Airtricity Response to

Consultation on Consultation on Scope of Transmission & Distribution Price Review 3 (2011-2015)

CER/09/047

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Introduction

Airtricity welcomes the opportunity to respond to the Commission's consultation on the scope of the forthcoming PR3 revenue revue for the Distribution and Transmission businesses in Ireland. This is an important issue for stakeholders, given the pressing need for network investment to deliver Grid 25 in the context of current economic circumstances. The current consultation is particularly welcome as it gives stakeholders an opportunity to provide input before the process has gone too far to change course and we welcome this initiative.

As a user of the Irish electricity networks, both as supplier and as generator, Airtricity understands the need for infrastructure investment to be delivered in a manner that is both technically and economically efficient and our overriding concern for PR3 is that it should provide appropriate incentives for this to be achieved. While tariffing is not part of this review, we believe that work is also required to create charging structures that both incentivise efficient network usage and allow Suppliers straightforwardly to reflect this incentive in their pricing. We believe that transmission pricing in particular is unnecessarily complex and look forward to a future consultation on simplification.

Consistent methodology

We support the Commission's objective of using a common set of principles for the transmission and distribution business price controls where possible. We also believe continuity in price control methodology is important, both to avoid step changes in apparent revenue requirement and because the benefits and flaws of the current methodology are understood. In our comments we emphasise the need for incremental development of the methodology rather than abrupt change to accommodate new ideas.

Revenue categories

The proposed revenue categories represent continuity with earlier price controls and we do not see any need to introduce change for PR3. We fully support the Commission's objective of delivering value for money through this process and believe that use of international yardsticks will be an important aspect of the analysis and target-setting process. It is also important that the price control structure includes use of incentive mechanisms wherever possible, so that revenue is properly earned, rather than merely delivered automatically through an unchallenging formulae.

Within the defined revenue categories and methodologies, implementation of the review will be key. Our comments, while supportive of the Commission's general approach, emphasise issues we see as important within each area.

5-year review

On the basis of continuity and to provide a reasonable level of planning certainty, we support the Commission's intention to continue with the existing 5-year review period.

Use of CAPM

While we agree that the CAPM is the appropriate tool to guide setting of the WACC, it is important that it is used in a transparent manner and that supplementary tools, such as the dividend growth model and market return analysis, are used to check that the model is providing robust answers. In particular it should be clear how;

- the proxy cost of equity is to be derived in the absence of real shareholders,
- international utility comparators are used,
- adjustments are made for business scale and interest rate differentials, etc.

It is important that the progression from input data to final conclusion is presented in a way that maximises use of objective data. If current financial conditions persist into the review timescale, then it will also be important to define the treatment of any anomalies in the interest rate spread between official rates and the cost of borrowing.

CPI-X

We agree that CPI-X is a useful proxy for competition in driving business efficiency. However the basis on which the X factor is set must be as clear and objective as possible. Again, the choice of yardsticks for comparison, adjustments for business scale and customer density etc, needs to be made clear. The question of incentives is also very important within this revenue heading.

The source of expertise needed to deliver innovation in the design and operation of networks lies within ESB and Eirgrid, so the CPI-X revenue category must include discrete categories of incentive to drive change. For example, increasingly smart networks to manage the growing level of embedded generation. However the important point is that incentives should reward actual performance and not be capable of delivery by default.

Previous revenue reviews have offered incentive mechanisms and the current consultation considers the risks of networks making unacceptably high profits if the revenue review period is too long. However we are unclear as to how revenue earned by semi-state enterprises from delivery of performance targets is used in the absence of a shareholder structure. The revenue review must therefore ensure that the performance mechanism can incentivise state enterprises as effectively they would a private firm.

Valuation & depreciation

As network valuation and depreciation is the most significant revenue driver, it is important that a robust valuation methodology is applied and international yardsticks used to validate the valuation. If the result is found to be that insufficient revenue is delivered, then the makeup amount should be separately identified in the revenue formula and treated as a legacy adjustment line.

While network investment is essential to meet the needs of the changing portfolio of users, it is equally necessary for all proposed investments to be subject to a robust and expert challenge process; both as to investment necessity and cost. In particular there must be disincentives to engage in "gold plating" of required investment, perhaps by use of international cost yardsticks or use of asset replacement modelling. There must also be scope for including directed expenditure, for example in fully metering the Distribution network to improve measurement of losses and customer demand, to improve transparency and accuracy in the SEM.

Those who build connection assets (and hand them over to the networks businesses for minimal cost) believe that information on the nature and valuation of this asset group should be part of the standard published dataset. As part of PR3, there should be a consultation on the valuation, treatment and balance sheet benefits attributable to these assets and means whereby these could be retained by the investors repaying the associated debt.

We agree that use of average asset lives is a reasonable approach, as it aligns overall revenue with lifetime of the overall asset portfolio. As previously stated, this will aid transparency by highlighting issues requiring investigation, such as the cost impact of particular asset classes that diverge materially from average, and provide a value to determine the cost/benefit balance of an enhanced maintenance programme.

Summary

In summary, Airtricity supports the Commission's intention to utilise the methodologies used for PRs 1 and 2 for PR3. We believe that the basic approach is sound and provides for re-evaluation of revenue requirements without sacrificing continuity with existing revenue streams. The challenge of this revenue revue will be to deliver value for money. We believe this translates to a regulatory challenge to develop meaningful additional incentive mechanisms, within the established price control framework, and ensure these deliver in the context of semi-state enterprises.

Documentation published for the PR2 consultation was comprehensive and provided an accessible structure that enabled stakeholders to gain a good understanding of both process and revenue requirement. We look forward to the PR3 consultation building on this.