



# Technical annex: Delivering service and outcomes

Draft Determination  
Annex 3



## About the Utility Regulator

The Utility Regulator is the independent non-ministerial government department responsible for regulating Northern Ireland's electricity, gas, water and sewerage industries, to promote the short and long-term interests of consumers.

We are not a policy-making department of government, but we make sure that the energy and water utility industries in Northern Ireland are regulated and developed within ministerial policy as set out in our statutory duties.

We are governed by a Board of Directors and are accountable to the Northern Ireland Assembly through financial and annual reporting obligations.

We are based at Queens House in the centre of Belfast. The Chief Executive leads a management team of directors representing each of the key functional areas in the organisation: Corporate Affairs, Markets and Networks. The staff team includes economists, engineers, accountants, utility specialists, legal advisors and administration professionals.



### Our mission

To protect the short- and long-term interests of consumers of electricity, gas and water.



### Our vision

To ensure value and sustainability in energy and water.



### Our values

- Be a best practice regulator: transparent, consistent, proportionate, accountable and targeted.
- Be professional – listening, explaining and acting with integrity.
- Be a collaborative, co-operative and learning team.
- Be motivated and empowered to make a difference.



## Abstract

This technical annex sets out more detailed views on our business plan assessment of test area 2 on delivering service and outcomes. It expands further and takes account of our business plan assessment annexes 1 and 2 and Main body Section 4 drafting for this test area.

## Audience

This document will be of interest to SONI and potentially its customers and other stakeholders.

## Consumer impact

SONI's TSO costs of running its business which we price control are typically around 2% of the NI consumers electricity bill. How it chooses to deploy the costs of running its business and performs its role has a larger impact on outcomes such decarbonisation, grid security and wider system costs (for example, system service, wholesale and transmission investment costs which make up part of the electricity bill for NI consumers); given the influence it has across the system. We incentivise SONI through the price control to deliver high quality service to contribute to these good outcomes.



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# 1. Introduction

1.1 This annex sets out our detailed response to the test questions within Delivering Service and Outcomes test area as part of our March 2019 regulatory approach. It includes:

- An overview of the relevant guidance as part of the regulatory approach.
- Our review of SONI's business plan in light of our guidance
- Our proposed interventions and actions

## 2. SONI proposed services and outcomes

### Our March 2019 regulatory approach

- 2.1 Our approach asked SONI to explain and justify the outcomes which matter to the SONI price control and how these are influenced by the range of services which it proposes to provide. We explained that outcomes can be thought of as high level objectives which benefit consumers, customers and other stakeholders. We said that we expect SONI to be responsible for developing these.<sup>1</sup> This relates to test question DS02.
- 2.2 We also set out how we are taking a more service focused approach. Given that SONI is a TSO service provider who can add value across the system we expect that it should set out clearly and accessibly the full range of services which it is to be funded in the price control.<sup>2</sup> We also expect SONI to support its proposals on the services that it proposes to provide over the 2020 to 25 period.<sup>3</sup> This relates to test question DS01 and DS02.
- 2.3 We further set out how we expected SONI to detail its plans to take a more whole system perspective and how it will swiftly enable system change. This relates primarily to test questions DS05 and DS06.

### Review of SONI's proposals on outcomes

- 2.4 SONI's business plan sets out material which attempts to explain and justify the outcomes which matter and how they are influenced by a range of services within its business plan. The main areas of the business plan which are relevant are:
- Chapter 1 sets out strategy themes and roles on decarbonisation and sustainability, grid and market operation, working for with partners, and better engagement.
  - Chapter 8 and Appendix F to I set out descriptions on how it will carry out its role under each of the above strategy. SONI sets out expectations and descriptions of how it will behave and things it will do (which it refers to as outcomes).
  - Appendix N describes four benefit areas and a heat map as part of its benefit sharing framework incentives proposals.
- 2.5 SONI's business plan gives emphasis to the concept of outcomes. For instance, in setting out its strategy SONI says: *"In approaching this price control, SONI and the UR agree that customers and the Northern Ireland customer will receive greater benefit if the regulatory framework evolves to focus more on principles and outcomes"*. We welcome this alignment with our proposed approach to the 2020-

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<sup>1</sup> This primarily relates to the first part of test question DS02.

<sup>2</sup> This relates to test question DS01

<sup>3</sup> This relates primarily to the latter part of test question DS02.

25 SONI price control. The business plan showed awareness of the benefits of a more outcomes focused approach.

- 2.6 One of our business plan test questions included the following: *“How well has the TSO explained and justified the outcomes which matter to the TSO price control and how these are influenced by the services that it can provide”*. SONI’s business plan did not seem to address this question directly.
- 2.7 We found that SONI’s plan did not provide a clear statement of what it considered are the desired outcomes from SONI activities, or what outcomes it is seeking to influence through its decision-making and behaviour. The closest we found in SONI’s plan to a statement of outcomes was a reference that its investments *“underpin and make possible the sector-level outcomes of decarbonisation, improved grid security and efficient system-wide costs”*.
- 2.8 SONI’s proposed benefits sharing mechanism involves the assessment of its performance in four separate “benefit areas”. The four benefit areas were not presented as outcomes, but they clearly relate to the outcomes that SONI’s performance can influence. In any event, we agreed with the prominence that SONI’s framework gave to decarbonisation; grid security; and (system-wide) costs.
- 2.9 For the purposes of our draft determination, and in particular for our proposed evaluative performance framework, we have specified high-level outcomes that draw on SONI’s four proposed benefit areas.<sup>4</sup> We found that we could adapt the drafting of the first three to present outcomes, but needed to modify the “performance” aspect to improve clarity and address gaps.
- 2.10 In addition to high-level outcomes and benefit areas, SONI identified outcomes in relation to some of its proposed business plan service initiatives and as part of its strategy approach.
- 2.11 For example, in Appendix F it identifies three outcomes under the “sustainability and decarbonisation” broad service initiative theme, which are: (i) establish new processes & tools; (ii) strengthen data and communications; and (iii) promote informed choices, and identified proposed initiatives that contribute to these outcomes.
- 2.12 These more granular outcomes did not seem as relevant to the business plan question on services and outcomes highlighted above, but are relevant to our review of the various proposed initiatives.<sup>5</sup> They also give potential insight into SONI’s view of how its strategic approach can influence outcomes. So we have considered this further below as it feels relevant to outcome justification and explanation.
- 2.13 We have concerns that SONI’s strategic approach may mean that it misses opportunities to influence good system outcomes effectively for the 2020 to 2025

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<sup>4</sup> See Evaluative performance framework Annex 4 and Section 5 of Main document for our view on outcomes.

<sup>5</sup> See Cost allowances framework Annex 6 for our cost assessment of these service initiatives

period and beyond. Many outcomes relating to system wide costs and decarbonisation, for example, risk not be appreciated to their fullest extent or missed altogether. We have given some examples to help illustrate this point:

- Risk of over-focusing on outcomes that can be achieved by delivering new infrastructure through stakeholder engagement, rather than other good outcomes that could be achieved by considering a broader perspective within its network planning and system insight role. For example, see GHD's Annex 9 on illustrative examples of international TSO practice, and also SECG views related to whole system planning.
- SECG member comments that decarbonisation is about more than renewable energy, and there are cross-vector opportunities that SONI should be coherently and actively planning for these.
- There is little in the strategy to suggest a more customer focused approach to sharing of data. Considering such an approach may open up opportunities to reduce other system wide costs not emphasised in the plan. For example, we are of the view that it should be strengthening data and communications by sharing and collaborating with market participants. It should also be establishing new processes and tools in a way that is fully responsive to the needs of new energy system actors, as well as more traditional ones.

2.14 We found some further issues with how the strategy themes may link to good outcome contribution. We have provided some key examples to help illustrate this point:

- We welcome that some aspects of SONI's strategy have a clearer, more tangible statement which seems to have been tested and informed by stakeholders to an extent. For example, SONI seeks to meet a target of 70% renewable electricity and we note this has been tested with SECG at least at a broad level. However, we are concerned that SONI has not fully considered the role that customers and stakeholders can play in the transition in this regard.
- 'Working with partners for positive change' theme. This has the potential to link very positively to outcomes. Yet it is unclear what role SONI seeks to play in working with partners like NIE Networks and others during the period and why it may be best placed to do so through, for example, the use of data and information.
- We also found other strategic roles to be largely generic descriptions of SONI's role during the period and how these could contribute to good outcomes. The linkage between the various components of the plan, like between service and outcome, also often seemed to be unclear. For example, the goal on grid security lacked sufficient information on what exactly SONI trying to achieve and how exactly this will meaningfully



improve outcomes.<sup>6</sup>

- 2.15 Overall, we did not find clear, well-organised and persuasive explanation in SONI's business plan of the outcomes it was seeking to influence through its service provision and service quality. But the plan did contain useful material to allow deduction on the high-level outcomes SONI envisages and which we could use.

## **Review of SONI's proposals on SONI roles and services**

- 2.16 The following elements in SONI's plan describe the range of services and the main areas where it attempts to support its service proposals for the 2020 to 2025 period:

- Appendix A sets out its view of each of its roles and service. As part of this, it describes the activities, source of obligations, outputs and lists the type of routine engagement it undertakes.
- Section 8 sets out the services and what it proposes to deliver during the period (its initiatives). Appendices D to W set out the supporting information and justification for these initiatives on need, optionality, risk, delivery, costs and benefits.
- Appendix N sets out its heat map material of how its services can potentially influence outcomes and benefit customers.

- 2.17 The information, particularly as demonstrated through Appendix A, is generally excellent in setting out and clearly describing the full range of services:

- It is clear that SONI has attempted to provide a focus on service description. There is generally a clear and accessible explanation which we consider stakeholders could understand. We note SECG views in this regard.
- There is also a high degree of granularity as the relevant licence conditions are set out for its existing services and activities and outputs identified.

- 2.18 We have made some interventions below which are minor, as they are largely presentational:

- Adapting “system adequacy” service to “Ensuring system adequacy and market development”. We believe this brings out important work which SONI carries out in relation to system services and capacity markets.
- Adapting “transmission network system planning” role to “transmission network system planning and system planning” and moved the “assessing and communicating system needs” from the “Independent expert voice role” into this area. We think this reflects this service activity sits better within this area given the interlinkages between planning the network and the system in a whole system way.

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<sup>6</sup> We also note that goal descriptions on P1-11 do not seem to correspond to those in Appendix G-5 'outcomes' which also makes it unclear as to what SONI is trying to achieve and why.

- Creating a “regulatory engagement” service within independent expert voice role to reflect concerns that have arisen during the price control process.
  - Removing the “support functions”. These are inward looking functions as opposed to customer, consumer and stakeholder focused service activity.
- 2.19 SONI has generally provided more relevant information than it has in previous submissions to support its new service proposition. We note SECG comments in this regard around provision of supporting information on need, cost, options and risk etc. For example, the Appendix I provided relevant and well-considered material on background (challenges) and need (as noted by a SECG member).
- 2.20 However, we have material concerns with the justification and evidence supporting the proposals on service initiatives. Our views on business plan quality set out in the Cost allowances Annex 6 on service initiative need, option, benefit are relevant in this regard.
- 2.21 We found no coherent explanation of why the enhanced service initiatives have been chosen and why other potential initiatives have not, with reference to all the outcomes it can influence through its full service scope. As a general point, a stronger response may have been able to demonstrate real, practical value by feeding the Appendix N work on benefit areas and heat map persuasively and clearly into its justification on the Appendix D to H service proposition (and also the strategy and role description work). However, the plan is unclear how this work has influenced SONI’s choice of and emphasis on enhanced service initiative provision.
- 2.22 We note comments made by SECG members that SONI’s view of roles and responsibilities could be clearer. We are concerned that in many key areas SONI is presuming that it is best placed to undertake certain service activity without any demonstrable justification and consideration. We have particular concerns that SONI should not necessarily be undertaking activity which potentially fits within the DSO and TAO roles and that the potential role of other 3<sup>rd</sup> parties is very limited.
- 2.23 Overall, it is unclear that risk has been fully considered and evidenced in terms of coming to choice of option. For example, for certain proposals, we are unclear why the chosen path is least regrets, why SONI and not another party is best placed to carry this proposal out and how exactly it has considered issues around timing. We are also concerned that need has not been fully considered. The main specific examples of this from SONI’s service initiatives are:
- Appendix E: Ownership of telecoms assets. We consider this cuts across NIE Networks role.
  - Renewable strategy initiative (F1): Digital performance monitoring, RES telecommunications lab, and DSM at a residential level.
  - Control centre tools (F2): we welcome further justification from SONI as to why RES-E dispatch is not a DSO role.
  - Migration to IP to support SCADA (F4): the initiative need relates to

managing and instructing distribution connected generation.

- Data service initiative (F3): we agree with SECG member views that SONI should be taking a more customer focused approach and considering how it can meaningfully collaborate with stakeholders and share its information with customers and stakeholders. This is likely to be a key area of the energy transition which SONI can influence and it should be demonstrably planning for this now rather than waiting as it proposes.
- Appendix H initiatives on stakeholder engagement: SECG members are concerned around the extent of SONI's role in educating customers, rather than seeking a more collaborative approach.

2.24 We also have concerns that the plan is limited in exploring innovative opportunities for variations in the service obligations it faces where this could improve outcomes. For example:

- We feel that Initiatives F1, F2 and F3 have the potential to bring material net benefits to consumers depending on how ambitiously and appropriately they are eventually scoped. However, it is difficult to understand how the majority of other initiatives represent a genuine enhancement in service.
- We note that most initiatives seem to relate to existing licence conditions and seek to demonstrate a compliance focus. For example, most of Appendix G.
- We also agree with SECG members concerns that Appendix H initiatives seem out step with the transformation required to support the energy transition. We note SONI's own view seems to support that these initiatives are essentially a realignment of its 2015-20 strategy rather an appropriate step-change.

2.25 Overall, we recognise some initiatives have potential to benefit consumers but we are disappointed with the overall level of ambition. We are of the view that SONI needs to consider its approach to innovation in a way which better reflects stakeholder engagement and how it can influence good outcomes during the energy transition. SECG members voiced concerns around the process and delivery of innovation. For example:

- Further clarity is required around how SONI intends to engage 3<sup>rd</sup> parties in innovation, how much it seeks to spend on this, and also its approach from learning from innovation and making it Business as Usual (BAU).
- SONI needs to be taking a more collaborative approach to innovation and also actively learning from best practice elsewhere as well as home-grown experience.

2.26 In light of the above concerns we have developed draft service expectations. These are set out as part of our performance framework proposals and are designed to inform our baseline view of our expectations of what SONI should be doing and

behaving. They have been informed by SECG views, but are draft and so we would welcome engagement on these to help refine.

- 2.27 We understand that some of our service expectations may represent a service gap over and beyond the status quo level of service provision and so we propose an uplift to SONI's baseline to allow it to scope out the types of deliverables which meet these expectations (see Cost allowances Annex 6)
- 2.28 There are also aspects of service roles that we do not consider well justified, such as NIE revenue collection, in way that means SONI bears risk on behalf of NIE Networks (see our Annex 7, Risk and return).

## **Review of SONI's proposals on a system-wide approach**

- 2.29 This area considers SONI's proposals for taking a direct role in taking a system-wide perspective and appraisal rather than a narrow focus on costs that it incurs directly from running its business. A key aspect of this is meaningful co-ordination and collaboration with other parties.
- 2.30 The following elements of SONI's plan are the main areas which we consider are potentially relevant to understanding the extent to which SONI's proposals for services demonstrate that it will bring a system-wide perspective and approach across all parts of the NI energy system:
- Chapter 1 strategy
  - Appendices E to J
  - Chapter 3 and 10 has a sub-section on system wide efficiencies
  - Appendix N
- 2.31 While SONI has provided some limited high level generic examples of the types of things that a system wide perspective may involve, we do not consider that these represent a firm practical understanding. This is because SONI has generally not set out a clear justification for how it will itself coordinate and collaborate during the forward look and beyond.<sup>7</sup> The references to coordination and collaborating with other parties, including NIE Networks, are generally high level statements and there is little to no explanation of how SONI is taking a whole system perspective.
- 2.32 We are very concerned that SONI's response demonstrates little to no appreciation of the factors that pose risks to a system wide perspective in key areas of material consumer interest:
- SONI is too often proposing to undertake activity with no justification of the risks of doing so, rather than considering whether a coordination and collaboration role would be more appropriate instead. The examples we set

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<sup>7</sup> One SECG member welcomed the description SONI had made on system change (table 1-6 of its business plan) but noted this did not feed into the plan and that SONI's view of decarbonisation risks not being system wide.

out above in paragraph 2.23 above are highly relevant in this regard.

- We are also concerned about its performance framework proposals, via the benefits sharing framework, do not totally support taking a whole system perspective and risk poor outcomes.

2.33 We are also concerned that there is no credible plan for adopting a system-wide perspective across its services and activities. There is little to no information about how it will prepare and plan its business for the period to bring a whole system perspective on the basis of the above. For example:

- We note that a key part of SONI's strategy is a supporting goal to 'work with partners for positive change'. Yet there is no service initiative business case to support this. This is somewhat surprising as we note SECG concerns during business plan development around working with NIE Networks and other stakeholders in this regard.

## **Review of SONI's proposals on system development**

2.34 This area is about SONI's TSO role in system evolution and development and how it can act as a swift enabler of developments which system users seek. Issues such as transparency and participation processes are relevant within system development as they can provide a way for customers/users and other stakeholders to contribute.

2.35 We do not consider that there is a clear and justified exposition of SONI's TSO involvement across different aspects of the system (and market), highlighting priority areas, drawing on stakeholder engagement and linking to desired outcomes:

- As noted above we are concerned that there is insufficient clarity on desired system wide outcomes. We are concerned here that there is little to no meaningful evidence and justification on how it will participate and be transparent and how this will lead to desired outcomes. For example, see our view in the outcomes section above.
- We could not find any evidence of how service initiatives have been prioritised and the dependencies mapped out between initiatives. We note SECG members' comments that priorities are unclear.
- We also have concerns that issues around transparency and participation around stakeholder engagement. It is unclear that initiatives have been fully tested with stakeholders to meet their specific needs.

2.36 We also do not consider that arrangements in place are effective to ensure it meets customer needs, including in relation to timescales, transparency, stakeholder participation and adaption over time. For example:

- SONI's proposed benefits sharing framework incentive arrangements and performance commitments are underdeveloped and/or risk not being in consumers interests. In particular, we think the mechanistic nature and

properties of the framework provide insufficient flexibility to incentivise effective performance during a time of energy transition.

- Stakeholders have concerns that arrangements to engage with customers, consumers and other stakeholders, which are essential part of timely system development, are poor. For example, SECG stakeholders have questioned how the business is set up to deal with uncertainty in responsive and agile way,<sup>8</sup> and had concerns with SONI plans to collaborate with 3<sup>rd</sup> parties.
- We could find no other arrangements to give confidence on how the service initiatives will be developed in a timely way during the period. As noted above, we have concerns around SONI's choice of optionality and timing for key initiatives. We also could find no basic tools bringing initiatives, timings and inter-dependencies together and setting out time scales. For example, provision of something like a road map of deliverables, clearly explaining rationale for timing and critical dependencies would have been helpful.

## **Our proposed approach for draft determinations**

2.37 The key interventions that we propose for the draft determination are as follows:

- We have made a small number of targeted presentational changes to the structure and specification of SONI roles and services.
- We do not plan to adopt SONI's proposed benefits sharing mechanism as a means to provide incentives for good performance by SONI and to ensure it is accountable for its performance. We have developed an evaluative performance framework, in line with our March 2019 regulatory approach, which we present in Evaluative performance framework, Annex 4. Our evaluative performance framework draws on some aspects of SONI's benefits sharing mechanism.
- We do not consider that SONI provided sufficient clarity on the outcomes it is trying to achieve or influence. We address this as part of the specification of the desired outcomes for the evaluative performance framework in Evaluative performance framework, Annex 4.
- We have set out service expectations in Evaluative performance framework, Annex 4. These inform our view of our baseline expectations of the behaviour and type of service activity which SONI should be undertaking. We understand that some of these expectations may represent a service gap beyond the status quo level of service. We propose an uplift to SONI's baseline to allow it to scope out deliverables which meet these expectations.

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<sup>8</sup> Comments such as "Appendix H places an emphasis on system planning – but what about responding? As SONI's own introduction explains, the energy transition brings uncertainty. So planning can only go so far – it needs to be matched with responsiveness and agility. What are the implications for DS3+ procurement, and for pricing in 'option value'"

### **3. SONI performance commitments and service levels**

#### **Our March 2019 regulatory approach**

- 3.1 We seek evidence on how appropriate, well-evidenced, relevant and stretching the company's proposed performance commitments and service levels are.
- 3.2 Our guidance seeks evidence that company proposals go beyond minimum levels required for compliance. We further requested justification for any additional cost costs resulting from enhanced service levels.

#### **Review of SONI's performance commitments and service levels**

- 3.3 We consider that SONI's response is substantially short of excellent. The plan provided on 31 October 2019 is very underdeveloped in this respect. SECG members also noted that these were underdeveloped or unclear.
- 3.4 For example, in the business plan D to H annexes on initiatives, SONI set out primary/secondary outcomes and the relevant metrics e.g. for the new disaster recovery building SONI stated:
- Primary outcome = improved resilience of the grid.
  - Secondary outcome = improved security of the DRBC.
  - Metrics = Reduction of system minutes lost.
- 3.5 While such an approach is welcome, various problems were identified within the business plan proposals including:
- SONI did not provide levels of base service associated with the proposed metric.
  - SONI did not provide targets associated with the performance metrics.
  - SONI did not typically explain how the investment would impact on the chosen metric.
  - Some of the metrics did not seem relevant or customer focused.
  - Sometimes types of metric, benefit or outcome seemed to be missing.
  - SONI has not justified why it thinks the investment is value-for-money given the impact on service levels.
- 3.6 We have since received a further submission, at the end of February 2020, which seeks to set out and develop the performance commitments or service levels. While

this helped provide some context to the targets proposed, however we still have significant concerns.

- 3.7 In particular, the link between business plan activity and the impact on performance metrics is particularly uncertain. Some of the targets do not seem innovative or stretching, though may be worthwhile monitoring. Areas of incentivisation also still seem to be missing, or not engaged with, despite having been discussed with by customers, stakeholders and UR regularly at various phases of the price control process: for example, collaborating and coordinating with NIE Networks. We set out our response to this within Annex 4, Evaluative performance framework.

### **Our proposed approach for draft determinations**

- 3.8 We propose that SONI provides updated performance metrics as part of its first forward plan as set out within Annex 4, Evaluative performance framework. We expect to work with SONI and stakeholders to ensure that these are developed in a way which meets expectations and are in the interests of consumers. We have provided for an additional cost allowance (uplift to baseline allowance) to support SONI in scoping out enhanced service levels.



## 4. Accountability for SONI performance

### Our March 2019 regulatory approach

- 4.1 In the March 2019 approach decision, we said that the way SONI delivers service across the system is important and is likely to grow in importance, but the price control regulatory framework is currently under-developed. We said that we considered that there should be a stronger role for the regulatory framework to offer incentives to SONI to deliver high quality service.
- 4.2 We proposed to adopt an ongoing evaluative approach, with stakeholder involvement, to encourage and incentivise good performance from SONI across a range of services and outcomes.<sup>9</sup>
- 4.3 We outlined a proposed new approach which included the following elements:
- SONI could receive a significant financial reward, or face a significant financial penalty, according to its performance under an evaluative performance framework
  - The determination of SONI's performance in these areas, and the application of any reward or penalty, would depend on a regulatory assessment of a range of evidence, including quantitative and qualitative evidence – we considered this to be more appropriate for the TSO than mechanistic financial incentives against pre-specified performance metrics.
  - This regulatory assessment would draw heavily on input from stakeholders.
  - The evaluation of SONI's performance, and the application of any financial reward or penalty, would be done on an ongoing basis during the five-year price control period (e.g. annually) rather than at the end of the price control period
- 4.4 We said that we would decide on the precise process and framework design during the price control determination period.
- 4.5 We said that we had considered precedent from other regulators and highlighted, in particular, that aspects of Ofgem's framework for regulation of the GB electricity system operator are relevant and could be adapted for the circumstances of SONI.
- 4.6 We identified a choice between a more mechanistic or a more evaluative approach to performance accountability, and proposed a more evaluative approach. We highlighted risks that a more mechanistic approach can bring unintended consequences, and the concern that the things that matter for consumers may not be well-suited to quantitative targets. We also valued the greater flexibility from a more evaluative rather than mechanistic approach, which is important in a context

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<sup>9</sup> UR (2019), SONI price control approach decision, page 31 to 37.

of uncertain future developments.

- 4.7 We identified that one potential downside from an ongoing evaluative approach is that, depending on how it is designed, there is a risk that such an approach could introduce revenue uncertainty for SONI. But we said that this could be mitigated through design measures, such as regulatory guidance and effective stakeholder engagement.

## **SONI's proposals on performance accountability**

- 4.8 SONI's business plan put forward a new "benefit sharing framework" which is intended to provide it with enhanced and coherent financial incentives in relation to its performance. SONI's approach involved extensive use of mechanistic financial incentives.

- 4.9 Some of the key features of SONI's proposed framework, as summarised in the main body of its business plan, are as follows:<sup>10</sup>

- SONI's performance would be assessed in relation to four key "benefit areas": decarbonisation; grid security; cost (viewed holistically); and performance.
- The assessment of decarbonisation, grid security and costs would be through quantitative assessment, through financial rewards or penalties determined by formulae applied to macro metrics (e.g. UK carbon intensity or an adjusted energy bill measure) and micro metrics (e.g. installed capacity of RES or specific types of costs such as system operator internal costs, or network costs).
- The performance area would be assessed through a qualitative assessment, and SONI suggested that there would be assessment by an independent panel of how each test area met the qualitative target of 'what good looks like'.
- There would be explicit weights used to calibrate the incentives, with 40% allocated to the cost area, and 20% to each of the decarbonisation, grid security and performance areas.
- There would be a maximum reward of £3m per year and a maximum penalty of £1.5m per year.

- 4.10 The benefit sharing framework was also the subject of a report by SONI's advisors KPMG which was attached as an appendix (Appendix N) to SONI's business plan. SONI did not publish this appendix when it published its main section of its business plan or share it SECG.

- 4.11 Appendix N gave more information on the process used by KPMG to develop the proposed framework. It provided and discussed some principles to be used to

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<sup>10</sup> SONI business plan, pages 11-3 to 11.12.

design or move to a benefit sharing framework, and it gave some examples of what this type of approach might mean if applied to the TSO (e.g. examples of metrics that might be used). However, Appendix N did not present a detailed explanation of how the benefit sharing framework would work in practice.

- 4.12 In late February 2020, SONI provided an additional document to the UR and members of SECG. This included a summary of its latest view on how the benefits sharing framework would work, and a series of proposed performance or output measures and targets. This clarified that SONI envisaged that for the areas of decarbonisation, grid security and costs, a series of financial rewards or penalties would be calculated directly through formulae relating to separate performance metrics.

## **Review of SONI's proposals on performance accountability**

- 4.13 We carried out a detailed view of SONI's submissions on its benefit sharing framework. Our main findings are as follows.
- 4.14 SONI's benefit sharing framework did not seem well aligned with the proposals from our March 2019 regulatory approach (and SONI has not engaged with some of the key issues we raised). We had proposed an approach that involved financial incentives arising from a more ongoing evaluative assessment of performance, whereas SONI's proposed approach seemed to be more mechanistic than we envisaged.
- 4.15 SONI's business plan did not engage directly with the type of approach we had proposed to use in our March 2019 decision. SONI's approach included an element of qualitative assessment (to be given a 20% weight in the overall assessment) alongside the quantitative or mechanistic part. But this amounted to quite a different type of approach to that which we had proposed. SONI did not explain why its alternative was superior.
- 4.16 Similarly, SONI's business plan did not show awareness of why Ofgem moved away from mechanistic financial incentives for National Grid's electricity system operation role, towards an evaluative approach.
- 4.17 Ofgem started with a mechanistic approach for electricity system operator incentives, and then moved, after years of experience with various different mechanistic incentive schemes, to an evaluative approach. The KPMG report at Appendix N to SONI's business plan provided a very brief case study of Ofgem's approach to the GB electricity system operator, for which the only material implication drawn for SONI was stated as follows: *"The move away from formulaic incentives to a subjective review is significant. It offers less certainty when making investment decisions, making business planning harder. It also reduces the likely range of outcomes with both penalties above the equity return and significant rewards probably less likely to be determined"*.
- 4.18 KPMG emphasise a potential drawback of a more subjective/evaluative incentive approach compared to a more mechanistic incentive approach, without showing

any awareness of the potential benefits from such an approach in comparison to a mechanistic approach.

- 4.19 Despite its lack of alignment with the approach proposed from our March 2019 decision, we did consider whether SONI's proposals provided grounds to reconsider the type of approach to performance accountability that we had envisaged. We found no such grounds.
- 4.20 We found SONI's proposed benefit sharing framework in its business plan to be under-developed. It contained some useful elements but was not close to something that could be implemented in practice.
- 4.21 The material provided by SONI did not provide confidence that, if substantial further work was done to put it into practice, the benefit sharing framework would work well in terms of holding SONI to account and encouraging ongoing improvements across desired outcomes. For instance:
- The scope of the benefit sharing mechanism seemed unduly narrow, missing out on aspects of SONI's role and services that matter for its overall performance (e.g. the service quality that SONI provides to parties seeking connections matters in itself, beyond its impact on high-level objectives/outcomes relating to decarbonisation, grid security and system-wide costs).
  - The approach proposed and supporting material in Appendix N showed very limited awareness of, and engagement with, the practical difficulties and risks of unintended consequences that arise in seeking to apply mechanistic financial incentives to the services and desired outcomes for an electricity system operator.
- 4.22 It is worth elaborating briefly on the last point above. The challenges of mechanistic incentives include the following:
- 4.23 SONI's decision-making and behaviour affect costs incurred by other parties in the system (e.g. NIE Networks and generators) many years into the future. There are risks that a mechanistic incentive scheme that uses measures of costs as a performance metric will provide perverse financial incentives for SONI to minimise costs in the short term at the expense of higher costs in the longer term.
- 4.24 Mechanistic financial incentives of the type proposed by SONI typically involve determination of a baseline, above which the regulated company is automatically entitled to rewards and below which it automatically faces financial penalties. This makes the determination of the baseline important to ensure a fair balance of risk and cost between customers and the regulated company (and, in turn, to maintain stakeholder trust in the incentive arrangements).
- 4.25 However, it can be very difficult for a regulator to set good baselines for some key aspects of the SONI's performance, because of: the lack of opportunities to benchmark with other organisations; the extent of change/variation over time which reduces the relevance of historical performance levels; and the technical nature of

the subject matter.

- 4.26 Not all aspects of SONI performance are conducive to quantifiable measures of performance that can be incorporated into a mechanistic incentive scheme. Mechanistic incentive schemes carry risks of unintended consequences and these risks seem particularly high for a new and untested framework. SONI's proposals did not seem to offer an effective way to tackle these issues.
- 4.27 We found that SONI's additional submission in late February 2020 was helpful in giving a clearer idea of how it envisaged the benefits sharing framework would work. This confirmed to us that, at least for the key performance areas of decarbonisation, grid security and system-wide cost, SONI was proposing a primarily mechanistic incentive framework (with some exceptions). It was helpful to see the specific performance metrics and targets that SONI had in mind. But this additional submission did little to make the case for the type of relatively mechanistic approach that SONI was proposing.
- 4.28 While we did not agree with SONI's overall approach for performance accountability for the SONI price control, we found some elements of the approach, and the supporting material that SONI provided, to be useful. In particular, SONI's submissions included useful input in relation to matters such as:
- The high-level outcomes that SONI's performance can influence.
  - The extent to which SONI's activities under different service areas can influence performance in relation to different outcomes.
  - Potential performance metrics (which could be used either for mechanistic incentives or as part of the evidence base for a more evaluative assessment).
  - The weighting of different high-level outcomes (SONI's benefit areas) as part of the overall calibration of financial incentives.
  - The maximum downside risk that SONI should bear.
  - Our proposed approach for draft determinations.

## Summary of stakeholder views on SONI proposals

- 4.29 We received some input from members of SECG on SONI's submission in relation to the following business plan test question: *To what extent do the arrangements proposed by the company for holding it to account and/or influencing its incentives over the price control period give confidence that it will meet its proposed performance commitments and achieve ongoing improvements?*
- 4.30 SONI did not provide its Appendix N to these stakeholders. SECG comments related to the information on its approach in its main business plan (e.g. chapter 11 which considered performance incentives and summarised its proposed its benefit

sharing framework) rather than the more detailed report from KPMG in Appendix N.

- 4.31 One stakeholder described section 11 of SONI's business plan as weak in demonstrating accountability. The stakeholder said that metrics mentioned in relevant appendices are notable, but there is no demonstrated accountability process.
- 4.32 One stakeholder said that the "holistic incentive design package" set out in figure 11.4 of SONI's business plan could give the requisite confidence, but whether it does will be dependent on the exact parameters/targets that are included in the final package.

### **Our proposed approach for draft determinations**

- 4.33 In line with our March 2019 Regulatory Approach decision, we have developed a new evaluative performance framework for the 2020-25 SONI price control.
- 4.34 We saw no good basis for which we could adopt SONI's proposed benefits sharing framework for the 2020-25 SONI price control period. SONI's framework was significantly different to what was envisaged in our March 2019 Regulatory Approach and had a number of serious shortcomings, as highlighted above.
- 4.35 Even so, we found some substantial elements of SONI's benefits sharing framework to be relevant and useful. We have drawn on these in developing our proposed evaluative performance framework. In addition, we have drawn heavily on the developments in Ofgem's regulation of the GB electricity system operator, which involves an evaluative performance framework.
- 4.36 We also considered whether there needed to be any additional regulatory safeguards in relation to SONI's performance in relation to services and outcomes beyond the evaluative performance framework (and obligations under existing licence conditions).
- 4.37 We identified a scenario in which SONI might receive additional ex ante price control funding for specific projects or initiatives that were intended to bring improvements against desired outcomes, but it may delay or fail to complete those initiatives. Under a mechanistic cost-sharing arrangement, customers could end up paying for anticipated benefits that are not achieved. However, for the treatment of SONI costs in the 2020-25 period, we are not proposing a mechanistic cost-sharing arrangement.
- 4.38 We would expect any projects initiatives to be funded either through an approach of remuneration of costs incurred subject to a cap, or through the new approach we are proposing of qualified cost-sharing incentives as set out in Annex 5, Cost remuneration and managing uncertainty. We propose that for the purposes of the qualified cost-sharing incentives, special arrangements, described in the next sub-section, apply in terms of performance accountability and cost remuneration.

### **Additional arrangements for price control deliverables**

- 4.39 We propose that the following default arrangements would apply for the purposes of the 2020-25 SONI price control for costs subject to conditional cost-sharing incentives. We may decide in specific cases that some aspects should not apply (e.g. if the evaluative performance framework is sufficient by itself to ensure accountability) but if we do not specify alternative arrangements in a specific case, the default arrangements below would apply.
- 4.40 Where we include a hypothecated expenditure allowance to fund a specific SONI project or initiative within SONI's ex ante allowance, we would specify price control deliverables that are expected to be delivered or achieved as part of this funding:
- The deliverables need to be verifiable and suitable for holding the TSO to account for potential non-delivery, under-delivery and late delivery.
  - As far as possible subject to point (a) above, deliverables should be specified in a way that provides flexibility for SONI as to how it achieves the benefits expected from the project or initiative. A deliverable might be expressed in terms of outcomes, benefits, outputs or, if these are not practical, in terms of inputs.
  - The deliverables should have a target delivery date and potentially a series of milestones for projects split into phases.
  - The specification of deliverables, and their monitoring, should take account of timeframes over which benefits from projects or initiatives are to be sustained. For instance, an investment initiative might be expected to bring a certain benefit over a five-year period and it would be important to recognise that achieving those benefits for two years only represents under-delivery. This point means that holding SONI to account for delivery of a project might span multiple price control periods.
- 4.41 The ex-ante expenditure allowance hypothecated for specific projects or initiatives would be treated separately from the main body of expenditure funded through an ex ante allowance and conditional cost-sharing incentives. For the allowances for these projects, the following financial adjustments would apply:
- If there is no delivery of the deliverable, financial adjustments would be made to price control allowances to deduct the value of the ex-ante funding that had been provided for that deliverable (including return on capital and regulatory depreciation for the ex-ante allowance).
  - If there is partial delivery of the deliverable, financial adjustments would be made to deduct the value of the ante cost allowance for that initiative, with the proportion reflecting an estimate of the proportion of the deliverable that is delivered or achieved.
  - If there is late delivery of the deliverable, we reserve the right to make financial adjustments to deduct the value of any financing costs benefit (e.g. allowed return) that SONI has received from delays to the project.

- 4.42 Subject to these adjustments, a 25% cost-sharing incentive on any over-spend or under-spend would apply directly to the costs of these initiatives, as performance in terms of outputs and outcomes would have already been taken into account. So the more evaluative process of regulatory assessment of over and under-spend envisaged for the main body of costs subject to conditional cost-sharing would not apply. The role of price control deliverables thereby simplifies the application of financial incentives on costs.
- 4.43 There would be no automatic financial adjustment for over-delivery (i.e. delivering benefits beyond the price control deliverables). But, as part of the general arrangements for the conditional cost-sharing incentives, SONI could make the case for recovery of over-spend associated with the efficient costs of over-delivery that achieves improved outcomes.
- 4.44 In addition, the performance against the price control deliverables would be taken into account as part of the evaluative performance framework as follows:
- Delivering in line with the specified price control deliverables would constitute baseline performance for the purposes of the evaluative performance framework, qualifying for neither reward nor penalty.
  - SONI might receive a financial penalty under the framework (or a lower reward) if the performance evaluation finds a likelihood of significant harm to desired outcomes from non-delivery, under-delivery or late delivery against deliverables that have been funded through the price control.
  - SONI might receive a financial reward under the framework (or a lower penalty) if the performance evaluation finds that non-delivery or under-delivery by SONI was likely to improve outcomes (e.g. if circumstances have changed and SONI considered it better overall to cancel a planned deliverable).
  - SONI might receive a financial reward for over-delivery, if the performance evaluation finds significant net benefit from going beyond the price control deliverables.