



VIRIDIAN

*Power & Energy*

**Response by Viridian Power & Energy to  
Single Electricity Market Consultation  
Paper SEM-10-050**

***SEMO Revenue and Tariffs  
October 2010 – September 2013***

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## **1. Introduction**

Viridian Power and Energy (VPE) has considered the consultation paper published by the Regulatory Authorities (RAs), as well as the background documents prepared by the Single Electricity Market Operator (SEMO), and would like to make a number of points in relation to the revenues and tariffs as proposed.

The structure of the submission is first to provide a number of general comments before addressing specific issues in relation to CAPEX, OPEX, KPIs and the introduction of menu regulation.

## **2. General comments**

VPE would like to acknowledge the important role of SEMO in administering the SEM and we recognise the relatively high quality of service they have sought to, and to a large extent have managed to achieve. Experience to date also indicates SEMO have exercised prudent budgetary control. However, in relation to this review it is important that costs are realistic and transparent, while delivering efficiencies where possible and ensure that the high level of service delivered by SEMO to date is at least maintained.

We welcome the introduction of a three year control period given the proven ability of SEMO to manage its budget in the years since inception.

In the current economic environment, all businesses (including VPE) and public bodies are having to curtail expenditure and take difficult cost reduction actions. In this regard it is important that no institutions are fully insulated from the prevailing market forces and that the effects of such downturns are borne throughout the economy. As such, the principles of cost minimisation and maximisation of efficiencies and productivity gains are imperative.

In this context, a proposed increase in SEMO tariffs of 22% to apply from 1<sup>st</sup> October appears to be excessive and in the current environment suppliers will face great difficulty in being able to pass through such an increase to customers, thus leaving suppliers to burden the cost. We note that this increase is principally due to the change in the accounting of CAPEX and the change in regulatory principles from rate of return regulation to a revenue cap with amortisation of CAPEX, through the tariff, to be completed in the year of investment. However, we also consider that the CAPEX and OPEX proposals put forward by SEMO are excessive and are not in keeping with the principles noted above.

On both CAPEX and OPEX it would greatly assist transparency and provide justification for cost associated with significant items of expenditure if a wider benchmarking exercise was engaged in. We note the RAs have undertaken this in relation to payroll costs but extension to other significant cost items in both CAPEX and OPEX should be undertaken.

The change in regulatory regime is not confined to CAPEX with RPI-X being introduced in relation to OPEX. For this review it is proposed that X is set equal to zero with the RA's applying cuts to certain costs submitted by SEMO. We concur with the cuts that RAs have proposed as we consider SEMO's proposals (based on the limited information provided) to be excessive however we also consider that the RAs proposals do not allow for future efficiencies and productivity gains. Effectively this is what X does in such a system and it may be appropriate to further consider the inclusion of X on certain cost items over the duration of the revenue and tariff control.

One issue we caution the RAs to consider further is the interaction between the regulatory principles and structures proposed. Specifically, that consideration be given to the interaction between RPI-X for OPEX and menu regulation for CAPEX, under a revenue cap principle. It is important to ensure that there is no incentive for potential, reasonably justified, overspends in OPEX in any year by SEMO to be recovered by utilisation of the menu mechanism in the subsequent year. Any potential reductions and/or scaling back of required capital investments should be avoided to ensure the quality of service offered by SEMO is not adversely affected.

Finally, we note that SEMO is not a typical 'for profit' company, it is a joint venture between TSOs with its duties defined by the Trading and Settlement Code and to date it has generally proven capable of managing its budget. In light of this it is important that the form of regulation applied to SEMO is appropriate and not excessively complex. We agree with many of the proposals forwarded by the RAs in relation to this review but caution that it is imperative for the SEM that the proposals in the review facilitate SEMO in continuing to carry out their duties and provide a high quality service to market participants.

Following on from these general points, the following section provides some summary views on the CAPEX, OPEX, KPIs and menu regulation proposals.

### **3. Specific issues for further consideration**

#### **CAPEX**

The proposal to implement a revenue cap principle for CAPEX with amortisation of new investments to be complete in the year of investment is a welcomed proposal, if all future investments are to be stable over time and/or at a very low level. If this is not the case, then the impact of this proposal is a lot more uncertain with significant implications for the stability/volatility of future tariffs. These are central concerns for the RAs in relation to many areas and as such should similarly be applied here.

On specific CAPEX proposals it appears as though many of the submitted costs are excessive, this remains a feature of some of the proposed costs to be allowed in the tariff. From our experience of similar and/or the same capital investments, particularly in the area of IT, many of these costs seem excessive and a number of synergies are apparent which could represent significant savings. It is important that such opportunities are availed of by SEMO in procurement. Furthermore, we would

urge a benchmarking exercise to be undertaken of these large CAPEX items and for efficiencies to be realised where possible.

From VPE's experience, the following specific issues with the CAPEX proposal are noted:

- Expenditure in relation to ABB upgrades appears excessive, efficiencies and/or synergies should be exploited to ensure a lower cost of delivery. This is similarly the case in relation to Sharepoint costs.
- The proposed testing budget and use of contractors is very high and at such levels may be more efficient and cost effective to employ dedicated permanent staff.
- From the detail provided, significant synergies and/or efficiencies could be realised in relation to:
  - Server monitoring and systems management
  - Reporting database upgrade and data warehouse project
  - Oracle database server and virtualisation, as well as other hardware replacement costs
  - CMS pre-production environment and virtualisation, as well as other hardware replacement costs
  - Electronic fax system and Sharepoint

Furthermore on the proposed costs, the inclusion of €250,000 for unplanned expenditure is equivalent to approximately €25k per staff member. This is excessive and should be reviewed.

Finally, we have already raised concern over the potential interaction between menu regulation (under a revenue cap) for CAPEX and RPI-X for OPEX, it is important that these are fully understood and market participants are assured that this combination of regulatory approaches does not affect the SEM and SEMO's ability to reasonably undertake its duties.

## **OPEX**

The introduction of RPI-X for OPEX is a significant change from the existing regime. We note that the RAs have introduced this new regime with an X equal to zero and instead they have revised the costs submitted by SEMO. In relation to many of these costs, cuts were clearly merited as they appeared excessive. However to drive continued productivity and efficiency gains we would recommend an X of 3% to be included on certain OPEX items outlined below..

On some of the specific proposals and cost items proposed in the consultation paper, VPE welcomes the decision to disallow the pension deficit allowance as no new independent entrant to the market would have taken the commercial decision to offer a defined benefit entitlement scheme. Such schemes are relics and commercial

realities dictate that such schemes should be phased out of all sectors of the economy.

The salary proposals contained in the document appear reasonable in light of the benchmarking exercise undertaken and we would consider a per annum reduction of 3% to be broadly consistent with the information provided and should be achievable through efficiency and productivity gains. We agree with the disallowance of a Real Price Effect, such an adjustment is inappropriate in the current economic climate. However, we note that such increases may be possible for SEMO, if deemed necessary, through efficiency savings that are likely to be possible through CAPEX initiatives. We would question the requirement for an Administration assistant especially at the proposed cost of €80k which is excessive and requires significant revision.

With respect to the proposals on IT and telecommunications costs, the analysis presented is somewhat sparse and thus it is difficult to comment extensively. In light of this and subject to further details being made available, the RAs proposal is considered reasonable.

Considering the proposals in relation to facilities, this seems excessive, particularly when benchmarked against our own expenses whereby we estimate the facilities costs of SEMO to be some 70% higher notwithstanding our costs cover 135 staff and 4 office locations. In light of this, it is considered to be more appropriate for the RAs to further apply X to this cost. A similar comment applies to the professional fees, and general and administration costs, as proposed in the consultation paper. For example the travel and subsistence costs proposed by SEMO would largely equate to the total cost of the Energia business of 135 staff which is highly sales orientated. Based on the information provided, the proposed levels of costs as proposed by the RAs appear to be reasonable however an X of 3% should be further considered to allow for future efficiencies and productivity gains. We would also recommend further benchmarking of such costs.

For corporate services, VPE agree with the disallowance of these costs and agree these costs should be assessed at the gross level within the Eirgrid and SONI price controls.

### ***KPIs***

VPE welcomes the introduction of two new KPIs as proposed in the consultation paper. It is important that KPIs provide the correct incentives for SEMO to continue to provide a high quality of service to market participants and as such the proposal for quarterly target is considered reasonable and is welcomed. The proposed weightings of the new KPI structure also appear reasonable.

### ***Menu regulation***

As already noted in this submission, it is vital that the introduction of menu regulation provides the correct incentives for SEMO to market participants to continue to provide a high quality of service to market participants. SEMO is not a typical 'for profit' commercial entity, commercial returns are (and should be) secondary to ensuring a high quality of service, stability and certainty in the SEM and for market participants. Furthermore, it is important that this is done in a transparent and cost efficient manner. VPE have concerns that the introduction of menu regulation for SEMO unnecessarily complicates the regulatory process, is somewhat misplaced in its objective, and in conjunction with other proposed regulatory mechanisms may create perverse incentives for SEMO in carrying out their duties in the market. As such it may be alarming to market participants if SEMO opted for a 'riskier' option. The integrity of the SEM should be first and foremost in such considerations and where possible unnecessary complexity should be avoided.

## **4. Conclusion**

The introduction of a three year price control for SEMO is welcomed. SEMO have proven capable of prudent budgetary management to date, albeit under different regulatory principles, and have delivered high quality output and service to market participants. However, it is important that this service is provided transparently and at a reasonable and justifiable level, wherein advantage is taken of productivity and efficiency gains, such that the integrity of the SEM is not compromised.

Based on the limited information provided, VPE does not consider that the proposals put forward by SEMO for CAPEX and OPEX indicate the principles of cost minimisation and maximisation of efficiencies and productivity gains which are imperative in today's environment.

VPE notes the significant increase in proposed SEMO tariffs to apply from October 1, as this is primarily due to the change in accounting rules for CAPEX it is important that this change is in the best interests of market participants and customers, and that it adheres to the RAs regulatory principles. As noted, if future investment is not stable and/or at a low level, this is unlikely to be the case and as such merits further consideration. The CAPEX costs submitted, as well as those proposed, appear to contain a number of excessively high costs and apparent synergetic opportunities, based on our own experience.

On OPEX, the introduction of RPI-X is seen to have merit but it is considered more appropriate to utilise the mechanism rather than set X equal to zero and to manually adjust forecast expenditure for the three years of the control. Notwithstanding this point, VPE agree with many of the disallowance and reductions applied by the RAs in relation to OPEX. Benchmarking these costs against our own business costs, many of the submitted costs appear to have been excessive. VPE further consider the introduction of X at 3% for costs (excluding payroll costs) to enable more efficiencies and productivity gains to be achieved.

VPE welcomes the introduction of two new KPI measures and for the opportunity for KPIs to act as incentives to continued good service through the introduction of quarterly thresholds. Measures that reflect the accuracy and timeliness of outputs are relevant and appropriate in this instance.

Taking the different changes to the regulatory regime within which SEMO operates separately, these all appear to be reasonable proposals. However, there is a degree of concern in relation to how these different regulatory regimes and structures will interact and the resulting incentive structure. We urge the RAs to consider this fully and to assess the need for additional complexity in relation to the regulation of SEMO.