through three different mechanisms.<sup>371</sup> The UR stated that the  $D_t$  mechanism provided an effective and flexible way to deal with different costs and would ensure that all costs receive the appropriate degree of scrutiny.<sup>372</sup>

6.123 The UR further stated that the use of ex-ante approval would ensure that SONI set clear justifications for projects and explained how it had estimated the costs. The process would also allow SONI some certainty on the views of the UR as to what reasonable costs would look like.<sup>373</sup> In this way consumers would be protected from inefficient costs and SONI would be assured that it would receive finance with respect to costs it needed for Significant Projects during the price control period.<sup>374</sup>

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<sup>368</sup> SONI response to CMA provisional determination, paragraph 5.19.

<sup>369</sup> SONI response to CMA provisional determination, paragraph 5.19.

<sup>370</sup> [Defence](#), paragraph 4.30.

<sup>371</sup> [Defence](#), paragraph 4.31.

<sup>372</sup> [Defence](#), paragraph 4.31.

<sup>373</sup> [Defence](#), paragraph 4.37.

<sup>374</sup> [Defence](#), paragraph 4.38.

- 6.124 With regard to the UR's ability to vary the  $D_t$  mechanism outside a licence modification, the UR stated that the definition of 'Price Control Decision Paper' fell well short of the purported 'Henry VIII' clause that SONI identified. The UR stated that Annex 1 of SONI's licence simply required SONI to take account of and give regard to 'Price Control Decision Papers' in making applications under the  $D_t$  mechanism.<sup>375</sup> It did not state that SONI must adhere to such decision papers in its application, nor that they would bind the UR.<sup>376</sup>
- 6.125 The UR therefore considered that the obligations imposed by the term were relatively weak. It argued that they were intended primarily to ensure that SONI's applications under the  $D_t$  mechanism contained all the necessary information that the UR required to make its decision and that SONI was aware of the information needed.<sup>377</sup>
- 6.126 In its hearing, the UR characterised the  $D_t$  mechanism as a 'managed pass through',<sup>378</sup> whereby, having agreed on a cap for spending, SONI faced limited risk of having its costs disallowed, unless they were deemed to be DIWE.

### **CCNI's views**

- 6.127 SLG, on behalf of CCNI, submitted that requiring significant projects costs to be recovered by additional allowances on a case-by-case basis resulted in a strong incentive for SONI to ensure that all such project costs were efficient and in customers' interests. SLG stated that, while the UR had not explicitly considered other recovery mechanisms, it seemed entirely reasonable and in customers' interests to require SONI to justify on a case-by-case basis any additional expenditure that it was seeking to recover from higher customer bills. In SLG's view, it would not be in customers' interests to allow SONI to pass through these extra costs without involving some regulatory check.<sup>379</sup>

### **Our assessment of Error 4**

- 6.128 We agree with SONI 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. In principle, there may be benefits in the

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<sup>375</sup> [Defence](#), paragraph 4.47.

<sup>376</sup> [Defence](#), paragraph 4.48.

<sup>377</sup> [Defence](#), paragraph 4.49.

<sup>378</sup> UR Hearing transcript, page 60.

<sup>379</sup> [CCNI R&O](#), Annex 3 (SLG Economics Ltd Report), paragraph 3.2.3.

UR setting out mechanisms for SONI to recover uncertain costs that are tailored to these different cost categories.

- 6.129 Where SONI has a high degree of control over its costs, there would be stronger incentives to minimise costs if the UR set an upfront allowance to deliver defined project outputs. Under such a framework, SONI would bear some of the risk associated with cost overruns, and would keep some of the savings from cost reductions. SONI would face at least some of the upside and downside of over- and underperformance, and would therefore face strong incentives to minimise its costs. Insulating SONI from risk in such cases (as with the  $D_t$  mechanism) may reduce its incentives to minimise costs, potentially to the detriment of consumers.
- 6.130 SONI has proposed an interim licence reopener for Significant Projects (including PCNPs),<sup>380</sup> with costs that are outside its control being remunerated on a simple pass through basis.<sup>381</sup> We consider that there are some desirable aspects of such an approach, since it may streamline the process for recovery of costs that are outside SONI's control, and may provide better incentives to reduce costs when they are within SONI's control.
- 6.131 Furthermore, we agree with SONI that the criteria it set out for good regulatory practice above in paragraph 6.109 are broadly sensible.
- 6.132 However, while we consider that the  $D_t$  mechanism put in place by the UR does not necessarily provide optimal incentives for SONI to minimise its costs for projects where it can control its costs, in practice the UR would be able to flex its approach to considering different types of  $D_t$  claims, for example by scrutinising costs more carefully where these are within SONI's control.
- 6.133 Overall, while we have concerns relating to how the  $D_t$  process may function in practice (discussed in Error 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.
- 6.134 We note the arguments SONI made in response to our provisional determination – that the lack of codification and clarity and the asymmetric risk under the  $D_t$  mechanism affect SONI's ability to finance Significant Projects (see paragraph 6.120 above). However, we consider the impact of the lack of clarity and asymmetric risk on financeability in our assessment of

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<sup>380</sup> NoA, paragraph 32.4. SONI response to CMA provisional determination, paragraph 5.22.

<sup>381</sup> NoA, paragraph 26.17.



Error 6. We do not consider that Significant Projects are fundamentally different to the other categories of  $D_t$  claim. We therefore do not find it necessary to undertake a separate analysis of the impact of the lack of clarity and asymmetric risk on financeability specifically for Significant Projects, since in our view this is covered by our analysis of Error 6.

- 6.135 Regarding SONI's concern that the  $D_t$  mechanism is subject to a 'Henry VIII clause',<sup>382</sup> we do not consider that the UR was wrong to maintain a degree of flexibility in its approach to  $D_t$  claims. It may well be appropriate for the UR to provide further detail about its expectations regarding  $D_t$  claims in due course, once it has had the benefit of more experience in processing  $D_t$  claims. Indeed, it is common regulatory practice for regulators to provide additional detail over time on how they apply the agreed regulatory framework. In this case, we do not consider that it exposes SONI to an undue level of regulatory risk to suggest that it should have regard to any such further document published by the UR when making  $D_t$  claims.

#### ***Our view on Error 4***

- 6.136 In view of the foregoing, we have reached the conclusion that the UR was not wrong with regards to Error 4.

#### **Error 5: No suitable right of appeal to the CMA**

- 6.137 SONI has claimed that the UR erred by failing to provide a suitable right of appeal concerning decisions regarding cost recovery for Significant Projects.

#### ***UR's Decision***

- 6.138 SONI is able to make a claim under paragraph 8.2 of Annex 1 of the Transmission Licence to the UR for recovery of the cost of Significant Projects and PCNPs, but recovery requires the approval of the UR, and the UR has indicated that such claims will be treated within the  $D_t$  mechanism.
- 6.139 The effect of this is that the UR's decision whether to approve such claims in whole or in part does not involve a further modification of SONI's licence. As with other non-licence modification decisions of the UR, such a decision is capable of being challenged by bringing judicial review proceedings, but, as it will not be a licence modification, it cannot be appealed to the CMA.

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<sup>382</sup> NoA, paragraph 26.23



## **SONI's views**

- 6.140 SONI submitted that, in deciding not to give SONI a right of appeal to the CMA in respect of such claims, the UR has failed properly to have regard to the duty to secure that SONI can finance its statutory functions, and has made a decision which is wrong in law.<sup>383</sup>
- 6.141 SONI claimed that the failure to give it a right of appeal to the CMA as regards material funding decisions taken by the UR is inappropriate, contrary to the requirements of the EU Third Energy package, out of step with good regulatory practice, and in breach of natural justice.<sup>384</sup>
- 6.142 SONI also considered that its inability to bring an appeal on a decision relating to the costs of Significant Projects before the CMA creates a degree of instability around the price control process which negatively impacts SONI's financeability.<sup>385</sup>
- 6.143 SONI submitted that the decision was inappropriate because Parliament had provided for an appeal of licence modifications to be made to a specialist body, the CMA, and so appeals against related decisions of the UR should be made to the same specialist body, not simply subject to judicial review.
- 6.144 SONI considered that the failure of the UR to give SONI a right of appeal to the CMA regarding a significant element of expenditure did not comply with the requirements of the EU Third Energy package, which provided that those affected by the decisions of National Regulatory Authorities had a suitable right of appeal to an independent body.<sup>386</sup>
- 6.145 SONI considered that it was in breach of natural justice for the UR to prevent it from being able to appeal material funding decisions to the CMA, as natural justice required that parties had a right to a fair hearing.<sup>387</sup>
- 6.146 SONI further claimed that it was plain that Parliament had provided that the CMA should have jurisdiction of licence modification appeals. By making a significant proportion of SONI's expenditure subject to the D<sub>t</sub> mechanism, which does not involve a licence modification, the UR had, in effect, taken to

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<sup>383</sup> SONI Clarification Hearing follow-up written response of 28 June 2017, Annex 1, page 11.

<sup>384</sup> NoA, paragraph 27.8.

<sup>385</sup> NoA, paragraph 27.9.

<sup>386</sup> NoA, paragraph 27.1.

<sup>387</sup> NoA, paragraph 27.12.

itself matters which should properly be subject to appeal to the CMA. SONI claimed this was an abuse of the UR's discretion.<sup>388</sup>

### **UR's views**

- 6.147 The UR submitted that the Electricity Order plainly envisaged licence conditions enabling it to make further determinations under those conditions, and that it was clear that Parliament intended for a right of appeal to the CMA to attach only to licence modifications.<sup>389</sup>
- 6.148 The UR pointed out that it made a great many decisions, including many which had important consequences for the companies it regulated, but which were not subject to appeal to the CMA.<sup>390</sup>
- 6.149 The UR also submitted that it had not deprived SONI of a right to challenge decisions relating to the costs of Significant Projects, as judicial review was available, and it was well established, by cases such *Upjohn*<sup>391</sup> and *Arcor*,<sup>392</sup> that this was capable of discharging a right of appeal in EU law.<sup>393</sup>
- 6.150 In particular, the UR submitted that a court in judicial review proceedings would be able to decide whether the UR's decision breached the UR's obligations in [Article 12\(2\)\(b\)](#) of the Energy Order by failing properly to have regard to its duty to secure that SONI could finance its statutory obligations<sup>394</sup> and that this satisfied the requirement in Article 37(17) of the Electricity Directive for a party affected by a decision of a regulatory authority to have a right of appeal to a body independent of the parties involved and of any government.<sup>395</sup>
- 6.151 The UR stated that SONI had not produced any evidence to support its claim that the UR's decision created instability or uncertainty or how any such effects had adversely affected SONI's financeability,<sup>396</sup> nor had SONI identified the 'regulatory best practice' which it claimed the UR had breached.<sup>397</sup>

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<sup>388</sup> SONI response to CMA provisional determination, paragraphs 5.28 – 5.30.

<sup>389</sup> [Defence](#), paragraph 5.20.

<sup>390</sup> [Defence](#), paragraph 5.38.

<sup>391</sup> Case C-120/97 *Upjohn v The Licensing Authority* [1999] ECR I-223.

<sup>392</sup> Case C-55/06 *Arcor v Germany* [2008] ECR I-2931.

<sup>393</sup> [Defence](#), paragraph 5.22.

<sup>394</sup> [Defence](#), paragraph 5.27.

<sup>395</sup> [Defence](#), paragraph 5.24.

<sup>396</sup> [NoA](#), paragraph 27.1.

<sup>397</sup> [Defence](#), paragraph 5.41.

## **CCNI's views**

6.152 SLG, on behalf of CCNI, did not consider that single or groups of projects should be appealed to the CMA, noting this would be disproportionate.<sup>398</sup>

## **Our assessment of Error 5**

### *Has the UR abused its discretion?*

6.153 There is no dispute between the parties that where the UR makes a decision having effect through the  $D_t$  mechanism, it is a decision made under the terms of the licence, and not one which gives rise to a licence modification.

6.154 There is also no dispute between the parties that a decision made under the terms of the licence, but which does not involve a licence modification, is not appealable to the CMA. SONI has accepted that not all decisions made by the UR need to be appealed to the CMA.<sup>399</sup>

6.155 Given that we have already accepted in relation to Error 4 above that it was legitimate for the UR to make use of the  $D_t$  mechanism for uncertain costs, unless there is a specific legal requirement for an appeal to the CMA to be made available for decisions in relation to such uncertain costs, we do not consider that the UR can be said to have abused its discretion by making such costs subject to the  $D_t$  mechanism, even if the scale of such possible  $D_t$  claims represents a significant proportion of SONI's total expenditure.

6.156 We therefore first considered whether an appeal to the CMA was required under EU law. We then considered whether a lack of express appeal right to the CMA resulted in any other legal issue, and whether this would increase the risk for SONI.

### *Does EU law require an appeal to the CMA?*

6.157 It is agreed by both SONI and the UR that the right of appeal against decisions of the regulator in the electricity market must comply with the requirements of the EU Third Energy Package, and in particular with Directive 2009/72/EC on Common Rules for the internal market in electricity.

6.158 Article 37.17 provides that:

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<sup>398</sup> CCNI R&O, Annex 3 (SLG Economics Ltd Report), paragraph 3.2.4.

<sup>399</sup> SONI response to CMA provisional determination, paragraph 5.27.

Member States shall ensure that suitable mechanisms exist at national level under which a party affected by a decision of a regulatory authority has a right of appeal to a body independent of the parties involved and of any government.

6.159 Recital (37) of that Directive states that:

The independent body to which a party affected by the decision of a national regulator has a right to appeal could be a court or other tribunal empowered to conduct a judicial review.

6.160 The issue of the scope of legal review under the domestic legal systems of each Member State of decisions by regulators has been considered by the European Court of Justice and the relevant general principles have been stated in the *Arcor*<sup>400</sup> case, cited by the UR, as follows:

- There has been no harmonisation of the national rules concerning the applicable court proceedings or the scope of any review by the courts.
- In the absence of relevant Community rules, it is for the domestic legal system of each Member State to designate the courts and tribunals having jurisdiction and to lay down the detailed procedural rules for safeguarding rights which individuals derive from Community law.
- Such rules must not be less favourable than those governing similar domestic actions (the principle of equivalence).
- Such rules must not render in practice impossible or excessively difficult the exercise of rights conferred by Community law (principle of effectiveness).

6.161 It is for the Government to decide where appeals against decisions of the regulator should be heard. The Electricity Order provides that appeals against licence modification decisions of the regulator should be determined by the CMA. Appeals against other (non-licence modification) decisions of the regulator are by way of judicial review.

6.162 There is clear authority from the Court of Appeal that judicial review is a suitable form of review of a regulator's decision and, moreover, that judicial review is sufficiently flexible to meet whatever standard of review is required under EU law. In the *T-Mobile* case<sup>401</sup> Jacob LJ drew attention to the way in

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<sup>400</sup> Case C-55/06 *Arcor v Germany* [2008] ECR I-2931.

<sup>401</sup> *T-Mobile (UK) Ltd & Telefónica 02 UK Ltd v Office of Communications* [2008] EWCA Civ 1373, at [18].

which the scope of judicial review had been extended to meet changes in the law as regards human rights, by citing part of the judgment of Lord Bingham in the Denbigh High School case:<sup>402</sup>

it is clear that the court's approach to an issue of proportionality under the Convention must go beyond that traditionally adopted to judicial review in a domestic setting. ... There is no shift to a merits review, but the intensity of review is greater than was previously appropriate, and greater even than the heightened scrutiny test adopted by the Court of Appeal in *R v Ministry of Defence, Ex p Smith* [1996] QB 517, 554.

6.163 Jacob LJ said expressly (as regards the EU communications package) that:

there can be no doubt that just as JR was adapted because the Human Rights Act so required, so it can and must be adapted to comply with EU law and in particular Article 4 of the Directive.

6.164 Just as judicial review was considered to be sufficiently flexible to comply with requirements of EU law in the T-Mobile case, we consider that it is also sufficient to meet the standard of review required by Article 37(17) of the Electricity Directive. There appears therefore to be 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 contrary to the requirements of the EU Third Energy Package, or is in some way not a 'suitable right of appeal against a decision of the regulator.

*Is there any other legal issue arising from the lack of an express appeal right?*

6.165 SONI has contended that requiring disputed decisions to be determined by a body other than the CMA would be a breach of its right to a fair hearing and so a breach of natural justice and good regulatory practice.

6.166 We note that appeals against many regulatory decisions in different sectors are decided by courts, and that only licence or code modifications and price control matters are usually decided by the CMA.

6.167 The right of appeal against decisions taken by the UR is given by EU law, and case law shows that judicial review can and must be adapted to comply with EU law, even in cases requiring an enhanced standard of review.

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<sup>402</sup> *R (SB) v Governors of Denbigh High School* [2006] UKHL 15, at [34].

6.168 There are no grounds therefore for finding that such proceedings would breach SONI's right to a fair hearing, or the principles of natural justice.

*Does lack of an express appeal increase the risk for SONI?*

6.169 We do not consider that any risk for SONI arising from disputed decisions will be increased by virtue of the fact that SONI does not have an express right to seek permission to appeal to the CMA and must challenge a disputed decision by seeking permission for judicial review. The process of judicial review is well understood and sufficiently certain that it should not adversely affect SONI's financeability to make certain decisions subject to judicial review, rather than an appeal to the CMA.

### ***Our view on Error 5***

6.170 For the reasons given above we consider that the UR has not abused its discretion; that SONI has a suitable right of appeal against disputed decisions of the UR; that this right of appeal complies with the requirements of the Electricity Directive; that SONI will have a right to a fair hearing; that the right of appeal complies with the requirements of natural justice and good regulatory practice; and that any uncertainty created by disputed decisions will not be increased for SONI by reason of an appeal being brought by judicial review.

6.171 For these reasons we are satisfied 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.

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

### ***UR's Decision***

6.172 The UR set out in the [Final Determination](#) that it would undertake a two-stage process when considering D<sub>t</sub> applications, whereby:

- (a) SONI submits a  $D_t$  application for a given project, and if the UR approves the project, it also approves a cap on the budget.<sup>403</sup>
- (b) Following completion of a project, SONI reports the actual cost of the project, and any underspend of the cap is returned via the K-factor.<sup>404</sup>
- (c) The UR can also disallow expenditure that it considers was incurred inefficiently – DIWE.<sup>405</sup>

### **SONI's views**

- 6.173 SONI submitted that it faced asymmetric risks as a result of the unworkable two-stage approval process,<sup>406</sup> whereby it did not benefit from any efficiency gain should actual costs be under the cap,<sup>407</sup> but that it was responsible for funding additional costs should actual costs be greater than the cap, even if efficient.<sup>408</sup>
- 6.174 In SONI's view, a key reason why it was uncertain whether it would be able to recover its costs is that for the 2015-2020 Price Control Decision the UR decided to modify the  $D_t$  mechanism by introducing the 'two-stage process' outlined above. SONI stated that this was a significant change from the previous price control where under the  $D_t$  mechanism, SONI was required to submit claims to the UR ex-post to recover unforeseen costs which it incurred above the total annual revenue cap during each year of the Price Control Period.<sup>409</sup>
- 6.175 SONI also strongly objected to the inclusion of a two-stage process in the framework for remunerating PCNPs under Error 2.<sup>410</sup> The aspects of the two-stage process SONI appealed were the need to seek ex-ante approval for the maximum amount it could spend, combined with the ex-post adjustment if it spent less than this amount. SONI stated that it did not object to the DIWE mechanism itself (subject to its concerns under Error 7 below).<sup>411</sup>
- 6.176 SONI stated that that the new two-stage process was inconsistent with good regulatory practice, was disproportionate, and further hindered its ability to

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<sup>403</sup> [Final Determination](#), paragraphs 442–444.

<sup>404</sup> [Final Determination](#), paragraph 444.

<sup>405</sup> [Final Determination](#), paragraph 462.

<sup>406</sup> [NoA](#), paragraph 28.1.

<sup>407</sup> [NoA](#), paragraph 28.5.

<sup>408</sup> [NoA](#), paragraph 28.5.

<sup>409</sup> [NoA](#), paragraph 28.2.

<sup>410</sup> [NoA](#), paragraph 24.12(b).

<sup>411</sup> SONI Hearing transcript, page 95.

recover its efficiently incurred costs to ensure it was, and it was able to demonstrate it was, financeable for the purpose of funding.<sup>412</sup>

6.177 In particular, SONI argued that:

- (a) the two-stage process exposed SONI to asymmetric risk;
- (b) the process created an unnecessary administrative burden while serving no clear purpose;
- (c) the need for pre-approval did not reflect the reality of financing arrangements; and
- (d) the two-stage process was particularly unsuited to PCNPs (argued in Error 2).

*The risk is asymmetric*

6.178 SONI stated that the two-stage process exposed it to unwarranted asymmetric risk. SONI noted that the UR had determined that SONI should not benefit from any efficiency gains should the actual costs of a project be lower than the cap, but SONI was responsible for funding additional costs should actual costs be greater than the cap, even if efficient.<sup>413</sup>

6.179 SONI noted UR's explanation in the Price Control Decision that in relation to PCNPs it could apply to recover costs in excess of the cap by submitting 'additional D<sub>t</sub> claim(s)'.<sup>414</sup> However, SONI did not consider that this resolved its concerns about the asymmetry of the process, given it was unclear why it would make a D<sub>t</sub> claim in circumstances where most PCNP projects would be funded by NIE rather than through the tariff.

6.180 In relation to other projects for which SONI would make applications under the D<sub>t</sub> process, SONI asserted that there was no provision for it to seek an increase in the cap. SONI stated that it had never been suggested in the context of previous projects that it could submit additional D<sub>t</sub> claims if costs rose.<sup>415</sup> SONI also noted that although this suggestion was included in the [Defence](#) it was not set out in the Licence or described in the [Final](#)

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<sup>412</sup> [NoA](#), paragraph 28.8.

<sup>413</sup> [NoA](#), paragraph 28.5.

<sup>414</sup> [NoA](#), paragraph 24.16.

<sup>415</sup> Clarification Hearing transcript, page 43.



Determination, other than in the Price Control Decision in relation to PCNPs.<sup>416</sup>

*Two-stage process creates an administrative burden*

- 6.181 SONI argued that the process of getting pre-approval for each project, combined with the ex-post adjustment, created an unnecessary administrative burden.<sup>417</sup>
- 6.182 In the absence of clear criteria, a timetable, or appropriate mechanism for approval, SONI submitted that the process was destined to result in uncertainty and delay.<sup>418</sup> SONI noted that in practice, it could take over a year for the UR to assess straightforward claims and provide the necessary funding to SONI.<sup>419</sup> For example SONI set out that in the case of its Auction Management Platform, the UR took 13 months to approve SONI's application under the D<sub>t</sub> mechanism. This was a full 9 months after the project had to be completed.<sup>420</sup>
- 6.183 In relation to PCNPs, SONI noted the real risk of delay under the two-stage process, which could impede its ability to fulfil its obligations under the licence.<sup>421</sup> Furthermore, SONI submitted that it may not be possible to identify and submit claims for unforeseen costs ahead of time.<sup>422</sup>

*Two-stage process serves no clear purpose*

- 6.184 SONI stated that it was unclear what additional purpose the ex-ante approval of a capped allowance served. The UR already had the ability, through the DIWE provision, to disallow inefficiently incurred costs as part of the ex-post review process.<sup>423</sup>

*The need for pre-approval is not compatible with the reality of financing arrangements*

- 6.185 SONI stated that the process of seeking pre-approval for each project undermined financeability as it failed to take into account the reality that SONI needed to put in place multi-year and multi-facility corporate finance

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<sup>416</sup> SONI Clarification Hearing follow-up written response of 28 June 2017, Annex 2, paragraph 2.2.

<sup>417</sup> NoA, paragraph 28.9.

<sup>418</sup> NoA, paragraph 28.12.

<sup>419</sup> NoA, paragraph 28.12.

<sup>420</sup> SONI reply to the Defence, paragraph 4.30.

<sup>421</sup> NoA, paragraph 24.12(a).

<sup>422</sup> NoA, paragraph 28.6.

<sup>423</sup> NoA, paragraph 28.9.

arrangements, given that for a company of SONI's size bespoke project by project finance would not be feasible or efficient.<sup>424</sup>

*The two-stage process is particularly unsuited to PCNPs*

- 6.186 Within Error 2, SONI also emphasised that it objected strongly to the introduction of the two-stage process in relation to PCNPs, both for the reasons above and for some reasons specific to PCNPs.
- 6.187 SONI noted that the asymmetric risk profile inherent in the two-stage process was potentially exacerbated for PCNPs given the difficulty of setting an ex-ante cap.<sup>425</sup> SONI submitted that PCNPs were generally accepted to be the phase in the development of a project most vulnerable to cost forecast deviations and increases.<sup>426</sup> SONI set out that in practice, its ability to forecast pre-construction costs was hampered by the fact these costs were not within its control.<sup>427</sup>
- 6.188 SONI also submitted that the potential incentive benefits of the regulator pre-approving and then holding the regulated company to a budget were not applicable to PCNPs since:
- (a) as an independent TSO, SONI would not be the ultimate owner of the asset and so lacked any incentive to 'gold plate' in the manner with which regulators are traditionally concerned in relation to network asset businesses;<sup>428</sup> and
  - (b) a pre-approval process potentially resulted in perverse investment incentives for PCNPs,<sup>429</sup> as SONI considered that it should be managing and investing in its pre-construction activities so as to minimise the whole life costs of the project, not to minimise the PCNP expenditure.<sup>430</sup>
- 6.189 Moreover, in SONI's view the UR had no vires in statute, the TSO licence or any other legal basis to introduce ex-ante approval for PCNPs.<sup>431</sup> SONI noted that UR attempted to codify the two-stage process in its Price Control Decision by defining a PCNP in the TSO Licence as a project that is

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<sup>424</sup> SONI reply to the Defence, paragraphs 3.50 & 4.1(d).

<sup>425</sup> NoA, paragraph 24.12(b).

<sup>426</sup> NoA, paragraph 24.12(b).

<sup>427</sup> NoA, paragraph 24.19.

<sup>428</sup> SONI written response of 28 July 2017 on the factual accuracy of the UR written response of 21 July 2017 to CMA clarification requests, paragraph 3.6.

<sup>429</sup> NoA, paragraph 24.19.

<sup>430</sup> NoA BT1, paragraph 196.

<sup>431</sup> NoA, paragraph 24.12(c).

submitted for approval by SONI and given approval by the UR,<sup>432</sup> but SONI considered this an insufficient basis for imposing a two-stage process.<sup>433</sup>

- 6.190 In response to our provisional determination, SONI set out that this error does not relate only to issues around timelines for the UR pre-approving projects and budget cap. It submitted that of more importance is the perception of investors that there is a significant risk that SONI will not be remunerated for its efficient expenditure under the  $D_t$  mechanism where it is obliged to undertake expenditure on  $D_t$  projects absent pre-approval.<sup>434</sup>

### ***UR's views***

- 6.191 The UR stated that SONI was incorrect in claiming that under the 2010-2015 Price Control Decision it was required to submit claims to UR ex-post. The UR stated that, for the most part, its proposed framework was a continuation of what has gone before rather than a new process.<sup>435</sup> The UR also noted that SONI's contention in Error 6 that the two-stage process was 'unworkable' was surprising, given that the same process was currently used for  $D_t$  applications by both SONI and NIE.<sup>436</sup>

- 6.192 The UR argued that the two-stage process was workable and allowed SONI to finance its reasonably incurred investments because:

- (a) the risk to SONI is relatively low and is not asymmetric;
- (b) there are good reasons for UR requiring regulatory approval of SONI's investments up front;
- (c) there are also good reasons to recover any underspend from SONI through an ex post review;
- (d) the two-stage process does not impose unnecessary burdens on SONI; and
- (e) the two-stage process is suitable for PCNPs as well as other  $D_t$  claims.

- 6.193 These points are discussed in more detail below.

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<sup>432</sup> NoA, paragraph 24.13.

<sup>433</sup> NoA, paragraph 24.14.

<sup>434</sup> SONI response to CMA provisional determination, paragraph 5.36.

<sup>435</sup> Defence, paragraph 6.6.

<sup>436</sup> Defence, paragraph 6.22.

*The risk to SONI is relatively low and is not asymmetric*

- 6.194 The UR submitted that SONI did not face asymmetric risks in practice as a result of the two-stage process. As a result, the UR considered that SONI should never have to undertake expenditure in excess of its cap, and therefore did not face downside risks.<sup>437</sup>
- 6.195 The UR did not accept that the risk profile of its proposed uncertainty mechanism was asymmetric or posed a risk of under recovery of costs. The UR stated that it considered that its approach ‘de-risked’ SONI’s expenditure.<sup>438</sup> It set out that:
- (a) there would typically be contingency included in the ex-ante cap, to cover unexpected increases in costs;<sup>439</sup>
  - (b) where, during the course of a project, SONI came to the view that its approved costs would be insufficient, SONI could request an increase in the cap ahead of incurring any expenditure that would be at risk, and the UR would consider such applications. Where the UR judged these additional costs to be appropriate, the cap would be increased;<sup>440</sup> and
  - (c) SONI could stop work if it was unable to agree an increase to the cap with the UR, and would still recover the costs it had incurred up to that point.<sup>441</sup>
- 6.196 The UR stated that, for PCNPs at least, this framework removed virtually all risk from SONI, as it would be evident if costs rose that this was outside SONI’s control and additional approval for further expenditure could be granted.<sup>442</sup> In addition, the UR expected SONI to include a prudent measure of contingency into the estimates that it provided for approval.<sup>443</sup>
- 6.197 Where SONI overspent on a particular project without having returned to the UR to ask for further funds, or where it incurred costs that were found to be inefficient, the UR submitted that SONI could not expect to pass those costs through to consumers.<sup>444</sup>

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<sup>437</sup> UR Hearing transcript, page 110.

<sup>438</sup> UR Hearing transcript, page 9.

<sup>439</sup> In its hearing, the UR set out that historically the cap had contained contingency of approximately 20% (UR Hearing transcript, page 92).

<sup>440</sup> [Defence](#), paragraph 2.98.

<sup>441</sup> UR Hearing transcript, page 111.

<sup>442</sup> Clarification Hearing transcript, page 70.

<sup>443</sup> [Defence](#), paragraph 2.97.

<sup>444</sup> [Defence](#), paragraph 2.101.

*There is good reason to require ex-ante approval (ie part one of the two-stage process)*

- 6.198 The UR considered that SONI's main contention was that ex-ante approval was unnecessary.<sup>445</sup> It considered this position surprising given that in previous correspondence with the UR, SONI had acknowledged the UR's responsibility for ensuring that customers receive value for money.<sup>446</sup> SONI had also noted that where appropriate this should include ex-ante approval and incentivisation.<sup>447</sup>
- 6.199 In the UR's view, it was precisely because of its responsibilities to consumers that ex-ante approval followed by an ex-post check on efficiency was required.<sup>448</sup>
- 6.200 According to the UR, ex-ante approval ensured that SONI set out a clear justification for its projects and explained its cost estimates. While SONI could ask for further costs, the use of initial approval ensured that SONI undertook robust budgeting and scoping at the outset, as any increase sought would need to be explained and justified as reasonable.<sup>449</sup>
- 6.201 The UR submitted that ex-ante approval also served to provide clarity and certainty to SONI as to the costs that it could recover. SONI would be able to secure finance on the back of approval provided by the UR in respect of the cost of a particular project. Such a regulatory decision would ultimately prove to be of a least as much value as a letter of comfort from the UR.<sup>450</sup> The UR argued that the process it had put in place did not lead to uncertainty. Rather it provided certainty by clearly indicating what the UR considered to be efficient costs at the outset of each project.<sup>451</sup>

*There is good reason to recover any underspend from SONI ex-post (ie part 2 of the two-stage process)*

- 6.202 The UR explained that it considered there was good reason to recover any monies that SONI did not spend on these projects rather than treat it as a fixed allowance. The uncertainty around these costs is such that SONI would not be able to provide estimates precise enough to make the provision of an

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<sup>445</sup> Defence, paragraph 6.16.

<sup>446</sup> Defence, paragraph 6.17.

<sup>447</sup> Defence, paragraph 6.17.

<sup>448</sup> Defence, paragraph 6.18.

<sup>449</sup> Defence, paragraph 4.37.

<sup>450</sup> Defence, paragraph 6.19.

<sup>451</sup> Defence, paragraph 6.20.

ex-ante allowance appropriate.<sup>452</sup> Instead the UR would provide SONI with access to funds, recoverable via its tariffs, upon which it could draw according to its needs.<sup>453</sup> The fact that SONI was granted, in effect, access to a 'pot' on which it could draw rather than a fixed allowance would also mean that SONI passed through to customers what it actually spent. It would not be appropriate to allow SONI to recoup a sum which might build in substantial contingency which was not in fact required.<sup>454</sup>

6.203 Furthermore, the UR submitted that the absence of a mechanism through which SONI could benefit by bringing costs in under its approved cap was not 'wrong' on any of the statutory grounds of appeal.<sup>455</sup> The fact that SONI cannot retain any underspend does not affect its financeability as it is able to recover its costs in full.<sup>456</sup>

6.204 In the UR's view, once it had decided it was inappropriate to make an ex-ante allowance or to simply allow SONI to pass through its costs without any check by the regulator, the two-stage process was perfectly reasonable and appropriate.<sup>457</sup>

*The two-stage process is not administratively burdensome*

6.205 The UR stated that SONI had presented no evidence as to how the use by the UR of an ex-ante approval mechanism would lead to delays and hinder project efficiency. In the UR's view, SONI has simply asserted that this would be the case.<sup>458</sup> In relation to PCNPs, the UR noted that the CC in the NIE price determination<sup>459</sup> affirmed project-by-project approval in respect to major transmission network projects when they were still the responsibility of NIE, in spite of the fact that it was alive to the risk of some delay.<sup>460</sup>

*The two-stage process is not particularly unsuited to PCNPs*

6.206 In relation to SONI's argument that the asymmetric risk was particularly acute in relation to PCNPs given the difficulty of estimating these costs accurately, the UR agreed that PCNPs costs are highly uncertain. However, it stated that it was precisely in view of such uncertainty that a case-by-case

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<sup>452</sup> [Defence](#), paragraph 2.18.

<sup>453</sup> [Defence](#), paragraph 2.19.

<sup>454</sup> [Defence](#), paragraph 2.22.

<sup>455</sup> [Defence](#), paragraph 2.95.

<sup>456</sup> [Defence](#), paragraph 2.96.

<sup>457</sup> [Defence](#), paragraphs 4.34–4.35.

<sup>458</sup> [Defence](#), paragraph 2.107.

<sup>459</sup> NIE price determination, [CC Final determination](#), 26 March 2014.

<sup>460</sup> [Defence](#), paragraph 2.108.

approval mechanism was appropriate, which could be supplemented as required through additional applications under the D<sub>1</sub> mechanism if costs unavoidably exceeded the approved cap.<sup>461</sup>

- 6.207 In relation to SONI's argument that pre-approval provided the wrong incentive in relation to PCNPs, the UR agreed that an incentive to minimise whole life costs would add value. However, having engaged with SONI on this matter it did not see how it could be achieved without significant complication. Indeed, the alternative that SONI proposed did not incentivise minimisation of whole life costs either.
- 6.208 The UR also rejected SONI's argument that the UR did not have vires to impose ex-ante approval for PCNPs, noting that it would be surprising if an economic regulator lacked the power to impose an ex-ante approval mechanism to ensure the costs incurred by a regulated entity are efficient.<sup>462</sup> The UR stated that its vires derived from [Articles 11\(1\)\(a\)](#) and [11\(3\)](#) of the Electricity Order. More broadly the UR set out that it had the power to do anything to facilitate the performance of its functions, including in the way best calculated to promote efficiency and economy on the part of licenced parties.<sup>463</sup>

### **CCNI's views**

- 6.209 SLG, on behalf of CCNI, submitted that it did not believe that the process proposed by the UR is unworkable. SLG said that it would expect that most of the information provided for the first stage of the process would be needed for SONI's internal project approval processes. In SLG's view, the UR proposal provided some assurance to SONI, before it embarked on a project, of the maximum budget available for that project, as well as providing a stronger efficiency incentive to deliver within the cap. SLG submitted that leaving the entire assessment to an ex-post review once the project had already delivered would not be in customers' interests.<sup>464</sup>

### **Our assessment of Error 6**

- 6.210 We considered first whether the two-stage approach followed by UR was wrong in itself – ie whether applying a two-stage approach would necessarily lead to asymmetric risks for SONI and an inability for it to secure finance to cover its efficient investments. We then considered whether the specific

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<sup>461</sup> [Defence](#), paragraph 2.71.

<sup>462</sup> [Defence](#), paragraph 2.88.

<sup>463</sup> [Defence](#), paragraphs 2.90–2.93.

<sup>464</sup> [CCNI R&O](#), Annex 3 (SLG Economics Ltd Report), paragraph 3.2.5.



approach proposed by the UR was wrong, particularly in the context of SONI's concerns about lack of codification of UR's process for applying the two-stage framework in practice.

*Is it wrong to approve projects ex-ante?*

- 6.211 As set out in paragraph 6.185 above, SONI raised concerns that the UR had to approve each project under the  $D_t$  mechanism individually.
- 6.212 We do not consider that the UR was wrong to implement a framework of this nature. We note the UR's remarks in its hearing that it would ideally like to move to a regime where it regulates only outputs, and assesses SONI's performance relative to these outputs.<sup>465</sup> The UR noted, however, that there are aspects of SONI's business that makes this impossible at present – in particular the fact that SONI has only recently taken on functions in relation to PCNPs (in May 2014),<sup>466</sup> meaning that there is limited track record, and that other large projects such as DS3 and I-SEM are driven by decisions outside SONI's direct control.<sup>467</sup> We agree that these factors make it difficult for the UR to avoid having to consider projects individually outside the upfront allowance in the price control.
- 6.213 We also note that whether or not to approve each project on an individual basis is a matter of judgment for the UR and we do not consider that SONI has put forward a sufficiently strong case that the UR is wrong on this aspect of Error 6.
- 6.214 While we do not consider that the UR was wrong to implement a framework in which it has to pre-approve each project, we consider in more detail below whether the specific two-stage process (combining ex-ante scrutiny with ex-post review) put in place by the UR was wrong.

*Is asymmetric risk wrong per se?*

- 6.215 Under the arrangements currently in place, the most revenue that SONI can receive for projects that are approved under the  $D_t$  mechanism is its actual expenditure. That is, SONI is not allowed to keep any cost savings if it is able to deliver the project below the level of the cap set by the UR. As a result, SONI does not benefit from any upside for outperformance with respect to its expenditure on  $D_t$  projects.

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<sup>465</sup> UR Hearing transcript, page 90.

<sup>466</sup> NoA, paragraph 3.32(a).

<sup>467</sup> UR Hearing transcript, page 90.



- 6.216 However, since SONI faces a cap on the amount of revenue it can receive for these projects, it may not recover any expenditure it incurs above this cap. As a result, there is the potential for downside risk of underperformance. There is therefore, in theory, scope for asymmetric risks of the type set out by SONI.<sup>468</sup>
- 6.217 The theoretical possibility of asymmetric risks does not necessarily mean that the UR was wrong to adopt such an approach. Any regulatory framework that involves an ex-post evaluation of costs may have similar asymmetric risk properties: the most a company can recover is its actual expenditure, but it faces a risk that some of its expenditure may be considered inefficient and it may not recover this portion of its expenditure.
- 6.218 To the extent that this puts pressure on a regulated company to undertake only efficient expenditure, this may be an efficient regulatory framework, and may be in the interest of consumers.<sup>469</sup> Furthermore, it is not clear that asymmetric risks of the sort described above necessarily result in negative expected profits for the company. Where employing such an asymmetric framework is beneficial to consumers, a regulator could compensate the company for the downside risk by making an additional allowance in the company's returns to reflect this asymmetric risk profile.
- 6.219 We therefore do not consider that an asymmetric risk profile of the sort resulting from UR's two-stage process is wrong *per se*. 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 this risk in a manner that is not overly costly to consumers, it is unlikely to be wrong.
- 6.220 However, if asymmetric risks result from a framework under which SONI faces considerable risk of not recovering its efficiently incurred costs without it being compensated for these risks, in our view this would not be consistent with UR's duty to ensure SONI's financeability.

*Is the treatment of asymmetric risk wrong in this case?*

- 6.221 As noted in paragraph 6.195 above, the UR set out that:

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<sup>468</sup> SONI additionally faces downside risks that costs may be disallowed by the UR following its DIWE assessment. These are considered separately under Error 7.

<sup>469</sup> However, the extent to which this is a useful tool in ensuring a regulated company undertakes only efficient expenditure depends on the extent to which the company is able to control its costs in this area.

- (a) the ex-ante cap will usually include a degree of contingency, reducing the risk that SONI will spend in excess of the cap (and risk being unable to recover its costs);
  - (b) SONI can apply for an increase to the cap before spending above the level of the previous cap, and the UR will consider such applications in a timely manner; and
  - (c) SONI can cease work if it is unable to agree a cap with the UR, and therefore not breach the cap.
- 6.222 As a result, the UR argued that in practice SONI faced a very low risk of being unable to recover its efficiently incurred costs.
- 6.223 However, SONI's past experience of seeking approval for projects under the D<sub>t</sub> mechanism suggests that it is likely to face significant downside risk as a result of regulatory uncertainty. We consider that SONI's investors have legitimate concerns that the regulatory framework could result in SONI not being allowed to recover its efficiently incurred costs.
- 6.224 Taking the example of the Fuel Switching Agreements, we note that SONI submitted a request for an allowance under the D<sub>t</sub> mechanism for £334,480 plus a 10% contingency. The final amount approved by the UR was £334,480, which did not allow for any contingency.<sup>470,471</sup> SONI has not provided evidence to suggest that this was an insufficient allowance. However, it suggests that the UR has in the past not included significant contingency in the cap.
- 6.225 Setting a cap with limited contingency is not necessarily the wrong approach. However, making no allowance (or only a limited allowance) for contingency means that in cases where SONI's efficient costs are higher than expected, it will need to apply for an increase to the cap. In such cases, in order to prevent SONI incurring costs in excess of the cap, the UR may need to consider applications for increases to the cap in a timely manner, since in some cases SONI may require approval of further spend promptly where cost increases occur.
- 6.226 However, in our view, we do not consider that investors could reasonably assume that the UR would respond to SONI's requests to increase the cap in a sufficiently timely manner.

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<sup>470</sup> Defence TH1, Exhibit TH1-05.

<sup>471</sup> We also note that the amount initially approved by the UR was £240,157 – considerably below the level requested by SONI.

- 6.227 First, we note that the UR has not set out any timelines for how long it will take to consider applications under the  $D_t$  mechanism, or applications to increase the cap. In our view, the UR should set out its targets for how long such a process should take. A more comprehensive (albeit less flexible) approach could involve the UR committing to consider applications within a certain timeframe. Having an open-ended process, as is currently the case, where SONI has no basis for understanding how long its applications are likely to take to be approved, is unsatisfactory.
- 6.228 Second, we note that in the case of SONI's Auction Management Platform, the UR took 13 months to approve SONI's application under the  $D_t$  mechanism.<sup>472</sup> This was a full 9 months after the project had to be completed.<sup>473</sup> As a result, SONI had to undertake expenditure without having received pre-approval from the UR, and therefore with no guarantee that the UR would approve *any* budget for this project. In our view, this sort of delay is likely to put considerable downside risk on SONI, and is likely to affect its financeability.<sup>474</sup>
- 6.229 In our view, the combination of a 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 will function as the UR intends. We consider that there is a material risk that SONI would have to spend in excess of the initial cap, or undertake expenditure before the UR has set an initial cap, with the risk that the UR may disallow the additional spend.
- 6.230 By having to undertake expenditure that has not yet been pre-approved by the UR, SONI is running the risk that when the UR does set the cap, its spend will not be included.<sup>475</sup> In addition, SONI faces similar risks where it has to undertake expenditure above an already agreed cap, before the UR has agreed an increase to the cap. We therefore consider it likely that the process as currently set out exposes SONI to material risks of being unable to recover its efficiently incurred costs.<sup>476</sup>

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<sup>472</sup> SONI set out in its hearing that the average  $D_t$  application during the Price Control Period 2011-2015 took seven and a half months from application to decision (SONI Hearing transcript, page 70).

<sup>473</sup> SONI reply to the Defence, paragraph 4.30.

<sup>474</sup> We note that in this particular example, the UR allowed SONI over 99.9% of the costs it requested (see Defence TH1, Exhibit TH1-06). Nevertheless, we consider that the delay in approving this request exposed SONI to risk around recovery of these costs.

<sup>475</sup> It is important to note that this is separate from the risk that SONI's expenditure will be disallowed under DIWE.

<sup>476</sup> We note that the UR has considered a number of other SONI  $D_t$  applications, where we do not have full information of the timing and outcome of these requests. However, we consider that the issues raised with respect to the two examples set out above result in material risk that the  $D_t$  mechanism will expose SONI to downside risks of the nature described.

- 6.231 In addition, the UR set out in its hearing that SONI could cease activity on a project if it failed to reach agreement with the UR on an increase to the level of the cap, and would still recover the costs it had incurred up to that point.<sup>477</sup> In principle this could reduce the risk of SONI having to undertake expenditure above its cap, and therefore reduce the risk of it not recovering its efficiently incurred costs. However, we do not consider that this is credible (or indeed desirable) in practice. Projects approved under the  $D_t$  mechanism are likely to be those that SONI and the UR agree are necessary and provide value to consumers. In our view, it is therefore not credible that SONI could unilaterally cease work on these projects if it disagrees with the cap approved by the UR.
- 6.232 We note SONI, in its response to our provisional determination, set out that more important than timelines was the risk that it might not be remunerated for efficient spend where it is obliged to undertake expenditure before approval has been granted.<sup>478</sup> We consider these to be related issues. In our view, putting in place more detailed guidance on the timelines should go some way towards reducing the risk of SONI having to undertake expenditure without the UR having pre-approved a budget cap.
- 6.233 However, we recognise that codifying the  $D_t$  process will not remove entirely the risk of SONI having to undertake expenditure that has not yet been approved by the UR. Even with codification, SONI will face some risk that it has to undertake expenditure before an initial cap has been approved, or before an increase to an already agreed cap has been approved. SONI also faces the risk that costs rise relative to initial budgeted costs, that it cannot justify that the increases in costs are efficient, and that the UR does not increase the cap.
- 6.234 In our view, as a result of the lack of clarity around the functioning of the two-stage process, investors will justifiably perceive there to be a risk that SONI will not be fully remunerated for its efficient expenditure under the  $D_t$  mechanism.
- 6.235 Overall, it is our view that there is a significant risk that the  $D_t$  mechanism will not function in the manner described by the UR (ie de-risking SONI's investments), since there is considerable uncertainty around how the  $D_t$  mechanism will function in practice. This gives rise to regulatory uncertainty around whether SONI will be able to recover its efficiently incurred costs.

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<sup>477</sup> UR Hearing transcript, page 111.

<sup>478</sup> Summarised above in paragraph 6.190.

- 6.236 Our finding is that the current framework introduces unnecessary asymmetric risk, not that asymmetric risk is wrong per se. We expect that a well-functioning mechanism would still include some asymmetric risk. While the UR has told us that it would normally expect to increase the cap if costs rise, it is inherent in the UR's overall approach to the regulation of SONI and consistent with the UR's duties and objectives that there should be some incentives for efficiency. An effective codified approach would need to include some assessment of efficiency between a full pass-through subject only to an extreme inefficiency test as the UR has characterised DIWE, and a binding cap, as SONI has characterised the current mechanism. We discuss the approach to providing efficiency incentives in Chapter 11, as part of our discussion of remedies.
- 6.237 We also set out in Chapter 7 relating to Ground 1, and in our discussion of remedies in Chapter 12, that SONI is still likely to face some asymmetric risk under the  $D_t$  mechanism. In our assessment of Ground 1, we set out in more detail our views on whether SONI should receive additional remuneration for any remaining asymmetric risk.

### ***Our view on Error 6***

- 6.238 In our view, there is a significant lack of clarity around the functioning of the two-stage process. Although in response to the appeal the UR has stated that the  $D_t$  mechanism is intended to 'de-risk' SONI's expenditure, our view is that there is considerable uncertainty around how the  $D_t$  mechanism set out in the [Final Determination](#) will function in practice. This gives rise to regulatory uncertainty around whether SONI will be able to recover its efficiently incurred costs.
- 6.239 For example, the UR has not given any indication of the timelines within which it will consider SONI's applications under the  $D_t$  mechanism. In addition, the fact that in the past SONI has had to incur costs before the UR made its decision on a  $D_t$  application indicates that there is a significant risk that this situation may occur again in the future.
- 6.240 A situation that results in SONI having to undertake expenditure on  $D_t$  projects without having received pre-approval is likely to result in significant risks for SONI. It is therefore likely that investors will justifiably perceive there to be a risk that SONI will not be remunerated for its efficient expenditure under the  $D_t$  mechanism.
- 6.241 We consider 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.

6.242 For these reasons, we are satisfied that this decision was wrong, as the UR failed properly to have regard to the Financeability Duty.

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

### ***UR's Decision***

6.243 The UR observed that in the NIE price determination, the CC determined 'that NIE's Licence should include a provision that the UR can adjust NIE's maximum regulated revenue or RAB to protect consumers from exposure to costs incurred by NIE which the UR finds to be demonstrably inefficient or wasteful.'<sup>479</sup>

6.244 In light of this approach suggested in relation to NIE, the UR, therefore, decided to include a new term, DIWE, into SONI's Licence in order to control 'demonstrably inefficient or wasteful expenditure'. Annex 1 (Charge Restrictions) to SONI's Licence defines this term as follows:

**Demonstrably Inefficient or Wasteful Expenditure** – means expenditure which the Authority has (giving the reasons for its decision) 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. 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.

6.245 The UR originally proposed that this term should apply to costs and amounts payable and levied under the A<sub>TSoI</sub> term for the purposes of restricting SSS/TUoS charges made by SONI, and that the UR 'may issue (and from time to time update) guidance as to the manner in which the term is to be interpreted and applied'. However, following consultation, the UR decided in the Price Control Decision 'to remove the Demonstrably Inefficient or

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<sup>479</sup> NIE price determination, [CC Final determination](#), 26 March 2014.

Wasteful element the [sic] A<sub>TSO</sub>t term within 2.2 (a) of Annex 1.’ and deleted the reference to issuing guidance.<sup>480</sup>

6.246 At paragraph 41 of the Price Control Decision the UR states that:<sup>481</sup>

... if the Demonstrably Inefficient or Wasteful element is used within the other elements of the [sic] Annex 1, the UR will provide guidance as to how this mechanism will be applied ...

6.247 On 27 July 2017 (ie during the course of this appeal), the UR published Guidance<sup>482</sup> which ‘provides the licensee with guidance on the interpretation and application of the Demonstrably Inefficient or Wasteful Expenditure Provision.’

### **SONI's views**

6.248 SONI stated that it did not object to the principle of the UR including the DIWE process in the Price Control. SONI noted that the concern of the UR was to ensure that all costs were being efficiently incurred, which was clearly a reasonable objective that it supported. However, it emphasised that this did not obviate the need for the UR to explain how the provision will apply.<sup>483</sup>

6.249 SONI stated 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.<sup>484</sup> In SONI's view, the failure of the UR to provide guidance left SONI without any certainty as to when, how and why the UR might seek to adjust its revenues downwards to account for DIWE.<sup>485</sup>

6.250 SONI contended that the effect of the decision was that it is entirely within the UR's discretion to apply the DIWE provision and reduce or remove funds from SONI, and (as the decision of the CC in the NIE price determination will have no binding application on the UR) it was incumbent on the UR to put in place safeguards when introducing the DIWE provision.<sup>486</sup>

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<sup>480</sup> [Price Control Decision](#), paragraphs 39–40.

<sup>481</sup> [Price Control Decision](#), paragraph 41.

<sup>482</sup> [Guidance on the interpretation and application of DIWE](#), 27 July 2017.

<sup>483</sup> [NoA](#), paragraph 29.3.

<sup>484</sup> [NoA](#), paragraph 29.7.

<sup>485</sup> [NoA](#), paragraph 29.10.

<sup>486</sup> [NoA](#), paragraph 29.9.

- 6.251 SONI stated 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 to the CMA).'<sup>487</sup>
- 6.252 SONI considered that 'this additional uncertainty has added even more risk onto [SONI] which is already operating in a heightened risk environment due to the impacts which can be expected from the extensive change progressing within the industry.'<sup>488</sup>
- 6.253 In response to our provisional determination, SONI maintained that the fact that the UR had now published guidance was an acknowledgement by the UR of its error.<sup>489</sup> However, SONI also pointed out that the UR did not consult on its guidance before it was published, and that SONI considers the guidance is deficient in a number of respects.<sup>490</sup>

### ***UR's views***

- 6.254 The UR stated that 'as SONI cannot reasonably suggest that it should be allowed to pass through expenditure which has been found to be DIWE ... SONI ... [is] attacking the fact that UR has decided not to issue immediate guidance with respect to it.'<sup>491</sup>
- 6.255 The UR noted that although it did not include a reference to guidance in the licence condition, it had stated that it would issue such guidance at a later date.<sup>492</sup>
- 6.256 The UR considered that, as the draft provision allowed, but did not require, guidance to be issued, there could be no possible grounds on which the UR's decision 'not to enshrine that power in the licence' could be said to be wrong.<sup>493</sup>
- 6.257 The UR noted that SONI had suggested that the UR put in place relevant safeguards when introducing the DIWE term, but it was clear that the definition of DIWE in paragraph 1.1. of Annex 1 of the SONI Licence included such safeguards.<sup>494</sup>
- 6.258 The UR accepted that it had stated that it would produce further guidance on the DIWE term, but considered that such guidance was not required in law,

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<sup>487</sup> NoA, paragraph 29.10.

<sup>488</sup> NoA, paragraph 29.11.

<sup>489</sup> SONI response to CMA provisional determination, paragraph 5.44.

<sup>490</sup> SONI response to CMA provisional determination, paragraph 5.48.

<sup>491</sup> Defence, paragraph 7.3.

<sup>492</sup> Defence, paragraph 7.5.

<sup>493</sup> Defence, paragraph 7.27.

<sup>494</sup> Defence, paragraphs 7.23–7.25.



as claimed by SONI. The UR also considered that the meaning of the term is clear on its face. The words ‘inefficient’ and ‘wasteful’ in the definition are to be given their natural meaning, and the word ‘demonstrably’ served to reverse the normal burden of proof, so that it was not for SONI to show that its actual spend was efficient. Costs approved by the UR under the D<sub>t</sub> process would be presumed to be efficient. The UR considered that this high hurdle for the UR to use the DIWE was the trade-off for any risk that SONI might be exposed to in an ex-post review of its costs.<sup>495</sup>

- 6.259 The UR noted that Ofgem had not provided guidance in relation to a similar provision in the price control for National Grid’s electricity transmission business, and that the CC did not require guidance to be issued with respect to its requirement for a DIWE provision for NIE.<sup>496</sup>

### **CCNI’s views**

- 6.260 SLG, on behalf of CCNI, supported the UR’s position, noting that the DIWE approach was in customers’ interests. They noted that any guidance should include a catch-all category to avoid gaming by SONI. CCNI did not consider that the timing of the guidance was problematic and that there should always be an incentive on SONI to deliver projects efficiently.<sup>497</sup>

### **Our assessment of Error 7**

- 6.261 As the UR has now published<sup>498</sup> guidance on the DIWE mechanism, SONI’s central claim, that the UR was wrong not to publish guidance, has been overtaken by events. Nevertheless, for the purposes of this appeal we have considered whether the UR was wrong not to publish guidance at the time of the Price Control Decision.
- 6.262 SONI said that the concern of the UR in introducing the DIWE term was to ensure that all costs were being efficiently incurred, which is clearly a reasonable objective that SONI supports.
- 6.263 However, SONI claimed that the failure by the UR to publish relevant guidance on the DIWE mechanism at the time of making its price control decision was an error of law, and that it was necessary for the UR to explain how the DIWE provision will apply.

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<sup>495</sup> [Defence](#), paragraph 7.34.

<sup>496</sup> [Defence](#), paragraph 7.35.

<sup>497</sup> [CCNI R&O](#), Annex 3 (SLG Economics Ltd Report), paragraph 3.2.6.

<sup>498</sup> [Guidance on the interpretation and application of DIWE](#), 27 July 2017.

6.264 We therefore consider first whether the UR had a legal duty to provide guidance, before assessing whether the lack of guidance negatively impacted on SONI's financeability

*Does the UR have a legal duty to provide guidance?*

6.265 The UR is not under any legal duty to publish guidance on the DIWE mechanism. The UR stated that it would publish guidance, but was not under a legal duty to do so by any specific date.

6.266 As the UR pointed out, the terms 'inefficient' and 'wasteful' will need to be applied having regard to their customary meaning and having regard to the relevant context. Moreover, the definition of the term DIWE in SONI's licence incorporates the same safeguards as was proposed by the CC in its NIE Decision, which the UR took into account when proposing the DIWE term.

*Would the lack of guidance negatively impact on SONI's financeability?*

6.267 SONI further contended that the effect of the Price Control Decision is that it will be entirely within the UR's discretion to apply the DIWE provision and reduce or remove funds from SONI, and that the failure of the UR to provide guidance leaves SONI without any certainty as to when, how and why the UR might seek to adjust its revenues downwards to account for DIWE.

6.268 To the extent that SONI may face additional 'ex-post' financial risk as a result of the introduction of the DIWE mechanism, in our view this does not arise because of any failure to publish guidance.

6.269 To the extent that the UR will be exercising a discretion when applying the DIWE, it will be important that guidance on the application of the DIWE mechanism is not so rigid and prescriptive that it has the effect of fettering the UR's discretion in the application of the mechanism to particular sets of circumstances.

6.270 SONI considers the guidance which the UR has now published<sup>499</sup> to be deficient in a number of respects. Although such guidance is not within the scope of this appeal, SONI's concerns suggest that the certainty, which SONI is seeking, as to when, how and why the UR might seek to adjust its revenues downwards to account for DIWE, may not be given by the simple act of publishing guidance.

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<sup>499</sup> [Guidance on the interpretation and application of the DIWE Provision](#), 27 July 2017.

- 6.271 In its decision in the NIE price determination, as the UR has pointed out, the CC declined to provide examples of circumstances when the DIWE provision would bite, because of ‘the danger of seeking to define the inefficient spend clause through hypothetical examples’.<sup>500</sup> We consider that the same risk is faced by the UR when providing guidance on the application of the DIWE mechanism, and that this supports the view that although guidance may produce additional certainty on matters of procedure and timing as regards the application of the DIWE term, it could not produce ‘certainty as to when, how and why the UR might seek to adjust its revenues downwards to account for DIWE’ as sought by SONI. Such decisions will by their nature depend on the relevant facts.
- 6.272 We therefore do not consider that the lack of guidance negatively impacts on SONI’s financeability.

### ***Our view on Error 7***

- 6.273 For the reasons set out above, we have concluded that the decision of the UR not to issue guidance at the same time as it published its decision to introduce a new DIWE term into SONI’s licence was not wrong.

## **Error 8: Unjustified creation of uncertainty through the introduction of the $Q_t$ adjustment**

- 6.274 Error 8 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. As discussed in paragraph 6.10, it raises different issues to the other errors within Ground 2, though it reflects ‘uncertainty’ insofar as SONI has argued the use of the  $Q_t$  was not expected and its amount was uncertain prior to the UR’s decision<sup>501</sup> made in August 2017.

### ***UR’s Decision***

- 6.275 The UR introduced the  $Q_t$  term in the Price Control Decision in March 2017. It stated that this was to ensure that the effective start date of the price control was 1 October 2015, and that the price controls set maximum regulated revenues for the five years to 30 September 2020. The  $Q_t$  term was required as the first two years of the price control had passed, namely 2015/16 and 2016/17. For these, the UR had approved tariffs for SONI that

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<sup>500</sup> NIE price determination, [CC Final determination](#), 26 March 2014.

<sup>501</sup> [UR Decision on  \$Q\_t\$  adjustment](#), 21 August 2017.

were rolled forward from the final year of the 2010-15 price control, at October 2014 levels. The intention was to implement the  $Q_t$  term only once, for tariffs in the 2017/18 year. The  $Q_t$  amount was intended to reflect the difference between the tariffs that had been applied and what the regulated tariffs set in the price control should have been, had the price control been enacted at the start date. It is effectively a truing-up mechanism.

### **SONI's views**

- 6.276 SONI contended that the effect of the decision was that it will be entirely within the UR's discretion<sup>502</sup> to apply the  $Q_t$  provision and reduce or remove funds from SONI, and that the failure of the UR to provide timely guidance left SONI without any certainty as to when, how and why the UR might seek to adjust its revenues downwards to account for the  $Q_t$  adjustment. SONI claimed 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.
- 6.277 SONI claimed that prior to the decision to adopt the  $Q_t$  adjustment, the previous approach adopted in the Price Control Decision, based on rolling forward the tariffs from the previous SONI price control, was consistent with the approach adopted in the NIE RP5 price control.<sup>503</sup> SONI said that it expected that these approved tariffs would apply, and it did not consider the approved tariffs to be a temporary measure that would be corrected by a true-up mechanism. It said it 'had no reason to believe that the arrangement ... would not continue', until the UR announced its intention to apply the  $Q_t$  adjustment in January 2017.<sup>504</sup>
- 6.278 SONI said that the UR had extended the tariffs under the previous control on 5 August 2015. It claimed that it had assumed that such approved and implemented interim tariffs would apply until the new price control was implemented.<sup>505</sup>
- 6.279 SONI contended that there had been a failure of the UR's process, in particular the lack of consultation on licence modifications and the lack of explanation of the intended application of the  $Q_t$  adjustment. SONI argued

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<sup>502</sup> NoA, paragraph 30.5.

<sup>503</sup> Price control decision for NIE for the period 2012–2017.

<sup>504</sup> NoA, paragraph 30.6.

<sup>505</sup> NoA, paragraph 30.7.

that this lack of explanation led to uncertainty and too much discretion. SONI said the uncertainty created additional financial risks.<sup>506</sup>

6.280 Subsequent to the submission of the [NoA](#) from SONI, the UR consulted on the  $Q_t$  term.<sup>507</sup> In response to this, SONI continued its objections to the application of the  $Q_t$  adjustment, including points relating to its retrospection and the impact on SONI's financeability.<sup>508</sup> SONI also raised some specific representations, including the treatment of allowances for PCNPs.

### **UR's views**

6.281 In its [Defence](#), the UR maintained that it had always clearly articulated the fact that the price control would be for five years and would be effective from the due date of 1 October 2015, rather than May 2017.<sup>509</sup> The UR agreed that the licence modifications could not be backdated to 1 October 2015, but stated that the price control would be.<sup>510</sup>

6.282 The UR further responded to comments by SONI about retrospection by noting that it did not intend to adjust the tariffs that SONI had already charged. It said the truing-up adjustments were to be made in 2017-18 to reflect the over-recovery made in the first two years and ensure the price control from 1 October 2015 was implemented.<sup>511</sup>

6.283 The UR noted that truing-up was used by the UR in the implementation of the CC re-determination for the NIE price control appeal, once this re-determination was confirmed.<sup>512</sup>

6.284 The UR noted<sup>513</sup> that SONI had always known that the tariffs were described and labelled as interim tariffs, reflecting arrangements that were interim until a true-up was progressed.<sup>514</sup>

6.285 The UR said that if the  $Q_t$  adjustment was not applied, this would amount to a windfall for SONI, whereby consumers would pay higher tariffs than was intended. The UR considered the  $Q_t$  adjustment avoided this scenario and

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<sup>506</sup> [NoA](#), paragraph 30.8.

<sup>507</sup> UR draft  $Q_t$  adjustment principles, draft guidance note, 5 July 2017 (submitted to CMA on 6 July 2017).

<sup>508</sup> SONI written response of 20 July 2017 (sent to the CMA on 21 July 2017) to the UR draft  $Q_t$  adjustment principles, draft guidance note of 5 July 2017 and SONI further written response of 27 July 2017 (sent to the CMA on 4 August 2017) to the UR draft  $Q_t$  adjustment principles, draft guidance note of 5 July 2017 (and further to a 25 July 2017 response from the UR to SONI).

<sup>509</sup> [Defence](#), paragraph 8.28.

<sup>510</sup> [Defence](#), paragraph 8.17.

<sup>511</sup> [Defence](#), paragraph 8.19.

<sup>512</sup> [Defence](#), paragraph 8.33.

<sup>513</sup> UR Hearing transcript, page 108, lines 23–26.

<sup>514</sup> [Defence](#), paragraph 8.29.

instead ensured customers paid tariffs in line with the complete price control determination.<sup>515</sup>

6.286 The UR issued a consultation paper<sup>516</sup> on the specifics of the  $Q_t$  adjustment after SONI's [NoA](#) had been submitted to the CMA and, after considering SONI's representations, the UR published its decision paper on 21 August 2017.<sup>517</sup> The UR has decided that a  $Q_t$  adjustment of –£1.8 million will be progressed.

### **CCNI's views**

6.287 SLG, on behalf of CCNI, commented on the proposed  $Q_t$  mechanism. SLG submitted that it was in customers' interests that if charges had been higher than necessary in the first year of the control period (due to the periodic review not being completed in time for the start date), any overpayment as a result of the previous 2010-15 allowance that had been rolled forward to 2015-16 was returned to customers by way of lower future charges. SLG stated that it was not in customers' interests to allow SONI to keep such a 'windfall'.<sup>518</sup>

### **Our assessment of Error 8**

6.288 The basis of Error 8 is that the UR was wrong in including a mechanism for adjusting tariffs to reflect the late start of the price control. In this appeal, SONI is not appealing the level of the adjustment, given that it was not informed of this at the time of its [NoA](#), but it is challenging in this appeal the existence of a mechanism for making the adjustment.

6.289 We are not persuaded by SONI's arguments that the interim tariffs should stand and that adjustments through the  $Q_t$  should not be made to ensure that the five-year price control is effective from 1 October 2015. It is plain from the [Final Determination](#), the Price Control Decision and SONI's [NoA](#) that the price control represents a five-year settlement, and in all other aspects of this appeal we are considering whether SONI's revenues correctly cover costs over a five-year period. It would be arbitrary to exclude the earlier part of the period from the calculations, unless there were good reasons for doing so. In addition, if the early part of the period were excluded, all the price control models would need to be amended to reflect the later starting date, in order for revenues to be consistent with costs over

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<sup>515</sup> [Defence](#), paragraph 8.37.

<sup>516</sup> UR draft  $Q_t$  adjustment principles, draft guidance note, 5 July 2017 (submitted to CMA on 6 July 2017).

<sup>517</sup> [UR Decision on  \$Q\_t\$  adjustment](#), 21 August 2017.

<sup>518</sup> [CCNI R&O](#), Annex 3 (SLG Economics Ltd Report), paragraph 4.7.

the Price Control Period. It is noteworthy that SONI did not suggest this in its [NoA](#).

- 6.290 We are also not persuaded by SONI's arguments that regulatory precedent requires the UR not to backdate the Price Control, or that it agreed a 'rollover' which implied no backdating of the Price Control. The precedents quoted by SONI reflect different circumstances, where the start date for the new price control was deferred. This does not mean that the UR could not have used such a rollover mechanism in this case, but we see no evidence that it committed to this process, or that it is more consistent with either the UR's actions or SONI's actions within the process or within this appeal. We note that the CMA's normal process in determining appeals is to backdate the decision, and that other regulators also focus on the revenues and costs over the Price Control Period, rather than in individual years.
- 6.291 Whilst the delays in implementation of the price control are regrettable, consumers should only pay the agreed [Final Determination](#) settlement. There should not be a windfall to SONI arising from the delays. The Price Control Period is for 5 years between October 2015 and September 2020, therefore revenues paid by customers should reflect the regulatory settlement for this full period. 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. By definition, the scale of the revenue adjustment could not have been known until the final  $Q_t$  determination had been made.
- 6.292 The UR did consult on the  $Q_t$  adjustment when it was able to estimate its value based on outturn values. It would not have been able to have progressed such a consultation earlier. We do not accept SONI's view that the application of the  $Q_t$  term required consultation, as it is clear that a late price control still requires customers to receive bills in line with the price control outcome. This is why the CMA remedies will adjust customer bills in the final two years of the price control.
- 6.293 We therefore do not agree with SONI that it was wrong to include a  $Q_t$  mechanism.
- 6.294 Whilst we do not find that the UR was wrong under Error 8, we would expect the final  $Q_t$  adjustment to reflect our decision in relation to other aspects of this appeal. Given that the UR has already issued its decision on the level of the  $Q_t$  adjustment, such decision may therefore need to be revisited following the conclusion of this appeal given that there are also CMA remedies to progress.



### ***Our view on Error 8***

6.295 For the reasons given above, we have concluded that the UR was not wrong to introduce and implement the  $Q_t$  adjustment, on the basis that the  $Q_t$  adjustment only corrects for the differences between actual tariffs in the first part of the 2015-20 period, and the tariffs which would have been consistent with the Price Control Decision.

### ***Observations on process***

- 6.296 We note that the UR was late to announce both its intention to apply the  $Q_t$  term and the detail of this. The  $Q_t$  term was not referenced in the [Final Determination](#). Its intended application only came to SONI's attention in January 2017.
- 6.297 At the clarification hearing, the UR told us that it was still unsure how it would progress the  $Q_t$  adjustment, noting it was undecided if it would consult on this and when this issue would be progressed.<sup>519</sup>
- 6.298 In our view, the lack of clarity on how the  $Q_t$  adjustment would be made was not good regulatory practice. SONI may have taken a different stance in its [NoA](#) if the UR had provided further detail at the time of the Price Control Decision. The calculation of the true-up should ideally be straightforward and transparent. Whilst the use of the  $Q_t$  is not wrong in principle, there should not be a material dispute over its value and scope. The UR should have referenced its intention to use the  $Q_t$  adjustment in the [Final Determination](#) and supported this with sufficient clarity of how the  $Q_t$  term would be applied.

### **Conclusion on Ground 2**

- 6.299 We have reached the conclusion that the UR was not wrong with regards to Errors 3, 4, 5, 7 and 8.
- 6.300 As regards Errors 2 and 6 we are satisfied that the UR's decision was wrong on the grounds that the UR failed properly to have regard to the Financeability Duty. In the case of Error 2, the UR failed to codify and specify clearly the mechanisms through which SONI is to recover its efficiently incurred PNCP costs, including under the TIA, notwithstanding that this may adversely affect SONI's ability to finance its statutory activities. In the case of Error 6, the UR has included a  $D_t$  mechanism which, as presently implemented, results in significant uncertainty for SONI and is

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<sup>519</sup> Clarification Hearing transcript, page 79, lines 15-18.



sufficiently unworkable that it is not consistent with the UR's duty to secure SONI's financeability.

## 7. Ground 1: Financeability of SONI

### Introduction

7.1 This chapter considers Ground 1 of SONI's appeal, the 'Financeability Methodology Ground' relating to the ability of SONI to obtain finance for its regulated activities.

### Outline of Ground 1

7.2 Ground 1 relates to the decision on the financial framework in the [Final Determination](#). This represents the approach taken by the UR to determine an assumed profit for SONI at a level consistent with the risks taken by SONI under the price control.

7.3 In Ground 1, SONI submitted that the UR had made three categories of error:

- (a) **Error 1(a): Failure to adopt a price control framework that could secure SONI's financeability.** SONI alleged that, by failing to take into account the specific characteristics of SONI's business, and the risks it faced in operating its business over the Price Control Period, the UR had erred in the way it remunerated the activities SONI was obliged to undertake as TSO. In particular, SONI stated that the UR's approach was not suitable for an 'asset-light' business such as SONI.<sup>520</sup>
- (b) **Error 1(b): Errors in the UR's assessment of financeability and remuneration for all layers of capital.** SONI alleged that the UR failed to conduct an adequate assessment of financeability, and failed to properly remunerate SONI for all the layers of capital invested in its TSO activities, both actual and committed.
- (c) **Error 1(c): Failure to undertake an equity financeability assessment and to assess non-systematic and asymmetric risks:** SONI alleged that the UR should have conducted financeability testing from the perspective of equity investors. Under this sub-ground SONI also pleaded that the UR had failed to take account of the non-systematic

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<sup>520</sup> [NoA](#), paragraphs 18.1–18.3.

and asymmetric risks SONI faced when using the Capital Asset Pricing Model (CAPM) to set its cost of capital.

### ***Statutory grounds of appeal***

7.4 SONI submitted that the alleged errors resulted in the Price Control Decision being wrong on the following statutory grounds:<sup>521</sup>

- (a) Error 1(a): the UR failed to adopt a price control framework that could secure SONI's financeability
  - (i) The UR failed properly to have regard to the Financeability Duty: the UR failed to conduct an adequate assessment of SONI's financeability.
  - (ii) Error of fact: the UR made a series of errors in conducting its assessment of SONI's financeability.
  - (iii) Wrong in law: the UR conducted an inadequate assessment of SONI's financeability, contrary to best regulatory practice.
  - (iv) Wrong in law: the UR failed to provide sufficient evidence to substantiate its conclusions, contrary to its duty to consult.
- (b) Error 1(b): the UR's limited and inadequate financeability assessment was subject to material errors
  - (i) The UR failed properly to have regard to the Financeability Duty.
  - (ii) Error of fact: the UR made a series of errors in conducting its assessment of SONI's financeability.
  - (iii) Wrong in law: the UR conducted an inadequate assessment of SONI's financeability, which lacked transparency and was contrary to best regulatory practice.
  - (iv) Wrong in law: the UR failed to provide sufficient evidence to substantiate its conclusions, contrary to its duty to properly consult.
- (c) Error 1(c): the UR failed to conduct a complete financeability assessment which, had it done so, would have demonstrated that SONI is not financeable

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<sup>521</sup> NoA, paragraph 17.4 and SONI Clarification Hearing follow-up written response of 28 June 2017, Annex1.

- (i) The UR failed properly to have regard to the Financeability Duty.
- (ii) Error of fact: the UR made a series of errors in conducting its assessment of SONI's financeability.
- (iii) Wrong in law: the UR conducted an inadequate assessment of SONI's financeability, which was contrary to best regulatory practice.
- (iv) Wrong in law: the UR failed to provide sufficient evidence to substantiate its conclusions, contrary to its duty to properly consult.

### ***Our approach to assessment of Ground 1***

7.5 We review Errors 1(a), 1(b) and 1(c) in turn. We note that many of the points raised in Error 1(b) and Error 1(c) provide reasoning and evidence for the case outlined in Error 1(a). We therefore conclude in the round at the end of this chapter on whether the financial framework was wrong for the reasons in Ground 1, given that the errors are inherently linked, both in the nature of the underlying decisions and in respect of the points pleaded by both SONI and the UR.

### **Error 1(a)**

7.6 Under Error 1(a), SONI alleged that the UR failed to adopt a price control framework that could secure SONI's financeability.

7.7 SONI's alleged error in 1(a) is a broad complaint that the UR's financial framework was wrong. It is not an appeal of the individual aspects of the UR's Price Control Decision, but an appeal that the overall framework in aggregate was wrong. In support of its appeal, SONI described the characteristics of its business, and then explained why, in its view, the UR's framework did not properly reflect those characteristics.

7.8 We therefore take the following approach to assessment of Error 1(a):

- (a) We first describe the approach taken by the UR in its [Final Determination](#). SONI had also argued in response to the [Draft Determination](#) that the UR's approach was wrong and would result in insufficient allowances for SONI. The [Final Determination](#) included a number of adjustments and refinements to the approach the UR had proposed in the [Draft Determination](#), which the UR considered should address SONI's response. Much of this appeal relates to SONI's case as to why the adjustments made by the UR were wrong, or why the UR failed to properly take into consideration SONI's characteristics in coming to its final decision on the financial framework.

- (b) Second, we summarise SONI's appeal as expressed within Error 1(a), including summarising the relevant parts of SONI's submissions on the characteristics of its business.
- (c) Third, we summarise the UR's response to SONI's case on Error 1(a), including any points relevant to Error 1(a) from its overall submissions on Ground 1.
- (d) Lastly, we assess SONI's case on Error 1(a).

7.9 SONI's submissions included presentations of evidence which related to Ground 1 broadly. To the extent that Error 1(a) relates to the question of whether the UR's financial framework was appropriate to remunerate SONI for the risks it is taking, we have included the majority of the hearing evidence we refer to in this regard in this section under Error 1(a).

### ***UR's Decision and reasoning***

7.10 We summarise below the UR's approach to the financial framework in the [Final Determination](#).

7.11 In the [Final Determination](#), the UR decided to apply the Regulatory Asset Base/Weighted average cost of capital (RAB/WACC) framework in remunerating SONI for the investments it makes in its business. This framework was used in SONI's previous price control (2010-2015), and in other regulatory decisions by the UR, including those for the regulation of NIE. It is also used by the Office of Gas and Electricity Markets (Ofgem) in regulation of network companies such as National Grid.

7.12 SONI had submitted as part of the 2015-2020 Price Control process that this approach was not sufficient to compensate SONI for the risks it faced in operating the network.<sup>522</sup> Following its review of SONI's submissions after the [Draft Determination](#), the UR concluded that the existing RAB/WACC framework remained appropriate. It stated that it had examined SONI's capital requirements, and that it had considered allowances for contingent equity capital, intangible capital or a margin, over and above the return on investments included in the RAB/WACC framework. Overall, it had found insufficient grounds for allowing any return on capital which was not covered by the RAB/WACC framework.<sup>523</sup>

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<sup>522</sup> NoA, paragraph 18.1.

<sup>523</sup> [Final Determination](#), page 3.

- 7.13 The UR, however, also noted that in its [Final Determination](#) it had made a number of amendments to the implementation of the framework in its [Draft Determination](#) including:
- (a) raising the WACC applied to SONI's RAB from 5.42% to 5.9% per year to reflect its risk profile;
  - (b) allowing SONI a financing cost of 2% per year above the London InterBank Offered Rate (LIBOR) on any cost under-recoveries until it recouped these through its tariff; and
  - (c) allowing the ongoing costs of maintaining a working capital debt facility, which enabled SONI to manage these cost under-recoveries.<sup>524</sup>
- 7.14 The UR explained that its approach would allow SONI to finance its licensed activities and served to protect the interest of consumers.<sup>525</sup>
- 7.15 The UR further explained that the approach it had taken reflected the recent focus of regulators when considering financeability. The emphasis was on ensuring that the framework and allowances in the overall price control package provided an efficiently managed company with sufficient returns to attract and maintain the financial capital that the business needed in order to carry out its obligations.<sup>526</sup>
- 7.16 The UR stated that one particular precedent that it had noted was the CMA's initial views on the fair return for asset-light GB energy suppliers as set out in the CMA's [Energy Market Investigation](#) provisional findings. The UR considered that there was a good read-across between the questions that the CMA had been considering and the issues that the UR had to deal with in SONI's price review, and had therefore sought to draw on the CMA's framework of analysis as much as possible.<sup>527</sup> The CMA had considered similar matters and concluded that the use of return on capital was the correct lens with which to look at profit for the energy retail companies. The CMA<sup>528</sup> had explained that:

... we do not agree that a low level of capital employed, in itself, makes a ROCE analysis less meaningful. Investors expect to earn a return on the actual capital they put at risk, which is

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<sup>524</sup> [Final Determination](#), page 3.

<sup>525</sup> [Final Determination](#), page 3.

<sup>526</sup> [Final Determination](#), page 2.

<sup>527</sup> [Final Determination](#), paragraph 269.

<sup>528</sup> CMA Energy Market Investigation, Provisional findings report, [Appendix 10.3: Analysis of retail supply profitability – ROCE and economic profit](#), paragraph 20, 10 July 2015.

limited to their equity or debt holding in a firm with limited liability

...<sup>529</sup>

- 7.17 The UR had therefore retained its overall approach from the previous price control of looking at each of the risks and capital requirements SONI had identified in its submissions, and of seeking to understand the capital requirements of the business and the fair reward for that capital.<sup>530</sup>
- 7.18 In its [Final Determination](#), the UR considered the following submissions by SONI:
- (a) unlike other regulated companies, SONI had submitted that it had significant intangible assets, and the UR's approach would not remunerate SONI for its investment in these assets;<sup>531</sup>
  - (b) SONI had submitted that it had a higher level of operational gearing (explained in paragraph 7.23 below) than other regulated businesses, and that this would result in a higher cost of capital; and
  - (c) in SONI's view, a more appropriate alternative approach for an 'asset-light' firm such as SONI would be an approach based on margins.
- 7.19 However, the UR concluded that the RAB/WACC approach remained appropriate.
- 7.20 We outline the UR's response in the [Final Determination](#) to each of SONI's arguments below.

#### *Remuneration of intangible assets*

- 7.21 The UR rejected SONI's contention in response to the [Draft Determination](#) that in its deliberations about the amount of profit SONI should expect to make, it should take account of SONI's intangible assets.<sup>532</sup> The UR considered that investments in tangible or intangible assets would qualify for remuneration under the Price Control where they represented investment by investors, rather than through an accumulation of value from amounts previously allowed as operating costs or RAB additions through past price controls.<sup>533</sup>

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<sup>529</sup> [Final Determination](#), paragraph 275.

<sup>530</sup> [Final Determination](#), paragraph 276.

<sup>531</sup> [Final Determination](#), paragraph 298.

<sup>532</sup> [Final Determination](#), paragraphs 298–305.

<sup>533</sup> [Final Determination](#), paragraph 303.

7.22 The UR continued by stating that human and intellectual capital, whether internally generated or purchased, whether capitalised or not, would have been paid for out of ordinary price control allowances. In the UR's view this did not lead to any additional cost (to SONI's investors or to anyone else) that would be left unremunerated within the Price Control calculation.<sup>534</sup>

#### *Cost of capital given high operational gearing*

7.23 In the [Final Determination](#), the UR decided to apply a pre-tax WACC of 5.9% to SONI's RAB<sup>535</sup> instead of the 5.42% proposed in its [Draft Determination](#). The UR refined some input assumptions it had used when deriving its estimate for SONI's WACC in the [Draft Determination](#). The UR explained that SONI had 'high operational gearing' which meant that SONI had a small RAB in relation to ongoing expenditures and revenues and therefore would see greater swings in out-turn profit compared to other regulated companies in the face of external shocks.<sup>536</sup>

7.24 Most notably, the UR significantly increased its assumption for SONI's asset beta. Beta, the UR explained, was a measure of the riskiness of a firm and might be considered to be a measure of the systematic risk that a firm had relative to the market portfolio. Typically, beta values would be obtained by measuring the correlation between movements in a firm's share price and movements in the value of the stock market as a whole.<sup>537</sup> The UR had concluded that its [Draft Determination](#) proposals had not fully reflected the operational gearing within SONI.<sup>538</sup>

7.25 The UR noted that SONI remained a regulated monopoly with no significant volume or competitive risks. SONI operated within a flexible regulatory framework where many significant costs were considered using the  $D_t$  term,<sup>539</sup> which, in the UR's view, allowed costs to be set with greater certainty and limited risk.<sup>540</sup>

7.26 Overall, the UR viewed SONI as facing greater risk than regulated network companies which did not face the same operational gearing challenges, but less risk than other firms which faced significant volume risk in a competitive market. Regulated network companies had recently been given asset betas around a range of 0.3 to 0.4, whereas the market average firm in the stock

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<sup>534</sup> [Final Determination](#), paragraph 304.

<sup>535</sup> [Final Determination](#), paragraph 349.

<sup>536</sup> [Final Determination](#), paragraph 334.

<sup>537</sup> [Final Determination](#), paragraph 351.

<sup>538</sup> [Final Determination](#), paragraph 356.

<sup>539</sup> See paragraph 2.56(d) and Chapter 6.

<sup>540</sup> [Final Determination](#), paragraph 357.



market had an asset beta range of 0.7 to 0.8.<sup>541</sup> Having regard to these considerations, the UR decided to set the asset beta at 0.6 (increased from 0.45 in the [Draft Determination](#)). In the UR's view, this addressed the increased risk associated with SONI's operational gearing.<sup>542</sup>

### *Consideration of margins based approach*

- 7.27 The UR considered the appropriateness of introducing an explicit margin in addition to, or in conjunction with, the return on the RAB and the allowances for the costs of working capital. It noted, however, 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 UR considered that it would need to see that it had somehow missed some element of the capital that SONI's investors put into the business or that SONI was otherwise being under-remunerated.<sup>543</sup>
- 7.28 The UR continued that, having reviewed the submissions that SONI had made during the previous 12–18 months, it had not been able to identify any such omission or oversight. It considered that the capital that SONI's investors had put into the business in the past, and were likely to be put into the business in the future, were fully recognised in the allowances included elsewhere in its [Final Determination](#). Provided that the UR had accurately estimated SONI's cost of capital, investors would be receiving fair reward for the financial commitment that they would make to the regulated business. Any additional reward would therefore constitute excess return and could not be justified.<sup>544</sup>

### **SONI's views**

- 7.29 In its [NoA](#), SONI submitted that the approach taken by the UR was wrong on the basis that it failed to secure SONI's financeability. SONI's arguments can be grouped into the following categories:
- (a) The UR failed to take into account the specific characteristics of and risks faced by SONI's business: SONI is physically asset-light, has high operational gearing and a volatile 'saw-tooth' RAB, a significant intangible asset base, and is taking on increased risks within the

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<sup>541</sup> [Final Determination](#), paragraph 358.

<sup>542</sup> [Final Determination](#), paragraph 359.

<sup>543</sup> [Final Determination](#), paragraph 306.

<sup>544</sup> [Final Determination](#), paragraph 307.



Network Planning function. As a result, the UR's overall approach was wrong.<sup>545</sup>

(b) The UR's approach was not adequate to reflect the characteristics of SONI and the risks faced by SONI – a margin approach would be more effective given SONI's characteristics.<sup>546</sup>

(c) The UR's approach failed to recognise the intangible assets associated with SONI's business and the consequences of higher operational gearing.<sup>547</sup>

7.30 SONI then suggested an alternative financing framework which, in its view, was more appropriate given its characteristics and risks it faced for which it was not adequately remunerated. SONI also provided evidence in respect of the approach taken by the CER for regulating EirGrid, a similar company to SONI.

7.31 We first summarise the arguments made by SONI under the categories above, then outline SONI's suggested alternative approach to that used by the UR, including a comparison with the CER approach.

#### *SONI faced specific characteristics and risks*

7.32 SONI submitted an analysis of its business characteristics which it considered needed to be taken into account when considering its financeability.

#### *High operational gearing*

7.33 SONI said that it was 'physically asset-light', and had high operational gearing.<sup>548</sup> SONI explained that high operational gearing in its case referred to the situation where the value of assets used in its business was low relative to turnover and operating costs.<sup>549</sup> SONI stated that this resulted in its profits having a higher exposure to external market factors and volatility in cash flows than asset-heavy utilities.<sup>550</sup>

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<sup>545</sup> NoA, paragraphs 18.1–18.13.

<sup>546</sup> NoA, paragraphs 18.14–18.22 and NoA, First Witness Statement of Dr Maciej Firla-Cuchra (NoA MC1), supporting document MC1/2 (KPMG 2).

<sup>547</sup> NoA, paragraphs 18.23–18.29 and NoA, First Witness Statement of Dr Andrew Lilico (NoA AL1).

<sup>548</sup> NoA, paragraphs 14.2 & 18.3.

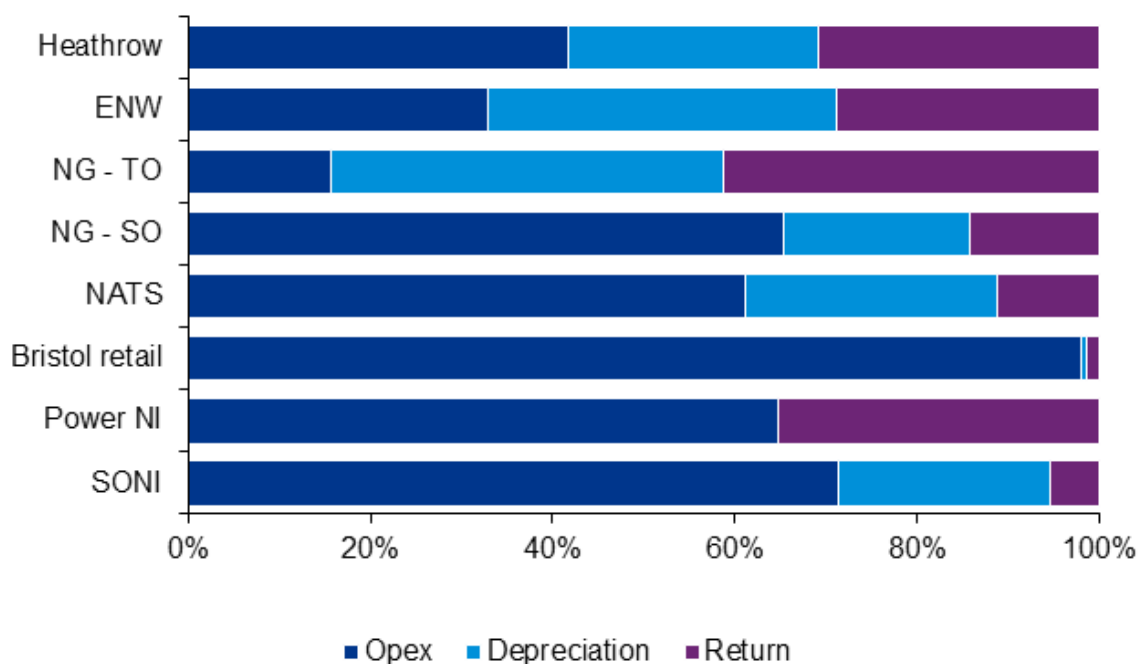
<sup>549</sup> SONI stated that its average RAB in 2015/2016 was £7.4 million whereas its total revenue in 2015/16 was £109 million (NoA, paragraph 14.3(c)).

<sup>550</sup> NoA, paragraph 14.3(c).

- 7.34 SONI provided analysis of its operational gearing by comparison to other network companies, using the measure of opex to price controlled revenue.<sup>551</sup>
- 7.35 SONI illustrated this comparison of its characteristics with other UK regulated businesses with the diagram reproduced in Figure 7.1 below. This shows that operational costs (captioned as ‘opex’ in the figure) comprised a much bigger proportion of the cost base of SONI’s services than for asset-heavy businesses such as National Grid’s transmission operations, Heathrow and Electricity North West. The profit element of SONI’s cost base (‘return’) by way of contrast was smaller than for the asset-heavy businesses. SONI provided this analysis in support of its statement that it was asset-light with significant operational activities that were not related to any major assets – it was not, for example, a transmission network asset owner. It had no significant RAB, equity return or balance sheet upon which to fund investments.<sup>552</sup>

**Figure 7.1: SONI’s breakdown of the broad type of costs incurred for the services provided by a range of UK regulated businesses**

### Operational gearing comparison



Source: NoA, Figure 2.

Notes: Heathrow = Heathrow Airport (BAA); ENW = Electricity North West; NG - TO = National Grid transmission operator; NG - SO = National Grid transmission systems operator; NATS = The UK Air traffic control operator; Bristol retail = Bristol Water retail operator; Power NI = default domestic retail supplier in NI.

<sup>551</sup> SONI noted that this measure was used by the CMA in the [Bristol Water price determination](#).

<sup>552</sup> NoA, paragraph 14.3(a).

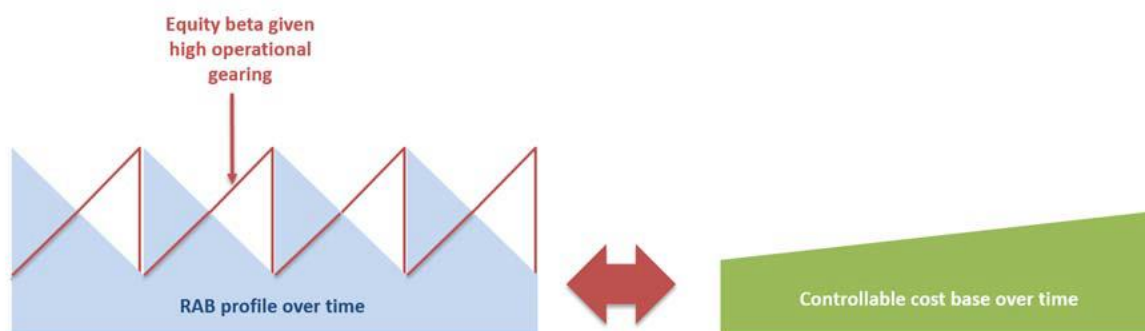
7.36 SONI made reference to a paper by Oxera, which illustrates that asset-light companies may have different risk and return characteristics to asset-heavy companies.<sup>553</sup>

*Low and unstable asset base*

7.37 SONI submitted that in order to carry out its regulated activities, SONI needed to make significant investments, over which it had little control, and which were rapidly depreciated. This resulted, in SONI's view, in a 'saw-tooth' pattern for its asset base, as illustrated below (see Figure 7.2 below for stylised illustration submitted by SONI). SONI submitted that the changing value of its assets resulted in unstable ratios of assets to controllable costs, and SONI experienced fluctuating levels of working capital both absolutely and relative to its RAB.<sup>554</sup>

7.38 SONI submitted that the instability in SONI's asset base made it difficult to secure finance on the basis of the standard regulatory model, which assumed that financing would be secured by reference to the regulatory asset base. SONI said that for a company with an unstable asset base, but stable and material operational costs, the ratio of assets to operating costs would vary significantly, as illustrated in its Figure 7.2.<sup>555</sup>

**Figure 7.2: SONI's stylised depiction of the contrast in the profile of investment in its RAB over time compared with the profile of its controllable operating cost base**



Source: NoA, Figure 3.

<sup>553</sup> NoA BT1, supporting document BT1/31/22 ([Oxera Agenda Something for nothing? Returns in low-asset industries](#), March 2014).

<sup>554</sup> NoA, paragraph 18.5.

<sup>555</sup> NoA, paragraph 14.3(b).

7.39 SONI also noted that much of its activity related to intangible assets and value-add activities, rather than the operation of tangible asset investments which would normally be observed for companies funded on the basis of a RAB model.<sup>556</sup>

*Materiality of its K-factor adjustments*

7.40 SONI told us that its business significantly differed from other regulated businesses in that its K-factor was much more material to its level of profits. SONI explained that K-factors were a regulatory mechanism to ‘true-up’ (or down) the revenues a regulated firm earned from its customers in any one period to the revenues that the regulator eventually determined that the firm should have earned from customers for that period.<sup>557</sup>

7.41 For a typical asset-heavy utility, SONI continued, K-factors might be in the order of 5-10% of profits (Earnings Before Interest and Tax (EBIT)), or less than 1% of RAB. In contrast, SONI’s K-factor had in the past been 100% of RAB or 200% of EBIT. In order to provide working capital to cope with revenue volatility of this scale, SONI had been required to maintain a contingent revolving debt facility which was larger than its RAB at the beginning of the control period (2014/15). This facility was put in place during the previous price control period by virtue of support through the provision of a cross-guarantee from EirGrid (for which no remuneration had been allowed under the Price Control).<sup>558</sup>

*Role in ensuring stability of the electricity system*

7.42 SONI submitted that it had a role in ensuring the stability of the electricity market, and this required access to a stable debt facility.<sup>559</sup> In addition, SONI had to make investments which would improve services and outputs for customers.<sup>560</sup> It stated that it had no access to the required financing without recourse to support from EirGrid or a Letter of Comfort from the UR agreeing that SONI would be able to recover any shortfalls in finance.<sup>561</sup> SONI

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<sup>556</sup> NoA, paragraph 14.3(d)–(f).

<sup>557</sup> Revenues raised in the first instance for a particular period are based on a tariff sanctioned by the regulator in advance of that period starting. That tariff will be based on expectations for that period. If however, for example, certain items are to be recovered on a cost pass-through basis and then outturn differed from expectations, then there would need to be an adjustment to prior period revenues to reflect that change in expectations. That adjustment would then be taken account of when setting the tariff for the subsequent period.

<sup>558</sup> SONI said that this facility had been due to expire in September 2016 but as a gesture of goodwill from the banks the facility had been extended, pending conclusion of the 2015-2020 price control process, and on the basis of the cross-guarantee from EirGrid remaining in place (NoA, First Witness Statement of Aidan Skelly (NoA AS1, paragraph 41)

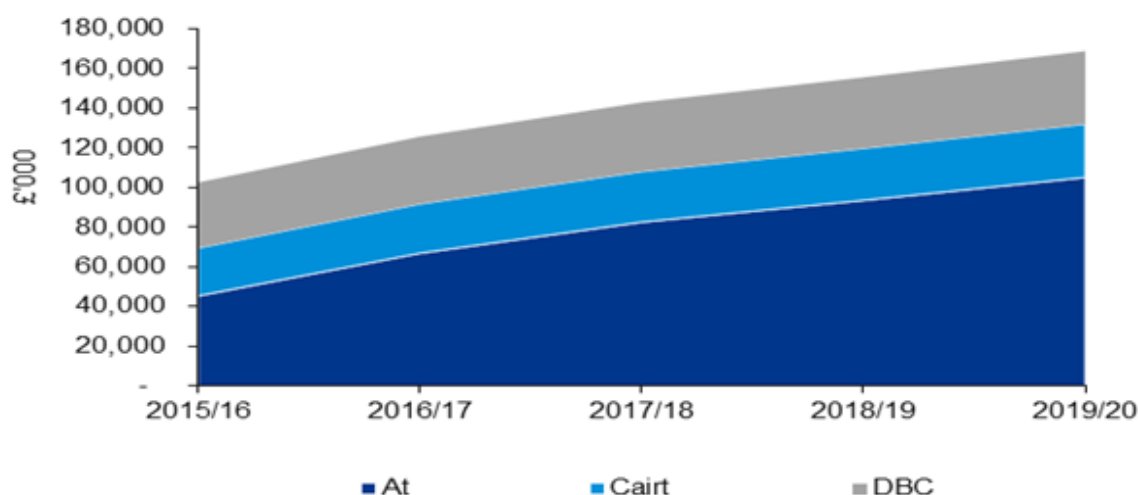
<sup>559</sup> NoA, paragraph 16.12.

<sup>560</sup> NoA, paragraph 16.16.

<sup>561</sup> NoA, paragraph 16.13.

provided a projection of the revenues and costs which it had to manage (see Figure 7.3), which shows that the charges collected by SONI are large by comparison to its asset base and expected to grow by approximately 60% over the price control period. In SONI's submission, these are significant cash flow risks over which SONI has limited influence.

**Figure 7.3: SONI's depiction of the evolution of charges collected on behalf of others**



Source: NoA, Figure 6.

Notes: At = At costs including System Services payable to generators; CAIRt = Collection Agency Income Requirement for Moyle Interconnector charges; DBC = unexpected Dispatch Balancing Costs payable to SEMO.

*The UR's approach was not adequate to reflect the characteristics of SONI and the risks faced by SONI*

7.43 At the heart of SONI's case on Ground 1(a) is that the risks outlined above represented a difference between SONI and other typical regulated networks. In SONI's submission, uplifting the WACC from 5.42% to 5.9% was the wrong way to address these risks.<sup>562</sup>

7.44 In particular, SONI submitted that the UR should have put in place a framework that reflected the risks faced by SONI. In SONI's view, these risks were largely driven by operational factors (opex risk and liquidity risk associated with pass-through costs) and factors that reflected its capital structure (operational gearing) rather than factors associated with financing and implementing capital investment.<sup>563</sup>

<sup>562</sup> NoA, paragraph 18.7.

<sup>563</sup> NoA, paragraph 18.16.

- 7.45 SONI relied on evidence from KPMG, which stressed the importance of remunerating all capital employed in the business and ensuring that profitability corresponded to the scale of business operations. The attractiveness of asset-light businesses to investors was highly sensitive to the expected remuneration on all tangible and intangible assets and for all economic activities.<sup>564</sup>
- 7.46 SONI, quoting the second expert report from KPMG,<sup>565</sup> argued that it was problematic to presume that a firm's ability to earn profits should be exclusively linked to the extent of its investment in tangible fixed assets for the following reasons:
- (a) it gave firms a bias to find solutions that involved investing in tangible fixed assets, a bias that would not necessarily generate value for consumers;
  - (b) it exposed firms to risks that they were not well placed to manage; and
  - (c) it left firms exposed to the risk of financial distress, which capital providers would not accept.<sup>566</sup>
- 7.47 Furthermore, SONI argued that the greater the proportion of operational activity to the value of the RAB, the less effective the RAB/WACC approach would be at providing adequate revenues to finance the business.<sup>567</sup>
- 7.48 SONI submitted that investors in SONI would be expecting their returns to be driven by the scale of SONI's operations and not by a return on capital invested in a limited tangible asset base. However, under the UR's RAB/WACC approach, expected profits were linked to the scale of SONI's investment in tangible assets, as opposed to the scale of its business operations. SONI submitted that business activities that involved managing operating costs, as opposed to investments, would not expect to earn a profit under this RAB/WACC framework, unless the business was able to outperform on the opex cost allowances that the regulator had set.<sup>568</sup>
- 7.49 Quoting KPMG, SONI argued that several revenue building blocks needed to be considered to ensure financeability.<sup>569</sup> SONI argued that an alternative approach that the UR should have considered was margin-based regulation,

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<sup>564</sup> NoA, paragraph 19.22 and NoA MC1, supporting document MC1/1 (KPMG 1), paragraph 9.2.3.

<sup>565</sup> NoA MC1, supporting document MC1/2 (KPMG 2), paragraph 3.2.8.

<sup>566</sup> NoA, paragraph 18.17.

<sup>567</sup> NoA, paragraph 18.18.

<sup>568</sup> NoA, paragraph 18.19.

<sup>569</sup> NoA, paragraph 18.6 and NoA BT1, supporting document BT1/31/7, page 32.

given that this approach was regularly applied to asset-light businesses., SONI submitted that margin-based price control regulation was a practical solution to the challenge of setting an allowed return where a business had little or no tangible assets with which to constitute a RAB.<sup>570,571</sup>

- 7.50 SONI submitted that a simple RAB/WACC approach, although an effective way of determining expected profits for asset-heavy, capital intensive regulated networks without significant intangible assets, had certain limitations and could result in significant challenges when applied in the context of an asset-light business.<sup>572</sup>

*The UR's approach failed to recognise the intangible assets associated with SONI's business and the consequences of higher operational gearing*

- 7.51 SONI relied on an expert report from Dr Andrew Lilico of Europe Economics.<sup>573</sup> Dr Lilico argued, in relation to non-remuneration of SONI's intangibles, that modest uplifts of the scale regulators found pragmatically convenient to deal with other areas of uncertainty in the price control – of the order of 0.5% – were simply not going to be sufficient if the issue was that much, if not most, of the asset base was not identified.<sup>574</sup>
- 7.52 Dr Lilico's expert report<sup>575</sup> argued that the UR's 'quick fix' failed to secure SONI's financeability. In his view, the UR's method of providing an asset beta uplift appeared to be unlikely to have been adequate, given certain structural similarities between the SONI business and that of EirGrid. Dr Lilico noted that EirGrid's price control includes additional allowances not included in the UR's financial framework for SONI.<sup>576</sup> Dr Lilico's calculations suggested that the UR's uplift had accounted for only of the order of one eighth to one third of the required additional return allowance.<sup>577</sup>
- 7.53 Dr Lilico said that the use of the RAB/WACC approach to address the higher risks faced by SONI would result in an implausibly high cost of capital.<sup>578</sup> In Dr Lilico's view, the consequence would be that an approach which included intangible assets, as well as tangible assets, in the asset base would result

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<sup>570</sup> NoA MC1, supporting document MC1/2 (KPMG 2), paragraph 5.3.3.

<sup>571</sup> NoA, paragraph 18.21.

<sup>572</sup> NoA, paragraph 18.14.

<sup>573</sup> NoA AL1, paragraph 9.4 & Figure 9.1.

<sup>574</sup> NoA, paragraph 18.26.

<sup>575</sup> NoA AL1, paragraph 10.5.

<sup>576</sup> Europe Economics had previously prepared a report for the CER, see NoA BT1, supporting document BT1/44 ([Operating Leverage of EirGrid/ESBN: Implications for PR4 Beta](#), July 2015).

<sup>577</sup> NoA, paragraph 18.29.

<sup>578</sup> NoA, paragraph 18.24.



in a more realistic return on capital. Dr Lilico concluded that this would better reflect the reality of SONI's business.<sup>579</sup>

### *Alternative approaches suggested by SONI*

- 7.54 After explaining why, in SONI's view, the UR's price control framework did not secure SONI's financeability, SONI explained in more detail the particular risks for which, it submitted, it was not adequately remunerated, and suggested alternative approaches.
- 7.55 SONI argued that the UR had inappropriately concluded that simply applying a traditional RAB/WACC framework would enable SONI to be financeable. In its view, the UR had not considered that any additional layers of capital employed in the business other than the RAB would require remuneration.<sup>580</sup> SONI disagreed with this view.
- 7.56 SONI submitted that instead of using the UR's RAB/WACC approach, it should be remunerated using a margin-based approach to secure its financeability. Specifically, SONI requested that it should expect to earn a EBIT margin of 11% on its controllable revenues.<sup>581</sup> KPMG's benchmarking analysis of UK listed firms operating in sectors considered similar to SONI<sup>582</sup> had indicated that margins on controllable revenues of 10–14% provided a useful comparator.<sup>583</sup> SONI calculated that a comparison to a margin of 11% implied a shortfall in expected profits for SONI under the UR's RAB/WACC approach of £5.3 million over five years.<sup>584</sup>
- 7.57 In response to our provisional determination, SONI said that it had also acknowledged in its hearing that a more tailored remuneration model based upon addressing the different activities, risks and layers of capital individually could also be an appropriate solution if that model were to be appropriately calibrated. SONI submitted that such an alternative would need to result in a sufficient increase in revenues for SONI to be financeable.<sup>585</sup>

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<sup>579</sup> NoA, paragraph 18.25 and NoA AL1, sections 8 & 9.

<sup>580</sup> NoA, paragraph 18.15.

<sup>581</sup> NoA, paragraphs 21.2–21.3.

<sup>582</sup> NoA MC1, supporting document MC1/1 (KPMG 1), paragraphs 9.6.8–9.6.13.

<sup>583</sup> NoA, paragraph 20.11 including footnote 165 referring to NoA MC1, supporting document MC1/1 (KPMG 1), paragraph 9.6.15.

<sup>584</sup> NoA, paragraph 15.3 & Figure 4.

<sup>585</sup> SONI response to CMA provisional determination, paragraph 6.59.



### *Risks for which SONI was not adequately remunerated*

7.58 In submissions subsequent to its [NoA](#) and in hearings, SONI further explained the particular risks it faced for which it was not adequately remunerated by the cost of capital set by the UR, and suggested alternative approaches. It supported its case by reference to the approach used for regulating EirGrid in the RoI by the CER.

#### *Collection agent risk*

- 7.59 SONI explained that it collected revenues on behalf of others. It referred to this activity as ‘custodian management’.
- 7.60 SONI said that in some cases, the arrangement was that SONI only paid out what it had collected as was the case with the Moyle Interconnector.<sup>586</sup> In other cases, such as with NIE’s transmission revenues, SONI had to pay out to NIE a fixed sum regardless of how much it had collected from retail suppliers and generators.<sup>587</sup>
- 7.61 In the case of dispatch balancing costs (DBC)<sup>588</sup>, SONI said it had to reimburse SEMO immediately for any additional DBC SEMO had incurred. However, SONI itself had to wait to recover these additional (ie unexpected) costs from its customers in due course through the SSS tariff.<sup>589</sup>
- 7.62 SONI stated that if there was a shortfall in revenues – which currently happened to be of the order of 2% in respect of NIE’s transmission revenues – then SONI would be paying out more than it had collected, which was a burden on its business. SONI had to pay a fixed amount to the asset owners and was taking on the volatility risk on those payments.<sup>590</sup>
- 7.63 SONI explained that ultimately it did not consider that there was a credit risk – it would get its money back – but there was a liquidity risk. SONI had to manage that liquidity risk within the overall gearing of the business.<sup>591</sup>
- 7.64 SONI submitted that it should be remunerated for taking on this risk by means of a working capital allowance. SONI said that a price control

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<sup>586</sup> See SONI Hearing, handout 4 (submitted to the CMA on 21 July 2017) – the Moyle Interconnector is shown under ‘in=out’.

<sup>587</sup> SONI Hearing transcript, page 115, lines 20–26.

<sup>588</sup> See Chapter 2.

<sup>589</sup> See SONI Hearing, handout 4 (submitted to the CMA on 21 July 2017) – DBC shortfalls.

<sup>590</sup> SONI Hearing transcript, page 116, lines 3–11.

<sup>591</sup> SONI Hearing transcript, page 114, lines 16–18.

framework based on margins that it was seeking under the appeal would not cover this risk.<sup>592</sup>

- *Increasing collection agent risk from new market arrangements*

- 7.65 SONI explained that the introduction in May 2018 of the new market arrangements for the island of Ireland, I-SEM, would result in the absence of a historical track record and pattern on which to base forecasts for constraint costs.<sup>593</sup> As a result, there was likely to be a much greater variance between the forecast costs which would be recovered by SONI through its tariff charges and the constraint costs it would actually occur. SONI explained that this had been its experience following the introduction of the SEM, the single ('non-integrated') market.<sup>594</sup>
- 7.66 SONI explained that, although there was no under recovery of constraint costs in 2014/15 and 2015/16, there had been a very significant under recovery in 2013. As a result, there was reason to believe that significant under recoveries may occur going forward.<sup>595</sup>
- 7.67 SONI highlighted that, although shortfalls were ultimately recoverable via the K-factor, it faced a significant liquidity issue because these constraint costs could be significantly volatile. As explained in paragraph 7.65, these constraint costs were not only expected to increase in their absolute scale but also in their volatility in the new I-SEM arrangements.<sup>596</sup>
- 7.68 SONI further explained that the expected increasing scale and volatility of the unexpected constraint costs were not directly related to the increasing levels of renewables, but to discontinuity caused by the introduction of I-SEM.<sup>597</sup>
- 7.69 SONI noted that the standby capital arrangements that would be required in the new I-SEM market were approximately three to four times the existing level. SONI currently had a standby facility of £12 million but had calculated that this would need to be in the order of £45 million under the new market arrangements.<sup>598</sup>

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<sup>592</sup> SONI Hearing transcript, page 116, lines 12–16.

<sup>593</sup> Constraint costs are DBC.

<sup>594</sup> SONI Hearing transcript, page 112, lines 10–15.

<sup>595</sup> SONI Hearing transcript, page 112, lines 7–9.

<sup>596</sup> SONI Hearing transcript, page 112, lines 22–26.

<sup>597</sup> SONI Hearing transcript, page 113, lines 22–26.

<sup>598</sup> SONI Hearing transcript, page 133, lines 5–9.

- *Standby facility for collection agent risk*

- 7.70 SONI noted that the facility underpinning its role as collection agent for unexpected constraints costs was a standby facility which was needed infrequently. However, when it was drawn upon, SONI's gearing ratio increased substantially as it would have significant debt with no corresponding assets.
- 7.71 SONI stated that it had a target gearing ratio of 50–60%, in line with the notional gearing reflected in the UR's debt financeability model. Implicitly, it argued, there was a level of equity support that had to be in place to back up that standby facility. SONI submitted that this layer of capital should be remunerated by means of a working capital allowance.<sup>599</sup>
- 7.72 SONI explained that there were three cost elements associated with being able to handle collection agent shortfalls: the cost of putting a facility in place in the first place (an arrangement fee paid to the bank); a commitment fee payable to the bank for the facility being in place but undrawn; and finally, there were the interest costs which arose if the facility was drawn upon. SONI submitted that such an arrangement consumed capital – in other words the arrangement required equity support.<sup>600</sup>
- 7.73 KPMG, on behalf of SONI, added that there would still be a need for an equity buffer for managing these activities. This was because the activity would not be perceived by the market to be risk-free, even if it were to be government guaranteed. Implicitly or explicitly, there was a risk, which KPMG compared to a triple A tranche of a securitisation.<sup>601</sup>

- *SONI's comments on collection agent risk in response to our provisional determination*

- 7.74 SONI welcomed our provisional determination that the UR was wrong not to recognise fully the risks faced by SONI acting as a collection agent.<sup>602</sup> SONI reiterated that it had in the past experienced periods of significant cost volatility and consequent under-recovery approaching double digit millions, which it noted was equivalent to the size of its RAB.<sup>603</sup>

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<sup>599</sup> SONI Hearing transcript, page 113, line 21 to page 114, line 2.

<sup>600</sup> SONI Hearing transcript, page 114, lines 7–13.

<sup>601</sup> SONI Hearing transcript, page 114, lines 19–24.

<sup>602</sup> SONI response to CMA provisional determination, paragraph 6.34.

<sup>603</sup> SONI response to CMA provisional determination, paragraph 6.35.

- 7.75 SONI told us that collection agent risks were expected to increase both in terms of absolute scale and of volatility following the implementation of I-SEM. SONI therefore considered it was imperative that it was properly remunerated to allow it to procure an increased facility to deal with these risks. In SONI's view, without an increased facility not only could the new wholesale market arrangements not function but also the wider SONI business could not access capital markets.<sup>604</sup>
- 7.76 SONI told us that there were three elements of cost in providing this collection agent service:<sup>605</sup>
- (a) First, there were direct costs associated with handling collection agent shortfalls. As well as the operational costs of providing the service, there was: the cost of putting a facility in place (an arrangement fee paid to the bank) plus the transaction costs to SONI (advisor fees, due diligence, etc); a commitment fee payable to the bank for the facility being in place but undrawn; and finally, the interest costs which arose if the facility was drawn upon.
  - (b) Second, there would also be a need for an equity buffer for managing these activities. This was because the activity would not be perceived by the market to be risk-free, even if it were to be government guaranteed. In addition, revolving capital facilities implicitly required some element of equity backing in order to make them available.
  - (c) Third, such facilities impacted SONI's overall financing position since they affected the overall gearing of the business. As a result, there was a consequential impact on the costs of financing the business as a whole.
- 7.77 SONI stated that performing this role also entailed taking on multilateral exposure to different parties. Remuneration of only the direct costs of the facility as proposed by the UR, and not also remunerating the risks associated with these activities, SONI submitted, would therefore significantly underestimate the true cost to SONI.<sup>606</sup> SONI said that we were therefore correct to consider that such an approach did not fully remunerate SONI for the risks it faced.<sup>607</sup>
- 7.78 SONI submitted that the use of a margin to remunerate SONI for this activity was the only practical solution that would secure SONI's financeability and

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<sup>604</sup> SONI response to CMA provisional determination, paragraph 6.36.

<sup>605</sup> SONI response to CMA provisional determination, paragraph 6.38.

<sup>606</sup> SONI response to CMA provisional determination, paragraph 6.39.

<sup>607</sup> SONI response to CMA provisional determination, paragraph 6.41.

allow it to access the debt markets. SONI agreed with our provisional determination that the UR could not have assumed that an uplift to the WACC would reliably address revenue collection activity risks, as these risks bore no relationship to the size of SONI's investment in tangible fixed assets ie its RAB. Such an approach to remuneration, SONI submitted, would be compounded by the unpredictable variability and saw-tooth nature of its RAB.<sup>608</sup>

- 7.79 SONI told us that consumer interests were also best served by a margin approach. This was because such an approach put the onus on SONI to deliver the service as efficiently as possible. SONI agreed with our provisional view that while a margins-based approach to remuneration was not a standard regulatory model, the activities in question were not standard regulated activities.<sup>609</sup>
- 7.80 SONI submitted that the remuneration of the PCG was not intended to address the remuneration of risks associated with the TSO collection agent function. SONI noted that, notwithstanding a PCG being in place, SONI's bankers also required a cross-guarantee from EirGrid for the associated credit facilities. SONI submitted that its bankers would not have insisted on a cross-guarantee had they regarded the PCG as somehow supporting SONI's collection agent function to a significant extent.<sup>610</sup>
- 7.81 SONI also submitted that, in any case, it would not be right to view remuneration for contingent capital such as the PCG as a reward for capital already employed in the business supporting a current activity such as collecting revenues. Rather, any allowance for the PCG was remuneration for an additional claim of capital that had been pledged. For both these reasons, the overlap between remuneration of the PCG and remuneration of the collection agent function was, in its view, minimal.<sup>611</sup>

*Adjusting the parameters of the existing price control framework would not fix the problem*

- 7.82 In its expert report, KPMG submitted that, given SONI's asset-light nature and the scale of operational gearing, the attempt by the UR to put a RAB/WACC model on a business like SONI was not a matter of a small change around some variations of the same regulatory mechanism. KPMG

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<sup>608</sup> SONI response to CMA provisional determination, paragraph 6.42.

<sup>609</sup> SONI response to CMA provisional determination, paragraph 6.42.

<sup>610</sup> Remedies Hearing transcript, page 48, lines 16–24.

<sup>611</sup> Remedies Hearing transcript, page 48 line 25 to page 49 line 9.

illustrated this by reference to a comparison of a variety of ratios for SONI and traditional utilities. KPMG stated that the UR had made the fundamental error of using a wrong regulatory approach and a wrong solution, given the nature of SONI's business.<sup>612</sup>

7.83 KPMG stated that adjusting the WACC applied to the RAB would not address these problems with the RAB/WACC model. As the RAB would not capture all the different types of capital employed in the business, the WACC that would generate sufficient revenues would be very high. In addition, it would be very difficult to estimate the level of the WACC given SONI's very thin asset base.<sup>613</sup>

7.84 KPMG said that while there might be an appearance that one could adjust the WACC to numerically generate the same level of revenues for a given year, the dynamics over time would be fundamentally different. Short asset lives and a very volatile RAB would result in very volatile revenue for SONI with a very high WACC.<sup>614</sup> Furthermore, such an approach would not address the incentive that SONI would have to invest rather than carry out operational activities.<sup>615</sup>

7.85 SONI said that the scale of its responsibilities, including managing reputational risk, governance risk and its fiduciary duties, was constant. The WACC, however, delivered a return that was variable. So, whilst a very high WACC, on the face of it, was attractive, this had to be seen in the context of the RAB to which it was applied.<sup>616</sup> As a consequence, SONI had not been able to persuade banks to provide finance.

- *SONI's comments on adjusting parameters in response to our provisional determination*

7.86 SONI noted that in our provisional determination we had reflected on whether the uplift to beta within the UR's WACC calculation could have been considered by the UR to have provided an element of remuneration for collection agent and asymmetric risk.<sup>617</sup> SONI endorsed our provisional conclusion that the uplift to beta did not remunerate those risks and provided what it viewed as supporting evidence for this view as follows:<sup>618</sup>

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<sup>612</sup> SONI Hearing transcript, page 126, lines 7–13.

<sup>613</sup> SONI Hearing transcript, page 126, line 24 to page 127, line 2.

<sup>614</sup> SONI Hearing transcript, page 127, lines 3–7.

<sup>615</sup> SONI Hearing transcript, page 127, lines 24–25.

<sup>616</sup> SONI Hearing transcript, page 135, lines 2–7.

<sup>617</sup> SONI response to CMA provisional determination, paragraph 6.46.

<sup>618</sup> SONI response to CMA provisional determination, paragraph 6.47.

- (a) First, there was no evidence that the UR had uplifted the beta specifically in recognition of these considerations:
- (i) In its [Final Determination](#), the UR had been explicit at paragraph 279 and then paragraph 283 that it *had not* adjusted returns to reflect risks associated with revenues collected on behalf of industry participants.<sup>619</sup>
  - (ii) SONI submitted that the UR's own analysis indicated that its uplift to beta only considered BAU costs, and could therefore not be seen to remunerate the risks of activities whose costs had not been included within that analysis.<sup>620</sup>
- (b) Second, an uplift to the beta (and therefore the WACC applied to SONI's RAB) could not remunerate SONI for asymmetric risk and custodian activities. This was because a RAB/WACC approach only remunerated SONI for those activities which were supported by its RAB ie its BAU activities. By definition, this approach would not remunerate any capital committed to the business other than the RAB or activities unrelated to the RAB.<sup>621</sup>
- (c) Third, SONI, concurring with our provisional view, noted that the increase to the WACC to a level higher than that for other regulated companies was merely reflective of an adjustment to reflect SONI's high operational gearing – which, owing to its unusual characteristics as an asset-light TSO, was of an order of magnitude greater than that of NIE (the example cited by the UR).<sup>622</sup>

7.87 SONI, submitted that there was a very clear justification for a 0.6 (or even higher) beta for SONI in respect of its activities. High operational gearing had financial implications for SONI in terms of both financial and liquidity management. The impact of a downside shock on SONI – with its small RAB relative to operating costs – was disproportionately higher than for a company with a large RAB relative to its costs.<sup>623</sup>

7.88 SONI also noted that the assumption that revenue collection activities could be remunerated through a RAB/WACC approach could lead to absurd

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<sup>619</sup> SONI response to CMA provisional determination, paragraph 6.48. Note that the relevant paragraphs quoted in the [Final Determination](#) relate to a discussion of what the UR characterised as SONI's ongoing working capital requirements. (The UR made a distinction between ongoing working capital requirements and contingent capital arrangements, including contingent working capital arrangements.)

<sup>620</sup> SONI response to CMA provisional determination, paragraph 6.49.

<sup>621</sup> SONI response to CMA provisional determination, paragraph 6.51.

<sup>622</sup> SONI response to CMA provisional determination, paragraph 6.53.

<sup>623</sup> SONI response to CMA provisional determination, paragraph 6.54.

conclusions as the level of RAB and investments in the RAB were not correlated to the risks inherent in the increasing and volatile revenues collected on behalf of industry participants.<sup>624</sup>

### *Asymmetric risk*

- 7.89 KPMG, on behalf of SONI, submitted that SONI faced downside risk, an asymmetric risk, for which SONI was not being remunerated. It said that the financial flows relating to this risk were very large for SONI.<sup>625</sup> The UR had set a price control which sought to remunerate SONI by means of its cost of capital determined under the principles of the CAPM model. The CAPM, however, had been designed primarily to remunerate risks that were both systematic and symmetrical in terms of the distribution of expected returns,<sup>626</sup> whereas SONI's expected returns in relation to PCNPs and spend on special projects such as for the I-SEM were not symmetrical.
- 7.90 KPMG said that it may be the case that other asset-heavy regulated utilities face this risk, but that the size of the risk would be small relative to the overall cash flows of those businesses. In the case of SONI, there was a very large downside risk exposure, disproportionate to the amount of liquidity buffer.<sup>627</sup>
- 7.91 KPMG quantified in its report the impact of the asymmetry on SONI.<sup>628</sup> In KPMG's view, based on its estimation of the exposure of SONI to disallowance risk on PCNPs and special projects, SONI's returns on capital employed (ROCEs) fell outside of ranges for return on regulatory capital that had been assumed by other UK regulators.<sup>629</sup>
- 7.92 In response to our requests for clarification in the hearing with SONI, KPMG stated that there were several ways one could deal with this asymmetric risk including:
- (a) Estimate the downside exposure, especially if the risk was particularly asymmetric, and apply a premium for bearing that downside risk. In KPMG's view, that was possibly the simplest and a scientific approach and was used in construction projects.

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<sup>624</sup> SONI response to CMA provisional determination, paragraph 6.52.

<sup>625</sup> SONI Hearing transcript, page 119, lines 9–18.

<sup>626</sup> SONI Hearing transcript, page 119, lines 1–5.

<sup>627</sup> SONI Hearing transcript, page 119, lines 9–18.

<sup>628</sup> NoA, Joint Witness Statement of Dr Maciej Firla-Cuchra and Michael Smart (NoA MC2), supporting document MC2/1 (KPMG 3).

<sup>629</sup> SONI Hearing transcript, page 131, line 20 to page 132, line 4.



(b) Apply a margin. In KPMG's view, this approach was less scientific, but might be easier to apply, was more in line with market practice, and was more appropriate for SONI.<sup>630</sup>

(c) An alternative approach whereby a standard WACC approach is applied to the activities that carry predictable and symmetrical risks and then price other specific, asymmetric, risks separately.<sup>631</sup>

7.93 KPMG explained that one way to remunerate the downside/asymmetric exposure set out in paragraph 7.92(a) would be to apply a premium to the cost of capital to compensate for the fact that SONI's allowed cash flows are not its mean-expected cash flows.<sup>632</sup> That premium would depend on the assumption made about the level of risk exposure.<sup>633</sup>

7.94 KPMG also explained that where a business faced many different risks and some of those risks were hard to estimate, then the margins approach as set out in paragraph 7.92(b) held an advantage over an alternative approach which combined a RAB/WACC component with separate allowances for other risks set in in paragraph 7.92(c). In KPMG's view, the margins approach was able to effectively benchmark the business as a whole rather than trying to estimate each of those risks individually. The alternative approach would probably be harder to apply and the norm for an asset-light business would be to remunerate it on a margins basis.<sup>634</sup>

- *SONI's comments on asymmetric risk in response to our provisional determination*

7.95 SONI agreed with our provisional determination that the UR was wrong to conclude that SONI did not face asymmetric risk in respect of PCNPs and other investments subject to the D<sub>t</sub> mechanism. SONI noted that without a credible risk of disallowance, there was no incentive for the company to act efficiently.<sup>635</sup>

7.96 Furthermore, SONI submitted, the UR had argued that these costs could not be pass-through in nature since it was in consumers' interests that regulatory scrutiny was applied ex-post and its right to disallow costs was retained. The UR, however, had subsequently tried to present a view that in

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<sup>630</sup> SONI Hearing transcript, page 119, lines 19–26.

<sup>631</sup> SONI Hearing transcript, page 120, lines 17–19.

<sup>632</sup> In NoA MC2, supporting document MC2/1 (KPMG 3), KPMG had estimated the gap between the mean expected cash flows and the assumptions reflected in the UR's price control model.

<sup>633</sup> SONI Hearing transcript, page 120, lines 5–9.

<sup>634</sup> SONI Hearing transcript, page 120, lines 20–26.

<sup>635</sup> SONI response to CMA provisional determination, paragraph 6.21.

reality there was no real risk attached to PCNP and D<sub>t</sub> project spend. SONI said that these two views were mutually exclusive. In SONI's view, we therefore were correct to state that unless the UR was saying that SONI would always be allowed to recover its investments, the framework must as a matter of principle be asymmetric.<sup>636</sup>

7.97 SONI submitted that these projects could not be termed 'zero risk' as the UR scrutinised such project spend both ex-ante and ex-post as well as under the DIWE mechanism.<sup>637</sup>

7.98 In the remedies hearing, SONI agreed with the UR that obvious profligacy should be disallowed under DIWE. SONI said that there would, however, be 'grey areas' that did not neatly fall into DIWE where SONI would face asymmetric risk. This situation resulted from the following three factors:

(a) First, there was the risk that costs would be different to forecasts. This could be due to 'a myriad of reasons', many of which might not be fully in SONI's control.

(b) Second, the information SONI would be able to put forward to the UR might be incomplete since it would not always be straightforward to prove that costs were efficient and necessary, rather than just offering better value for customers.

(c) Third, the actual amounts allowed would be down to regulatory discretion and judgment, which given the documentation that SONI would be able to provide, might be extremely subjective.<sup>638</sup>

7.99 SONI also submitted in its response to our provisional determination that the asymmetric risk to which SONI was exposed had a serious effect on SONI's financeability. It therefore agreed with our observation that, given its current RAB was below £10 million, a small disallowance would have a material effect on its profitability. SONI submitted that this asymmetric risk had been noted by financiers and was a key reason why SONI could not currently access debt markets.<sup>639</sup>

7.100 SONI agreed with us that the mechanism for remunerating it for taking on asymmetric risk should reflect the principle of a "fair bet".<sup>640</sup> SONI submitted that incentives for it to deliver efficiently and reasonable rewards for doing so

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<sup>636</sup> SONI response to CMA provisional determination, paragraph 6.24.

<sup>637</sup> SONI response to CMA provisional determination, paragraph 6.31.

<sup>638</sup> Remedies Hearing transcript, page 157 line 22 to page 158 line 16.

<sup>639</sup> SONI response to CMA provisional determination, paragraph 6.26.

<sup>640</sup> SONI response to CMA provisional determination, paragraph 6.28.

were, in its view, in consumers' interests. It said that the UR must be in a position to act on behalf of consumers where it considered that SONI had not delivered efficiently.<sup>641</sup>

- 7.101 SONI emphasised that when considering the risk/reward balance, we should recognise that the premium on such expenditure needed to compensate SONI both for its mean expected loss and for it taking on the risk in the first place.<sup>642</sup> SONI also agreed with our view expressed in our provisional determination that, although it would be possible to reflect an arithmetically equivalent uplift in the WACC, such an approach would be less transparent and not consistent with core principles of CAPM.<sup>643</sup>

*Comparison with CER approach to regulating a similar company to SONI*

- 7.102 In its NoA, SONI explained that it had highlighted the approach adopted by the CER to remunerating EirGrid.<sup>644</sup>
- 7.103 In its hearing, SONI explained that EirGrid business fulfilled almost exactly the same set of functions in the RoI as the SONI business did in NI. The CER's approach to setting EirGrid's price control had provided for a financeable business.<sup>645</sup> Consequently, EirGrid was one of the best comparators in terms of the regulatory treatment for the SONI business.<sup>646</sup>
- 7.104 SONI provided a high-level summary of the approach the CER had adopted in its hearing and followed this up with a detailed submission explaining the various elements of EirGrid's price control along with supporting CER documentation.<sup>647</sup> We summarise the approach taken by the CER based on the information provided in Table 7.1 below.

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<sup>641</sup> SONI response to CMA provisional determination, paragraph 6.29.

<sup>642</sup> SONI response to CMA provisional determination, paragraph 6.30.

<sup>643</sup> SONI response to CMA provisional determination, paragraph 6.32.

<sup>644</sup> NoA BT1, paragraphs 93–94 & 110.

<sup>645</sup> SONI Hearing transcript, page 124, lines 25–26.

<sup>646</sup> SONI Hearing transcript, page 121, lines 9–11.

<sup>647</sup> SONI Hearing follow-up written response of 21 July 2017, CER Margin Calculation.

**Table 7.1: The CER’s approach to remunerating EirGrid for its RoI TSO activities over the Price Control Period**

<i>Activities remunerated</i>	<i>CER’s approach to remuneration</i>	<i>CER’s quantification</i>
1. TSO activities	WACC/RAB on physical assets on the balance sheet of, and depreciated by EirGrid.  (According to SONI, these assets are similar to the ‘saw-tooth’ short life assets that it possesses).	WACC of 4.95%, the same cost of capital applied to ESB’s RoI network transmission business
2. Network planning projects	A return on a ‘side-RAB’ for ‘Stage 1 expenditure’.  (Equivalent for SONI is its spend on PCNPs).	A WACC of 4.95% applied to the indexed cost of the project up to the point of its ‘sale’ to ESB, the transmission asset owner.
3. Managing working capital requirements associated with volatile costs arising from TSO and MO activities, ie system services and dispatch balancing.  (CER refers to this as the TSO managing ‘income variation’.)  <i>remunerated from 2001</i>	A working capital allowance: <b>profit margin</b> element to remunerate: <ul style="list-style-type: none"> <li>• financing costs until such time as EirGrid can raise its tariff.</li> <li>• the risk of a failure by suppliers to pay their TUoS charges, resulting in a shortfall between receipts and payments.</li> </ul> <p>The CER decided to allow the TSO an equity rate of return on the capital employed to ensure that it:</p> <ul style="list-style-type: none"> <li>• maintained sufficient liquidity to meet its financial obligations</li> <li>• was compensated for the opportunity cost of working capital</li> </ul>	The CER considered that EirGrid would require capital employed to cover the risk of its external costs being 20% higher than allowed for in any given year and that this balance should earn a real WACC return.  SONI noted that this could equally be expressed as being equivalent to a margin of 1% on the external costs as the WACC is just under 5%.
4(a). Collection agent role on behalf of other operators in value chain such as for ESB  <i>remunerated from 2011</i>	A working capital allowance: <b>turnover margin</b> element to remunerate the same risks as above but in relation to other charges that the TSO collected.  A margin on the transmission revenues that EirGrid collects on behalf of ESB and the East/West Interconnector (equivalents for SONI would be NIE and the Moyle Interconnector respectively)	0.5% of total transmission revenues (TUoS) considered a reasonable basis for an additional provision of working capital; 0.25% had already been taken account of in 3 above, leaving a net 0.25%.
4(b). An element of the higher operational leverage on EirGrid’s TSO activities  <i>adjustment from 2016</i>	CER decided to adjust 4(a) above to account for inconsistencies in its calculation of operational leverage at the consultation stage.	CER increased the working capital allowance turnover margin element of 0.25% (ie 4(a) above) by 0.25% to correct this.

Source: CMA analysis of SONI Hearing transcript, pages 121–122; SONI Hearing follow-up written response of 21 July 2017, CER Margin Calculation, including Annexes; and [Decision on TSO and TAO Transmission Revenue for 2016 to 2020, CER](#), 23 December 2015, page 13.

7.105 SONI noted that the CER, as part of the process of setting EirGrid’s TSO price control, had employed Europe Economics to review the existing arrangements. Europe Economics had reviewed the CER’s existing approach as described in Table 7.1 above and compared it with an approach of simply adjusting the WACC. Europe Economics had sought to ascertain

what adjustment to the WACC would be necessary to ensure that EirGrid's business would be financeable. Based on its analysis, Europe Economics concluded that achieving this through adjusting the WACC alone was not credible. Europe Economics concluded that the CER's existing approach, recalibrated for the increased risks in 2016 to 2020, remained the correct approach.<sup>648</sup>

### ***UR's views***

7.106 In response to SONI's appeal on Ground 1 in general, and with particular relevance to Error 1(a), the UR stated that it had followed a 'tried and tested' approach to financeability. The UR submitted that SONI had failed to demonstrate that its approach was 'wrong' and that its appeal concentrated unduly on how an alternative approach could have been used.

7.107 The UR did not dispute that SONI, as an independent TSO, was relatively 'asset-light' and had higher operational gearing than other regulated companies.

### ***The UR's overall approach***

7.108 The UR rejected SONI's characterisation of the approach it had taken as 'simple' or 'traditional'.<sup>649</sup> In the UR's view, a more accurate characterisation of its approach was set out in the [Final Determination](#) (see paragraphs 7.10 to 7.28 above).<sup>650</sup> The UR submitted that a price control framework that sought to identify and then reward financial capital as it had done was capable of securing SONI's financeability.<sup>651</sup>

7.109 The UR submitted that the value of SONI's RAB – an objective and transparent measure of SONI's past and future investment – had not been the *only* item that it had considered. It had set out other items in the [Final Determination](#).<sup>652</sup> The UR recapped its approach to assessing SONI's financial capital which we have set out in Table 7.2 below:

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<sup>648</sup> SONI Hearing transcript, page 122, line 17 to page 123, line 5.

<sup>649</sup> [Defence](#), paragraph 1.24 (quoting [NoA](#), paragraphs 18.14–18.15).

<sup>650</sup> [Defence](#), paragraph 1.24.

<sup>651</sup> [Defence](#), paragraph 1.26.

<sup>652</sup> [Defence](#), paragraph 1.25.

**Table 7.2: The approach adopted by the UR to reward SONI's financial capital requirements over the 2015-2020 Price Control Period**

<i>UR's typography</i>	<i>Item within price control</i>	<i>Description of item</i>	<i>UR's approach to remuneration</i>
Baseline investment	Investment in tangible fixed assets	Historical and prospective investment by SONI in assets such as IT and facilities ie SONI's RAB.	Apply an estimate of the opportunity cost of capital ie WACC of 5.9% per annum.
	Bank facility ie contingent working capital	SONI must maintain access to additional capital to manage mismatches in the timings of certain payments and receipts it is responsible for as TSO. SONI has historically elected to use a £12 million bank facility for that purpose. This facility was underpinned by a letter of comfort from the UR.*	Reimburse within the opex allowance the current fee for this facility, namely 90 basis points (or £108,000) per annum.
	Parent company support ie contingent capital	There is a licence requirement that EirGrid undertakes to provide the financial support needed to ensure that SONI may meet its obligations. This requirement is fulfilled by an EirGrid Parent Company Guarantee (PCG) to provide support for SONI in future up to the amount of £10 million.	Acknowledge that the PCG given by EirGrid had a cost, but not include within cost base for SONI's price control on the grounds that this cost had been recognised in full in the separate SEMO price control.  Assume that a) the PCG allowance within the SEMO price control provided remuneration for SONI's TSO risks <i>as well as</i> SEMO's risks.† b) The risks that the two licensees (SEMO and SONI as TSO) faced were inextricably linked,‡ and c) that SEMO faced limited risks.
Additional capital calls	Additional investment	A series of additional investments, whose precise costs were not known at the time of setting of the price control (February 2016).	Provide for a D <sub>t</sub> adjustment process, in which allowances for such expenditure would be made on a case-by-case basis and in which the costs of financing [= remuneration] would be capitalised into SONI's RAB at the prevailing WACC.
	Additional short-term working capital	When, as system operator, SONI must unexpectedly make payments ahead of receipts, it may under-recover against its regulated revenue entitlement, resulting in a shortfall in funds.	Recognise the cash amounts that SONI needs to finance in the K-factor adjustment to the following year's tariffs, which for regulatory purposes would attract an interest rate of LIBOR plus 2%.

Source: CMA's summary of the [Defence](#), paragraphs 1.8–1.10 and UR response to CMA provisional determination.

\* UR response to CMA provisional determination, paragraph 1.67(a).

† UR response to CMA provisional determination, paragraph 1.51.

‡ UR response to CMA provisional determination, paragraph 1.46.

7.110 The UR submitted that the CMA had deployed an identical line of thinking in its [Energy Market Investigation](#), and had concluded that a ROCE approach was appropriate.

7.111 The UR submitted that it did not consider that there was anything peculiar about SONI that meant that it would not be possible in practice to estimate

either the financial capital that the business required or the cost of that capital.<sup>653</sup>

- 7.112 The UR reiterated its view from the [Final Determination](#) that SONI's financeability was 'tied inextricably' to the return on capital; so long as the allowed rate of return was sufficient to cover the marginal cost of financing investment via equity capital, and provided that the UR also covered the cost of committed contingent bank and equity facilities, then SONI should be capable of attracting and maintaining the medium- to long-term capital that it required for its activities.<sup>654</sup>
- 7.113 The UR stated that it had taken account of the possibility that SONI might in future choose to finance some of its investment with debt. The cost of capital calculation had been based on a 45:55 equity:debt capital structure. The UR noted that this geared structure, somewhat counter-intuitively, gave rise to a higher overall cost of capital, perhaps due to the relatively high cost of debt that it (the UR) had assumed.<sup>655</sup>
- 7.114 The UR continued that the 5.9% allowed rate of return it had set sat 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%).<sup>656</sup>
- 7.115 The UR said that it had taken considerable comfort from the read-across between this cost of equity calculation and the CMA's equivalent calculation<sup>657</sup> in its [Energy Market Investigation](#).<sup>658</sup> The UR noted that its 5.9% was positioned logically next to the CMA's estimate of the cost of capital for GB energy retail companies.<sup>659</sup> In the UR's view, the risks faced by SONI were no greater than the risks faced by the GB energy retail businesses. As a result, SONI's allowed return was in line with the CMA's assessment of the cost of capital (which the UR had calculated to be 4.75% to 6.75% on a like-for-like basis with SONI ie a post-corporation tax real

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<sup>653</sup> [Defence](#), paragraph 1.30.

<sup>654</sup> [Defence](#), paragraph 1.54.

<sup>655</sup> [Defence](#), paragraph 1.14.

<sup>656</sup> [Defence](#), paragraph 1.55.

<sup>657</sup> CMA Energy Market Investigation, Final Report, [Appendix 9.12: Cost of capital](#), 24 June 2016.

<sup>658</sup> [Defence](#), paragraph 1.17.

<sup>659</sup> [Defence](#), paragraph 1.55.

return).<sup>660</sup> The UR submitted that this provided confidence in SONI as an attractive equity proposition.<sup>661</sup>

7.116 The UR stated that its 5.9% allowed rate of return ought to be capable of supporting a range of equity:debt mixes, including a 100:0 wholly equity-financed capital base.<sup>662</sup>

7.117 The UR also noted that, insofar as SONI was 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.<sup>663</sup>

*Response to SONI's case that the UR had not adequately taken into account the characteristics of SONI and the risks faced by SONI*

7.118 The UR submitted as context that, as SONI had failed to clear its first hurdle and demonstrate that the UR's approach to the Price Control had been 'wrong', it was in consequence strictly unnecessary for the UR to offer observations on SONI's preferred alternative of a profit allowance set in line with margin benchmarking. Nevertheless, the UR made the following points.<sup>664</sup>

7.119 The UR rejected the idea that expected profit should vary in proportion to the size of SONI's expenditures rather than investor capital, and considered it conceptually unsound.<sup>665</sup> The UR illustrated this with an example of two firms operating in different markets but which had the same annual expenditures. If the former firm only required a small level of financial capital whereas the latter firm required a much larger amount, then that did not mean that both firms should expect to earn the same level of revenues and profits. The latter firm would need to generate additional revenues/profits to service its investor capital.<sup>666</sup>

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<sup>660</sup> The UR converted the CMA's range for the pre-tax nominal cost of capital for GB energy retailers as set out in Appendix 9.12, Table 1, of 9.3% to 11.5% to 4.75% to 6.75% 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% (see CMA Energy Market Investigation, Final Report, [Appendix 9.12: Cost of capital](#), Table 1, 24 June 2016.).

<sup>661</sup> [Defence](#), paragraph 1.17.

<sup>662</sup> [Defence](#), paragraph 1.60.

<sup>663</sup> [Defence](#), paragraph 1.55.

<sup>664</sup> [Defence](#), paragraph 1.42.

<sup>665</sup> [Defence](#), paragraph 1.43.

<sup>666</sup> [Defence](#), paragraph 1.44.



- 7.120 Second, the UR criticised the approach SONI’s advisors, KPMG,<sup>667</sup> had taken to identifying a benchmark margin as follows:
- (a) the firms selected did not undertake similar activities to SONI;
  - (b) no attempt had been made to control for variations in the amounts of investor capital across potential comparators; and
  - (c) the benchmarking exercise suffered from numerous issues of selectivity and bias.<sup>668</sup>
- 7.121 Taken together, in the UR’s view the level of margin arrived at by KPMG of 10–14% of turnover had been too approximate and too imprecise for a regulator such as it to rely on when setting a price control.<sup>669</sup>
- 7.122 Third, the UR stated that one of SONI’s experts, Dr Lilico,<sup>670</sup> had noted in his expert report that a margin-based approach to price control settings had a number of drawbacks. The UR stated that this demonstrated that, as yet, there was no consensus regarding how to set the correct margin, 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 would be infeasible or disproportionate to adopt a more robust, theoretically driven approach.<sup>671</sup>
- 7.123 Fourth, and as set out in the [Final Determination](#) – see paragraphs 7.27 and 7.28 above – the UR had set out its position on this matter very clearly.<sup>672</sup> The UR therefore rejected SONI’s submission that its consideration of SONI’s proposed margins-based approach to setting the Price Control had been ‘cursory’.<sup>673</sup>

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<sup>667</sup> NoA MC1, supporting document MC1/2 (KPMG 2).

<sup>668</sup> [Defence](#), paragraph 1.45.

<sup>669</sup> [Defence](#), paragraph 1.46.

<sup>670</sup> NoA AL1, paragraphs 8.17–8.18.

<sup>671</sup> [Defence](#), paragraph 1.48.

<sup>672</sup> [Defence](#), paragraph 1.50.

<sup>673</sup> [Defence](#), paragraph 1.51.

*Comments made by the UR in response to our provisional determination*

- *The UR's complaint that our provisional determination had been the first occasion of stating clearly the basis on which its decision had been challenged*

- 7.124 The UR submitted that it was unsatisfactory that the first occasion on which the UR had seen a clear statement of the case against which it had been assessed had been in our provisional determination itself.<sup>674</sup> Whereas SONI had pleaded its case in the form of three specific errors, we had, in contrast, elected to consider Ground 1 'broadly', taking an 'overarching view', on an 'in the round' basis. As a result, we had, in effect, reconstituted SONI's claim by placing it on a different footing to that actually advanced by SONI.<sup>675</sup>
- 7.125 Moreover, the UR submitted, we had done so after having found the case advanced by SONI to be wanting. For example, although we had considered that SONI had not shown the UR to have been wrong to have used the RAB/WACC approach (Error 1(a)) as an important building block of its overall approach to setting SONI's price control and that SONI had not shown that the UR had failed to conduct a complete financeability assessment (Error 1(c)), we, nevertheless, had provisionally determined the UR to have been wrong on all three errors within Ground 1.<sup>676</sup>
- 7.126 A further striking example of us reconstituting SONI's case, the UR continued, had involved us reaching conclusions on matters relating to formula terms in the price control (eg the  $CAIR_t$  and  $A_t$  terms) that were plainly not within the scope of appeal under the NoA.<sup>677</sup> (See paragraph 7.130 below for more detail of the UR's submission on this point.)
- 7.127 The UR submitted that in a statutory appeal process, it was a matter of basic procedural fairness that the Defendant was entitled to know the case to which it was required to respond. Under our Appeal Rules, the UR continued, it had had only a single opportunity to make formal written submissions in the appeal. Were the grounds of appeal as presented by the Appellant (SONI) not to be those on which the appeal was now being determined, then it would be effectively deprived of an opportunity to make written submissions in response to the claim now being made against it.<sup>678</sup>

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<sup>674</sup> UR response to CMA provisional determination, paragraph 1.13.

<sup>675</sup> UR response to CMA provisional determination, paragraph 1.10.

<sup>676</sup> UR response to CMA provisional determination, paragraph 1.11.

<sup>677</sup> UR response to CMA provisional determination, paragraph 1.13.

<sup>678</sup> UR response to CMA provisional determination, paragraph 1.9(b).

Nonetheless, the UR went on to make comments on the substance of our provisional determination, as summarised below.

- *The UR's comments on how SONI's lower systematic risk interrelated with its high operational gearing*

7.128 The UR said that the price control it had set reflected limited cost benchmarking, lacked strong output incentives for SONI and made extensive use of mechanisms to deal with uncertainty. The UR argued that this meant SONI faced lower systematic risk than English water companies and NIE, and hence the asset beta of 0.6 it had used when setting SONI's cost of capital appropriately reflected the risk that SONI bore due to the relatively small size of its RAB relative to its controllable costs.<sup>679,680</sup>

7.129 The UR also noted that the real risk-free rate (1.25%) and expected market return (6.5%) used in its calculation of SONI's WACC was well above the values that Ofwat and Ofgem had said should be used in a CAPM calculation. The UR considered that to be a relevant consideration in any assessment of whether the return that SONI would earn in the 2015-20 under its price control settlement was wrong or not wrong.<sup>681</sup>

- *The UR's comments on remunerating SONI's collection agent function*

7.130 The UR told us that it had been surprised that in our provisional determination we had chosen to address the treatment of SONI's 'collection agent' functions. The UR submitted that there had been no indication in the [NoA](#) that SONI had been appealing against the UR's methods of addressing the uncertainties that there were around the CAIR<sub>t</sub> (Moyle Interconnector revenues) and A<sub>t</sub> terms (revenues for, amongst other things, generator ancillary charges) in SONI's price control formula, or the UR's treatment of DBCs within the Price Control.<sup>682</sup>

7.131 In response to our provisional determination to recognise, and therefore remunerate, SONI's collection agent function, the UR acknowledged that SONI had a short-term cash flow risk to manage. However, the UR submitted that there was no material risk of SONI losing its financial

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<sup>679</sup> Within the Price Control, 'controllable costs' are those TSO operational costs which the UR is responsible for determining. Most notably they exclude ancillary charges and the revenues SONI is responsible for collecting and then passing onto NIE and the Moyle Interconnector.

<sup>680</sup> UR response to CMA provisional determination, paragraph 1.5.

<sup>681</sup> UR response to CMA provisional determination, paragraph 1.4, footnote 3.

<sup>682</sup> UR response to CMA provisional determination, paragraph 1.55.

capital.<sup>683</sup> The UR further observed that, as SONI had no predictable day-to-day requirement for working capital,<sup>684</sup> our assessment should only be concerned with SONI's access to contingent capital in the event that costs and revenues differed from SONI's own forecast.<sup>685</sup>

7.132 In relation to TAO transmission charges, the single biggest component of 'collection agent' revenues, the UR acknowledged that there was the potential for a small mismatch between payments made and payments received (eg if volumes turn out to be lower than expected). However, in the UR's view, the scale of this risk should not be overstated for the following reasons:<sup>686</sup>

- (a) SONI was responsible for predicting energy consumption volumes and these volumes were neither that volatile nor difficult to predict.
- (b) Should any firm from whom SONI collects monies become insolvent, there was a provision in SONI's licence to permit SONI to roll over such monies into the following year's tariffs. As a consequence, SONI was not exposed to any customer credit risk.
- (c) The UR already remunerated any under-recoveries arising due to (a) or (b) through an appropriate rate of interest, namely the LIBOR plus 2% rate of interest attached to the K-factor term in the Price Control.

7.133 In summary, in the UR's view, the short-term cash flow risks were appropriately remunerated and it was unlikely that SONI could suffer a permanent loss of capital.<sup>687</sup>

7.134 The UR told us that SONI did not collect DBCs at all – the SEMO JV collected the forecast level of charges instead.<sup>688</sup> The UR said that it had made provision within the price control to remunerate SONI for the fact that it, rather than SEMO JV, was responsible for financing any unexpected shortfall in costs collected through SEMO JV charges.<sup>689</sup> The UR emphasised that, through a combination of the D<sub>t</sub> claim mechanism available for any un-remunerated intra-year SEMO JV working capital requirements<sup>690</sup> and interest on tariff year-end timing mismatches being awarded at LIBOR

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<sup>683</sup> UR response to CMA provisional determination, paragraph 1.56.

<sup>684</sup> UR response to CMA provisional determination, paragraph 1.57.

<sup>685</sup> UR response to CMA provisional determination, paragraph 1.59.

<sup>686</sup> UR response to CMA provisional determination, paragraph 1.64.

<sup>687</sup> UR response to CMA provisional determination, paragraph 1.65.

<sup>688</sup> UR response to CMA provisional determination, paragraph 1.67.

<sup>689</sup> UR response to CMA provisional determination, paragraph 1.67. That position is summarised in Table 7.2 under 'Bank facility ie contingent working capital' and 'Additional short-term working capital'.

<sup>690</sup> UR response to CMA provisional determination, paragraph 1.131.

plus 2%, SONI had a means to recover fully any unremunerated DBC shortfalls.<sup>691</sup> The UR therefore saw no error in how it had remunerated SONI for its financing costs.<sup>692</sup>

- 7.135 The UR questioned the principle of remunerating SONI for its collection agent function in relation to certain items,<sup>693</sup> most notably ancillary charges, the price control for which was determined by the SEMC. Remunerating the collection agent function would lead to there being an imbalance in the approach to remuneration between that applying in NI and that applying in Rol. That would leave NI consumers worse off and EirGrid with additional profit.<sup>694</sup>
- 7.136 In the remedies hearing, the UR clarified its logic for its assertion that remunerating SONI in this way would result in an imbalance across the island of Ireland in view of the fact that the CER already remunerated EirGrid (TSO) for collecting Rol ancillary charges on a margins basis. The UR responded that the structure of SONI's TSO price control differed from that which the CER had determined for EirGrid (TSO). As a result, the UR asserted, we would be 'lifting one jigsaw out of the UR's price control and replacing it with something that did not match'.<sup>695</sup>
- 7.137 The UR said that its approach fully compensated SONI for its efficient 'collection agent' costs. These were the cost of the facility fee plus any drawdown costs. The UR noted that the cost of management and staff time engaged in collecting and disbursing monies had been covered in TSO BAU opex allowances.<sup>696</sup>
- *Comparison of two approaches to remunerate the collection agent function: NI versus Rol*
- 7.138 The UR contrasted the approach it had taken to remunerating SONI to that which had been adopted by the CER to the TSO in Rol as summarised in the Table 7.3.

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<sup>691</sup> Some of the details of the UR's 'collection agent' remuneration package for SONI were clarified at the remedies hearing.

<sup>692</sup> UR response to CMA provisional determination, paragraph 1.68.

<sup>693</sup> These items being those remunerated through the A<sub>1</sub> term within SONI's price control.

<sup>694</sup> UR response to CMA provisional determination, paragraph 1.72.

<sup>695</sup> Remedies Hearing transcript, page 102 line 13 to page 103 line 25.

<sup>696</sup> UR response to CMA provisional determination, paragraph 1.77.

**Table 7.3: The UR's comparison of its TSO regulatory framework with that of CER**

<i>Framework element</i>	<i>UR's approach</i>	<i>CER's approach</i>
Remuneration of TSO activities	RAB x conventional network WACC  Uplift to WACC for high operational gearing	RAB x conventional network WACC  The UR noted that the CER's approach did not include the uplift to WACC for high operational gearing.* The UR also noted that the CER had increased the level of the margin on TSO 'collection agent' revenues to obviate the need for an uplift to the WACC in respect of high operating gearing for the 2016-2020 price control.†
Remuneration of collection agent function	<i>Reimbursement of efficient financing costs</i> <ul style="list-style-type: none"> <li>• Facility cost for bank standby facilities</li> <li>• Return for contingent capital ie PCG, which underwrites this function</li> <li>• Interest on K-factor adjustments (ie relating to tariff year end timing difference balances) at LIBOR plus 2%</li> <li>• The ability of SONI to make a D<sub>t</sub> application to remunerate it for interest on intra tariff year timing difference balances</li> <li>• Uplift to 'BAU' cost of capital ie uplift to WACC</li> </ul>	<i>Margin allowance on relevant revenues</i>  The UR noted that this margin also covered for the fact that the CER's interest on timing differences (K-factor) is at EURIBOR, which is currently negative.

Source: CMA summary of UR response to CMA provisional determination, paragraphs 1.79–1.81 and fourth footnote to paragraph 7.134.

\* UR response to CMA provisional determination, paragraph 1.80.

† UR response to CMA provisional determination, paragraph 1.81(a).

7.139 The UR submitted that it had simply adopted a different method to the CER and that the sums awarded under the two approaches were broadly comparable, when the following were added together:

- (a) the value to SONI of the uplift to the WACC that the UR had awarded SONI for high operational gearing;<sup>697</sup>
- (b) the allowance that the SEMC had given SEMO in respect of SONI's PCG;<sup>698</sup>
- (c) the allowance that the UR had provided in respect of facility fees on SONI's current £12 million standby facility; and

<sup>697</sup> The UR computed the value of this uplift as the difference between SONI's and NIE WACC (5.9% per annum less 3.8% per annum) multiplied by SONI's expected average RAB (including side-RAB) over the 5-year price control period of £18 million. The UR then ascribed all of this uplift to the collection agent function.

<sup>698</sup> The UR ascribed *all* of the annual value placed on the PCG in the SEMO JV price control (ie 2.5% per year of £10 million) to SONI's collection agent function, and therefore none to the SEMO JV, nor to any other of SONI's functions.

(d) the remuneration of any outstanding tariff year end timing difference balances arising at LIBOR plus 2% per year.

7.140 According to the UR, SONI would receive £3.7 million in allowances, in addition to any interest earned on tariff year end timing difference balances over the 5 years of the price control, and this was comparable in level with the £1.5 million to £3.5 million<sup>699</sup> in allowances that would have been awarded had the CER's approach of calibrating allowances at 0.5% of relevant remuneration per year been adopted.<sup>700</sup> The UR argued that this comparison showed that its approach had not been wrong.<sup>701</sup>

7.141 The UR submitted that any finding that the UR's approach was wrong must ultimately rest on the availability of a superior approach. The UR argued that a margins approach, the approach we had proposed to adopt to remunerate SONI for the idiosyncratic role that it undertook here, suffered in two major ways:

(a) we lacked good and relevant information to set the level of the margin on revenues collected. The levels proposed –0.25% to 0.5% were highly speculative, based likewise on the speculative calculations of the CER. In contrast, the UR's approach had the great benefit that it was based on market information directly related to the costs that SONI faced to procure the services needed to manage cash flow in its collection agent function, both in terms of facility fee and the interest rate.

(b) SONI would have a direct financial incentive to increase the level of spend on the transmission network system as a whole because SONI would as a result earn revenue worth 0.5% per year of NIE's revenues. The UR submitted that would be to the direct detriment of consumers, given SONI's influence across the NI electricity system.<sup>702</sup>

- *The UR had sought to remunerate SONI's collection agent function based on the existing, rather than future, wholesale market arrangements*

7.142 The UR told us that the price control under appeal addressed the revenue requirements for the TSO under the existing wholesale market arrangements for the island of Ireland (the SEM) only. As a result, the UR had deliberately

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<sup>699</sup> The UR provided this range because it disputed the fact that SONI was collecting DBCs on behalf of SEMO, and therefore whether such revenues would be in scope of such an allowance.

<sup>700</sup> UR response to CMA provisional determination, paragraph 1.83.

<sup>701</sup> UR response to CMA provisional determination, paragraph 1.84.

<sup>702</sup> UR response to CMA provisional determination, paragraph 1.87.

excluded from its price control considerations increases to SONI's TSO and MO funding requirements likely to arise from the introduction of the planned new wholesale market arrangements in May 2018, the I-SEM.<sup>703</sup>

- 7.143 The UR told us that the SEMC was engaged in a separate process with the two TSOs, EirGrid and SONI, about the consequences of the new market, including any implications for contingent capital. The UR considered it important that we should not pre-empt this work of the SEMC and the two TSOs. Once there was good rather than merely speculative information about any increases in costs, the SEMC would make a decision.<sup>704</sup>
- 7.144 The UR explained that the SEMC had identified funding requirements for SONI on the introduction of the I-SEM under a number of headings including additional contingent capital in relation to EirGrid's and SONI's TSO responsibilities.<sup>705</sup> The TSOs had estimated that they would need approximately €200 million in total, of which SONI's share would be £45 million.<sup>706</sup>
- 7.145 The UR said it could not understand how we could have found it wrong for the UR to leave the future funding arrangements for SONI's collection agent function open when we had not provisionally found it wrong for the UR to leave the allowances for I-SEM capex open.<sup>707</sup>
- 7.146 The UR added that both it and its counterpart, the CER, were in the process of imposing a number of price controls separate to that under appeal to ensure revenue adequacy for both TSOs under the I-SEM. The UR explained that they had taken expert market consultancy advice in this regard. The UR and the CER were therefore both confident that they had developed an approach to cost recovery for contingent capital which would not require the measures suggested in our provisional determination.<sup>708</sup>
- 7.147 The UR acknowledged that I-SEM was likely to change SONI's future capital requirements, and dialogue with SONI and EirGrid had been advancing outside of our appeal process. The UR submitted that it was for the SEMC, not the CMA, to amend the prevailing price control arrangements in that respect.<sup>709</sup> The UR noted that page 5 of its [Final Determination](#) referred to

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<sup>703</sup> UR response to CMA provisional determination, paragraph 1.92.

<sup>704</sup> UR response to CMA provisional determination, paragraphs 1.89–1.90.

<sup>705</sup> Note the UR referred to MO responsibilities but it is the TSO, rather than the MO, responsibility to fund shortfalls in Imperfections Charges revenues. The two TSO have used revolving bank facilities to manage the risk of these shortfalls.

<sup>706</sup> UR response to CMA provisional determination, paragraphs 1.93.

<sup>707</sup> UR response to CMA provisional determination, paragraphs 1.89–1.90.

<sup>708</sup> UR response to CMA provisional determination, paragraphs 1.98.

<sup>709</sup> UR response to CMA provisional determination, paragraphs 1.131.



TSO allowances increasing once the I-SEM and DS3 implementation costs had been established.<sup>710</sup>

7.148 In the remedies hearing, the UR emphasised that that it was important for the SEMC to understand the size of the working capital facility that would be needed under I-SEM. The work being done in this area, however, would be jeopardized if we were to decide for a margins approach to remunerate this activity instead.<sup>711</sup> In response to our observation that a regulator when calibrating allowed revenues would not normally also be looking to specify the method of financing for that activity, the UR said that the SEMC nevertheless needed to assess the size of the facility that SONI would require.<sup>712</sup> In the UR's view, that seemed a more reliable way of arriving at an ex-ante value for an allowance than our proposed approach of applying a percentage to revenues.<sup>713</sup>

- *UR's comments on the existence of, and the principle of remunerating SONI for, asymmetric risk*

7.149 The UR told us that while it was broadly supportive of our proposal that the PCNP and D<sub>t</sub> cost recovery mechanisms be codified, it was concerned that we had not tied together our provisional remedy for Ground 2 with our conclusions under Ground 1.<sup>714</sup> The UR told us no remedy would be required in respect of asymmetric risk.<sup>715</sup>

7.150 The UR also submitted that, at a minimum, it would be inappropriate for us to take as the starting point for our proposed remedy the figure that SONI had put forward in its [NoA](#). Regardless of whether that figure (ie 4% of relevant spend) had been initially justifiable, the UR submitted that it could no longer be valid because it was based on SONI's assessment of expected losses under arrangements which we now proposed to remedy.<sup>716</sup>

- *Consideration of inefficient expenditure*

7.151 The UR told us that under our proposed remedies, SONI would be remunerated for the risk that the UR might disallow inefficient expenditure.<sup>717</sup> In the UR's view, investors in a regulated company did not need, and should

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<sup>710</sup> Remedies Hearing transcript, page 121, lines 11–16.

<sup>711</sup> Remedies Hearing transcript, page 107, lines 1–23.

<sup>712</sup> Remedies Hearing transcript, page 108, lines 21–25.

<sup>713</sup> Remedies Hearing transcript, page 109, lines 3–22.

<sup>714</sup> UR response to CMA provisional determination, paragraphs 1.100–1.101.

<sup>715</sup> UR response to CMA provisional determination, paragraphs 1.116.

<sup>716</sup> UR response to CMA provisional determination, paragraphs 1.100–1.101.

<sup>717</sup> UR response to CMA provisional determination, paragraphs 1.102–1.103.

not receive, a profit allowance to cover the extreme risk that the company is found to have incurred DIWE.<sup>718</sup>

- 7.152 The UR explained its logic for equating inefficient expenditure with DIWE. It argued that in practice it was very difficult for a regulator to disallow actual expenditure *ex-post*. The UR referred to the lack of a track record in NI of disallowing incurred costs.<sup>719</sup>
- 7.153 The UR highlighted that a long-standing and wholly uncontroversial underpinning of economic regulation in the UK and globally was that customers should pay the efficient costs of the services that they receive, but shareholders should bear the inefficient costs. The UR was therefore concerned and surprised by our proposal to remunerate SONI for that risk.<sup>720</sup> The UR said that we appeared to be saying that a regulated company must be paid the expected value of its inefficient and wasteful costs up front in a lump-sum allowance. In the UR's view, we had applied confused regulatory principles,<sup>721</sup> resulting in an unprecedented conclusion.<sup>722</sup>
- 7.154 The UR also told us that in its view the correct approach would be to assume that an efficient company would expect no material risk of disallowance from DIWE.<sup>723</sup> In the UR's view, it would be a novel proposition for us to provide SONI with a *guaranteed* upfront allowance equal to the speculative value of future DIWE costs to cover the *potential* that SONI might be so clearly and demonstrably inefficient that the UR found it necessary to intervene to impose a disallowance.<sup>724</sup>
- *Consideration of other asymmetries within price control*
- 7.155 The UR told us that we should assess asymmetry at the level of the price control framework as a whole, not individual parts of it. In its view, any approach that cherry picked parts of the price control framework to argue for asymmetry would be inadequate.<sup>725</sup>
- 7.156 The UR submitted that any expected downside related to the special arrangements for PCNP and D<sub>t</sub> expenditure was accompanied by expected

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<sup>718</sup> UR response to CMA provisional determination, paragraph 1.109(a).

<sup>719</sup> UR response to CMA provisional determination, paragraph 1.115.

<sup>720</sup> UR response to CMA provisional determination, paragraphs 1.102–1.103.

<sup>721</sup> UR response to CMA provisional determination, paragraph 1.116.

<sup>722</sup> UR response to CMA provisional determination, paragraph 1.104.

<sup>723</sup> UR response to CMA provisional determination, paragraph 1.110.

<sup>724</sup> UR response to CMA provisional determination, paragraph 1.133.

<sup>725</sup> UR response to CMA provisional determination, paragraph 1.109(b).

upside for SONI in its BAU expenditure. In the UR's view, this was not just a theoretical possibility – SONI's track record since its creation was one of repeated outperformance against UR price control assumptions.<sup>726</sup>

7.157 The UR added that the price control framework under appeal also exhibited this feature.<sup>727</sup> SONI's TSO BAU expenditure allowance was subject to a 50:50 risk share for over- or under-spends but, in the UR's view, there was a higher probability of under-spend than over-spend. That asymmetry, to SONI's benefit, arose from a number of factors, including in particular:

- (a) SONI's ability to mitigate downside risk of over-spend by deferring or scaling back planned expenditure, due to a lack of outputs or outcome delivery incentives in the price control.
- (b) The UR had given a large weight to SONI's own Business Plan forecasts when it had determined the ex-ante allowances for SONI's TSO BAU opex and capex. The UR contrasted the approach it had taken here with approaches involving benchmarking of historical opex and use of upper quartile benchmarks.<sup>728</sup>

7.158 The UR continued that were we to ignore these two factors when considering asymmetry we would be 'completely at odds' with the rationale for price control reforms made by Ofwat, Ofgem and the CC (in the case of NIE), which the UR had not yet been able to adopt for SONI.<sup>729</sup>

7.159 The UR submitted that, taken across the TSO price control as a whole, there was insufficient evidence of downside asymmetry in SONI's expected returns to warrant the finding of error.<sup>730</sup>

- *The UR's comments on its approach to assessing financeability*

7.160 SONI had submitted that the approach that the UR had adopted when setting SONI's TSO price control challenged the standard UK regulatory assumption that financeability of a price control should be assessed as though the licensed activities were carried out on a standalone basis. In response, the UR acknowledged that SONI's TSO price control was a special case. The PCG had been remunerated under the SEMO JV price control, whereas the working capital for the SEMO JV was being

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<sup>726</sup> UR response to CMA provisional determination, paragraph 1.111.

<sup>727</sup> UR response to CMA provisional determination, paragraph 1.111.

<sup>728</sup> UR response to CMA provisional determination, paragraph 1.112.

<sup>729</sup> UR response to CMA provisional determination, paragraph 1.113.

<sup>730</sup> UR response to CMA provisional determination, paragraph 1.114.

remunerated under the TSO control. The UR's view was that we should consider whether the overall remuneration package had been right given the interactions between SONI's TSO price control and the SEMO JV's price control. The UR submitted that as a result of these interactions, we needed to look wider than usual when considering financeability.<sup>731</sup>

- *The UR's comment on the overall TSO price control settlement*

7.161 The UR cautioned against us erring on the side of providing too much rather than too little remuneration by taking a pessimistic view of the risks that SONI faced, given that a comparatively small incremental cost per customer made a big difference to SONI.<sup>732</sup> The UR submitted that across different sources of financing (eg equity, corporate debt, bank lending) potential investors competed against each other to invest in businesses. Investors that took a more optimistic view of a company's future performance would generally out-compete those that took a pessimistic view.<sup>733</sup>

*Response to SONI's case that the UR failed to recognise the intangible assets associated with SONI's business*

7.162 The UR said that the best argument that SONI and its experts could make regarding either the extent of capital investment or the cost of that capital was that SONI had unobservable 'intangible' assets. SONI had argued that such assets would be difficult to identify and quantify and were likely to have been overlooked in the UR's analysis. Such assets included knowledge, expertise, human capital, the talent of its employees, intellectual property, know-how and innovation, entrepreneurship, time spent, and reputation and responsibility.<sup>734</sup>

7.163 The UR re-iterated that none of these items had in the past involved or would in the future involve lenders or shareholders investing financial capital in SONI; or, to the extent to which any such investment might have been involved, this would have already been remunerated and any further reward would be a double recovery. That would boost the return of SONI's shareholders to well in excess of a market-based return on its investment, which the UR did not consider could be justified.<sup>735</sup> The UR also noted that the CMA had taken a similar line recently in the [Energy Market](#)

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<sup>731</sup> Remedies Hearing transcript, page 95, line 24 to page 96 line 10.

<sup>732</sup> UR response to CMA provisional determination, paragraph 1.127.

<sup>733</sup> UR response to CMA provisional determination, paragraph 1.129.

<sup>734</sup> [Defence](#), paragraph 1.33.

<sup>735</sup> [Defence](#), paragraph 1.34.

[Investigation](#)<sup>736</sup> when assessing the claims made by retail energy suppliers that they required additional profit in relation to their brands and skilled workforces.<sup>737</sup>

- 7.164 The UR submitted that, in its view, SONI's arguments for an element of return over and above the WACC plus the costs of committed contingent capital could all be seen to rest ultimately on the ideas that SONI had intangible assets and that these intangibles should contribute to the level of expected profit. The UR did not agree with this position.<sup>738</sup>
- 7.165 Furthermore, the UR rejected the interpretation that had been made by one of SONI's experts, Dr Lilico, of the UR's selection of 0.6 for the asset beta used in its calculation to estimate the level of SONI's WACC. Its selection of 0.6 – rather than, say, the 0.38 beta that the UR was currently proposing for NIE in its ongoing review of NIE's transmission price control – was not a back-door way of remunerating 'unobservable intangibles'.<sup>739</sup>
- 7.166 The UR submitted that 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 price determination](#), when the CMA, like the UR, was determining a price control for 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. The UR said that like the CMA, it did not claim that it has a foolproof way of calculating the necessary uplift, but equally the UR did not consider it to be an insurmountable challenge to come up with a reasonable estimate.<sup>740</sup>

### **CCNI's views**

- 7.167 CCNI's submission commented on SONI's allegation that the UR's approach was not adequate to reflect the characteristics of SONI and the risks faced by SONI.
- 7.168 SLG, on behalf of CCNI, noted that the [Final Determination](#) had discussed financeability purely in terms of the settlement providing a reasonable return to investors. SLG said that the [Final Determination](#) had not acknowledged the financeability challenge that could be presented by a RAB/WACC

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<sup>736</sup> CMA Energy Market Investigation, Final Report, [Analysis of retail supply profitability – ROCE](#), paragraphs 62 & 78, 24 June 2016.

<sup>737</sup> [Defence](#), paragraph 1.35. See also paragraph 7.181 for further context about the CMA's profitability analysis of GB retail energy suppliers.

<sup>738</sup> [Defence](#), paragraph 1.36.

<sup>739</sup> [Defence](#), paragraph 1.39.

<sup>740</sup> [Defence](#), paragraph 1.40.

approach for an asset-light business which used the expected return as a financial buffer against operational risk as well as to generate a return for investors. Given the arguments that SONI had presented in the [NoA](#), SLG would have expected the UR to ensure that the level of return provided was sufficient to cover reasonable shocks to the business. SLG agreed with Europe Economics' analysis that a small increment to the WACC is unlikely to be an appropriate mechanism to address the problem.<sup>741</sup>

### ***Our assessment of Error 1(a)***

- 7.169 The starting point for SONI's Ground 1 is that SONI, as TSO, is asset-light, and that this has consequences for the scale of risks that it faces relative to other regulated businesses such as NIE. This is broadly agreed in principle by the parties to the appeal.
- 7.170 In addition to its core TSO functions, which have the objective of balancing the electricity system in NI, SONI has explained that it manages a number of other risks:
- (a) the sometimes-volatile fluctuating working capital requirements associated with both its TSO and MO activities;<sup>742</sup>
  - (b) SONI works with its counterpart TSO in the RoI (EirGrid) to deliver all-island projects – the current focus is on the introduction of new market arrangements (I-SEM) and DS3; and
  - (c) SONI also acts as collection agent for other businesses in the NI electricity value chain such for NIE for transmission charges and for the Moyle Interconnector, which involves SONI receiving and paying monies to industry participants.
- 7.171 Recently SONI has also taken on the transmission network planning function, undertaking the pre-construction phase of network projects as well as preparing the annual 10-year forward plan. All of these significant activities have the potential to impact the profit that SONI reports for any given period.
- 7.172 We summarise SONI's different activities and the sums involved in Table 7.4 below.

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<sup>741</sup> [CCNI R&O](#), Annex 3 (SLG Economics Ltd Report), page 4.

<sup>742</sup> The MO function in the island of Ireland is undertaken by a joint venture between SONI and EirGrid, the equivalent organisation in GB being Elexon. The linkage between MO and TSO is that SONI is required to immediately reimburse this joint venture for unexpectedly high DBC costs.

**Table 7.4: The different activities that SONI undertakes as a TSO and Network Planner**

<i>CMA terminology for activity</i>	<i>Description of activity</i>	<i>Nature of and sums involved over price control period</i>
1. TSO BAU	Balancing NI's electricity system Also preparing the 10-year annual plan for network transmission projects (This does not include managing working capital requirements for unexpected DBCs or System Services. See 4(a).)	£69 million revenues reflecting ex-ante opex, depreciation of RAB and profit allowances of £55 million, £12 million and £1.8 million respectively.
2. TSO special projects	I-SEM and DS3 – SONI's 25% share of joint all-island capex projects supporting I-SEM other (opex) activities remunerated under D <sub>t</sub> mechanism	£11 million and £2 million expected capex spend for I-SEM and DS3 – revenues in the period for same £15 million. Expected £6 million of other opex
3. Transmission network planning projects	Pre-construction work on individual network transmission projects. (a new responsibility for SONI from 28 March 2014)	£17 million of expected spend plus £1.6 million return on side-RAB
4(a). Collection agent role – collecting own volatile external costs	Managing working capital requirements associated with volatile costs arising from own TSO activities (System Services) & MO activities (unexpected element of dispatch balancing costs is funded by TSO) EirGrid provides a cross-guarantee to the revolving credit facility (RCF) which is used to manage unexpected DBCs.	See Figure 7.3 at paragraph 7.42 above, for the extent of the costs involved – currently around £75 million a year. See paragraph 7.66 for info on past balances on RCF and paragraph 7.69 for predictions for the future.
4(b). Collection agent role – collecting revenues on behalf of other operators in value chain	Collecting revenues from suppliers and generators and managing associated working capital requirements SONI collects a) wholesale transmission charges due to NIE and b) wholesale charges for the Moyle Interconnector between NI and Scotland.	See Figure 7.3 at paragraph 7.42 above, for the extent of the Moyle Interconnector revenues – currently around £25 million a year.
5. Insurance for activities above	£10 million PCG given by EirGrid	No allowance specific to TSO price control.

Source: CMA analysis. Unless otherwise indicated, source of figures is SONI's response to clarification requests, 17 July 2017, consistent with SONI numbers in its [NoA](#).

- 7.173 One financial concept which results from SONI being asset-light and which is referred to by both parties is that SONI has high 'operational gearing'. It is agreed that SONI has higher operational gearing than asset-heavy companies such as NIE, and that this is consistent with a higher rate of return, as the UR explicitly increased the WACC in the [Final Determination](#) to reflect SONI's higher operational gearing. This is discussed further at paragraph 7.190 below.
- 7.174 As highlighted by KPMG and discussed in more detail under Error 1(c) below, an important part of the risks faced by SONI are asymmetric in nature. SONI has taken on the Network Planning function and expects to make significant investments relating to the I-SEM. SONI has estimated that

these would represent in combination around 35% of its revenues over the price control period.<sup>743</sup> The approach used by the UR and described under Ground 2 introduces some asymmetric risk to SONI's returns, as there is a risk that SONI incurs costs deemed to be inefficient by the UR. Both the Network Planning function and the I-SEM represent changes to SONI's responsibilities by comparison to prior price control periods, and it is reasonable for SONI to assume that it faces some regulatory risk in how these are treated.

7.175 The UR has argued that SONI has highlighted submissions that alternative approaches would be more appropriate, in particular a margins approach and a more explicit valuation of intangible assets, but has been 'unwilling to engage' with the question as to whether the UR's approach was wrong. We do not agree. An important part of SONI's case is its submission that a review of the profit allowance which would result from the use of alternative approaches demonstrates that it would be materially higher than under the UR's approach. We agree that this is relevant to whether the UR's allowed return was too low under the approach adopted by the UR, in addition to whether the UR was wrong to use its RAB/WACC approach rather than such an alternative approach.

#### *Our assessment – SONI's alternative approaches*

7.176 SONI's first argument under Error 1(a) is that a margins approach should have been used. KPMG provided examples of where a margins approach had been used.<sup>744</sup> Examples are:

(a) Retail businesses (water, Power NI, gas); and

(b) Royal Mail (Ofcom (2011)).<sup>745</sup>

7.177 The majority of SONI's examples relate to retail businesses. Whilst such retail-based examples demonstrate that a margins approach to price control regulation is feasible, the examples do not in themselves demonstrate that UR was wrong to consider an approach based on returns on capital employed for SONI. There are a number of reasons why the UR might

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<sup>743</sup> NoA, paragraph 3.27

<sup>744</sup> NoA MC1, supporting document MC1/1 (KPMG 1).

<sup>745</sup> Another recent example of a low-asset being price regulated on the basis of margins, not quoted by SONI/KPMG, is the Digital Communications Company (DCC). Its 'wholesale' role is to manage the digital communications integral to the GB smart electricity and gas meter rollout programme. DCC won a competitive tender to fulfil this function at the outset. Ofgem sets DCC's expected profit on an annual basis on the basis of margin on its costs.



choose to follow an approach based on returns on capital employed in this case, rather than a margins approach:

- (a) Investment in fixed assets are a bigger proportion of costs for SONI than the retail examples. SONI's own submission in Figure 7.1 above illustrates that SONI has a different balance of assets and operating costs to such retail businesses.<sup>746</sup>
- (b) The level of SONI's fixed asset and working capital base is expected to increase over the 2015-20 period due to the significant investments in the I-SEM and network planning projects respectively.
- (c) As stated by the UR, and quoting Dr Lilico, there is limited theoretical basis for setting a benchmark margin for a company such as SONI,<sup>747</sup> and KPMG's margin benchmarking exercise suffered from numerous issues of selectivity and bias regarding comparators.<sup>748</sup>

7.178 We therefore consider that SONI has not shown through these examples that it is wrong in principle to use RAB/WACC as an important building block of the overall approach to setting a price control to which other components could be added.

7.179 Similarly, we do not agree that the existence of intangible assets<sup>749</sup> can in itself show that the UR was wrong to use RAB/WACC. All network companies have both tangible and intangible assets. What distinguishes SONI from other regulated firms to which the RAB/WACC price control model is applied, is that it is asset-light and that: (a) much of SONI's activity does not relate particularly well to, or scale well with, the level of its investment in fixed assets; and (b) SONI is bearing risks, such as the collection agent functions, which are unrelated to its (modest) asset base. In that sense, we agree with the Europe Economics report to the extent that we agree with Dr Lilico that it is necessary to test the plausibility of making adjustments to the WACC when seeking to address the characteristics of SONI in the financial framework.

7.180 As discussed above, SONI's evidence demonstrates that there are material risks it faces which may not have been properly addressed by the UR's adjustments:

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<sup>746</sup> In addition, SONI's comparison to Royal Mail does not provide clear precedent in respect of a decision as to what level to set an ex-ante margin, since Ofcom decided to follow an ex-post monitoring approach.

<sup>747</sup> [Defence](#), paragraph 1.48 and NoA AL1, paragraphs 8.17–8.18.

<sup>748</sup> [Defence](#), paragraph 1.45(c).

<sup>749</sup> Examples of intangible assets identified by SONI, as summarised by the UR, are set out in the final sentence of paragraph 7.162.

- (a) Activity 1: SONI has shown it faces significantly higher operational gearing than typical regulated asset-heavy network companies. This would merit an upward adjustment to a WACC determined for such a company.
- (b) Activities 2 & 3: SONI has stated that it faces significant asymmetric risks, which is discussed further under Error 1(c) below<sup>750</sup> but is also relevant to SONI's case that the current financial framework does not take account of the asymmetric risks SONI faces. Such asymmetric risks are not reflected in the RAB/WACC model, which, following CAPM principles, assumes that the returns are symmetric and therefore that the expected return on capital is equal to the WACC.
- (c) Activities 4 & 5: SONI has described how it faces additional risks from managing its sometimes-volatile TSO and MO working capital requirements and the collection function on behalf of others guaranteeing their income over the shorter term. These risks are not addressed by any adjustment to the WACC applied to tangible fixed assets, ie the RAB.

*Relevance of the CMA's retail profitability analysis*

- 7.181 The UR referred to the CMA's analysis as part of the [Energy Market Investigation](#). We agree that the CMA's [Energy Market Investigation](#) represents an example of an approach to setting expected returns for a low asset business. The CMA recognised that there were low assets in energy retail. The CMA's [Energy Market Investigation](#) concluded that this did not mean that ROCE was irrelevant; but also, that adjustments to actual and contingent capital would be required.
- 7.182 An assessment of the risks faced by GB energy retailers was a strong theme of the approach taken to assessing their profitability in the CMA's [Energy Market Investigation](#). The CMA's [Energy Market Investigation](#) concluded that for the energy retail companies, which had low tangible asset bases and significant levels of working capital, a return on capital approach should be applied, and that adjustments would be required to the basic approach in order for a meaningful return on capital to be estimated. Two adjustments that were made are particularly relevant in the context of this appeal.
- 7.183 First, the CMA recognised that prudent energy retailers who sought to lock in the cost of wholesale energy that they had committed to supply were subject

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<sup>750</sup> See paragraphs 7.361 to 7.363 under Error 1(c).

to the risk of having to post collateral, were wholesale energy prices subsequently to move adversely. The CMA acknowledged that the GB large energy retailers were able to rely on PCGs (ie contingent capital) in place of posting actual collateral. The CMA estimated the opportunity cost to the large retailers of this practice by using the cost incurred by mid-tier GB energy retailers. Such retailers paid a small premium on the market cost of their forward energy purchases procured from their wholesale energy suppliers for these wholesale suppliers to take this risk.<sup>751</sup>

7.184 Second, the CMA recognised that energy retailers who prudently managed their exposure to future movements in wholesale energy costs, as described in paragraph 7.183, still faced exposure to certain shorter-term shocks. These shocks arose, for example, from departures from expected weather conditions, most notably a warmer than expected winter, and from short notice changes to the cost of implementing government energy policies. Because they would have committed to supply their customers at a fixed price for a certain period, these retailers would have no option but to bear the impact of such shorter-term shocks in order to ensure continuity of supply. The CMA concluded that a prudent retailer might hold a cash buffer to withstand such shocks and estimated that a buffer of 2% to 3%<sup>752</sup> of annual wholesale energy costs would be reasonable.<sup>753</sup>

7.185 In summary, the CMA's analysis in the [Energy Market Investigation](#) made adjustments to take account of two distinct risks that energy retailers face which did not directly relate to the size of the retailer in terms of their investment in fixed assets. Rather, the adjustments related to the size of the retailer's customer base and therefore the size of its wholesale energy purchases. The approach taken in the [Energy Market Investigation](#) therefore did not reject analysing profitability on the basis of a return on capital employed, but acknowledged that some capital may not be reflected on the balance sheet, and that where appropriate, this would still be taken into account.

#### *Our view of SONI's alternative approaches*

7.186 In summary, for the reasons above, we do not consider that the examples provided by SONI of margin-based approaches to regulation are analogous to its business, and in our view SONI has not shown that the UR was wrong

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<sup>751</sup> CMA Energy Market Investigation, Final Report, [Appendix 9.10: Analysis of retail supply profitability – ROCE](#), 24 June 2016.

<sup>752</sup> 2% for all large GB energy retailers except for Centrica (3%) which sold a much greater proportion of gas, whose consumption is more exposed to unexpected weather fluctuations than electricity.

<sup>753</sup> CMA Energy Market Investigation, Final Report, [Appendix 9.10: Analysis of retail supply profitability – ROCE](#), paragraphs 135–136, 24 June 2016.

in using an approach which has RAB/WACC as a component of the total return.

- 7.187 However, we agree with SONI that the particular risks that it faces, as set out in the [NoA](#) and summarised in paragraph 7.180 above, need to be considered as part of the financeability assessment. These are separate risks with separate cost drivers, and the UR's approach does not remunerate these risks. SONI's submissions illustrate that an approach could be followed which would combine a return on capital (RAB/WACC) with other adjustments which can, in combination take account of the risks faced by SONI in the Price Control Period.
- 7.188 We have concluded that the UR had not fully considered the risks associated with either the revenue collection functions or the asymmetric risks in the Price Control Decision both on the level of the WACC and more generally in its approach to the financeability of SONI. The UR made an assumption of a higher beta to reflect higher operational gearing, but it did not do any analysis which would have demonstrated whether this higher beta was sufficient to cover the risks faced by SONI.
- 7.189 We now consider how each of the three additional risks we have identified in paragraph 7.180 above could be included within a financeability assessment, and whether the UR was wrong not to include allowances for these in the Price Control.

*Our assessment – higher operational gearing for TSO and Network Planning activities*

- 7.190 In the Price Control Decision, the UR applied a beta of 0.6. In this section we consider the evidence provided by SONI and the UR in respect of this adjustment. SONI has argued that a higher adjustment would be needed to reflect the risks that it faces, and it provided further submissions to this appeal.
- 7.191 In SONI's reply to the Defence, it indicated that, including the collection agent function,<sup>754</sup> the level of operational gearing faced by SONI would result in an asset beta as high as between 7 to 14.<sup>755</sup> SONI's analysis was based on an approach to adjusting betas previously used by the CMA in the

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<sup>754</sup> SONI's calculation for operational gearing referred to all of its activities including that for collection agent. It was not limited to its 'controllable costs' activities ie TSO & Network Planning activities.

<sup>755</sup> SONI reply to the Defence, paragraph 3.32.

Bristol Water price determinations, which the UR also referred to in support of its own choice of beta estimate as discussed in paragraph 7.166.<sup>756</sup>

- 7.192 As part of the determination of Bristol Water's price control in 2010 and 2015, the CMA was required to consider whether Bristol Water should have a higher beta to reflect its higher operational gearing. The approach taken by the CMA in these cases was to adjust the asset beta upwards to reflect higher operational gearing. The adjustment used was based on a calculation comparable to that applied by SONI. The consequential adjustment was to increase beta by approximately 0.04. However, the CMA's report also made clear that many other factors would influence the asset beta, and that the decision on the asset beta was a judgment based on a wide range of factors.<sup>757</sup>
- 7.193 SONI submitted that if this approach were followed, this would imply an implausibly high WACC. SONI also noted that if the collection agent function were excluded, the implied beta would still be high as between 1.0 to 1.7, by comparison with the UR's beta assumption of 0.6.<sup>758</sup>
- 7.194 This was similar in principle to Dr Lilico's report, which was based on analysis submitted to the CER for its review of EirGrid's price control. Dr Lilico concluded that either an implausibly high WACC should be applied, or an adjustment should be made to reflect intangible assets.
- 7.195 In its submissions to this appeal, the UR provided further evidence in support of its adjustment of SONI's beta to 0.6. The UR provided a quantitative assessment to this appeal, whereas in the [Final Determination](#) it made a judgment based on comparison with regulatory precedent and the market as a whole. The UR submitted that given the increase in RAB over this period, the CMA's approach in the [Bristol Water price determination](#) would imply a beta consistent with its decision of 0.6.<sup>759</sup>
- 7.196 It is undisputed that SONI faces higher operational gearing than typical network utilities such as NIE. Both SONI and the UR have provided an indicative assessment of the effect of higher operational gearing on the WACC, having regard to precedent from the CMA.
- 7.197 The UR's assumption of using a beta of 0.6 was based on a qualitative assessment that SONI was higher risk than network companies such as NIE

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<sup>756</sup> SONI reply to the Defence, paragraph 3.32, footnote 60.

<sup>757</sup> [Bristol Water price determination](#), 6 October 2015.

<sup>758</sup> SONI reply to the Defence, paragraph 3.32.

<sup>759</sup> Reckon LLP, on behalf of the UR, set out the methodology used to estimate asset beta (see UR Hearing follow-up written response of 4 August 2017, 'Note on CMA operational gearing adjustment').

but lower risk than the market as a whole. Given the scale of difference in operational gearing, it is feasible that the assumption that any monopoly such as SONI is lower risk than the market may not hold. For example, there is no reason why a very highly geared monopoly might not be taking above average market risk, if it is tied into a long-term regulatory contract with material financing risk or input cost inflation risk.

- 7.198 We therefore agree that it is appropriate to cross-check whether the adjustment made by the UR is appropriate. We have reviewed the information provided by the parties. Overall, we do not consider that SONI has shown that the UR's adjustment is wrong. Our reasons are below.
- 7.199 Firstly, we note the UR's analysis that under the Bristol Water approach, a value for beta of 0.6 can be derived. We note that other approaches could be used which would result in higher numbers, and also that there is significant variability over the period, which is consistent with the 'saw-tooth' argument made by SONI. However, the nature of beta analysis is that it is often based on extrapolating from imperfect market data, and beta estimates are consequently chosen from ranges using a combination of judgment and statistical analysis. The analysis by the UR suggests that, following one particular approach to this statistical analysis, 0.6 is within the range of potential values of beta. This suggests that 0.6 is a plausible estimate for the beta to be used for SONI.
- 7.200 Second, we note that the analysis of alternative beta estimates provided by SONI and the UR assumes that there is a direct correlation between operational gearing and beta. Whilst this is in part because the parties have applied an approach previously used by the CMA, this was in a different context, where it was necessary to estimate the scale of an adjustment, and where the size of the adjustment was small by comparison with this case. In practice, a number of factors will affect the level of beta. In considering a larger adjustment to a beta, such as this case, where the adjustment is relative to a benchmark based on market data or established precedent such as NIE, a wider range of factors would also need to be considered. We would expect that the level of the beta for a firm with higher operational gearing but otherwise the same level of business risk would also reflect other factors. These might include the market's view of the exposure of investors in regulated utilities to long-term macro-economic factors, and the expected long-term effects on allowed returns. These would need to be assessed alongside factors such as operational gearing which affect the variability of returns in the current period.

- 7.201 Third, the analysis assumes that all the systematic risk assumed by investors in the current period is directly related to the level of operational gearing.
- 7.202 The existence of these other factors which would be expected to also influence market betas does not imply that it is wrong to make an operational gearing adjustment. However, the scale of the adjustment would need to have regard to other factors, and some of these factors would be likely to reduce the size of any adjustment.
- 7.203 On that basis, we do not consider that the UR's choice of a beta of 0.6 was wrong. In other words, we agree with the UR that, given the comparisons in Figure 7.1 above, an adjustment to 0.6 is consistent with the evidence.
- 7.204 We agree however with SONI that this assessment only covers the risks associated with the low tangible asset base relative to the costs of operating those assets. In other words, the adjustment to 0.6 is consistent with the symmetric risks associated with SONI's existing TSO operations and the symmetric risks of the activity of operating the Network Planning<sup>760</sup> function. The adjustment to 0.6 does not take into account the other factors identified by SONI, ie the collection agent risk and the asymmetric risks associated with the Network Planning function and certain other functions. Given that we consider that a return of 5.9% would be sufficient to cover the risks associated with the TSO BAU activities, we agree with SONI that the UR needed to also consider these additional risks as part of the overall financeability assessment.

*Our assessment – collection agent functions*

- 7.205 In the case of the collection agent functions, including that relating to managing volatile TSO and constraint costs, we do not consider that an approach which only reimburses any direct costs that SONI incurs or has incurred on an ex-post basis, remunerates SONI for the risk it faces. This activity of acting as a payment intermediary would not be undertaken by a commercial operator without additional reward for not only the direct and indirect financial cost of managing the flows but also the risks of delayed- or non-payment, however small these might be perceived to be.
- 7.206 We also consider that, as the revenue collection activities have risks which have no relationship to the size of SONI's investment in tangible fixed assets, the UR could not have assumed that the RAB/WACC approach

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<sup>760</sup> Transmission network planning, in particular the preparation of the 10-year forward looking plan prepared annually.

would reliably address these risks, not least given the variability of, and the potential lack of predictability in, the size of its modest RAB.

- 7.207 In this section we compare the different approaches to remuneration, discuss the relevance of the SEMO JV's Imperfections Charges and the introduction of the I-SEM, before discussing the properties of the remuneration structure we are considering.

*Comparison of different approaches to remuneration*

- 7.208 In its response to our provisional determination, the UR cautioned us against adopting one element of the CER's remuneration approach, namely the allowance based on a margin of revenue collected. It considered that we needed to take into account the other elements of remuneration it had awarded SONI for performing this function, and that there might be an element of double-counting. The UR also sought to illustrate that the level of the remuneration it had provided under its package was broadly equivalent to the approach we had proposed.<sup>761</sup>
- 7.209 We do not agree that the UR has identified correctly those elements of the [Final Determination](#) remuneration package which relate to SONI's collection agent role. As a result, we disagree with the UR's analysis that its approach and our proposed approach are broadly similar in terms of the level of remuneration they provide to SONI for the reasons set out in Table 7.5 below:

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<sup>761</sup> See paragraphs 7.138 to 7.140 above.



**Table 7.5: Our assessment of the UR’s package of remuneration that the UR submitted was comparable to our proposal to provide SONI with a collection agent allowance based on a margin of relevant revenues**

<i>Element of remuneration package ascribed by the UR to SONI’s collection agent function</i>	<i>UR’s estimate of value over 5 years of price control*</i>	<i>Our assessment</i>
The value to SONI of the uplift to the WACC that the UR had awarded SONI for its high operational gearing	£1.9 million†	Even if it had been a correct approach to remunerate SONI for its collection agent role through an uplift to beta (which in our view it is not – see paragraphs 7.190 to 7.204), it would not be correct to ascribe <i>all</i> of the resulting increase in the level of the expected profit allowance to SONI’s collection agent function. SONI has high operational gearing primarily because of the high ratio of its TSO BAU opex spend relative to the size of the corresponding RAB.
The allowance that the SEMC had given the SEMO JV in respect of SONI’s PCG	£1.25 million‡	First, and as explained in paragraph 7.317, there is an incremental opportunity cost to EirGrid of providing the PCG to SONI that is a requirement in SONI’s MO licence. It therefore cannot be right to attribute <i>all</i> of value of the allowance given in SEMO JV price controls to remuneration of the PCG in respect of SONI’s TSO price control activities.  Second, the ability to call on the TSO PCG is not restricted to those situations where SONI acts as a collection agent. Therefore, it would not be correct to ascribe <i>all</i> of the value of the TSO element of the cost of the guarantee to SONI’s collection agent role.
The allowance that the UR had provided in respect of facility fees on SONI’s current £12 million standby facility	£0.54 million	We note that this allowance is in respect of the level of SONI’s current facility, which is likely to need to increase, possibly substantially, over the period of the TSO price control.
The remuneration of any outstanding tariff year end timing difference balances arising at LIBOR plus 2% per year	Amounts, if any, only capable of being determined after the event	Interest on any inter-tariff year payment/receipt imbalances could in principle provide some compensation to SONI for the time value of money associated with its collection agent activities.
<b>Total ie value of the UR’s package of remuneration as above</b>	<b>£3.7 million</b>	

Source: Columns 1 and 2: UR response to CMA provisional determination, paragraph 1.83, Table 2. Column 3: CMA analysis.  
 \* See column 2 of the UR’s Table 2 Values of the UR and CER additions to a RAB x conventional utility WACC calculation, 2015-20 at paragraph 1.83 in its response to the CMA provisional determination.  
 † See footnote to paragraph 7.139(a) for an explanation of how the UR arrived at this value.  
 ‡ See footnote to paragraph 7.139(b) for an explanation of how the UR arrived at this value.

7.210 The UR submitted that its £3.7 million as set out in the table above compared favourably with the total value of our proposed remuneration for SONI’s collection agent of between £1.5 million to £3.5 million over 5 years.<sup>762</sup> In the remedies hearing, the UR clarified that this range was based on assuming remuneration between a range of 0.25% to 0.5% of

<sup>762</sup> UR response to CMA provisional determination, paragraph 1.83.

relevant revenues (which for these purposes also included the SONI's share of the SEMO's JV Imperfections Charges revenues).

- 7.211 We also note SONI's submission that the CER had awarded EirGrid an allowance for the cost of its bank facility *as well as* a margin allowance on relevant revenues.<sup>763</sup>

#### *Relevance of the SEMO JV's Imperfections Charges*

- 7.212 The SEMO JV's Imperfections Charges relate to an all Ireland TSO SEM activity, namely the activity of financing any temporary shortfall between the level of Imperfections Charges already collected by the SEMO JV in any one period and the actual outgoings of the SEMO JV in the same period. The approach to the level of recovery in the respective TSO price controls is not, in this area, exclusively determined by the SEMC.<sup>764</sup> As the manner and level of the recovery of the cost for managing these shortfalls has significantly differed across the two TSO regulators, this had led to the situation where both the SEMC and the TSO regulators have exerted influence over the level of its recovery within the individual TSO price controls. See Table 7.1 for an analysis of the CER's approach to remunerating EirGrid (TSO) for its collection agent function.
- 7.213 EirGrid, as parent of both the NI TSO (SONI) and ROI TSO (EirGrid as TSO) since 2009, has sought to realise economies of scale by operating a fully integrated business model across both TSOs. Examples of this included a single regulatory team or one set of TSO systems tools. There is, therefore, also significant levels of joint working between the two TSOs across many (non-SEM) TSO activities. EirGrid apportions<sup>765</sup> the total costs of these common activities to the two TSOs in accordance with its cost allocation system.<sup>766</sup> However, and in contrast to the approach taken by the SEMC in relation to SEM matters, it is up to the two national TSO regulators to decide whether, in what manner and the extent to which they remunerate the activities in respect of which such expenditure has been incurred.<sup>767</sup>
- 7.214 In this appeal, SONI and the UR have disputed whether SONI was in fact collecting these charges, and therefore whether SONI was in the position to be remunerated for 'collecting' these revenues. We consider that the economic substance of the present arrangements are such that SONI is

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<sup>763</sup> Remedies Hearing, SONI handout 1: '*Analysis of UR's Representation of CER framework in PR4*', paragraph 1.11.

<sup>764</sup> See paragraph 2.40 for further explanation.

<sup>765</sup> EirGrid's cost allocation process between EirGrid (TSO) and SONI (TSO) is subject to annual statutory audit.

<sup>766</sup> Clarification Hearing transcript, page 13, line 19 to page 15, line 10.

<sup>767</sup> Clarification Hearing transcript, page 76, line 21 to page 77, line 5.

collecting its 25% share of the SEMO JV's Imperfections Charges for the following two reasons:

- (a) Firstly, the primary risk associated with administering the wholesale electricity market is that the revenues raised are not sufficient in the shorter term to cover the payments that have needed to be made so that the wholesale market functioned as intended. As that risk has been transferred to the TSOs, then it is they who in substance are bearing the risk of performing the collection agent role, and therefore should be rewarded for doing so.
- (b) Secondly, we note that the SEMO JV in whose name the Imperfections Charges are levied is a virtual entity, created out of a contract between SONI and EirGrid, rather than an entity with its own limited liability which would render it a distinct and separate concept from that of EirGrid/SONI. For this reason too, it is SONI who is performing this function.

7.215 We also note that across a series of TSO price controls the CER has awarded EirGrid with an allowance which is computed as a percentage of EirGrid's 75% share of the SEMO JV's Imperfections Charges revenues. As the split of responsibilities for making the electricity market work across the island of Ireland between the SEMO JV on the one hand and the individual TSOs on the other must be the same, then the scope of the relevant revenues on which a margin would be awarded following our approach would not be inconsistent with the CER's approach thus far.

*Relevance of the introduction of the I-SEM*

7.216 The UR argued that, as the overall level of remuneration that SONI would receive for performing the collection agent function over the time frame of the price control had the potential to increase, it would be wrong for us to find an error. The UR said that the SEMC might increase the level of allowances for increased contingent capital, including that relating to the collection agent function.

7.217 Whilst the SEMC may change the treatment of these functions following the introduction of the I-SEM, we are considering the TSO price control for the whole period, including the period prior to the I-SEM. Our decision in this appeal is whether there is an error in the price control as determined in the licence modifications. To the extent that there may be changes during the period of the price control subsequent to the I-SEM, these do not in themselves mean that there is no error in the treatment of these functions in respect of the price control period as a whole. We consider separately in the

consideration of remedies whether there is an effect on the level of an alternative measure based on margins.

- 7.218 We also note that the UR had not clearly communicated in the [Final Determination](#) that the allowances it had awarded SONI for managing any shortfalls in SEMO JV Imperfections Charges revenues were subject to revision and might well increase following the introduction of the I-SEM. In the [Final Determination](#) the UR had prominently referred to the fact that allowances in relation to I-SEM *implementation* capital expenditure were still to be determined but not also the fact that operational cost allowances<sup>768</sup> awarded for the whole price control period might need to be revised post the introduction of the I-SEM.<sup>769</sup>
- 7.219 We note that SONI already has to manage revenues and costs of well over £100 million per annum, and needs access to financing facilities to manage the timing risks associated with these. The cost of managing this risk will be large for a business such as SONI, which has around £1 million per annum of profit expected under the price control, and that cost is not related to the size of SONI's assets.
- 7.220 We note that for important elements of the revenues collected, namely SONI's share of the SEMO JV's Imperfections Charges and TSO ancillary charges, the timing risks are higher in both size and scale than they are for other elements, and SONI has explained that it is these very elements which will be increasing once I-SEM is introduced. This means that existing arrangements, even if they had been adequate to manage and remunerate the existing risks, would be unlikely to suffice throughout the Price Control Period. The UR argues, however, that we should defer to the SEMC to make sure future arrangements are adequate.
- 7.221 As discussed in Chapter 12, we do not propose that any remedies should 'pre-empt' any such decisions on the financing of these functions following the introduction of the I-SEM. We, however, do not consider that any future decision by the SEMC should address the risks across the price control period as a whole.

*Conclusion – collection agent functions*

- 7.222 As described above, we have identified that:

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<sup>768</sup> The bank facility fee was an element of the opex cost allowance.

<sup>769</sup> See [Final Determination](#), page 5 and paragraph 31.

- (a) SONI faces material risks associated with the collection agent functions, which cover revenues of the order of £100 million per annum, relative to an assumed profit margin of £1 million;
- (b) that these risks are not remunerated through the price control at present, as the allowances provided by the UR reflect other aspects of the TSO price control settlement;
- (c) that these risks will both have a direct cost, in respect of relevant financing facilities, and will also increase SONI's cost of financing as a whole; and
- (d) that, whilst the remuneration of these risks may change following the introduction of the I-SEM, this cannot in itself mean that there is no error in considering the price control period as a whole.

7.223 In response to our provisional determination, the UR submitted that it had been the CMA, rather than SONI in its [NoA](#), who had argued that SONI had not been remunerated for its collection agent functions. To support this view, the UR noted that SONI had not challenged two terms in the TSO price control formulae which would now be key inputs into determining the level of remuneration for SONI's collection agent function.<sup>770</sup>

7.224 We disagree with the UR's view that SONI had not made a case in its [NoA](#) about the level of remuneration for managing the revenues it collected on behalf of other industry participants which in turn affected its financeability.<sup>771</sup> While SONI did not present all the relevant evidence and arguments under those sections (17 to 21) of its [NoA](#) where it had discussed the details of its stated errors under the financeability methodology ground, many of the key points had already been made in the introductory sections to the [NoA, in particular sections 14 to 16 which provide background to Ground 1](#). SONI had also at the start of section 17 made it clear that

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<sup>770</sup> See paragraphs 7.126 and 7.130 7.126above.

<sup>771</sup> [NoA](#) references include paragraphs 3.8 to 3.11 (which describe SONI's collection agent role and the risks to which SONI is as a result exposed to); paragraphs 3.24 to 3.25 (which assert that the price control did not appropriately reflect the level of risks SONI faced as 'custodian' of industry revenues and that this was a reason why SONI had argued for thorough reform of its regulatory framework); paragraphs 16.11 to 16.14 (which depict and describe the revenues SONI collects and how the price control does not provide an allowance for managing payments or any remuneration on equity provided, including that supporting the debt arrangements; paragraph 18.16 (which describes how the UR should have put in place a framework that reflected SONI's risks, which were largely driven by operational factors ie liquidity risk associated with pass through costs [ie industry revenues] as well as opex risk, rather than by factors associated with the financing and implementing of capital investment; and paragraph 23.6 (which noted that SONI would be required to manage industry payments following the implementation of the I-SEM, which would be both larger and more difficult to forecast). See also the first footnote to paragraph 7.385 below for references to where we probed SONI and the UR about SONI being responsible for shortfalls on Imperfections Charges (ie DBCs) – the major risk associated with collecting these charges.

Ground 1 also needed to be read in the context of all the listed supporting material it had adduced in its [NoA](#).<sup>772</sup>

- 7.225 It is also our view that the fact that SONI did not in its appeal challenge the two formulae terms that the UR submitted were not in dispute, is, however, not relevant to the finding of the financeability error in the first place. The use of these two terms is only of relevance to this appeal once we seek to calibrate the level of remuneration under our remedy to this aspect of the financeability error we have found.
- 7.226 We therefore have decided that the price control was wrong to the extent that it did not remunerate SONI for these risks.

#### *Properties of remuneration structure*

- 7.227 The UR was concerned that SONI would have a perverse incentive to increase NIE's revenues at the expense of the interests of consumers were we to structure its remuneration in relation to its collection agent role on the basis of a margin on NIE's transmission revenues.<sup>773</sup>
- 7.228 In considering SONI's influence on the level of NIE's transmission revenues, we note that it is the UR, rather than SONI, who determines the level of NIE's allowed transmission revenues. As discussed in Ground 2, the UR also pre-approves all new investment in PCNPs. We also observe that the CER appears to have had no issue with remunerating the TSO in this way, adopting an approach based on margins for TAO revenues since 2011.<sup>774</sup> We therefore do not consider that this is a material risk.

#### *Our assessment – asymmetric risk*

- 7.229 In the case of the risks associated with PCNP and other investments subject to the  $D_t$  mechanism, we do not agree with the UR that there is no asymmetric risk.<sup>775</sup> It is fundamental to the principle of such mechanisms that there is a credible risk of disallowance: otherwise there is no incentive on the company to act efficiently. The incentive for SONI should be to minimise such efficiency adjustments.

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<sup>772</sup> [NoA](#), paragraph 17.2(a) to 17.2(g).

<sup>773</sup> See paragraph 7.141(b).

<sup>774</sup> See [CER Decision on TSO and TAO transmission revenue for 2011 to 2015](#), 19 November 2010, pages 129 to 133.

<sup>775</sup> See paragraphs 6.229 to 6.230.

- 7.230 We agree with SONI that in the context of the size of the investments it has to make in this period, which it estimates to be £37 million, these risks are significant and should be reflected in the risk and return framework. We therefore conclude that, to the extent that the regulatory framework transfers such risks to SONI, it needs also to include an allowance to offset this risk.<sup>776</sup>
- 7.231 In response to our provisional determination, the UR argued that SONI is at risk of disallowed costs only in relation to those that the UR has determined are DIWE.<sup>777</sup> The UR described this as a very high bar.<sup>778</sup> It argued that SONI should not receive an additional return to cover expenditure which might be excluded under the DIWE assessment, since this would be rewarding inefficient investment.
- 7.232 We agree with the UR that SONI should not receive an additional return to cover inefficiencies which are excluded under the DIWE assessment. However, we disagree with the UR that this is the only basis on which SONI might not recover its full costs.
- 7.233 As discussed in our analysis of the treatment of PCNPs and  $D_t$  claims under Ground 2, we have found that the UR was not wrong to require SONI to submit claims for ex-ante approval. Where costs increase above the initial budget during a project, whether because of a widening of project scope or because of some other cost increase, SONI would be required to go back to the UR for approval of these additional costs.
- 7.234 In approving both the initial project budget and any subsequent project variation, we consider that the UR should have the ability to scrutinise SONI's proposed costs and require SONI to justify its expenditure. We expect the UR to disallow additional expenditure where there was not clear evidence that it was justified.
- 7.235 In our view, a logical implication of the process for PCNPs and costs allowed under the  $D_t$  mechanism is that SONI faces some risk of cost disallowance. In contrast, as noted by SONI in its appeal on Ground 2, under the uncertainty mechanism for PCNPs and  $D_t$  there is no circumstance in which it can earn more than its actual costs.

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<sup>776</sup> We also note two other points. Firstly, the taking on of asymmetric risk cannot in principle be rewarded by applying a WACC determined on CAPM principles, as the CAPM assumes that all risks are symmetrical. Secondly, the WACC is applied to a working capital balance, rather than to fixed assets which SONI then uses in its own business. This means that remuneration for taking asymmetric risk will depend not on the level of the spend on the project, rather the level of working capital that SONI holds.

<sup>777</sup> UR response to CMA provisional determination, paragraph 1.106.

<sup>778</sup> See paragraphs 7.152 to 7.154 above.

- 7.236 The purpose of there being a reward within the price control for taking on asymmetric risk is that SONI will be incentivised to strive to be efficient. In our view, incentivising SONI in a way which does not promote efficiency (other than through DIWE) would not serve the longer-term interests of consumers.
- 7.237 The UR also argued that we should not seek to remunerate what we saw as asymmetric risk in one area (SONI's spend on projects subject to the D<sub>t</sub> mechanism) without taking into account asymmetry in another area (SONI's TSO BAU expenditure).<sup>779</sup> We disagree. The relevant consideration, in our view, is that the remuneration of each distinct area of SONI's portfolio of responsibilities<sup>780</sup> should be structured in such a way that each element of the package represented a 'fair bet' for SONI.
- 7.238 This consideration is reflected in SONI's TSO licence – the licence specifies levels of remuneration for each of its activities by way of distinct elements in the overall TSO price control formula. It would not be desirable if failings in the approach to the remuneration of one individual area could be seen to be remedied by countervailing failings in the approach to remuneration in another area on the grounds that the price control settlement, taken in-the-round, was somehow seen as a 'fair bet'.
- 7.239 We therefore consider that the treatment of asymmetric risk needs to be considered separately, and that the Price Control was wrong to the extent that it failed to properly remunerate SONI for taking asymmetric risk.

### ***Our view on Error 1(a)***

- 7.240 We note that much of SONI's case in respect of Error 1(a) relates to the use of alternative approaches for the Price Control. SONI has submitted that it operates in a very different financial and economic context to other regulated companies, and that this implies that the UR should have changed its approach to regulation to reflect this.
- 7.241 In support of this, SONI provided evidence for a margins approach, and that alternatively the UR could have given more weight to intangible assets in its assessment.

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<sup>779</sup> See paragraphs 7.155 to 7.159 above.

<sup>780</sup> As set out in Table 7.4 above.



- 7.242 The circumstances facing the UR were complex. We consider that SONI has not demonstrated it was wrong for the UR to start with an approach which includes a RAB/WACC component.
- 7.243 The UR sought to apply the approach which it used in other price controls for asset-heavy businesses such as NIE, and SONI has shown that it faces very different circumstances to comparators such as NIE. In contrast to NIE, SONI is very asset-light with a small and fluctuating RAB. The UR has taken the approach it applies for NIE and made adjustments to reflect some aspects of SONI's operations. We have considered these above and concluded that the adjustments made were insufficient to address the characteristics of SONI's business.
- 7.244 In that context, we have concluded that SONI has made the case that the UR's approach does not fully reflect the risks that it faces. We agree with SONI that increasing the return on a small and unstable asset base to allow for higher operational gearing is not a reliable mechanism for addressing the risks faced by a business with the characteristics of SONI. This approach does not remunerate SONI for:
- (a) undertaking uncertain investments and opex activities with some asymmetric risk, such as PCNPs and spend subject to the D: mechanism. This represents around £37 million across the Price Control Period; and
  - (b) managing the financing risk associated with the operation of the market, which requires SONI to manage the timing risks associated with revenues and costs of over £100 million in the later part of the Price Control Period.
- 7.245 SONI has provided further evidence in respect of the scale of these risks in Error 1(b) and Error 1(c) below. As discussed above, we consider that it is appropriate to consider SONI's case on Ground 1 broadly in assessing whether this failure to remunerate SONI for these risks means that the Price Control Decision was wrong.
- 7.246 We conclude on the 'in-the-round' aspects of Ground 1, including whether the failure to reflect these risks results in an error in the Price Control, in paragraphs 7.372 to 7.383 below.

## **Error 1(b)**

- 7.247 Under Error 1(b), SONI alleged that the UR failed to conduct an adequate assessment of financeability, and failed to properly remunerate SONI for all

the layers of capital invested in its TSO activities, both actual and committed. SONI also alleged that the UR's financeability testing for SONI had been flawed.

## ***UR's Decision***

### *Financeability assessment*

7.248 In the [Draft Determination](#) the UR conducted debt financeability modelling based on the then assumption, consistent with its WACC proposal, that SONI might be partially funded by debt. It set out the standard ratios it had calculated in section 7.10.<sup>781</sup> The UR in the [Final Determination](#) presented revised ratio analysis<sup>782</sup>, again on the basis that SONI might be partially funded through debt. However, the UR noted that limited weight should be placed on these ratios as it had modified the WACC to be sufficient to cover the cost of capital for a 100% equity financed business. In consequence, the UR considered that as least as much weight should be placed on those scenarios. Provided that the WACC was sufficient to cover funding through 100% equity, the UR could be assured that SONI was financeable.<sup>783</sup>

### *Provision of a Parent Company Guarantee (PCG)*

7.249 As part of SONI's Licence, SONI is required to have a guarantee in place from its parent, to provide financial security in the case where SONI enters financial difficulties.<sup>784</sup>

7.250 The UR explained that having a PCG in place was a mechanism to ensure adequate financial resources within a licensed business like SONI's. In the event of a financial need, eg a new IT system, there would be a commitment from the owner to provide the regulated business with the funds that it needed to enable the business to deliver its obligations. Once deployed, those funds would be rewarded within the SONI price control, eg a new IT system will receive a WACC return.<sup>785</sup>

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<sup>781</sup> [Draft Determination](#), paragraphs 239–244.

<sup>782</sup> [Final Determination](#), paragraph 314.

<sup>783</sup> [Final Determination](#), paragraph 316.

<sup>784</sup> Condition 3A – Parent Company Undertaking from EirGrid plc, page 28 of [SONI's transmission licence](#) (consolidated January 2016). 3A provides that (so long as EirGrid is the legal and beneficial owner of SONI and SONI holds the Transmission licence) SONI is required to procure an undertaking from EirGrid, in a form approved by the UR, to ensure that SONI has adequate financial and non-financial resources to perform its obligations and meet any liabilities under the Licence. SONI told us in its [NoA](#) that EirGrid provided a £10 million PCG pursuant to this licence condition, when it acquired SONI.

<sup>785</sup> [Final Determination](#), paragraph 290.

- 7.251 The UR noted that EirGrid had provided ‘maximum aggregate financial support’ of £10 million for SONI to have adequate financial and non-financial resources to perform its obligations in accordance with the requirements of both SONI’s TSO and MO licences.
- 7.252 The UR explained that the SEMC had approved<sup>786</sup> an annual allowance of €300,000 (being £10 million x 2.5% converted to Euros) in the SEMO price control. The allowance was applied to SEMO, the corporate joint venture between SONI (as a TSO) and EirGrid (as a TSO) on the explicit basis that no such allowance had been included within the existing (2010 to 2015) SONI TSO price control.<sup>787</sup>
- 7.253 The UR explained that the SEMC had taken this approach because SONI (in its capacity as a MO licensee) had argued that it had not been remunerated for the £10 million PCG in the then SONI TSO price control and therefore this should be dealt with in the forthcoming SEMO price control.<sup>788</sup> The SEMC had justified<sup>789</sup> the €300,000 as being its assessment of the fair value of the requirement to have in place the PCG and the likely cost of procuring such a facility for contingent capital.<sup>790</sup>
- 7.254 The UR therefore concluded that remuneration of the PCG had been fully covered in the SEMO price control.<sup>791</sup> As such, there was no basis for allowing an additional amount within SONI’s TSO price control for the upfront cost of that contingent equity capital.<sup>792</sup>

#### *Working capital financing*

- 7.255 SONI has a revolving credit facility of £12 million which acts as a working capital facility for the unexpected dispatch balancing costs SONI incurs. Within SONI’s opex allowance the UR allowed for a recurring facility fee of 90 basis points per annum (0.9%) on this £12 million.<sup>793</sup>

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<sup>786</sup> [SEMO Revenue Requirement for price control commencing 1 October 2013](#), 6 August 2013, paragraph 13.2.5.

<sup>787</sup> [Final Determination](#), paragraph 294.

<sup>788</sup> [Final Determination](#), paragraph 293.

<sup>789</sup> [SEMO Revenue Requirement for price control commencing 1 October 2013](#), 6 August 2013, paragraph 13.2.5.

<sup>790</sup> [Final Determination](#), paragraph 295.

<sup>791</sup> [Final Determination](#), paragraph 292.

<sup>792</sup> [Final Determination](#), paragraph 297.

<sup>793</sup> [Final Determination](#), paragraph 289.

## **SONI's views**

7.256 SONI submitted that the UR performed an inadequate debt financeability assessment, leading it to make errors in its decision. It provided further expert evidence from KPMG, which it submitted demonstrated that the UR's approach was wrong.<sup>794</sup> SONI also submitted evidence that it was unable in practice to finance its business in the context of the UR's regulatory model, and provided evidence that its discussions with banks had resulted in it not being able to obtain finance.

### *The UR's financeability analysis was limited and inadequate*

7.257 SONI submitted that the UR undertook a limited and inadequate financeability assessment. It provided three reasons, based on assessment by KPMG.

7.258 First, that SONI's business characteristics implied that the standard financeability assessment approach that is applied to traditional utilities was neither appropriate nor sufficient to assess SONI's financeability.<sup>795</sup>

7.259 SONI submitted that there were specific factors which should have been reflected, including that its financeability tests should have been forward-looking so as to take into account the projected evolution of risks, as the risks faced by SONI were increasing over the Price Control Period. SONI also submitted that the UR failed to consider all sources of capital employed, focusing only on the capital reflected in the RAB.<sup>796</sup>

7.260 Second, SONI submitted that the UR should have considered equity financeability, and should have paid particular regard to the level of financial headroom and run downside scenarios, given SONI's state as an asset-light company with limited ability to manage financial risk.<sup>797</sup>

7.261 Third, SONI submitted that the UR should have considered how SONI would mitigate any financial problems that would arise, and that this was particularly important since banks will not lend to SONI without a cross-guarantee or Letter of Comfort.<sup>798</sup>

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<sup>794</sup> NoA MC1, supporting document MC1/1 (KPMG 1).

<sup>795</sup> NoA, paragraph 19.13.

<sup>796</sup> NoA, paragraph 19.15.

<sup>797</sup> NoA, paragraph 19.16.

<sup>798</sup> NoA, paragraph 19.19.

*The UR failed to remunerate all layers of capital – the Parent Company Guarantee (PCG)*

- 7.262 SONI argued that all layers of capital need to be identified and remunerated.<sup>799</sup>
- 7.263 SONI identified that it has a £10 million PCG from EirGrid to ensure it has adequate resources, as required by Condition 3A of its Licence.<sup>800</sup> It also has a £12 million revolving credit bank facility.
- 7.264 SONI submitted that the UR's reason for not remunerating the PCG under the Licence is that an identical licence obligation applies for SEMO and that the UR was erroneously concerned about 'double recovery'. SONI submitted that the TSO Licence requirement was separate and should be remunerated separately.

*SONI's comments in response to our provisional determination*

- 7.265 SONI agreed with our provisional determination that the UR had been wrong to provide a zero allowance for the PCG that SONI was required to procure from EirGrid pursuant to Condition 3A of its TSO Licence. SONI noted that we had acknowledged that the UR had not recognised, valued or remunerated the TSO PCG at all. In SONI's view, the TSO PCG corresponded to risks that were separate, independent and largely uncorrelated with those associated with its MO Licence.<sup>801</sup>
- 7.266 SONI said that it would, however, be concerned if we were to endorse the view that it would be acceptable for one set of risks to be remunerated via the price control of another since:
- (a) the price controls are not aligned (the current SEMO control ends in 2018); and
  - (b) the SEMO price control was not set out in SEMO's licence.<sup>802</sup>
- 7.267 SONI submitted that adopting an approach where the price controls relied on each other for financeability, would lead to less transparency overall. As a result, the scope for error would be increased. Such an approach, SONI argued, would fundamentally change and undermine the principle on which the entire UK regulatory framework for price controls was based, namely that

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<sup>799</sup> NoA, paragraph 19.22.

<sup>800</sup> NoA, paragraph 19.23.

<sup>801</sup> SONI response to CMA provisional determination, paragraph 6.13.

<sup>802</sup> SONI response to CMA provisional determination, paragraph 6.15.

the financeability of each individual licence holder should be assessed on a standalone basis.<sup>803</sup>

- 7.268 SONI agreed with the position we had set out in our provisional determination that the SEMC's decision to allow the cost of the SEMO guarantee to be recovered within the SEMO price control did not indicate that the cost of the SONI guarantee would also be recovered. SONI highlighted that throughout the appeal process the UR had failed to put forward any evidence to suggest that the cost of the SONI TSO guarantee had been taken into account in the calculation of the level of remuneration for the PCG in the SEMO price control.<sup>804</sup>
- 7.269 SONI submitted that as we had recognised that the risks in respect of the SONI TSO guarantee were unremunerated, we should undertake a separate analysis to determine the appropriate level of remuneration. SONI submitted that the approach to determining the level of remuneration should be based on available market benchmarks and cross-checked against company-specific analysis. In SONI's view, such an analysis supported a range of 2.0% to 3.4% with a point estimate of 2.55% (compared with our indicative range of 1.5% to 2.5%).<sup>805</sup>
- 7.270 In the remedies hearing, SONI also highlighted that in its recent consultation document<sup>806</sup> the SEMC had proposed not to make any allowance for the PCG in the SEMO JV's prospective price control as from May 2018.

*The UR's approach had resulted in banks refusing to provide finance to SONI*

- 7.271 SONI submitted that the fact that it was not financeable under the Price Control was demonstrated by the fact that the banks would not lend to it. SONI could not raise debt financing and existing important bank facilities were at risk of not being renewed.<sup>807</sup>
- 7.272 In support of its case that the UR had not provided it with a framework which allowed it to finance its activities, SONI provided evidence that banks were unwilling to lend to SONI based on the [Final Determination](#), without the provision of a Letter of Comfort or a guarantee from EirGrid. SONI submitted that it needed a stable debt facility in order to manage the 'uncontrollable

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<sup>803</sup> SONI response to CMA provisional determination, paragraph 6.15.

<sup>804</sup> SONI response to CMA provisional determination, paragraph 6.19.

<sup>805</sup> SONI response to CMA provisional determination, paragraph 6.20.

<sup>806</sup> [SEMO Price Control, Draft Determination consultation paper](#), SEM-17-075, 28 September 2017.

<sup>807</sup> SONI Hearing transcript, page 8, lines 1–4.

costs' it manages as TSO. In respect of Error 1(b), SONI submitted that it needed all such capital commitments to be financed to ensure financeability.

- 7.273 SONI provided supporting evidence in the form of letters from its banks confirming that it faced undue risks in respect of large projects, including PCNPs. SONI submitted that this would result in it being unable to finance these investments.<sup>808</sup> SONI also provided evidence in support of the discussions with these banks<sup>809</sup>. The banks had indicated that a combination of factors, including the delay in the Price Control Decision, contributed to their decisions. SONI stated that it was clear evidence of regulatory failure that lenders required additional information.
- 7.274 In its hearing, SONI said that the most efficient way for it to raise debt finance would be through a composite upfront package. The transaction costs for the alternative – going piece by piece – would be simply very high.<sup>810</sup>
- 7.275 SONI referred to evidence from KPMG, who compared SONI's situation with that of National Grid. KPMG explained that National Grid could access capital markets continuously. Optimising financing, changing the balance, and tailoring finance continuously, rather than accessing finance in a single engagement upfront. In contrast, SONI would try to secure financing for a period of time, and, unless it had a facility it could draw on, absorb the cost arising from any fluctuations within that period. The situation for SONI was not unlike that for a small water company or a small network, which could only access capital on an infrequent basis for a fixed amount on a fixed term basis.<sup>811</sup>

#### *Errors in the financial model*

- 7.276 SONI also submitted that there are errors in the UR's financial model, which resulted in errors in the level of debt assumed, as well as inconsistency in the choice of benchmarks used.

#### ***UR's views***

- 7.277 The UR addressed the main arguments made by SONI under Error 1(b).

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<sup>808</sup> NoA, paragraph 19.13.

<sup>809</sup> NoA, First Witness Statement of Aidan Skelly (NoA AS1).

<sup>810</sup> SONI Hearing transcript, page 84, lines 2–4.

<sup>811</sup> SONI Hearing transcript, page 84, lines 5–15.

### *The UR's financeability analysis*

- 7.278 The UR submitted that SONI had misrepresented the approach taken by the UR in the [Final Determination](#). It concluded in the [Final Determination](#) that limited weight should be placed on financial ratio test given that the choice to raise debt finance was a matter for SONI alone.<sup>812</sup>
- 7.279 The UR confirmed that, in its view, as long as the allowed rate of return is sufficient to cover the opportunity cost of financing investment via equity capital, and that, as the UR had also covered 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 required for its activities.<sup>813</sup>
- 7.280 In respect of SONI's statement that the UR should have undertaken 'equity financeability tests', the UR submitted that, to its knowledge, no UK regulator had ever applied such tests, and in any case, that 'equity financeability' did not rely on passing such tests in the context of a growing RAB.<sup>814</sup>
- 7.281 The UR also stated that the claim that downside sensitivities were needed was contrary to the UR's statutory duties, to the extent that it implied a premium return to allow shareholders to earn a return even in downside scenarios.<sup>815</sup>

### *Remuneration of all layers of capital*

- 7.282 The UR's response focused on the issue of the remuneration of the PCG for the £10 million but it also referred to the cross-guarantee provided by EirGrid in relation to the £12 million working capital facility.

### *Parent Company Guarantee (PCG)*

- 7.283 The UR stated that EirGrid's letter had been given pursuant to both SONI's TSO and the MO<sup>816</sup> Licence.<sup>817</sup> In the UR's view, SONI was arguing that it should be paid twice.<sup>818</sup> Although the UR agreed that there were two Licence

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<sup>812</sup> [Defence](#), paragraph 1.53.

<sup>813</sup> [Defence](#), paragraphs 1.63–1.64.

<sup>814</sup> [Defence](#), paragraph 1.62.

<sup>815</sup> [Defence](#), paragraph 1.69.

<sup>816</sup> See Condition 3A in [SONI's Licence to act as a SEM operator](#), updated to 10 March 2017. See footnote to paragraph 7.249 for references to the TSO equivalent for the PCG.

<sup>817</sup> [Defence](#), paragraph 1.79.

<sup>818</sup> [Defence](#), paragraph 1.84.



requirements, there was only one 11 March 2009 letter, one parent company undertaking and one sum of £10 million in contingent capital.<sup>819</sup>

7.284 Because a PCG was contingent rather than actual capital, the UR (through the SEMC) had placed a value on it of 2.5% of the value of £10 million, just above the 2% costing that the CMA had placed on contingent capital/letters of credit in its [Energy Market Investigation](#).<sup>820</sup> In its profitability analysis the CMA had assumed that energy retailers would finance their regulatory collateral requirements largely via the use of letters of credit.<sup>821</sup>

- *UR's comments in response to our provisional determination*

7.285 The UR commented that the PCG was at first sight unusual but reflected a conscious decision that it would be better for SONI to have standby contingent capital than for it to take additional expensive equity from shareholders and hold cash on its balance sheet. This PCG should, therefore, be considered in the same basic terms as a letter of credit or standby equity capital. The UR submitted that it should not be thought of as equivalent to sub-prime debt, because the risk of the PCG being called, let alone EirGrid ever suffering a loss of capital, was minimal.<sup>822</sup>

7.286 The UR highlighted that we were proposing to award SONI a return of 1.5% to 2.5% on the face value of the £10 million PCG in addition to the 2.5% return that the SEMC had factored into the current SEMO price control.<sup>823</sup>

7.287 The UR submitted that the PCG should be valued on the basis of the market cost for such a guarantee. The UR argued that as the current fair rate of return on preference shares in excess of the risk-free rate was 3.1% per annum and the excess return on preference shares would overestimate the market level of remuneration for the PCG, then, an aggregate return across the two price controls of 4.0% to 5.0% would be grossly excessive.<sup>824</sup>

7.288 The UR also disputed the statement in our provisional determination that the allowance in the SEMO price control for the PCG appeared to be broadly in line with what might be expected for a company with SEMO's risk profile. The UR said that, we had set out no evidence for that crucial proposition.

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<sup>819</sup> [Defence](#), paragraph 1.86.

<sup>820</sup> [Defence](#), paragraph 1.82.

<sup>821</sup> CMA Energy Market Investigation, Final Report, [Appendix 9.10: Analysis of retail supply profitability – ROCE](#), paragraph 139, 24 June 2016.

<sup>822</sup> UR response to CMA provisional determination, paragraphs 1.132.

<sup>823</sup> UR response to CMA provisional determination, paragraphs 1.16, 1.48(f) and 1.93(d). We note that the SEMO price control is due to be superseded by a new SEMO price control on cessation of SEM wholesale market arrangements in May 2018, with the new price control reflecting the new I-SEM wholesale market arrangements.

<sup>824</sup> UR response to CMA provisional determination, paragraphs 1.45 & 1.48.

The UR submitted that, were we to investigate what SEMO did, we would, according to the UR, find that SEMO had taken on a relatively small subset of what had previously been system operator functions and that the SEMC had set up SEMO in such a way that all the material risks that it would otherwise have faced had been passed onto other parties, namely the two TSOs and consumers.<sup>825</sup> SEMO was therefore, the UR submitted, an extremely low-risk joint venture.<sup>826</sup>

- 7.289 As a result, the UR argued, it was scarcely conceivable that SEMO could cause EirGrid to incur a meaningful loss under its PCG.<sup>827</sup> The UR submitted that we appeared to have misunderstood its position. The UR submitted that it was not arguing that there was no incremental cost for a guarantee that covered both SEMO and TSO risks as compared to one covering just SEMO risks. The UR's case was that the 2.5% already provided under the SEMO control was sufficient to cover both, and was clearly excessive for the very limited SEMO risks.<sup>828</sup>
- 7.290 The UR told us that the approach we proposed to take to analysing the cost of the PCG in our provisional determination was reasonable, but in arriving at the level of remuneration for our proposed remedy we had failed to adopt that approach. In particular, the UR submitted that we had failed to take the initial step of assessing the aggregate cost of the PCG across the two businesses.<sup>829</sup> In response to our observation that further analysis on the PCG issue had been promised in the August 2013 SEMO decision but none had been subsequently forthcoming, the UR told us that it was the CMA, rather than the UR, that had failed to do sufficient analysis.<sup>830</sup> In consequence, our provisional determination did not provide the analysis needed to support our provisional conclusion that the allowance for the PCG in the Price Control was inadequate.<sup>831</sup>
- 7.291 The UR also submitted that, when analysing the risk that the PCG might be called on in relation to SONI's TSO activities, we should recognise the hierarchy of risk the UR had assumed within the [Final Determination](#). In the UR's view, the PCG stood *after* SONI's TSO equity capital, in other words the around £18 million that SONI would have invested in its RAB. It was,

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<sup>825</sup> Remedies Hearing transcript, page 92, lines 3–8.

<sup>826</sup> UR response to CMA provisional determination, paragraphs 1.48.

<sup>827</sup> UR response to CMA provisional determination, paragraphs 1.50.

<sup>828</sup> UR response to CMA provisional determination, paragraphs 1.51.

<sup>829</sup> UR response to CMA provisional determination, paragraphs 1.52.

<sup>830</sup> UR response to CMA provisional determination, paragraphs 1.52.

<sup>831</sup> UR response to CMA provisional determination, paragraphs 1.53.

therefore extremely unlikely that the PCG would ever result in a loss to EirGrid.<sup>832</sup>

- 7.292 The UR elaborated on its thinking by stating that, given a significant loss scenario, existing investors in such a regulatory business faced a choice between forsaking the value of their sunk investment in RAB or injecting the necessary equity funds into the business. It would be only after injecting funds up the value of existing RAB, would the PCG in practice be called on.<sup>833</sup>

#### *Financial model*

- 7.293 The UR provided a supporting witness statement from a financial modelling expert, who stated that in his view, SONI's statements were either not errors, or were immaterial to the outputs of the financial model.

#### **CCNI's views**

##### *SONI alleged that the UR failed to remunerate all layers of capital*

- 7.294 SLG, on behalf of CCNI, noted that, to the extent that extending the PCG to cover SONI increased the cost of the PCG, such extra costs should be allowed. However, in SLG's view, the fact that the PCG covered other independent and separate risks would not be a reason for including it unless there was a clear incremental cost over and above the cost of providing a PCG for SEMO.<sup>834</sup>
- 7.295 SLG continued that SONI raised a further argument, that it was currently unable to raise additional debt without either a PCG or a Letter of Comfort from the UR. This was strong evidence (if confirmed by supporting evidence provided by SONI) challenging the UR's conclusion that SONI is financeable under the [Final Determination](#) and that the financeability assessment was sufficient to ensure that it remained able to access sources of finance.<sup>835</sup>

##### *SONI alleged that the UR's financeability analysis was limited and inadequate*

- 7.296 SLG noted that SONI had submitted it was currently unable to raise additional debt without either a PCG or a Letter of Comfort from the UR. In

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<sup>832</sup> Remedies Hearing transcript, page 89, lines 20–25.

<sup>833</sup> Remedies Hearing transcript, pages 123–125.

<sup>834</sup> [CCNI R&O](#), Annex 3 (SLG Economics Ltd Report), page 5.

<sup>835</sup> [CCNI R&O](#), Annex 3 (SLG Economics Ltd Report), page 6.

SLG's view, that was strong evidence, if confirmed by supporting evidence provided by SONI, challenging the UR's conclusion that SONI was financeable under the [Final Determination](#).<sup>836</sup>

- 7.297 Regarding the many criticisms SONI had made on the UR's financeability modelling, SLG considered the lack of scenarios which tested SONI's resilience to down-side shocks to be the most important in terms of potential downside consequences for consumers. Lack of such an assessment could call into question the adequacy of the UR's analysis.<sup>837</sup>
- 7.298 SLG also noted that whether incentive payments should be included in the base case in the modelling for financeability depended on the structure of such incentive regimes – if they had a neutral/zero expected value, then payments should not be included; however, if they had a positive expected value (for example because payment rates or caps, collars etc were not-symmetrical) then the expected payments should be included. In addition, the potential for incentive payments to be negative (and therefore for SONI to receive less funds than expected) should have been considered in the analysis of whether SONI was financeable under various credible downside scenarios.<sup>838</sup>

### ***Our assessment of Error 1(b)***

- 7.299 The core of SONI's alleged errors under Error 1(b) is that the UR performed a debt financeability assessment which was insufficient to manage the risks which it would face in this period. In particular, SONI faces significant investments, a new price control framework, and increasing exposure to the risks associated with financing the collection function.
- 7.300 In that context, SONI considers that the remuneration of the PCG is also insufficient, as it is limited to the risks faced by SEMO.
- 7.301 In our view, SONI's case can be separated into two points:
- (a) First, that the UR's assessment is insufficient given the higher risk faced by SONI than comparator companies, and that given the 100% equity assumption, a separate financeability test, including downside risk, should have been included in the UR's assessment.
  - (b) Second, that the UR's assessment does not properly consider the costs of additional finance required by SONI, including working capital

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<sup>836</sup> CCNI R&O, Annex 3 (SLG Economics Ltd Report), page 6.

<sup>837</sup> CCNI R&O, Annex 3 (SLG Economics Ltd Report), page 5.

<sup>838</sup> CCNI R&O, Annex 3 (SLG Economics Ltd Report), page 5.

financing and the PCG, and this is supported by the actual difficulties SONI faces in trying to raise finance from its banks.

7.302 The UR's responses can be summarised as:

- (a) First, that its assessment of financeability is sufficient as it covers normal risks, that the use of downside scenarios implies above-average returns, and that equity financeability is meaningless.
- (b) Second, that it has already remunerated the PCG (via SEMO) and the cost of working capital finance (the LIBOR plus 2% and the facility fee).

7.303 We consider these points separately.

#### *The UR's financeability assessment*

7.304 We have reviewed SONI's assessment of the UR's financeability analysis. SONI is seeking further analysis which could inform the UR's understanding of SONI's financial position in different scenarios. We agree with SONI that such analysis could be informative in understanding the financial position of SONI, both in the base case and downside scenario.

7.305 However, we also agree with the UR that, in this case, its failure to run such scenarios was not wrong. We can see that there would be some benefits in running downside scenarios, in particular where there are material uncertainties about the effect of the market changes which are expected within the next price control period. It would be particularly important if SONI were relying on certain ratios to maintain debt finance, but we do not consider that it was wrong for the UR to reach the view that downside scenarios would add little in this case, other than in consideration of asymmetric risk, which SONI considers under Error 1(c) below.

7.306 We also agree with the UR that it is well established regulatory precedent that there are many financing structures that can be used, and that it is not for the regulator to impose any particular financing structure, other than to the extent of requiring minimum financial strength. We therefore agree with the UR that, as long as the return on capital is sufficient, it would be for SONI to identify a suitable approach to dividend policy and investment. We also agree with the UR that SONI might expect to have to invest capital at a point when its RAB is growing.

#### *The UR failed to remunerate all layers of capital*

7.307 Whilst we agree with the UR's approach to the financing of the investments in RAB assets, we have identified in Error 1(a) above that its approach does

not consider the need for SONI to finance significant timing differences, and that there will be a cost in raising such finance, which may be material to a small business such as SONI.

- 7.308 We consider that the UR has not provided any remuneration to cover the risks associated with the management of working capital. The UR has allowed a cost linked to the ongoing costs of the facility provided by banks up to 2017 (which is currently backed up by a cross-guarantee from EirGrid), but has not allowed any amounts for refinancing or for managing the risks associated with the future financing costs. The UR has not provided any revenue to cover the costs of the PCG.

*Remuneration of Parent Company Guarantee (PCG)*

- 7.309 We do not consider that it is wrong in itself for the total cost of the guarantee to be remunerated only through the SEMO JV price control, ie for there to be one allowance to cover the aggregate cost to EirGrid of one guarantee which covers the risks arising from SONI fulfilling both its MO and TSO licence obligations. Whilst we consider that it would be more normal, and lead to less confusion, for the guarantee to be remunerated across all relevant price controls, this aspect of the UR's stated approach does not appear wrong in principle; eg there is no impact on competition as SONI is a monopoly provider across all these price controls. What is important in this case is that the cost of the PCG should be remunerated across all relevant price controls in total.
- 7.310 We therefore consider that the correct analysis in this case is:
- (a) What is the aggregate cost of the guarantee arising from SONI's TSO and MO obligations?
  - (b) What is allowed in the SEMO JV price control?
  - (c) What is the outstanding cost (if any) that should be reflected in the SONI TSO price control?
- 7.311 Based on the evidence we have, we remain of the view that the UR has done very limited analysis of whether the amount allowed in the SEMO JV price control was sufficient to remunerate the PCG requirement associated with the distinct MO and TSO licence obligations that SONI has. We do not accept that there is no incremental cost associated with a guarantee that covers two discrete sets of licence obligations, and therefore covers two sets of risks. It is straightforward probability analysis that if a guarantor takes on two risks, either which are independent or which, if they occur together, will result in a higher cost to the guarantor, this will be a greater risk than a

guarantee of the same size but covering a single risk. The 'expected loss' to the guarantor will be higher. This will increase the market price of that risk.

- 7.312 We agree with the UR as far as it states that there is a risk of a 'double count' were the cost of the two separate guarantees to be considered to be simply twice the cost of single guarantee. However, we do not consider that this is sufficient to establish whether the cost assumed for the guarantee in relation to SONI's MO obligations is sufficient for a guarantee which also covers SONI's TSO obligations. SONI's analysis of the value the guarantee is consistent with the principle that the guarantee of SONI's TSO obligations represents an incremental risk to the guarantor.
- 7.313 The question is therefore whether the cost allowed in the SEMO JV price control was high enough to cover the cost of both the risks arising from both SONI's TSO as well as MO obligations. We agree with SONI's case that the approach followed by the UR to allow the cost of its MO obligations guarantee does not indicate that the cost of its TSO obligations guarantee has already been covered with the SEMO JV price control.
- 7.314 In our provisional determination, we stated that the cost of the guarantee for the SEMO JV appeared to be broadly in line with what might be expected for a company with the SEMO JV's risk profile. We noted that the UR (through the SEMC) had stated in its SEMO JV decision that it would undertake further analysis to test the cost of the guarantee across SEMO and SONI.<sup>839</sup> It remains the case from the evidence submitted to us during this appeal that the UR had not done so in coming to its decision on the SONI price control.
- 7.315 In response to our provisional determination, the UR told us that the SEMO JV had been set up in such a way that all material risks had been transferred away from the JV, and therefore the JV was very low risk. The remuneration for the PCG within the SEMO JV price control had been set at a sufficiently high level (2.5%) that, in the UR's view, it plainly covered both guarantees. The UR again referred to the fact that the SEMC had checked whether the then SONI TSO price control had made provision for the PCG as evidence for this assertion.<sup>840</sup>
- 7.316 We note, however, that the wording of the SEMC when deciding to remunerate the SEMO JV, made reference only to the fact that an allowance had not been given in the previous SONI TSO price control. The SEMC,

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<sup>839</sup> [SEMO Revenue Requirement for price control commencing 1 October 2013](#), 6 August 2013, paragraph 13.2.6.

<sup>840</sup> UR response to CMA provisional determination, paragraph 1.47.



therefore, left the question open as to what activities, and therefore which risks, the allowance it had awarded the SEMO JV was intended to cover.

- 7.317 We note that this appeal does not concern the SEMO JV price control and it would normally be outside the scope of an appeal to have to consider the risks contained within another price control not under appeal. Notwithstanding this, it is clear to us that the risks that the SEMO JV currently faces, and is likely to face in the future after the introduction of the I-SEM, are not zero, not least because the SEMC has proposed to capitalise the capital expenditure relating to the SEMO JV's operational activities on the balance sheets of the respective TSOs, leaving the JV with little assets, and therefore little expected profit of its own.<sup>841</sup>
- 7.318 In addition, we note that the SEMC has decided to reduce the level in respect of SONI current PCG obligation (for £10 million) for which SONI is remunerated within the current (SEM-based) SEMO JV price control from £10 million to £2 million as from May 2018.<sup>842</sup> We also note that in its recently published consultation document for the prospective (I-SEM-based) SEMO JV price control, it has not proposed any remuneration for the PCG. In our view both these (proposed) decisions call into question the UR's argument that we would be doubly remunerating SONI were we to provide an allowance for the PCG in respect of SONI's TSO licence obligations within this Price Control.
- 7.319 We therefore conclude that the UR was wrong in principle to set the allowance for the PCG in respect of the obligations that SONI fulfils in its TSO price control at zero. We consider the question of how much of the current allowance for the PCG within the SEMO JV should be ascribed to the risks faced by SONI from performing those of its MO obligations if fulfils through the SEMO JV in our discussion of remedies in Chapter 12.

#### *Remuneration of cross-guarantee*

- 7.320 We discussed in Error 1(a) above (see paragraphs 7.205 to 7.206) that there is no explicit allowance for risk on the activities associated with the collection agent function. Under Error 1(b) SONI further argues that this means that one of the layers of capital has not been remunerated.

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<sup>841</sup> See [SEMO Price Control, Draft Determination consultation paper](#), SEM-17-075, 28 September 2017, page 43.

<sup>842</sup> See [SEMO Revenue Requirement, Price control commencing 1 October 2016, Decision Paper](#), SEM-16-043, 3 August 2016, page 51.



- 7.321 The UR did make an allowance for the actual costs of the working capital facility, on the following assumptions:
- (a) The facility costs of 90 basis points (0.9%) per annum.
  - (b) The facility will remain at £12 million.
  - (c) The interest rate will be LIBOR plus 2%.
- 7.322 We agree in principle with the UR that some form of working capital facility should be available to manage the costs associated with timing issues. The evidence suggests that there should be reasonable certainty that the costs will be returned to SONI in due course.
- 7.323 However, we also agree with SONI's case that it faces a significant increase in working capital and timing risks, and that these have not been reflected in the UR's assessment.
- 7.324 The management of the collection function is unusual in regulatory terms: it represents a clear risk for the investor that it is unable to finance the costs, and there is a real cost to securing working capital facilities, both in terms of the direct cost of securing the facility and the impact on SONI's broader ability to raise debt finance at reasonable rates. There is a risk to investors that facilities are not available when needed. Unlike most comparable regulatory obligations, the size of the risk is so material, with Table 7.3 illustrating that SONI will have to manage cash flows of over £100 million in the later years of the Price Control, that it is difficult to assume that it can be managed without costs.
- 7.325 The UR has allowed an amount equal to the ongoing cost of the current standby facilities. We do not consider that this is sufficient. The risk to SONI is increasing not least because the value of the revenue it is collecting is increasing. We also note that the impact of the forthcoming revised wholesale market arrangements (I-SEM) is uncertain and this in itself presents an increased risk. The cost of having standby facilities in place is therefore likely to increase. SONI is also facing material capital calls in respect of its price controlled activities.
- 7.326 SONI has provided evidence that it has found it difficult to raise finance from its banks. From our consideration of this appeal more generally and Ground 2 in particular, in our view there are a number of reasons, relating to the development of the regime for PCNPs and D<sub>t</sub> applications, why SONI might be finding difficulties in raising finance. We would expect that a clarified process for new investments as indicated within Ground 2 would resolve some of these difficulties.

- 7.327 SONI's case on Ground 1 is not that it is looking to change the obligations which it faces in respect of revenue collection, which would make financing easier. SONI's case is that it requires a higher return to be financeable, including providing sufficient returns to investors. We therefore conclude that SONI's discussions with its banks do not in themselves show that the UR was wrong in respect of Ground 1. SONI's banks would be facing similar risks in lending to SONI to manage working capital risks, even if SONI had a higher profit allowance.
- 7.328 However, we agree with SONI that the obligations it faces in managing industry cash flows involve material working capital flows and will require significant financing facilities. This will inevitably increase the perception of risk for providers of finance to SONI, particularly where there is uncertainty about the scale of the underlying cash flows. We agree with SONI that the existence of obligations of this size and uncertainty will have some cost in terms of increasing the risk of SONI, and therefore the cost of obtaining finance from investors.
- 7.329 SONI provided evidence of the approach followed in Ireland by the CER, which allows an effective margin of 0.5% for the lower-risk revenue collection functions,<sup>843</sup> and a margin equivalent to approximately 1% of revenue on the more risky parts of these functions, in particular DBCs. These represent part of EirGrid's relevant costs to be recovered from price controlled tariffs to remunerate EirGrid for taking on the working capital risk.<sup>844</sup> This approach has regard to the unusual nature of the relevant functions, and the case for moving away from the standard regulatory approach.
- 7.330 We appreciate that this form of working capital management is normally managed by regulated companies without any separate remuneration. However, SONI's revenues including its revenue collection and dispatch balancing functions are approximately five times its Price Control revenues.<sup>845</sup> Given this scale, we do not accept that any other regulated company, nor any private company, would accept such very significant cash flow management risks without some form of remuneration for doing so. To this extent, we note that many of the examples of retail margins provided by KPMG<sup>846</sup> and discussed in Error 1(a) above, whilst not particularly relevant

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<sup>843</sup> Note, however, as explained in Table 7.1 above, this 0.5% also reflects a correction of an error in the adjustment made by the CER when setting EirGrid's WACC to take account of its higher operational gearing at the consultation stage.

<sup>844</sup> See Table 7.1 above.

<sup>845</sup> See Table 7.3 above.

<sup>846</sup> NoA MC1, supporting document MC1/1 (KPMG 1).

to the remuneration of investment in SONI's core operations, may be relevant to the remuneration of the cash management functions of SONI.

7.331 We consider the implication of this finding as part of our overall assessment of Ground 1 below.

### ***Our view on Error 1(b)***

7.332 We have found that there were omissions in the UR's allowances in respect of remuneration of the other layers of capital. In our view, we consider that the UR erred in not making allowances in respect of working capital risk and the PCG.

7.333 We consider the broader implications for SONI's price control under our overall assessment below.

### **Error 1(c)**

7.334 SONI alleged that the UR should have conducted financeability testing from the perspective of equity investors. Under this sub-ground SONI also pleaded that the UR had failed to take account of the non-systematic and asymmetric risks SONI faced when using the CAPM to set its cost of capital.

### ***UR's Decision***

7.335 The UR explained that its position on financeability testing was in line with developments in UK regulatory practice. UK regulators had recently focused on ensuring that the framework and allowances in the overall Price Control package provided an efficiently managed company with sufficient returns to attract and maintain the financial capital that the business needed in order to carry out its obligations.<sup>847</sup> The UR remarked that the CC's determination of NIE's RP5 (2012-2017) price control<sup>848</sup> had set out a number of important principles in this regard, which had again been reinforced by the CMA in its recent [Bristol Water price determination](#).<sup>849</sup>

7.336 The UR explained that this meant less focus on credit metrics and financial ratios than had sometimes been the case in the past, with choices about capital structure (ie the mix of debt and equity) being more explicitly left to

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<sup>847</sup> [Final Determination](#), paragraph 317.

<sup>848</sup> [CC NIE price control determination](#), 26 March 2014, in particular, paragraph 17.97 and paragraph 17.100 onwards.

<sup>849</sup> [Bristol Water price determination](#), section 11.

the firm to determine.<sup>850</sup> As a result, the UR had put less focus on letting modelled credit ratios for debt drive the calibration of the price control package.<sup>851</sup>

7.337 The UR presented in the [Final Determination](#) two tables of financial ratios entitled *Modelled financial ratios (2010/11 to 2014/15)* and *Modelled financial ratios (2015/16 to 2019/20)* based on an equity: debt funding split assumption of 55:45.<sup>852</sup> The UR, however, noted that it had placed limited weight on those ratios given that the amount of debt finance that the business utilised was a matter for SONI alone. It regarded, in particular, that as least as much weight should be placed on scenarios in which SONI financed investment via equity and has 0% gearing. The UR continued that, provided that the allowed WACC was sufficient to cover the cost of capital for a 100% equity financed business, it (the UR) would be assured that the price control package left SONI in a position where it would be able to finance its activities. Any decision to depart from such a scenario and draw on debt finance was for SONI.<sup>853</sup>

7.338 Finally, the UR observed that its financial ratio analysis had highlighted the high level of operational gearing which SONI experienced. That did have an impact on the overall risk level of the business but it (the UR) had increased SONI's allowed rate of return on capital between the [Draft Determination](#) and [Final Determination](#) to take account of that.<sup>854</sup>

### **SONI's views**

7.339 All the points that SONI made under this sub-ground have arisen only after the [Final Determination](#) was published as it was only in that document that the UR assumed 100% equity funding and introduced the two-stage D<sub>t</sub> process, and therefore, in SONI's view, introduced asymmetric risk. SONI makes a number of points under the following headings:

- (a) That the UR was wrong as it failed to conduct financeability testing such as margin benchmarking, in the context of a 100% equity financing assumption.
- (b) The UR was wrong as it failed to take account of all the risks faced by SONI, including asymmetric risks.

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<sup>850</sup> [Final Determination](#), paragraph 272.

<sup>851</sup> [Final Determination](#), paragraph 317.

<sup>852</sup> [Final Determination](#), paragraph 314.

<sup>853</sup> [Final Determination](#), paragraph 316.

<sup>854</sup> [Final Determination](#), paragraph 318.

(c) The UR failed to consider financial resilience.

*The UR should have conducted equity financeability testing*

7.340 SONI noted that the UR had not undertaken any financial modelling which sought to assess SONI's financeability from the perspective of equity investors.<sup>855</sup> It instructed KPMG to:

- (a) compare its expected margins under the UR's price control determination to a reasonable benchmark;
- (b) assess whether SONI would be exposed to a level of risk that SONI could be reasonably expected to manage; and
- (c) assess whether the allowed equity returns per the [Final Determination](#) were adequate in light of the risks faced by SONI.<sup>856</sup>

7.341 KPMG explained that a key driver for equity financeability was for investors to expect, on average, to earn the equity return required.<sup>857</sup> Where the Price Control had been set such that the mean expected return was below this allowed return, the business would not be able to attract capital and hence would not be financeable. The key measure, therefore, in conducting its assessment was whether or not the expected returns as provided for under the [Final Determination](#) would be sufficient to enable SONI to attract capital and have sufficient cash to finance its activities.

7.342 SONI argued that, had the UR conducted a margin benchmarking analysis – that is to say element (a) as set out paragraph 7.340 above, as KPMG had done<sup>858</sup> – then it would have identified that SONI's expected returns for equity investors fell below the required benchmark. That meant the Price Control would not be financeable.<sup>859</sup>

*The UR failed to take account of the non-systematic risks SONI faces*

7.343 SONI pointed to the analysis by KPMG that evaluated the adequacy of equity returns for SONI given the risks it faced based on the level of allowances set out in the [Final Determination](#).<sup>860</sup>

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<sup>855</sup> [NoA](#), paragraph 20.1.

<sup>856</sup> [NoA](#), paragraph 20.2.

<sup>857</sup> NoA MC2, supporting document MC2/1 (KPMG 3).

<sup>858</sup> NoA MC1, supporting document MC1/1 (KPMG 1).

<sup>859</sup> [NoA](#), paragraphs 20.6–20.16.

<sup>860</sup> NoA MC2, supporting document MC2/1 (KPMG 3).

- 7.344 KPMG had explained that, where a regulated business was subject to risks that had not been reflected in the allowed revenues – that is to say, where the allowed revenues were not equal to expected cash flows because they did not fully take into account downside risks – and those risks were also not controllable ie they could not be mitigated by the management taking action – then the allowed return based on the CAPM framework would underestimate the required level of equity returns.
- 7.345 KPMG had further explained that the case where a firm was exposed to non-systematic risks which exhibited significant negative mean values was particularly relevant to SONI. In that situation, the allowed return estimated using CAPM would under-compensate shareholders for the risks that businesses like SONI bore. Another of KPMG's reports, *Assessing the risk-return balance for SONI*,<sup>861</sup> had demonstrated that SONI was exposed to risks that exhibited that profile. In that report, KPMG had estimated the gap between the allowed return and the expected return that this implied.<sup>862</sup>
- 7.346 SONI continued that it was, in fact, exposed to a significant expected loss on network projects because there was a much greater likelihood of unforeseen costs on that type of work and also spend was subject to a cap rather than a symmetric risk sharing mechanism.<sup>863</sup> Estimating the level of that expected loss was not straight forward. SONI submitted that determining the likelihood that SONI would not recover all the costs it would incur required a probabilistic assessment of potential scenarios which would result in a loss or non-recovery of costs. This was not a straightforward exercise for the sort of projects that SONI would be undertaking, not least because it required clarity on the basis on which the UR would set the expenditure cap, clarity which SONI simply did not have.<sup>864</sup>
- 7.347 In the absence of that clarity, and for the purposes of it arriving at its estimate of the shortfall for in price control revenues, SONI estimated the risk it was exposed to, in other words, the level of the expected loss.<sup>865</sup> SONI assumed this would be 4% of all expenditure in respect of not only network projects but also other projects it would be undertaking subject to the D<sub>t</sub> process.<sup>866</sup> KPMG had used similar, but the not the same, assumptions when undertaking its equity financeability modelling.<sup>867</sup>

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<sup>861</sup> NoA MC2, supporting document MC2/1 (KPMG 3).

<sup>862</sup> NoA, paragraph 20.21.

<sup>863</sup> NoA, paragraphs 20.22–20.23.

<sup>864</sup> NoA, paragraph 20.23.

<sup>865</sup> NoA, paragraphs 20.24–20.26.

<sup>866</sup> SONI Hearing transcript, page 138, lines 9–18.

<sup>867</sup> SONI Hearing transcript, page 138, lines 22–23.

7.348 SONI said that the outputs of KPMG's equity financeability modelling showed that SONI was expected to earn low or negative returns and hence profitability would be significantly below the relevant benchmark that any equity investor would be likely to accept.<sup>868</sup> That was due not only to network project planning risks but also liquidity and  $D_t$  revenue cap risks.<sup>869</sup>

### **UR's views**

7.349 The UR submitted that it failed to see what Error 1(c) added to what SONI had already said in relation to Errors 1(a) and 1(b). However, the UR did still respond to the issues raised in SONI's case for Error 1(c).

#### *The UR should have conducted equity financeability testing*

7.350 The UR observed first of all that 'equity financeability tests' were not a conventional feature of regulators' price review analysis. To the best of the UR's knowledge, no UK regulator had ever applied the kind of tests (relating to minimum levels of dividend cover, dividend payout ratio and annual profit) that it considered that SONI and KPMG were insisting that the UR should have applied.<sup>870</sup>

7.351 The UR did not agree that 'equity financeability' rested on passing such tests. In its assessment, equity would flow freely to a firm so long as the net present value of the cashflows arising from equity investment was non-negative. In a regulatory setting, that  $NPV \geq 0$  constraint would be satisfied when (i) the regulator's provisions for opex and capex constituted reasonable allowances for efficient expenditure; (ii) there was a reasonable expectation that SONI's customers would pay back efficient investments over time; and (iii) the allowed rate of return covered the opportunity cost of capital. All of these conditions were satisfied in SONI's case, and, in particular, the key to ensuring that SONI would be able to finance its activities was getting the allowed rate of return right.<sup>871</sup>

7.352 The UR continued that, in its view, it was not necessary to layer other elements on top of the  $NPV \geq 0$  test, as SONI and KPMG had done in their submissions. The focus on dividend cover and dividend payout ratios stemmed from their view that equity providers required a minimum level of cash return over short time horizons (eg five years) even on  $NPV \geq 0$

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<sup>868</sup> NoA, paragraph 20.44.

<sup>869</sup> NoA, paragraph 20.43.

<sup>870</sup> Defence, paragraph 1.62.

<sup>871</sup> Defence, paragraph 1.63.

investments. The UR submitted that that did not fit easily with the long-term horizon that many equity investors have, especially in the regulated sectors. It did not allow, in particular, for the way in which profits crystallised unevenly over the life of many investments.<sup>872</sup>

7.353 Furthermore, the UR noted, the CC had observed in the 2014 NIE price control determination<sup>873</sup> 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. The CC considered that shareholders had an incentive to supply finance as long as the overall rate of return was in line with the WACC, and that the regulatory regime has appropriate provision for situations where shareholders were unable to, or refuse to, supply finance.<sup>874</sup>

7.354 The UR argued that this statement applied just as readily to the present case. It noted that SONI had had several years of very strong profits, due in part to the rundown of its RAB. It was now entering a period which was tilted more towards new investment. In the circumstances, the UR did not consider that it would be 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. That would especially be the case if the effect of such a requirement would be for SONI to earn excess returns over the long term.<sup>875</sup>

*The UR failed to take account of the non-systematic risks SONI faces*

7.355 Regarding the allegation that SONI faced asymmetric returns, the UR explained that it had set out its views on the appropriateness of its treatment of network planning costs and other D<sub>t</sub> items in its response to Ground 2 (see Chapter 6).<sup>876</sup> In short, the presumption that the UR would exhibit a tendency to disallow efficiently incurred expenditure was a construction of SONI's imagination.<sup>877</sup> In the UR's view, it was not the case that the Price Control would be biased towards under-remuneration of the efficient costs that SONI would incur in carrying out its licensed activities, inclusive of a fair return on capital.<sup>878</sup>

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<sup>872</sup> [Defence](#), paragraph 1.64.

<sup>873</sup> [CC NIE price control determination](#), page 456, paragraph 17.100.

<sup>874</sup> [Defence](#), paragraph 1.65.

<sup>875</sup> [Defence](#), paragraph 1.66.

<sup>876</sup> [Defence](#), paragraph 1.92.

<sup>877</sup> [Defence](#), paragraph 1.93.

<sup>878</sup> [Defence](#), paragraph 1.97.



## **CCNI's views**

- 7.356 SLG, on behalf of CCNI, drew attention to the analysis that KPMG had performed based on SONI's contention that the cap on individual network planning project spending would mean that there would be a lack of symmetry in the outturns, where outperformance would be impossible while underperformance would be likely. According to KPMG's analysis, were there to be, for example, a 25% probability of a 15% shortfall this would equate to a reduction in shareholder returns of around £150,000 per year, and affect investor's willingness to commit capital to the business.<sup>879</sup>
- 7.357 SLG observed that, if the risks that SONI had highlighted it was exposed to – network planning risk, liquidity risk and significant project risk – were in fact significant, then the UR should have considered them in its financeability analysis or ensured that there would be a regulatory mechanism (such as an interim review) to appropriately deal with them.<sup>880</sup>

### **Our assessment of Error 1(c)**

- 7.358 We have considered whether SONI's submissions on Error 1(c) provide any further evidence over and above the points considered in respect of Error 1(a) and Error 1(b).
- 7.359 We consider SONI's additional arguments can be seen in two ways:
- (a) First, SONI is stating that the UR was wrong not to perform further analysis, as has been done by KPMG, which would have shown that SONI is not financeable.
  - (b) Second, SONI is stating that the UR was wrong to fail to have regard to the asymmetric risk faced by SONI, that such risk needs to be reflected in the price control, and that the UR's CAPM-based approach does not do so.
- 7.360 We do not agree with SONI that the UR was wrong not to perform some form of equity financeability analysis. The focus of the UR's analysis was on setting a suitable level of return. We are not persuaded that the forms of benchmarking analysis indicated in SONI's [NoA](#) were necessary or would have changed the UR's decision. Much of the analysis by KPMG as quoted within the [NoA](#) relates to the impact of asymmetric risk on expected returns.<sup>881</sup> The UR has indicated in its response to SONI that it does not

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<sup>879</sup> CCNI R&O, Annex 3 (SLG Economics Ltd Report), page 6.

<sup>880</sup> CCNI R&O, Annex 3 (SLG Economics Ltd Report), page 7.

<sup>881</sup> NoA MC2, supporting document MC2/1 (KPMG 3).

agree that such asymmetric risk exists under the price control. If the asymmetric risk were excluded, SONI's analysis would show sufficient returns on capital across the period.

- 7.361 However, we consider that the basic principle of SONI's case is correct in terms of its implications for whether the framework is sufficient to remunerate SONI for the risks it faces. The evidence provided by SONI and the UR under Ground 2, and SONI's submissions under Error 1(c) demonstrate that it is inherent in the ex-post review applied by UR that there is some asymmetric risk. SONI has to make significant investments where it will under normal circumstances earn its return on capital, but under some circumstances it may not do so.
- 7.362 This may be where the UR has determined that SONI has acted inefficiently under the DIWE principle, or where the UR considers that SONI has made investments which were unnecessary. This represents an example of an expected loss: where there is zero probability of an outperformance against the expected return on capital, and some probability of a lower return. We note that any disallowances may relate to a finding that SONI made inefficient investments. It is a core principle in economic regulation that there are incentives to invest efficiently, and that the risks to investors that they fail to meet incentives should be reflected in the risk and reward framework. Unless some form of adjustment is made to the allowed return for this asymmetry in returns, the expected return for SONI will be below the cost of capital.
- 7.363 We agree with SONI that the UR needed to take asymmetric risk into consideration. We consider that the UR should have taken account of the asymmetric risk that its framework implied when setting the Price Control.
- 7.364 SONI's submissions on Error 1(c) provided further clarification on this point. We do not necessarily agree that the UR was wrong for the reasons stated in Error 1(c) – that it should have performed a further financeability assessment. However, we do agree that the evidence provided in Error 1(c) is indicative of the broader concerns raised in Error 1(a) – that the framework did not remunerate all the risks faced by SONI.
- 7.365 The UR has responded that there is no asymmetric risk. We do not agree. This seems inconsistent with the whole premise of the regulation put in place by the UR, which is designed to provide incentives to invest where it is efficient. We agree that this is a different risk to the standard regulatory approach with an ex-ante allowance and risk sharing. However, unless the UR is saying that SONI will always be allowed to recover its investments, this framework must as a matter of principle be asymmetric.

- 7.366 SONI has estimated that the disallowance risk may be 4%. Whilst we have seen little evidence for this number, it is a useful starting point in understanding the scale of this risk and its effect on SONI. If SONI were provided with a 4% mark-up on such spend to reflect the risk of aggregate losses due to disallowances, this would increase its allowed revenue by over £1 million over the Price Control Period. SONI would then have the incentive to minimise inefficient investment. It could be that under a regime where the UR states that there is no asymmetric risk and makes no allowance for SONI to cover asymmetric risk, it would be difficult for the UR to make any adjustments to SONI's costs, even where there was evidence on inefficient spend.
- 7.367 We acknowledge that it would be feasible to use a regime which is not asymmetric as it is effectively a pass-through. As an alternative remedy to the SONI's concerns, it would be open to the UR to state that it would follow a regime where it is not testing the scope or scale of SONI's investments for efficiency.
- 7.368 However, this is not our reading of the UR's current position in respect of this appeal and Ground 2 in particular. We note that the CER has recently moved to strengthen the comparable efficiency incentives on EirGrid, after very limited disallowances in the last two price controls.<sup>882</sup> We have discussed under Ground 2 that the UR has sought to restrain SONI from recovering its costs from NIE on PCNPs, which is consistent with its broader statements that it needs to be able to assess the efficiency of SONI's investments. We consider that there will inevitably be some regulatory risk during the development of a new regime, such as that for SONI.
- 7.369 More generally, we have agreed in Ground 2 that a regime in which the UR within an appropriate framework reviews SONI's spend for efficiency is reasonable and provides SONI with an incentive to outperform on expectations.
- 7.370 Given that SONI has around £37 million of expenditure in the current price control period subject to the ex-post review process, and given its current RAB is below £10 million, a small disallowance would have a material effect on its profitability. We agree with SONI's assessment that this is a relevant part of the UR's considerations in setting the risk and reward framework for SONI.

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<sup>882</sup> [Decision on TSO and TAO Transmission Revenues for 2016 to 2012](#), 23 December 2015, page 65.

### ***Our view on Error 1(c)***

7.371 We do not consider that, as constructed, Error 1(c) constitutes a separate error by the UR, to the extent that Error 1(c) is an alleged failure to perform financeability analysis. However, we agree with SONI that the UR failed to have regard to asymmetric risk and that, as indicated by SONI's own analysis, this would result in expected returns being lower than the assumed WACC. As a result, the evidence provided under Error 1(c) is relevant to the overall assessment of Ground 1.

### **Conclusion on Ground 1**

7.372 Through our review of the evidence in Error 1(a), Error 1(b) and Error 1(c), including further evidence provided in this appeal, we have concluded that SONI has identified three areas in which the UR's approach did not fully remunerate it for the risks that it takes in the current price control period:

- (a) SONI faces asymmetric risk in relation to network planning and special TSO projects as well as other expenditure subject to the uncertainty mechanism; and this was not reflected in the UR's analysis at all, in part because the UR stated that it considered that SONI did not face asymmetric risk.
- (b) SONI faces working capital risk relating to its industry functions which is material to its price control allowances, and we would expect an investor to have to put aside capital to reflect this, with a cost.
- (c) SONI has to provide a PCG which should be remunerated at the market price. The UR did not provide an additional allowance to cover the incremental risks associated with SONI.

7.373 We note that the UR has described its approach as a 'hybrid'. We agree that because SONI is asset-light the risks above are of an unusual scale within a regulatory determination, ie that the cost to SONI of these risks will be relatively much higher than for a comparator such as NIE. This indicates that some form of alternative approach is likely to be necessary such that SONI's investors are remunerated for the risks faced by SONI. However, we do not agree that the UR's approach was sufficient.

7.374 First, there were no allowances for the risks associated with the three items above, apart from including the current ongoing cost of maintaining SONI's existing £12 million working capital facility, and remunerating any drawdown on the working capital facility to reflect timing differentials at an interest rate of LIBOR plus 2% on tariff year-end balances. The UR's approach provided

for the facility fee costs currently incurred and any interest incurred, rather than remunerating the activities performed and risks taken.

- 7.375 Secondly, the allowances elsewhere in the framework (in particular the PCG allowance in the SEMO price control) have not been shown to be sufficient to address these risks.
- 7.376 Thirdly, these adjustments would materially affect the return required to remunerate SONI for the risks faced by investors. In the context of an expected profit of around £1 million per annum,<sup>883</sup> the risks associated with the estimated £37 million of spending subject to the ex-post mechanisms<sup>884</sup> and £100 million of revenue collection<sup>885</sup> are material.
- 7.377 Finally, whilst the UR stated that it has set the WACC at a high level relative to other regulated companies such as NIE, the increase in WACC appears to be consistent with an adjustment to cover the higher operational gearing associated with SONI's TSO BAU. SONI's operating costs at £10 million per annum are many times the profit allowance for each year the UR had provided. As illustrated in SONI's evidence, and in the UR's analysis in this appeal, this itself was sufficient to justify a higher return. We do not consider it also covers the risks above.
- 7.378 In response to our provisional determination, the UR cautioned against us being overly generous to SONI, arguing that the marginal supplier of finance would be taking a more optimistic view of SONI's prospects than infra-marginal suppliers. We do not consider that this reflects normal regulatory practice, and that it is open to us to follow the standard regulatory approach of considering market values for the financing cost of the risks taken by SONI.
- 7.379 In this appeal, we have identified a number of aspects of additional risk taken by SONI, where, in each case, SONI's case demonstrates that the UR has allowed no return for the risks under consideration. Taken together, these indicate that the UR's approach cannot be expected to sufficiently remunerate SONI for the risk taken, and therefore that the UR's decision on the financial framework, ie the level of return allowed to cover the risks taken by SONI, is wrong.
- 7.380 We recognise that the circumstances are complex for SONI and that in other regulatory contexts an adjustment to the WACC would be an appropriate mechanism and would be sufficient to address such risks, as part of an 'in-

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<sup>883</sup> This level of expected profit also includes an estimate of the return on PNCPs and TSO special projects.

<sup>884</sup> See Table 7.3 and paragraph 7.172 above.

<sup>885</sup> See paragraph 7.42 and Figure 7.3 above, for an illustration of the sums involved.

the-round' assessment. However, given the small size of SONI's RAB, and the fact that it fluctuates significantly over time, we do not consider that this is a sufficient or reliable approach in this case, and that it would pose significant risks to SONI's financeability. In any case, the evidence provided suggested that the UR had made an adjustment to the WACC for other factors, not those which we have found to be omissions from the financial framework.

- 7.381 We also agree that other approaches were available to the UR which would better reflect the circumstances of SONI. Whilst we do not agree with SONI that a margins approach should be applied, we note that SONI also provided references to other approaches, including CER's approach. CER provides remuneration for additional risks faced by EirGrid, including the use of margins in the specific context of revenue collection, in addition to the standard return on capital approach for the price controlled system operator functions.
- 7.382 We have concluded that the UR was wrong as its approach did not properly remunerate SONI in respect of the risks set out in paragraph 7.372 above.
- 7.383 As noted in paragraphs to 7.124 to 7.127 above, in response to our provisional determination, the UR stated that our approach to this appeal was not consistent with our Rules and precedent, as our findings did not reflect SONI's case.
- 7.384 Our assessment of SONI's case addresses the question of whether the Price Control was wrong, ie the UR's price control settlement provided it with too little remuneration for it to be able to secure the financeability of its TSO price controlled activities across the Price Control Period. In our assessment, we have taken into account SONI's overall submissions in its [NoA](#) in respect of Ground 1, including the background and supporting material it included in its [NoA](#) and further referred to at its hearing. Our role in the appeal is to assess whether the price control was wrong, for reasons in the [NoA](#), not whether we agree with all the points made by SONI in its evidence. We have followed the same approach here as specified in the legal framework, and as we have followed in previous appeals.
- 7.385 During our interactions with UR and SONI through the appeal process leading up to the notification of our provisional determination, we sought evidence from both parties in respect of each of these three issues.<sup>886</sup> We

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<sup>886</sup> For example, at the clarification hearing, we asked SONI about asymmetric risk (Clarification Hearing transcript, page 42) and the UR about it remunerating SONI for its role as collection agent (Clarification Hearing

therefore reject the UR's submission that it had only become aware of the lens through which we were provisionally finding the UR to be in error regarding SONI's financeability once it had read our provisional determination.

- 7.386 Finally, we note that the UR has said that it would be 'exactly the wrong approach' to err on the side of giving SONI too much revenue, rather than too little. We consider the level of remuneration in our remedies decision in Chapter 12. It is relevant to our overall decision in respect of Ground 1 that in respect of each of the areas of risk identified in paragraph 7.371, the UR provided no allowance at all for risk taken by SONI in the TSO control. Our assessment of Ground 1 is that we agree with SONI that the UR's approach to financeability is wrong as it does not remunerate SONI for the risks that it takes as an asset-light business.
- 7.387 Our decision is, therefore, that for the reasons set out above: the UR failed properly to have regard to the Financeability Duty and the decision was based, wholly or partly, on an error of fact; and by virtue of [Article 14D\(4\)\(a\)](#) and [\(c\)](#) of the Electricity Order, Ground 1 of the appeal should be allowed.

## Observations on process on Ground 1

### *Inexplicit interrelationships between price controls*

- 7.388 In Ground 1 of this appeal, we have been concerned with the claim that the remuneration that SONI has been provided for risk has been insufficient to address the risks that it takes in the TSO price control.
- 7.389 In our review, we have identified a number of areas where SONI's returns either do not relate to SONI's TSO activities at all, or where the ultimate decisions on whether the costs relating to SONI's activities should be recovered are taken outside the TSO control. The UR and SONI have described various aspects of the regulatory framework which demonstrate that there are interactions between the different price controls for SONI's TSO and MO activities, including in respect of the decisions on the financial framework.
- 7.390 This approach to regulation, where a decision in one price control for one licence has consequential effects on the costs and revenues associated with

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transcript, page 62) as well as asking many questions of both SONI and the UR about SONI contingent capital requirements, the most material input for SONI being able to provide a collection agent service, especially in relation to the Imperfections Charges (ie the DBCs). At its hearing, the UR summarised its position regarding how it had remunerated SONI in its [Final Determination](#) for collecting monies (UR Hearing, handout 10: *Financing Costs / Capital employed*).

another licence, and where the remuneration is under a different price control, could be problematic and has significant risks to its effectiveness. Some of these risks have become clear in this appeal.

7.391 However, where the regulator considers that it has no option but to use such an approach to regulation, it is particularly important that the regulatory decisions are clearly linked and cross-referred where possible. In this case, this did not happen, and the consequence was a significant loss in transparency and clarity in what the level of expected remuneration for a particular set of activities is considered to be. We note that, in addition the two sets of price controls, do not cover the same time periods and are set by two different decision-making bodies, making alignment of remuneration across the two sets of controls highly problematic.

## **8. Determination**

8.1 For the reasons given above, we have made the following determination.

8.2 Our findings on SONI's claims are as follows:

- Ground 1: Financeability Methodology
  - The UR failed to adopt a price control framework that could secure the SONI's financeability (Error 1(a)) and the financeability assessment carried out by the UR was inadequate and subject to material errors (Errors 1(b) and 1(c)).
- Ground 2: Revenue Uncertainty
  - The UR failed to provide a cost recovery mechanism for PCNPs (Error 2).
  - The UR failed to manage uncertainty by creating additional uncertainty through implementing an unworkable two-stage approval process (Error 6).
- Ground 3: Inadequate Allowances
  - The UR failed to provide adequate pensions allowances (Error 10).
  - The UR failed to provide an adequate IS capex allowance by making an incorrect adjustment for inflation (Error 11(b)).

8.3 We are satisfied that the Price Control Decision was wrong on the grounds that:



- The UR failed properly to have regard to a matter to which it must have regard in a matter mentioned in [Article 14D\(2\)](#) of the Electricity Order, in particular, to the need to secure that SONI is able to finance the activities which are the subject of obligations imposed by or under [Part II](#) of the Electricity Order (in Errors 1, 2, 6, 10 and 11(b)).
- The modifications failed to achieve, in whole or in part, the effect stated by the UR (in Error 2).
- The UR's decision was based on an error of fact (in Errors 1, 10 and 11(b)).

8.4 We therefore allow the appeal to that extent.

8.5 We have not found the Price Control Decision to have been wrong under any of the other errors alleged in this appeal (Errors 3, 4, 5, 7, 8, 9, and 11(a)). Accordingly, we do not allow the appeal, and we confirm the Price Control Decision, to that extent.

8.6 The following chapters set out our remedies following this conclusion.

## Observations

8.7 In determining the appeal, we are required by [Article 14D\(2\)](#) of the Electricity Order to 'have regard to the same extent as is required of the Authority, to the matters to which the Authority must have regard', and in particular to the 'principal objective under [Article 12](#) of the Energy Order' of protecting the interests of consumers of electricity.

8.8 We consider that regulatory procedures, which create delay or uncertainty or both for the licence holder, are not in the interests of consumers as they may have adverse effects on the company's ability to carry out its statutory functions associated with the transmission of electricity.

8.9 In this appeal, we have noted the following procedural issues, which are relevant both to the circumstances of this appeal and generally.

8.10 The timeline of this Price Control review was unusual. The control period commenced in October 2015 for five years, yet the UR issued the [Final Determination](#) in February 2016 and published the relevant Licence modifications a year later, in March 2017. Even then, a number of issues were not fully resolved and, in some cases, the UR had not yet decided the process that it would follow to resolve outstanding issues. We sought to identify credible reasons for these long delays, but did not receive satisfactory explanations from the parties involved.

- 8.11 We do consider that this timeline contributed to financeability issues for the regulated company and to both the decision to appeal and scope of this. Such uncertainty is not in the public interest. Whilst we recognise the limited resources available to the UR, we do feel that the timeline has been problematic.
- 8.12 Furthermore, the regulatory options chosen and the arguments made for them appear to have changed significantly on several issues during the course of this appeal.
- 8.13 In this determination, we have referenced specific areas where we consider the process had scope for improvement, noting that in some areas SONI had contributed to the problems.
- 8.14 It is vital that regulators and regulated companies strive to progress and resolve regulatory price controls in a timely manner. This will involve targeted efforts where issues are complex and/or material to the outcome of the relevant specific price control. As a small, asset-light company, SONI's position is potentially different from that of many other regulated companies and hence the specific circumstances do need to be fully explored before determining the appropriate regulatory approach. If the conclusion is that a standard regulatory approach, based on established precedent, is nevertheless still warranted, the reasons for this should be clearly articulated. Appropriate efforts must be made to be transparent so that trust and confidence is not unnecessarily eroded between parties and with consumers.
- 8.15 The services provided by SONI are vital to the people and economy of NI, making it imperative that the Price Control is now resolved at the earliest opportunity. We are mindful of this in our decisions on remedies.

## **9. Introduction to remedies**

- 9.1 We have found the UR to be wrong in respect of aspects of each of the three grounds of appeal, to the extent specified in Chapter 8 above.
- 9.2 If the CMA allows to any extent an appeal in relation to a price control decision, 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 UR for reconsideration and determination in accordance with any directions given by the CMA; and/or

- (c) substitute the CMA's decision for that of the UR (to the extent that the appeal is allowed) and give any directions to the UR or any other party to the appeal.<sup>887</sup>
- 9.3 In relation to a price control decision, and to the extent that the CMA has allowed the appeal, the CMA has a wide-ranging power to act in order to remedy the errors it has found, consistent with its role as an expert body. Any directions which the CMA gives to SONI, or to the UR, must not require SONI or the UR to do anything which it does not have power to do,<sup>888</sup> but otherwise the CMA considers it can give directions on a range of matters, and the person to whom a direction is given must comply with it.<sup>889</sup> A direction given to a licence-holder is enforceable as if it were an order of the High Court.<sup>890</sup>
- 9.4 In coming to our decision on remedies, we have had regard to both our primary objective of disposing of the appeal fairly and efficiently, and also the UR's objectives and duties as set out in the Energy Order. In that context, we have considered the practical aspects associated with implementing a remedy within the timetable of an appeal. The appeal process clearly envisages that the CMA should be in the position to implement a remedy within the timetable allowed for an appeal. Whether this is feasible in all circumstances will depend on the nature of the issue under appeal, and whether there is sufficient information within the evidence to the appeal to allow us to come to a decision on an alternative remedy.
- 9.5 The CMA's approach will depend on a number of considerations:
- (a) The feasibility of identifying and implementing an effective remedy within the timetable for this appeal.
  - (b) The costs associated with remittal of the matter to the UR, including any costs associated with further delay to the relevant aspects of the price control.
  - (c) The existence of interactions between any remedy and other parts of the price control framework which are not subject to this appeal, which will affect the feasibility of a remedy to effectively address the error identified without wider consequences.

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<sup>887</sup> [Article 14E\(2\)](#) Electricity Order.

<sup>888</sup> [Article 14E\(4\)](#) Electricity Order.

<sup>889</sup> [Article 14E\(5\)](#) Electricity Order.

<sup>890</sup> [Article 14E\(6\)](#) Electricity Order.

- (d) The benefits of any further consultation on the issues subject to the remedy, including consultation with third parties.
- 9.6 We note that if we decide to remit the matter to the UR, we can do so with directions, which can be specific to the form of the proposed remedy. Our assessment therefore includes two decisions:
- (a) Whether the remedies process is able to identify an effective remedy which will address the errors found in this appeal.
- (b) If so, whether the implementation of that remedy should be through remittal to the UR, in order that the UR can implement the remedy, or through substitution of our decision for that of the UR.
- 9.7 There are benefits to the CMA both identifying a suitable remedy rather than remitting the decision to the UR, and substituting its decision for that of the UR rather than directing the UR to implement the remedy. These benefits, including timely changes to the price control, need to be set against any associated costs, including the need to consider any issues which have not been raised within this appeal but which are relevant to the choice of an effective remedy.
- 9.8 We set out below (in Chapters 10 to 12) our decisions on both the design of appropriate remedies, and also as to how the remedies should be implemented, taking into account both written submissions received in response to our provisional determination and the outcome of the remedies hearing and roundtable with the parties. As with the chapters setting out our decisions on the grounds of appeal, we considered it appropriate to address remedies for Ground 3 first, then Ground 2 and lastly Ground 1.
- 9.9 In Chapter 13, we set out the impact of our remedies, including the required changes to the level of the Price Control, the impact on tariffs and consumers, and the expected timing of the remedies implementation.

## **10. Remedies – Ground 3**

- 10.1 In Ground 3, we have found the following errors:
- (a) Under Error 10 (both Error 10(a) and Error 10(b)), there were errors in the approach taken by the UR to pension contributions.
- (b) Under Error 11(b), there was an error in the level of capex assumed, due to errors in the financial model.

- 10.2 In respect of both Error 10(a) and Error 11(b), we have decided that there is an alternative approach which would directly remedy the errors identified. Our decision is that the appropriate remedy would be to include a different assumption within the price control model to correct the errors identified in the choice of cost assumptions.
- 10.3 In respect of Error 10(b), the UR has consulted on an alternative approach and in October 2017 confirmed its final conclusions<sup>891</sup> that update its approach from that outlined in the [Final Determination](#). We consider the implications of this below.

## Error 10(a)

- 10.4 In Error 10(a), we have found that the UR applied a level of ongoing contributions which was below that identified in SONI's actuarial valuation, and that this was wrong.
- 10.5 The UR's final conclusions on pensions indicated the following approach to the level of ongoing contributions:<sup>892</sup>
- (a) The 2015/16 year is complete and so should reflect actual contributions made.
  - (b) The UR allowed a contribution of 38.4% compared to the 40.3% in SONI's Business Plan.
  - (c) The UR also made adjustments to reflect the expected retirement profiles for SONI employees in the Defined Benefit (DB) pension scheme.
- 10.6 In the remedies hearing, SONI reported that the actual contributions made in 2015/16 were £842,000 (2014 prices), and presented written correspondence confirming this.<sup>893</sup> The UR confirmed that this was acceptable evidence.<sup>894</sup> Whilst the UR published its final conclusions on pensions<sup>895</sup> two days after the remedies hearing, which included a different final figure for pensions contributions in 2015/16, this was a timing issue

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<sup>891</sup> [SONI: TSO Price Control Changes, Conclusions on Pensions Allowances and Decision on Change of Law provisions](#), 19 October 2017.

<sup>892</sup> [SONI: TSO Price Control Changes, Conclusions on Pensions Allowances and Decision on Change of Law provisions](#), 19 October 2017.

<sup>893</sup> Remedies Hearing transcript, page 77, lines 5–10 and a letter from SONI's actuaries (Barnett Waddingham LLP) confirming pension contributions paid for year ended 30 September 2016, 17 October 2017.

<sup>894</sup> Remedies Hearing transcript, page 142, lines 18–24.

<sup>895</sup> [SONI: TSO Price Control Changes, Conclusions on Pensions Allowances and Decision on Change of Law provisions](#), 19 October 2017.

only. The information from SONI was too late to incorporate in the UR's final conclusions document.

- 10.7 We consider that the approach put forward in the UR's final conclusions on pensions,<sup>896</sup> outlined in paragraph 10.5 above, but correcting for the actual contributions provided by SONI in 2015/16, is appropriate. We consider that a 38.4% contribution rate is correct. We also consider that the adjustments to retirement profiles made by the UR are appropriate. The UR's retirement profile adjustments are more realistic, using additional information, and are still cautious assumptions. As a result, the CMA remedy for ongoing pension contributions is to increase allowances by £1,390,000 over the Price Control Period compared to the [Final Determination](#). The annual profile of this is shown in Table 10.1 below:

**Table 10.1: Ongoing pension allowances**

<i>Decision</i>						£000s, 2014 prices
	<i>2015/16</i>	<i>2016/17</i>	<i>2017/18</i>	<i>2018/19</i>	<i>2019/20</i>	<i>5-year total</i>
<a href="#">Final Determination</a>	400	400	400	400	400	2,000
<a href="#">UR's final conclusions on pensions</a>	692	763	665	574	546	3,240
CMA remedy	842	763	665	574	546	3,390

Source: [Final Determination](#); [SONI: TSO Price Control Changes, Conclusions on Pensions Allowances and Decision on Change of Law provisions](#), 19 October 2017; and CMA analysis.

## Error 10(b)

- 10.8 The [Final Determination](#) was based on the 2015 pensions valuation and a proposed cut-off date of March 2015. The UR has now decided in its final conclusions<sup>897</sup> to reflect the 2016 pensions valuation, which shows a lower deficit than that estimated in the 2015 valuation. The deficit valuation has fallen from £1,885,000 in 2015 to £706,000 in 2016.<sup>898</sup> Furthermore, the UR has proposed a revised cut-off date of March 2019.
- 10.9 The effect of the change to the pensions valuation date is to reduce the allowance for deficit funding by £393,000 over the Price Control Period. Our remedy matches the UR's latest allowance since we accept their latest assessment and for completeness is shown in Table 10.2.

<sup>896</sup> [SONI: TSO Price Control Changes, Conclusions on Pensions Allowances and Decision on Change of Law provisions](#), 19 October 2017.

<sup>897</sup> [SONI: TSO Price Control Changes, Conclusions on Pensions Allowances and Decision on Change of Law provisions](#), 19 October 2017.

<sup>898</sup> [SONI: TSO Price Control Changes, Draft Decision](#), 16 August 2017, paragraph 47.

**Table 10.2: Pension deficit repair allowances**

<i>Decision</i>						£000s, 2014 prices
	<i>2015/16</i>	<i>2016/17</i>	<i>2017/18</i>	<i>2018/19</i>	<i>2019/20</i>	<i>5-year total</i>
<a href="#">Final Determination</a>	189	189	189	189	189	945
<a href="#">UR's final conclusions on pensions</a>	268*	71	71	71	71	552
<a href="#">CMA remedy</a>	268	71	71	71	71	552

Source: [Final Determination](#); [SONI: TSO Price Control Changes, Conclusions on Pensions Allowances and Decision on Change of Law provisions](#), 19 October 2017; and CMA analysis.

\* This 2015/16 value of £268k is nominal, which is £262k in real terms (2014 prices).

10.10 In its revised approach, which includes a cut-off date of 31 March 2019, the UR now appears to be taking due consideration of the specific circumstances of SONI. The UR has estimated<sup>899</sup> the costs that SONI would incur to comply with a cut-off date, if it were to take such a decision, and in the remedies hearing SONI confirmed these were 'broadly within the range of reason' and therefore not contested.<sup>900</sup>

10.11 We also consider that it is good regulatory practice for the UR to provide an early signal to SONI of its statement that it has decided to apply a 31 March 2019 cut-off date, as this allows SONI and its actuaries sufficient time to prepare.

10.12 In terms of this appeal, we note that the UR's new approach that signals a 31 March 2019 cut-off date has no direct impact on the allowances in the current Price Control Period (2015-2020). In these circumstances, we do not consider that any further action is necessary on our part in respect of the UR's approach to the funding of the pension deficit, which will impact SONI's price control in future price control periods.

10.13 We have therefore decided to quash the UR's original decision to adopt a cut-off date of 31 March 2015.

## **Error 10 (combined for Errors 10(a) and 10(b))**

10.14 In terms of aggregated allowance for ongoing contributions and deficit repair, our remedy will add £0.997 million to SONI's licence over the price control period. This £0.997 million comprises £1.390 million extra for ongoing contributions, less £0.393 million for the 2016 lower deficit valuation.

<sup>899</sup> The UR estimated this were £15-20k for set-up and for each subsequent re-valuation every three years.

<sup>900</sup> Remedies Hearing transcript, page 80, lines 14–15.

10.15 Our remedy exceeds the UR's final conclusions<sup>901</sup> by £0.15million. This reflects the actual spend confirmed by SONI in the remedies hearing, which the UR said was acceptable.<sup>902</sup>

## **Error 11(b)**

10.16 Error 11(b) relates to the inflation re-basing of SONI's Business Plan submission for IS capex, which was not corrected by the UR.

10.17 The correction of the re-basing error equates to an extra £212,000 capex allowance.<sup>903</sup> We estimate the revenue requirement from this is £121,000 over the five years to cover the required return and depreciation allowances arising from this expenditure. The [NoA](#) had referred to an uplift of £291,000 rather than £212,000, but the UR identified that this was calculated incorrectly, which SONI accepted.<sup>904</sup>

## **Implementation of the remedies**

10.18 Our remedies on Ground 3 require an increase in SONI's allowed revenue equivalent to £1.1 million over the Price Control Period. The accompanying Order includes directions to change the Licence to reflect these revised allowances for pensions and Error 11(b). We have decided to direct the UR to change the Price Control in accordance with our remedies decision. We urge the UR to implement the remedies on Ground 3 promptly following our final determination.

## **11. Remedies – Ground 2**

11.1 In Ground 2, we have found the following errors:

- (a) The UR failed to provide a cost recovery mechanism for PCNPs (Error 2).
- (b) The UR failed to manage uncertainty by creating additional uncertainty through implementing an unworkable two-stage approval process for PCNPs and Dt claims (Error 6).

11.2 As discussed in Chapter 6, we have found that the UR was wrong in the ways noted above because its approach was not well specified, created

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<sup>901</sup> [SONI: TSO Price Control Changes, Conclusions on Pensions Allowances and Decision on Change of Law provisions](#), 19 October 2017.

<sup>902</sup> Remedies Hearing transcript, page 142, lines 18–24.

<sup>903</sup> UR response to CMA provisional determination, paragraph 3.58.

<sup>904</sup> Remedies Hearing transcript, page 85, lines 15–16.



uncertainty and therefore would make it difficult for SONI to finance its investments. In addition, there was a lack of clarity over the level of risk taken by SONI, creating unnecessary regulatory uncertainty. We therefore consider that the appropriate remedy is to codify an effective process for review of PCNPs and projects subject to the  $D_t$  mechanism.

## **Our overall approach to the remedies for Ground 2**

- 11.3 Our findings on Ground 2 relate to the codification of the approach by which SONI is able to recover from customers the costs incurred in PCNPs and projects subject to the  $D_t$  mechanism. These costs are recovered under a framework where there is no ex-ante price control allowance, but there is an assumption that the level of the price control will be adjusted during the price control period to reflect actual costs incurred by SONI.
- 11.4 This sort of price control mechanism, where the level of the price control is adjusted during the period, reflects the specific circumstances of SONI, and requires the tariffs determined under the licence condition to be able to change during the period. The licence condition needs to reflect both the ability of allowed tariffs to change in principle, and also to make reference to the process to be followed by SONI and the UR in order that a change to the price control can be implemented in practice.
- 11.5 In this appeal, we have focused on the process to be followed by SONI and the UR, as this has been the starting point for SONI's appeal ie that there is 'no mechanism' for recovery of PCNPs and an 'unworkable' process for PCNPs and  $D_t$  claims.
- 11.6 Based on submissions to the appeal, we consider that there are a number of benefits in the CMA specifying the process which should be applied within this Price Control Period and remitting to the UR with clear directions to implement a remedy based on the alternative methodology, as opposed to remitting the decision to the UR for an open review of the processes. This will help SONI with financing its investments and negotiating a new banking facility.
- 11.7 In addition, given we are now two years into the current Price Control, we consider that there are benefits in identifying a process which can be implemented promptly. It will be for the UR to decide, subject to appropriate consultation, whether the same approach should be applied to future control periods.
- 11.8 In order to remedy the error, we consider that some changes to the Licence are necessary, and we discuss this below. However, we have concluded that

much of the codification should be outside the Licence. In response to our provisional determination, both SONI and the UR have confirmed their views on what changes are required to the licence for an effective process to be in place. The changes to the Licence proposed will be part of codification, but the majority of the codification will be in the form of rules and/or guidance to be followed by SONI and the UR in order that there is an effective process for the recovery of costs incurred by SONI.

- 11.9 We have considered the submissions from the parties in response to our provisional determination, and have decided what licence modifications are required and what processes need to be in place.
- 11.10 However, it is neither practicable in the time available nor appropriate for the CMA to write the actual guidance or direct the UR in respect of the wording of guidance. There are many areas of guidance where the specific circumstances of the UR and SONI need to be reflected, making it more appropriate that the actual wording is prepared by the UR. We therefore focus in this chapter on what we have decided needs to be included in codification, such that codification can be effective in remedying the errors identified by SONI in respect of the current process. Given our decisions on what is needed for an effective process, we have decided that documentation should be agreed within four months of notifying parties of our final determination.

### **An effective process for PCNPs and $D_t$ costs**

- 11.11 In our provisional determination and during the remedies hearing, we sought views from the parties as to the contents of guidance. We indicated that, in our view, an effective process would need to include:
- (a) Timelines for the process, including at what point prior to investment SONI is required to make submissions to the UR, and on what timelines the UR is required to respond with any objections.
  - (b) Specification of what level of detail the UR expects to review prior to investment by SONI in a project, eg identification of need, scope of works, outputs, expected cost, risks, and timelines for the UR to respond to and publish its assessment of an application.
  - (c) Any ongoing reporting during the project lifetime.
  - (d) An approach to variations in project cost or specification.
  - (e) Agreement on the process by which agreed spend is recoverable through transfer to capital base and tariffs.

11.12 We discuss below in more detail what would be necessary in respect of each of these stages in the process, in order for the mechanisms to be effective and to address the points raised in the appeal. The mechanism may not need to be the same for PCNPs as for some or all D<sub>t</sub> applications.

### ***Timelines***

11.13 The first area where we have decided that increased certainty is required is that there should be formalised timelines under which both SONI and the UR are required to deliver different stages of the process. In our provisional determination, we outlined that in the preliminary phase in advance of project initiation (ie commitment of financial capital), the following approach could be workable:

- (a) a timeline in advance of project initiation, by which SONI is required to provide documentation to the UR about the project; and
- (b) following receipt of documentation from SONI, a timeline in advance of project initiation by which the UR is required to identify and explain any objections. This would ensure that SONI has sufficient notice as to whether the UR considers it should proceed with the relevant projects on the basis of its submissions.

11.14 We proposed in our provisional determination that the minimum notice for SONI to provide information in advance of project initiation should be six months, and the UR should then respond within four months, ie SONI would receive the UR's response at a minimum two months before project initiation.

11.15 In this four month period, the UR should review SONI's submissions based on its duties and would be able to undertake stakeholder consultation where appropriate. This period should also allow the UR sufficient time to consult its Board. It is important for an effective mechanism that there are clear obligations on both SONI and the UR:

- (a) that SONI should comply with the project submission requirements discussed in the next section; and
- (b) that if the UR has potential objections, those objections should be flagged promptly and there should be no ambiguity as to whether any queries raised constitute clarifications or objections.

11.16 Such an approach would appear to resolve a number of the concerns raised in this appeal and should be practicable based on what we have been told about project timelines, in particular for PCNPs.

- 11.17 In response to our provisional determination, both the UR and SONI indicated that this timeline would be feasible. SONI set out its view that the longest time that the UR should take to consider a PCNP application should be four months.<sup>905</sup> SONI also set out that the UR should consider D<sub>t</sub> applications for large capex projects within four months.<sup>906</sup> For recurring opex,<sup>907</sup> and smaller opex and capex,<sup>908</sup> SONI set out that the UR should respond to D<sub>t</sub> applications within two months.
- 11.18 More generally, SONI submitted that for both PCNPs and D<sub>t</sub> applications, the UR should be able to respond more quickly to projects that can be signed off by the CEO instead of requiring Board approval.<sup>909</sup> In response to our draft Order, SONI set out that the UR should provide its decision on projects that do not require approval of the UR Board within 40 working days of receiving SONI's submission.<sup>910</sup>
- 11.19 The UR noted that it was broadly content with our proposed timelines.<sup>911</sup> In the remedies hearing, the UR set out that it may be possible for it to approve projects that did not require Board approval in less than four months.<sup>912</sup>
- 11.20 We agree with SONI that the process outlined above is suitable for most PCNPs and for large D<sub>t</sub> applications, but that this process could be simplified for smaller PCNPs and/or recurring D<sub>t</sub> applications.
- 11.21 We do not consider it necessary in specifying the remedy to identify a suitable materiality threshold, not least because the error we have found relates to lack of codification, and this point relates to whether any remedy could be more limited in scope. For the same reason, we do not propose to specify particular timelines shorter than those required for full applications.
- 11.22 However, the evidence provided by SONI does indicate that a proportionate approach to codification would be expected to have some flexibility and would not require the same level of detail or length of timeline for all projects. The submissions required and timelines could be limited for any of the following reasons:
- (a) lack of materiality;

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<sup>905</sup> SONI response to CMA provisional determination – Ground 2 remedies paper, paragraph 8.8.

<sup>906</sup> SONI response to CMA provisional determination – Ground 2 remedies paper, paragraph 14.8.

<sup>907</sup> SONI response to CMA provisional determination – Ground 2 remedies paper, paragraph 16.1.

<sup>908</sup> SONI response to CMA provisional determination – Ground 2 remedies paper, paragraph 18.2.

<sup>909</sup> SONI response to CMA provisional determination – Ground 2 remedies paper, paragraphs 8.8 & 14.8.

<sup>910</sup> SONI response to CMA draft Order, Annex 1, 6 November 2017, page 11.

<sup>911</sup> UR response to CMA provisional determination, paragraph 2.29.

<sup>912</sup> Remedies Hearing transcript, page 128, lines 8–10.

- (b) lack of complexity, including the potential for automated or accelerated processes for repeating items; and/or
- (c) lower level of approval required (eg a more timely approach could be in place for applications which do not require approval by the UR Board and do not require public consultation).

#### *Treatment of pre-approval spend*

- 11.23 In the appeal, SONI sought to remove pre-approval of expenditure by the UR. We did not find that SONI had demonstrated that the UR was wrong to require pre-approval of expenditure, and therefore did not allow this part of SONI's appeal.
- 11.24 We would however expect that there should be some flexibility around pre-approval in a codified process. For example, where in a large project there are efficiency benefits in making small amounts of expenditure prior to formal project approval, we would not expect that SONI would be penalised for acting efficiently.
- 11.25 Whilst it is within SONI's commercial discretion to incur costs at any time, the UR has indicated that SONI cannot have the expectation of recovering costs from customers where it does not obtain pre-approval. Whilst we do not find that this is wrong in principle, it does appear that there may be circumstances where it is in customers' interests for SONI to incur some costs prior to completion of the pre-approval process. This could be reflected as part of a review of materiality within the approach to codification. We discuss this further in respect of Project Variation below.

#### ***Project Specification***

- 11.26 The second area where we have decided that increased certainty is required is that there should be formal codification of the detail which would need to be included in any project proposal by SONI in order for it to be accepted by the UR as suitable for inclusion as a PCNP or in the  $D_t$  mechanism. SONI and the UR should agree a clear template, drawing on previous submissions, for information, and we would expect this to be information which should be available to SONI in any case as part of an effective project planning process. This would include, for example, in respect of PCNPs and larger projects subject to the  $D_t$  mechanism:
- (a) Trigger for investment.
  - (b) Project scope.

- (c) Project plan, including key milestones.
  - (d) Risks.
  - (e) Project budget, including project timeline.
  - (f) Outputs and/or outcomes.
- 11.27 Based on such a template, the UR should be able to commit to respond to submissions within the fixed period outlined above. Where SONI meets the criteria, the UR would then be required to respond and to identify any concerns within a suitable timescale as specified in the process.
- 11.28 Following our provisional determination, the UR provided us with a template for Project Specification for PCNPs. Whilst this has not been formally agreed, both parties indicated during the remedies hearing that they expected agreement would be feasible in due course. We consider agreement should be feasible within the timeframe under which the UR is required to codify the PCNP and D<sub>t</sub> processes, discussed below.
- 11.29 As in respect of Timelines, we expect that for smaller D<sub>t</sub> items, or repeating items, the submissions from SONI will be more limited. We understand that this is already the case, although the UR has stated that SONI has not provided the information as indicated by the current D<sub>t</sub> process. We expect that the codified process would include obligations on SONI to provide the information required to the UR where it is seeking to recover its costs through tariffs.
- 11.30 We therefore have decided to that the format of Project Specification should be formalised as part of the codified process, and that the UR and SONI should agree the form of Project Specification within the timeframe for codification.

### ***Ongoing project reporting***

- 11.31 The third area where we have decided that formal codification is required is ongoing reporting of projects subject to the D<sub>t</sub> and PCNP cost recovery mechanisms. To the extent that SONI has a wide range of projects ongoing under the mechanisms which are the subject of this appeal, there should be annual ongoing reporting of the projects under this process.
- 11.32 This would have a number of benefits:

- (a) Transparency: both between SONI and the UR, for SONI's financiers and, within confidentiality requirements, as part of public regulatory reporting.
  - (b) Predictability: of future spend requirements.
  - (c) Risk mitigation.
- 11.33 In response to the provisional determination, SONI proposed that it should undertake ongoing reporting. For example, it suggested a new annual 'April Submission', under which it would report on current and expected  $D_t$  applications.<sup>913</sup>
- 11.34 We have therefore decided that SONI should be required to provide ongoing reporting as part of the codification of the process for PCNPs and  $D_t$  mechanisms. We will require the UR, in consultation with SONI, to provide a template for the reporting by SONI.

### ***Project Variation***

- 11.35 The fourth area where we have decided that increased certainty is required is Project Variation. We consider that the UR's pre-approval process for PCNPs and multi-period projects under the  $D_t$  mechanism requires a Project Variation process to be able to work effectively. The lack of a codified Project Variation process is a key aspect of our finding in respect of SONI's appeal on Error 6 in particular.
- 11.36 SONI's appeal on the  $D_t$  mechanism is related to the process for dealing with changes in costs and scope of projects after the initial approval stage. SONI submitted that under the UR's 'cap' approach, it faces asymmetric risk.<sup>914</sup> The UR disagreed, and stated that SONI can request an increase in the cap.<sup>915</sup> The UR further confirmed this position in its response to the provisional determination, where it confirmed that its preferred mechanism was one where increases in budget were pre-approved before SONI spent above the cap.<sup>916</sup>
- 11.37 It is clearly important for an effective process that the management of changes in project scope or budgets is properly codified. On the basis that

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<sup>913</sup> SONI response to CMA provisional determination – Ground 2 remedies paper, paragraph 5.1.

<sup>914</sup> [NoA](#), paragraphs 24.15 & 28.5.

<sup>915</sup> [Defence](#), paragraph 2.21.

<sup>916</sup> UR response to CMA provisional determination, paragraph 2.41.

there is a clearly defined initial project scope, there are several reasons why the costs might increase, including:

- (a) Increases in project scope, for example due to changes in output specification.
- (b) Cost inflation being higher than planned.
- (c) Inefficiency, for example the need to duplicate costs due to ineffective project management.

11.38 We consider that there are two aspects of the Project Variation process that both need to be effective to resolve the issues of codification identified in SONI's appeal and also to retain meaningful incentives on SONI to be efficient. First, we consider that there needs to be a mechanism for addressing unexpected increases in budgeted spend, for example for increases in project scope. Second, there needs to be a mechanism for scrutiny of such increases in budget spend which might represent inefficiency, without requiring SONI to 'down tools' and stop work while the UR reviews project increases.

11.39 In the remedies hearing, the UR said that it would normally expect to increase the cap if costs rise, and gave the example of the North-South interconnector.<sup>917</sup> SONI has said that a lack of codification and the ex-ante cap mean that it has no certainty that the UR will follow this process in future cases. While we understand that the UR has said that this would happen, we agree with SONI that codification of the variation process will give greater certainty to it for financing projects such as PCNPs.

11.40 We therefore consider that it is important to efficient project delivery that a comparable process to that in place for Project Specification is put in place for Project Variations, also including timelines. We propose that the codification applied to D<sub>i</sub> and PCNP mechanisms should also include timelines for Project Variations, including a pre-specification of the detail required for the UR to consider variation requests by SONI.

11.41 In paragraph 11.24 above, we note that it is feasible that it may be efficient for SONI to incur some initial spend in projects before formal approval is in place, and that there would be benefits in some cases if this is recognised in codification, within reasonable materiality thresholds. This would be even more likely in the context of Project Variations.

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<sup>917</sup> Remedies Hearing transcript, page 137 line 16 to page 138 line 2.



- 11.42 The UR and SONI should consider whether codification should include a mechanism for small and/or urgent project variations. For example, small changes within a certain percentage of project spend could be subject only to DIWE at the end of the project, with only large changes being subject to a full-scale project variation process. Should the UR and SONI decide to include such a mechanism, it should be specified as part of the codification.
- 11.43 At the remedies roundtable, the UR confirmed that it would expect to pre-approve all spend, including changes to an already agreed budget cap. The UR stated that this was part of its approach to regulation of this expenditure, which it characterised as ‘managed pass-through’.
- 11.44 We have discussed in Chapter 6 above our overall views on the UR’s statements on efficiency. Whilst it is for the UR to determine the level of efficient spend on a case-by-case basis, we do not consider that an effective remedy is one that allows SONI to be inefficient, and does not disallow any of the costs of that inefficiency. In that context, it is also inherent in the UR’s overall approach to regulation of SONI, and consistent with the UR’s duties and objectives that there should be some incentives for efficiency.
- 11.45 This would provide perverse incentives to SONI to identify expensive options for procurement of agreed projects and/or to inflate the scope of its projects, without fear of disallowance as long as it provided advance notice to the UR of any increase in spend. We therefore consider that the process should allow for disallowance on efficiency grounds. As also discussed in our Ground 1 remedies (see Chapter 12), we consider that this should be a credible risk, as we do not expect that the UR would only review SONI’s projects for efficiency in the case of extreme risks, ie DIWE, and would otherwise pass-through all SONI’s costs. For example, we would expect an efficiency review where a Project Variation includes an increase in the budget for a project to a level which is above contingency and where there is no evidence that the increased spend is efficient, or represents a necessary increase in scope.
- 11.46 In the remedies hearing, the UR stated that this efficiency challenge should not be limited purely to disallowance of demonstrably inefficient costs (ie DIWE). The UR noted that it did not consider the DIWE term to be sufficient on its own, since it relies on the UR being able to demonstrate SONI has been wasteful and inefficient, and this demonstration would be based on the evidence SONI provides. It therefore considers that there is a ‘high bar’ to disallow costs under DIWE.<sup>918</sup> We agree with this statement by the UR, and

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<sup>918</sup> Remedies Hearing transcript, page 130, lines 16–26.

consider that an efficiency challenge aside from DIWE is a necessary part of an effective approval process.

- 11.47 There are a number of ways in which a project variation process could be implemented, and the appropriate mechanism may vary across projects, for example depending on the scale of the project. One practical approach to this could be that the onus should be on SONI (as is the case with the initial budget submission) to demonstrate its case for being allowed additional budget as a result of project variation, subject to materiality thresholds. In the context of large projects or large variations, it may be that the UR's review could include an independent assessment by a technical expert, as with the current approach taken to reviewing for efficiency as part of the ex-ante Price Control process. The UR would also continue to have the power to disallow demonstrably inefficient spend on the basis of DIWE.
- 11.48 In response to our provisional determination, SONI set out a detailed flow diagram which illustrated how it proposed the codification to be implemented for different types of project. Under SONI's proposals, it would recover its actually incurred spend for PCNP and D<sub>t</sub> projects<sup>919</sup>, without the UR giving express approval of any budget cap or variations in proposed spend. In contrast, the UR set out in its response to our provisional determination that it is important that the UR maintains the ability to disallow spend in excess of the budget cap for reasons other than DIWE. It noted that it is not in the best interests of consumers for SONI to overspend an approved cap and for it then to prove difficult for the UR to disallow any inefficient costs in that overspend.<sup>920</sup>
- 11.49 As discussed in Chapter 12 below, we have concluded that there is some asymmetric risk inherent in a process which sets the maximum return at actual spend, and allows for disallowances on the basis of efficiency. This is in contrast to other categories of cost that are remunerated via an upfront allowance, whereby (under the 50:50 risk-sharing arrangements) SONI is exposed to both the upside of outperformance as well as the downside of underperformance. However, we do not consider that asymmetric risk is wrong in principle. We have accepted SONI's case that its investors should be rewarded for taking asymmetric risk as part of our assessment of Ground 1, and have concluded that this can be done through a small uplift on the relevant project value with a minimal effect on customer bills.

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<sup>919</sup> SONI response to CMA provisional determination – Ground 2 remedies paper, paragraphs 7.15, 14.14, 16.8 & 18.8

<sup>920</sup> UR response to CMA provisional determination, paragraph 2.39.

11.50 As a result, the main purpose of codifying the project variation process would be to provide SONI with clarification of the UR's approach to changes in scope and/or cost drivers, to support the financing of latter stages of the projects. An effective project variation process should reduce risk to SONI. For example, SONI may have a number of options to address changes to project outputs or other factors outside its control which influence the efficient project plan. In that case, it may benefit both SONI and the UR if this is reviewed in advance of the implementation of a particular option, rather than ex-post when it may be more difficult to provide evidence that the actual decision was right at the time, for example with an independent assessment by technical experts.

11.51 As with project specification, we consider that the approach to project variation should be effective, timely, and reflect the need to make normal commercial decisions. This would suggest:

- (a) SONI should have the option of submitting a project variation request at any time.
- (b) The UR should be required to respond in a timeline consistent with the needs of different projects (including complexity) if it wishes to disallow any aspect of additional spend associated with a project variation request. Timelines should be included within the codification of the process, and these should be able to be processed by the UR more quickly than project initiation submissions;
- (c) It should be at SONI's risk that overspend could be characterised as inefficiency where it spends more than the cap or seeks to increase the cap without evidence that the increases in cost are efficient. Any disallowances of increases to the cap should be for reasons of efficiency. Where increases are due to factors outside SONI's control, or reflect increases in the scope of the project, the cap would be increased.

11.52 In summary:

- (a) A project variation process is essential for the PCNP and D<sub>t</sub> process to work effectively.
- (b) The UR should review project variations relating to increased budgets for both efficiency and scope changes, and it would have the option to disallow increased spend which SONI is unable to demonstrate is efficient as part of the project variation process.

- (c) Timelines and minimum requirements for a project variation submission should be agreed in a way comparable to an upfront project submission. We would expect that small changes could be managed efficiently.
- (d) Where SONI needs to spend pre-approval, this would be at SONI's risk, and subject to risk of disallowance on efficiency grounds.
- (e) However, to the extent that SONI is required to urgently incur additional efficient costs, for the reasons of unexpected increases in project scope, the codification should include either a process for urgent review, or an exception to pre-approval where certain tests are met.

### ***Transfer of investments into the capital base and tariffs***

- 11.53 The final component which we have identified that needs to be codified for an effective regime is the mechanism by which funds are transferred into the RAB and/or tariffs. Currently, there is a specified mechanism for  $D_t$ , but not for PCNPs.
- 11.54 Based on the evidence provided to the appeal, we consider that the following steps need to be completed:
- (a) The UR should change the licence to include a 'side-RAB' formula for PCNPs, to allow recovery of ongoing costs of financing PCNPs through tariffs.
  - (b) The current recovery mechanism for  $D_t$  should continue, but SONI should comply with the annual reporting regime and pre-approval for recovery of costs under the  $D_t$  mechanism.
  - (c) The UR should consult on and agree a mechanism for the transfer of PCNPs to NIE under the TIA (whether under a Licence modification or otherwise).
  - (d) The UR should, in due course, consult on and agree a process for the other methods by which SONI recovers the costs of PCNPs, including through SONI exercising its step-in rights and when a third party takes on construction.
- 11.55 The approach of including a 'side-RAB' for recovery of ongoing costs was proposed as part of the [NoA](#). In submissions to our remedies process, the UR proposed indicative wording for a licence modification to implement the side-RAB. The submissions from SONI and the UR indicate that the working of the side-RAB is largely agreed, although some detailed implementation

points remain. We therefore have decided to direct the UR to implement a licence modification to include a side-RAB, in consultation with SONI.

- 11.56 The main area of dispute in respect of the side-RAB is whether it should explicitly include the expenditure which SONI has incurred in respect of PCNPs since May 2014. SONI has indicated that this may be as much as £7 million. The UR has submitted that these amounts cannot be included in the side-RAB at this point since SONI has not provided the evidence which the UR requires for approval of PCNPs. This amount is clearly highly material to SONI and we have decided to direct the UR to apply the same process as envisaged for future PCNPs so that these existing PCNPs may be included in the side-RAB.
- 11.57 However, the intention of our remedies is to provide codification and a clear process for the recovery of SONI's efficiently incurred costs through tariffs, not to provide retrospective approval to SONI of existing PCNPs. We have not directed the UR to automatically include all PCNPs in the opening side-RAB, as we would expect the UR to follow the same process of approval for these existing PCNPs as for future PCNPs.
- 11.58 The UR has submitted that the inclusion of a 'side-RAB' may provide incentives for SONI to defer the transfer to NIE. To the extent that there is any such risk, we would expect that this would be addressed through the codification of the process by the UR.

## **Our decision on guidance**

- 11.59 In summary, we have decided that codification is necessary for the  $D_t$  mechanisms and PCNP cost recovery process to be effective, that codification should include both commitments by the UR as to how SONI should recover costs, and also clear rules as to what SONI has to submit for the UR to undertake this process. We expect the UR and SONI to refine further the details of the process in line with the decisions in this final determination, but that the codification needs to, at a minimum, include the following.

### ***Timelines***

- 11.60 In order to recover costs through tariffs in the current price control period, SONI should submit applications for PCNPs and the recovery of  $D_t$  costs at least six months ahead of project initiation.

- 11.61 The UR should approve or reject SONI's application within four months of receiving the required information, setting out any objections to SONI's application.
- 11.62 SONI and the UR should consider whether there is scope for reducing these timelines when there is a lack of materiality, lack of complexity, or for projects with lower level of approval required (e.g. those that do not require sign-off from the UR Board).

### ***Project Specification***

- 11.63 SONI and the UR should work together to agree and codify a detailed process for pre-approval, including templates to be completed by SONI as part of project initiation.
- 11.64 The UR should pre-approve PCNP and D<sub>t</sub> projects, including setting an initial budget cap for each project.

### ***Ongoing project reporting***

- 11.65 SONI should report to the UR at least annually with its progress on PCNP and projects subject to the D<sub>t</sub> mechanism, under a template to be proposed by the UR following consultation with SONI.

### ***Project Variation***

- 11.66 In order to recover costs above the initial pre-approved budget through tariffs in the current price control period, SONI should submit applications for Project Variation, including evidence as to why additional costs are required and reflect changes in the efficient costs of the project.
- 11.67 The UR should approve or reject SONI's application within a pre-specified period of receiving the required information, setting out any objections to SONI's application. This period should be specified in codification, should be consistent with the needs of different projects (including complexity) and in any case should be no longer than the four months required for initial project approval.
- 11.68 As with pre-approval, SONI and the UR should work together to agree the details of the information SONI should provide as part of its applications for approval of variations to project specification.
- 11.69 Whilst pre-approval will remain the case for the majority of Project Variations, there should be a process for allowing SONI to act efficiently

without penalty when it faces urgent increases in budget relating to changes in project scope.

### ***Transfer of investments into the capital base and tariffs***

- 11.70 The Licence should include codification of the side-RAB that applies to SONI's efficiently incurred costs in respect of PCNPs, in such a way that SONI has certainty that it will be able to recover PCNP costs it incurs that the UR has approved. This process should also be applied to the efficiently incurred costs in respect of PCNPs since May 2014.
- 11.71 The Licence should also codify the return SONI receives (equal to the WACC) on the side-RAB, and how SONI recovers this during the period before the PCNP proceeds to construction, or is not pursued.
- 11.72 The UR should consult on and agree a mechanism for the transfer of PCNPs to NIE under the TIA.
- 11.73 The UR should consult on and agree a process for the other methods by which SONI recovers the costs of PCNPs, including through SONI exercising its step-in rights and when a third party takes on construction.

### **Implementation of the remedy**

- 11.74 Our implementation includes three steps: process codification, side-RAB for recovery of ongoing costs of PCNPs, and approach to recovery of the costs of completed projects. This requires both changes to the Licence, and codification of the process to be followed in applying the terms in the Licence.
- 11.75 In respect of process codification, we have been told by the UR and SONI in response to our provisional determination that the Licence already includes a mechanism for recovery of  $D_t$  costs, but not of PCNPs.

#### *Licence modifications*

- 11.76 The codification will include the obligations on SONI to deliver information of sufficient quality to the UR, and the conditions under which SONI can then recover costs through tariffs.
- 11.77 We have concluded that the detailed process should not be included in the Licence, as it requires a level of detail which is not suitable for a licence modification. The process also includes obligations on the UR, as well as on SONI, whereas the Licence only provides obligations on SONI.

- 11.78 However, the codification as to how the UR will act and the obligations on SONI to provide information to the UR should nevertheless be referred to in the licence conditions.
- 11.79 The codification will be in the form of procedural guidance (as agreed between SONI and the UR), which will set out details of how SONI must make claims for recovery of its costs and how the UR will process such claims. The UR will then incorporate the agreed procedural guidance by reference into Annex 1 of SONI's licence. We have included a direction to the UR to do so. In view of the need for this to be done expeditiously, we are also directing both SONI and the UR to send a report each month to the CMA on the progress that has been made in agreeing the terms of this procedural guidance.
- 11.80 In respect of the side-RAB, both SONI and the UR provided wording as to how the side-RAB could be included in the licence. We have decided to direct the UR to include wording in the licence to reflect the side-RAB on the basis proposed by the UR, but subject to consultation with SONI on the detailed implementation.
- 11.81 In respect of the recovery of costs of PCNPs once they are completed, SONI provided indicative wording for the Licence. We have decided that this process needs to take into consideration views of other industry stakeholders, including NIE. We have therefore decided to remit the process to the UR to complete, but we expect that this can be completed in line with the timelines set out below, alongside the process which the UR has started on the formalisation of the relevant aspects of the TIA.
- 11.82 We note that, as part of this appeal, SONI has stated that it is not clear how it will recover the costs it has already incurred on PCNPs since the transfer of the Network Planning function. We agree with SONI that this is not clear, and we have included within the directions a requirement for the UR to specify the process that will apply to the expenditure incurred in respect of PCNPs since 1 May 2014. This should be consistent with the process for recovery of PCNP costs set out in this final determination.

*Timing for remedy implementation and monitoring*

- 11.83 In the case of Ground 2, our remedy includes a direction to the UR to codify a process, including the completion of documentation to be referred to in the licence. We have decided that it would be more appropriate for the UR to draft the detailed documentation, but we have indicated in this final determination our decisions on what should be included in the



documentation underlying the recovery of costs for PCNPs and the D<sub>t</sub> mechanism.

- 11.84 We note that the UR has already started discussions with SONI as part of our remedies process. We therefore consider that, subject to co-operation by SONI, it should be feasible for the UR to complete the process of codification within four months.
- 11.85 We therefore have decided to direct that the UR should use its best endeavours to implement our Ground 2 remedies within four months.
- 11.86 Given the nature of the remedy under Ground 2, in order that the CMA is able to assess compliance, ie whether the remedy has been implemented effectively and in a timely manner, we are directing both the UR and SONI to report to the CMA on implementation of the Ground 2 remedies. We are requiring that, up to the point at which the remedy has been fully implemented, compliance with the remedy should include a short monthly submission to the CMA.

### **Summary of the remedy**

- 11.87 Our remedy on Ground 2 is four-fold:
- (a) the UR should put in place a licence condition to allow SONI to recover the ongoing costs of PCNPs under a 'side-RAB';
  - (b) the UR should put in place codification to provide certainty to SONI on the process it should follow to recover the costs of D<sub>t</sub> 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;
  - (c) the UR should confirm to SONI the approach by which its efficient investment in PCNPs to date can be recovered under this process; and
  - (d) on remittal, the UR should 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.
- 11.88 We consider that a short timeline should be feasible for (a), (b), and (c), and have decided that these should be completed within four months of notifying parties our final determination.
- 11.89 The TIA process may take longer, but given that the UR has already started the process, we would expect that it should also be completed in a

comparable timeline. We have indicated that the UR should seek to complete this process by March 2018.

## 12. Remedies – Ground 1

12.1 In Ground 1, we found that the UR was wrong in its approach to remunerating SONI for the risks that it faced across the Price Control Period. We found that the UR's financial framework was wrong for three reasons:

- (a) The UR failed to provide an allowance for the PCG provided by EirGrid, and this was wrong as the amount assumed in the SEMO control, which was relied on by the UR, did not reflect the additional risks taken by EirGrid in providing a guarantee to SONI in addition to SEMO.
- (b) The approach to determining the level of return for SONI, in particular the way in which the UR applied a RAB/WACC approach, was wrong, as it did not remunerate SONI for the asymmetric risk it faced, and therefore it was not suitable for ensuring SONI's financeability.
- (c) The approach to determining the level of return for SONI, in particular the way in which the UR applied a RAB/WACC approach, was wrong, as it did not reflect the risks faced by SONI in respect of the management of industry revenue,<sup>921</sup> and therefore it was not suitable for ensuring SONI's financeability.

12.2 Our assessment is that the appropriate remedy in each case would be to include an additional allowance within the Price Control that would align the return assumptions within SONI's allowed revenues with the risks faced by SONI.

12.3 In this chapter, we provide details of our decisions in respect of the remedy for Ground 1. In designing a remedy for the error identified by SONI, we have identified an alternative price control measure and/or input assumption for SONI in respect of each of (a) – (c) in paragraph 12.1 above. In each case, this represents an additional allowance for SONI, with the objective that, in combination, the existing returns and the new allowances will result in a balance of risk and reward which will ensure SONI's financeability.

12.4 We provide below an explanation of how each of the price control adjustments which will collectively remedy Ground 1 should be calculated. We first outline the structure of the alternative price control measure, and

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<sup>921</sup> In this document we sometimes refer to the activity of 'management of industry revenue' as 'SONI acting as a collection agent'.

second provide our view on the calibration of that alternative measure, ie what is the size of the adjustment to the price control. In respect of the asymmetric risk and the cost of managing industry revenue, we have identified both the scope of the underlying cash flows to which our remedy applies and the level of the adjustment in percentage terms.

- 12.5 We have decided that our remedy should be implemented by the UR on remittal. We consider that this is preferable to the alternative of substitution by the CMA, as:
- (a) we have stated clearly the parameters of the revisions required to the Price Control to implement the remedy, and therefore there are limited implementation risks;
  - (b) tariffs have been set for 2017/18, and therefore our remedy will not have an effect on tariffs until October 2018;
  - (c) there are some secondary points of detail to be agreed as part of the implementation of the remedy, and these are better managed by the UR; and
  - (d) given the short period available for the remedy process, there are risks for the CMA in identifying a suitable approach to substitution within the time available.
- 12.6 We have [published](#) our Order alongside this final determination, which requires the UR to implement the remedy as set out below. We would expect the UR to issue a Licence Modification in respect of Ground 1 promptly.
- 12.7 In September 2017, we notified our provisional determination to SONI and the UR, where we sought views on all of the points discussed in this chapter, and provided indicative levels for the remedy in respect of Ground 1. Where relevant, we have summarised the evidence from SONI and the UR below.

## **Parent Company Guarantee (PCG)**

### ***Introduction***

- 12.8 Based on our analysis in Chapter 7, we consider that it is appropriate to include an allowance for the PCG in the Price Control for SONI. The allowance for each price control period would be based on:
- (a) the cost of a standalone PCG covering both SEMO and SONI's TSO risks with a single sum of contingent capital; less

- (b) the level of remuneration awarded in respect of the PCG within the SEMO price control for the corresponding period.
- 12.9 The allowance to be included in the TSO price control can therefore be deconstructed into the following elements:
- (a) the cost of SONI's TSO PCG on a standalone basis; plus
  - (b) the cost of the SEMO PCG on a standalone basis; less
  - (c) the cost of a 'contingent capital risk premium' reflected in both the cost of a) as well as the cost of b) above, to prevent a 'double-count' where EirGrid would be remunerated twice for the single amount of capital it has committed to; less
  - (d) the level of the PCG remuneration in the SEMO price control.
- 12.10 In the submissions to the appeal, and the submissions on remedies in response to our provisional determination, both parties provided evidence as to factors we should consider in placing a value on the PCG in SONI's TSO price control. We summarise these first, then present our decision.
- 12.11 In our provisional determination we provisionally proposed that the value of the remedy would be within a range of 1.5%–2.5% per annum of the face value of the guarantee of £10 million.
- 12.12 In this section, we provide our decision on the appropriate alternative measure for the cost of the PCG.

### ***Parties' submissions***

- 12.13 We consider the submissions in three categories:
- (a) First, the priority of the PCG, ie the circumstances under which it would be called and the likely consequences if it were called.
  - (b) Second, the reasons why there might be a double-count between amounts allowed under the SEMO control and the SONI TSO control.
  - (c) Third, the appropriate ranges for the cost of the PCG, including the size of any adjustment for a double-count.

*Priority in which providers of capital would be called on in event of need: PCG versus alternative sources*

- 12.14 An important consideration in placing a value on the cost of the standalone guarantees for elements a) and b) in paragraph 12.9 is the likelihood of the guarantor of the PCG, in this case EirGrid, being called on to provide capital. A significant determinant of the cost of the PCG is where the PCG stands in the pecking order (or 'priority') of sources of finance. For example, a company has a contractual commitment to service interest payments on debt, but will cease to pay dividends to equity holders if it has an alternative call over its cash reserves. Therefore debt can be said to have 'priority' over equity.
- 12.15 Both parties provided submissions on the priority of the PCG, as the level of priority has an effect on the market value of the PCG.

*SONI's submissions*

- 12.16 SONI submitted that the provider of the PCG's exposure to risk could be considered similar to that of an investor in preference shares. In the event of a shock, SONI explained, the priority given by a firm to avoiding not paying out dividends on preference shares would be similar to the priority given to calling on the PCG.<sup>922</sup>
- 12.17 SONI submitted that the PCG would sit below debt in terms of priority of payments. After SONI's own financial buffer had been exhausted, the PCG would be called upon to avoid it defaulting on paying interest on its debt. The PCG therefore provided support for investors in debt.<sup>923</sup>
- 12.18 SONI submitted that the PCG was more like a cash equity buffer, which could be drawn on as needed. SONI submitted that, like investors in equity, the provider of the PCG would not acquire any additional control rights eg the right to foreclose on assets. The provider of the PCG's claim would instead have a claim on the future profits of the business. The provider of debt, in contrast, would acquire control rights in the event of payment default and its only interest was to immediately recover its principal investment.<sup>924</sup>
- 12.19 In the remedies hearing, SONI provided a handout in which it compared its access to capital with Bristol Water. We have presented SONI's handout as Figure 12.1. Bristol Water is an asset-heavy water utility whose preference

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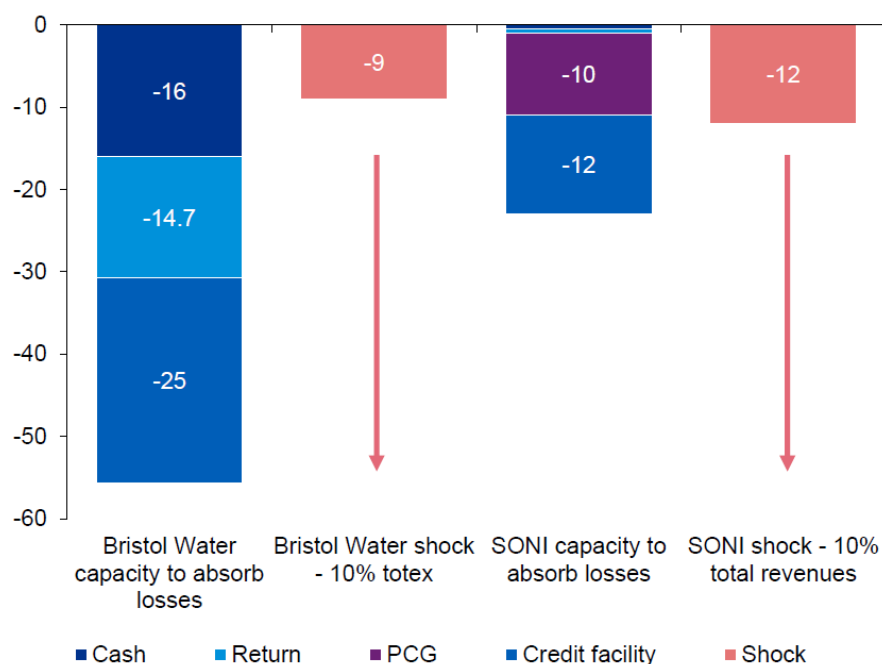
<sup>922</sup> SONI response to CMA provisional determination – Ground 1 remedies paper, paragraph 2.11.

<sup>923</sup> SONI response to CMA provisional determination – Ground 1 remedies paper, paragraph 2.16.

<sup>924</sup> SONI response to CMA provisional determination – Ground 1 remedies paper, paragraph 2.17.

shares SONI had previously referred to as a possible benchmark for valuing the PCG. Bristol Water, SONI explained, held a ‘cushion’ of cash of £16 million, had an expectation of earning nearly £15 million of profits each year (‘return’) and had access to a credit facility of around £25 million. By way of contrast, SONI as TSO, held a “very thin” layer of capital, which resulted in it only earning a small level of return each year with which to manage revenue risk. To absorb a 10% loss in its revenues SONI would need to call in the PCG. In contrast the equivalent shock to Bristol Water, which it expressed as a percentage of total expenditure (totex),<sup>925</sup> would be met out of cash reserves.

**Figure 12.1: SONI’s depiction of ‘investor capital available to absorb losses’ in £ million**



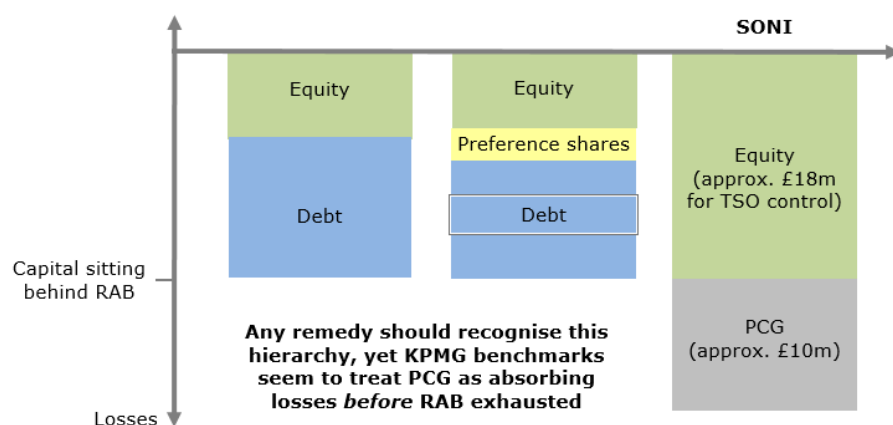
Source: Remedies Hearing, SONI handout 3: ‘Correction of UR diagram – “Investor capital available to absorb losses”’. SONI’s stated sources for the figure above were CMA’s [Bristol Water Final Determination](#) (21 October 2015), Bristol Water’s Annual Report (2017) and SONI’s price control financial model.

### *UR’s submissions*

12.20 The UR challenged SONI’s submissions that the PCG would be next to be called upon once profits earned in the current period and any available cash reserves had been exhausted. In the remedies hearing, the UR provided a handout which illustrated this view as shown in Figure 12.2 below.

<sup>925</sup> Total expenditure (totex), comprising operating expenditure (opex) and capital expenditure (capex).

**Figure 12.2: The UR's depiction of three possible financing scenarios for SONI**



Source: Remedies Hearing, UR handout 1.

12.21 The UR argued that, after current profits and cash reserves had been exhausted, losses would be met by existing equity investors in SONI's RAB. The UR submitted that these equity investors should be willing to inject further equity into SONI's TSO business up to the value of their RAB investment.

12.22 The second and third columns in Figure 12.2 compared the UR's interpretation of the scenario faced by SONI with a scenario where some of the RAB investment was provided by preference shares (as with Bristol Water, which was used as a comparator by KPMG). In the UR's view, preference share investors sat between equity and debt in terms of priority of being called upon to inject further funds into the business. The UR explained, however, that SONI's PCG was not akin to preference shares as had been argued by SONI's advisors, KPMG. In the UR's view, and as depicted in the third column in Figure 12.2, the PCG would only be called upon only once equity holders had injected further funds up to the value of the existing RAB into the TSO business. Existing equity holders would do this to protect the value of their existing investment in the RAB, which would otherwise be in jeopardy. As a result, the risk of loss under the PCG was 'hard to conceive'.<sup>926</sup>

12.23 The UR argued that the third column in Figure 12.2 was the most appropriate way of looking at the issue of priority because in the [Final Determination](#) it had set SONI's TSO price control WACC on the assumption that SONI would be 100% equity funded. The UR argued that it would not have set the WACC to be a generous 5.9% per year had it been the PCG investors who had been next in line after current profits and cash reserves to

<sup>926</sup> Remedies Hearing transcript, page 125, line 4.

absorb losses. The UR urged us when calibrating the level of remuneration for the PCG to be consistent with the hierarchy of risk reflected within the [Final Determination](#).<sup>927</sup>

*'Double-count' of remuneration already reflected within PCG allowance within the SEMO price control*

#### *SONI's submissions*

- 12.24 SONI said it was first necessary to establish whether there was any correlation between the risks under the TSO PCG and the MO PCG ie the SEMO business. This step was necessary to determine whether there would be “overlap” between these two guarantees. In SONI’s view, there was no overlap because the two guarantees related to two separate business activities with their own sets of risks. SONI pointed to the evidence and analysis it had previously submitted about the different portfolio of activities and risks that the TSO and SEMO businesses respectively faced.<sup>928</sup>
- 12.25 SONI submitted that it was irrelevant that the two guarantees (one TSO, one MO) had been written together as part of one contract. It was possible for a single contract to cover a number of “insurance policies”, the key point being that they related to different sets of activities and different risks.<sup>929</sup> SONI continued that, although there was a single £10 million of common capital supporting both the TSO and MO guarantees, it was important to consider how that affected the valuation of the (TSO) PCG, if at all. SONI referred to the analysis set out in KPMG1 which had explicitly considered whether remuneration of the PCG on a standalone basis within the TSO control would double-count remuneration for activities or risks in respect of PCG remuneration given in the SEMO price control.<sup>930</sup>
- 12.26 SONI continued that the starting point should be that the value placed on each guarantee would not be influenced by the fact that there was only a single pool of capital. There would be only two circumstances in which the level of the risk premium would be affected, both of which SONI argued would be very unlikely in this context, namely:
- (a) there was a clear and explicit risk of default by the guarantor on one guarantee due to the other one being present; or

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<sup>927</sup> Remedies Hearing transcript, page 123, line 3 to page 125, line 20.

<sup>928</sup> SONI response to CMA provisional determination – Ground 1 remedies paper, paragraphs 2.27–2.31.

<sup>929</sup> SONI response to CMA provisional determination – Ground 1 remedies paper, paragraph 2.36.

<sup>930</sup> SONI response to CMA provisional determination – Ground 1 remedies paper, paragraph 2.37.



(b) the single amount of capital would be insufficient to cover both guarantees at any particular point in time.<sup>931</sup>

#### *UR's submissions*

12.27 The UR submitted that the aggregate return for the PCG across both the TSO and SEMO price controls we had proposed of 4.0% to 5.0%<sup>932</sup> per year on its £10 million face value was manifestly excessive when looked at alongside the risk that the parent, EirGrid, was carrying. The UR compared the level of aggregate return we had proposed to:

(a) the premium over the risk-free rate of 1.6% per year that EirGrid could earn if it had put the same £10 million into BBB rated investment-grade bonds;

(b) the cost of around 2% per year of face value for another form of contingent finance, namely letters of credit, for firms of similar or slightly higher riskiness. For example, the CMA's [Energy Market Investigation](#) retail profitability analysis had assumed that such letters of credit would cost energy retailers 2% per year; and

(c) the premium over the risk-free rate of 2.2% to 3.5% per year that EirGrid could earn if had invested the £10 million into BB or B-rated junk bonds.<sup>933</sup>

12.28 We had, the UR continued, positioned the return that EirGrid would get beyond the extreme end of the spectrum of investment returns it had set out. The rate of return we would be allowing would exceed even that which would normally be associated with sub-prime debt. There was simply no evidence to support the view that SONI's risk profile was such that a PCG for it would cost more than the above instruments.<sup>934</sup>

#### *Range for the value of remuneration for the PCG in the TSO price control*

12.29 In this section we summarise further submissions from both SONI and the UR in respect of the potential range of values for the PCG. Both SONI and the UR provided benchmarks. We have described some of the benchmarks proposed by the UR in the previous section, as they were also referred to in

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<sup>931</sup> SONI response to CMA provisional determination – Ground 1 remedies paper, paragraph 2.38.

<sup>932</sup> This equated to our proposal to remunerate the TSO PCG through an allowance of between 1.5% to 2.5% per year plus the 2.5% per year already provided for the PCG in the SEMO price control.

<sup>933</sup> UR response to CMA provisional determination, paragraph 1.17.

<sup>934</sup> UR response to CMA provisional determination, paragraph 1.18.

the UR's submissions that the combined value of the guarantee was too high.

12.30 In describing SONI's submissions, we make reference to the premium within the cost of debt which we had indicated in our provisional determination might represent a market value for the double-count described in the previous section. We describe this premium in this final determination as the 'contingent capital risk premium'.

### *SONI's submissions*

12.31 In support of its [NoA](#), SONI submitted a number of options for valuing the TSO PCG for SONI, prepared by its economic consultants KPMG.<sup>935</sup> KPMG provided five approaches to valuing the TSO guarantee. All of KPMG's analysis related to the cost of a standalone TSO PCG. We have summarised each of KPMG's approaches in Table 12.1.

**Table 12.1: KPMG's proposed approaches and associated remuneration levels for the value of a standalone TSO PCG**

<i>Approach</i>	<i>Required remuneration per annum (%)</i>	<i>Potential bias</i>
<b>Approach 1:</b> Preference shares approach	3.1	Likely biased down since Bristol Water and NIE have a lower risk profile than SONI.
<b>Approach 2:</b> Regulatory precedent	2.5	Likely biased down since SEMO has a lower risk profile than SONI.
<b>Approach 3:</b> Expected loss calculation approach	3.68	Potential imprecision from assuming a normal distribution and assumptions about standard deviation derived from historical data.
<b>Approach 4 (upper bound):</b> Equity risk premium	6.36	Upper bound estimate as the PCG has a lower risk profile than equity.
<b>Approach 5 (lower bound):</b> Debt premium	1.7	Lower bound estimate as the PCG has a higher risk profile than debt.
<b>Average of Approach 1–3</b>	approx. 3.1	An arithmetic average is used on Approach 1–3 instead of the median so that each approach is equally weighted.

Source: NoA MC1, supporting document MC1/1 (KPMG 1), Figure 8.

12.32 In response to our provisional determination, and drawing on KPMG's analysis, SONI stated that the remuneration for the PCG should be from a range of 1.98%–3.39% per year, determined in accordance with Table 12.2.

<sup>935</sup> NoA MC1, supporting document MC1/1 (KPMG 1), pages 40–59.

**Table 12.2: SONI's proposed range for the value of the standalone TSO PCG**

<i>Approach</i>	<i>(% per year)</i>	
	<i>Low end of range</i>	<i>High end of range</i>
<b>Approach 1:</b> Preference shares approach		3.10
<b>Approach 3:</b> Expected loss calculation approach	2.25	3.68
<b>Approach 5:</b> Debt premium	1.70	
<b>SONI range</b>	<b>1.98</b>	<b>3.39</b>

Source: SONI response to CMA provisional determination, paragraphs 2.73–2.74.

- 12.33 SONI submitted that it did not agree with the approach in our provisional determination that there should be an adjustment to remove the double-count in respect of the contingent capital risk premium. SONI submitted that, under KPMG's expected loss approach to estimating the cost of the standalone TSO PCG, KPMG had been correct to add 1.43% per year for contingent capital risk premium to the annual value of the expected loss.
- 12.34 SONI stated that, were we to make an adjustment for double-counting, it should be restricted to the 'liquidity risk premium' element of the contingent capital risk premium which remunerated EirGrid for the capital it had committed under the PCG. SONI submitted that EirGrid should receive the 'default risk premium' element, and as a result, our provisional adjustment of 1.43% per year covering both the liquidity risk and default risk premiums was too high. SONI provided a number of options for an alternative approach to measuring the liquidity risk premium, with a range of values of 0.23%–1.15% per year.
- 12.35 Based on this assessment, and its take on our provisional determination that the PCG allowance should take into consideration any 'double-count' of the contingent capital risk premium as depicted in Figure 12.1 above as well as the allowance already provided for in the SEMO control, SONI proposed that the value of the remuneration for the TSO PCG should be 2.55% per year. This was calculated by SONI as the sum of PCGs for SEMO and SONI on the preference shares approach (3.1% and 3.1% per year), less the SEMO allowance of 2.5% and a liquidity risk premium of 1.15% per year.<sup>936</sup>

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<sup>936</sup> SONI response to CMA provisional determination, paragraph 2.57.

## *UR's submissions*

12.36 As discussed in Chapter 7, the UR made submissions that the total cost of the guarantee was lower than we had assumed in our provisional determination. It submitted that the allowance within the SEMO price control already remunerated SONI for the risks across both the TSO price control and SEMO price control. In this section we provide the UR's submissions on the level of the cost of the PCG.

- *Benchmark derived from expected corporate bond returns*

12.37 In response to our provisional determination, the UR agreed with us that one helpful way of assessing the level of the return that SONI would require for the PCG would be to benchmark to the return on comparable market securities. Fixed income securities, the UR explained, provided a good comparator for the PCG because fixed income securities – unlike, say, equities – promised a fixed amount of income in exchange for the risk that the investor might suffer a capital loss. The relevant benchmark would be the prevailing market return/yield for the security less the time value of money ie the market premium over the risk-free rate.<sup>937</sup>

12.38 The UR provided an analysis of corporate bonds associated with a broad range of creditworthiness as shown in Table 12.3:

**Table 12.3: The UR's analysis of expected returns for a range of corporate bonds of different creditworthiness**

<i>Corporate bond</i>	<i>(% per year of amount invested)</i>	
	<i>Debt rating</i>	<i>Premium over the risk-free rate (%)</i>
Investment-grade credit quality	AA	0.6
	A	1.0
	BBB	1.6
Sub-investment-grade credit quality	BB	2.2
	B	3.5

Source: UR response to CMA provisional determination, paragraph 1.20. (Note, the UR did not provide a source for its numbers.)

12.39 The UR observed that the SEMC's decision<sup>938</sup> provided EirGrid with a return of 2.5% per year before tax or 2.0% after tax within the SEMO price control.

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<sup>937</sup> UR response to CMA provisional determination, paragraph 1.19.

<sup>938</sup> Single Electricity Market Operator (SEMO) Revenue Requirement Price control commencing 1 October 2013, [Decision Paper](#), 6 August 2013, paragraph 13.2.5. We note that this paragraph does not express the PCG allowance in terms of a percentage allowance, rather an absolute amount of €0.300 million per year.

The UR reiterated its view that the PCG allowance provided by the SEMC remunerated both SONI's TSO and MO PCG requirement. At worst, the UR continued, that level of remuneration put the risks contained within the PCG on a par with the lowest rung of investment-grade credit quality (or possibly slightly below). The burden was, in its view, on SONI to provide evidence on why the risks that its parent was taking on either matched or exceeded the risk that an investor would take on, say, BBB-rated debt. The UR argued that SONI had failed to provide this evidence in any of its submissions.<sup>939</sup>

- *Benchmark derived from letters of credit*

12.40 The UR also submitted that the cost of letters of credit were a relevant benchmark. A letter of credit, it explained, was an undertaking from a third-party (normally a bank) to discharge a company's liabilities to a trading partner in the event that the company was unable to meet its obligations itself. In the UR's view, the liabilities that a bank had under a letter of credit were virtually identical to the liabilities that EirGrid had under the PCG.<sup>940</sup>

12.41 The UR submitted that it and the CMA had recently both separately placed a value on letters of credit at 2% per year of face value. In the UR's case, this had been as part of its review of Firmus Energy Supply's submissions when setting its retail price control<sup>941</sup> and, in the CMA's case, as part of its work to assess retail energy suppliers' profitability in the [Energy Market Investigation](#).<sup>942</sup> The UR added that it was for SONI to show why the reliance it had placed on the costing of letters of credit in the CMA's [Energy Market Investigation](#) had been wrong.<sup>943</sup>

### ***Our assessment: the cost of the TSO PCG***

12.42 We consider; first the value of the TSO PCG on a standalone basis, then the value of the SEMO PCG (MO guarantee), and finally the market value of the 'double-count'.

#### *Consideration of the cost of TSO PCG on a standalone basis*

12.43 We consider that KPMG's analysis as described in paragraphs 12.31 to 12.35 provides a comprehensive set of options for valuing the TSO guarantee on a standalone basis. The UR's examples as described in

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<sup>939</sup> UR response to CMA provisional determination, paragraph 1.22.

<sup>940</sup> UR response to CMA provisional determination, paragraph 1.27.

<sup>941</sup> The UR referred to this retail price control review as SPC17.

<sup>942</sup> UR response to CMA provisional determination, paragraph 1.29.

<sup>943</sup> UR response to CMA provisional determination, paragraph 1.30.

paragraphs 12.36 to 12.41 are also relevant, and are largely consistent with KPMG's analysis of the value of the guarantee based on the debt premium for comparator regulated companies (Approach 4 below).

- 12.44 We would note as an over-arching comment that the range of options provided by KPMG and the UR illustrates the difficulty in placing a value on a PCG. It demonstrates that some form of regulatory judgment is likely to be required – either in the choice of an approach from a range of possible valid approaches, or in the weighting given to a particular value from a range of potentially valid values for a given valid approach.

#### *Consideration of KPMG's submissions*

- 12.45 First, we consider KPMG's approaches. We consider in turn:

- (a) the expected loss approach (Approach 3);
- (b) the benchmark of the value previously awarded for the (MO) PCG in the SEMO price control (Approach 2); and
- (c) values based on alternative market valuation approaches (Approaches 1, 4 and 5).

- *KPMG's expected loss approach*

- 12.46 KPMG's expected loss approach (Approach 3) is based around a statistical assessment of the expected loss to the guarantor. KPMG provides extensive detail of the modelling which it followed in estimating expected loss, including the way it evaluated risk, the choice of statistical distribution, and the relevant value of expected loss to the guarantor. KPMG then added 143bps (1.43%) to reflect the premium for contingent capital risk, which is discussed further below.
- 12.47 In principle, we agree that an expected loss approach should have some relevance when evaluating the cost of a guarantee. However, we would normally consider that values based on market-based valuations are preferable, where the data exists. It is more consistent with financeability that the allowances assumed by regulators are based on actual market values for the costs faced by regulated companies, rather than notional values based on theoretical models
- 12.48 In this appeal, we have identified a number of areas which have illustrated the difficulties in analysing the scale of the risks faced by SONI as a TSO, and therefore by its guarantor under the TSO PCG. KPMG's own report on SONI's financeability, and the report by Jacobs, illustrate both the scale of

risks faced by SONI as a TSO, and also important aspects of the difficulty in measuring that risk.<sup>944</sup>

12.49 We therefore conclude that this form of expected loss analysis can be given limited weight in the setting of regulatory allowances in the case of a firm in SONI's position. At most, if the results of an expected loss analysis were very different to market-based valuation measures, we might use this to query the validity of the market measures used. There is no evidence that this is the case here. We do not consider the expected loss analysis further in respect of valuing the TSO PCG.

- *KPMG's approach based on previous regulatory precedent*

12.50 KPMG has also made reference to consistency with the value placed on the SEMO guarantee by the SEMC (Approach 2). Regulatory consistency is an important principle. However, in this case, we have identified in our analysis of the evidence that the value of the SEMO guarantee was an estimate, based on limited evidence, and that it was intended to be reviewed over time. The UR has also submitted that the PCG allowance awarded in the SEMO price control was also intended to recover the cost of the TSO PCG. Given these concerns with the relevance of the allowance given in the SEMO price control as a measure for the market cost of providing the SEMO guarantee, we do not consider that the allowance given in the SEMO price control should be given weight as a reference point in setting a value for SONI in this appeal.

- *KPMG's approach based on values for comparable market securities*

12.51 As a result, we consider that the market measures are of greater relevance. We agree with SONI that the value of a PCG should reflect a measure of premium over the risk-free rate. This is equal to the required return on comparable market securities, which for a guarantee with fixed value would normally be fixed income securities (Approaches 1 and 5), less the time value of money. This measure reflects that the provider of a PCG to a firm such as SONI faces a comparable return profile to that of a lender to the firm: both the guarantor and a lender would have the expectation of a fixed positive return, but with a risk of significant downside. The principal difference between a guarantor such as a provider of a PCG and a lender is that the PCG provider does not provide funds upfront, and so would not expect to earn the time value of money on the sum it had committed to. In

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<sup>944</sup> NoA, First Witness Statement of Joanne Moran (NoA JM1), supporting document JM1/1 (Jacobs report, 'Pre-construction Risk Assessment, SONI EirGrid', 3 April 2017).

other words, the guarantor would not earn the risk-free rate of return on that sum.

12.52 Approach 4 (equity premium) is less directly comparable to the position of EirGrid as a guarantor as equity holders assume a different balance of risk and return, although we agree with KPMG that it could in principle be relevant as an upper bound for the cost of the PCG. In the remedies hearing, SONI provided a number of reasons why the guarantee is more 'equity-like' than 'debt-like'.<sup>945</sup> These are relevant to the question of whether preference shares are a better comparator than debt securities for deriving the market cost of the PCG. However, we consider that variable equity returns are fundamentally different to the fixed return earned from providing a guarantee, and therefore that the equity premium cannot be seen as a direct comparator.

12.53 From the market measures identified by KPMG, we consider that the standalone value of the guarantee would be expected to sit in the range between the debt premium (Approach 5) and the preference share premium (Approach 1) as:

(a) It appears in this case that the PCG is likely to be higher risk than a market debt security (Approach 5). Providers of debt to the companies used as comparators in KPMG's analysis would normally expect significant recovery, even where there is default on the relevant bonds. The PCG would, however, be called as a 'last resort' and therefore there would be a high probability of loss to the guarantor if the PCG is called. Given SONI's low level of assets, there is likely to be a greater risk of loss than for lenders to asset-heavy network companies which would normally recover much of any loss by recourse to the underlying asset values.

(b) However, this PCG is also 'debt-like' to the extent that it has a fixed, committed return. If it were called, an amount invested under a guarantee would in theory be expected to have priority over existing equity investors if SONI were to be at risk of not being able to meet its financial obligations. This would make the level of risk associated with the PCG more comparable to the risk associated with the debt comparators, rather than the preference shares, which represent already committed capital that would rank below debt in the case of financial

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<sup>945</sup> Remedies Hearing, SONI handout 2: 'Characteristics of the PCG'.



restructuring and if there were not sufficient financial resources to pay ongoing finance charges.

- 12.54 We note the UR's comparator of a Letter of Credit of 2%,<sup>946</sup> and consider that this is a relevant benchmark. The UR has also identified benchmark debt premia for comparators of 1.6% for BBB and 2.2% for BB. It is reflected in the need for a guarantee that SONI as a TSO on a standalone basis would be unlikely to represent an investment-grade prospect.
- 12.55 The KPMG submissions on market value indicate a range of 1.7%–3.1%, and we consider this range is also supported by the UR's comparators. This range is wide. The choice from within the range, relates to the most appropriate assumption on the risk and priority of the guarantees for SONI, relative to the benchmarks of the debt premium and preference share premium for investment-grade network companies.
- 12.56 In determining the size of the risk of the PCG, the UR stated that the PCG for SONI as a TSO should be considered lower-risk than the comparators as it is underpinned by £18 million of equity investment in the TSO RAB.<sup>947</sup> We are not persuaded that this has a material effect on the market value of the guarantee for SONI. The UR has continued to require EirGrid to maintain a guarantee to SONI as TSO notwithstanding that it has for the purposes of this Price Control assumed that SONI is funded 100% with equity. As indicated in SONI's submissions on priority, the first call on capital where there are losses, after the allowance for the return on the RAB, is the PCG. Unlike debt, the PCG does not have security over an asset base, although we recognise that unlike preference shares, there may be some recovery depending on the circumstances under which the PCG is called.
- 12.57 The UR said in the remedies hearing that it was extremely unlikely that the guarantee would be called.<sup>948</sup> However, that is also the case for the comparators the UR quoted. BBB debt, for example, has a very small probability of default. We do not consider that this in itself is determinative of the market value of the TSO guarantee for SONI. In practice, whilst SONI is similar in many ways to the comparators as a regulated monopoly, SONI is likely to be perceived by lenders as greater risk than companies such as Bristol Water which have a more established regulatory framework.

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<sup>946</sup> The UR quoted CMA Energy Market Investigation, Final Report, [Analysis of retail supply profitability – ROCE](#), paragraph 139, 24 June 2016.

<sup>947</sup> See paragraph 12.22.

<sup>948</sup> Remedies Hearing transcript, page 89, lines 20–25.

*Our conclusion on the cost of the TSO PCG on a standalone basis*

12.58 We therefore consider that the correct range for the market value of the standalone TSO PCG is 1.7%–3.1% per year, and that the actual value is likely to be towards or above the middle of this range, reflecting the lower priority and therefore lower security of assets, and also that the TSO is likely to be a higher risk than BBB comparators.<sup>949</sup>

*Cost of standalone SEMO PCG*

12.59 In considering the assumption for the cost of a standalone SEMO PCG, we have considered a number of factors:

- (a) The UR did, and continues to, require a guarantee of £10 million in respect of SONI's TSO activities. While the UR has said that there is a low risk that the guarantee is called, the guarantee is nevertheless required.
- (b) If SONI (in the form of the SEMO JV) were to obtain a guarantee from the market, which was a guarantee that could be called on where the SEMO JV had insufficient funds, and as such faced similar risks to debt, it is reasonable to assume that the market would price the guarantee based on the cost of debt for comparable companies.
- (c) Whilst the scale of the risks is smaller, the probability that the guarantee would be called is higher for SEMO than SONI as a TSO, as SEMO has no capital on which it can earn a profit, and therefore the cost of the guarantee is covering any loss, by comparison to SONI as TSO, which can first fund any losses out of retained profits.

12.60 We consider that a market provider of the guarantee to SEMO would price the guarantee in a way comparable to that for SONI as a TSO. In other words, the starting point for the cost of the guarantee would be in the range of 1.7%–3.1% per year. To the extent that SEMO is overall lower risk than SONI as a TSO, this might indicate a value in the bottom half of the range for SEMO.

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<sup>949</sup> The UR's data indicated 1.6% as a lower bound. We have used 1.7% as KPMG's data was based on defined and reasonably close comparators, but we do not consider that the choice of lower bound would affect our decision.

### *Consideration of 'double-count'*

- 12.61 We next consider the effect of the 'double-count'. EirGrid has provided two PCGs underpinned by a single sum of committed capital of £10 million, covering both SONI as a TSO and SONI as a MO (ie SEMO).
- 12.62 We first consider the UR's submission that the fact that EirGrid has provided a single sum of committed capital means that we should consider the cost of a single guarantee as being the relevant benchmark. The UR's submissions had two limbs: first, that there was one guarantee that should be valued against benchmarks for one guarantee, and in that context the total value of PCG remuneration across the TSO and SEMO price controls of 4% to 5% per year was very high; and second that the SEMO guarantee was very low risk, and therefore we could not assume that the SEMO control was intended to have a standalone guarantee with a cost of 2.5% per year.
- 12.63 In respect of the first point, which is largely a factual matter, we have reviewed the evidence provided both in written submissions and in hearing evidence. In our view, it is clear that there are two guarantee requirements. One is the PCG requirement in SONI's MO licence which is remunerated through the SEMO price control. The parameters for the remuneration of that PCG requirement are under review as part of the I-SEM implementation, and are expected to change. The other is in the TSO licence, the parameters for which are not under review. The risks covered by the two PCGs are different. We have decided that for the purposes of the TSO price control we should take into account the fact that there are two separate guarantees, and that it is appropriate to consider the market-based cost of those guarantees separately.
- 12.64 In respect of the second point, the UR has explained that the risks associated with SEMO were very low, and it was not feasible that these would result in a loss of up to £10 million.<sup>950</sup> This explanation may have some relevance to the cost of obtaining a guarantee from the market. We, however, conclude that little weight should be given to a valuation based on a detailed 'bottom-up' assessment of SEMO's risks. Consistent with our view of KPMG's proposed approach to valuing the TSO PCG on the basis of expected loss,<sup>951</sup> we consider that it is more appropriate to value the PCG by reference to market values where feasible.
- 12.65 We therefore consider that the effect of the double-count should be calculated on a market value basis, which we have decided should be

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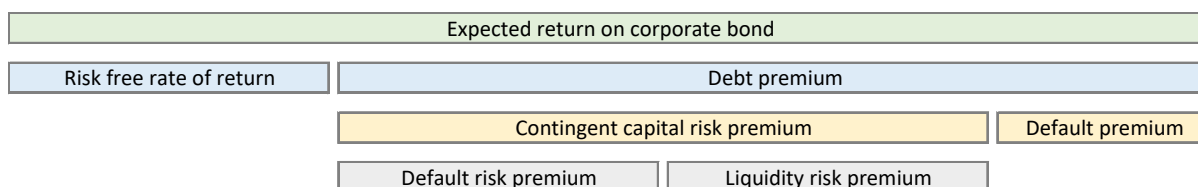
<sup>950</sup> Remedies Hearing transcript, page 123, line 23 to page 124, line 2 and page 127, line 1.

<sup>951</sup> See paragraphs 12.46 to 12.49.

reflected in an estimate of the ‘contingent capital risk premium’. This premium reflects the extent to which the value of a combined guarantee would be lower than the cost of two separate guarantees. A combined guarantee costs EirGrid less than two standalone guarantees would because EirGrid is only committing to a single sum of capital (£10 million) across the two guarantees whereas in the latter situation two sums of capital of £10 million would be committed.

12.66 As illustrated in Figure 12.3 it is possible to disaggregate the expected return on a corporate bond into distinct elements and then aggregate two of these elements, namely the default risk premium and the liquidity risk premium into a contingent capital risk premium. There is extensive technical literature to support conceptually decomposing expected returns in the way illustrated in Figure 12.3.<sup>952</sup> What, however, has proved more difficult is to establish reliable costings for each element of the total expected return.

**Figure 12.3: Decomposition of expected return on a corporate bond**



Source: CMA analysis.

Note 1: ‘Default premium’ remunerates an investor for the expected loss from bond defaulting.

Note 2: Not to scale.

12.67 In our provisional determination, we referred to KPMG’s analysis of the contingent capital risk premium of 1.43% per year<sup>953</sup> which it had added to the annual expected loss, to arrive at the annual cost of the TSO guarantee. In response, we note above that KPMG provided two additional forms of analysis:

- (a) First, analysis illustrating that the relevant measure of contingent capital risk premium had been lower in other cases. SONI submitted that the extent of any double-count should therefore be lower than the 1.43% per year.
- (b) Second, analysis illustrating that this premium should be split into a ‘default risk premium’, the level of remuneration for which was directly related to the level of the expected loss rather than the capital sum at

<sup>952</sup> A relatively short explanation is provided in the Bank of England quarterly bulletin, L. Webber, ‘Decomposing corporate bond spreads’, 2007. See also the CC’s report on the [Heathrow Airport Ltd and Gatwick Airport Ltd price control review](#), 3 October 2007, [Appendix F](#), Cost of Capital, paragraph 93 including footnote 18.

<sup>953</sup> NoA MC1, supporting document MC1/1 (KPMG 1, paragraph 6.2.68).

stake, and a 'liquidity risk premium'. SONI submitted that only the latter element was related to the sum of capital at stake, and therefore was relevant to the issue of double-count.

- *Our overall conclusion on double-count*

- 12.68 We recognise that this analysis is difficult, and that there is no single established model for calculating the adjustment. The contingent capital risk premium of 1.43% per year assumed in KPMG1, when calculating the value for the PCG on an expected loss basis of 3.68% per annum, is higher than the size of the contingent capital risk premium that would be implied by a debt premium of 1.7% per year. We therefore agree with SONI that the size of the contingent capital risk premium would be lower than 1.43% in our calculation.
- 12.69 However, we are not persuaded by KPMG's argument that the default risk premium would always be allocated to the default premium ie the expected loss, whereas the liquidity risk premium would always be allocated to the capital. KPMG's analysis also illustrates the difficulty in identifying a measure for splitting the contingent capital risk premium into the default risk premium and the liquidity risk premium. Given the lack of certainty over the analysis of bond premia, it is impossible to identify with any certainty how much of the liquidity risk premium would be a 'double-count' in the context of two guarantees underpinned by a single amount of capital. We consider that some non-zero adjustment is appropriate, and we accept SONI's submission that it would be lower than 1.43%. We have decided to use a range of 0.5%–1.0% for the adjustment.

#### *Assessment of the incremental cost of the TSO PCG*

- 12.70 As indicated at the beginning of this section, we consider that valuing the PCG will require some judgment. Our analysis of the submissions to the appeal, particularly that provided by KPMG, demonstrates that there are a range of potential approaches, and some uncertainty about the values that would result from those approaches. We have identified that there is a wide range of 1.7%–3.1% per year for the value of the PCG.
- 12.71 We agree with SONI that there are credible arguments as to why the cost of the PCG might be higher than the investment grade debt premia at the bottom of the range. The scenarios where the PCG might be called appear to be similar to the scenarios under which debt might be called, were SONI funded with equity and debt. The extent of capital recovery associated with SONI's PCG, however, is likely to be lower than that for debt holders. Holders of debt in companies which are not asset-light would expect to

recover more of their capital, particularly if the company in question was an asset-heavy network company.

- 12.72 We have therefore concluded that the following are the relevant elements to consider in coming to a point estimate for the value of the PCG for SONI:
- (a) the value of the SONI TSO guarantee on a standalone basis, which we consider should lie around the middle to upper end of the range of 1.7%–3.1% per year, ie we have assumed a range of 2.5%–3.0%;
  - (b) the value of the SEMO guarantee on a standalone basis, from around the lower end of a range of 1.7%–3.1% per year, ie we have assumed a range of 2.0%–2.5%; less
  - (c) the proportion of a contingent capital risk premium which would represent a ‘double count’ when calculating the market value of one capital amount applied to two separate guarantees, which is hard to reliably measure, but which we have assumed is likely to be in the range of around 0.5%–1.0% per year; less
  - (d) the allowance for the PCG within the SEMO price control, which is 2.5% per year.
- 12.73 Taking the ranges above imply a range for the incremental cost of the TSO guarantee, based on market security prices, of around 1.5%–2.0% per year. We have therefore decided that the cost of the TSO PCG to be recovered in the TSO price control should have a value of 1.75% per year.
- 12.74 We note that it is currently expected that allowances for the PCG within the SEMO price control(s) will change, following the implementation of the I-SEM. It is therefore likely that the UR will need to revisit the combined value of the guarantee when setting the allowances for SEMO and/or SONI for the period of the price control following implementation of the I-SEM. We have not made any assumptions in our decision about any changes to the future level of the cost of the guarantee following the wind-down of the SEM and the introduction of the I-SEM.

## **Asymmetric risk**

- 12.75 We have also found the UR was wrong because its process of allowing investment into the price control under the  $D_t$  and PCNP mechanisms exposes SONI to asymmetric risk, and that the expected return is therefore lower than the cost of capital.

- 12.76 As set out in Chapter 11, we are putting in place remedies under Ground 2 to address concerns about a lack of codification of the  $D_t$  and PCNP mechanisms. In this section, we assume that these remedies will be implemented and will be effective in reducing the asymmetric risk faced by SONI. We are not double-counting any additional costs associated with the current regime, where there is additional asymmetric risk associated with the lack of codification and a perception by SONI that it is exposed to a binding cap on some of its uncertain investment projects.
- 12.77 However, even with these changes, we consider that SONI will still be exposed to some asymmetric risk. This risk is a result of the design of the mechanism for recovery of costs under PCNPs and costs subject to the  $D_t$  mechanism, where returns are capped to a return on actual expenditure, with no opportunity for outperformance. The aim of the remedy set out below is to ensure that SONI has sufficient return to compensate it for the asymmetric risks which remain once the Ground 2 remedies have been implemented.
- 12.78 We have noted in our approach to remedies for the PCG that market-based measures are most suitable for use in setting regulatory assumptions. However, it is difficult to identify a market-based measure to remunerate a firm for taking on asymmetric risk. Remuneration in this case will be specific to SONI and to the way in which the  $D_t$  and PCNP mechanisms work in practice.
- 12.79 As discussed in Chapter 6, we have concluded that it is appropriate for SONI to face incentives to operate efficiently. SONI has estimated that it will incur approximately £37 million of spend in respect of PCNPs and projects subject to the  $D_t$  mechanism over the Price Control Period.<sup>954</sup> We would expect the UR's process of reviewing these important projects to provide incentives for SONI to act efficiently. This would be reflected in practice through the UR disallowing expenditure which it considers to be inefficient. It is good regulatory practice for there to be suitable efficiency incentives, both in terms of the savings to consumers in lower costs, but also the incentives on SONI to develop processes to ensure efficiency. This is consistent with the approach to design of the PCNP and  $D_t$  mechanism set out in our remedies to Ground 2.
- 12.80 This implies, for each project, that there is asymmetric risk, as the maximum return is capped at SONI's actual spend but there is the potential for losses if the UR finds that SONI's spend is inefficient. For the financial framework to

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<sup>954</sup> NoA, paragraph 3.35.

work as intended, SONI should have a reasonable expectation that, assuming it acts in an efficient manner, it would be able to earn at least its return on capital.

- 12.81 While the value of an uplift to reflect asymmetric risk may be a matter of judgment, we consider it should in principle not be zero. In theory, the level of the uplift should have regard to the scale of expected losses,<sup>955</sup> but in practice the choice of any uplift will also need to reflect regulatory judgment.
- 12.82 Both the parties provided evidence as to factors we should consider in assessing the size of asymmetric risk. We summarise these first, then present our decision.
- 12.83 In our provisional determination, we provisionally proposed that a starting point for the value of the premium would be 4%. This had regard to SONI's submissions in its [NoA](#),<sup>956</sup> which indicated an expected loss of 4%.

### ***SONI's submissions – asymmetric risk***

- 12.84 SONI agreed with the principle of an uplift for asymmetric risk as an appropriate remedy for this aspect of our Ground 1 assessment, as the risks faced could not be 'zero risk'. SONI submitted that the asymmetric risk should be set at the expected loss plus a risk premium.<sup>957</sup>
- 12.85 SONI said that an asymmetric risk mechanism needed to reflect two factors: first to provide for a meaningful level of cost scrutiny, and second, that it should not overcompensate SONI for the risks.<sup>958</sup>
- 12.86 In support of its [NoA](#), SONI had projected expected losses of 4%.<sup>959</sup> We note that SONI provided no quantitative evidence for its assessment.
- 12.87 SONI provided a report by Jacobs on project risk, in particular relating to PCNPs. The Jacobs report indicated very significant contingencies would be needed on some projects and that project costs often rise for different reasons, some of which will be outside SONI's control.<sup>960</sup>

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<sup>955</sup> In this context, the 'expected loss' to SONI would be the amount it would reasonably expect to lose relative to an assumption that all its spend (excluding DIWE) would be included in tariffs. This would require a probability-weighted estimate of the amounts which might be excluded from its allowances following review by the UR, as a proportion of total spend.

<sup>956</sup> NoA AS1, paragraph 124.

<sup>957</sup> SONI response to CMA provisional determination, paragraph 6.31.

<sup>958</sup> SONI response to CMA provisional determination – Ground 1 remedies paper, paragraph 3.22.

<sup>959</sup> NoA AS1, paragraph 124.

<sup>960</sup> NoA JM1, supporting document JM1/1 (Jacobs report, 'Pre-construction Risk Assessment, SONI EirGrid', 3 April 2017).



- 12.88 SONI noted that it could be argued that different  $D_t$  and PCNP costs would have different risks, but in no case would there be zero risk.<sup>961</sup>
- 12.89 SONI had also commissioned work from KPMG on the scale of asymmetric risk. In support of its [NoA](#), this report, KPMG3, included scenarios for downside risk, including a scenario of a 25% probability of a 15% loss, equivalent to a 3.75% expected loss.<sup>962</sup> SONI submitted that this was at the lower end of risk, given the context of the Jacobs report.
- 12.90 SONI provided two examples of where the UR and CER had disallowed expenditure (in absolute terms or in respect of timing). SONI indicated that these were disallowances of 5% and 10%.<sup>963</sup>

### ***UR submissions – asymmetric risk***

- 12.91 The UR disagreed with our proposed remedy, and submitted that any uplift was inappropriate. The UR stated that it was:
- a novel proposition to provide SONI with a guaranteed upfront allowance equal to the speculative value of future DIWE costs, against the potential that it might be so clearly and demonstrably inefficient that the UR finds it necessary to intervene to impose a disallowance.<sup>964</sup>
- 12.92 In support of this, the UR stated that it was an established regulatory principle that financeability was related to ‘efficient’ costs, and provided examples, including from the CMA.<sup>965</sup>
- 12.93 The UR said that, at a minimum, SONI’s assumption of 4% was inappropriate as a starting point for an uplift, as the CMA is remedying SONI’s concerns about the process under Ground 2.<sup>966</sup>
- 12.94 The UR submitted that 4% was too high, if we were to apply an uplift. It indicated that for a 5% risk of disallowance, this indicated 80% non-recovery, which was untenable.

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<sup>961</sup> SONI response to CMA provisional determination – Ground 1 remedies paper, paragraph 3.20.

<sup>962</sup> NoA MC2, supporting document MC2/1 (KPMG 3), for example, section 6.3.

<sup>963</sup> SONI response to CMA provisional determination – Ground 1 remedies paper, paragraph 3.33–3.39.

<sup>964</sup> UR response to CMA provisional determination, paragraph 1.133.

<sup>965</sup> UR response to CMA provisional determination, paragraph 1.109.

<sup>966</sup> UR response to CMA provisional determination, paragraph 1.101.

- 12.95 The UR also submitted that we had taken a ‘narrow view’ of asymmetry, and that SONI had the potential for upside in respect of other parts of the UR’s determination.<sup>967</sup>
- 12.96 The UR submitted that if we did apply an uplift, it should be set at a fixed allowance to avoid perverse incentives to increase costs through the  $D_t$  mechanism.<sup>968</sup>

### ***Our assessment – asymmetric risk***

- 12.97 In our assessment we consider both the UR’s case that there should be no mark-up for asymmetric risk, and submissions on the level of any mark-up.

#### *The need for a mark-up to reflect asymmetric risk*

- 12.98 We consider two separate elements to the UR’s case: first that it is departing from regulatory precedent to set the level of costs in the price control at a level higher than efficient costs, and secondly that, if there is asymmetric risk, it is DIWE and should not be remunerated in the price control.
- 12.99 The UR has highlighted correctly that the standard regulatory approach is to finance efficient costs. For example, when setting opex allowances, tariffs are set based upon a projection of efficient costs.
- 12.100 The example that the UR quotes is, however, also consistent with the ‘fair bet’ principle. When setting opex allowances, regulators set an allowance which balances risk of overspend against incentives to underspend. It is for the regulator to consider both risk and reward.
- 12.101 We also note that the UR has identified areas of the price control mechanism where it considers that there is upside potential for SONI, including in respect of ex-ante allowances for opex and capex. However, we do not consider that these items are linked to the operation of the  $D_t$  and PCNP mechanisms: it is for the UR to set appropriate allowances and incentives in the price control based on evidence, and we have seen no evidence that there is a deliberate offsetting of risks between aspects of the price control in this case.
- 12.102 We recognise that the circumstances in this case are unusual, and that regulators do not usually set allowances to reflect asymmetric risk. Our remedy reflects the unusual circumstances of this case, and in particular that

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<sup>967</sup> UR response to CMA provisional determination, paragraphs 1.111–1.113.

<sup>968</sup> UR response to CMA provisional determination, paragraph 1.123.

the proportion of SONI's costs which are recoverable through the capped cost recovery mechanism is so high, comprising £37 million of costs over the Price Control Period. The application of asymmetric risk to such a large proportion of SONI's costs without a corresponding return would be inconsistent with the expectations of investors that, on average, returns would be expected to be consistent with the cost of capital.

12.103 We therefore have decided that an adjustment to reflect the existence of asymmetric risk within the capped cost recovery mechanisms applied to  $D_t$  and PCNPs is appropriate.

#### *Size of the mark-up*

12.104 The size of the adjustment is a matter of judgment, but should have regard to the size of any potential expected loss, and the need to provide appropriate incentives to SONI invest in the right projects, and to do so efficiently.

12.105 SONI has provided some examples of disallowances and of the scale of risk it faces. This evidence supports the case that the risk is non-zero, but does not particularly support any number. In particular, while SONI has indicated that there is a credible risk of loss, it has not demonstrated that it is consistent with its estimate in its NoA of 4%. For example, we agree with the UR that some of the risks identified in the Jacobs report and quoted by SONI in support of its case would not be asymmetric risks given our Ground 2 remedies. We also note that the UR has said that it will normally, though not always, allow some contingency in budget estimates, which reduces the risk of overspend.

12.106 However, we also agree with SONI that some of the risks in the Jacobs report also indicate that disallowances could be higher than 4% if material cost increases in PCNPs were disallowed.

12.107 Whilst we recognise that it is important to consider the evidence that is available, in this case there is limited evidence, and we are required to consider the facts of the case in coming to an assessment of a suitable uplift for risk. We have considered that:

- (a) consistent with our findings on Ground 2, there should be a risk of disallowance of cost items within projects implemented by SONI within this Price Control Period. The total scale of costs subject to cost recovery under  $D_t$  and PCNPs was estimated by SONI to represent 35% of its total revenues over the period. This implies that a non-zero uplift to the Price Control for SONI is necessary to maintain financeability;

- (b) in this case SONI otherwise has only a small return given the size of its business, and that it cannot be reliably assumed that SONI can manage the asymmetric risk through the profits it earns on what is a small RAB; and
- (c) there are therefore residual asymmetric risks on a material share of SONI's investments which are not remunerated elsewhere in the Price Control, and that the framework should set an allowance which both covers expected loss and provides SONI's investors with a return to compensate for the risk taken.

12.108 In setting the level of the uplift, we have also considered the following:

- (a) that some of these projects are uncertain and the kind of projects where, as indicated by Jacobs, there would be significant risk, being well above 4% in an individual project;
- (b) that the size of overspend (15%) indicated by KPMG that might occur in respect of some of SONI's projects is feasible, but may be offset by contingency or efficiencies elsewhere in the project;
- (c) that there is a wide range of projects and other costs subject to the D<sub>t</sub> and PCNP mechanism. Whilst SONI may be right that the risk is non-zero for all of these, the risk appears to be small for some of the smaller expenditure; and
- (d) that the UR has indicated both that it will provide contingency in budgets, and that it will, following our Ground 2 remedies, put in place a formal process for reviews of variations to budgets. We expect asymmetric risk will be reduced but not eliminated once this codification is in place, which we understand will be approximately half way through the Price Control Period.

12.109 Taking into account the issues discussed above, we consider that an uplift of 3% is appropriate. This should be sufficient to cover a suitable risk premium to cover SONI for expected loss, and to rebalance the risk and reward profile for SONI's investors. Across the relevant projects and given our Ground 2 remedies, the likelihood of a loss of 4% (or higher) should be relatively small, although it is feasible. If we were to set the uplift at a lower level, eg as low as 2%, we consider this would be insufficient to reflect both the expected costs associated with asymmetric risk, and the need for some premium for taking risk. We therefore consider that an uplift of 3% is appropriate. This balances the need to allow SONI a 'fair bet' with the need not to overcompensate SONI for the risks taken.

12.110 Our judgment on the evidence is that at this level, there is a credible balance of risk for SONI, including that it may incur greater losses than this if it is inefficient. In other words, if SONI is efficient, it will earn a small premium to its cost of capital, and if it is inefficient, it will earn below its cost of capital. This ensures financeability, and these outcomes are consistent with normal regulatory practice.

12.111 We also consider that the decision is proportionate as the effect on customers is very small: this adjustment is equivalent to less than 10 pence per annum on customer bills. In that context, we consider that the existence of an adjustment which explicitly supports SONI's financeability and the need to be efficient in respect of what are some of the most important parts of the TSO's role is appropriate.

#### *Application of the uplift to SONI's costs in the Price Control Period*

12.112 The UR submitted that it would be preferable to apply the uplift as a fixed allowance, rather than as an uplift on the actual expenditure. In theory, there is no difference for SONI's financeability, other than the possibility that its actual uplift may be either marginally lower than 3% or marginally higher than 3%, depending on whether the actual expenditure under these mechanisms is higher or lower than projected in this appeal.

12.113 In other words, the UR has suggested that, if we decide to set an allowance for asymmetric risk, it should be in the form of a fixed ex-ante allowance, rather than allowance on the actual costs incurred by SONI in the relevant categories. If we set the allowance at 3% of actual spend, there may be some risks, albeit small, that this could provide perverse incentives to direct costs into these categories. We therefore propose to set a fixed ex-ante allowance based on the projected values in the Business Plan. By setting a fixed allowance, we are remunerating SONI for the aggregate risk taken over the Price Control Period. Whilst the level of cost of the relevant mechanisms is not known with certainty, we have set the allowance at £220,000 per annum, which is a point estimate based on submissions that the aggregate spend on these cost areas will be around £35–40 million over the Price Control Period.<sup>969</sup>

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<sup>969</sup> Based on the [NoA](#) and subsequent submissions in response to requests for data during the appeal.

## Revenue collection risk

- 12.114 We have also found that the UR was wrong in respect of its approach to remunerating SONI for the risks it faced in respect of the revenue collection functions<sup>970</sup> which it performs on behalf of the industry. The UR had awarded an allowance of SONI's facility fee for a £12 million facility with a cross-guarantee, and LIBOR plus 2% on any tariff year-end working capital balances. These revenue collection activities are summarised in Chapter 2.
- 12.115 We decided in Chapter 7 that the UR's approach would underestimate the total cost to SONI. There are risks to SONI associated with these operations. The costs may be higher than expected, and there may be consequential effects on the costs for SONI of raising finance for its other activities. SONI is not remunerated for these risks in the UR's approach, which sought to remunerate SONI's direct costs.
- 12.116 We therefore conclude that the amounts allowed into SONI's tariffs should include an upwards adjustment to cover the cost to SONI and its shareholder of managing the risks associated with these functions. As in the previous section on the asymmetric risk, the value of such an uplift to reflect revenue collection risk cannot be precisely defined, but it should not be zero.
- 12.117 In the submissions on remedies in response to our provisional determination, both parties provided evidence as to factors we should consider when assessing the size of revenue collection risk. In addition, as explained in Chapter 7, SONI provided evidence of the approach taken by the CER, which allowed a margin to EirGrid to cover these risks. We summarise the parties' submissions first, then present our decision.
- 12.118 In our provisional determination we provisionally proposed that the margin should lie in the range of 0.25%–0.5% of relevant revenues. This was based in part on a comparison to the approach followed by the CER, which provided a return on the working capital for some revenues<sup>971</sup> and a margin on revenues collected for others, so that EirGrid was remunerated for managing those revenues. Given the risk profile of SONI, we concluded that this would translate to a margin of approximately 0.25%–0.5%.

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<sup>970</sup> We note that we sometimes refer to 'revenue collection functions' as 'management of industry revenues'.

<sup>971</sup> We note that this return on working capital could also be expressed as a margin on revenues. This was because the return on working capital was itself expressed as a percentage of revenues in a period multiplied by the relevant cost of capital.

## SONI's submissions

12.119 SONI provided us with evidence of the approach taken by CER in EirGrid's most recent TSO price control. In response to our provisional determination, SONI sought to quantify how this approach would translate to a margin on SONI's activities (see Table 12.4).

**Table 12.4: SONI's summary of the components of EirGrid's TSO collection agent revenues and margins applied**

<i>Item</i>	<i>External opex</i>	<i>DBC</i>	<i>Total revenues (including TUoS, excluding DBC)</i>	<i>Weighted average</i>
Description	Managing working capital requirements associated with volatile costs arising from external opex including system services.	Managing working capital requirements associated with volatile costs arising from dispatch balancing.	Collection agent role on behalf of other operators in value chain such as for ESB.	
Value (€m)	90	150	255 (345 less 90)	
Approach	External opex * 20% * WACC + External opex * 0.5% margin	DBC * 20% * WACC	Total revenues * 0.5%	
Implied margin (%)	1.5	1	0.5	0.83

Source: SONI response to CMA provisional determination – Ground 1 remedies paper, paragraph 4.47.

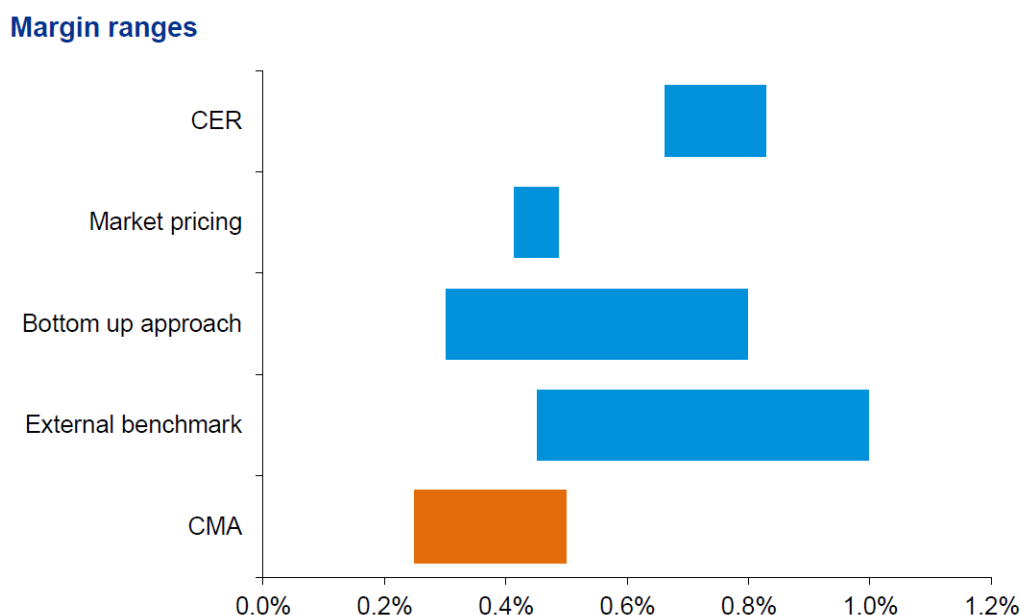
12.120 SONI noted that the equivalent figure for SONI would be approximately 0.66%, on the basis that the CER figure included an uplift for operational gearing which has been separately reflected in SONI's control through an adjustment to the WACC.<sup>972</sup>

12.121 SONI also provided a number of other comparators for the size of the margin, based on external sources. The sources provided by SONI of the numbers in Figure 12.4 other than the CER's approach are discussed below.

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<sup>972</sup> SONI observed that the implied margins on revenues collected shown in Table 12.4. (ie the bottom row) all reflected an additional 0.25% uplift in respect of EirGrid's TSO operational gearing. Under the UR's approach that would be remunerated in respect of BAU activities separately through the uplift of beta to 0.6.

**Figure 12.4: SONI’s depiction of ranges for the level of margin on revenues collected**



Source: SONI response to CMA provisional determination – Ground 1 remedies paper, paragraph 4.62.

12.122 SONI submitted that we should consider the following comparators:

- (a) Invoice Financing: SONI submitted that factoring services, where companies obtain finance secured on future revenues, are a relevant comparator. SONI provided a range of comparison rates from Invoice Discounting banks, which it considered indicated a benchmark price of 1-5% (see Table 12.5).

**Table 12.5: SONI’s summary of the fees charged by invoice factoring service providers**

<i>Provider</i>	<i>Service charge</i>	<i>Discounting charge</i>
Lloyds Bank Commercial Finance	1.2% sales turnover	1.5%–5% above Lloyds Bank base rate
Santander Invoice Finance	0.5%–3% of monthly turnover	1.75%–3% above BoE base rate
RBS Invoice Finance	0.03%–5% of annual turnover	1.0%–4.5% above base rate
Hitachi Capital Invoice Finance	0.25%–3% of gross annual turnover	2%–4% above base rate

Source: SONI response to CMA provisional determination – Ground 1 remedies paper, paragraph 4.28; as sourced from [moneyfacts.co.uk/business/invoice-factoring](http://moneyfacts.co.uk/business/invoice-factoring).

- (b) Custodian services: SONI submitted that these services, where banks handle payments and funds on behalf of clients, represent a low risk comparator to its role in managing industry revenues. It submitted that a



low risk comparator based on custodian services would be 0.2%–0.45%.<sup>973</sup>

- (c) Bottom-up pricing: SONI provided estimates from its banking advisers that illustrated the cost of a larger facility that it would need to manage these risks. It submitted that these fees (excluding arrangement fees) would comprise 0.27%–0.8% per annum on revenues.
- (d) SONI also provided an estimate from a relationship bank for a working capital facility, which had indicated a cost of 0.41%–0.49%. Our understanding is that this is illustrated in Figure 12.4 above as 'Market Pricing'.
- (e) Finally, SONI compared its overall revenue margin to an external benchmark which it derived from an assessment of the margins of other regulated companies. It considered that this implied a range for total margin (including the return on capital) of 1.5%–3.0%, which it calculated implied a margin on collection agent revenues of at least 0.6%.

12.123 On the basis of this evidence, SONI proposed that an appropriate range for the margin would be 0.5%–0.7% of relevant revenues, with a point estimate of 0.6%.

12.124 SONI also provided submissions on the underlying risks associated with the cash flows to which we might apply a margin. In support of its case that there is risk associated with the cash flows, and that therefore the relevant benchmarks are those which also reflect timing risk, SONI presented in the remedies hearing its analysis of the risk of the relevant revenues, as shown in Figure 12.5 below.

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<sup>973</sup> SONI response to CMA provisional determination – Ground 1 remedies paper, paragraphs 4.32–4.33.

**Figure 12.5: Cost to SONI of revenues collected on behalf of industry participants**

	TUoS	CAIRt	DBC	Other At
Scale (average expected per annum 2015-20)	£36m	£15m	£37m	£35m
1) Potential for costs to increase	Medium	Low	High	High
2) Transactional and administrative cost (the market would not provide these services for free)	Medium	Medium	High	High
3) Premium for counterparty risk (the government is not the counterparty).	Low	Low	Low	Low
4) Direct cost of funds	Medium	Low	High	Medium
5) Cost of cross-guarantee	Low	Low	Medium	Low
6) Cost of equity buffer	Medium	Low	High	Medium
7) Implications for overall cost of financing for SONI, including impacts on covenants and increases in gearing	High	Low	High	Medium
8) Revenue uncertainty	High	Low	Medium	Medium

Source: Remedies Hearing, SONI handout 5: 'Cost to SONI of revenues collected on behalf of industry participants'.

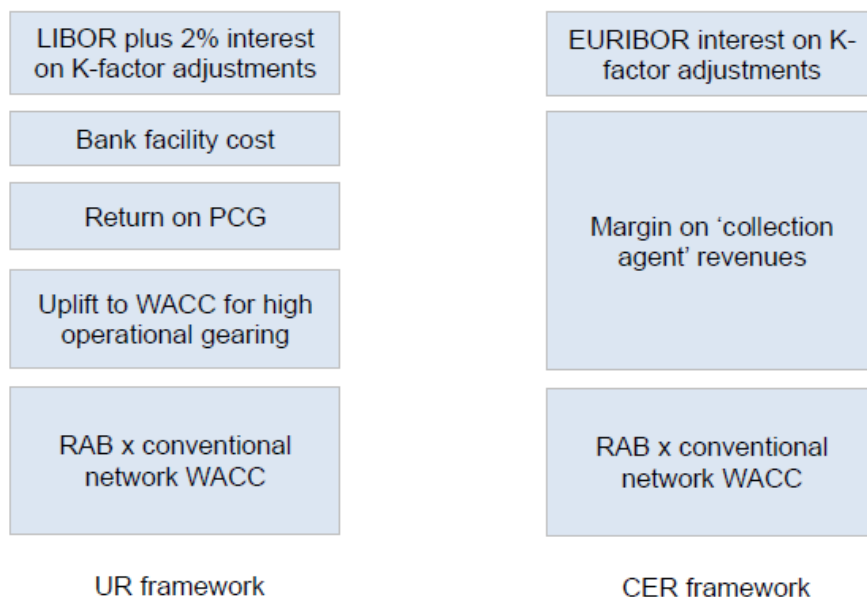
### ***UR's submissions***

12.125 The UR disagreed with our approach of allowing SONI a margin. It also disagreed with the size of the proposed margin. The UR submitted that return is usually a reward for taking risk. In respect of SONI's 'collection agent' functions, even if it is handling comparatively large sums of money, the UR stated that SONI took no credit risk and faces no prospect of losing investor capital. To the extent that SONI bore cash flow risk, the UR submitted that this was adequately covered by the operation of the K-factor, together with SONI's bank facility and the contingent funding made available by EirGrid under the PCG.<sup>974</sup>

12.126 The UR submitted that the CER comparator does not imply an additional return, because the CER framework did not include returns for other items included in the SONI TSO price control. The UR depicted what it saw as its package of remuneration for this function and compared it to that of CER's for EirGrid as a TSO in the following schematic (see Figure 12.6).

<sup>974</sup> UR response to CMA provisional determination, paragraph 1.75.

**Figure 12.6: The UR's comparison of the two remuneration frameworks for collection agent role**



Source: UR response to CMA provisional determination, paragraph 1.79.

12.127 The UR also submitted that to the extent that the CMA was having regard to the likely increases in the size of the revenues being handled, the primary driver of these increases is I-SEM, and that EirGrid/SONI are engaged in a separate process with the SEMC about the consequences of the new market, including any implications for contingent capital for the TSOs. The UR said that the SEMC is engaging with SONI to take this initial analysis forward and therefore the CMA should not pre-empt the work that the parties were doing in this context.<sup>975</sup>

12.128 In respect of the activities performed by SONI, the UR submitted the following:

- (a) CAIR<sub>t</sub> (Moyle Interconnector): the UR submitted that there is zero risk, as SONI only has to pay out what it has collected;
- (b) TUoS charges: the UR submitted that there is negligible cash flow risk and zero credit risk;

<sup>975</sup> UR response to CMA provisional determination, paragraphs 1.89–1.90.

- (c) DBCs (ie Imperfections Charges): the UR submitted that there is some cash flow and timing risk, and this is adequately covered by the facility fee (which was within the range of 0.25%–0.5% margin on DBCs; and
- (d) Other A: the UR submitted that these are SEMC and NI Local Reserve decisions, that any under-recoveries would be covered by the K-factor, and there was zero risk of a permanent loss.

12.129 In summary, the UR submitted that a margins approach was wrong, as it is very difficult to specify the appropriate margin for the idiosyncratic role faced by SONI in its ‘collection agent’ functions, due to a lack of good and relevant information. The UR submitted that its approach had the great benefit that it had been based on market information directly related to the costs that SONI faced to procure the services needed to manage cash flow in its ‘collection agent’ function, both in terms of facility fee and the interest rate. It also noted that a margins approach would provide perverse incentives to SONI to increase the revenues that it handled, which it considered to be at a direct detriment to customers.

### ***Our assessment***

12.130 We present below our assessment of the appropriate margin as follows:

- (a) First, we consider the UR’s arguments that no margin should be applied at all to provide additional remuneration, as the current facility fee would be sufficient.
- (b) Second, we consider the scope of the margin.
- (c) Finally, we consider the level of the margin.

### *The use of a margin approach*

12.131 The UR compared the CER’s approach to its own, and stated that the level of the return allowed under each of the two approaches was comparable, if all the factors of both approaches were considered together. We have compared the two approaches in Chapter 7. Whether or not both approaches are reasonable in themselves, we consider it is the case that the CER has allowed greater revenues to EirGrid for managing these revenue risks than the UR’s approach.

12.132 The UR said that a margin approach was not a suitable alternative approach, as there is limited evidence to support our choice of level of margin. We do not agree. In Chapter 7, we found that the UR’s approach was wrong, as it failed to remunerate SONI for the risks taken. We therefore

disagree with the UR that the difficulty in identifying the level of the 'right' margin from a single objective data source means that no alternative approach is available. It is straightforward to identify the relevant revenues and to implement a margin approach, and our analysis suggests that a small margin would remunerate SONI for the risk taken in a way that the UR's approach of including no margin does not. The fact that it is difficult to identify the 'right' margin is of no consequence. The same would apply to any cost of capital decision, including the UR's choice of 5.9%, which is a best estimate based on a range of input assumptions. We would not suggest that the UR would be wrong to apply the CAPM model because there is very limited data on the right level of beta for SONI. What is important in this context is that the data that does exist should be used properly to inform the level of the remuneration by way of a margin on relevant revenues.

- 12.133 We note the UR's comments about the relevance of the I-SEM. We agree with the UR that it is not appropriate for the CMA to seek to pre-empt the SEMC's decisions. Our proposed approach is to reflect the evidence provided to this appeal, which includes current projections as to what may happen after the I-SEM. To the extent that the actual design of the I-SEM turns out to be different to current projections, we would expect the UR to reflect this in its design of the regulatory framework following the I-SEM. In other words, it is possible that further adjustments may need to be made in the future to reflect decisions made by the SEMC in relation to I-SEM. However, we do not consider that this should prevent us from taking action now to remedy the error that we have identified.
- 12.134 The UR suggested that the level of the margin should be zero for all items other than Imperfections Charges (ie the DBCs). This implies that SONI's investors would be indifferent between handling these cash flows and not handling them. We do not consider that this is consistent with the evidence. Where the management of industry cash flows can be done with little or no working capital, then SONI may be indifferent or even may choose to manage the cash, as this may enhance its finances. The evidence provided by the UR and SONI indicates that, with the exception of CAIR<sub>t</sub>, there are risks associated with managing the cash flows, and SONI would not, by choice, manage these cash flows without remuneration.
- 12.135 In the remedies hearing, the UR further argued that the right way to reflect SONI's financing risk was through a review of the level of the facility fee following the implementation of I-SEM. We have considered the possibility of using an enhanced facility fee approach. Whilst this might be a theoretically feasible solution, and might be effective in particular where there was a smaller revenue to manage, we are not persuaded it is the most effective remedy in this case.

- 12.136 The use of a facility fee effectively regulates SONI's financial structure, which is not normal regulatory practice, and also excludes any knock-on effect of managing incremental risks on SONI's cost of capital more generally. We expect that the risk taken in managing cash flows of the order of £100 million per annum would be reflected in SONI's credit risk, and therefore in its cost of capital. We have decided that a margin is more consistent with rewarding SONI for its activities and the risk taken, and with providing incentives to SONI to manage its finances efficiently.
- 12.137 SONI is effectively providing a cash flow management service to the industry, and doing so from within its regulated business. This will inevitably have some effects on the aggregate risk and financing costs of SONI as an entity, and the size of these effects will grow with the size of the operations that SONI is managing. SONI may be able to manage this, and might be in a position after this appeal to obtain low cost facilities which allow it to manage these costs. However, this is at SONI's risk, circumstances may change, and there will inevitably be some incremental effect on SONI's perceived risk as an entity.
- 12.138 We therefore consider that some risk premium would be appropriate, and that this should be in the form of a margin on revenues, as the level of risk is related to the size of the revenues handled. Were it to be the case that the incremental risk is so small that this risk premium is very close to zero, then we would not have found the UR to be wrong. In practice, the size of these cash flows is up to and potentially over £100 million a year, which is so large relative to the SONI's business and buffer that we do not consider it reasonable to assume that there is no incremental cost of managing this risk. This means that we consider a remedy is appropriate with a non-zero margin.

*Scope of the revenues to which a margin should be applied*

- 12.139 In terms of the scope of the remedy, we have considered the submissions from SONI and the UR. The UR has stated, and SONI has acknowledged in its risk analysis, that the risk associated with Moyle Interconnector costs (CAIR<sub>t</sub>) is exceptionally low. Whilst in theory this could form part of the calibration of the margin, the approach of setting a margin on these revenues, even one reduced to reflect the lower risk associated with CAIR<sub>t</sub>, would be inconsistent with the objectives of the risk premium, which is to remunerate SONI for taking risk.
- 12.140 We therefore have decided that the margin should be applied to each of:
- (a) Imperfections Charges;

(b) TuOS (part of A<sub>t</sub>); and

(c) Other system services (also part of A<sub>t</sub>).

12.141 We have decided to include in the scope of the remedy SONI's share of the Imperfections Charges levied by the SEMO JV, which are based on the expected level of DBCs for the period. The principal risk associated with collecting these revenues sits with SONI as the TSO, and SONI is not remunerated for any of the risk associated with managing Imperfections Charges through the SEMO control.

12.142 The UR has submitted that the risk should not be remunerated through the TSO control, as the revenues are collected by the SEMO JV. However, our decision is that the economic substance of the obligation on SONI is that it is bearing the risk and cost of managing SONI's share of the Imperfections Charges. This is discussed further in paragraphs 7.212 to 7.214 above. We have therefore decided that, through the TSO price control, SONI should be allowed a margin to remunerate it for the risks it bears in handling these revenues and managing the risk. Another way of presenting the decision to include these revenues is that if we were not to include the margin on these revenues, we would have to significantly increase the margin associated with the revenues collected under the TSO price control, in order for the margin to also cover the financing risk associated with unexpected DBCs. The unexpected DBCs are an obligation for the TSO, where the UR has accepted that SONI faces timing risk, but which are small in many years.

12.143 We have therefore decided that the UR should include an allowance in the Price Control, in the form of a margin, and calculated by reference to Collection Agent Revenues, by which we mean Imperfections Charges (expected DBCs), TUoS and Ancillary Services.

*Our decision on the level of the margin*

12.144 We have considered the level of the margin in the context of the nature of the risks faced by SONI. As discussed in Chapter 7, some of the characteristics of these risks include:

- SONI faces limited underlying credit risk or financial risk, since the risks relate primarily to timing differences between revenues and costs;
- these revenues and associated costs are very high relative to SONI's core price controlled business, posing a significant challenge to its financing; and

- these revenues and associated costs are either likely to increase or be subject to greater risk following the introduction of the I-SEM in 2018.

12.145 We are aware that there are differences between the level of risk for SONI in respect of its different revenue collection activities. In particular, the DBCs appear to have a greater risk for SONI than the activities of collecting and onward payment of transmission charges. The evidence suggests that the DBCs are volatile and the scale of the risk is expected to be higher in the future. The UR has said that we should not reflect any changes following the I-SEM, as there is already a process in place to consider the capital requirements following the I-SEM. We can confirm that we have not set an allowance which is set at a level which assumes any particular change in risk following the introduction of the I-SEM. Our approach is broadly consistent, to the extent of providing remuneration for the risk associated with these activities, with the approach taken by the CER.

12.146 We note that in EirGrid's price control set by the CER, this is reflected in a different regulatory approach for DBCs. This is discussed in more depth in our assessment of Ground 1 in Table 7.1 above, in which we summarise CER's approach in the 2016-2020 price control. CER allows a return on capital for a working capital facility for DBCs equivalent to around 1% margin on these costs, and a margin of 0.5% on other revenues. The margin of 0.5% on other revenues was increased by CER in the current review to reflect particular issues relating to operational gearing, and therefore the previous margin of 0.25% may be more directly comparable to SONI. This was reflected in SONI's submission to in response to our provisional determination, where it estimated that these values would compare to a margin of 0.66% for SONI's activities.

12.147 We have reviewed the CER's analysis and it demonstrates the challenges in coming to a point estimate for the level of the margin. In our provisional determination, we indicated that the CER analysis would suggest a point estimate from the range of 0.25%–0.5%. Given that we have decided not to include the CAIR<sub>t</sub> revenues, we expect that a comparable point estimate would be closer to the top end of the range.

12.148 We have considered the many comparators provided by SONI. Whilst the other comparators are in some cases higher than our range, we are not persuaded that those comparators are particularly relevant to our decision, for the reasons below.



- 12.149 First, we considered the comparison to margins for other regulated businesses. This analysis was also provided as part of the [NoA](#) evidence.<sup>976</sup> We consider that it is too difficult to read across margins from such different businesses, all of which have greater risk than SONI in terms of volume risk, exposure to competition or credit risk. We do not consider that this analysis helps in calibrating the level of the margin.
- 12.150 Secondly, we considered the invoice discounting (factoring) comparators. As a general principle, factoring appears to be a good comparator. Although SONI has said that it would be difficult to do so,<sup>977</sup> we expect that SONI could in principle seek to outsource the timing risk through a contract comparable to a factoring arrangement. However, there is very little we can do with the evidence that SONI has provided, which indicates a range so wide that we cannot draw any conclusions as to the right cost for factoring, and whether it is higher than 0.5%, together with LIBOR plus 2% on multi-year timing differences. We do not consider that SONI's evidence demonstrates that the cost of factoring is higher than 0.5%, when combined with LIBOR plus 2% on year-end balances. There is also the risk of a 'double-count', as SONI's allowances include an opex cost for administration of these activities, and some of the cost of factoring (or custodian services) would be to compensate for administrative costs.
- 12.151 SONI's other submissions either overlapped materially with our range or sat within our range.
- 12.152 We therefore conclude that our range of 0.25%–0.5% remains appropriate, and given that we have excluded the lowest-risk cash flows we have erred on the side of caution and set a margin at the top of the range, at 0.5%, to apply to the remainder of the revenues that SONI collects.
- 12.153 We have decided that this is proportionate, is within the range of reasonable options, and reflects the risk taken by SONI. Our assessment is that SONI has been asked to manage an important function on behalf of the industry, it is likely that there are efficiencies to other industry participants in SONI having these functions, and in any case SONI is obliged to do so by its Licence. It is reasonable for customers to pay SONI's costs in operating this function. The same applies to EirGrid in RoI, which has comparable functions and a slightly higher allowance from the CER.
- 12.154 We note that this margin allowance should be in place of the facility fee of £108,000 per annum currently included in the Price Control. The allowance

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<sup>976</sup> See NoA MC1, supporting document MC1/1 (KPMG 1, section 9.7).

<sup>977</sup> SONI response to CMA provisional determination – Ground 1 remedies paper, paragraph 4.53.

would cover the cost and risk associated with managing these activities, and it would be for SONI to determine the appropriate balance of internal and external sources of finance.

- 12.155 The UR has submitted that the 2% adjustment to LIBOR in respect of revenue collection should be excluded if a margin allowance is included.<sup>978</sup> We have calculated the size of the margin on the assumption that the 2% adjustment to LIBOR is part of the mechanisms for recovering costs over multiple periods. We do not therefore consider that it should be excluded. We have decided that the margin approach should be in place of a facility fee for managing the incremental costs of obtaining finance, including the effect on the cost of capital, which are separate to the cost of the time value of money.
- 12.156 We have observed in paragraph 12.150 above that the level of the interest payable associated with market approaches to management of cash flows, such as invoice discounting, would also be above LIBOR, and that a rate of 2% over LIBOR is consistent with the range presented in SONI's evidence. In addition, the K-factor largely applies to cash flows that are symmetric, and the size of the margin can have a symmetric effect as a result, with the level of the margin affecting SONI's incentives not to over-recover revenues.
- 12.157 The UR has said that it already has a mechanism for recovering additional intra-year financing costs which are not already recovered through tariffs, using the  $D_t$  mechanism. Whilst, for the reasons above, our decision is that this is not sufficient to address the risks faces by SONI, we would clarify that we would not expect SONI to seek to also recover costs through  $D_t$ , if it has a margin allowance in the price control to cover the same financing risks.

## **Consequential effects**

- 12.158 We have also considered whether there would be any consequential effects on the rest of the financial framework, and in particular the WACC. In our view is that no other changes would be required. We did not find that the use of a WACC of 5.9% was wrong, in the sense of being too generous. SONI has a small asset base and a large operating cost base. The choice of a WACC requires a number of input assumptions. The UR itself chose its assumption for the level of the WACC at the top of a range of 5.5%–5.9%. We do not find that it was wrong to do so, and also, we do not consider that any of the remedies above would remove the justification made by the UR in

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<sup>978</sup> UR's November 2017 correspondence re adjustments to the licence.

setting the WACC at this level, which was based on the level of operational gearing for SONI.

## Implementation of Ground 1

- 12.159 Our remedies on Ground 1 require an increase in SONI's allowed revenue. Under the Price Control, SONI does not have a single number for allowed revenue, but is able to recover revenue based on the sum of a number of separately calculated allowances. These include, for example, allowances for opex, a return on RAB, and for pensions.
- 12.160 Currently SONI's total assumed profit is provided by the return on its RAB within allowed revenues. In order to implement our remedies, we therefore consider that a separate adjustment needs to be made to SONI's revenues. This would be added to the other items included in price control revenues. As discussed in Chapter 2, this is currently described in SONI's licence as the 'B<sub>t</sub>' term.
- 12.161 Based on discussions with SONI and the UR, we consider that this approach is appropriate and would be effective. In response to our provisional determination, SONI provided indicative licence drafting, which it subsequently updated following comments from the UR. As discussed above, the actual changes to the licence will be implemented by the UR on remittal. However, we expect that these would be largely consistent with the drafting provided by SONI to us. We note that the UR has indicated that the allowances could be in a separate term (N<sub>t</sub>) to be added to B<sub>t</sub>, rather than within B<sub>t</sub>. We have no preference.
- 12.162 The components of the additional term would be:
- (a) An annual amount of 1.75% on the prevailing value of the PCG, which will be equivalent to £175,000 per annum in nominal terms, as long as the PCG remains at £10 million.
  - (b) A fixed annual amount of £220,000, based on a 3% uplift applied to estimated D<sub>t</sub> and PCNP costs. This would reflect an allowance for SONI taking on the asymmetric risk associated with this expenditure.
  - (c) An annual amount equal to a percentage applied to TUoS, Ancillary Services, and SEMO JV Imperfections Charges revenues.
- 12.163 We note that there may be some timing differences which result from (c) above, to the extent that allowed revenues will in the first instance be based on projections – in the case of D<sub>t</sub> and PCNPs, on submissions of projected efficient costs and in the case of collection agency revenues, on forecasts of

revenues collected. We would expect that this could be resolved through the K-factor.

- 12.164 We have therefore decided to impose a requirement on the UR within the Order to add an additional term to the Licence, which increases the value of the price controlled revenues currently calculated under the  $B_t$  term to reflect the three remedies discussed above. We have decided to direct the UR to change the Price Control in accordance with our remedies decision. We urge the UR to implement the remedies on Ground 1 promptly following our final determination.
- 12.165 We note that the combined effect of our remedies on Ground 1 is to increase SONI's revenue by around £4.3 million over the Price Control Period, equivalent to close to £1 million per annum. The size of our remedy of £4.3 million compares to a combined request of approximately £8.4 million which SONI sought in respect of Ground 1 of its appeal, which was based on a margins approach to remuneration across a broad range of its activities.
- 12.166 Whilst our remedy is material in terms of the UR's assumed profit allowance, as the UR's model assumed a profit allowance of around £1 million per annum, we consider that this is consistent with our broader finding on Ground 1, that the UR's framework failed to remunerate SONI for the risks taken. We consider that this package of remedies would mean that SONI is remunerated for the risks it is taking in this Price Control Period.

## **13. Impact of our remedies**

### **Required changes to the level of the Price Control**

- 13.1 In respect of Ground 1 and Ground 3 we are proposing changes to the Price Control.
- 13.2 While the correction should be straightforward, there are a number of changes in the numbers within the price control formula as expressed in the Licence. We consider that it is appropriate that we order the UR to make the consequential changes, rather than seeking to substitute a decision that will include a wide range of changes to the numbers in the Licence. There would be benefits in terms of transparency and removing risk of error if the UR implements the licence modifications, rather than the CMA.

13.3 As in earlier determinations, we recognise the risk of knock-on effects from changing one aspect of a complex regulatory decision.<sup>979</sup> The principle that the CMA adopted in those cases, and which we adopt here, is to consider on a case-by-case basis any evidence submitted to the CMA regarding links between the parts of the decision which are challenged and parts which are not.<sup>980</sup> However, based on submissions received in this appeal, we do not consider that changing the Price Control in accordance with our proposed remedies will require changes to other parts of the decision.

### ***Calculations of allowed revenues and adjustments to the Price Control***

13.4 The tables below give our calculations of the impact of our remedies on the Price Control, based on submissions from parties. We have directed that the changes below should be implemented in the Licence, although we acknowledge that it is possible that further minor modifications may be identified by the parties prior to implementation of the licence modification by the UR. The following tables are in 2014 prices.

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<sup>979</sup> *British Gas Trading v GEMA*, [Final determination](#), 29 September 2015, paragraph 3.50 and *Northern Powergrid (Northeast) Limited and Northern Powergrid (Yorkshire) plc v GEMA*, [Final determination](#), 29 September 2015, paragraph 3.49.

<sup>980</sup> *British Gas Trading v GEMA*, [Final determination](#), 29 September 2015, paragraph 3.52 and *Northern Powergrid (Northeast) Limited and Northern Powergrid (Yorkshire) plc v GEMA*, [Final determination](#), 29 September 2015, paragraph 3.51.

### Revised Table A

	(£m)				
<i>Relevant Year t</i>	1	2	3	4	5
Payroll	7.659	7.580	7.482	7.391	7.363
IT & Communications	1.783	1.850	1.924	1.948	1.997
Other opex	1.303	1.303	1.303	1.303	1.303
Pension Deficit	0.262	0.071	0.071	0.071	0.071
Depreciation on Non-Building Assets	3.999	1.763	1.364	1.313	1.273
Depreciation on Building Assets	0.116	0.116	0.116	0.116	0.116
Depreciation on capex Overspend for 2010-2015	n/a	n/a	n/a	0.850	0.850
Real Price Effects & Productivity	0.146	0.222	0.299	0.375	0.454

### Revised Table B

	(£m)				
<i>Relevant Year t</i>	1	2	3	4	5
Rate of return allowance	0.444	0.347	0.314	0.374	0.332

### RAB adjustments

	(£m)				
<i>Relevant Year t</i>	1	2	3	4	5
Average Non-Building RAB	5.135	3.611	3.217	3.081	3.332
Average Building RAB	2.385	2.268	2.152	2.036	1.919
Average capex Overspend 2010-2015 RAB	n/a	n/a	n/a	1.275	0.425
Average RAB Total	7.520	5.879	5.369	6.392	5.676

## Impact of our remedies on tariffs and consumers

13.5 We provide in Table 13.1 below an estimate of the total impact of our proposed remedies on SONI's revenues in the Price Control Period of 2015-2020.

**Table 13.1: Estimated value of our remedies (2014 prices)**

	<i>Value of Adjusted Final Determination Allowance over 5 years (£m)</i>	<i>Annual Average (£000)</i>
PCG at 1.75%*	0.823m	£165k
Asymmetric risk for Dts and PCNPs	£1.100m	£220k
Collection agent risk at 0.5% (less existing £0.54 million allowance)	£2.410m	£482k
Ongoing pensions allowance†	£1.390m	£278k
Pension deficit repair allowance‡	-£0.397m	-£79k
Inflation adjustment for error 11(b)	£0.121m	£24k
TOTAL	£5.4m	£1.1m

Source: CMA analysis.

\*£175K per annum, adjusted to reflect indexation assumptions in the UR's model

†Of 38% rather than 28%.

‡Using 2016 valuation rather than 2013, as used in the [Final Determination](#).

Note: Baseline for PCNPs and  $D_t$  are based on SONI's Notice of Appeal. The remuneration for collection agent risk is based on forecast (SONI) revenues for TUoS charges, Ancillary charges and sundry other charges (Sync Comp, Moyle Frequency and Interco GTUoS) as per UR's price control model and actual /forecast revenues for SEMO JV Imperfections Charges as per a) Table 2 of the [SEMC's Imperfections Charges Consultation Paper](#), 5 July 2017 and b) [CER's TSO 2016 to 2020 price control model](#), Assumptions tab (last two periods only). 25% of Imperfection Charges allocated to SONI and all € amounts converted to £s at €1.10 to £1.

13.6 In summary, the combined benefit to SONI of the different remedies would be approximately £5.4 million over the price control period (compared to the £14.7 million of relief sought by SONI).<sup>981</sup> Of this total, around £1 million will reflect increases in the asset base and may be deferred into future periods ( $D_t$  and capex additions). The total annual effect on household bills would be small, as the total increase in tariffs would be around £1.1 million per annum, which we expect would be around 50 pence per annum on average domestic tariffs.<sup>982</sup> After the CMA remedies are implemented, both business and domestic customers will continue to see a small reduction<sup>983</sup> in the electricity transmission component of their bills in real terms over the five-year period of the Price Control (2015 to 2020).

13.7 The UR should calculate the tariff adjustment for the remaining two years of the price control period (2018/19 and 2019/20) so that SONI recovers this £5.4 million over these two years. This should be an NPV-neutral adjustment with equal values for the last two years.

<sup>981</sup> [NoA](#), paragraph 15.3.

<sup>982</sup>The annual domestic bill impact of 50 pence is based on 794,000 domestic customers, using on average 3,600 kWh of electricity each year. In NI, there are also 71,500 industrial and commercial customers, using on average 6,900 kWh of electricity per year.

<sup>983</sup> The UR's FD impact on domestic bills was a reduction of 65 pence per year for average domestic bills. The CMA impact is estimated at 50 pence, so a reduction of 15 pence per year becomes the overall effect. This is estimated; the actual bill impact is dependent on any future  $D_t$  claims submitted by SONI.

## Timing of the implementation of our remedies

- 13.8 We have issued an Order (published on our [webpage](#)) with directions to the UR and, to the extent applicable, to SONI to ensure the errors identified in our final determination are remedied.
- 13.9 Our expectation is that parties will be cooperative and reasonable, and that discussions between the parties and implementation of the remedies will take place in a timely manner:
- In respect of Ground 1, the licence modification of the ‘side-RAB’ under Ground 2, and Ground 3, we expect the final decision on the licence modification to be published by the UR promptly, and certainly no later than 31 March 2018.
  - In respect of Ground 2, we expect the UR to use best endeavours to publish guidance consistent with the framework outlined in Chapter 11 of our final determination promptly, and in any case within four months of the date of the Order, having consulted with and reflected comments from industry stakeholders.

## 14. Costs

- 14.1 The legislation (and associated CMA Rules and guidance) makes provision for (a) the payment of the CMA’s costs, (b) the payment by one party of the costs of another party (*inter partes* costs) and (c) related ancillary matters.<sup>984</sup>
- 14.2 The CMA is reserving its position on costs and will consult the parties prior to making a written Order.<sup>985</sup>

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<sup>984</sup> See [Electricity Order](#), Schedule 5A, paragraph 13; [CC14](#), Rule 19, and [CC15](#), paragraphs 5.1–5.8.

<sup>985</sup> [CC15](#), paragraph 5.5.



## Appendix A: Chronology of the key steps in the price control consultation process<sup>1</sup>

Date	Event
15 February 2013	SEMC publishes its preliminary TSO Certification Decision
12 April 2013	European Commission decision of 12.4.2013 pursuant to Article 3(1) of Regulation (EC) No 714/2009 and Article 10(6) of Directive 2009/72/EC – United Kingdom (Northern Ireland) – SONI/NIE
20 September 2013	UR publishes its consultation on measures for the purposes of the EU Third Internal Energy Package
5 December 2013	Meeting between SONI and the UR to discuss the structure of the process for the 2015-2020 Price Control review, due to take effect upon the expiry of the 2010-2015 Price Control on 30 September 2015
2 February 2014	SONI submits the Principles & Key Issues paper to the UR
6 March 2014	Meeting between SONI and the UR in respect of the recovery framework for transfer of investment planning
27 March 2014	Meeting between SONI and the UR to discuss transfer of the Network Planning function, SONI Price Control and regulatory accounts
28 March 2014	Publication of the revised TSO Licence transferring responsibility for network planning to SONI
30 April 2014	Execution of an Implementation Agreement between NIE and SONI relating to transfer of transmission system investment planning function
1 May 2014	Transfer of NIE staff to SONI takes effect
1 July 2014	Letter from the UR to SONI notifying it of the final decision on the certification of the Appellant as TSO
9 July 2014	UR publishes the Approach Paper
21 October 2014	SONI submits its Business Plan
5 December 2014	Meeting between the SONI Board, members of the EirGrid Board, and the UR Board to discuss the treatment of Network

<sup>1</sup> See [NoA](#), Annex 2, pages 185–186.

	Planning, the ongoing Price Control review and the appropriateness of the continuing application of the RAB/WACC regulatory framework
22 December 2014	Publication of the Position Paper
January – July 2015	SONI provides responses to the UR's queries in respect of its Business Plan
2 April 2015	UR publishes the Draft Determination
18 May 2015	SONI makes submissions in response to the Draft Determination
June – August 2015	SONI provides responses to the UR's queries in respect of its response to the Draft Determination
4–9 December 2015	UR provides SONI with a copy of its draft Final Determination for factual review and draft Licence Modifications
11–15 December 2015	SONI provides its responses to the factual review of the draft Final Determination
24 February 2016	UR publishes the Final Determination and consultation on the Draft Licence Modifications to the TSO Licence
23 March 2016	SONI provides its response to the UR's statutory consultation on the Draft Licence Modifications to the TSO Licence
13 May 2016	Response from the UR relating to the UR's statutory consultation on the Draft Licence Modifications to the TSO licence
7 June 2016	Meeting between the UR and SONI to discuss the Draft Licence Modifications
14 June 2016	Follow-up submission from SONI on the UR's statutory consultation on the Draft Licence Modifications to the TSO licence
11 January 2017	UR provides SONI with a draft of the Final Licence Modifications and accompanying Decision Paper in advance of publication
19 January 2017	Meeting between the UR Board and representatives of the EirGrid and SONI Boards
14 March 2017	UR publishes Decision Paper and Final Licence Modifications

## Glossary

<b>BAU</b>	Business as usual.
<b>Business Plan</b>	<b>SONI's</b> Business Plan as submitted to the <b>UR</b> on 21 October 2014.
<b>CAIRt</b>	Collection agency income requirement.
<b>Capex</b>	Capital expenditure.
<b>CAPM</b>	Capital asset pricing model.
<b>CC</b>	Competition Commission.
<b>CC14</b>	See <b>the Rules</b> . ( <a href="#">CC14</a> has now been replaced by the <a href="#">Energy Licence Modification Appeals: Competition and Markets Authority Rules (CMA70)</a> . However, at the time of these proceedings, the relevant rules document was <a href="#">CC14</a> .)
<b>CC15</b>	See <b>the Guidance</b> . ( <a href="#">CC15</a> has now been replaced by the <a href="#">Energy Licence Modification Appeals: Competition and Markets Authority Guide (CMA71)</a> . However, at the time of these proceedings, the relevant guidance document was <a href="#">CC15</a> .)
<b>CCNI</b>	Consumer Council (Northern Ireland).
<b>CCNI R&amp;O</b>	<a href="#">CCNI representations and observations on the NoA</a> , submitted on 2 June 2017.
<b>CCNI response to SONI reply</b>	<b>CCNI</b> response to <b>SONI's</b> reply to <a href="#">CCNI R&amp;O</a> , submitted on 14 July 2017 (in lieu of a hearing).
<b>CER</b>	Commission for Energy Regulation. (During the course of these proceedings, the CER changed its name to the Commission for Regulation of Utilities ( <b>CRU</b> ) to better reflect the expanded powers and functions of the organisation (see <a href="#">CRU website</a> ). In this document, we are consistent in our use of the name CER.)
<b>CMA</b>	Competition and Markets Authority.
<b>CRU</b>	Commission for Regulation of Utilities. (See <b>CER</b> .)

<b>DB</b>	Defined Benefit.
<b>DBC</b>	Dispatch Balancing Costs.
<b>DC</b>	Defined Contribution.
<b>Defence</b>	The <b>UR</b> <a href="#">representations and observations on the NoA</a> , submitted on 2 June 2017.
<b>DIWE</b>	Demonstrably Inefficient and Wasteful Expenditure.
<b>Draft Determination</b>	The <b>UR</b> 's <a href="#">Draft Determination to the Price Control 2015-2020 for the Electricity System Operator for Northern Ireland (SONI)</a> , published by the <b>UR</b> on 2 April 2015.
<b>DS3 Programme</b>	“Delivering a Secure Sustainable Electricity System”, a programme designed by <b>SONI</b> and <b>EirGrid</b> in response to binding national and European targets which aims to put in place the required changes to system policies, tools and performance to allow the electricity system to operate safely with a high penetration of non-synchronous generation.
<b>D<sub>t</sub></b>	A tariff adjustment mechanism for ex-post recovery of uncertain costs.
<b>EirGrid</b>	EirGrid Plc – since 2006, EirGrid has operated and developed the national high voltage electricity grid in the <b>RoI</b> . EirGrid is owned by the Irish State.
<b>EirGrid Group</b>	The EirGrid corporate group, which includes <b>EirGrid</b> , <b>SONI</b> , <b>SEMO</b> , EirGrid Interconnector DAC and EirGrid Telecoms DAC.
<b>Electricity Order</b>	<a href="#">Electricity (Northern Ireland) Order 1992</a> .
<b>Energy Order</b>	<a href="#">Energy (Northern Ireland) Order 2003</a> .
<b>Final Determination</b>	The <b>UR</b> 's <a href="#">Final Determination to the Price Control 2015-2020 for the Electricity System Operator for Northern Ireland (SONI)</a> , dated 22 February 2016 and published by the <b>UR</b> on 24 February 2016.
<b>FTE</b>	Full time equivalent.
<b>GAD</b>	Government Actuary's Department.

<b>IME3</b>	Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC OJ 2009 L211/55 (also known as the “Third Internal Market in Electricity Directive”)
<b>I-SEM</b>	Integrated Single Electricity Market for <b>NI</b> and the <b>RoI</b> , the new wholesale electricity market for the island of Ireland which is scheduled to go live in May 2018 and is overseen by the <b>SEMC</b> .
<b>IS</b>	Information Systems.
<b>ITP</b>	Any person, qualifying body or association referred to in section 11C(2) of the Electricity Act 1989 or section 23B(2) of the Gas Act 1986 (as the case may be) who is not an appellant (ie in this case, <b>SONI</b> ).
<b>LIBOR</b>	London InterBank Offered Rate. It is the primary benchmark for short term interest rates, calculated from the average of interest rates estimated by each of the leading banks in London which they would be charged were they to borrow from each other.
<b>Licence</b>	The electricity transmission licence held by <b>SONI</b> .
<b>MO</b>	Market Operator.
<b>Moyle</b>	Moyle Interconnector Limited.
<b>Network Planning</b>	Includes activities required to progress a transmission project from the conceptual stage through to the point where project construction commences – specifically Phases 1 (Project Identification) and 2 (Pre-Construction activities) of transmission connection and development connection projects. The Network Planning function formally transferred from <b>NIE</b> to <b>SONI</b> on 1 May 2014 at the direction of the <b>UR</b> .
<b>NI</b>	Northern Ireland.
<b>NIE</b>	Northern Ireland Electricity Networks Limited, owner of the electricity transmission and distribution network and operator of the electricity distribution network in <b>NI</b> (previously known as Northern Ireland Electricity Limited).

<b>NoA</b>	<a href="#">SONI's Notice of Appeal</a> , submitted to the <b>CMA</b> on 12 April 2017.
<b>ONS</b>	Office for National Statistics.
<b>Opex</b>	Operational expenditure.
<b>PCG</b>	Parent company guarantee.
<b>PCNP</b>	Pre-construction transmission network project.
<b>Price Control</b>	The price control for the <b>SONI TSO</b> business which was due to start on 1 October 2015 and run until 30 September 2020.
<b>Price Control Decision</b>	<a href="#">Decision on the Licence Modifications for the Price Control 2015-2020 of the Electricity System Operator for Northern Ireland (SONI) and Modifications to SONI Limited's Electricity Transmission Licence</a> , by the <b>UR</b> , published on 14 March 2017. These Licence modifications reflect the <b>Final Determination</b> (dated 22 February 2016 and published by the <b>UR</b> on 24 February 2016), where the <b>UR's</b> reasoning for its Decision was explained.
<b>Price Control Period</b>	Duration of the <b>Price Control</b> , starting on 1 October 2015 and running until 30 September 2020.
<b>Q<sub>t</sub></b>	An adjustment to the <b>SSS</b> tariff for year ending 30 September 2017.
<b>RAB</b>	Regulatory Asset Base.
<b>ROCE</b>	Return on capital employed.
<b>Rol</b>	Republic of Ireland.
<b>SEM</b>	Single Electricity Market – the wholesale electricity market for the island of Ireland which is jointly regulated by the <b>UR</b> and <b>CER</b> and governed by the <b>SEMC</b> .
<b>SEMC</b>	Single Electricity Market Committee – the decision making authority for all <b>SEM</b> matters, consisting of up to three <b>CER</b> and up to three <b>UR</b> representatives along with an independent and a deputy independent member.
<b>SEM matter</b>	Per Article 6(3) of the Electricity (Single Wholesale Market) (Northern Ireland) Order 2007 SI 2007/913, a matter is a

SEM matter if the **SEMC** determines that the exercise of a relevant function of the **UR** in relation to that matter materially affects, or is likely materially to affect, the **SEM**.

<b>SEMO</b>	Single Electricity Market Operator – facilitates the continuous operation and administration of the <b>SEM</b> . SEMO is a contractual joint venture between <b>EirGrid</b> , the <b>TSO</b> for the <b>RoI</b> , and <b>SONI</b> , the <b>TSO</b> for <b>NI</b> . SEMO is licensed and regulated cooperatively by the <b>UR</b> in <b>NI</b> and the <b>CER</b> in the <b>RoI</b> through their respective <b>SEMCs</b> .
<b>Side-RAB</b>	Temporary additions to the <b>RAB</b> of <b>SONI</b> prior to any transfer to <b>NIE</b> .
<b>Significant Projects</b>	Including (i) large-scale <b>PCNPs</b> ; (ii) <b>I-SEM</b> implementation; (iii) the <b>DS3</b> programme.
<b>SLG</b>	SLG Economics Ltd – economic advisors to <b>CCNI</b> .
<b>Smart Grid</b>	Developments in the transmission network to support renewable energy usage.
<b>SMP</b>	System Marginal Price.
<b>SONI</b>	SONI Ltd. The independent electricity transmission system operator for Northern Ireland.
<b>SONI reply to CCNI R&amp;O</b>	<b>SONI</b> reply to <a href="#">CCNI R&amp;O</a> , submitted on 26 June 2017.
<b>SONI reply to the Defence</b>	<b>SONI</b> reply to the <a href="#">Defence</a> , submitted on 26 June 2017.
<b>SSS</b>	System Support Services tariff.
<b>System Services</b>	A key area of the <b>DS3 Programme</b> . <b>SONI</b> seeks to ensure that the electricity system operates securely and efficiently, while facilitating the transmission of higher levels of renewable energy. To achieve this, <b>SONI</b> works to obtain services from generators and market participants.
<b>TAO</b>	Transmission Asset Owner, which is <b>NIE</b> pursuant to the arrangements in <b>NI</b> .
<b>The Guidance</b>	<a href="#">Energy Licence Modification Appeals: Competition Commission Guide (CC15)</a> . ( <a href="#">CC15</a> has now been replaced

by the [Energy Licence Modification Appeals: Competition and Markets Authority Guide \(CMA71\)](#). However, at the time of these proceedings, the relevant guidance document was [CC15](#).)

<b>The Rules</b>	<a href="#">Competition Commission Energy Licence Modification Appeals Rules (CC14)</a> as adopted by the <b>CMA</b> . ( <a href="#">CC14</a> has now been replaced by the <a href="#">Energy Licence Modification Appeals: Competition and Markets Authority Rules (CMA70)</a> . However, at the time of these proceedings, the relevant rules document was <a href="#">CC14</a> .)
<b>TIA</b>	Transmission Interface Arrangements.
<b>TSO</b>	Transmission System Operator.
<b>TSO BAU</b>	<b>TSO</b> business as usual.
<b>TUoS</b>	Transmission Use of System tariff.
<b>TUPE</b>	The Transfer of Undertakings (Protection of Employment) Regulations 2006 SI 2006/246 and the Service Provision Change (Protection of Employment) Regulations (Northern Ireland) 2006 SR 2006/177.
<b>Uncertainty mechanism</b>	Funding arrangements to deal with costs/revenues that are significantly uncertainty during the <b>Price Control Period</b> .
<b>UR</b>	Northern Ireland Authority for Utility Regulation.
<b>WACC</b>	Weighted average cost of capital.