[Draft] Conditional Cost Sharing guidance

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1. Introduction

1.1 This document sets out draft guidance on the application of the conditional cost sharing arrangements introduced as part of our final determinations on SONI's price control for the 2020 to 2025 period.

Structure of document

1.2 We have structured the subsequent sections of this document as follows:

- We provide an overview of the conditional cost sharing arrangements.
- We set out the annual process that we will use to determine whether to make adjustments under the conditional cost sharing arrangements and, if so, the value of those adjustments.
- We set out the methodology we will use for specific aspects of that process.
- We provide guidance on the evidence and other information that SONI should provide to us as part of the annual process.

Interactions with cap on SONI's financial rewards and penalties

1.3 This guidance is focused on the process and approach that we will take to determine the set of adjustments to make, if any, under the conditional cost sharing arrangements. This is before the application of the combined cap that applies to the annual net position from the price control cost-sharing arrangements (conditional cost-sharing and mechanistic cost-sharing) and the outcome of the evaluative performance assessment.

1.4 The cap applied to this net position limits the maximum financial incentive reward to SONI, in respect of performance in any financial year to £1.25m and limits the maximum financial incentive penalty to £0.75m (both on a nominal pre-tax basis).

1.5 This cap may mean that, when taken in combination with the outcome of the evaluative performance framework, the financial adjustments to price control revenues and/or RAB differ to what would be implied by the conditional cost-sharing arrangements in isolation.

2. Overview of the conditional cost sharing arrangements

2.1 This section gives an overview of the conditional cost sharing arrangements.

2.2 The conditional cost sharing arrangement refers to the approach that applies to a certain set of SONI's costs and which governs how SONI's price control revenues and/or RAB should be adjusted in light of any over-spend or under-spend against the ex ante allowances for those costs.

2.3 The set of costs that are within the scope of these arrangements is specified in SONI's licence.

2.4 Within this scope of costs, for the purposes of implementation of the cost-sharing approach, we distinguish between three broad categories of costs, namely:

- operating expenditure;
- capital additions attributable to the buildings RAB; and
- capital additions attributable to the non-buildings RAB.

2.5 All of the ex ante baseline allowance set in our final determinations for costs falling under the conditional cost sharing arrangements, falls within the first category above, and so the ex ante allowances for the second and third categories above, are zero, for the purposes of the conditional cost sharing arrangements. Nonetheless, the approach set out in this document is designed to apply to outturn expenditure across all three categories above, in order to avoid introducing unnecessary distortions in regulatory treatment between operating expenditure and capital expenditure.

2.6 The conditional cost-sharing approach builds on a conventional mechanistic cost-sharing incentive approach, with a 25% incentive rate to any over-spend or under-spend against ex ante allowances. However, the application of the incentive rate is not automatic, and is conditional on evidence about the nature and source of any over-spend or under-spend. In practice, this means that:

- 75% of the value of any over-spend or under-spend will be passed through to regulated charges to customers automatically under the licence (and our RAB policies).
- Whether (or the extent to which) the remaining 25% is passed through to regulated charges, or retained by SONI as a financial reward/penalty, will depend on the outcome of a regulatory assessment, using the process set out in this document.

2.7 This guidance is focused on the regulatory assessment under the second element above. In broad terms, and subject to materiality threshold specified in this guidance document, the role of regulatory assessment in the second bullet, in paragraph 2.6 above, is that:

- In the case of an under-spend, SONI should only qualify for a financial reward, from the 25% cost-sharing incentive rate, if it can provide good evidence to the UR that the under-spend was not due to a reduction in costs that came at the expense of SONI performing worse in terms of the services delivered or the outcomes (likely to be) achieved.

- In the case of an over-spend, if SONI can provide good evidence to the UR to show that this was due to the efficient costs of justified improvements to aspects of their performance, it should be remunerated in full for those additional costs, rather than facing a penalty under the 25% cost-sharing incentive rate.

2.8 We will implement the above by determining, through an annual process, a set of adjustments to SONI's price control revenues and/or RAB.

2.9 In comparison to a more conventional and mechanistic cost-sharing approach, the conditional cost-sharing arrangement is designed to help improve system-wide outcomes, over the long-term.

3. The annual process

3.1 This section sets out the process that we will follow to determine (i) whether to make an adjustment to price control revenues and/or RAB in light of any over-spend or under-spend against the ex ante allowances for those costs that are within scope of the conditional cost sharing arrangement, and (ii) if so, what the value of that adjustment should be.

3.2 The process will be an annual one.

Step 1: SONI's conditional cost-sharing submission

3.3 The starting point for the process is SONI's submission of information required by the Regulatory Instructions and Guidance (RIGS) for the previous financial year.

3.4 In addition to that information, and of particular interest for the purpose of implementing the conditional cost sharing arrangement, SONI should provide at the same time as the RIGS submission, a submission on conditional cost sharing, which provides:

- Information on its outturn expenditure on costs that are within the scope of the conditional cost sharing arrangement.
- Information on its outturn expenditure on costs that are outside the scope of the conditional cost sharing arrangement.
- Where applicable, evidence to explain any under- or over-spend of expenditure on costs that are within the scope of the conditional cost sharing arrangement.
- A reasoned proposal for whether or not the UR should make an adjustment under Step 4 of the process below and, if so, the amount of that adjustment.

3.5 Section 5 of this document provides more detail on the information that SONI should provide under step 1.

Step 2: Verification of under-spend or over-spend

3.6 We will draw on the information from step 1 to verify SONI's calculation of the total under-spend or over-spend on costs, which are within the scope of the conditional cost sharing arrangement, for each of the following three categories of expenditure:

- operating expenditure;
- capital additions attributable to the buildings RAB; and
- capital additions attributable to the non-buildings RAB.

3.7 The value of any under-spend or over-spend identified in this step will feed into the application of the materiality threshold in step 3 below and, subject to that, our assessment of the potential adjustments for the purposes of conditional cost sharing.

3.8 As part of this step, we will seek to address the risk of differences in interpretation with regard to whether particular expenditure items should be considered to be within, or outside the conditional cost sharing arrangement. It is helpful to identify and seek to resolve any such differences, early in the process. In the event that our calculation of SONI's expenditure for each of the three categories of expenditure does not agree with figures put forward by SONI, we will write to SONI to set out our figures. We will explain the basis for them and invite it to respond. We will review the response and, in the light of that, consider whether and how to revise our initial figures.

Step 3: Application of materiality threshold

3.9 On the basis of the figures arrived at in Step 2, we will calculate SONI's aggregate expenditure on costs that are within the scope of the conditional cost sharing arrangement, in the relevant financial year. This will be the aggregate across all three categories of expenditure listed above.

3.10 We will compare the aggregate outturn expenditure with the sum, across those three categories of expenditure, of the ex-ante cost allowances for expenditure within the conditional cost sharing arrangements for the specific financial year. The measure of aggregate outturn expenditure and the sum of the relevant ex ante allowances will both be expressed in nominal terms.

3.11 We will determine whether the difference between the two amounts is greater than the materiality threshold we have specified for the conditional cost sharing arrangement. We have set the materiality threshold at £300,000.

3.12 If the materiality threshold is not met:

- We will publish a brief decision that (i) confirms that the materiality threshold has not been met, and (ii) sets out that there will be no adjustments to the price control revenues and/or RAB in light of any over-spend or under-spend against ex ante allowances for those costs that are within scope of the conditional cost sharing arrangements (i.e. no further adjustments beyond the application of 75% pass-through of any under-spend or over-spend).
- The annual process will end at this step.

3.13 If the materiality threshold is met, we will proceed with the remaining steps of the annual process.

Step 4: Our draft assessment on the conditional cost-sharing adjustments

3.14 This step is concerned with making a proposed decision on:

- Whether any adjustments to price control revenues and/or RAB should be made for the purposes of the conditional cost-sharing arrangements.

- If so, the value of these adjustments.

3.15 Our proposed decision will draw on our review of the evidence that SONI submitted in Step 1, and any other evidence, information or factors that we consider relevant.

3.16 Our proposed decision will set out (i) whether we propose to make an adjustment in respect of operating expenditure, capital additions attributable to the buildings RAB and capital additions attributable to the non-buildings RAB, and if so (ii) our proposed values for those adjustments.

3.17 Before making a decision (see next step 5) we will engage with SONI in a timely manner setting out our minded to position and reasoning, and give SONI the opportunity to respond. The opportunity will be for SONI to point to any errors we might have made, in the interpretation of the data and evidence that it submitted in earlier steps of the process. It is not intended to provide SONI with an opportunity to introduce new evidence to the assessment, which ought to have been provided in Step 1.

3.18 We provide further information on our assessment under this Step 4 with Section 4.

Step 5: Decision on conditional cost sharing adjustments

3.19 We will make a decision on the adjustments for the conditional cost sharing arrangements within 10 weeks of the submission of RIGS, or such later date we consider appropriate,

3.20 We will decide whether to make an adjustment, and if so for what amount, in respect of each of (i) operating expenditure; (ii) capital additions attributable to the buildings RAB and (iii) capital additions attributable to the non-buildings RAB.

4. Methodology

4.1 This section outlines the methodology we will follow to determine (i) whether to make an adjustment to price control revenues and/or RAB in light of any over-spend or under-spend against the ex ante allowances for those costs that are within scope of the conditional cost sharing arrangement, and (ii), if so, what the value of that adjustment should be.

4.2 We described in Section 3 that we will follow an annual process to determine the value of the adjustments under the conditional cost sharing arrangement. In the description of the methodology in the subsections below, we refer to the calculations pertinent to the adjustment in relation to financial year *t*.

4.3 We have structured the presentation of the methodology in a way that is aligned to the series of steps of the annual process, which we outlined in Section 3. The mapping between the subsections below and the steps of that annual process is as set out in the table below.

Table 1 Mapping of subsections to steps in annual process

Subsection	Step in annual process
Verification of over- or under spend.	Step 2
Application of materiality threshold.	Step 3
Potential adjustment in event of over-spend	Steps 4 and 5 in the event of an over-spend
Potential adjustment in event of under-spend	Steps 4 and 5 in the event of an under-spend

Verification of over- or under-spend

4.4 We will verify SONI's over- or under-spend in financial year *t* in relation to costs that are within the conditional cost sharing arrangements.

Costs within scope of the conditional cost sharing arrangements.

4.5 The set of costs that are within the conditional cost sharing arrangements, and so relevant to the calculation of the over- or under-spend, are set all of SONI's costs with the exclusion of a subset of those costs. The subset of excluded costs is defined in the licence conditions. [Add cross-reference to licence condition]

Calculations

4.6 Table 2 highlights the calculations we will carry out to compute the over- or under-spend in financial year *t* of expenditure falling within scope of the conditional cost sharing arrangement.

Table 2 Calculations to verify under- or over-spend

Stage	Item	Source / comment
1	Ex ante allowances for financial year t for costs subject to conditional cost sharing determined at price control review, identified separately for (i) operating expenditure; (ii) capital additions attributable to the buildings RAB and (iii) capital additions attributable to the non-buildings RAB. Figures in April 2019 CPIH prices.	Price control FD and/or TSO licence
2	Additional ex ante allowances for financial year t for costs subject to conditional cost sharing approved during the price control period, identified separately for (i) operating expenditure; (ii) capital additions attributable to the buildings RAB and (iii) capital additions attributable to the non-buildings RAB. Figures in April 2019 CPIH prices.	Published decisions of the Utility Regulator during price control period If we approve hypothecated allowances for projects /initiatives that have associated price control deliverables, these will be outside scope of conditional cost sharing and not added here
3	Total ex ante allowances for financial year t for costs subject to conditional cost sharing, identified separately for (i) operating expenditure; (ii) capital additions attributable to the buildings RAB and (iii) capital additions attributable to the non-buildings RAB. Figures in nominal terms	= (Relevant item in (1) + Relevant item in (2)) * $CPIH_{April\ year\ t}$ / $CPIH_{April\ 2019}$
4	SONI expenditure in financial year *t* for costs subject to conditional cost sharing, identified separately for (i) operating expenditure; (ii) capital additions attributable to the buildings RAB and (iii) capital additions attributable to the non-buildings RAB. Figures in nominal terms.	The figures will be based on actual expenditure reported by SONI as part of formal regulatory reporting and subject to applicable auditing and assurance requirements. As set out in Step 2 of the annual approach outlined in Section 3, we will review the value reported by SONI of the total expenditure reported for each of the three broad categories of expenditure.
5	Difference between outturn expenditure and ex ante allowances in financial year *t* for costs subject to conditional cost sharing, identified separately for (i) operating expenditure; (ii) capital additions attributable to the buildings RAB and (iii) capital additions attributable to the non-buildings RAB. Figure in nominal terms.	= (Relevant item in (4)) – (Relevant item in (3)) For each of the three categories of expenditure, the number can be negative, zero or positive. As set out in Step 2 of the annual approach outlined in Section 3, we will review the values reported by SONI for each of the three categories of expenditure.
6	Aggregate difference between outturn expenditure and ex ante allowances in	= Sum of items in (5) The number can be negative, zero or

Stage	Item	Source / comment
	financial year *t* for costs subject to conditional cost sharing Figure in nominal terms.	positive. A negative number indicates that in aggregate across the set of costs subject to conditional cost sharing arrangements SONI under-spent; a positive number indicates that it over-spent.

Application of the materiality threshold

4.7 We will determine whether the over- or under-spend is within the materiality threshold that applies to the conditional cost sharing arrangement.

4.8 We have set the materiality threshold at £300,000 in nominal terms.

4.9 We will determine whether the materiality threshold is greater or not than the absolute value of the result of the calculation in Stage 6 of Table 2.

Potential adjustments in the event of over-spend

4.10 Under the overall approach and process for conditional cost-sharing, the licence (and our RAB policy) will automatically pass-through 75% of any over-spend to regulated charges. The purpose of the assessment described below is to determine the treatment of the remaining 25% of any over-spend. The adjustment we refer to below is an adjustment to pass-through to regulated charges over and above 75% of the value of an over-spend.

4.11 We will determine whether to make an adjustment and, if so, the value of that adjustment to the amount that SONI can recover from an over-spend in the event that the difference between SONI's aggregate outturn expenditure and aggregate ex ante allowances for costs subject to conditional cost sharing, as calculated in Stage 6 of Table 2, is:

- a positive number; and
- greater than the materiality threshold, as determined above.

4.12 We will determine whether to make an adjustment (and if so, what amount) for each of the three categories of expenditure.

4.13 In the event of an over-spend at an aggregate level, (i.e. across the three categories of expenditure), our decision on the value of the set of adjustments will be constrained by the following:

- The adjustments will be such that the aggregate value of the over-spend that SONI could recover would lie in the range of 75% to 100% of the value of the aggregate over-spend.
- The adjustments will be such that the over-spend that SONI could recover for each of the three categories of expenditure would lie in the range of 75%

to 100% of the over-spend in that category.

- The adjustments will not have the effect of clawing back any under-spend that SONI may have achieved in any of the three categories of expenditure.

4.14 Subject to the constraints above, we will assess the case for an adjustment as follows:

- If we find that there is good evidence to demonstrate that the over-spend (or part of the over-spend) was due to the efficient costs of justified improvements in performance, in relation to SONI's services and/or the desired outcomes, then we will set the adjustment as 25% of the efficient costs of the justified improvements in performance.

- Otherwise (and for any remaining part of the over-spend), the adjustment will be 0%.

4.15 We provide information in Section 5 on the type of evidence SONI would need to put forward for such an adjustment. Further to that information provided by SONI, we expect that our assessment would also draw on evidence that stakeholders may submit to us, as well as any relevant evidence emerging from processes under the evaluative framework of performance.

4.16 In the event that SONI overspent at the aggregate level, effect of the set of constraints above will be to focus our assessment of the evidence on those expenditure categories within which SONI overspent.

Potential adjustment in the event of under-spend

4.17 Under the overall approach and process for conditional cost-sharing, the licence (and our RAB policy) will automatically pass-through 75% of any under-spend to regulated charges. The purpose of the assessment described below is to determine the treatment of the remaining 25% of any under-spend. The adjustment we refer to below is an adjustment to pass-through to regulated charges over and above the 75% of the under-spend.

4.18 We will determine whether to make an adjustment and, if so, the value of that adjustment to the amount that SONI can retain as a financial benefit in the event that the difference between SONI's aggregate outturn expenditure and aggregate ex ante allowances for costs subject to conditional cost sharing, as calculated in Stage 6 of Table 2, is:

- a negative number; and

- greater, in absolute terms, than the materiality threshold, as determined above.

4.19 We will determine the value of an adjustment at an aggregate level (i.e. across operating expenditure, capital additions attributable to the buildings RAB, and capital additions attributable to the non-buildings RAB).

4.20 We will also determine how that aggregate adjustment will be divided for the purpose of adjusting the cost sharing in each of those three categories of expenditure.

4.21 In the event of an under-spend at an aggregate level (i.e. across the three categories of cost), our decision on the value of the set of adjustments will be constrained by the following:

- The adjustments will be such that the financial benefit (pre-tax) that SONI could obtain under the conditional cost sharing arrangements, would lie in the range of 0% to 25% of the value of the aggregate under-spend.

- The adjustments will be such that the financial benefit that SONI could obtain under the conditional cost sharing arrangements for each broad expenditure category, would lie in the range of 0% to 25% of the under-spend in that category.

- The adjustments will not increase the price control revenue and/or RAB for an over-spend that SONI may have experienced in any of the three categories of expenditure.

4.22 In the event that SONI underspent at the aggregate level, the effect of the set of constraints above will be to focus our assessment of the evidence on those expenditure categories within which SONI underspent.

4.23 Subject to the constraints above, we will assess the case for an adjustment as follows:

- If we find that there is good evidence to demonstrate that the under-spend (or part of the under-spend) was *not* due to a reduction in costs that came at the expense of worse performance against the desired outcomes, then we will set the adjustment as 0% of the value of that under-spend (0% of the relevant part of the under-spend).

- Otherwise (and for any remaining part of the under-spend), the adjustment will be 25% of the value of the under-spend.

4.24 We provide information in Section 5 on the type of evidence SONI would need to put forward for such an adjustment. Further to that information provided by SONI, we expect that our assessment would also draw on evidence that stakeholders may submit to us, as well as any relevant evidence emerging from the assessment carried out by the panel as part of the evaluative framework of performance.

5. Evidence to be submitted by SONI

5.1 In this section we set out guidance to assist SONI in the compilation of the evidence to submit as part of Step 1 of the annual process, outlined in Section 3.

5.2 In this section we refer to three broad categories of expenditure. These refer to expenditure relating to costs that are within scope of the conditional cost sharing arrangements, as specified in Section 4, categorised into (i) operating expenditure, (ii) capital additions attributable to the buildings RAB, and capital additions attributable to the non-buildings RAB.

Identifying materiality of over or under-spend

5.3 As part of its submission, we expect SONI to provide the following information:

- SONI's expenditure, for the relevant financial year, that falls within the conditional cost sharing arrangements, reported separately for each of the three broad categories of expenditure referred to at the start of this section.
- SONI's expenditure, for the relevant financial year, that falls outside the conditional cost sharing arrangements, reported separately for each of the three broad categories of expenditure referred to at the start of this section, for the purposes of reconciliation. This should include details, in particular, of any operating expenditure incurred but not falling within scope.
- SONI's ex ante allowance, for the relevant financial year, in respect of expenditure that are within the conditional cost sharing arrangements, reported separately for the three broad categories of expenditure.
- SONI's over- or under-spend in the relevant financial year, for each of the three broad categories of expenditure.
- SONI's assessment of whether the aggregate over- or under-spend across the three categories of expenditure lies within or without the materiality threshold.

Proposed adjustments for conditional cost sharing arrangement

5.4 In the event that SONI submits the aggregate value of the over-spend or of the under-spend across the three broad categories of expenditure referred to above is greater, in absolute terms, than the materiality threshold, we expect SONI to include within its submission:

- Its proposal for the adjustments to be applied to the cost sharing arrangements, for each of the expenditure categories that would be relevant.
- Evidence in support of its proposed adjustments.

5.5 We turn to the evidence in support of SONI's proposed adjustments below. The nature of that evidence may be different depending on whether the proposed adjustment is made to reflect an under-spend or is made to reflect an over-spend. We discuss each of those cases in turn.

Evidence in support of adjustments to an over-spend

5.6 If SONI proposes that we make an adjustment to allow it to recover more than 75% of an over-spend, we expect that the evidence put forward by SONI would cover a number of elements:

a) Evidence on the baseline level of performance that should act as a reference point. This should reflect service quality and/or performance in 2019/20 plus the aggregate of all performance improvements that have been funded through the price control framework up to and including the relevant year.

b) Evidence that SONI's actual performance in the relevant year exceeded the baseline level of performance. This could include, for example, evidence of improvements in relevant quality performance metrics or evidence of greater stakeholder satisfaction in areas associated with the expenditure category (or categories) for which there was an over-spend.

c) Evidence that demonstrates that SONI incurred additional costs to deliver the improvement(s) in performance, compared to the baseline, which contributed to an over-spend and fall within the scope of the conditional cost sharing arrangements.

d) Evidence that the costs of the improvements it put forward are not funded through allowances from elsewhere in the price control. For example, that they are not covered by hypothecated allowances for new initiatives set at the price control or via uncertainty mechanisms.

e) Evidence of the efficiency of the costs of the improvement(s) in performance, compared to the baseline, that SONI delivered. This could include the presentation of evidence on SONI's approach to selecting the option it chose to deliver the improved performance (e.g. evidence that it considered different options and costed these, and evidence of how it tested or benchmarked those costs).

f) Evidence that the efficient costs incurred in providing the improvements in performance, compared to the baseline level, are justified by the outcomes they achieve in relation to whole system costs, decarbonisation, grid security and/or service quality. That is to say, SONI should provide evidence of how the improvements it put forward improve overall outcomes and provide good value for money. We would expect this to include evidence of stakeholder support for the relevant initiatives and of stakeholder recognition of the value created by the SONI's improvement.

5.7 As part of its submission, and in support of its case, SONI may need to provide evidence on its approach to its allocation of costs across different expenditure categories.

Evidence in support of adjustments to an under-spend

5.8 In the event of an under-spend, if SONI proposes that we make no adjustment (or a partial adjustment) so that it retains a financial incentive from an under-spend, SONI should provide at least one of the following:

- Evidence that the levels of performance have been maintained, or improved, across SONI's services and activities despite the under-spend. This may include reporting on levels of metrics of performance, or on absence of stakeholder concerns being raised.
- Evidence that the under-spend is explained by factors such as genuine efficiency improvement, unanticipated changes in external factors, and/or by the ex-ante cost assessment over-estimating efficient levels of costs.

5.9 It may assist SONI presenting evidence on the points above if it has previously provided to the UR resource plans and budgets for its use of the ex ante allowance, subject to conditional cost sharing. Such plans, setting out what SONI planned to deliver at the outset of the year and the resources required for that, could provide a useful backdrop against which it could locate and explain under-spends and provide evidence of their interactions with the outturn performance delivered.