Financing of the SO Preferred Connection Method in Contestable Builds

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<th>DOCUMENT TYPE:</th>
<th>Decision Paper</th>
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<tr>
<td>REFERENCE:</td>
<td>CER/11/188</td>
</tr>
<tr>
<td>DATE PUBLISHED:</td>
<td>26 October 2011</td>
</tr>
<tr>
<td>QUERIES TO:</td>
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Abstract:

When the connection method specified by the Transmission System Operator (TSO) or Distribution System Operator (DSO) as System Operators (SOs), results in costs greater than the Least Cost Chargeable (LCC) or Least Cost Technically Acceptable (LCTA) Connection method, and such a connection is being built contestably, these extra costs may result in an additional financing burden on the Independent Power Producer (IPP).

In February 2011 the CER consulted (CER/11/027) on the financing of SO preferred connection method in contestable builds. CER/11/027(a) published alongside CER/11/207, set out the proposal from ESB Networks (TAO, DAO and DSO) and EirGrid (TSO) on how this issue would be addressed.

This paper outlines the CER’s decision on the matter.

Target Audience:

This decision paper is for the attention of members of the public, the energy industry, customers and all interested parties.

It will be of particular interest to project developers that are engaged-in or considering the development of contestable builds where the connection method preferred by the System Operator is more extensive or of higher specification - and hence of greater cost - than the Least Cost Technically Acceptable (LCTA) or Least Cost Chargeable (LCC) method.

Related Documents:

- CER/11/027 and CER/11/027(a) – CER consultation financing of SOs preferred connection method in contestable builds and SOs proposals.
- CER/10/085(g): Joint TSO and DSO Group Processing Approach - Charging and Rebating Principles.
- CER/10/056: Contestability for Distribution & Transmission Level Connections to the Electricity System.

Queries on this decision paper should be submitted to Jamie Burke (jburke@cer.ie) in the CER.
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1.0 Introduction

1.1 The Commission for Energy Regulation

The Commission for Energy Regulation (‘the CER’) is the independent body responsible for overseeing the regulation of Ireland’s electricity and gas sector’s. The CER was initially established and granted regulatory powers over the electricity market under the Electricity Regulation Act, 1999. The enactment of the Gas (Interim) (Regulation) Act, 2002 expanded the Commission’s jurisdiction to include regulation of the natural gas market, while the Energy (Miscellaneous Provisions) Act 2006 granted the CER additional powers in relation to gas and electricity safety.

The Electricity Regulation Amendment (SEM) Act 2007 outlined the CER’s functions in relation to the Single Electricity Market (SEM) for the island of Ireland. This market is regulated by the CER and the Northern Ireland Authority for Utility Regulation (NIAUR). The CER is working to ensure that consumers benefit from regulation and the introduction of competition in the energy sector.

1.2 Purpose of this paper

In February the CER, through CER/11/027 and CER/11/027(a) consulted with industry on the issue of financing issues faced by IPPs when choosing the ‘Contestable Build’ option, such as the higher level of borrowing required when financing cost for the extra capital raised.

This paper outlines the CER’s decision on the matter.

1.3 Background Information

When the connection method specified by the System Operator results in costs greater than the Least Cost Chargeable (LCC) or Least Cost Technically Acceptable (LCTA) Connection method, the additional capital and maintenance costs are ultimately borne by the End User. However, those extra costs may result in an additional financing burden over the course of the project on the Independent Power Producer (IPP) undertaking a contestable build.

Earlier this year ESB Networks Ltd, EirGrid and ESB – as DSO, TSO, DAO, TAO respectively - submitted to CER a proposal\(^1\) for the approval of arrangements on this matter. CER/11/027(a) noted there were two concerns that IPPs may have with regard to the extra costs identified, (i) a higher amount of borrowing is required and (ii) there is a financing cost for the extra capital raised.

The SOs proposed that to address (i) a clear written undertaking demonstrating the obligation of the Asset Owner to pay monies for the satisfactory completion of the

\(^1\) Please refer to CER/11/027(a)
relevant assets would provide comfort to financiers providing the additional capital funding. To address (ii) two financing options were proposed.

1.4 Queries to this paper

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2.0 Responses to CER/11/027 and CER/11/027(a)

In February the CER consulted (CER/11/027) on the financing of SO preferred connection method in contestable builds, i.e. over and above that required specifically by an IPP for its own connection to the grid. Essentially the issue revolves around when this specified ‘overbuild’ by the SO results in costs greater than the LCC or LCTA Connection method, and such a connection is being built contestably, such extra costs may result in an additional financing burden on the IPP.

CER/11/027a, published alongside CER/11/207 set out the proposal from EirGrid and ESB Networks on how this issue would be addressed. Two main aspects were discussed:

- The requirement to raise additional finance for the ‘overbuild’ - it was proposed that a clear written obligation would be provided setting out the obligation on the Asset Owner to pay monies for the satisfactory completion of the assets (using CER approved standard charges).
- Covering the costs of the additional finance – it was proposed that the IPP would receive a contribution consistent with the CER approved WACC against the assumed expenditure profile for the assets in question.

There were five responses received to the consultation:

- Coillte;
- ESB Wind Development;
- SSE Renewables;
- Viridian Power and Energy; and
- Viridian Power and Energy lenders.

EirGrid, ESB Networks Ltd. and ESB provided a response to the responses received post consultation.

The following section provides a summary of the responses received and the CER response to the themes advanced by respondents.

Higher Borrowing required

Most of the respondents favoured a position where the extra capital associated with this additional build is covered by the SOs on a staged basis, i.e. over the course of the project build as opposed to receiving the entire payment at project completion.

As one respondent noted, staged-payments “removes to a large extent the requirement to raise additional finance, and contrary to the EirGrid / ESB Networks statement that the UoS (Use of System) customer would see no increased financial commitment, it will in fact reduce the overall cost to the customer through a reduction
in interest carry cost. It also reduces a significant complexity from the developer’s financing”.
A number of the respondents questioned the assertion that there would be additional contractual complexity with introducing a staged-payments system.

**CER response**

The CER acknowledge the concerns of respondents that where a connection method specified by the SO results in costs greater than the LCC or LCTA connection method, and such a connection is being built contestably, these extra costs may result in an additional financing burden on the IPP. Basically, this ‘overbuild’ is an SO requirement, taking into account the benefit to all users, but placed on the IPP through no choice of its own. Staged payments would provide the IPP with a more positive cash-flow through the various steps to project completion.

However, as noted in CER/11/027 the CER must ensure that the UoS customer is not adversely affected in financial terms, which includes the additional risk of stranded assets where an IPP does not complete a project. The investment made by the UoS customer, through staged-payments made by the Asset Owner to the IPP, may be sunk without the delivery of the projected benefit. “From a due diligence point of view and a sustainably and effectively managed electricity system, EirGrid or ESB Networks would be unable to agree to operate or own an asset that has yet to completed, commissioned or declared fit”.

The CER can see both sides of the argument and acknowledges that there is no perfect solution to this matter. However, the decision outlined in section 3 below attempts to balance the interest of the UoS customer (financial neutrality between contestable and non-contestable build), with that of the IPP (project costs/completion and successful roll-out of Gate 3).

In relation to the comment that staged-payment reduce the overall cost to the customer through a reduction in interest carry cost, it should also be noted that the approach proposed would be NPV neutral regardless of whether staged-payments were introduced or not.

**Financing cost for the extra capital**

This was the second issue identified in CER/11/027(a), covering the costs of the additional finance that may be required by the IPPs to carry out overbuild.

Most of the respondents favoured a situation where payments to the IPP accurately reflect the additional financing costs which it will incur, i.e. it receives its actual cost of finance and not the regulated WACC proposed in CER/11/027(a).

One respondent believed that it is important that any form of payment, made to an IPP, is made on a consistent basis and applying a consistent methodology. Its
argument was that the regulated WACC figure, such as under the Price Review 3 process, represents such an approach. Furthermore, “the UoS customer should not be exposed to a specific banking arrangement of an IPP. The unique and customer specific debt facility arrangements agreed between an IPP and their financier is entirely a matter for those respective parties and is not in any way a matter for the UoS customer”.

**CER response**

As with the first issue, there are reasonable justifications in choosing either direction, i.e. for the cost of finance for overbuild to be paid on a vouched-basis or on the basis of the regulated WACC. Again there is no perfect solution which will meet the needs of all parties concerned.

In this case, however, the CER believes that the protection of the UoS customer is of paramount importance. The CER is of the opinion that the decision outlined in section 3 reflects this.

**Thresholds for no payments to IPPs**

Most of the respondents believed that the threshold should be removed altogether, “given that such costs would arise, not at the IPP’s discretion, but from the SOs specification of a connection method”. These respondents also believed that the threshold proposed (€1 million or 25% of the IPPs capital requirements) in CER/11/027(a) to be too high. If kept in place, one respondent proposed a threshold where the additional capital costs to exceed €0.25 million or 5% of IPPs connection capital requirements.

**CER response**

The CER are in agreement with the respondents who believe the original threshold in CER/11/027(a) to be too high. It is acknowledged that any requirements above LCTA are a financing burden for IPPs. In their submission the SOs acknowledged this point and proposed to reduce the threshold to where the additional capital costs to exceed €0.25 million or 5% of IPPs connection capital requirements.

The CER are in agreement with this position and this is discussed in the next section.
3.0 CER Decision

As noted above the decision outlined below attempts to balance the interest of the UoS customer (financial neutrality between contestable and non-contestable build), with that of the IPP (project completion and successful roll-out of Gate3). It also takes into account the concerns raised by ESB Networks and EirGrid during the consultation process in relation to the assurance that the UoS customer receives responsible protection in terms of risk and cost, and that any asset delivered under this process meets specifications and is fit for purpose.

The CER believe that the UoS customer should be largely unaffected by whether an IPP chooses a non-contestable or contestable connection. While the CER aims to encourage and facilitate contestable delivery of connection, it is still a choice for the IPP as to whether they will contest or not. In addition, an IPP will only contest if there is a benefit for that business in contesting, be it that they believe they can deliver the connection faster or cheaper than a connection built non-contestably.

On the other hand, the CER is aware that in delivering an SO preferred connection; the IPP is being asked to “overbuild”, i.e. built to a more expensive or larger connection than would be required if delivering the Least Cost Chargeable (LCC) build for their connection. This overbuild and the additional cost associated with it, in some cases may be the difference between the ability of an IPP to contest the connection or not. Therefore, in considering its decision on this matter, the CER is aiming to balance the objective to protect the UoS customer from any additional risk associated with IPP building of SO preferred connections and the objective to ensure that IPPs are facilitated in building these connections.

The level of risk for the UoS customer should also be broadly equivalent to that which occurs for a similar connection which is being provided non-contestably. All IPPs in a particular category are treated equally, and those that select a contestable connection should not be discriminated against.

After reviewing the submissions made to CER/11/027(a), and in consultation with our technical experts, the CER have made a decision in the following four areas:

- Stage payments;
- Standard or vouched costs for transmission build;
- Financing costs; and
- Threshold of the scheme.

Each of these is discussed in the sections below.
3.1 Stage payments

The CER acknowledge that whilst a few of the respondents did not specifically express a rejection of payment for overbuild at energisation, ignoring the consideration of staged-payments does not recognise the spirit of the consultation responses.

As part of their response the ESB Networks and EirGrid assert that there is a risk that the additional connection assets could become stranded if the connection (and presumably therefore the development) is abandoned. The CER acknowledges the SOs concern with regard to oversight, in particular from the Asset Owner who ultimately will be making the payment to the IPP for carrying out the overbuild works. In relation to transmission build the CER accepts that the TAO’s obligation in relation to direct lines is one of due diligence, as set out in Schedule 14 of the Infrastructure Agreement (IA):

“the Board shall not be required to assume ownership of any Direct Line unless the Parties shall:

(a) have carried out with due diligence an enquiry as to the technical specification and condition of the Direct Line, and as to any obligation or financial liability associated with the Direct Line; and

(b) each have satisfied itself as to the compatibility of the Direct Line with the Transmission System”.

However, under current contestable connections (for connection purposes only, i.e. not specifically for overbuild) the due diligence required on behalf of the UoS customer is carried out over the course of the project at particular stages. This is done primarily for practical reasons and in an effort to avoid problems where possible. The project is not finally signed off as being acceptable until it has been successfully commissioned.

The CER believe that for position set out by ESB Networks and EirGrid to be sustainable there would need to be a higher risk of stranding when the customer has decided to select a contestable connection. The CER does not believe this to be the case as doing so would be discriminatory toward contestable connections over non-contestable. Several of the respondents challenged this assertion concerning stranding and suggested that the likelihood of this is very low, one set out a number of reasons for this view. The CER and its technical consultants concluded that this was a convincing list of reasons, suggesting that such stranding is unlikely.

Therefore, the CER cannot support the view that such a risk in contestable connections means that staged-payments are inappropriate. Furthermore, EirGrid and particular ESB Networks believe that staged-payments will require them to ‘step back’ into the provision of the connection in a way that negates the contestable connection approach. This appears to be based on the assumption that the quality of the work would need to be checked before such stage payments are made.
However the design/specification of any contestable build undertaken by IPPs (whether specifically for connection purposes or overbuild) has to be approved by the SO. As noted above, for contestable connections (with no overbuild) due diligence required is carried out over the course of the project, at particular stages, to ensure specifications are being met.

The obligation to build to SO specifications is also built into the contract that the IPP signs with a third party contractor who delivers the infrastructure. At specific milestones during a contestable connection (with no overbuild) the process of due diligence is carried out as an advisory role, to ensure a better standard. However, this process is a pre-requisite to sign-off by the IPPs engineers and subsequent payment to the third party contractor. The CER considers that a similar system, where overbuild works are required, can be implemented. To be clear if SO specifications are not met, staged-payments to the IPP will not be made.

For further protection of the UoS customer from stranding, the CER has decided that the largest payment to the IPP for overbuild will only be made when the connection is fully commissioned. This should provide an adequate level of comfort, while minimising the possibility of stranded assets being left to the UoS customer.

The format of the staged-payment structure is now outlined. The Asset Owners will provide payments for works in excess of LCTA or LCC at particular stages which will be passed to the relevant SO who will then disburse this to the IPP. At the start of a project they will also provide to the relevant SO to provide to the IPP a clear written undertaking demonstrating their obligation to pay monies for the satisfactory completion of certain stages of build. This should provide comfort to financiers providing the additional capital funding to IPPs.

If required, provisions will be drafted in to the relevant connection agreement to facilitate sign-off by the SO and AO at each milestone. The CER does not believe this process to be complex or administratively burdensome.

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<th>Level of staged payment</th>
<th>SO/AO sign-off required for payment</th>
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<td>At completion of civil works.</td>
<td>20% of expected standard charges &gt; LCTA or LCC.</td>
<td>Yes</td>
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<tr>
<td>At completion of installation of electrical assets.</td>
<td>30% of expected standard charges &gt; LCTA or LCC.</td>
<td>Yes</td>
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<tr>
<td>At project completion (full commissioning) &amp; post asset transfer to Asset Owner.</td>
<td>50% of expected standard charges &gt; LCTA or LCC.</td>
<td>Yes</td>
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3.2 Standard or vouched charges for build

The CER believes that it is important that any form of payment, made to an IPP, is made on a consistent basis and applying a consistent methodology. In the case of transmission the application of standard transmission charges, published by the CER in CER/10/235 (current version), to overbuild assets is consistent in the manner. The current version of the applicable distribution charges are contained in CER/10/224.

Using standard charges to calculate the payments to be made will allow the IPP to select the most attractive arrangement for undertaking the overbuild works (from both an economic and quality of work viewpoint). The CER does not believe it prudent to allow the vouched costs of overbuild.

Using standard charges is transparent, equitable and leaves the UoS customer in a neutral position, whether contestable or non-contestable build is undertaken. Where assets required for overbuild are not of a standard nature (i.e. not listed in CER/10/235 or CER/10/224 and future publications covering standard charges), the CER will discuss the matter with the SOs.

3.3 Financing costs

As with standard charges it is important that any form of payment including financing costs, made to an IPP, is made on a consistent basis and applying a consistent methodology.

The CER acknowledges that a number of respondents strongly argued for “vouched” financing costs. This is based on the view that this overbuild investment is required by the SOs and therefore the IPP should be permitted to recover all of the associated financing costs. The inverse argument is that such costs should not be socialised across the UoS customer.

In the CER’s view the deciding factor here again should be the impact on the UoS customer. In non-contestable build the costs of overbuilding are added to the applicable RAB and remunerated at the regulated WACC. The decision by an IPP to select a contestable connection should not undermine this and therefore the UoS customer should be left in a neutral position. In some cases it may well be that the cost of finance for an IPP exceeds that of the regulated WACC, but it is solely for IPPs to judge whether the overall benefit of selecting a contestable connection is worthwhile to them. This is not a matter for the CER and therefore financing costs for overbuild, will be based on the regulated WACC.

The payment in respect of the financing costs will be at the regulated WACC\(^2\) and any subsequent amendments to same. It will be included in the assumed amount of principal overbuild expended by the IPP at the stages outlined in the table of section

\(^2\) Please refer to Section 5 in CER/10/206 at the following link.
3.1. Financing costs, like staged-payment, will not be paid until sign-off is received by the SOs and AOs. The amount payable to the IPP will be calculated as per option 2 of section 4(b) in CER/11/027(a):

\[
\text{Interest payable} = [(1 + \text{Regulated WACC}) \times (1 + \text{applicable HICP})] \times \text{Assumed amount of principal overbuild expended}
\]

As noted above, at the start of a project the SOs will also provide the IPPs with a clear written undertaking demonstrating the Asset Owner’s obligation to pay monies (including financing costs) for the satisfactory completion of certain stages of build. This should provide comfort to financiers providing the additional capital funding to IPPs.

3.4 **Threshold of the scheme**

The CER notes the concern of respondents about the thresholds outlined in CER/11/027(a) and welcomes the proposal to reduce them. Therefore the threshold payments for overbuild will be made available to IPPs where additional capital costs exceed €250,000 or 5% of capital outlay.
4.0 Conclusion

This decision paper looks to address the following - how should the additional financing burden which may be placed on an IPP, when the connection method specified by the SO results in costs greater than the LCC or LCTA connection method, and such a connection is being built contestably, be managed?

The CER believes that the structures outlined in Section 3 adequately address this concern. Furthermore, they reflect the correct balance between meeting the interests of the SOs and IPPs, while leaving the UoS customer in a position of neutrality as to whether works are completed contestability or non-contestability. The CER has decided the following:

- Staged-payments at certain intervals will be provided to IPPs in the case where SO specified overbuild is required in a contestable project. SO/AO engineers sign-off will be required before payment is made to the IPP to ensure that the work carried out is in line with SO specifications and standards.

- Staged-payments will be made on the basis of the CER standard charges, the most recent of which are published in CER/10/235 and CER/10/224.

- Financing costs will be made at the regulated WACC (in nominal terms) and at the same intervals of principal payments for overbuild.

- At the start of a project the SOs will also provide the IPPs with a clear written undertaking demonstrating the Asset Owner’s obligation to pay monies (principal and financing costs), and for them to pass these monies on to the IPP, for the satisfactory completion of certain stages of build.

- The payment threshold equates to where additional capital costs exceed €250,000 or 5% of capital outlay.

Queries on this decision paper should be submitted to Jamie Burke (jburke@cer.ie) in the CER.