

Technical annex: Cost remuneration and managing uncertainty

Draft Determination Annex 5





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.



- 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 sets out more detailed work on design and guidance for our proposals for cost remuneration and uncertainty mechanisms. It expands on the main body section 6 and relevant analysis in business plan assessment annex 2

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.





Contents page

1.	Introduction	3
	The importance of reviewing the cost remuneration approach	3
	Our March 2019 regulatory approach	5
2.	SONI's proposals on cost remuneration approach	7
	SONI's business plan proposals	7
	Review of SONI's business plan	7
	Implications for our draft determinations	9
3.	Developing options for SONI cost remuneration	10
	Alternative cost remuneration approaches	11
	Categorisation of SONI costs	17
	Interaction with evaluative performance framework	
	Policy options for SONI cost remuneration approaches	19
4.	Evaluation of options	24
	Assessment criteria	
	Evaluation of policy options against assessment criteria	27
	Proposed approach for draft determinations	
5.	Role for enhanced cost transparency	35
6.	Uncertainty mechanisms	38
	March 2019 regulatory approach to uncertainty mechanisms	
	SONI business plan proposals for uncertainty mechanisms	
	SECG member views on SONI business plan	
	Proposed approach to transmission network planning	
	Our proposals for other uncertainty mechanisms	
	Cost allowance under conditional cost-sharing incentives	
	Accountability for delivery of bonefits from funding	
	Balance between upfront and within-period cost assessment	40 46
App	endix A: conditional cost-sharing approach	48





1. Introduction

- 1.1 We use the term "cost remuneration approach" to refer to the price control arrangements that apply to SONI's costs, or to specific categories of SONI costs, which determine how SONI is remunerated for those costs.
- 1.2 The cost remuneration approach concerns a range of interrelated regulatory policy questions for the design of the price control framework, such as:
 - How does the price control remunerate SONI for the (efficient) costs of its services and activities?
 - What is the role for financial incentives within the price control framework to encourage efficiency in the costs incurred by SONI?
 - How does the price control framework protect customers from the costs of any inefficiency on the part of SONI?
 - How does the price control framework protect SONI and customers from uncertainty, at the time of the price control review, about the efficient level of costs for SONI's services and activities over the price control period?
- 1.3 In this appendix, we present our draft determinations on the cost remuneration approach for the 2020-25 SONI price control.
- 1.4 The cost remuneration approach overlaps to some degree with the use of uncertainty mechanisms for costs that are difficult to predict at the price control review. We also include in this appendix our draft determinations on the use of uncertainty mechanisms relating to cost uncertainty (section 6).

The importance of reviewing the cost remuneration approach

- 1.5 The environment in which SONI as a TSO is operating in is experiencing rapid change in technology and there is need for a NI TSO to respond to these changes swiftly and more ambitiously. In light of this, we have concerns with aspects of the existing cost remuneration approach for the SONI price control, especially given the importance we are attaching to the role of the TSO in contributing to desired outcomes across the Northern Ireland Electricity system.
- 1.6 At the same time, we recognise the need for some retention of mechanisms which provide for an appropriate and proportionate amount of pressure on cost efficiency, not least given the stage of maturity which SONI is at in this area. We feel this point remains appropriate given our concerns around business plan quality with respect to cost efficiency. So our policy preference remains in favour of an adaptation of the existing approach to cost remuneration to better align SONI incentives with desired outcomes, whilst still promoting a degree of SONI cost efficiency.
- 1.7 This appendix sets out our detailed review of options for the cost remuneration approach for the SONI price control framework over the 2020-25 period. We

considered this to be a high priority issue for our draft determinations, and an area that we marked out for further development in our SONI price control approach decision in March 2019.

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- 1.8 A significant element of the costs incurred by SONI in its TSO role is, under the current price control framework, subject to conventional mechanistic financial incentive arrangements. By this we mean that the regulator sets an ex ante allowance for the efficient level of costs during the price control period, and any difference between the actual costs incurred by the company and the ex-ante allowance is shared in a fixed proportion (e.g. 50% each) between customers and the company (and its investors). This means that the regulated company gets a fixed share of the benefits from spending less than this amount (as a financial reward) and bears a fixed share of the costs from spending more than this amount (as a financial penalty). While this is a familiar approach within the context of UK RAB-based price control regulation, there are reasons to think that it may not be appropriate for a TSO such as SONI.
- 1.9 SONI costs which have been the subject of "conventional" mechanistic financial incentives represent around 2% of the NI consumer electricity bill, but how the TSO performs and delivers services can influence a much greater element of the total electricity bill, given its system wide influence. This is illustrated in Figure 1. By SONI internal costs, we mean costs incurred by SONI in its TSO role which are not system support services and excluding transmission/interconnector revenues collected on behalf of NIE and Moyle.



Figure 1: Costs incurred by SONI and other costs it influences

1.10 There is a serious risk that applying conventional price control cost incentives to SONI's internal costs could lead to small savings in these costs, at the expense of higher costs elsewhere in the system (e.g. increases in future transmission infrastructure costs due to worse quality network planning by SONI) and at the

expense of desired outcomes besides costs (e.g. decarbonisation and service quality to SONI customers and other stakeholders). This risk is exacerbated by the lack of an established and effective regulatory framework for encouraging good performance from SONI in terms of the costs it influences in the system and in relation to desired outcomes beyond that of managing costs.

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- 1.11 A further concern with the use of conventional mechanistic financial incentives for SONI's costs is that this places weight on a regulator's ex ante assessment of the efficient costs of SONI activities over the price control period. In some UK regulated sectors (e.g. electricity distribution and water supply), regulators can draw heavily on cost benchmarking analysis across companies to support ex ante cost assessment. This helps supports the effectiveness of the financial incentives on costs and gives the regulator more information on the efficient costs of regulated activities to use when setting ex ante allowances. However, due to the relatively idiosyncratic nature of SONI (e.g. in terms of structure, role and size) there is a lack of close comparators for benchmarking its costs, which will tend to limit the power of mechanistic financial incentives and increase risks of ex ante allowances being set too high (or too low).
- 1.12 In relation to the price control regulation of the electricity system operator in Great Britain, National Grid ESO, Ofgem has already moved away from the use of mechanistic financial incentives on the ESO's external costs (e.g. GB electricity system constraint management costs) and plans, as part of the RIIO2 ESO control, to move away from the use of mechanistic financial incentives on the ESO's internal costs.¹
- 1.13 Over time, the SONI price control framework in Northern Ireland has moved some way from conventional price control cost incentives. For instance, under the 2015-20 price control, there are special arrangements for transmission network pre-construction costs and separate regulatory treatment of the costs incurred by SONI purchasing system support services. There is now a question of whether the range of different cost remuneration approaches applied to different categories of SONI costs is logical and appropriate. Lessons can be drawn from the evolution of the price control framework so far. And there is a need to consider the risks of distortions to expenditure and efficiency from different regulatory approaches being applied to different categories of SONI costs. There is merit in carrying out a fuller review of the potential approaches that could be applied across the various SONI cost categories.

Our March 2019 regulatory approach

1.14 In our decision on the regulatory approach for the 2020-25 SONI price control, we recognised that three main forms of cost remuneration approach are used within the 2015-20 SONI price control framework. These are summarised in Table 1, reproduced from our March 2019 regulatory approach document. The table shows

¹ See Ofgem RIIO-2 Sector Specific Methodology Decision and further consultation - Electricity System Operator May 2019 <u>https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-</u> <u>2 sector specific methodoloy decision - eso.pdf</u>



how different approaches (or structures) are used for different TSO activities (or types of costs).

Existing structure	Allowance setting	Activity
Ex-ante baseline (with cost incentive mechanism)	At price control review	Capex and Opex e.g. staff, facility costs, corporate costs, telecommunications, IT and buildings capex spend etc.
Pass through	During price control period	Ancillary services, TUoS and market operator costs recovered by the TSO
Regulatory approval processes	During price control period	Transmission Network Project Planning (TNPP), I-SEM implementation, ENTSO-E fees, licence fees etc.

Table 1: Current cost remuneration approaches for the SONI price)
control	

- 1.15 In our March 2019 regulatory approach decision, we proposed to apply a mix of structures across SON's activities, in a way which is tailored to the service and cost characteristics of each. Our proposals included:
 - Less use of mechanistic financial incentives on SONI costs.
 - Reducing the incentive rate (which determines the scale of financial reward/penalty applied) where such mechanistic incentives apply.
 - Greater use of approaches involving remuneration of costs incurred by SONI up to an approved cap.
 - Where costs are subject to remuneration up to an approved cap, setting an indicative baseline, set at the price control review, representing a central forecast or benchmark for what SONI might spend. The difference between the cap and the indicative baseline would represent an allowance for contingency. SONI's performance against the indicative baseline would provide information on its performance in terms of cost efficiency
 - Taking account of the level of costs incurred by SONI as part of a broader evaluative performance framework, with potential for financial reward or penalty, based on regulatory and stakeholder review.
- 1.16 As part of our business plan test questions, we included a question on: how well has the company justified its proposals for the approach to the price control remuneration of different elements of its costs (including associated incentive structures) and given confidence that these will deliver good outcomes? We said that the business plan should include a granular mapping between the proposed SONI services and the proposed cost remuneration structure to apply in each case, explaining differences from the structure for the 2015-20 SONI price control and alignment with our March 2019 regulatory approach decision to the 2020-25 control.





2. SONI's proposals on cost remuneration approach

SONI's business plan proposals

- 2.1 SONI's business plan proposed a specific change to the current incentive rates for cost-sharing incentives, in response to our proposals to reduce this incentive rate. SONI proposed a lower incentive rate (15% vs 50%) for those TSO costs which are currently subject to mechanistic financial incentives. SONI said that as part of the preparation of its business plan SONI had given consideration to the application of the appropriate rate and that it believed the appropriate rate was somewhere between 10% and 20%.
- 2.2 SONI's proposals on the incentive rate for these costs were made in the context of its wider benefits sharing framework (e.g. it was proposing a 15% "benefit sharing factor"). More generally, SONI's business plan indicated that the price control treatment of its costs would be part of a wider performance framework, rather than a separate element.
- 2.3 In addition, SONI proposed a change to the price control remuneration of the scoping and feasibility costs associated with transmission network planning projects. We consider this separately in our consideration of uncertainty mechanisms in Section 6 below.
- 2.4 Beyond this, SONI's business plan did not explicitly consider what type of cost remuneration approach would be appropriate for different categories of TSO costs. SONI's business plan did not respond directly to the material we presented in our March 2019 regulatory approach paper on the different types of cost remuneration approach currently applied to different categories of SONI's costs and on the potential to adapt these for the 2020-25 price control framework.

Review of SONI's business plan

- 2.5 Overall, we did not consider that SONI's business plan engaged in detail with the issues we raised in our March 2019 regulatory Approach paper on the appropriate price control treatment of different categories of SONI's costs.
- 2.6 SONI's proposal to reduce the incentive rate applied to mechanistic cost-sharing incentives from 50% to 15% is consistent with the proposal from our Approach paper to reduce the rate. SONI did not provide specific analysis or evidence to support its view that 10% to 20% was the appropriate range.
- 2.7 SONI's proposals for how its incurred costs should be treated were part of a holistic benefits sharing framework, which we found to be under-developed. The material provided in SONI's plan does not provide confidence that this framework would achieve good outcomes if put into practice (see Annex 2, Delivering service and outcomes)).

2.8 SONI's work on its proposed benefits sharing mechanism did not engage sufficiently with the challenging issue of how to better align SONI's incentives on its (internal) costs with wider system outcomes.

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- 2.9 The appendix on the benefit sharing mechanism that SONI provided as part of its business plan (Appendix N) made a number of references to the importance of incentive equalisation and alignment, but did not elaborate on how this could be achieved in practice in a way that could be expected to work well. SONI's plan proposed a 15% mechanistic financial incentive on any reductions it can achieve on its internal costs but Appendix N proposed to apply only a reputational incentive to its performance metric for the "adjusted electricity bill", suggesting that incentives would not be aligned between its own costs and system-wide costs.
- 2.10 SONI's business plan (especially appendix N) showed insufficient engagement with the challenges that arise in applying mechanistic incentives in practice to a TSO. These challenges include:
 - The risk of providing incentives for short-term cost reduction at the expense of longer term cost efficiency. For instance, the 5-year rolling average window proposed in Appendix N for assessment under the proposed framework does not seem capable of providing a good balance of incentives over time given that expenditure decisions today will achieve benefits and affect costs many years into the future (e.g. transmission network investments may have economic asset lives of over 40 years).
 - The difficulty of applying the same financial incentives rates across different categories of costs incurred by SONI (e.g. internal and external costs associated with system operation and balancing) especially given differences in scale and volatility across different cost categories.
 - The risk of an incentive bias towards what is readily measurable (e.g. costs that have been incurred by SONI) at the expense of what is not (e.g. other dimensions of performance such as the quality of its system planning).
 - The potential implications for SONI's financial risk exposure, and the cost of capital that customers need to fund through the price control, from attempts to take the type of mechanistic financial incentives applied to some of the SONI's internal costs and apply these to SONI's external costs (e.g. system support services) as a means to improve incentive alignment.
 - The difficulty of setting reasonable ex ante performance baselines in areas where the SONI has greater information and expertise than the regulator and other stakeholders and where there are limited opportunities for benchmarking comparisons.
- 2.11 We felt that SONI's business plan recognised the benefits of an approach that could lead to better alignment of incentives between different cost categories, over time, and between costs and different aspects of performance. However, while we recognised that no feasible approach would be perfect, we felt that the proposed



benefits sharing framework SONI proposed did not offer a realistic prospect of achieving these benefits. Turning back to some of the points made in our March 2019 regulatory approach, we felt that SONI had headed in the wrong direction by focusing on the development of a framework that would make greater use of mechanistic financial incentives than at present, and that it had overlooked the potential opportunities from an approach that departed from mechanistic financial incentives.

2.12 Those SECG members who provided written comments on SONI's business plan did not provide comments in relation to SONI's proposed approach to cost incentives and remuneration of SONI's costs (excluding cost of capital). SONI had not provided its Appendix N to SECG members.

Implications for our draft determinations

2.13 We do not consider that SONI's plan provided a good basis for the approach to cost remuneration for the 2020-25 control. We therefore carried out further policy development, building on our March 2019 regulatory approach decision and carrying out a further stage of option development and evaluation. The remainder of this appendix describes our process and proposals.





3. Developing options for SONI cost remuneration

- 3.1 In this section we describe the set of policy options that we developed for the cost remuneration approach for the SONI price control over the 2020-25 period.
- 3.2 The development and specification of these policy options is complicated by two main challenges:
 - There are numerous options for the regulatory approach or regulatory treatment of SONI costs, and these do not fit into neat and simple boxes. There is a risk of over-simplification if the apparent options are specified in a brief and high-level way. The options that are relevant in practice each incorporate a number of different features (e.g. involving multiple regulatory provisions and regulatory tools) and there are elements of overlap across different options. Options need to be specified in some detail before they can be properly compared and evaluated.
 - The policy question is not which regulatory approach should be applied to SONI's costs. Rather, the question is which approach should be applied to each category of costs (and how those categories should be defined). As highlighted above, the current SONI price control framework for the 2015-2020 period applies quite different types of approach to different categories of SONI expenditure. The use of different approaches across different categories of son of costs is not unusual for companies subject to price control regulation (e.g. uncertainty mechanisms applied by the UR and Ofgem to energy network companies have the effect of applying a different regulatory approach to costs, by defining alternative arrangements for specified categories of costs). But in the case of the SONI price control at least, the extent of the variation in the approach across different categories of costs is so great that it is unhelpful to proceed by seeking to determine a single default approach for the SONI price control, before considering potential exceptions.
- 3.3 We addressed these challenges by adopting the following steps in order to develop and specify a set of policy options:
 - Step 1. We first specified a number of different options for the regulatory approach that could be applied, in principle, to a particular category of costs, abstracting from the question of which categories of costs that approach would be applied to.
 - Step 2. We specified a list of cost categories for which different cost treatment approaches might apply, taking account of the differences that apply under the current SONI price control framework.
 - Step 3. We considered interactions between cost treatment approaches and the introduction of a broad evaluative performance framework for SONI.



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- 3.4 The policy options that we identified are therefore packages of options for the regulatory approach to apply across different categories of SONI's costs. It is possible to conceive of a very large number of such policy options. For instance, we identify eight alternative regulatory approaches in step 1 and 13 SONI cost categories in step 2. This gives a great many possible options for combinations of the eight different approaches in each of the 13 cost categories. We did not seek to consider all possible combinations. Instead, we defined four policy options, based on prioritisation and judgement. A small number of policy options helps limit complexity, keeps the work manageable and enables each option to be considered in sufficient detail.
- 3.5 The four options we specified cover: a status quo option; an option based on proposals from SONI's business plan; and two further options which represent alternative ways to try to tackle some of the limitations of the current price control framework and enable the regulatory approach to costs to fit within a broader evaluative performance framework.
- 3.6 A consequence of our approach is that there is an overlap between the policy options set out in this section and issues that, in other contexts, might be considered under the separate topic of price control uncertainty mechanisms. For instance, under the current SONI price control, the arrangements for the price control remuneration of transition network planning pre-construction expenditure might be seen as an uncertainty mechanism. But we take some of the questions relating to the price control treatment of transition network planning expenditure within this section (at least at a high level).
- 3.7 While this section covers options for the treatment of various categories of costs, it does not cover all potential uncertainty mechanisms relating to costs. More specifically, it does not cover uncertainty mechanisms that might be applied to cost items that apply at a more granular level to the cost categories that we have used (. We turn to those more detailed points in section 6 of this appendix.

Alternative cost remuneration approaches

3.8 For the purposes of our policy development, we identified and distinguished between eight alternative approaches for the price control treatment of specific categories of costs, which we label approaches A to H. As a simplified introduction to these approaches, Figure 2 positions them on a spectrum ranging from mechanistic ex ante financial incentives to full pass-through of costs.





Figure 2: Overview of regulatory approaches for cost remuneration



3.9 Table 2 provides a more detailed description of the eight approaches introduced in Figure 2. This table lists a series of potential features of the regulatory approach to the treatment of SONI's costs within the price control framework, and indicates which of these features would apply to the each of the eight approaches. This table helps to show where there are similarities across approaches and where there are differences. We elaborate further on these approaches in the text that follows Table 2. At the end of this section, we explain how approaches A to H relate to the various options for the "cost remuneration structures" that we identified in the March 2019 regulatory approach.



Table 2: Definition of cost remuneration approaches by key features



- 3.10 In order to avoid an unmanageable proliferation of approaches and options, the features listed in Table 2 do not cover all of the regulatory features that might apply to a particular cost category, and which might be relevant to consider for the 2020-25 SONI price control. For instance, we have not distinguished between approaches according to their use of additional regulatory tools such as behavioural or process requirements (e.g. on efficient purchasing or decision-making), enhanced cost transparency obligations or external business efficiency reviews. We have focused on the features listed in Table 2 as these seem most important for the purposes of this annex.
- 3.11 Of the eight approaches set out above, approaches A, F and H are close, in approximate terms at least, to the approach taken for particular parts of the current SONI price control:
 - Approach A applies to a series of cost categories defined in the licence under the BTSOt term (e.g. SONI payroll, IT and communications and deprecation on TSO assets).
 - Approach F applies to: transmission network pre-construction project costs; costs funded through the Dt uncertainty mechanism; and costs funded through the arrangements for "special projects costs".
 - Approach Happlies to the costs of system support services (these are



treated as a pass-through item in the licence and there is no explicit DIWE provision, although the licence does place some process and procurement requirements on SONI in relation to these costs).

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- 3.12 Approaches B and G involve reasonably simple modifications to some of the arrangements above:
 - Approach B can be seen as a modification of approach A, and incorporates two specific proposals from SONI's business plan: (a) a reduction in the SONI's financial exposure to over-spend and under-spend from 50% to 15%; and (b) making any financial reward for under-spend, and any financial penalty for over-spend, subject to cap and collar arrangements that apply across a broader performance framework. SONI's business plan proposed a maximum penalty of £1.5m and a maximum reward of £3m across different aspects of performance.²
 - Approach G is a version of approach H with the introduction of a provision that the UR may disallow recovery of any costs that are demonstrably inefficient or wasteful (DIWE).
- 3.13 The remaining three approaches, C, D and E, involve more significant modifications but also build on elements of the existing arrangements, representing evolutionary change rather than radical change.
- 3.14 Approach C can be seen to start from the perspective of a mechanistic cost-sharing incentive arrangement (as for approaches A and B) with a significant modification. This modification is designed to contribute to improved system-wide outcomes over the longer term and to fit better with an evaluative performance framework. Under this approach there would be specified ex ante cost baseline and a specified incentive rate. But any financial upside or downside to SONI would be conditional not just on the difference between outturn costs and the costs baseline, but also on a regulatory evaluation of evidence from SONI that is relevant to understanding that difference.
- 3.15 Under approach C, this would work in the following way, which represents modifications to the circumstances in which cost-sharing of under- and over-spend applies:
 - SONI would qualify for a financial benefit (reward) from cost-sharing in the case of an under-spend as long as it can provide good evidence to the UR that the under-spend was *not* due to a reduction in costs at the expense of worse performance affecting outcomes (higher costs elsewhere in the system or worse performance in relation to decarbonisation, grid security or SONI service quality).
 - If SONI can provide good evidence to the UR to show that an over-spend

² We leave the question of the appropriate level of cap/collar aside for the purposes of this section and focus on the principles and approach, proceeding under the working assumption that the cap and collar are not set so narrowly as to render the financial incentives ineffective.



was due to the efficient costs of justified improvement in performance against outcomes (e.g. action which is likely to reduce, or have reduced, whole system costs over the long term, or which is attributable to the efficient costs of justified improvements in performance relating to decarbonisation, grid security or SONI service quality), it would be remunerated in full for those costs. If not, it would face a financial downside (penalty) through application of cost-sharing to the over-spend.

- 3.16 We refer to this approach as conditional cost-sharing incentives, and provide a more detailed explanation in Appendix A.
- 3.17 We specified the incentive rate that SONI would face under approach C to be 25%. This is an intermediate position between the incentive rate from approach A (50%) and that from approach B (15%). We felt that a rate of 50% was unnecessarily high but that there was a danger of the financial incentives being too weak if the 15% from approach B was adopted. Under approach C, the incentive rate would determine the maximum hypothetical upside or downside financial exposure for a given under- or over-spend, but in practice the financial reward or penalty could be lower than this, because only part of the under- or over-spend may qualify for the application of the cost-sharing incentive rate. We thought that if 15% was an appropriate rate under approach B, the corresponding rate should be higher under approach C.
- 3.18 Approach D can be seen to take approach F (involving remuneration of costs incurred up to the approved cap) and supplement this with an evaluative performance framework in which SONI may receive financial rewards or penalties according to a regulatory evaluation of its overall performance. There would be an ex-ante baseline, reflecting an estimate of efficient costs over the price control period, but this would be for indicative purposes only, providing some relevant information for the performance evaluation. The difference between the cap and the indicative baseline would represent an allowance for contingency.
- 3.19 Under approach D, SONI's outturn costs versus the indicative baseline would provide some information on its performance in terms of cost efficiency, but this would not be used mechanistically or in isolation to provide financial rewards and penalties for SONI. Instead, this information would feed into the evaluative performance framework alongside information on the wider circumstances and information on performance in other areas (e.g. influence on electricity system costs incurred by other parties such as generators or NIE Networks, or contribution to decarbonisation). Any financial rewards or penalties for SONI's performance in relation to the costs it incurs would arise from the evaluative performance framework. We would be able to adjust the approved cap upwards (but not downwards) during the price control period, including in response to developments from the annual performance assessment processes.
- 3.20 Approach E can be seen as a simpler version of approach D in that it does not involve a cap set by the UR on the costs that SONI is permitted to recover through the price control or an exante baseline. SONI would recover the costs that it incurs, subject to any financial reward or penalty under the broad evaluative performance



framework. Under approach E, costs would not be subject to an explicit DIWE provision.

- 3.21 The provisions summarised above for approaches C, D and E are intended to help tackle a key concern highlighted in section 1 of this appendix: under approaches A and B, SONI would tend to have financial incentives to do things which limit or reduce the costs that it incurs even if this increased whole system costs over the long term, or compromised another aspect of performance besides whole system costs (e.g. decarbonisation or service quality to SONI customers).
- 3.22 Because of the nature of the SONI's role within the electricity system, and the broad reach of the desired outcomes from SONI, we consider it highly unlikely that, for the 2020-25 SONI price control at least, this concern can be adequately tackled by regulatory obligations and incentives that apply to measures of whole system costs and metrics for aspects of SONI performance besides the costs that it incurs.
- 3.23 Finally, we highlight the relationship between the various cost remuneration approaches defined above, and the different options that we identified in our March 2019 regulatory approach decision. In that decision document, we categorised the main cost remuneration structures that apply under the 2015-20 SONI price control and identified some high-level cost remuneration structures that might be used for the 2020-25 SONI price control.
- 3.24 The existing structures were described as: ex-ante baseline (with cost incentive mechanism); pass through; and regulatory approval processes. The potential structures for the 2020-25 control were described as: ex-ante baseline (50% cost incentive rate); ex-ante baseline (lower cost incentive rate); remuneration up to approved cap with indicative baseline; cost recovery without cap.
- 3.25 Table 3 takes each of our approaches A to H and identifies which of the cost remuneration structures from the March 2019 regulatory approach decision correspond most closely to it and, where relevant, highlights how the approach differs from that structure. This table shows that the more detailed specification of approaches that we have used for the purposes of our draft determination build on, and further develop, our earlier work from the SONI price control approach decision.

Approach defined for DD	Corresponding cost structure from the March 2019 regulatory approach decision	How approach differs from the corresponding cost structure from the March 2019 regulatory approach decision
Approach A	Ex-ante baseline (50% cost incentive rate)	No difference
Approach B	Ex-ante baseline (low er cost incentive rate)	SONI exposure to under- and over-spend subject to cap and collar from wider performance incentive framework
Approach C	Ex-ante baseline (low er cost incentive rate):	Financial reward/penalty conditional on regulatory assessment of the efficiency of any under- or over-spend, taking account of whole

Table 3: Mapping approaches A-H to options from March 2019



Approach defined for DD	Corresponding cost structure from the March 2019 regulatory approach decision	How approach differs from the corresponding cost structure from the March 2019 regulatory approach decision
		system costs and quality
		SONI exposure to under- and over-spend subject to cap and collar from wider performance incentive framework
Approach D	Remuneration up to approved cap with indicative baseline	No difference
Approach E	Pass-through	Consideration of SONI performance on these costs taken into account for wider performance incentive framew ork
Approach F	Regulatory approval processes	No difference
Approach G	Cost recovery without cap	No difference
Approach H	Pass-through	No difference

Categorisation of SONI costs

- 3.26 We now describe how we categorised costs for the purpose of developing the policy options for our draft determinations.
- 3.27 We started by compiling a list of cost categories for which the regulatory cost treatment approach could be defined. For this list, we distinguished between the ten main SONI services (or service areas) from Appendix A to SONI's business plan. We omitted SONI's "support functions" category as the costs of these support functions are themselves costs incurred by SONI as part of the provision of the other ten services, and we did not see benefit in treating these as a separate category. Considering costs from the perspective of services is consistent with the UR's broader policy of trying to bring greater visibility to, and understanding of, the services provided by SONI, as part of the price control framework.
- 3.28 We made some further distinctions within some of the service categories to accommodate cases where the cost treatment approach under the 2015-20 control varies within a service category. For instance, within the category of "ensuring system adequacy", system services costs incurred by SONI are remunerated on a pass-through basis while other costs (e.g. costs of SONI staff involved in this service) are subject to a 50% cost sharing incentive arrangement.
- 3.29 We did not consider it appropriate to distinguish between different types of costs (e.g. operating expenditure versus capital expenditure/depreciation, payroll versus fees to contractors) within each service area. This would add complexity and did not seem to be a priority in a context where applying quite different regulatory approaches to different types of costs within the same service area could lead to unnecessary distortions in incentives. Recent UK regulatory practice has generally sought to align, as far as practical, the regulatory approach to cost incentives across operating expenditure and capital expenditure.



3.30 Table 4 lists the cost categories we distinguished between and indicates the regulatory approach from the section above (approaches A to G) which aligns most closely to that applied under the 2015-2020 control for each category.

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Table 4: Cost remuneration approach under 2015-20 control

SONI cost category	Approach			
System operation and adequacy				
Scheduling and dispatch: system support services (SSS) costs (where applicable)	Н			
Ensuring system adequacy and market development: SSS costs (where applicable)	н			
Scheduling and dispatch: other costs	A			
Ensuring system adequacy and market development: other costs	A			
Independent expert				
Expert voice	А			
Industry governance	A			
Regulatory engagement	A			
Transmission network development and system planning				
Assess and communicate system needs	A			
Project scoping and feasibility	A			
Outline design and consenting	F			
Handover and commissioning	F			
Commercial Interface				
Connection and access rights	А			
Contractual Interface: TUoS and Moyle revenues	н			
Contractual Interface: other costs	А			

Interaction with evaluative performance framework

- 3.31 For all of the policy options considered, we assumed that the evaluative performance framework will apply to aspects of the SONI's performance besides that which relate to the efficiency of the costs SONI incurs. We set out our proposals for that new evaluative performance framework for SONI in Annex 4.
- 3.32 We adopted the following position on how this broad evaluative performance framework would work in conjunction with each of the potential regulatory approaches from step 1:



- Approaches A, B and C can be seen to apply targeted financial incentives to costs. For any category of cost subject to approaches A, B or C, SONI's outturn level of cost in that category would be excluded from the performance assessment under the broad evaluative performance. This is to avoid double counting in the application of financial rewards or penalties to these categories of SONI costs: once through the targeted financial incentives under cost treatment approaches A, B or C and once under the financial incentives from the broad evaluative framework.
- Under approaches D or E, costs incurred by SONI would be taken into consideration as part of the broad evaluative performance framework.
- Under approaches F, G and H, the SONI's costs would not be subject to financial incentives from the evaluative performance framework, and the SONI's outturn costs in any categories subject to these approaches would be excluded from consideration in the performance evaluation.
- 3.33 In effect, approaches D and E are designed to incorporate consideration of costs within a broader evaluative performance framework. In contrast, approaches A, B and C apply self-standing financial incentive arrangements that would be additional to, and operate largely outside of, the evaluative performance framework. So it would be necessary to limit the scope of the evaluative performance framework's consideration of costs subject to approaches A, B and C to avoid duplication in the regulatory arrangements applied in respect of SONI performance in these costs.

Policy options for SONI cost remuneration approaches

- 3.34 We identified four key regulatory policy options for evaluation. Each policy option is defined in terms of which of the eight regulatory cost treatment approaches (step 1 above) would apply to each of the 13 SONI cost categories (step 2). In developing policy options, we took account of the interactions with the use of a broad evaluative performance framework (step 3).
- 3.35 The four regulatory policy options are briefly introduced as follows:
 - **Option 1**. This option is intended to represent a baseline option, based on the current SONI price control framework with some limited modifications due to interactions with the broad evaluative performance framework. It was developed from the list of approaches in Table 3 above, but with the following changes to incorporate the broad evaluative performance framework: (i) the approach for system support services costs is changed from approach H to approach E; and (ii) the approach for transmission planning outline design and consenting and handover and commissioning costs is changed from approach F to approach D. As discussed under step 3 above, no change is made to the treatment of the costs relating to the TUoS revenue that SONI collects on behalf of NIE Networks and the amount of interconnector revenue SONI collects on behalf of Moyle.
 - Option 2. This option involves two main changes from Option 1. These



changes are based on two specific proposals from SONI's business plan. First, the approach for the SONI service "Project scoping and feasibility" is changed from approach A to E. This change reflects the suggestion from SONI for these costs to be remunerated on the basis of costs incurred subject to a DIWE provision (which is explained in its business plan Appendix I) but with a modification we introduced to ensure that these costs are also covered by the scope of the broad evaluative performance framework. Second, for all other cost categories which are subject to approach A under Option 1, the approach is changed to approach B. This reflects SONI's proposal for a reduction in the mechanistic cost-sharing incentive rate (where currently applied) from 50% to 15% and for the financial incentives from this cost incentive to be subject to a cap and collar arrangement that applies more broadly across SONI performance.

- **Option 3**. This option adapts Option 1 so that approach C is applied in a targeted way. Approach C would generally be applied to those cost categories that are subject to mechanistic 50% cost-sharing incentives (i.e. approach A) under Option 1. The one exception is that, under option 3, project scoping and feasibility costs would be changed from approach A to approach D. This would help bring consistency of approach with other elements of transmission network planning costs, which are subject to approach D in Option 1.
- **Option 4**. This policy option would apply cost treatment approach D to most categories of SONI costs, bringing a greater degree of consistency across SONI cost categories compared to the other three options. For each cost category that is subject to approach C under Option 3, this is replaced with approach D under Option 4.
- 3.36 The four regulatory policy options are specified more fully in Table 5, by reference to the cost remuneration approach used for each category of SONI costs.

 Table 5: Specification of policy options according to cost treatment

 approach used for each category of SONI costs

SONI cost category	Option 1	Option 2	Option 3	Option 4
System operation and adequacy				
Scheduling and dispatch: system support services costs	E	E	Е	E
Ensuring system adequacy and market development: SSS costs	E	E	Е	E
Scheduling and dispatch: other costs	Α	В	С	D
Ensuring system adequacy and market development: other costs	A	в	С	D
Independent expert				



Expert voice	Α	В	С	D
Industry governance	Α	В	С	D
Regulatory engagement	Α	В	С	D
Transmission network development and system planning	Transmission network development and system planning			
Assess and communicate system needs	Α	В	С	D
Project scoping and feasibility	Α	В	D	D
Outline design and consenting	D	D	D	D
Handover and commissioning	D	D	D	D
Commercial interface				
Connection and access rights:	Α	В	С	D
Contractual interface: TUoS and Moyle revenue	н	н	н	н
Contractual interface: other costs	Α	В	С	D
Other costs				
Support costs and overheads (HR, IT systems etc)	Α	В	С	D

- 3.37 As indicated above, Option 1 is a baseline option, based on the current SONI price control framework with some limited modifications due to interactions with the broad evaluative performance framework. The other three options can each be seen to build on the initial proposals indicated in our March 2019 regulatory approach decision, subject to some modification:
 - Option 2 reduces the cost incentive rate from 50% to 15% for those costs subject to a mechanistic sharing of over- and under- spend against an ex ante baseline, and makes limited use of cost remuneration approach D.
 - Option 3 makes further modification to the use of exante incentives, beyond a reduction in the incentive rate, through the introduction of approach C (which makes make any financial penalty or reward conditional on a regulatory assessment any under- or over-spend, taking account of whole system costs and quality) and makes greater use of cost remuneration approach D.
 - Option 4 makes the most use of cost remuneration approach D, including as a replacement to the use of mechanistic sharing of over- and under- spend against an ex ante baseline (i.e. as a replacement to options A or B).
- 3.38 All of the policy options we specify involve the costs of system support services being subject to cost recovery with no cap, but with SONI's performance in relation to these costs being taken into consideration as part of the broader evaluative



performance framework.

- 3.39 There are many possible permutations of regulatory approaches across the cost categories, and the options we defined reflect prioritisation and a desire to keep the work manageable. For instance:
 - We did not consider it a priority to specify an option in which all SONI cost categories are subject to cost remuneration approach C. This would represent a major change to the treatment of transmission network planning costs, which did not seem a priority following the work on this area during the 2017 CMA appeal.
 - We did not consider it a priority to specify a policy option that placed emphasis on approach E (beyond its application to system support costs). We were concerned about moving to an approach which amounted to a form of cost pass-through with limited additional regulatory safeguards besides the consideration of SONI costs as part of a broad evaluative performance incentive framework. We prioritised options that included additional regulatory safeguards, such as targeted financial incentives on SONI costs (as under approaches A, B and C) or approved caps on the costs recoverable under the price control (as under approach D). It may be possible to make more use of approach E in future price control periods, once we have more experience of the evaluative performance incentive framework.
 - We did not consider it a priority to specify a policy option in which options A, B, C or D would be applied to system support costs. We considered that, at least for the 2020-25 SONI price control, it would be relatively difficult to apply these approaches to system service costs in a way that could be expected to work well. System support costs tend to be difficult to predict and subject to large fluctuations for reasons outside of the SONI's direct control, which makes it more challenging to apply approaches involving ex ante baselines of efficient costs (approaches A, B and C) or approved caps on SONI cost recovery (approach D).
 - We did not consider it a priority to specify options that would make more use of regulatory approaches F, G and H than at present. Approaches F, G and H offer less than approaches B, C, D and E in terms of features to help tackle concerns with the current price control approach to SONI costs and they would not fit well with the introduction of a broad evaluative performance framework for SONI.
 - We did not consider it a priority to specify options that would apply either targeted financial incentives (under approaches A, B or C) or the broad evaluative performance framework (under approaches D or E) to the amount of TUoS revenue that SONI collects on behalf of NIE Networks and the amount of interconnector revenue SONI collects on behalf of Moyle. Although this may be recorded as a SONI cost for accounting purposes, the SONI's role has been seen as similar to that of a collection agent in respect



of TUoS and interconnector revenues. Furthermore, we would expect the broad evaluative performance framework to separately consider the SONI's influence on transmission network costs and interconnector costs (in the short term and long term). It would seem duplicative to also cover the level of TUoS and interconnector revenues collected by SONI and passed on to NIE Networks and Moyle, and the SONI's influence is likely to be more important on future revenues rather than current revenues. For this reason, under all four policy options, we apply the current approach, approach H, to the amount of TUoS revenue that SONI collects on behalf of NIE Networks and the amount of interconnector revenue SONI collects on behalf of Moyle.

Utility Regulator

3.40 We considered that the four policy options provided a good starting point from which to choose a preferred core approach for consultation. In addition, we identified that there may be merit in further exploration and refinement of the preferred approach (e.g. consideration of the pros and cons of potential add-on tools such as further cost transparency obligations), but this can be separated from the choice of the core approach.



4. Evaluation of options

4.1 We now turn to our assessment of the four policy options specified in the previous section. To support a structured and transparent evaluation of these options, we developed a set of assessment criteria, which we introduce before turning to the evaluation.

Assessment criteria

- 4.2 In developing assessment criteria, we took account of our desired outcomes from the SONI price control framework, and other factors such as regulatory implementation issues. We also drew on issues raised in our March 2019 regulatory approach decision and SONI's price control business plan (including appendix N on its proposed benefits sharing framework).
- 4.3 The development of the criteria was an iterative process. The four options were assessed using initial candidate criteria and these criteria were gradually refined to ensure that they allowed for meaningful comparisons between options and captured the range of considerations that seemed important in choosing between options.
- 4.4 In developing the high-level assessment criteria, and the subsidiary criteria, we sought to strike a balance between the coverage of the relatively important considerations for price control policy development purposes and the desire to limit complexity and keep the evaluation proportionate.
- 4.5 As a starting point, we identified four high-level assessment criteria (see the outcomes proposed for the evaluative performance framework in Annex 3, Evaluative performance framework):
 - Contribution to desired outcomes relating to whole systems costs. This assessment criterion concerns factors which affect the likely success of the regulatory framework for SONI in achieving desired outcomes related to whole system costs. Whole system costs include costs incurred by SONI and other electricity system costs (e.g. network infrastructure costs incurred by NIE Networks), some of which SONI may have influence on.
 - Contribution to desired outcomes relating to grid security, decarbonisation, and SONI service quality. Although the main focus of the four policy options is the price control treatment of costs incurred by the SONI, which directly affects whole system costs, the options may have indirect effects on the likely success in relation to other desired outcomes: outcomes relating to grid security, decarbonisation and SONI service quality. This reflects the interactions between the regulatory approach to costs incurred by SONI and SONI's likely behaviour and performance in relation to the other outcomes. We take these three outcomes together to help keep the assessment manageable and because the impacts of different policy options is likely to be similar, though perhaps not identical, across all three.
 - Coherence with a broad evaluative performance framework. This



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- **Regulatory implementation effort and risk**. This criterion concerns the regulatory implementation risk associated with the incorporation of the policy option within the SONI price control framework for the 2020-25 period, and the potential regulatory effort required to help mitigate implementation risk. Implementation risk includes the risk that the policy option does not work as intended, or has unexpected effects. This is a cross-cutting issue and is relevant across all of the desired outcomes. The extent of implementation risk will depend, among other things, on: the complexity of the arrangements; the degree of novelty relative to the current SONI price control framework which has been applied in practice; and the availability of experience and lessons from the application of similar approaches for other regulated companies.
- 4.6 For our evaluation, we found it necessary to consider the first high-level criterion above, relating to whole systems costs, in greater detail, as explained in the subsection below.
- 4.7 The assessment of the options in terms of their likely implications for the whole systems costs outcome is a particularly complex, and important, part of the comparison of these options. We identified a number of subsidiary factors or criteria that may affect the overall performance of an option in terms of whole system costs, and we carried out a more granular evaluation of the four options against each of these subsidiary criteria. We list these subsidiary criteria in Figure 3 below. The identification of these subsidiary criteria took account of the following:
 - Whole system costs include costs directly incurred by SONI and electricity system costs incurred by other parties that SONI can have a significant influence upon.
 - SONI's efficiency and success in cost control in certain categories of cost will be affected by the direct financial/commercial incentives it faces to control those costs, which are heavily influenced by the regulatory approach to costs under the price control framework. It will also be affected by oversight and contributions to cost efficiency from other parties such as us, customers and other stakeholders; the regulatory framework, including performance assessment and transparency measures, will affect how effective and influential these pressures and contributions are.
 - The design of the regulatory framework can affect the degree to which SONI's focus and incentives are on costs (and wider performance) in the short term, rather than adopting a longer-term perspective.



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- The costs to the wider electricity system of SONI activities include the price control remuneration of SONI's equity and debt investors (e.g. the allowed cost of capital on the SONI RAB). The scale of these financing costs will be affected by the financial risk that SONI faces which, in turn, will be heavily influenced by the price control treatment of the costs incurred by SONI.
- There are risks that the costs to the wider electricity system of SONI activities include are in excess of what is needed to cover the reasonable costs of SONI's activities and provide a reasonable return on capital. The scale and nature of these risks depend on the design of the price control framework. For instance, policy options that put more weight on ex ante expenditure allowances allow divergence between revenues and costs and this can create risks of excessive allowances if it is difficult for the regulator to set good forward-looking expenditure baselines at the price control review.
- Different policy options for the price control treatment of the costs incurred by SONI will have different implications for the administrative costs faced by us and the costs arising from regulatory activity incurred by SONI and potentially other stakeholders. There may also be different degrees of risk to cost efficiency from different degrees of regulatory intervention (and potential micro-management) in SONI's costs, strategy and decision-making.

Figure 3: Subsidiary criteria for assessment of contribution to whole system costs

Direct financial incentives on TSO to reduce and restrain its costs	Risk of inefficiency in costs incurred by the TSO from stronger financial incentives in relation to costs over the short term than long term	Risk of inefficiency from unbalanced incentives between different categories of costs that TSO incurs
Reputational incentives on TSO for cost efficiency	Risk of inefficiency from unbalanced incentives between costs that TSO incurs and system costs incurred by other parties which TSO influences	Opportunity for diversity in perspective, knowledge and ideas influencing TSO strategy and decision-making
Regulatory effort and burden (at price control review and during period) and risks from regulatory micro-management	Scale of TSO's financial risk exposure to costs it incurs, which need to be compensated through financing cost allowances within TSO control	Risks of TSO price control allowances exceeding levels needed to cover reasonable TSO costs (and provide reasonable return to investors)



Evaluation of policy options against assessment criteria

- 4.8 This section presents our evaluation of the four specified policy options against the high-level assessment criteria introduced in the section above. This represents a preliminary evaluation and we are keen to receive stakeholder feedback on the pros and cons of different options, to help refine our assessment and choice of approach before final determinations.
- 4.9 Table 6 below provides an overview of our evaluation against the four high-level criteria. The assessment is a comparative one: options are ranked according to our view on their relative performance against the other options listed. An option being marked with a lighter shade (and a lower number) means that we saw the option as performing better, in terms of the applicable assessment criterion, than options marked with a darker shade (and higher number). Where two options have the same shade/rank this means that, on the basis of the analysis and information available for the purposes of this appendix, we did not reach a clear position on their relative merits against the applicable assessment criterion; it is possible that further analysis and information could help distinguish them. The evaluation inevitably involves a degree of judgement.

		Policy	option	
Assessment criteria	1	2	3	4
Contribution to desired outcomes relating to whole systems costs	4	3	2	2
Contribution to desired outcomes relating to grid security, decarbonisation, and SONI customer service quality		3	2	2
Coherence with a broad evaluative performance incentive framew ork		3	2	1
Regulatory implementation effort and risk		2	3	3
V au				
1 2 <u>3</u>			4	
← Better Worse →			→	

Table 6: Evaluation of options against high-level assessment criteria

4.10 We elaborate further on our assessment against the criteria below.

4.11 The first criterion in the table concerns the influence on whole system costs. This is a particularly complex part of the overall evaluation, and we built up our view from a more detailed assessment of the four options against the nine subsidiary assessment criteria that we introduced earlier in Figure 3. We report on that more detailed assessment in Table 7 below, which provides a comparative ranking of the performance of each policy option against the nine subsidiary assessment criteria.



Table 7 is organised as follows:

- The first group of subsidiary assessment criteria relates most directly to factors that are likely to affect efficiency in the costs incurred by SONI.
- The second group of criteria relates to additional factors that are likely to affect the system-wide costs over the long term, recognising that SONI strategy, behaviour and decision-making can have a significant influence on the costs faced by other parties to the system.
- The final row of the table provides an overall assessment, looking across the nine criteria above. This is inherently subjective and we used judgement in taking account of the rankings across individual criteria (it did not seem appropriate to treat each of them equally).
- 4.12 The use of two groups of criteria in Table 7 is a simplification (some criteria apply to both groups to some degree) and is primarily to help ease the presentation of the analysis.

Policy option Assessmentcriteria 1 2 3 4 Factors affecting efficiency in costs SONI incurs Direct financial incentives on SONI to reduce and restrain its 3 Δ costs Risk of inefficiency in costs incurred by SONI from stronger 4 3 financial incentives in relation to costs over the short term than long term Risk of inefficiency from unbalanced incentives between different 3 4 categories of costs that SONI incurs Reputational incentives on SONI for cost efficiency 3 3 Opportunity for diversity in perspective, know ledge and ideas 3 3 influencing SONI strategy and decision-making Broader factors affecting long term system-wide costs Risk of inefficiency from unbalanced incentives between costs 4 3 that SONI incurs and system costs incurred by other parties which SONI influences Regulatory effort and burden (at price control review and during period) and risks from regulatory micro-management

Table 7: Evaluation of options against subsidiary assessment criteria for whole-system costs



		Policy	option	
Assessmentcriteria	1	2	3	4
Scale of SONI's financial risk exposure to costs it incurs, which need to be compensated through financing cost allow ances within SONI price control	4	2	2	2
Risks of SONI price control allow ances exceeding levels needed to cover reasonable SONI costs (and provide reasonable return to investors)	4	3	2	
Overall assessment				
View on overall comparative performance of options in terms of contribution to desired outcome on whole system costs	4	3	2	2
Кеу				
1 2 3			4	
← Better			Worse	→

- 4.13 We now turn to our evaluation for the other three high-level assessment criteria. We briefly explain the assessment as follows:
 - We considered that Option 1 performs the worst in terms of the contribution to desired outcomes relating to grid security, decarbonisation, and SONI customer service quality. This reflects the concern that, under this option, SONI would face stronger financial incentives to reduce and restrain its own costs than to perform well in dimensions of performance affecting other outcomes. This, in turn, reflects the difficulty we see in applying similarly strong and direct financial incentives as part of the broad evaluative performance framework, resulting in unbalanced incentives across different aspects of SONI performance. Option 2 performs better than Option 1 because the financial incentives on SONI to reduce and restrain its own costs are reduced, although this reduction provides only a partial mitigation of the concern with Option 1. Options 3 and 4 perform better for this assessment criterion because under both of these options the financial incentives that apply in relation to SONI's costs are subject to broader regulatory consideration of wider system costs and dimensions of SONI performance besides costs.
 - We considered Option 4 to be most coherent with a broad evaluative performance incentive framework. Option 4 makes the most extensive use of cost treatment approaches D and E, under which any financial incentives applying to the costs incurred by SONI arise from the consideration of these costs alongside other factors under the regulatory evaluation of performance. Option 3 also fits reasonably well with such a framework: although approach C involves separate incentive arrangements for SONI costs, the regulatory assessment required under these arrangements could form part of the same regulatory and stakeholder processes used for the broad evaluation of performance and draw on common information and

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- Option 1 is ranked best in terms of regulatory implementation effort and risk. This option involves the least change from the SONI price control for the 2015-20 period. Option 2 involves some reasonably simple revisions to option 1, though there is uncertainty about the effects of such a large reduction in the cost-sharing incentive rate. In contrast, Options 3 and 4 involve the introduction of new regulatory arrangements which affect both the regulatory work required at the price control review, and that required during the price control period. The implementation of these new arrangements is unlikely to be straightforward. We considered the implementation risk to be similar for Options 3 and 4. The key difference between these options is that those SONI costs subject to approach C under option 3 are subject to approach D under option 4. The greater use of approach D under option 4 brings both benefits and drawbacks in terms of regulatory implementation risk. Approach D offers more flexibility than approach C in the way that SONI costs are assessed and the way that any financial reward or penalty is determined, which can allow for adaption and improvement over time which mitigates implementation risk. However, under approach D there is greater uncertainty about the how SONI costs would be assessed and considered as part of the application of the broad evaluative framework, leaving implementation issues which may need to be resolved before significant financial incentives can be applied to those costs.
- 4.14 The rankings given to Options 3 and 4 do not differ much across the high-level criteria. This reflects the high degree of similarity between these two options (reflecting in turn the similarity between cost treatment approaches C and D). However, there are some differences to be aware of, which come out more clearly in the more detailed comparison of options presented in the next section. In addition, it is possible that further work on these options could bring to light further considerations which are relevant in drawing comparisons between them.
- 4.15 It is essential to recognise that the assessment of the four policy options presented above is specific to the application of these options to SONI. We would expect significant differences in the assessment if these options were considered for application to other regulated companies. To take one example, while Option 1 performs relatively badly in our assessment for SONI, it would perform much better in the case of the English and Welsh water companies regulated by Ofwat:
 - For these companies, Ofwat is able to make extensive use of cost benchmarking analysis, which we consider an important ingredient to help enable policy Option 1 to work well, given the weight this option places on mechanistic ex ante cost incentives. For instance, a regulatory framework that emphasises cost benchmarking can help to (a) mitigate the concern that arises for the TSO that apparent financial incentives to reduce costs are undermined by expectations that such reductions lead to lower allowances

at the next price control review (the ratchet effect); and (b) provide incentives for the regulated company to incur additional costs today if this is likely to lead to significantly lower costs in future price control periods.

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- Ofwat's price control framework applies a range of mechanistic financial incentives relating to outcomes besides costs, which help guard against the risk that a company seeks cost reductions at the expense of service quality (Ofwat's approach also makes use of benchmarking of companies on aspects of service quality and environmental performance).
- 4.16 The features and circumstances that can support policy Option 1 for Ofwat's price control framework do not apply in the same way to the SONI price control framework. There are no opportunities, at present, to make corresponding use of cost benchmarking for SONI. The current SONI price control framework is under-developed in its approach to aspects of service quality and performance besides costs. And the nature of the SONI's activities and services make it difficult to apply mechanistic financial incentives in some key areas of service quality (e.g. the quality of long-term transmission system planning and pioneering, and the contribution to decarbonisation of the electricity system).
- 4.17 Compared to policy Options 1 and 2, Options 3 and 4 involve more regulatory judgement and discretion in determining what financial rewards or penalties (if any) apply to the SONI's performance in relation to the costs it incurs. While this might be detrimental in a different context, it provides a practical way to avoid specific problems that would arise from an attempt to apply mechanistic ex ante incentives to SONI costs.
- 4.18 Finally, we should highlight that the evaluation above is made for the design of the 2020-25 SONI price control, taking account of the wider context that currently applies. It is possible that for subsequent price controls the balance between options differs. A relevant feature of the current SONI price control arrangements is the under-developed nature of regulatory incentives and obligations relating to the TSO's service quality, outputs and outcomes (besides costs). These arrangements can be developed and improved through our proposed evaluative performance framework, which is likely to make use of a range of metrics and sources of evidence and to evolve over time. Once those arrangements are further developed, it may be possible to apply more direct financial incentives for some specific service areas (e.g. application of approach A or B to some system operation services) without significant risk of this compromising aspects of SONI performance that are influenced by that service area. However, at present we consider that this risk applies across all service areas and that it is not realistic to expect it to be addressed in time for the 2020-25 SONI price control determination.

Proposed approach for draft determinations

4.19 In the light of the evaluation of policy options above, we identified a strong case for moving away from policy Option 1. Even with the introduction of an evaluative performance framework, we are concerned about the implications of Option 1 for SONI's performance across different outcomes.



4.20 We considered that Option 2 would be an improvement on Option 1, but that it is inferior to Options 3 and 4. Options 3 and 4 offer considerably more in terms of alignment of the regulatory framework with achievement of desired outcomes.

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- 4.21 We considered the choice between Options 3 and 4 to be finely balanced. Option 4 has the benefit of greater internal consistency in the treatment of SONI costs. But Option 3 can be seen as a more incremental step from the current approach. It retains some form of financial incentive on most of the SONI costs currently subject to mechanistic cost-sharing, rather than relying on the new evaluative performance framework to play this role.
- 4.22 Our proposed approach for draft determinations is Option 3, but we are keen to receive stakeholder input, especially on the balance between Options 3 and 4.
- 4.23 We recognise the potential for additional regulatory and administrative burden under approaches 3 and 4 compared to approaches 1 and 2. However, to a large extent this arises from the need, under these approaches, for the regulated company to understand, and be able to demonstrate, how changes in its costs have affected its performance (and how changes in its performance have affected its costs). Understanding and being able to demonstrate these things seems a feature of a well-run system operator.
- 4.24 Figure 4 provides an overview of our proposed approach to cost remuneration, summarising the different elements of our preferred Option 3.



Figure 4: Overview of proposed approach to cost remuneration

Majority of TSO "internal" costs

Applies to system operation costs (excluding costs of system support services), commercial interface costs (excluding TUoS and Moyle revenues) and support function costs (e.g. HR, IT, legal)

New "conditional cost-sharing approach" adapted from current cost incentives:

- Financial incentives for under- or overspend conditional on targeted regulatory assessment
- The TSO would qualify for a financial benefit in the case of an under-spend as long as it can provide good evidence that the under-spend was not due to a reduction in TSO costs at expense of worse performance or outcomes
- No financial penalty for over-spend if there is evidence that this is likely to reduce whole system costs over the long term, or enables justified improvements to other aspects of performance
- 25% incentive rate if financial incentive applies
- Financial incentive subject to overall cap on financial reward or penalty from evaluative performance framework

Transmission network development costs

Builds on current uncertainty mechanism for transmission network planning project costs

- TSO can recover the costs it incurs up to a cap approved by the UR, and subject to potential disallowance of costs that are demonstrably inefficient or wasteful (DIWE)
- These arrangements would apply to all transmission planning costs (including early scoping) for greater internal consistency
- These network planning costs taken into account as part of evaluative performance framework, with potential for financial reward or penalty for its performance in relation to these costs

Costs of purchasing system support services

- TSO can recover the costs it incurs (no cap applies)
- The TSO's performance in relation to these costs taken into account as part of evaluative performance framework
- 4.25 Within the structure summarised above, the conditional cost-sharing approach is the more novel feature, and we explain the principles behind this further in Appendix A to this document.
- 4.26 Furthermore, we propose that the financial incentives arising from the conditional cost-sharing approach are subject to a single, combined cap (maximum penalty or reward of £1m per year) that covers the net position from these incentives and the outcome of the evaluative performance assessment (see Annex 4).
- 4.27 In terms of the implementation of the conditional cost-sharing incentives in the TSO licence conditions, we propose that the scope of costs subject to conditional cost sharing incentives is defined as SONI TSO costs not subject to other specific remuneration arrangements (i.e. cost pass-through or remuneration up to a cap). More specifically, the scope of costs would *exclude*:
 - Costs attributable to transmission network planning activities (including project scoping and feasibility activities or to transmission network preconstruction projects), with the exception of costs for support functions and overheads which are intended to be recoverable through the ex-ante allowances determined by the UR.
 - System support services (ancillary services) costs and amounts payable by SONI for transmission use of system charges (TUoS).



- Pension deficit repair contributions.
- Any other costs otherwise recoverable under the SONI price control through specific licence provisions (e.g. specific cost items recoverable under an uncertainty mechanism involving remuneration up to an approved cap).

Utility Regulator

- 4.28 In addition, we propose that a number of specified items of costs are excluded from cost-sharing with customers, and that SONI's investors would bear 100% of any deviations from our exante allowances:
 - Any costs that the UR determines at any time to be Demonstrably Inefficient or Wasteful Expenditure (DIWE).
 - Costs reasonably allocated or attributed to activities or services subject to the SONI's connection charges.
 - Costs treated as excluded SSS/TUoS costs or Special Project costs in the TSO licence.
 - Any costs reasonably allocated or attributed to a regulatory appeal to the CMA (including costs of preparatory work for a potential appeal, whether or not this proceeds).
 - Other costs of any description which the UR may determine in a published decision from time to time to be manifestly unreasonable to include in costs partially shared with customers.
- 4.29 The approach of specifying exclusions from cost-sharing is part of established UK regulatory practice (e.g. see the exclusions to the NIE Networks cost sharing incentives specified by the Competition Commission in 2014³ and implemented in the NIE Networks distribution licence).

³ Competition Commission 2014 Northern Ireland Electricity Limited price determination: final determination, paragraph 19.48.





5. Role for enhanced cost transparency

- 5.1 In the previous section we set out our proposal for the core approach to cost remuneration for the 2020-25 SONI price control. However, we identified in the specification of alternative approaches from section 3 that in addition to the core options there were further regulatory tools to consider that could form part of the overall price control framework.
- 5.2 We consider that under each of options A to D from the previous section, there is a strong case for introducing additional cost transparency provisions. Enhanced cost transparency and cost reporting initiatives for SONI could support cost efficiency in a number of ways:
 - help harness reputational incentives to encourage efficiency and avoid wasteful expenditure (e.g. excessive remuneration of senior staff).
 - help allow stakeholders to identify potential opportunities for SONI to operate more efficiently.
 - provide information that is useful to the assessment required for the purposes of the evaluative performance incentive framework for SONI or for assessments for conditional cost-sharing incentives.
 - improve opportunities for benchmarking between SONI and other organisations.
 - provide a more detailed evidence base to use when setting ex-ante cost baselines, and when making approvals of expenditure caps for price control purposes.
- 5.3 As far as possible, while recognising the potential need for some redactions where justified on grounds of commercial confidentiality, we would envisage SONI publishing the data for the benefit of stakeholders rather than just providing to the regulator.
- 5.4 We would develop more detailed reporting guidance, which would be subject to separate consultation.
- 5.5 We identified a range of potential areas for enhanced cost transparency and cost reporting:
 - Reporting of costs incurred by SONI broken down by the individual services areas identified for SONI (or at a less granular level, the four broad SONI roles).
 - Information on how key SONI resources (e.g. staff, consultant spend) are allocated across the different SONI roles and services, potentially with a detailed staff resource plan across the organisation.
 - More granular reporting of the costs incurred for various different categories



of system support services in Northern Ireland.

- Aside from system services costs, requirements to report in summary form (similar to requirements on public bodies) the spend under contracts with third parties that involve total costs over a specified threshold. This may be especially relevant in relation to spend on regulatory engagement, as there could be concerns if this spend were excessive in relation to the benefits accruing to SONI customers and the wider system, rather than benefits accruing to SONI shareholders.
- Reporting of (anonymised) staff costs against the granular occupational categories used by the ONS and NISRA for the Annual Survey of Hours and Earnings (ASHE). This would allow for more like-for-like comparisons between the salaries of SONI staff and employees from other organisations, using published national statistics.
- Full reporting of methodologies for cost allocation within SONI and for calculation of intra-group recharges.
- 5.6 We had asked SONI for information of bullet 1, in the paragraph above, as part of the data templates required from SONI as part of its price control business plan submission. SONI did not provide this information, even when we asked for estimates on a "best endeavours" basis.
- 5.7 We recognise that additional regulatory reporting requirements involve costs for both the regulated company and the regulator. However, subject to any further evidence submitted as part of stakeholder feedback on our draft determinations, we consider these costs are likely to be proportionate given the benefits above. This is particularly so in the case of the SONI price control because of two factors.
- 5.8 First, there are very limited opportunities for cost benchmarking analysis for SONI using the type of aggregated cost data that SONI currently reports on. This is in contrast to other areas of our price control regulation. For our regulation of NIE Networks' electricity distribution business, Northern Ireland Water and the NI gas distribution companies, our price control reviews can draw on benchmarking analysis for cost assessment, particularly with other regulated companies elsewhere in the UK.
- 5.9 Second, the smaller role for mechanistic financial incentives for cost efficiency within the SONI price control framework means there is a greater need for enhanced transparency than in other sectors. Even under policy options A and B from the previous section, a large part of SONI's costs would not be subject to mechanistic financial incentives (e.g. transmission network pre-construction costs and system support services costs).
- 5.10 We are therefore proposing a package of enhanced cost transparency and cost reporting requirements on SONI in relation to its SONI activities, covering each of the areas under (a) to (f) above.
- 5.11 We welcome stakeholder feedback on this proposal, especially on how enhanced





cost transparency can be designed to provide the most net benefits in relation to the desired outcomes from the SONI price control.





6. Uncertainty mechanisms

- 6.1 This section considers uncertainty mechanisms to provide some additional flexibility within the price control, beyond that provided by the core cost remuneration approach, for uncertainty in the costs of the SONI's activities over the price control.
- 6.2 This section is organised as follows:
 - March 2019 regulatory approach to uncertainty mechanisms.
 - SONI business plan proposals for uncertainty mechanisms.
 - SECG member views on SONI business plan.
 - Proposed approach to transmission network planning.
 - Our proposals for other uncertainty mechanisms.
 - Cost allowance under conditional cost-sharing incentives.
 - Costs subject to remuneration up to approved cap.
 - Accountability for delivery of benefits from funding.
 - Balance between upfront and within-period cost assessment.
- 6.3 This section does not consider the potential application of an uncertainty mechanism, for corporation tax. This is covered in Annex 7, Risk and return.

March 2019 regulatory approach to uncertainty mechanisms

- 6.4 In our March 2019 regulatory approach decision we envisaged a potential role for uncertainty mechanisms.
- 6.5 In relation to SONI's costs for transmission network pre-construction projects, we indicated in our approach decision that the current uncertainty mechanism was likely to remain broadly appropriate for the 2020-25 period. Our position took account of the considerable work which had been carried out to date under the existing framework, including the CMA's review of these arrangements during the SONI appeal in 2017 and the CMA's remedies (particularly in relation to regulatory guidance and licence codifications of the arrangements).
- 6.6 In relation to uncertainty mechanisms for other SONI activities and costs, we identified a range of models that might be used, and kept open the type of approach and scope of uncertainty mechanisms for the 2020-25 period. We said that, in its business plan, we expected SONI to:
 - take account of the arrangements which have been developed as part of the existing framework when considering the benefits and drawbacks of different approaches;



- detail its views robustly on these issues and provide rationale for any proposed framework changes;
- reference its consideration of all the options and explain the relative merits of any proposed option(s);

Utility Regulator

- set out how its proposals affect their own risk levels and are to the ultimate benefit of consumers; and to
- consider how any changes fit cogently and coherently with elements of the framework proposed elsewhere.

SONI business plan proposals for uncertainty mechanisms

- 6.7 SONI's business plan said that SONI was only proposing minor adjustments to the uncertainty mechanisms that were robustly assessed by the CMA in 2017.
- 6.8 In particular, SONI proposed a change to the arrangements for transition network pre-construction projects. This concerned the "scoping and feasibility" stage of work on potential transmission network pre-construction projects. Appendix I to SONI's business plan contained an explanation of SONI's concerns and a discussion of different options for the treatment of "project scoping and feasibility" costs, including the use of uncertainty mechanisms. While we had concerns about the scope of options considered as part of that appendix, it was generally a helpful document.
- 6.9 SONI reported that, under the current price control arrangements, a small part of the initial work to identify the scoping and feasibility of a necessary investment is funded through the Bt opex allowance and the remainder is to be funded through the Transmission Network Preconstruction Projects (TNPP) process. However, SONI identified a funding gap, especially in relation to the costs of the work needed to produce information required as part of its TNPP submissions or required in response to queries from the UR on those submissions. SONI said that it was at risk of not recovering some scoping and feasibility costs and that these issues posed risks of delays to the overall transmission network planning processes.
- 6.10 SONI said that there were two aspects of uncertainty relating to scoping and feasibility costs. These are concerned with: first, uncertainty on the number of projects that SONI will need to progress through the feasibility stage between 2020 and 2025; and second, uncertainty on the amount of investigation and stakeholder engagement required as part of these feasibility assessments.
- 6.11 SONI considered four options for the treatment of scoping and feasibility costs: ex ante allowance for these costs set at the price control review; an allowance determined according to a mechanistic volumetric adjustment that depends on the number of projects that SONI progresses through the scoping and feasibility phase; and two different cost recovery or cost pass-through arrangements (one reconciled every five years and one done annually). Its preferred approach was cost recovery, subject to DIWE, reconciled annually.
- 6.12 Further to its proposal on transmission network planning costs, SONI proposed that



two specific activities would be funded through the Dt uncertainty mechanism: (i) work to implement the Electricity Balancing Guidelines; (ii) and work associated with the Clean Energy Package. In addition, SONI sought a re-opener (Dt) for the full costs of initiative F5 (data services), but provided little explanation of this.

- 6.13 These proposals by SONI concern the use of the Dt mechanism during the price control period; they do not concern the design of uncertainty mechanisms for the 2020-25 period and are not directly relevant to the issues covered in this section (and this appendix). Under the current Dt mechanism (and our proposed modifications explained further below) it is not necessary to identify at the price control review which specific projects or initiatives would be considered under the uncertainty mechanism.
- 6.14 Under our proposed uncertainty mechanisms, set out later in this section, SONI would have opportunity to seek additional funding for costs relating to the Electricity Balancing Guidelines and the Clean Energy Package. There is no need to take a position at this stage on whether or not such costs would qualify for additional funding through uncertainty mechanisms.

SECG member views on SONI business plan

6.15 One of the SECG members that provided written feedback on SONI's business plan said that the justification and drawbacks of uncertainty mechanisms have not been adequately demonstrated. The member raised a concern that SONI's push for use of uncertainty mechanisms for so many activities would make the uncertainty mechanism unsustainable and unjustifiable.

Proposed approach to transmission network planning

- 6.16 We propose to keep the current uncertainty mechanism for transmission network planning projects, with the addition of a materiality threshold of £40k in line with other uncertainty mechanisms. We would welcome views on the appropriateness of this level of materiality.
- 6.17 In addition, and in light of SONI's business plan submission, we propose to make changes to the treatment of transmission network project scoping and feasibility costs. We agreed with SONI's view that there might be a funding gap in the current process which could affect the quality of early stage network planning work or which may lead to delays in network planning processes.
- 6.18 We propose the following arrangements:
 - All costs relating to transmission network project scoping and feasibility would be treated under our cost remuneration approach D (see section 4 above). Under this approach SONI could recover costs up to the approved cap, subject to any deduction for DIWE.
 - We would set at the price control review an initial approved cap for transmission network project scoping and feasibility costs over the five-year



price control period. The approved cap would not be tied to specific projects or potential projects.

- We would have discretion, during the price control period, to increase the approved cap for transmission network project scoping and feasibility costs.
- Our cap would include a contingency on top of an estimate of the level of costs required over the five-year period. SONI's outturn spend relative to the pre-contingency estimate would be considered as part of the evaluative performance framework.
- Once a project has been approved for the purposes of the existing uncertainty mechanism for transmission network planning projects no further costs on that project should be reported for scoping and feasibility.
- 6.19 We considered that this extension would help tackle the key concerns raised by SONI in relation to project scoping and feasibility in its business plan Appendix I. In particular it would: provide explicit funding mechanism for network project scoping and feasibility costs; provide flexibility in the funding arrangements, recognising the uncertainties in this area; and support consistency between the price control treatment of project scoping and feasibility and the price control treatment of preconstruction project costs.
- 6.20 SONI's own preferred solution involved an entitlement under the price control for it to recover costs incurred on scoping and feasibility, subject to any DIWE, but without this being constrained by a cap set by the UR. SONI considered four options, but none of these options involved cost recovery subject to a cap. We considered this to be a significant limitation in SONI's options analysis, especially since cost recovery subject to a cap is the approach applied to transmission network project costs. We considered that a cap provides a useful safeguard, and this applies as much for scoping and feasibility costs as for pre-construction project costs.
- 6.21 In line with the approach for the transmission network planning project costs to be funded through cost recovery up to an approved cap, we would provide an allowance for asymmetric risk, in light of the outcome of the CMA appeal in 2017 and our approach to risk and return (see Annex 7, Risk and return).

Our proposals for other uncertainty mechanisms

- 6.22 In the remainder of section 6 we consider what arrangements should apply for costs that do not fall under the uncertainty mechanism for transmission network planning.
- 6.23 The current TSO licence provides substantial flexibility, through the "Dt mechanism" provisions at paragraph 8 and 9 if the SONI price control licence conditions, for the UR to approve requests from SONI for additional price control allowances for "reasonable and efficient costs incurred (or likely to be incurred)" by SONI that were not taken into account in setting the existing price control. If we do approve additional allowances, these are remunerated on the basis of costs incurred up to



an approved cap, subject to the DIWE provision.

- 6.24 Following the CMA appeal in 2017, we produced regulatory guidance documents relating to the use of the Dt mechanism.
- 6.25 We see three key questions for our draft determinations:
 - a) **Scope**. Should the broad flexibility for us to approve additional allowances during the price control period be retained, or should this provision only apply to a defined subset of costs determined at the price control review (e.g. areas of costs where there is greater uncertainty)?
 - b) **Cost remuneration approach**. Where such approvals are made by us, what cost remuneration approach should apply in relation to the additional costs?
 - c) **Accountability**. What arrangements should apply to ensure that SONI is held accountable for delivery and performance in relation to the anticipated benefits resulting from the approved costs?
- 6.26 We have not identified good reasons to move away from an approach that gives us flexibility to approve additional allowances during the price control period.
- 6.27 However, we recognise that in considering any request for additional funding from SONI it would be important to consider whether there is already any implicit or explicit allowance within our price control determination for the relevant costs. We would also consider whether an uncertainty mechanism adjustment is necessary given the opportunity, under the conditional cost sharing incentives discussed earlier in this appendix, for SONI to receive additional funding for over-spend attributable to the efficient costs of justified improvements in performance. We propose to address these issues through regulatory guidance on the uncertainty mechanism and comment on them further below.
- 6.28 The current approach to cost remuneration for the uncertainty mechanisms involves remuneration on the basis of costs incurred (subject to any cap on recoverable costs specified by us as part of the approval). For the 2020-25 SONI price control, we propose to bring more consistency between the types of approach to cost remuneration for approvals made during the price control as for cost allowances set at the price control review. Drawing on our wider proposals for cost remuneration in (see section 4 above), we consider that approvals during the price control period would be remunerated primarily through one of two options:
 - a) Ex ante baseline set for the efficient costs during price control period, and these being subject to conditional cost-sharing arrangements (i.e. aligned with approach C from the options on cost remuneration approaches above).
 - b) Remuneration of costs incurred, subject to an approved cap, but with potential to take account of the costs incurred by us in this area as part of the wider evaluative performance incentive framework. This is aligned with cost remuneration approach D from section 3 above.



Utility Regulator

- 6.30 To limit risks of distortions to SONI's incentives and cost reporting, our starting position would be that the cost remuneration approach for any approval would be aligned with that used within the SONI price control for other similar costs. For instance, since costs of system operation activities would be treated under cost remuneration approach C, the second option above would be the starting point for additional expenditure allowance approved to bring enhanced benefits to system operation. But there is merit in allowing some flexibility to depart from this starting point. For instance recovery of costs up to a cap under (b) may make sense if it is difficult or not worthwhile setting an ex ante baseline.
- 6.31 In each case, cost recovery would be via adjustment to operating expenditure allowances and/or adjustment to the RAB (and in turn depreciation and rate of return allowances), depending on the mix of operating expenditure and capital expenditure in the relevant costs.
- 6.32 In the next sections we explain in more detail the arrangements we envisage for the uncertainty mechanisms working through cost remuneration approaches (a) and (b) above. These would form part of the regulatory guidance documents for the uncertainty mechanisms that apply outside of the arrangements for transmission network planning costs for the 2020-25 period.

Cost allowance under conditional cost-sharing incentives

- 6.33 For costs subject to conditional cost-sharing incentives (cost remuneration approach C), we need to set an ex ante baseline reflecting a regulatory view of the efficient level of those costs over the 2020-25 period.
- 6.34 We propose to use the uncertainty mechanisms proposed above to provide flexibility to make additions to the ex-ante baseline for costs subject to conditional cost-sharing incentives during the price control period. This would work as follows:
 - Any increase to the ex-ante baseline allowance would be specifically to fund an initiative that is intended to achieve an enhanced service from SONI (including enhancements that would reduce wider system costs). The enhancement initiative service should be shown to have a positive influence on the SONI outcomes.
 - We would not expect to increase the ex-ante allowance for reasons other than changes to SONI's obligations or deliverables (e.g. we would not expect changes for differences between forecast and outturn RPEs, unexpected changes in electricity demand, or wider circumstances).
 - We would not reduce the ex-ante allowance compared to that set at the price control review.



Utility Regulator

- The achievement or delivery of the enhancement initiative should be demonstrable (e.g. through deliverables, outputs or benefits that SONI can be held to account against, to protect customers).
- The enhancement initiative should not have been already funded through other allowances at the price control review, or through allowances during previous price control periods.
- When we approve an enhancement initiative during the period, we would determine the outputs or deliverables that SONI would be accountable for achieving or delivering, and set an allowance reflecting an exante assessment of the efficient costs of this. This would have the effect of adding to the ex-ante baseline but would be separately recorded, and SONI would need to keep separate records of the outturn costs for that initiative.

Costs subject to remuneration up to approved cap

- 6.35 For SONI costs to be remunerated subject to approved cap, there would need to be upfront caps for specific projects/initiatives and/or specific SONI service areas. At the price control review, the caps would comprise two main elements:
 - Costs covered by approved caps that are already established (e.g. preconstruction projects for which we approved costs during the 2015-20 SONI price control and which have not been completed by 30 September 2020).
 - An approved amount, set at the price control review, for the costs of some activities over the 2020-25 period (as part of our draft determinations we are approving an amount for transmission network planning scoping and feasibility activities).
- 6.36 We would then have the flexibility to add to (but not decrease) the approved caps during the price control period (e.g. as part of an annual process linked to the process for the evaluative performance framework).
- 6.37 For all transmission network planning expenditure, the arrangements for withinperiod approval would be based on the arrangements established following the CMA appeal in 2017.
- 6.38 For potential approvals during the period that are not governed by the post-CMA arrangements, we could adopt a similar process as for enhancement initiatives



suggested above. More specifically:

- Any capped funding allowance for a new project or initiative, or any increase to an existing cap, would be specifically to fund an initiative that is intended to achieve an enhanced service from SONI (including enhancements that would reduce wider system costs). The enhancement initiative service should be shown to have a positive influence on the SONI outcomes.
- The enhancement initiative should not have been already funded through other allowances at the price control review, or through allowances during previous price control periods.
- The achievement or delivery of the enhancement initiative should be demonstrable (e.g. through deliverables, outputs or benefits that SONI can be held to account against, to protect customers).
- When we approve an enhancement initiative during the period, we would determine the outputs or deliverables that SONI would be accountable for achieving or delivering.
- 6.39 Where possible and proportionate, we would also set an ex ante baseline reflecting a regulatory view of the efficient level of approved costs over the 2020-25 period. The difference between the approved cap and the baseline view would represent a contingency allowance. The ex-ante baseline would provide relevant evidence to take into account as part of the review of the SONI's performance in relation to these costs under the evaluative performance framework.

Accountability for delivery of benefits from funding

- 6.40 We recognise that a key part of any within-period cost assessment and approval is not the costs, but ensuring that SONI will deliver the proposed benefits from any additional allowance. It is perhaps natural that submissions from regulated companies tend to focus on how much money is needed but in the context of the SONI price control it is equally important to ensure that SONI's actions are contributing to desired outcomes, and that SONI can be held accountable.
- 6.41 In terms of accountability, our starting position is that there should be a clear specification of what SONI is required to deliver or achieve through the additional cost allowance, as part of the approval process.
- 6.42 As explained in more detail in Annex 3, Delivering service and outcomes, we would generally expect to specify "price control deliverables" where uncertainty mechanisms are used to increase price control funding for SONI. One exception to this is where the allowance is for the costs of additional obligations and SONI would not have discretion to avoid spending the additional costs claimed.
- 6.43 For costs remunerated under conditional cost-sharing incentives, we would make financial adjustments to remove the value of funding associated with deliverables that are not delivered or partially.



6.44 In all cases, SONI's delivery against price control deliverables (e.g. was it delivered on time, does it match the initial specification of the initiative) would be taken into account in the evaluative performance framework (see Annex 4, Evaluative performance framework).

Utility Regulator

6.45 An annual process for SONI to propose enhancement initiatives, and for the UR and stakeholders to review them, would be incorporated into the annual process for the evaluative performance (e.g. proposals and supporting evidence for enhancement initiatives provided as part of SONI's annual forward plan). SONI would have the opportunity for being rewarded if it brings forward good proposals for good initiatives, and to be penalised if it does not provide good evidence to support proposals or fails to develop proposals that contribute to desired outcomes.

Balance between upfront and within-period cost assessment

- 6.46 We now draw out some implications of our proposals above on uncertainty mechanisms for the balance between cost assessment at the price control review and cost assessment during the price control period.
- 6.47 We give particular attention to the treatment of the costs of "new initiatives" that have been proposed by SONI in its business plan or which may be identified during the price control period. We separately present our review of these initiatives in Annex 6, Cost allowances.
- 6.48 We envisage a price control framework for SONI in which we would be carrying out regulatory assessments (of need and cost) for initiatives proposed by SONI not just at the price control review, but also during the price control period.
- 6.49 There is already a major role for within-period determinations under the current SONI price control (e.g. pre-construction projects, I-SEM implementation costs, other Dt items). And our proposals above on uncertainty mechanisms would provide significant flexibility to consider potential new initiatives during the price control period.
- 6.50 A clear role for within-period cost assessment seems well-suited in the context of SONI's business plan for the 2020-25 period. The plan contains a variety of initiatives that *might* bring net benefits to the system, but which seem under-developed in areas such as the clarity on benefits/outputs and confidence on costing. In some cases SONI has simply not provided good enough evidence, but in other cases the lack of evidence also reflects the early stage in the development of an initiative. Rather than taking a binary decision on these projects at the price control review, there is merit in enabling SONI to come back during the price control period with a more developed submission.
- 6.51 Although we could become more engaged in cost assessment and approval processes during the price control review, this should be offset, to some degree at least, by the reduced risks to customers from making a decision based on under-developed information from SONI, and by the benefits to SONI and customers from being able to make the case for new initiatives when better information on benefits



and costs are available.

- 6.52 We recognised that a member of SECG was concerned about the potential drawbacks and risks from using uncertainty mechanisms (in response to SONI's business plan proposals). We are conscious of potential drawbacks and risks from uncertainty mechanisms in general, in terms of potential additional complexity, additional regulatory uncertainty, risks of double counting, and incentive distortions. We sought to mitigate these risks through the design of the arrangements set out above:
 - While uncertainty mechanisms can be complex, the types we are proposing are relatively straightforward and build on the type of approval-based uncertainty mechanism that is already established for SONI.
 - We propose to prepare regulatory guidance documents to explain the arrangements and approval processes (as for the 2020-25 control) to reduce concerns about regulatory uncertainty.
 - This guidance would include measures to reduce risks of double counting. In any event, given the nature of cost assessment for SONI, we consider that risks of double counting also arise at the price control review and we did not consider these to be exacerbated in this case by the use of uncertainty mechanisms.
 - We have sought to limit incentive distortions by introducing the option for additional funding to be provided on an ex ante basis, subject to conditional cost sharing incentives, which allows for greater alignment of the cost remuneration and incentive approach in some areas than the current Dt process.
- 6.53 Furthermore, we considered that any residual risk was tolerable given the benefits we see from being able to use uncertainty mechanisms to bring flexibility to price control funding (and associated deliverables) over the price control period. This flexibility is especially important as part of our proposed introduction of an evaluative performance framework involving annual assessment. It allows for more ongoing engagement between SONI and stakeholders about its plans and initiatives and how these should be developed and adapted over time.





Appendix A: conditional cost-sharing approach

- 6.54 This appendix provides further information on the conditional cost-sharing approach introduced in section 3 (as approach C), which forms part of our preferred policy option for the cost remuneration approach for the 2020-25 TSO control.
- 6.55 We start with an overview of some of the principles behind the conditional costsharing approach. The table below lists a number of possible reasons why SONI might show an under-spend or an over-spend against an ex ante allowance, and specifies how we intend this to be treated under the conditional cost-sharing approach. In particular, the table indicates for each reason whether cost-sharing of any under-spend or over-spend would apply or not (if cost-sharing does not apply the alternative would be cost recovery / cost pass-through).

Possible reason for over- or under-spend	Under-spend scenario	Over-spend scenario
SONI efficiency (from system-wide perspective)	Genuine improvement in SONI efficiency Cost-sharing incentive rate applies to under-spend: SONI retains some of the financial benefits from under-spend; remainder goes to customers	Inefficiency by SONI Cost-sharing incentive rate applies to over-spend: SONI bears some of the additional costs from over-spend; remainder borne by customers
Interactions between SONI costs and its performance in relation to wider system costs or other outcomes	Under-spend due to a reduction in SONI costs at expense of (risk of) worse performance affecting outcomes (e.g. higher costs elsewhere in the system or worse service quality) Cost-sharing incentive rate should not apply to the under-spend: no financial benefit to SONI from the under-spend; full pass-through of under-spend to customers	Over-spend due to efficient costs of justified improvement in performance by SONI, in terms of either: (a) action that is likely to improve (or have improved) efficiency in whole system costs over the long term; or b) enhanced performance in terms of decarbonisation, grid security or SONI service quality Cost-sharing incentive rate should not apply to the over- spend: SONI remunerated in full for the over-spend Potential financial reward for such improvements available under the separate evaluative performance framework
Unanticipated changes in external factors	Good luck from unanticipated reductions in costs due to external factors not anticipated when ex ante baseline set	Bad luck from unanticipated increases in costs due to external factors not anticipated when ex ante baseline set
	Cost-sharing incentive rate applies to under-spend : SONI retains some of the financial benefits from under-	Cost-sharing incentive rate applies to over-spend : SONI bears some of the additional costs from over-spend;

Table 1: Conditional application of cost sharing incentives

	spend; remainder goes to	remainder borne by customers
	customers	•
Limitations in ex ante cost assessment (given information reasonably available at the time)	Ex ante cost assessment over- estimated efficient level of costs (given information reasonably available at the time)	Ex ante cost assessment under-estimated efficient level of costs (given information reasonably available at the time)
	Cost-sharing incentive rate applies to under-spend : SONI retains some of the financial benefits from under- spend; remainder goes to customers	Cost-sharing incentive rate applies to over-spend : SONI bears some of the additional costs from over-spend; remainder borne by customers

Utility Regulator

- 6.56 The table above highlights that the point of departure from an approach of mechanistic cost-sharing incentives concerns any under-spend or over-spend arising from the interactions between SONI costs and its performance in relation to wider system costs or other outcomes.
- 6.57 Our proposed approach under the conditional cost-sharing incentives is risk-based and concerns the interactions between SONI costs and its performance in relation to wider system costs or other outcomes. In a context where the SONI's performance and service quality across its range of services is difficult to monitor, there is a significant risk that an under-spend arises because of a reduction in costs at the expense of worse performance or service quality.⁴ Given our broader desire to improve SONI performance and improve outcomes, this is not something we would want to financially reward SONI for. One key role of the conditional costsharing incentive approach is to make the cost-sharing only apply in an underspend scenario where there is some assurance against this risk.
- 6.58 To do so, we propose that SONI would qualify for a financial benefit (reward) from cost-sharing incentives in the case of an under-spend as long as it can provide good evidence that the under-spend was *not* due to a reduction in costs at expense of worse performance affecting outcomes (higher costs elsewhere in the system or worse performance in relation to decarbonisation, grid security or service quality). This evidence could take one of two forms (or perhaps both):
 - a) Evidence showing that levels of performance have been maintained, or improved, across SONI's services and activities despite the under-spend.
 - b) Evidence that the under-spend is explained by other 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
- 6.59 In the absence of such evidence, the full value of the under-spend would go to customers, rather than being shared between SONI and customers under the cost-sharing incentive rate.

⁴ While this risk to service quality and performance may also arise in an over-spend scenario, we consider it higher risk in an under-spend scenario, and focus the proposed arrangements on this for the purposes of limiting complexity.

6.60 The relevant evidence to be considered here is targeted on the issue of interactions between SONI costs and its performance in relation to wider system costs or other outcomes. For instance, it would not be necessary for the UR to assess whether an under-spend was due to efficiency improvement or good luck: a financial reward under the cost-sharing incentive rate would apply in both cases.

Utility Regulator

- 6.61 In practice, it is possible that an under-spend is due to a mix of factors and so judgement would be needed to determine, given the evidence available, the proportion that should qualify for the cost-sharing incentives and the proportion that should go in full to customers.
- 6.62 There would be one exception to the treatment of under-spends under the conditional cost sharing approach. Where there is a hypothecated ex ante cost allowance for delivering (or achieving) specified price control deliverables (e.g. ex ante funding which represents the estimated efficient costs of delivering an agreed new project or initiative) there is a lower risk that an underspend against these costs arises because of a reduction in SONI costs at the expense of worse performance or service quality. In these cases, SONI would be accountable for delivery of the price control deliverable. If the deliverable is not delivered (or under-delivered) 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 (or an estimate of the proportion not delivered). With this regulatory evaluation of delivery, and any financial adjustments determined, we would then apply the cost-sharing incentive rate mechanistically without further evaluation. This enables a simpler approach to cost-sharing incentives where risks to customers or lower or mitigated through other regulatory tools.
- 6.63 In addition, the conditional cost-sharing approach would provide an opportunity for SONI to avoid, in certain circumstances, the type of financial penalty that would apply to over-spend under an approach of purely mechanistic cost sharing incentives. Specifically, we propose that, if SONI can provide good evidence to show that an over-spend was due to the efficient costs of justified improvement in performance, it would be remunerated in full for those costs rather than facing a financial penalty through financial exposure to a share of the over-spend. This evidence would need to involve the following elements:
 - evidence of the justified improvement in performance (compared to performance levels funded through the ex-ante baseline) in relation to whole system costs, decarbonisation, grid security or SONI service quality;
 - evidence of the efficient costs of the improvement; and
 - evidence of why this improvement provides good value for money overall.
- 6.64 We would generally expect to see evidence of SONI taking account of stakeholder views as part of its assessment of whether an over-spend would provide good value for money overall.
- 6.65 It is possible in practice for there to be an over-spend in one area and an underspend in another. In such cases, we would first look at the evidence that higher



costs have been incurred in one area due to the efficient costs of justified improvement in performance, and if so this would effectively imply an uplift to the ex-ante baseline, from which the appropriate treatment of any under-spend against that uplifted baseline could then be assessed. This would enable a financial upside (reward) to SONI even if the overall spend was more than the baseline.

- 6.66 The design of these arrangements means that it is for SONI to provide evidence that under-spend has not come at the expense of wider performance, and for SONI to provide evidence that an over-spend is efficient and good value for money. The UR would make a regulatory determination in the light of evidence provided by SONI. This process recognises that SONI will generally have much better evidence available, or reasonably available, to it than other parties (e.g. the regulator or other stakeholders) on why its costs differ from ex ante allowances and on whether under-spend or over-spend is attributable to variations in wider performance or service quality.
- 6.67 Insofar as this process places evidential requirements on SONI, it is important to recognise that these relate to the ability of SONI to understand, and be able to demonstrate, how changes in its costs may have affected its performance and how changes in its performance may have affected its costs. Understanding and being able to demonstrate these things seems a feature of a well-run system operator, rather than something that should properly be seen as regulatory burden.