Competition Authority response to Commission for Electricity Regulation's Draft Direction on the Infrastructure Agreement between ESB and Eirgrid.

October 17, 2001

1. Introduction

Statutory Instrument No. 445 of 2000 provides for a statutory separation of functions between the Electricity Supply Board (ESB), as electricity Transmission Assets Owner (TAO), and a new State company, Eirgrid, as Transmission System Operator (TSO). In order to enable Eirgrid to discharge its functions as TSO, the SI requires that the ESB and Eirgrid enter into a contract to be known as the Infrastructure Agreement (IA), which is subject to the approval of the Commission for Electricity Regulation (CER). In the event that the IA is not made by the effective date[1], the CER shall, as soon as may be, direct EirGrid and ESB to reach agreement so as to comply with industry requirements as duly specified by the CER.

Following the failure of the parties to reach voluntary agreement by the effective date, the CER issued a Transmission Infrastructure Agreement Principles Paper (CER/01/59) (the Principles Paper), setting out the essential principles and contractual relationships which will be enshrined in the IA and which will determine the relationship between the parties. The Commission published this document and invited comments on it. The Competition Authority submitted comments in response to the consultation (available on its website at www.tca.ie).

The CER subsequently issued a draft Direction on the Infrastructure Agreement to both ESB and Eirgrid, and invited their comments by 12 October 2001, with the intention of issuing a final Direction within the following week or so. The draft was also published on the CER's website, but comments from other interested parties were not invited.

Regulation 18(1)(d) of the SI provides that the CER may consult the Competition Authority "… for the purpose of exercising its power to approve the infrastructure agreement." On 11 October 2001 the CER gave the Authority the draft Direction and invited its comments on it. The Authority appreciates the fact that it was consulted on this

[1] According to the CER's Transmission Infrastructure Agreement Principles Paper (1 June 2001), "[T]he effective date is to be no later than 20 June 2001 or a later date if the CER requests the setting of a later date, stating the reasons for this request, and the Minister agrees."

issue, which it considers a very important one for the future of the electricity industry in Ireland. In view of the very tight timescale for responding, the Authority must reserve the right to make further comments; however, we appreciate that the CER is also working within severe time constraints.

2. Section 5: Responsibilities for Development and Construction.

In its Principles Paper, the CER set out an eight-stage process for development and construction activities, allocating the primary responsibility for each stage as follows:

Stage		Party Responsible
1	Conduct Planning/Feasibility Studies	**TSO**
2	Develop indicative programme for project stages	**TSO**
3	Advance to planning permission	**TSO**
4	Preliminary work for procurement	**TSO/TAO**
5	Prepare project Detailed Design and Specification	**TAO**
6	Construct project	**TAO**
7	Project review	**TAO**
8	Issue Declaration of Fitness, Commission and Hand-over	**TAO/TSO**

In its Response to CER/01/59, the Competition Authority set out its concerns about this approach:

> "This proposed arrangement allows the ESB as TAO excessive control of the transmission system and has the potential to inhibit nascent competition in the electricity sector."

The Authority's view was that allowing the ESB to have control of any aspect of the transmission network had a chilling effect on the market: potential entrants were less likely to enter the market at all and competition for generation would be damaged. It proposed that the ESB's statutory right as the sole supplier of construction services on the transmission network should be interpreted so that the TSO's control over the network was perceived to be maximised by potential entrants. To this end, only responsibility for the construction state (stage 6) should be given to the ESB; responsibility for all other stages should be given to the TSO.

The Authority is concerned that the proposals in the draft Direction still give too much power to the ESB. These concerns are discussed in detail below. Briefly, we feel that the agreement is not one between equal parties (in terms of size, assets and resources, the ESB is by far the more powerful); that the ESB, like any other vertically-integrated incumbent in a network industry, has an incentive to delay allowing competitors access to its network; that allowing the ESB control over how and when the facilities allowing access to its network are constructed will, at the very least, have a chilling effect on the market; and that the TSO, as an independent third party, must have as much control as

possible over the process in order to create confidence among potential entrants. Our view is that the Infrastructure Agreement must create appropriate incentives and penalties to make the system work in favour of new entry.

The sections below consider stages 4 - 8 of the construction process, as set out in the draft Direction. We have no comments on stages 1 - 3.

3. Section 5.2.4 Stage 4 – Preliminary work for Procurement – Role of Project Agreements.

CER Proposals

The Draft Direction proposes that responsibility for this phase will be split between the TAO and the TSO. The primary responsibility for progressing specific projects to achieving planning permission will rest with the TSO, while primary responsibility for progression projects from planning permission to commissioning will rest with the TAO. Once planning permission has been achieved, projects will be identified as "Committed Projects" and will be subject to a handover from the Operator to the Owner. The Owner will then propose an implementation plan to the Operator, which will approve or reject it on the basis that it fulfils or does not fulfil the requirements of the Development Plan, the high-level specification, the approved design standards and the functional specification.

The Infrastructure Agreement will provide for a Project Agreement for each project; the sum of the project agreements for each year will, in principle, correspond to that year's Development Plan output and will form the basis for the allowed capital costs to be recovered under the Transmission Use of System tariffs for that year.

The Operator will establish a "client engineer" for each transmission project who will be the formal interface between the parties.

Co-operation between the Owner and the Operator on procurement will take place through a Procurement Strategy Committee, to be chaired by and have majority representation of the owner, but with substantive input from the Operator. The Operator's primary input in the procurement of materials and contractors will be exercised through the agreement of bid lists and input to the technical considerations of the Procurement Strategy Committee. The Owner will be responsible for management of individual contracts. The Operator may, where it considers that the integrity of the transmission system requires it to do so, require the Owner in advance of contract award or post contract award to use reasonable endeavours to modify the terms of a specific contract. However, "the Operator's right to intervene in individual cases should only arise in exceptional circumstances and where the Operator can show that the general protection it will have through setting standards, approving lists of contractors etc. is not sufficient to protect its position."

Competition Authority Response.

In its response to the Principles Paper, the Authority outlined its concerns with the Project Agreement approach. "Agreements" work where it is in both sides' interests that they work, and where both sides have approximately equal weight at the negotiating table. In this case, neither of these conditions is true. Unfortunately, there is a clear incentive for the incumbent to delay works which would facilitate the connection of a competitor to the grid. And the absence of any mention of penalties for late completion of work means that Eirgrid could have great difficulty in having a project implemented. Under the SI the CER has a role as arbiter in the resolution of differences and disputes arising from the IA; it does not appear to have the power to direct the parties. Thus, Eirgrid appears to have no sanctions against the TAO if things go wrong. Moreover, Section 9 ("Remuneration of Owner"), dealing with payments to the Owner for construction and maintenance works, provides that ***"The Operator shall not under any circumstances withhold these monthly payments."*** This is an extraordinarily strong, and indeed one-sided, provision to find in any type of agreement – all the more so in such an innovative one where the whole concept is new and can be expected to take some time to "bed down". Effectively this removes all power from Eirgrid to sanction ESB for breaches of the agreement.

Another concern is that, whereas the Principles Paper included among the purposes of the project agreement "Provisions for ensuring the works meet TSO requirements and standards" and "Provisions for step-in rights", these do not appear to feature in the description of the Project Agreements included in the Draft Direction. While provisions for the latter (step-in rights) are explicitly addressed elsewhere, provisions for the former do not appear to be so addressed.

As stated in our response to the Principles Paper, we feel that a contract approach would be more appropriate than the negotiated agreement approach. Here, the TSO would draw up terms of contract for required construction work and the TAO would have first right of refusal; if it chose not to exercise that right, then alternative construction firms could be sought. If this is infeasible, the parties should be required to reach agreement within a reasonable time limit and the CER should have powers to direct them to reach agreement if they do not. Thus an effective and rapid dispute settlement mechanism is critical, as is a clear timeframe for intervention by the CER. ***Moreover, it is essential that the contracts or agreements should include penalties for delay or default.***

The TSO's responsibilities for, and control over, procurement appear to be more limited now than they were under the Principles Paper, since their role is now limited to the approval of lists of contractors and minority participation in the Procurement Strategy committee. Even where the Operator considers that the integrity of the transmission system requires the terms of a specific contract to be modified, it cannot require such modification – it can only require the Owner to "use reasonable endeavours" to do so.

A further concern is that the TAO's control over procurement, and indeed over a number of other aspects of the process, raises concerns about possible "gold-plating" in view of the fact that the sum of the Project Agreements forms the basis for the TAO's allowed capital costs. Since whatever the TAO spends is recoverable, there is arguably little or no incentive for the TAO to seek the best value for money. Moreover, it is not clear how disputes as to the costs of each individual project are to be resolved.

4. Section 5.2.5 Stage 5 – Prepare Project Detailed Design and Specifications

CER Proposals

In the Principles Paper, the CER stated that detailed design was in part inseparable from implementation (because of the need for iteration) and would be the responsibility of the TAO. However, the TSO would be the design authority and would establish and maintain generic standards and designs as required. In addition to generic standards, the TSO would have the opportunity to input any specific technical requirements through the outline design for each project. Any options provided by the TAO and/or contractors, and any variations from the standards indicated in the outline design during the course of the project, would only be implemented following consultation and agreement with the TSO.

The Draft Direction provides that the TAO will provide the TSO's client engineer with access to detailed design documents to ensure compatibility with functional specifications, to enable to TSO to satisfy itself that site-specific requirements meet the Operator's design standards and that any major errors or omissions are identified and corrected. However, while it allows the TSO to make comments, and provides that the TAO will take due account of those comments, the TAO remains the final authority in relation to the fitness for purpose of the detailed design (subject to the general dispute resolution procedure).

In relation to options provided by the TSO and its contractors, or variations from the standards indicated in the outline design during the project, these can now be implemented by the TAO "following consultation with the Operator", rather than "following consultation *and agreement*", as in the Principles Paper.

Competition Authority Response

These provisions appear to leave the TSO's "Client Engineer" in rather an anomalous position. Notionally, he is presumably representing "the customer" - in this case, the TSO – who is eventually paying for the work to be done. It might be expected, therefore, that the client engineer would have to be happy with the detailed design. However, the Draft Direction seems to give the TAO the power to override the client engineer's concerns. The client engineer seems to have no powers to require the TAO to carry out this stage as the TSO sees fit, other than the general dispute resolution procedure.

Similarly, in relation to options and variations, the TAO is only required to *consult* with the TSO, and not to *consult and agree*, as foreseen in the Principles Paper. This appears to represent a weakening of its role, the rationale for which is not presented in the draft Directive. It also seems to leave open the possibility of "gold-plating", without sanction (see comments on previous section).

5. Section 5.2.6 Stage 6 – Construct Project

CER Proposals

The Owner is to be responsible for constructing all projects in accordance with the Operator's development plan, using its own resources and/or outsourcing to contractors. The Owner will manage the project from hand-over to completion, and will report on progress to the Operator, including signalling any possible difficulties or delays arising. Specific arrangements for co-operation between the parties on development and construction activities are set out in section 5.3 of the Draft Direction; they include the establishment of regular progress meetings, both general and on a project-by-project basis).

Competition Authority's Response

The Authority has no specific concerns about this particular allocation of responsibility, but feels that the concerns expressed above about the nature of project agreements, the role of the client engineer and the lack of penalties for late delivery, all combine to put the TSO in a weak position vis-à-vis the TAO. If the TAO is going to receive its monthly payments, basically irrespective of progress, then it is difficult to see what negotiating strength the TSO will have in these meetings in the event of delay.

6. Section 5.2.7 Stage 7 –Project Review.

CER Proposals

The Principles Paper proposed that, while the TAO should have primary responsibility for project review, the TSO could require project variations, which would be accommodated in accordance with the terms of individual project agreements. The TAO could request project variations from the TSO if it considered them necessary. The TSO would approve any variations in the scope of projects and issue interim certification.

The Draft Direction does not refer explicitly to project variations, but states that "The Parties will co-operate on project reviews in accordance with the procedures" described elsewhere in the document. Any material change in the expected project "milestones" should be advised to the Operator, including how the Owner intends to address the situation and the impact, if any, on the scheduled completion date.

Competition Authority Response

Again, the changes which have taken place between the Principles Paper and the Draft Direction seem to represent an unnecessary dilution of the powers of the TSO to require project variations.

7. Section 6 – Responsibilities for Maintenance.

CER Proposals

The Principles Paper set out draft responsibilities for each stage in the maintenance programme. These have been slightly revised in the Draft Direction. A Maintenance Policy and Standards committee is to be established as a forum for co-operation between the parties on discharging their respective responsibilities for maintenance matters. This committee is to be chaired by, and have majority representation from, the TSO. The TAO is to carry out maintenance tasks as required by the operator, using its own resources and outsourcing to contractors. The Operator is to ensure maintenance of the transmission system.

Competition Authority Response

The Authority has no comment to make on the allocation of responsibilities for maintenance. It sees maintenance as less problematic than construction, since all parties have a common interest in the proper maintenance of the system, although it must be acknowledged that competitive problems can still arise in that there may be an incentive for the incumbent to treat problems differently, depending on what generator or customer is most directly affected by them. One point of concern is that, whereas the Principles Document referred to penalties – "The IA shall specify escalation procedures to expedite the process and penalties where targets are not met" – this reference appears to have been dropped in the Draft Direction. The Authority considers that penalties are an important element of the agreement, both for construction and for maintenance, particularly given the division of responsibilities between the TAO and the TSO. If the TSO is *responsible* for ensuring the maintenance of the transmission system, but does not carry out the work itself, then it must have the power to incentivise ESB to meet its requirements.

8. Section 8 – Remuneration of Owner.

CER Proposals

The CER proposes that the remuneration due to the TAO for construction and maintenance work will be determined by the CER, in advance, annually. The Parties are to agree a system of monthly payments to the TAO. The TSO shall not under any circumstances withhold these monthly payments.

Competition Authority Response

As stated above, the Authority considers this last provision to be extraordinarily strong and one-sided. Coupled with the absence of any mention of a system of penalties for non-delivery of contracted work, it puts the ESB in a very strong position vis-à-vis Eirgrid, since they are going to get paid no matter what contractual disputes occur between the parties. The Authority considers that this provision should be removed.

9. Section 9 – Step-in rights.

CER Proposals

In the Principles Paper, the CER outlined a five-stage process which the TSO must follow before exercising its step-in rights. The Authority, in its comments, recommended that the process of triggering step-in rights should be simpler and that the TSO should be given greater discretion to determine when step-in rights should be exercised.

In the Draft Direction, the process has been simplified to the extent that the CER is notified at the same time as the TAO when the TSO considers that there has been delay or default. This eliminates some of the steps in the process. All contracts entered into by the TAO for the provision of labour and/or materials are to include a provision that allows the TSO to take over such contract. The TSO may seek emergency-style step-in rights and the CER may allow such rights, where it is satisfied that the exceptional circumstances require more step-in.

Competition Authority response

The simplified procedures for step-in are welcome, as are the provisions to allow the TSO to take over contracts and for more rapid step-in rights in case of emergency.

10. Section 12 – Risk, Liabilities and Indemnities.

CER Proposals

The Principles Paper outlined what the CER considered to be an appropriate allocation of risk, envisaging that risk "should be allocated according to the activities carried out by the parties." The Draft Direction "does not purport to deal with the scope or detail of such risks and potential liabilities which are matters of general law." It proposes that risks should be allocated between the Parties to reflect the allocation of their respective responsibilities under the Agreement; and that each party should indemnify the other against liabilities incurred to third parties as a result of actions, errors, negligent acts or omissions, or a breach of the Infrastructure Agreement, by the first party. It also proposes that the Parties will acknowledge that they each have a potential liability, that they rely

on each other to limit that liability, and that they will co-operate in the management and containment of any liability if and when it arises.

Competition Authority Response

The Authority proposed, in its response to the Principles Paper, that risk should be allocated according to function where the TAO's function was confined to the construction stage only. This would allow liability to be delineated more clearly and reduce the potential for confusion. It would also be more conducive to the entry of new market players and hence to the development of effective competition in the sector.

The Authority also pointed out that requiring the TAO to indemnify the TSO meant that third parties damaged by delays in or default on maintenance and development work would have to recover damages from the TSO which would in turn seek to recover them from the TAO, and that such a procedure would be slow and cumbersome. It would also mean that the TSO would be held primarily responsible for actions or inactions of the ESB as TAO. The likely effect would be to render the TSO overly cautious in selecting and designing projects, resulting in possible connection delays and discouraging new entry into generation. The Authority suggested that one possible approach would be to require the ESB as TAO to enter into a bond up front, out of which compensation would be paid to third parties pending resolution of the issue of liability. This still appears to be a valid approach.

11. Section 18 – Periodic Review – and Section 19 - Term.

CER Proposals

Section 18 proposes that the Agreement shall contain provisions for its periodic (annual) review, the first such review to commence one year after the Agreement comes into effect. The review is to be carried out jointly by the parties, but may contain separate commentaries and recommendations. Section 19 proposes that the term of the agreement be indefinite, subject to the Regulations being repealed or amended.

Competition Authority Response

In themselves, provisions for the review of an agreement are generally a good idea. In this instance, because the operation of the agreement is likely to be fractious and because the interests of the parties differ widely, the Authority would have some concern that the annual review would become an opportunity for the parties to "dump" their problems on to the regulator. If some of the previous comments about incentives, penalties etc. could be incorporated into the agreement, this would go some way towards easing these concerns. Failing that, it might be advisable for the CER to make it clear in some way that it will not consider itself bound to adjudicate on every matter raised in the annual review. By the same token, an indefinite term for the agreement may encourage the parties to continually fight for relatively minor changes to it; if a time limit – say, five

years – were put on the agreement, it might be possible to have a radical review then (assuming the overall industry structure still necessitates such an agreement) and maintain a more manageable review process in the interim.

12. Conclusion

The CER in drawing up the infrastructure agreement governing the contractual relations between ESB, the provider, and Eirgrid, the purchaser, faces an extremely difficult task. It has into account a series of factors in designing the contractual conditions. These include:

- the incentives governing each parties behaviour:
- the role of sanctions in enforcing any contract;
- the ease of monitoring compliance by each party;
- the scope for opportunistic behaviour;
- the need for clear unambiguous roles; and,
- the extent of asymmetric information.

The contract is not designed in a vacuum. The purpose is to provide a set of rules for the creation of infrastructure, which as a natural monopoly and a common carrier, provides the interface between electricity producers - generators, including ESB - and electricity consumers.

In the Authority's view the rules as currently designed are sub-optimal, because they take insufficient account of the factors mentioned above. The outcome is likely to be an excessively costly system of contractual relations between the ESB and Eirgrid. However, higher than necessary transaction costs is only part of the problem. In the Authority's view, the proposed contractual terms learn heavily towards the state-mandated monopoly provider, ESB, rather than the purchaser, Eirgrid. Given the incentives under which ESB operates as a result of its dominant position in electricity generation, it seems reasonable to assume that the proposed contractual terms are likely to impede new entry into electricity generation, thus maintaining the dominant position of ESB. Thus somewhat paradoxically the proposed contractual rules may raise transaction costs and reduce the threat of new entry into electricity generation.