



SEMO Revenue and Tariffs
October 2010 – September 2013

Response to the Consultation Paper
3rd September 2010

EXECUTIVE SUMMARY

The Regulatory Authorities has published proposals for the introduction of a three year multi-annual incentive based revenue control for SEMO. This is a welcome development which should ultimately lead to a reduced regulatory burden and lower costs for consumers.

SEMO also welcome the endorsement of the underlying resourcing complement within the business, which has developed under close regulatory scrutiny over the past three years and which has been deemed appropriate going forward.

Page | 2

This response, in two parts, supports the papers submitted to the Regulatory Authorities (RA's) on 16th March and 1st April 2010.

The consultation has introduced new ideas to the regulatory debate; some of these such as the use of Menu Regulation and revealed preference techniques have some merit; others such as the provision of capital up front, we believe do not. In summary SEMO believes the traditional RAB based approach to the treatment of capital investment should continue. This will be elaborated further in this response.

This response outlines SEMO's concerns in relation to four key aspects of the consultation proposal:

1. The proposed treatment of **capex as opex**.
2. The proposal in respect of the **disallowance of pension deficit** costs.
3. The Regulatory Authorities have **proposal to disallow corporate services** charges
4. The **proposed reduction in operating costs**.

The proposed treatment of **capex as opex** will give rise to higher, not lower, costs for participants, has poor incentive properties and introduces a rate shock to participants for each of the 3 years of the price control.

We argue that were the proposal to ultimately be adopted provision must be made for deadweight tax losses and the proposed penalties removed as the absence of underlying return means an inability to finance the tax costs or the penalties. It would also eliminate the capacity to raise finance for periodic major capital investment programmes. This will ultimately cost more.

The proposal in respect of the **disallowance of pension deficit** costs is at variance with standard regulatory practice and does not take account of the circumstances in which the pension deficit attributable to EirGrid and SONI, SEMO's parents, arose.

That a regulated business whose very genesis and structure has been influenced by previous regulatory decisions, and which have been subject to inherited pension deficits, should be assessed as if a new entrant is simply not tenable. Such an approach would see the SEM Committee at variance with practice across the UK and further afield.

The Regulatory Authorities have proposed the **disallowance of corporate services** charges; these are necessary services to enable the business to fulfil its licenced functions. They are provided at a lower cost level than would be the case if SEMO had to hire additional specialist staff or procure these services from a third party provider.

Page | 3

A decision to not provide for cross allocation of costs as a matter of course when the revenues associated with such cross charging were, and will be, included as income by EirGrid TSO and SONI TSO in their own submissions does little to encourage the identification of synergies or the most efficient form of service provision between EirGrid and SONI's licensed activities. It is also at variance with the licence provisions which require no cross subsidy between licencees today. Allowance of the cross charges will not give rise to double recovery.

Limited evidence is provided to support the **proposed reduction in operating costs**. The proposal does not take into account previously imposed efficiencies and the degree to which SEMO's costs will be influenced by future trends in the wider economy; if left unaltered this will impact SEMO's ability to carry out its activities.

The imposition of further significant efficiencies, without substantive justification, not only results in worrying regulatory precedent, but will also limit the ability of SEMO to deliver the high quality market services industry has come to expect of it at a time of significant change and market development.

The final determination should address these four aspects. Much has been achieved by SEMO in a short period of time since its establishment. This price control, if it makes adequate provision for these issues, will represent the platform for the next stage in that journey.

The format of the response is in two parts:

- [Part 1](#) identifies the four key issues and relevant principles
- [Part 2](#) provides a specific response to the proposals within the consultation paper.

CONTENTS

Executive Summary 2

Part 1

Introduction..... 7

Form of Regulation 9

Principles of Incentive Based Regulation9

Incentivisation and Savings11

Treatment of Capex as Opex 12

Incentives for Capex/Opex Tradeoffs12

Cost to Consumers12

Increased Tax Burden13

Ability to pay Penalties and Incentive Design13

Additional Issues with the Proposed Treatment of Capex.....14

Capital Allowance14

Introduction of Unwarranted Efficiencies14

An Appropriately Designed Menu15

Treatment of Major Market Capex – The Impact of Operational Gearing15

Conclusion – Treatment of Capex as Opex16

Treatment of Pensions and Pension Deficits 17

Regulatory Precedent for Treatment of Pensions17

Specific Context in the Case of EirGrid and SONI.....18

Conclusion in Relation to Treatment of Pensions20

Principle in Relation to Treatment of Group Costs..... 21

Introduction21

Basis of SEMO Establishment21

Allocation of Costs22

A Reasonable Basis for Regulatory Provision.....22

Conclusion23

Sustainable Operating Costs..... 24

Introduction24

Determination of Payroll Proposals.....24

Baseline Costs in Line with Market24

Efficient Payroll Costs Going Forward (Real Price Effect).....26

Conclusion in Relation to Payroll Proposals.....27

Treatment of Other Opex Categories27

Conclusion in relation to Treatment of Other Opex Categories28

Part 2

Introduction..... 30

Regulatory Framework 31

Form of Regulation31

SEMO’s Response31

Indexation31

SEMO’s Response31

K Factor33

SEMO’s Response33

Operational Expenditure	34
Baseline (54 Staff).....	34
SEMO's Response	34
Payroll	34
SEMO's Response	34
Pension Deficit Contribution	35
SEMO's Response	35
Use of Contractors.....	35
SEMO's Response	35
Additional Resource	36
SEMO's Response	36
Real Price Effect.....	36
SEMO's Response	36
IT and Telecommunications.....	36
Facilities.....	37
SEMO's Response	37
Professional Fees.....	37
SEMO's Response	37
General and Administrative Costs	37
SEMO's Response	37
Corporate Services	38
SEMO's Response	38
Miscellaneous.....	40
Capital Expenditure	41
Menu Regulation Vs Single Allowance.....	41
SEMO Response.....	41
Penalty Risk	42
Incentivisation Caveats.....	42
Efficiency Stretch of 5%	42
Cost of Capital.....	43
WACC	43
SEMO's Response	43
Depreciation.....	43
SEMO's Response	43
Incentivisation	44
Key Performance Indicators (KPIs)	44
SEMO's Response	44
Opex Savings	44
SEMO's Response	44
IT Release Support Incentive	44
SEMO's Response	44
Biannual IT Release Support Capex	45
Appendix 1 Oxera Paper	46
Appendix 2 – Stylised Example of Tax Lost to the System.....	51
Appendix 3: Calculation of 2010/2011 Baseline.....	53

Part 1

Regulatory Principles and Key Issues

INTRODUCTION

The role of SEMO over the past three years has been to settle the market arrangements and processes and to ensure the efficient operation of the electricity market. . It has also adopted agreed modifications to the Trading & Settlement Code in a timely cost effective manner. In less than three years since “go-live”, SEMO has delivered greater reliability, enhanced service and greater functionality in line with the evolving market needs.

Page | 7

Looking forward, SEMO needs to be able to continue to meet the evolving needs of industry and consumers, and indeed to be able to respond adequately to the Regulatory Authorities' own plans. SEMO will drive these developments over the next three years, and potentially well beyond, in order to provide the market with a well maintained operating system capable of providing for the future developments of the market.

SEMO made a comprehensive submission on the March 16th and April 1st and has continued to engage with the RAs in the timeframe up to the consultation period. SEMO remains of the view that the level of information and the questionnaire responses submitted in March and April reflect a proposal which would ensure an efficient Price Control provision for the next three years.

Having operated under three pass-through controls, SEMO welcomes the move to a multi-annual incentive based revenue control. *Ex ante* revenue cap regulation provides incentives for the regulated business to efficiently manage costs and improve services to the ultimate benefit of customers.

However, SEMO has a number of fundamental concerns with the Regulatory Authorities' consultation paper. Certain elements of SEMO's required revenue are proposed to be disallowed without adequate justification; this will be to the detriment of the services which SEMO can provide to its customers. In addition, while SEMO welcomes the move to incentive based regulation, the detailed design being proposed by the RAs effectively removes the incentives for SEMO to seek out efficiencies and will fail to provide for a sustainable longer term financeable business. In particular:

1. The proposed treatment of **capex as opex**; it will give rise to higher, not lower, costs for participants and has poor incentive properties.
2. The proposal in respect of the **disallowance of pension deficit** costs is at variance with standard regulatory practice and does not take account of the circumstances in which the pension deficit attributable to EirGrid and SONI, SEMO's parents, arose.
3. The Regulatory Authorities have proposed the **disallowance of corporate services** charges; these are necessary services to enable the business to fulfil its licensed functions and are provided on a lower cost level than would be the case if SEMO had

to hire additional specialist staff or procure these services from a third party provider.

4. Limited evidence is provided to support the proposed **reduction in operating costs**. The proposal does not take into account previously imposed efficiencies and the degree to which it will be influenced by future trends in the wider economy; if left unaltered this will impact SEMO's ability to carry out its activities.

Page | 8

The following section discusses the form of regulation and design principles that should be applied in moving to an incentive-based control. The remainder of this section then provides further detail and evidence in support of SEMO's position in relation to the above key concerns.

FORM OF REGULATION

PRINCIPLES OF INCENTIVE BASED REGULATION

The Regulatory Authorities are proposing a move from cost pass-through regulation to a three year incentive regime. Incentives have ultimately been shown elsewhere to deliver benefits to customers and SEMO welcomes the move to greater incentivisation through the introduction of a revenue cap mechanism. *Ex ante* revenue cap regulation provides incentives for the regulated business to efficiently manage costs while also ensuring that any benefits will ultimately be shared with customers.

Page | 9

The move to incentive based regulation involves a revised approach to regulation which should ultimately reduce both the regulatory burden and the costs of regulation; whereas cost pass-through is about the monitoring of costs incurred, incentive regulation is about the allowance of efficient revenues taking into account the risks to which the business is exposed. The incentive then acts in place of the regulator to impose commercial discipline upon the regulated entity in its operation. Through the sharing of savings, efficiencies are incentivised and consumers will ultimately receive the efficient level of services and face efficient costs.

However, SEMO has some concerns regarding the proposed application of the incentive based revenue-cap mechanism. In particular:

- Revenue cap regulation is premised upon the power of the incentive to deliver benefit to consumers. The Regulators are proposing that savings resulting from mis-forecasting will be clawed back. Forecast risks to both the regulated entity and consumers are a feature of *ex ante* regulation. This will undermine the incentive and it is ultimately the consumer who will lose out.
- A regulated business should have the ability and incentive to most efficiently and flexibly allocate expenditure, whether capex or opex, in response to changing circumstances. Conditions have been proposed by the Regulatory Authorities that will not allow SEMO to operate flexibly or to make capex/opex trade-offs.
- Efficiency targets need to be set at a realistic level, recognising the efficiency measures introduced to date. The Regulatory Authorities proposals are not substantiated.

The issues in relation to the flexible allocation of expenditure and the setting of efficiency targets are discussed as part of subsequent sections.

In summary the proposed treatment as opex will:

- Unnecessarily increase the volatility of the tariff
- Directly increase costs as compared to the previous capital recovery mechanism
- Has tax and finance cost implications for SEMO that have not properly recognized in the consultation paper and
- Introduces inequity in investment between existing and new participants (i.e. existing participants will pay for investments that newer participants will enjoy for free).
- This will eliminate any incentive for a rational investor to provide capital for the core SEM systems.

INCENTIVISATION AND SAVINGS

Incentives only work well to the degree there is a common understanding as to their application between the regulator and the regulated business. If there is uncertainty in relation to the application of incentives, including the way savings will be treated, then this affects not only the period in question but the degree to which the incentive will be meaningful in future periods.

Page | 11

One such concern relates to the insertion of a principle within the incentive framework that any benefits associated with mis-forecasting will be clawed back. It appears this is proposed to be introduced in an asymmetric fashion with no indication that where the costs are mis-forecast resulting in loss that an adjustment is proposed to be made.

In the standard incentive model, adopted by regulators with success elsewhere, the allowable revenues for the business are well codified in accordance with the licencing and legislative framework pertaining. In the case of under spend the business can retain the savings. If the business overspends due to forecasting error, then this is generally expected to be absorbed by the business consistent with preserving the incentive for the company to efficiently manage costs.

Ex ante revenue cap regulation is premised upon the power of the incentive to deliver benefit to consumers. If that incentive is undermined then it is ultimately the consumer who will lose out. It is therefore important that the principle of the retention of savings is not undermined. The imposition of conditions upon the use of the revenues provided, particularly when introduced in an asymmetric fashion such as in the case of the non retention of benefits which the Regulatory Authorities may, at its discretion, determine ex post represented 'mis-forecasting' does precisely that. This condition should therefore be amended or removed from the final determination.

TREATMENT OF CAPEX AS OPEX

One of the more significant proposals contained within the Regulatory Authorities consultation paper is to provide for capital expended in the year of incurrence. This approach has been proposed on the basis that it provides the appropriate incentive for the business to make capex and opex tradeoffs, to identify the most efficient overall solution and that it is deemed to be ultimately cheaper for customers in the long run.

Page | 12

There are a number of reasons why these objectives will not be achieved under the Regulatory Authorities' proposals and a number of disadvantages which have not been articulated in the paper. The remainder of this section discusses these issues. SEMO engaged OXERA to provide advice in relation to the proposed treatment of capex. The OXERA paper is attached as an [Appendix 1](#).

INCENTIVES FOR CAPEX/OPEX TRADEOFFS

SEMO understands the thinking behind the objective to incentivise efficient capex and opex trade-offs; indeed achieving incentive regimes which overcome the distinction in treatment between opex and capex has been a goal of economic regulators for some time.

However, the proposal put forward in this paper will not provide incentives for efficient trade-offs. This is because conditions have been placed around capex delivery that will not allow trade-offs to be made including conditions in respect of the delivery of each of the capex projects. Therefore, the incentive created by removing the distinction between capex and opex is fundamentally distorted. Oxera addresses this in their paper under the area of High Level Outputs versus Individual Projects whereby they argue a 'project by project application can create distorted incentives if there is a certain amount of substitutability between projects' or 'if SEMO decide to drop a Capex project in exchange for increasing Opex'. SEMO has further outlined its concerns in this regard in the previous section on the Form of Regulation.

COST TO CONSUMERS

In relation to the Regulatory Authorities' objective of a regime that is cheaper for consumers in the long run, the analysis is overly simplistic. It fails to take account of the degree to which future revenue streams are both discounted in terms of their value to consumers today and, indeed the degree to which they are incurred by different consumers. If the customers' discount rate equals the level of return on capital provided then the cost of both

regimes in NPV terms are the same; if customers' discount rates exceed the rate of return provided then the smoothing of tariffs through capitalisation is not only more equitable inter-generationally but also cheaper in NPV terms. The WACC proposed is consistent with, or perhaps below, that used elsewhere to measure society's discount rate.¹ Therefore the NPV cost of the capitalised approach is the same, or lower, than on an 'as incurred' basis and the benefit is nonexistent.

INCREASED TAX BURDEN

In addition, the proposal will bring about an increased tax burden, due to the misalignment of the regulatory accounting and taxation treatment, and thereby the proposal would in fact be *more expensive* for consumers in the long run.

In particular, while the Regulatory Authorities proposes to provide for the cost of capital investment up front, the associated capital allowances can only be recognised on a phased basis. Effectively, giving the full provision in revenue terms boosts up front profits, giving rise to a tax liability which may not subsequently be recoverable as taxable losses can only be carried back one year, thereby giving rise to the problem of the additional tax payable in the year of regulatory allowance being "trapped" and not recoverable in future years. By means of a stylised example we show that the associated deadweight loss to the system to be of the order of 10% of the capital which will be expended over the period of the Price Control. Neither SEMO, nor its parents, could accept the imposition of this approach without recognition of the associated taxation costs. These costs would be unnecessarily incurred and on the capex proposed in the three year period would amount to an additional c.€1m cost to consumers. A stylised example is attached as [Appendix 2](#).

ABILITY TO PAY PENALTIES AND INCENTIVE DESIGN

Equally concerning for consumers will be the poor incentive properties which will result. It is not possible for an investor to accept the current regulatory proposals whereby, with a risk of capex overspend, a penalty is payable and costs are unrecovered, while at the same time being provided no underlying return for the capital expended. It is not clear in a model with an absence of other return from where the money to pay such penalties is supposed to be

¹ E.g. the 6% real rate which has traditionally been assumed in the HMT Green Book <http://www.hm-treasury.gov.uk>

derived. Classical regulatory incentive models would see companies which perform poorly experience lower returns to equity holders. This is something SEMO and its parents could accept. However, how equity holders would fund a penalty when no underlying return is provided for is unexplained. Therefore the model, even were it to be adjusted for the tax loss discussed above, could not be accepted by SEMO, or its parents, in its current form.

A more standard regulatory model, which sought to incentivise better performance through the application of higher returns and to penalise poor performance through lower effective returns, is not only tried and tested but provides the appropriate incentive to deliver benefits which are ultimately shared with customers.

Page | 14

ADDITIONAL ISSUES WITH THE PROPOSED TREATMENT OF CAPEX

The issues outlined above represent the most fundamental flaws with the Regulatory Authorities' proposals in relation to the treatment of capex. However there are a number of further flaws in that the model fails to recognise:

- the intra generational effects on consumers,
- the reduced financeability in future years as a result of higher operational gearing and;
- the ensuing volatility in tariffs.

CAPITAL ALLOWANCE

INTRODUCTION OF UNWARRANTED EFFICIENCIES

The consultation paper applies an entirely unwarranted and unjustified 5% efficiency stretch in respect of the capex proposals. This is introduced without basis. Indeed the reduction is all the more unwarranted in that SEMO submitted its costs on the assumption of a cost pass through basis for tariff purposes only. No incentive would therefore have existed for SEMO to seek to overstate the expected costs of these projects. Indeed, the estimate which may be appropriate for the purposes of inclusion in a regulatory revenue cap ought to be weighted by the probabilistic set of outcomes and reflect the ability of the business, while still operating efficiently, to absorb downside risk while still remaining financeable. It is likely this is higher than a simple best cost estimate. An allowance should be provided consistent

with the risk profile to which it is ultimately determined SEMO be exposed and consistent with 17 business cases submitted.

AN APPROPRIATELY DESIGNED MENU

SEMO does not have an issue with the introduction of revealed preference techniques such as Menu Regulation where the menus are appropriately designed and represent a reasonable balance of risks and rewards.

Page | 15

SEMO would therefore propose the Menu be recast as a more traditional RAB based approach with a choice to be exercised by SEMO as to the degree of risk and reward which it is ultimately prepared to accept.

TREATMENT OF MAJOR MARKET CAPEX – THE IMPACT OF OPERATIONAL GEARING

The precise treatment of Major Market Capex and its recovery is not detailed in the consultation paper. However, it is likely given its scale, and the resultant volatility in tariffs which would ensue were it to be recovered in the year of incurrence, that it would require to be capitalised and recovered with the application of a rate of return over a number of years. However, the ongoing absence of a sustained balance sheet to support this would render such an approach almost untenable at that time, or at a cost of financing associated with much lower assumed credit ratings than traditionally the case for regulated businesses given the inability of an asset thin business to meet traditional credit rating tests.

Effectively the introduction of this approach significantly increases the Operational Gearing of the business with implications for the costs of both working capital today and further longer term funding in the future. The absence of an underlying regulatory equity return effectively wipes out the business's ability to deal with adverse circumstances and unexpected shocks, yet without the provision of a margin or other working capital provision. This is not a sustainable business model. These points are further elaborated in the accompanying Oxera paper.

CONCLUSION – TREATMENT OF CAPEX AS OPEX

- *The proposed treatment of capex as opex, whether in the case of single offering, or by way of Menu would not have an ability to fund penalties in the case of overspend and has poor incentive properties. A RAB based approach for the treatment of capital investment should be maintained.*
- *Any baseline should be assessed against the costs submitted by SEMO rather than against the unjustified removal of 5% under the guise of an efficiency stretch.*
- *SEMO does not have an issue with the introduction of Menu Regulation or other Revealed Preference techniques but these should be based upon application of traditional rate of return. Moreover, while the proposed approach would increase operational gearing and make the financing of future capital expenditure difficult, the application of a RAB based return will mitigate this and help both Regulators meet their underlying financeability obligations.*

TREATMENT OF PENSIONS AND PENSION DEFICITS

The second significant issue of principle within the Regulatory Authorities consultation paper is the proposed disallowance of the costs of pension deficit repair of €201,000 per annum. The rationale given is that:

The RAs are of the view that the revenue requirement for OPEX should be set at the level that would be possible for a new entrant to undertake SEMO's operational duties. Any costs in excess of that required by an efficient notional company should be borne by SEMO's shareholder

Page | 17

SEMO would contend that the proposed approach is not appropriate in that:

- It is not in accord with regulatory practice elsewhere, including both the Competition Commission's recent findings, and NIAUR's own practice;
- It has not considered the specific circumstances under which the deficit of SEMO's parent companies, EirGrid and SONI, arose.

REGULATORY PRECEDENT FOR TREATMENT OF PENSIONS

There is widespread regulatory precedent for the provision of pension deficit repair costs in the recoverable revenues of regulated businesses; effectively as these deficits arose from past decisions by the regulator, or its antecedents, to allow less revenue be recovered than was ultimately required to enable the company to meet its pension liabilities²; customers in the past paid too little for the service which was provided (benchmarked in whatever manner pertained at the time), and customers today must make good the shortfall.

Ofgem in particular has considered this issue in some detail and has in place a set of Pensions Principles. Essentially the Ofgem pension principles provide for only the efficient costs of the business being allowable going forward (no specific differential treatment of pensions from anything else) but full revenue recovery by the regulated business of deficit related contributions. Any gains, or losses, relative to assumptions in relation to pension deficits are to the account of customers. The logic extends to the treatment of future deficit in that if customers had only ever paid for efficient level of costs in the past then, if external assumptions change that a deficit arises, customers, through no fault of their own paid too little and must make good the shortfall. The converse holds in the case of surplus. These principles were reviewed, consulted upon and applied by Ofgem in the case of DPCR5.

² Which may themselves have changed due to exogenous factors such as change in average earnings or mortality assumptions.

It is also useful to look at other precedent. The findings of the Competition Commission (CC) are particularly relevant as the CC represents the ultimate recourse in relation to any disagreement in respect of the findings of a Price Control in the UK. The recent CC decision in relation to Bristol Water which appealed its control effectively determined that the Ofwat approach was not appropriate. Specifically, the CC found that 100% of the deficit repair should be provided for as this is necessary to enable Bristol Water to fulfill its statutory duties and given that the matter is effectively outside of its current control; effectively “past employment costs were understated and this understatement must be corrected for the company to meet its contractual obligations to employees and pensioners; we acknowledge there is an inevitable inter generational transfer of costs from past customers to current and future customers”. The CC also finds that the allowance for ongoing costs “should be the actual cash which has been agreed to be paid” and that “contributions in future years will depend upon the agreement with the Trustees”³ This effectively sets the current context to UK regulatory decisions.

Moreover, NIAUR itself has always provided for pension deficit repair in the context of regulated businesses, including in the case of the SONI TSO licensee. This proposal therefore marks a radical departure in approach. While the issue of pensions is raised in the context of the Strategy Paper on RP5, the fifth NIE T&D control, it is not in the context of disallowance but rather seeking views on the appropriate length of the recovery period and the impact on gearing and financeability.

Therefore, while the precise treatment among regulators differs in the detail there is effectively universal acceptance of the basis for pension deficit recovery. That this proposed decision is at variance with this, including variance with NIAUR's own approach and the CC's own findings as recently as of June 2010, is therefore surprising.

SPECIFIC CONTEXT IN THE CASE OF EIRGRID AND SONI

There are no SEMO specific employees with all employees being contracted to either EirGrid plc. or SONI Ltd. This was the basis upon which the market was set up and the basis upon which the licences were granted. In both case the licences to operate the Single Electricity Market replaced market functions which had been carried out by EirGrid and SONI pre SEM. The principle that a regulated business whose very genesis and structure has been influenced by previous regulatory decisions should be assessed as a notionally efficient new

³ http://www.competition-commission.org.uk/inquiries/ref2010/bristol/pdf/pfs_for_publication.PDF

(pages 64-68)

entrant is simply not tenable. This does not reflect the accepted basis the industry in either Ireland or Northern Ireland is regulated.

The consultation paper does not take into account the basis upon which the deficit in respect of both companies has arisen. In the case of EirGrid plc, the deficit was almost entirely inherited by EirGrid upon the transfer of ESB employees in accordance with the arrangements as set out in SI 445 (2000). This is a deficit over which it neither had, nor has, any significant degree of control. Indeed EirGrid appealed the scale of liability upon vesting but it was ultimately found that the approach, however unfavourable, was that in accordance with the legislative arrangements pertaining. The deficit, while small relative to other utilities, is large relative to the EirGrid balance sheet. It is therefore imperative it be addressed. An appropriate proportion must be allocated to the Market Operator licensee in accordance with the underlying licence arrangements which prevent cross subsidy.

Page | 19

In the case of SONI Ltd. the deficit relates to employment contracts entered into historically and prior to the closure of the Defined Benefit scheme. Indeed many of these pre-date even the original vesting and privatisation of NIE in the early 1990s. Such employment contracts are protected under the legal arrangements entered into at that time. The current beneficial owner of SONI Ltd., EirGrid plc., is not at liberty to alter them; this indeed was a pre-condition of divestment as was the requirement that matching arrangements to those which had pertained were put in place. The decision to divest SONI from Viridian was one which was made in the wider public policy interest to increase its perceived independence given its pivotal role in both System Operation as well as operator of the SEM. The SONI licences which potential purchasers were offered included a specific provision that the pensions costs would be treated as an excluded cost; this had always been the case and is consistent with the regulatory precedent from elsewhere, including the recent decision from the Competition Commission, outlined above. To seek to alter this at this juncture would simply not be a tenable position. In making provision for these costs for SONI Ltd., it is proper that an appropriate allocation be apportioned to the Market Operator thus being in accordance with the provisions relating to cross subsidy within the licences.

CONCLUSION IN RELATION TO TREATMENT OF PENSIONS

- *The approach proposed is both at variance with standard regulatory practice and takes no account of the circumstances under which the deficit attributable to SEMO, in respect of both EirGrid and SONI, arose. The paragraph which suggests this should be removed.*
- *Moreover the pension deficit contributions sought in respect of both licencees should be provided for. However, to the extent it is proposed they will be dealt with elsewhere we would seek, at a minimum, a statement to that effect and an assurance that any arrangements ultimately agreed will be reflected from the commencement of the SEMO Revenue control period.*

PRINCIPLE IN RELATION TO TREATMENT OF GROUP COSTS

INTRODUCTION

The third area of important principle with which SEMO has issue in the consultation paper relates to the complete disallowance of group services charges. The Regulatory Authorities have failed to provide for the €300k per annum of corporate services charges submitted by SEMO as part of the 2010-13 revenue control process. This is despite allowances having been made in previous years and the fact that there is no other direct provision of the services concerned – corporate governance support, internal audit, treasury management, human resource management, payroll administration or procurement services – in the underlying allowance proposed. These are necessary services to enable the business to fulfill its licenced functions. It is not a tenable position that the costs associated with their provision are not provided. These services and capabilities must be included in the SEMO business model if we are to adhere to the high standard of corporate governance and financial control expected by all stakeholders. The alternative to procuring these services from the parents, EirGrid and SONI, would be for SONI to hire additional specialist staff or to appoint external service providers. The costs associated with such an alternative would be considerably higher than the €300k submitted for by SEMO.

Page | 21

BASIS OF SEMO ESTABLISHMENT

SEMO has been established as a Contractual Joint Venture between EirGrid plc. and SONI Ltd. There are no SEMO staff, with all staff employed either by EirGrid or SONI; the majority of staff employed directly in the SEMO business do, however, come under a SEMO management structure reporting to the general manager of SEMO. There are, however, a number of instances where both EirGrid and SONI are able to manage their businesses both more efficiently, and to ensure a common application of standards across the board, through the centralised provision of group service functions. Such an approach exists in respect of Human Resource and Payroll services, Procurement, Group Financial Reporting, Internal and External Audit, Regulatory and Legal Support and Facilities Management. The costs associated with the provision of these services are charged out to the relevant business units. That these services are sourced from within the Group structure does not make them any less legitimate in terms of the necessary conduct of the business activity.

Moreover, there has been a requirement to strengthen group functions following the EirGrid acquisition of SONI and with the wider scope and increased level of activity.

Additional directors were appointed to the EirGrid Board, and the nature of a group of businesses meant enhanced group finance and legal functions.

ALLOCATION OF COSTS

All the licences under which EirGrid and SONI operate require an appropriate allocation of costs to ensure no cross subsidisation between businesses exist. Moreover both regulators within the SEM Committee have an underlying obligation to ensure licencees can finance their activities. It is reasonable that the regulator provide that each licensed entity is capable of financing its functions as if it operated on a standalone basis; to provide for more than this would potentially be to do customers a dis-service; to provide for less could mean customers pay less than an efficient price for the services perceived and could be interpreted as the regulator taking a stance on the merits of a particular corporate structure. In the case of SEMO it is not a single licenced entity but two separate licencees.

Page | 22

As outlined above there are a number of areas where the current structure of SEMO is such that it is entirely reliant upon its two parents for service provision.

An example of this is in the area of banking relationships and Treasury management. The basis of SEMO's establishment was that it was not permitted to separately enter into banking relationships or to independently raise borrowings; consequently it was not resourced to do so. All funding for SEMO is originated and managed by the treasury team in EirGrid. This includes the funding of capital investment and working capital as well as the standby facilities for unbudgeted constraint costs. This activity requires specialist staff and also the incurrence from time to time of significant legal and advisory fees. These costs are included in the overall management and governance charges allocated to SEMO.

Human resource and payroll provision is further example. As the SEM Committee is aware no specific human resource provision is made under the direct SEMO organisational structure and SEMO sources human resource support and payroll services from both parents. Further examples are outlined in [Part 2 Corporate Services](#).

A REASONABLE BASIS FOR REGULATORY PROVISION

A charge of €300k per annum to the two MO licencees for the services listed above represents the approximate cost of 3-4 FTEs once overheads and other costs are taken into account. The recovery allowed by the Regulatory Authorities should only be less than this if it believes the services can all be procured for both licencees operating on a standalone basis for less than the cost of 3-4 FTEs. That is less than 2 FTEs per licencee to cover:

- The necessary corporate governance support in line with good governance procedures including oversight from independent directors,
- internal audit functions consistent with the requirements for a €2bn plus market,
- human resource and payroll services associated with the recruitment of staff of the order of magnitude of turnover SEMO has experienced,
- services to ensure compliance with procurement guidelines and to secure value for money through competitive tendering.
- specialist treasury, regulatory and legal support services.

If, however, the cost of acquiring all such services on a stand-alone basis for both licencees would either equate to, or exceed, the current basis of group service charging then the Regulatory Authorities should provide this cost.

This is the principle which should apply, and the lens against which an assessment should be made. Moreover SEMO would like to dispel any notion that this somehow represents an approach of 'double counting'. The associated revenue streams were explicitly assumed in the making of the EirGrid TSO submission as they will be in the forthcoming SONI TSO submission. To not provide for the revenue here, while the very same revenues have been assumed as income elsewhere to the other licencees, has the potential to give rise to non recovery of the costs of services necessary to the conduct of the business.

We contend that the cost on a standalone basis for the two licencees would be significantly in excess of the current charge out rate. To that extent customers are receiving a direct benefit by virtue of the corporate structure in place. It could be argued that this benefit should accrue to the shareholders in EirGrid plc. and SONI Ltd., at least in the first instance, and in accordance with the normal principles of incentive based regulation under which the Regulatory Authorities operates. However, both SEMO, and its parent companies, are happy that the revenue allowance be provided upon the basis sought.

CONCLUSION

- *The €300k per annum sought in respect of corporate services should be provided; it represents a significantly lower cost to customers than that which would be necessary were the two MO licencees to operate on a standalone basis.*

SUSTAINABLE OPERATING COSTS

INTRODUCTION

SEMO has achieved a considerable amount in less than three years since 'go live'. It now commands the trust and support of the industry and is seen as a deliverer of high quality market services. SEMO has been subject to significant regulatory scrutiny to ensure that the costs which it has been provided on a pass through basis have been efficiently incurred.

Page | 24

The Regulatory Authorities have suggested significant additional efficiencies are achievable by SEMO in the forthcoming three year period, 2010-13. However, these proposals are not substantiated. They are based upon the results of benchmarking exercises which find that SEMO is in line with market against any margin of error. They are also overly predicated upon the costs incurred year to date without recognition that these are both lumpy in their incurrence and will evolve going forward. The proposals also do not recognise that significant additional efficiencies were imposed upon SEMO last year when a 2% real payroll allowance reduction was introduced on the justification that this was 'in line with trends' when in fact significant real wage spikes were recorded across the economy⁴.

SEMO made its submission on the basis of an efficient resourcing model; seeking costs associated with permanent headcount where this represented the best option; seeking additional contractors where the work was either short term, unpredictable or specialised in nature.

DETERMINATION OF PAYROLL PROPOSALS

BASELINE COSTS IN LINE WITH MARKET

In considering the appropriateness of SEMO's payroll costs, the Regulatory Authorities commissioned research from a number of consultants. However, the analysis presented to justify the proposal is limited and the relationship between the analysis and proposal is less than transparent, as set out below.

⁴ CSO Statistics (2010) – Earnings and Labour Costs recorded a 1% nominal, or over 5% real, hourly labour cost increase in 2009. Ref.

-
- Regarding the PWC report it is not clear how large a sample size was taken to reach its conclusion. It is likely that the result is within any margin of error making it difficult to draw conclusions. Nonetheless this indicates, if anything, that SEMO is more than prudent in its payroll expenditure.
 - A comparison is made between SEMO and Elexon, the Balancing and Settlement Code Company for Great Britain, by Lane Clark and Peacock (LCP). As mentioned by the Authority a direct comparison of payroll costs between just two companies raises statistical significance difficulties. In addition to this the overall LCP approach also has a number of omissions. An important principle is that costs specific to a jurisdiction are respected in any comparative study. A Purchase Power Parity (PPP) and standard of living adjustment is required to be undertaken. The analysis presented solely focuses on the impact of a varying market exchange rate between Euro and Sterling. It presents the impact a number of different exchange rate scenarios have. It is clear that the rate at a particular point in time will be influential.
 - Indeed the exchange rate is now materially different from that assumed in the LCP report. As of 25th August 2010 it stood at £1:€1.227. This is an increase of 6.7% in the strength of the Sterling, a significant development. If the latest rate is used, the comparison establishes that SEMO had the same level, or less than, of Elexon payroll costs.
 - The “Bottom Up” approach undertaken by LCP is also limited. It is inconsistent in its jurisdictional data sources, disciplines and perhaps overly focused at the starting salary level. While the Brightwater Salary Survey has data for both jurisdictions its wide variety of disciplines without benchmark to specific experience of competencies, restricts its validity. The Engineers Ireland survey is solely based on employment in Ireland and there are questions over its reliability. The CER have themselves raised this concern⁵ in the TAO and TSO draft Price Control determination (CER/10/102). Finally the Graduates Survey is only focused on starting salaries. The 7% conclusion based on the above evidence is within the margin of error of such surveys, a point acknowledged by LCP, and to draw conclusive outcome from it is unjustifiable.
 - More worrying perhaps than the limited analysis undertaken is the disconnect between the studies' findings and the conclusion drawn in the proposal. A range of 7% to 14.26% reduction in payroll allowance is given. However, this is not supported by the studies.

⁵ “...the results of this comparison should be treated with caution as the Engineer Ireland data is a small sample of self reported data and may not be wholly representative.”

The evidence provided does not indicate that further efficiencies are required to bring SEMO in line with market. Indeed that significant efficiencies relative to market movements were placed upon SEMO last year. This is effectively the findings of the various surveys undertaken by Regulatory Authorities.

EFFICIENT PAYROLL COSTS GOING FORWARD (REAL PRICE EFFECT)

In addition to the baseline, the Regulatory Authorities should provide for an evolution of allowed revenues that reflect the costs of business going forward.

The Regulatory Authorities employs the ESRI's *Quarterly Economic Commentary* citing their forecast of a nominal decrease in wages in 2009 and 2010. It is asserted a reasoned forecast is needed for 2011 before further consideration can be given to the requirement for a Real Price Effect. The ESRI has recently published its Recovery Scenarios for Ireland which forecast wage growth of between 2.2% and 2.4% per annum over the 2011-15 period. This provides such a forecast but one which has been overlooked by the Regulatory Authorities in its findings.

Indeed, the Regulatory Authorities acknowledge that the energy sector which is largely international in nature, remains buoyant and demand remains high for trained and experienced staff. It has, however, not taken its own views into account in setting out its proposals both in terms of baseline and trend. The effect outlined in the paper whereby it is asserted that this buoyancy will translate into greater labour supply intake to the sector is a long term effect and does little to counter the shorter term labour supply inelasticity, i.e. over the three year period, which is the consideration of this control.

The Regulatory Authorities appear to accept that if allowance is not made for staff progression that there will inevitably be a high degree of turnover. While some staff turnover is healthy SEMO does not share the Regulatory Authorities view that aiming for high level of turnover is "beneficial". Indeed the specialised and critical nature of the SEMO roles mean significant resources must be expended not only on recruitment but also the requisite training before analysts are able to perform the functions. Even following this, a wealth of experience which had been built up had it been possible to retain staff will be lost. These are not costs which were built into the SEMO submission. Note the only costs submitted for in relation to Human Resources in order to carry out this recruitment under Corporate Services are proposed to be disallowed.

Finally, the Regulatory Authorities has not taken into account recent regulatory precedent which recognises operating costs in even efficient regulated businesses rise more rapidly than underlying price inflation (Ofgem: RPI+1.2%; ORR: RPI +0.75% and OPFA: RPI + 0.8%). There is consensus among regulators in the UK that a 'real price effect' exists which is based on; expected Input Cost Inflation *less* expected Sector Specific Productivity *less* Forecast

General Inflation. It is important to consider these factors when determining how costs will adapt over time in real terms.

SEMO does recognise that these are difficult times in which to make long range forecasts. However it is critical that SEMO has an appropriate operating cost allowance over the three year period to effectively undertake its activities.

CONCLUSION IN RELATION TO PAYROLL PROPOSALS

The various surveys conducted by the Regulatory Authorities are indicative evidence at best. However, the evidence that they provide is that SEMO is in line with market norms within the two jurisdictions in which it operates. There is therefore no justification for the imposition of further unexplained efficiencies in relation to the payroll provisions and, indeed, there is a disconnect between the surveys and the proposed 7% - 14.26% reduction. Especially recognising the significant real efficiencies imposed last year no reduction is justified.

Looking forward, the allowed revenues need to take into account the views of economic forecasters in relation to the economy in general, the buoyancy of the energy sector internationally as acknowledged in the consultation paper, and the recognition as evidenced by regulatory precedent elsewhere that labour intensive activities increase in cost more rapidly than general price inflation. The imposition of general price inflation therefore in and of itself imposes a hidden efficiency.

It is important that SEMO is adequately resourced to meet the needs of industry. SEMO proposed the use of contractors where the resource requirement was either short term, unpredictable or specialised in nature. However, no provision has been made for this despite the increased workload which is expected as a result of the Regulatory Authorities own work programme and to support a significant business development capital programme. There is therefore an inconsistency in the Regulatory Authorities paper which should be removed and the additional contractor resource provided for.

TREATMENT OF OTHER OPEX CATEGORIES

The section above has focused upon the payroll proposals as the most significant opex category in terms of scale. Equally concerning is the proposal to not provide for approximately €2.5m of other operating costs, a significant sum in the context of the SEMO operation. For example, in the area of professional fees where a paper and substantive

excel spreadsheet was provided by SEMO, the Regulatory Authorities analysis is reduced to an excerpt from the SEMO submission followed by a regulatory proposal.

In the case of the third party warranty, support and maintenance cost arrangements a reduction of over €950k is proposed despite the figures which were submitted for being less than the previous regulatory allowance and based upon a simple extrapolation of the year to date figures. SEMO has explained that the costs are by their very nature lumpy in their occurrence.

Page | 28

See [Opex Section in Part 2](#) of this document (Proposal 4 to 14) for information on the specific cost categories.

CONCLUSION IN RELATION TO TREATMENT OF OTHER OPEX CATEGORIES

The reduction of more than €2.5m when compared to forecast will impinge upon SEMO's ability to carry on its activities.

The reduction of over €950k in relation to IT support and warranty costs in particular gives cause for concern and would be likely to expose the SEM systems, and therefore the SEM participants, to unnecessary system risk.

Part 2

Response

to the proposals contained in

**The SEMO Revenue and Tariffs
Consultation Paper**

INTRODUCTION

Part 2 of this submission provides specific response to the RA's set of proposals.

It should be noted that the market has operated successfully since November 2007 which is a testament to SEMO's commitment to deliver a high quality service to the ultimate benefit of participants and consumers. This has been acknowledged in the SEM Committee's annual reports to date. SEMO remains committed to this standard of performance and to adding further value as the Market continues to develop.

It must be recognised that the Market Operator business continues to grow and evolve and is not as described in the RA's response "the corresponding workload for SEMO would be expected to decrease". The Day1+ Project and the need for the creation of bi-annual IT Releases continuing into 2012 is direct evidence of the continued growth of the market. Further changes in policy areas such as renewables integration, Market Coupling, Intra Day Trading and Global Aggregation must all be recognised as a significant development of the Market.

REGULATORY FRAMEWORK

For the three regulatory framework proposals SEMO has provided the following responses.

FORM OF REGULATION

RAs PROPOSAL 1: SEMO'S OPEX TO BE REGULATED UNDER RPI-X FRAMEWORK AND REVENUE CAP REGIME FOR CAPEX

Page | 31

SEMO'S RESPONSE

See Part 1 [Principles of Incentive Based Regulation](#) and SEMO response to [RA's proposal 19](#).

INDEXATION

RAs PROPOSAL 2: SEMO'S ALLOWANCE TO BE CORRECT BY THE OUT-TURN INFLATION FIGURE.

SEMO'S RESPONSE

For each of the SEMO Price Controls to date, the process in determining Payroll has been on a certain standard format, taking the baseline from the previous determined allowance and adjusting upwards/downwards for inflation, real payroll cuts and any additional headcount.

The baseline used in the 2010-2013 consultation paper is not picking up the agreed SEMO payroll baseline figure from the SEMO Revenue and Tariffs for October 2009 to September 2010 Decision Paper. The corrected baseline figures are set out below.

2009/2010 DETERMINED BASELINE

The SEMO payroll baseline figure as determined in the 2009/2010 RA decision paper is as follows:

The Table below summarizes the SEM Committee decision on SEMO's payroll:

Payroll Allowance	SEMO's Allowance for the Current PC (March 08 Prices)	SEMO's Allowance for the Current PC (March 09 Prices) -2.07%	SEMO's Proposed Allowance for the Next Price Control (March 09 Prices)	RAs Decision in March 09 Prices (- 2% Payroll)	RAs Decision in March 10 Prices (- 2.5%)
Payroll	€ 4,032,000.00	€ 3,948,537.60	€ 3,948,537.60	€ 3,869,566.85	€ 3,772,827.68
Expanded Payroll (New Encuring Obligations)			€ 258,000.00	€ 258,000.00	€ 251,550.00
NWA paid in April 2008			€ 81,000.00	€ 81,000.00	€ 78,975.00
Total Cost	€ 4,032,000.00	€ 3,948,537.60	€ 4,287,537.60	€ 4,208,566.85	€ 4,103,352.68
Average Cost per Head for 51 employees				€ 82,520.92	€ 80,457.90
2 New Resources (2 x Average)				€ 165,041.84	€ 160,915.79
Total Expanded Cost				€ 4,373,608.69	€ 4,264,268.47

Table: 2009/2010 Determined Baseline

DECISION 2

The allowed budget for Payroll will be **€4,264,268 (March 2010 Prices)**

It in turn was based on the 2008/2009 baseline as adjusted for inflation to bring the prices to mid 2009 and then to forecast prices to mid 2010. A forecasted inflation rate of minus 2.5% was used to bring the baseline from mid 2009 prices to forecasted mid 2010 prices. In addition a real cut of 2% was applied to the payroll allowances.

2010/2011 BASELINE

In order to determine the 2010/2011 baseline, the payroll allowance for 2009/2010 needs to be corrected for the actual inflation outturn. The payroll allowance for 2009/2010 was €4,264,268 which includes a forecasted inflation figure of minus 2.5%. Adding back this forecasted inflation figure gives an allowance of €4,373,608.

The actual outturn inflation for the 12 months to March 2010 is minus 1.2%⁶. Adjusting the €4,373,608 above for actual inflation of minus 1.2% to March 2010 gives an allowance of €4,320,032. This is for an approved headcount of 53 people giving an average payroll cost of €81,510.

⁶ Blended of minus -3.1% CPI and +4.4% RPI

In addition to this an additional two headcount were approved by the RA's in November 2009 giving an additional €163,020 ($€81,510 * 2$). Also the RA's propose approving one extra headcount for 2010-2013 giving an additional €81,510.

The corrected baseline payroll allowance for 2010/2011 is therefore €4,564,562 ($€4,320,032 + €163,020 + €81,510$).

The RA's then propose to reduce the baseline by 7% over 3 years, 1.1% for year 1, which gives a proposed payroll allowance for 2010/2011 of €4,514,351. Page | 33

All the above calculations are also included in [Appendix 3](#).

K FACTOR

RAS PROPOSAL 3: K-FACTOR TO COMPARE RECOVERY OF REVENUE TO THE REVENUE ALLOWANCE AND NOT ACTUAL EXPENDITURE.

SEMO'S RESPONSE

SEMO agrees with the K Factor proposal for the recovery of revenue. As per the RA's consultation paper, the K Factor calculation should include two proposed caveats as follows:

- Any foreign exchange gains or losses will form part of the K Factor calculations as a cost pass through element
- Interest on funding from the parent companies will also form part of the K factor calculations as a cost pass through element

OPERATIONAL EXPENDITURE**BASELINE (54 STAFF)****RAS PROPOSAL 4: ALLOW THE CURRENT BASELINE OF 54 STAFF**

Page | 34

SEMO'S RESPONSE

SEMO support this proposal however, it should be acknowledged that SEMO require the flexibility to use contract staff. This allows SEMO to best use staff resources, bringing efficiencies and cost awareness to its payroll costs. The need for such flexibility is required to address the considerable future demands of the forward work program facing SEMO during the development of the SEM.

PAYROLL**RAS PROPOSAL 5: THE TOTAL PAYROLL ALLOWANCE TO BE REDUCED IN THE RANGE BETWEEN 7% AND 14.26% (5% PER YEAR) OVER 3 YEARS.**

The Payroll proposals contained within the Revenue Submission paper will impact on the service levels SEMO currently offer. The Regulators make the point that the market is stabilizing and market change is less frequent. SEMO would contend that volume and complexity of significant design changes is increasing rather than decreasing and that SEMO are at risk of not being able to discharge fully its Market Operator obligations as outlined in the Trading and Settlement Code.

SEMO'S RESPONSE

In determining the RAs proposal for Payroll benchmark the Authority commissioned research from a number of consultants. However, the analysis presented to justify the proposal is limited. In addition, the relationship between the analysis and the proposal is less than transparent (see [Part 1 Determination of Payroll Proposals](#)).

The reductions are suggested without recognising the significant downward adjustments in Payroll costs in the previous Regulatory price control. In last year's determination in addition to a 2% real cut and a 2½ percent deflationary adjustment was also made. The net effect of this was a 4½% reduction to the Payroll allowance year on year. This proposal also does not recognize the non application of the National Wage Agreement (3.75% saving) in previous years. The application of the proposed range of payroll reductions can only result

in reduced availability of resources and a consequential detrimental service impact on participants.

PENSION DEFICIT CONTRIBUTION

RAS PROPOSAL 6: DISALLOW THE INCREASED PENSION FUND PAYMENTS

Page | 35

SEMO'S RESPONSE

See [Part 1 Treatment of Pensions and Pension Deficits](#).

USE OF CONTRACTORS

RAS PROPOSAL 7: DISALLOW THE PROPOSED INCREASED USE OF CONTRACTORS

SEMO'S RESPONSE

The proposal states that:

the need for contractors decreases rather than increases and the pace of change and the corresponding workload for SEMO would be expected to decrease

SEMO would have issue with both these statements. SEMO's approach in its Revenue Submission was not to seek additional permanent resources and to supplement any additional resource requirements on a contractual basis. SEMO considered that this was a prudent approach that gave SEMO the flexibility to resource projects as and when the need arose and in the longer term would reduce costs as there would be no associated pension, payroll or training costs. This flexibility allows SEMO recruit specialist contract services and optimise the timing and utilisation of these services (e.g. testing resources a month before a release) and that the increased use of contractors is both prudent and justifiable.

The RAs also state that SEMO are entering a period of market design stability. SEMO contends that there are now a significant number of Working Groups and the scale of proposed Intra Day Trading solution and other Regional Integration Developments (Forward Explicit Auctions, Day Ahead Coupling, SO to SO Trades, Capacity Payments etc.) is material. SEMO will be charged with assessing fundamental and significant developments throughout the duration of the price control.

SEMO therefore advises that proposal 7 would seriously impact the capacity of SEMO to deliver the scope of market changes required in a timely and efficient manner.

ADDITIONAL RESOURCE

RAS PROPOSAL 8: THE RAS ARE OF THE VIEW THAT THIS IS A REASONABLE REQUIREMENT AND ARE MINDED TO APPROVE.

SEMO'S RESPONSE

SEMO welcome the Regulators proposal to provide SEMO with an additional resource.

Page | 36

REAL PRICE EFFECT

RAS PROPOSAL 9: NO "REAL PRICE EFFECT"

SEMO'S RESPONSE

See [Part 1 Efficient Payroll Costs Going Forward \(Real Price Effect\)](#).

IT AND TELECOMMUNICATIONS

RAS PROPOSAL 10: SEMO'S TELECOMMUNICATIONS PROPOSED BUDGETS BE ALLOWED BUT THAT WARRANTY, SUPPORT AND MAINTENANCE BE LIMITED TO 1,600, 1,800 AND 1,800 IN YEARS 1, 2 AND 3 RESPECTIVELY.

Note that SEMO's original proposal has been revised upwards based on the Capital projects SEMO intend to implement (see details on spreadsheet submitted June 16th). The estimate total Warranty and Support Deficit is approximately €947k.

SEMO maintains a very large hardware portfolio (currently in excess of 120 servers), has considerable data storage obligations and supports high capacity communications links. The Warranty Support and Maintenance costs requested are required and SEMO are concerned that the risk of not providing these services is significant to participants.

Warranty Support and Maintenance Allowance	Year 1	Year 2	Year 3	Total
SEMO's Proposal	€1,820,000	€2,157,000	€2,170,000	
RAs Proposal	€1,600,000	€1,800,000	€1,800,000	
Deficit	€220,000	€357,000	€370,000	€947,000

FACILITIES**RAS PROPOSAL 11: SEMO'S PROPOSED BUDGET FOR FACILITIES TO BE ALLOWED.**

SEMO'S RESPONSE

SEMO welcomes this. SEMO's proposals were below that allowed last year and will therefore deliver increased value for money to consumers.

Page | 37

PROFESSIONAL FEES**RAS PROPOSAL 12: SEMO TO BE ALLOWED A BUDGET OF €640K PER YEAR FOR PROFESSIONAL FEES.**

SEMO'S RESPONSE

SEMO contend that the proposed amount of €640k will not be sufficient for SEMO to develop and implement a number of new projects currently under consideration within the Forward Work Program. SEMO are concerned that due to the unique nature of the services required to deliver the range of projects the proposed allowance will be insufficient. It is relevant to note that €250k to 300k of this budget is for the Market Audit and approximately 140k is for the various Market Forums (Mods meetings, Working Groups, MOUGs etc.) Recruitment, Disputes, and Legal advice for participants. This leaves SEMO approximately €200k per annum for direct professional services which SEMO contend is inadequate based on the volumes and complexity of the work that SEMO are about to engage in (Intra Day Trading, Regional Integration etc.).

GENERAL AND ADMINISTRATIVE COSTS**RAS PROPOSAL 13: THE RAS PROPOSE THAT SEMO BE ALLOWED A BUDGET FOR GENERAL AND ADMINISTRATIVE COSTS OF €275K PER YEAR.**

SEMO'S RESPONSE

General and Administration costs cover headings such as bank charges, training and travel and subsistence. Bank charges are increasing due to volumes not decreasing. As mentioned elsewhere SEMO has a high level of turnover, 28% since this time last year. This fact means that sufficient allowance for training new staff members is needed in order to maintain the level of service and discharge of SEMO functions. Travel and subsistence predominantly covers the cost of SEMO staff travelling between both sites. A 25% cut in the SEMO

proposal for General and Administration costs and will negatively impact SEMO's ability to function adequately.

CORPORATE SERVICES

RAS PROPOSAL 14: SEMO'S PROPOSED BUDGET OF €300K PER YEAR FOR CORPORATE SERVICES TO BE DISALLOWED.

Page | 38

SEMO'S RESPONSE

Corporate Services are essential to SEMO as they include ongoing support and specialist services that SEMO require. SEMO maintain that it is significantly more efficient to source these services from the EirGrid Group and that to do so provides good value for market participants and consumers. The Corporate Service cost of €300k is readily justifiable (See Part 1 [Principle in Relation to Treatment of Group Costs](#)) and in addition a breakdown of specific costs is detailed below.

RECRUITMENT

Independent external recruitment agency costs are generally in the region of 30 to 40% of the annual salary of the person to be employed. Using the lower figure of 30% and using SEMO's current 28% staff turnover along with staff numbers of 54 and average payroll cost of 80k the following derived cost can be achieved.

Thirty Percent of €57k = €17k

28% of 54 Staff = 15 staff members

Total Recruitment Agency cost = €17k multiplied by 15 = €255k.

SEMO are seeking €80k recruitment costs.

PROCUREMENT

Procurement services ensure compliance with that national and EU public procurement regulations. They also ensure that goods and services are procured by SEMO on an efficient cost competitive basis. SEMO do not have the necessary expertise in this area. Rather than hire additional specialist staff or use a third party procurement advisor it is deemed more cost-effective to instead use the of the EirGrid Procurement Department. SEMO have used this procurement services to:

- Conduct tender competitions and manage the purchase order and vendor payment cycle. Examples of recent tenders include:
 - Upgrade of the SEMO Website and
 - Nomination of a Legal Firm to provide specialist legal advice to the Modifications Committee.

SEMO would contend that the procurement costs of the website were in the region of €70k and the identification of the Legal firm cost approximately €10k. SEMO are seeking €40k on an annual basis for the provision of these specialist procurement services.

CORPORATE GOVERNANCE

Governance for SEMO is provided by a Governing Committee made up of two senior executives drawn from both from EirGrid and from SEMO. This is deemed more efficient than appointing independent directors at additional cost. The committee is very active and meets approximately 18 times a year and the total cost charged by the parents in this regard is €50k.

TRAINING

SEMO provide training to staff in courses such as Written and Verbal Communication, Analysing and Problem Solving and Organising work and Achieving Objectives. These courses are generally one day courses which cost in the region of €300 per course. SEMO staff also attends approximately two of these courses per year. The total cost to SEMO would be in the region of €32,400 (2 courses * €300 * 54 staff). SEMO are seeking €20k for the provision of these services.

PAYROLL SERVICES

All payroll administration for SEM is provided by EirGrid and by SONI. A Payroll run cost approximately €35 per staff member. With a headcount of 54 people the annual Payroll costs are approximately €22,680 (€35 * 54 staff * 12 months). SEMO avail of these services for €10k per annum.

FINANCIAL/LEGAL ADVICE

All treasury services for SEMO are provided by EirGrid treasury. This includes fund-raising for capital expenditure, working capital and stand-by facilities for constraints. Associated with these activities significant legal and advisory fees arise on a periodic basis. Costs also arise in relation to financial reporting and external audit services. SEMO are charged approximately €60k for these services.

INTERNAL AUDITS

SEMO are audited internally up to five times a year. The approximate cost per audit is €10k. Total approximate total cost is €50k SEMO are seeking €25k.

MISCELLANEOUS

SEMO business avails of PR, Health and Safety, Staff support services etc. from EirGrid. This cost is approximately €15k per annum.

CAPITAL EXPENDITURE

The RAs are proposing two options for the determination of the CAPEX allowance and the incentive rate: a 'single offer' (whereby the RAs would set the allowance on the basis of their baseline estimate of efficient CAPEX, and SEMO would retain 50% of any under- or overspend); or 'menu regulation' (whereby the RAs would invite SEMO to 'bid' an allowance against the baseline and would set the incentive rate accordingly).

Page | 41

MENU REGULATION VS SINGLE ALLOWANCE

RAS PROPOSAL 15: THE RAS WELCOME VIEW FROM MARKET PARTICIPANTS PRIOR TO THE DETERMINATION OF THE CAPEX ALLOWANCE

SEMO RESPONSE

Menu Regulation was introduced in the UK by Ofgem in 2004. It consists of a Menu of rewards/penalties which regulated business can choose from. It is designed to deliver reduced capital spending so commercial organizations can retain a reward. The long term risk is that these organizations will under invest in capital just to achieve a financial reward.

The Menu consists of the following variables:

- A **baseline** figure – the Regulators view of a company's capital expenditure requirements.
- A **business plan** - outlining the company's projected expenditure.
- An **efficiency incentive rate** – is the rate at which companies' outperformance or underperformance in terms of their allowed expenditure is rewarded or penalised.
- An **allowed expenditure** row
- An **additional income** – this is an adjustment factor, either positive or negative, used to ensure that companies submit a business plan that reflects their true potential cost reductions
- **Actual expenditure** – refers to the outturn costs incurred by companies and
- The **total reward/penalty** – is the amount that companies would earn beyond their economic costs.

The proposal made by the regulators does not reveal all these variables and as such SEMO feels the transparency of the proposed incentive is not fully clear.

PENALTY RISK

See Part 1 [Ability to pay Penalties and Incentive Design](#)

INCENTIVISATION CAVEATS

Page | 42

The proposed regulatory caveats outlined in section 10.6.3 are counter to standard Menu Regulation practice. There is no mention of SEMO being allowed to revise the baseline upwards if essential IT projects were identified. If additional projects were added it would be impossible for SEMO to finance these essential projects without a Rate of Return thus exposing participants to an unnecessary market risk.

There is a possibility that SEMO could deliver all the business benefits of three of the business cases by overspending on one of the capital projects. In this scenario SEMO could be penalised for spending inefficiently.

SEMO submitted its costs on a cost pass through basis. The 17 capital business cases were used to determine a suitable Capital Allowance for budgetary purposes only. SEMO are now concerned that figures provided in good faith as estimates are now being used as a basis for incentive regulation with possible significant downsides.

EFFICIENCY STRETCH OF 5%

In the Revenue Submission paper the Regulators quote:

*Based on the analysis of each CAPEX component the proposed CAPEX of € **11,180,000** is considered to be reasonable subject to an efficiency stretch of 5%. Therefore the RAs proposes that the baseline for controllable CAPEX to be set at € **10,621,000**.*

The regulators have not presented any justified argument for this 5% efficiency stretch and SEMO contend that the original figure of €11,180,000 should be reinstated as the IT Baseline for Menu Regulation.

See [Part 1 Introduction of Unwarranted Efficiencies](#).

COST OF CAPITAL

WACC

RAS PROPOSAL 16: USE THE PREVAILING BLENDED WACC FROM EIRGRID AND SONI. THE CURRENT BLEND RATE OF 3:1 TO BE APPLIED.

Page | 43

SEMO'S RESPONSE

SEMO agree with the WACC proposal for the blended rate.

DEPRECIATION

RAS PROPOSAL 17: KEEP THE CURRENT STRAIGHT LINE DEPRECIATION MECHANISMS.

SEMO'S RESPONSE

SEMO welcome the Depreciation proposals

INCENTIVISATION

KEY PERFORMANCE INDICATORS (KPIs)

RAS PROPOSAL 18: THE RAS WELCOME VIEW FROM MARKET PARTICIPANTS PRIOR TO THE DETERMINATION ON KPIs

Page | 44

SEMO'S RESPONSE

In Section 13.1.2 the Regulators propose:

Therefore the RAs proposes that the assumption 3 (first two weeks after a System Release) is removed.

In light of the opex proposals (cut in payroll and IT allowances and to disallow the increased use of contractors) SEMO believe that we are not in a position as yet to remove this caveat. SEMO maintain that the emphasis on the first two weeks after an IT release should be spent looking for defects or material errors and not trying to maintain a KPI. It should also be noted that participants through the MSDP consultation were in favor of longer and more rigorous testing which would require the use of specialist contracted resources.

OPEX SAVINGS

RAS PROPOSAL 19: RPI-X TO CORRECT SEMO'S OPEX ALLOWANCE ON ANNUAL BASIS (X=0). SEMO TO RETAIN THE SAVINGS AND BE LIABLE FOR ANY OVER EXPENDITURE ON OPEX.

SEMO'S RESPONSE

See [Part 1 Incentivisation and Savings](#).

IT RELEASE SUPPORT INCENTIVE

RAS PROPOSAL 20: NO PROVISION FOR IT RELEASE CAPEX INCENTIVE

SEMO'S RESPONSE

The releases are an important mechanism for delivering change to the market and timely delivery of scheduled releases ensures a co-ordinated and consistent industry wide approach to implementing change. The delivery of changes is a complex process involving all the risks associated with a project with numerous external and internal stakeholders. Incentivisation is a key mechanism to encourage SEMO to make every effort to meet and where possible exceed our obligations to deliver timely change to the market.

BIANNUAL IT RELEASE SUPPORT CAPEX

In section 10.5 the regulators quote

There is no historic evidence to date to support this allowance.

Note SEMO submitted to the Regulators evidence and corrections to this paragraph on June 16th and July 27th.

Remuneration and incentivisation of CAPEX

Note prepared for SEMO

August 27th 2010

1 Introduction

This note reviews the treatment of CAPEX proposed by the Commission for Energy Regulation (CER) and the Utility Regulator—hereafter referred to collectively as the ‘RAs’—in their consultation paper for SEMO's price control⁷. Apart from the specific CAPEX numbers, the proposals have the following main elements:

- to remunerate *new* CAPEX through a revenue cap—determined by the assumed level of CAPEX, rather than a revenue based on depreciation and rate of return;
- assessment and incentivisation of CAPEX through ‘menu’ regulation, similar to that practised by Ofgem and Ofwat in recent price reviews;
- monitoring and incentivisation of CAPEX outputs on an individual project basis, rather than on the basis of more high-level outputs.

Each of these proposals is assessed in turn, but our conclusions are, in brief, as follows.

- If the RAs are serious about incentivising CAPEX *and* about having SEMO as a financially viable stand-alone basis, then this requires SEMO to earn some sort of reasonable margin for ‘par’ performance—not having such a margin implies dispensing with either meaningful incentivisation or stand-alone financial viability in the longer term.
- Compared with the alternative proposed by the RAs (a ‘single regulatory offer’), menu regulation offers a more comprehensive set of incentives in respect of CAPEX itself and respect of information provision to regulators, albeit that the latter will not apply in this

⁷ Commission for Energy Regulation and Utility Regulator (2010), ‘Single Electricity Market – SEMO revenue and tariffs – October 2010 – September 2013 – Consultation paper’, August 6th, ref SEM-10-050

review to the extent that the menu mechanisms did not exist when the when the information was provided by the company.

- Incentivising companies to deliver high-level of outputs will deliver superior efficiency incentives, compared with a requirement to deliver individual projects.

2 The importance of a margin

Under SEMO's existing rate of return regime, new CAPEX is incorporated into the RAB and depreciated over five years while earning a return. The RAs are proposing that this regime should be replaced *for future investment* by a 'revenue cap'. Under the new regime, CAPEX would earn no margin and would, instead, be treated in the same way as OPEX—ie, remunerated on the basis of assumed costs to be incurred within the relevant period. In this approach, SEMO would earn a margin over its actual costs only to the extent that it out-performed the RAs' expectations on those costs, in respect of CAPEX as well as OPEX.

This is not an appropriate approach if the RAs intend to achieve the twin objectives of:

- giving strong efficiency incentives; *and*
- creating SEMO as a financially viable stand-alone entity in the longer term.

There is no doubt that the approach proposed by the RAs would achieve the first of these objectives. However, it would not achieve the second. Incentive regulation works as a 'discovery' process, searching out the efficient level of costs of delivering the required outputs. This may well mean—and, indeed, has meant for many regulated entities which have been exposed to incentive regulation for the first time—that significant improvements in efficiency are made for a period. During this period, a regulated entity may make a significant margin, even though the regime is premised on a margin only being earned through out-performance against a regulators' assessment of an efficient outcome—ie, there is no margin for barely efficient or 'par' performance.

Sooner or later, this process of dramatic efficiency improvement peters out and there is probably at least one review period of under-performance, as has happened with some of the GB electricity network operators, at least in respect of OPEX. At this point, companies in what the RAs would term a rate-of-return regime (but which GB regulators call a RPI-X regime) earn reduced margins.

For GB energy networks, this process has tended to work itself out for OPEX before CAPEX. This has probably been due, at least in part, to Ofgem only recently—in the last electricity distribution review, DPCR5—really specifying what outputs companies have to deliver. It has therefore been easier for companies to simply not deliver some of the outputs that they were *implicitly* intending to deliver. It is worth noting that the specification of high-level outputs is more difficult for, say, an energy network—where there may not be a simple *short-term* relationship between spend and outputs—than it would be for an organisation like SEMO. In other words, the high-level performance of a network—in terms of, for example, duration and frequency of customer interruptions—may not be worsened *in the short term* by not replacing assets. It might actually improve, not least because less of the network has had to be taken out for work on it and because new assets are often quite unreliable. SEMO's outputs would look to be both easier to specify and to link much more closely to the level of spend.

In sum, over a period of time, stand-alone financial viability—within the sort of revenue cap regime envisaged by the RAs—can only be achieved by continuous out-performance. This would not be sustainable. The only obvious example of such a regime being applied in GB would be the *external* short-term System Operator (SO) incentives which apply to National Grid⁸—and this has only been sustainable because the National Grid SO activities are not stand-alone businesses and can thus be supported by the rate-of-return regulated—to use the RAs' terminology—transmission network businesses (as well as the revenues derived from the *internal* SO incentives) as and when they make losses on their external incentives. It should be noted that National Grid's SO activities *do* earn a RAB-based margin on their 'internal' costs—and this is the obvious analogy with SEMO.

Given that the only sustainable form of incentive regulation for a stand-alone SEMO would be one which allowed a margin for par performance, there is then the question of how that margin should be set (in an *ex ante* sense). Allowing a rate of return on fixed assets is clearly not the only option and, indeed, is not even necessarily the appropriate option for relatively asset-light businesses. For example:

- Ofgem (previously Offer and Ofgas) used to allow margins of 0.5% to 1.5% on allowed costs for energy supply when electricity and gas supply were price-controlled activities;
- CER allows a margin of 1.3% on allowed costs in its price control for end-users.

3 Menu regulation versus single regulatory offer

The RAs consider two options for the form of incentivisation of CAPEX:

- a 'single regulatory offer', in which SEMO would be rewarded for out-performing a single level of CAPEX; and
- 'menu regulation', in which the incentive rate would depend on the degree of divergence between SEMO's estimate of its required CAPEX and the estimate made by the RAs.

In general, menu regulation offers a richer set of incentives than the single regulatory offer—including an incentive to be reasonable in forecasting CAPEX requirements (Ofgem's original name for the incentive was the Information Quality Incentive), as well as an incentive to be efficient in delivering the required outputs. It would therefore look to be preferable in principle.

It is worth noting that, because the menu was not in place before SEMO submitted its CAPEX forecast, any benefit in influencing that forecast has not been obtained in this review. That said, and as the RAs suggest in their consultation paper, the menu does have the significant advantage over the single regulatory offer in that the menu makes more allowance for the company and regulator having genuinely different views on the level of CAPEX required. Overall, the case for using the menu approach would seem to be strong, even in this review.

⁸ The external SO incentives apply to the services which National Grid buys to manage the system (e.g., costs of reserve, response and transmission constraints, as against the internal incentives which cover the costs of running control centres and related activities).

4 High-level outputs versus individual projects

In section 10.6.3 of their consultation paper, the RAs propose to monitor the delivery of CAPEX projects at the next price control review and claw back the revenues associated with any individual project that has not been delivered (a process sometimes termed 'shortfalling'). SEMO can substitute projects, but only with the RAs' approval.

The motivation for this mechanism is that SEMO should be rewarded for delivering agreed outputs at a lower cost than anticipated, but not for cutting on outputs delivery. In other words, SEMO is incentivised to outperform the 'unit cost' rather than the 'volume' of CAPEX projects.

Page | 49

While the motivation for this clause is understandable, a rigid project-by-project application can create distorted incentives if there is a certain amount of substitutability between projects (or some uncertainty with regard to output requirements). For example, suppose that, at some point during the price control period, SEMO finds a way of meeting its requirements in terms of data storage that involves spending an additional €50k on project 8 ('data warehouse') in exchange for cancelling project 7 ('data storage') and saving the associated costs of €100k.⁹ This new approach would enable SEMO to deliver the output valued by customers (security and reliability in data storage) at a lower cost than anticipated at the price control review. Under the proposed regime, however, the RAs would claw back the €100k saved on project 7 *and* would expose SEMO to 50% of the over-spend on project 8 under the single offer mechanism (or whatever the relevant incentive rate would under menu regulation). The result is that SEMO would actually be worse off for undertaking the substitution. A similar result could occur if SEMO decided to drop a CAPEX project in exchange for increasing OPEX.

In GB, the current regulatory stance is very much in the favour of setting high-level outputs and incentivising companies to find the most efficient way of delivering them, whether by project substitution, trading off OPEX against CAPEX or whatever. This has been one of the major themes of Ofgem's major review of incentive regulation, the 'RPI-X@20 project'.

A flavour of this approach can be gleaned from a recent open letter from Ofgem in relation to gas distribution network capacity incentives.

Our thinking on the setting of allowances has moved on significantly. DPCR5 signalled a movement away from allowances for specific types of expenditure, with the approach being instead to set an overall level of expenditure allowance in combination with a requirement to deliver a clear set of outputs over the price control period. This approach provides companies with the flexibility to determine the optimal expenditure solutions to deliver a defined set of outputs. It also involves ensuring that the rewards for outperforming the price control settlement are equalised across all types of expenditure. One of the recommendations of the RPI-X@20 review is to adopt and further develop this approach for future price controls.¹⁰

⁹ Project numbers and names relate to Table 21 of the consultation paper.

¹⁰ Ofgem (2010), 'Minded to position on Gas Distribution Network capacity outputs incentive 2013/14 and 2014/15', August 19th.

It is worth noting that, as remarked in section 2 above, the setting of high-level outputs for SEMO would look to be much more straightforward than for networks. It would thus make considerable sense for the RAs to move to this approach for the regulation of SEMO.

5 Summary of conclusions

In sum, and on the three issues discussed in this note, our conclusion is that:

- SEMO should be assumed to earn a margin for par efficiency performance on CAPEX, rather than only for out-performance;
- menu regulation should be preferred to the single regulatory offer; and
- the regulatory regime should be based on the delivery of high-level outputs, rather than the completion of specific projects.

APPENDIX 2 – STYLISED EXAMPLE OF TAX LOST TO THE SYSTEM

Outlined below is a stylised example assuming Capex of €100m per annum for each of three years where this represents the sole income stream. It illustrates how a change from the current application of a traditional RAB based approach for Capex to an approach which returns the Capex to the company in the year in question creates a systematic tax loss. This tax loss occurs due the divergence and inconsistency between the proposed new regulatory approach and that of the tax treatment of capital allowances.

With two different tax regimes and capital allowance treatments in place in the UK and the ROI, the example is divided for these jurisdictional differences and a total impact figure is then provided.

The total additional loss to the system due to this mismatch is in the order of 10%. While the numbers may differ in practice the underlying effect will be seen.

UK - 25% of assumed Capex (in millions) Year	1	2	3	4	5	6	7
Capital Allowance Carried Forward		€20.00	€36.00	€48.80	€39.04	€31.23	€24.99
Capex	€25.00	€25.00	€25.00				
Capital Allowance in Year	€5.00	€9.00	€12.20	€9.76	€7.81	€6.25	€5.00
Remaining Capital Allowances	€20.00	€36.00	€48.80	€39.04	€31.23	€24.99	€19.99
Taxable profits	€20.00	€16.00	€12.80	-€9.76	-€7.81	-€6.25	-€5.00
tax @ 28%	-€5.60	-€4.48	-€3.58	€2.73			
Loss to system (% = Tax paid/ Total Capex)	-14.57%						

ROI - 75% of assumed Capex							
Year	1	2	3	4	5	6	7
Capex	€75.00	€75.00	€75.00				
Capital Allowance	€9.38	€18.75	€28.13	€28.13	€28.13	€28.13	€28.13
Taxable profits	€65.63	€56.25	€46.88	-€28.13	-€28.13	-€28.13	-€28.13
tax @ 12.5%	-€8.20	-€7.03	-€5.86	€3.52			
Loss to system (% = Tax paid/ Total Capex)	-7.81%						

Total Loss	-9.50%
-------------------	---------------

Basis

- The Capital Allowance in the UK is formulated on a reducing balance basis at 20% of the Capex. For example Year 1 Capex = £100; Capital Allowance is £100 * 20% = £20. Year 2 Capex carried for allowance = £80; Capital Allowance is £80 * 20% = £16 etc.
- The Capital Allowance in the ROI is formulated on a straight line 8 year basis.
- Taxable losses are carried back one year as is currently provided for in the taxation treatment in both jurisdictions.
- The UK corporation tax rate used was 28%.
- The ROI corporation tax rate used was 12.5%.
- This example omits two effects
 - Proposal to reduce UK corporation tax on a phased basis. The lower tax rate will marginally reduce the loss. However, it will also reduce the value of the tax losses carried back, negating to some degree the lower tax rate benefit.
 - Proposal to reduce capital allowances from 20% to 18% in the UK. This will have the effect of increasing the tax liability. Indeed it will be more significant than the benefit gained from the reduction in the corporation tax rate.

APPENDIX 3: CALCULATION OF 2010/2011 BASELINE

				2010/2011 Allowance	2011/2012 Allowance	2012/2013 Allowance
2009/2010 Payroll Allowance				4,264,268		
Addback forecasted inflation	-2.50%			4,373,608		
Adjust for actual inflation	Note 1	-1.2%		4,320,032		
Corrected Baseline for 2010/2011				4,320,032		
Average				81,510		
Baseline for 2010/2011 as above				4,320,032		
Plus additional 2 approved by RA's in November 2009	2	81,510		163,020		
Plus one additional headcount for 2010-2013	1	81,510		81,510		
				<u>4,564,562</u>	4,564,562	4,514,351
					4,410,521	4,410,521
Less real cut in payroll allowance (% proposed by RAs)	-1.1%			-	50,210	
	-2.3%				-	103,830
	-2.3%					-
					-	101,442
Payroll Allowance for 2010 - 2013				<u>4,514,351</u>	<u>4,410,521</u>	<u>4,309,079</u>
				4,408,000	4,310,000	4,214,000
Note 1:						
	CPI	RPI	Blended			
Actual Outturn Inflation to March 2010	-3.10%	4.40%				
	0.75	0.25	-1.2%			