



SONI price control 2020-2025

Draft Determination
6 July 2020



About the Utility Regulator

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

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

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

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



Our mission

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



Our vision

To ensure value and sustainability in energy and water.



Our values

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



Abstract

Today we publish for consultation our draft price control 2020-2025 for SONI, the electricity transmission system operator for Northern Ireland. Our consultation proposals follow an extensive review of SONI's business plan submission and engagement with stakeholders, including feedback from our Stakeholder Expert Challenge Group (SECG).

During this price control period, we are seeking to support SONI during the energy transition to deliver an electricity system that promotes whole system outcomes that matter to consumers, such as greater decarbonisation, grid security and lower energy bills.

As it delivers whole system outcomes, we encourage SONI to take an open, flexible and collaborative approach to the consideration of new ideas and technologies that could have the potential to support the energy transition process.

This consultation proposes a price control framework which works together to support SONI as it provides real value for consumers through high quality service, during a time of significant change. At the heart of our approach, is our desire to build on our existing price control framework to support SONI in delivering whole system outcomes.

Our key price control proposals include:

- putting in place an outcomes focused, evaluative performance framework, with financial rewards and penalties, to promote high levels of performance from SONI and deliver whole system outcomes, adding value for consumers.
- adapting our approach to cost remuneration to incentivise delivery of whole system outcomes.
- providing a total cost allowance of £79m (which compares to the SONI business plan submission of £121m).
- bringing more consistency to our use of uncertainty mechanisms with the approach to cost remuneration.
- setting an allowed return on SONI's Regulatory Asset Base (RAB) of 3.79% applied to a CPIH-indexed RAB - which is 1.29% lower than SONI's request. We also propose an allowed margin on revenue collection activities in respect of the recovery of system services costs, and an adjustment to allowed return for asymmetric risk.

Written responses to our draft determination consultation should be received no later than 5pm, September 14 2020.

Audience

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

Consumer impact

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



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Executive Summary

SONI is the Electricity Transmission System Operator (TSO) in Northern Ireland (NI), undertaking TSO activity for NI consumers. SONI also has a separate licence to operate the electricity market in conjunction with the Republic of Ireland TSO, EirGrid, on an all island basis.

The UR sets a SONI price control in Northern Ireland to provide SONI with an allowance and framework to support it in providing great TSO service for NI consumers. In March 2019 we set out our regulatory approach for how we would carry out a price control from 2020 to 2025. Having reviewed SONI's business plan, and engaged with stakeholders, we now set out our draft determination proposals for consultation.

We welcome this opportunity for you to provide us with your views on our proposals.

Supporting good outcomes for consumers during the energy transition

Change envisaged during the 2020 to 2025 period presents significant opportunities for consumers as we plan for the energy transition. The energy transition will change the way energy is produced, transported and consumed across the whole energy system.

SONI already plays a leading role as the TSO for Northern Ireland. The way it performs its role can lead to great benefits for energy consumers, as it can positively influence whole system outcomes such as greater decarbonisation, grid security and lower energy bills (particularly wider system costs beyond those from running its business).

We will support SONI during the 2020 to 2025 period as it branches out to play a lead whole system collaboration and coordination role. We want to encourage SONI to take an open, flexible and collaborative approach to the consideration of new ideas and technologies that could have the potential to support the transition process.

Building on the existing regulatory framework to support SONI during a time of change

We have listened to stakeholder feedback. It is clear that our framework needs to adapt to support SONI as it maximises these opportunities. We have built on our existing approach to focus on delivering whole system outcomes.

This draft determination provides incentives for SONI to deliver a more “outcomes focused” approach to performance. To complement this, we also see value in adapting the existing approach on how SONI recovers the costs of running its business to support delivery of whole system outcomes. We seek to ensure there is enough flexibility for SONI to request further allowances to meet varied and evolving customer preferences during a time of rapid change.

Given the highly leveraged value that SONI can add in supporting opportunities for consumers, we are also strongly supportive of providing additional allowances to SONI during the period. This is the case where we can be sufficiently confident SONI will deliver whole system outcomes of benefit to consumers.

Our approach is going to require collaborative and trust based working with SONI, and other stakeholders. Good progress has been made so far through, for example, our Stakeholder Expert Challenge Group (SECG), which allows stakeholders to challenge our framework proposals and SONI's business plan proposals.

We hope to strengthen relationships with SONI and other stakeholders through our proposed framework and further collaboration. To help, we are setting clearer expectations of what we and stakeholders would like SONI to deliver, whilst allowing SONI enough freedom to continue to innovate in partnership with stakeholders.

We are cognisant of the desirability of our proposals being consistent, wherever possible, with the Competition Markets Authority (CMA) decisions concerning the existing SONI price control (and indeed other previous CMA cases). In particular, we have built on our proposals for aligning risk and return in a way which is consistent with the previous Competition Markets Authority decisions concerning the existing SONI price control. We are also satisfied that our analysis to check the robustness and internal consistency of our proposals is consistent with our obligations regarding SONI's ability to finance its activities.

We look forward to engaging further with SONI and other stakeholders as we progress towards final determination.

Our key proposals

Evaluative performance framework

Section 5 proposes a new evaluative performance framework which is “outcomes based” and informed by insight from regulatory developments for TSOs facing energy transitions in other jurisdictions. We propose a £1.0m per annum reward and penalty performance incentive which is annually determined by the UR. Our determination will be informed by assessment from an independently led stakeholder panel. We also set out service expectations. These are behaviours and examples of activities that we expect from a reasonably well-run and reasonably efficient TSO, to inform SONI's baseline level of performance.

Cost remuneration

Section 6 sets out our proposals for cost remuneration. We propose to adapt the way that the price control framework enables SONI to recover the costs of its activities. We also propose to adapt the way that the framework exposes SONI to financial incentives and financial risk around its costs. At the heart of our proposals is our desire that the regulatory framework supports improved whole system outcomes.

For some of SONI's costs, the current regulatory approach risks SONI having direct financial incentives to minimise these costs, without sufficient regard to how this may affect whole system outcomes. We propose to retain financial incentives on these costs, to encourage SONI to operate efficiently, but with some adaptations. First, we propose to reduce the scale of financial incentives on these costs. Second, we propose that the incentives involve a safeguard arrangement so that the regulatory framework does not reward cost reduction that comes at the expense of quality and performance. Furthermore, our proposed approach

would give SONI greater opportunity to be remunerated for higher costs where it can show that this improves whole system outcomes. We refer to this adapted approach as conditional cost-sharing incentives.

We propose to retain the existing approach where SONI can recover transmission network pre-construction project costs up to an approved cap, subject to them not being demonstrably wasteful or inefficient. This approach was upheld by the 2017 CMA appeal process. We propose to extend the scope of qualifying costs for this arrangement, to cover project scoping and feasibility activities. This will bring greater consistency in the treatment of SONI's network planning costs. It will also enhance the positive role that SONI can play at the early stages of project development.

We also propose to retain the approach which allows SONI to recover its full costs in purchasing system services and the amounts it pays in respect of transmission use of system charges. No price control cap is applicable to these costs.¹

For transmission planning and system services, we will take account of SONI's performance in relation to the level of costs under our evaluative performance framework.

We also propose a requirement for greater cost transparency to support our proposals on cost allowances, remuneration and performance.

Managing uncertainty

Section 6 also proposes to bring more consistency to our use of uncertainty mechanisms and the above approach to cost remuneration. It also allows greater flexibility for the regulatory framework to accommodate new initiatives and new developments during the price control period.

We propose to retain the existing Transmission Network Planning Process (TNPP).

For funding other additional cost allowances for new initiatives that can provide benefits to the wider electricity system), we propose to make use of one of the following types of approaches,

- Set an incremental cost allowance based on an estimate of the efficient level of the new/additional costs, with the costs incurred by SONI being subject to the conditional cost-sharing incentives approach highlighted above.
- Allow for remuneration of the costs incurred, subject to an approved cap.

Cost allowances

Section 7 sets out our proposals on cost allowances for running the business.

The chart below illustrates SONI's business plan cost request (opex and capex)² for this 2020 to 2025 period compared to previous requests, along with our propose draft

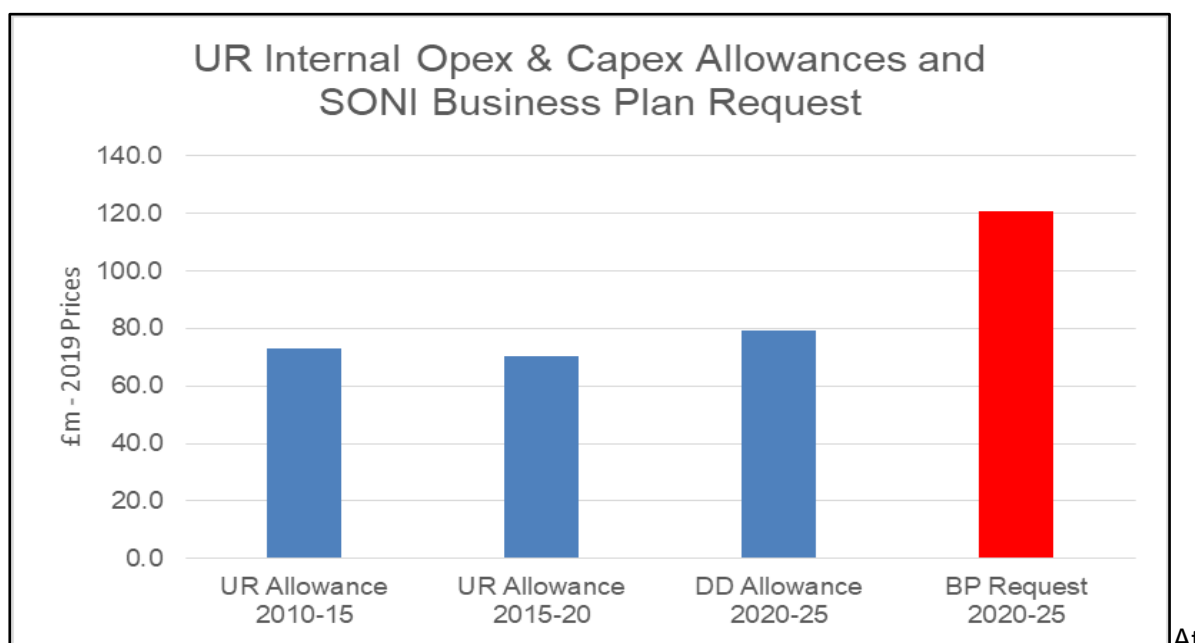
¹ Expenditure for system services is approved outside of this price control and we note that no new capital expenditure has been approved.

² This excludes PCG, margin and asymmetric risk returns.

determination allowance for the 2020 to 2025 period.

SONI requested £121m for this 2020 to 2025 period. We note that this is a significant increase compared to previous business plan submissions. In coming to our proposals we have taken account of the size of this increase and our assessment of business plan quality. We propose to allow £79m.

While our proposal represents an increase of 12.5%, for the 2020 to 2025 period compared to the 2015 to 2020 period, there is a gap between SONI's request and what we are proposing. At this point, the justification and evidence submitted by SONI does not provide sufficient confidence to allow us to meet its full cost request. We set out in the draft determination where we seek more evidence from SONI to inform our final determination. It is important to note that we are also committed to funding strategic, innovative and value for money initiatives during the price control period.



SONI's cost request is split into IT and Telecoms related Business as Usual (BAU) and service enhancements across decarbonisation, grid security and stakeholder engagement themes. We propose to accept most of the IT BAU, but found insufficient evidence and justification to accept many of the other proposed enhancements. This sometimes reflects the early stage in initiative development, but in many cases a lack of evidence and justification. We are also particularly concerned that some initiatives do not represent an enhancement, and also may not go far enough in meeting whole system outcomes.

We have set out detailed actions for SONI to provide justification and evidence in its response to this consultation. There are also opportunities for SONI to come back during the price control period with a more developed submission as part of our approach to managing uncertainty, as set out in Chapter 6. We intend to engage with SONI during this consultation period to consider how best to manage this process.

It is important to stress that we envisage significant opportunities for SONI to innovate during this price control period which we prepared to fund. For example, strategic and innovative,

value for money, capex and opex expenditure related to:

- Collaborating and coordinating through a robust, transparent and open approach to data;
- Developing markets effectively through competition and stakeholder engagement and collaboration; and
- Collaborating and coordinating across system boundaries with 3rd parties, and NIE Networks across its various roles as Distribution System Operator (DSO), Distribution Network Operator (DNO) and Transmission Operator (TO).

We look forward to engaging with SONI and stakeholders as SONI innovates to take advantage of the significant opportunities required to deliver whole system outcomes.

Risk and return

In Section 8 we set out our proposals for remunerating equity and debt financing:

- We propose a pre-tax WACC of 3.79% on a CPIH stripped basis. This compares to SONI request a pre-tax WACC on a CPIH stripped basis of 5.08%. Our assessment of the pre-tax WACC reflects a detailed review of SONI's proposals and other evidence. A large part of the difference arises because SONI's proposed WACC is calculated using an asset beta assumption that we considered excessive, and it assumes a greater proportion of higher-cost debt finance than we consider reasonable.
- The pre-tax WACC figures above assume a 17% corporation tax rate, which is the rate assumed in SONI's business plan. The corporation tax rate over the next five years is difficult to predict. We propose that the allowed pre-tax WACC adjusts automatically according to the prevailing statutory corporation tax rate during the price control period. If the tax rate remains at the current level of 19%, the pre-tax WACC would be 3.88% rather than 3.79%.
- We propose to remove the regulatory obligations on SONI to procure a PCG from its parent company EirGrid in relation to TSO activities. On that basis, PCG remuneration would be £0m.
- We propose to retain the 0.5% margin allowance on SONI's revenue collection role in respect of the recovery of system services costs, in line with the margin determined by the CMA.
- We propose to change the licence arrangements that determine the SONI role in relation to TUoS revenue collection on behalf of NIE Networks, so that any risk lies with NIE Networks rather than SONI (as is case for Moyle, for which CMA applied zero margin) and enable customers to avoid the need to pay a margin on TUoS revenue collection as part of the SONI price control.
- We propose to accept SONI's proposal for an additional profit allowance of 3% on certain categories of costs for which SONI's remuneration is subject to

approved caps. This is in recognition of potential for SONI to face asymmetric risk exposure in relation to these costs, and the CMA's determination of an adjustment for asymmetric risks in the 2017 appeal.

We have undertaken financial modelling of debt financeability metrics and of the impacts of various risk scenarios on the return to regulated equity (RoRE). We are satisfied that these detailed checks support the robustness and internal consistency of our proposals for draft determinations and align with the CMA principles applied in recent determinations. Our overall package of proposals is financeable.

Interaction between the price control and the review of SONI governance

Following a Call for Evidence, the UR is separately developing a consultation paper on proposals for changes to SONI's governance arrangements. The governance review complements our price control work as, good governance supports the delivery of service and efficiency expectations by helping to drive appropriate behaviours by a regulated monopoly company which is remunerated by customers. In this draft determination our proposals for cost allowances and risk and return do not take account of any future governance changes we may propose. To the extent that our governance proposals do affect these areas, we will set this impact out in the consultation on governance.

2. Introduction

Purpose of this document

- 2.1 Our role is to protect the interests of current and future Northern Ireland (NI) electricity consumers. A crucial way we do this is by providing SONI with a price control framework to ensure that its TSO interests can be aligned to those of its customers and consumers.³
- 2.2 We began the process of putting our proposed price control framework in summer 2018 when we commenced our approach phase. We undertook extensive engagement and published a decision on our approach in March 2019.⁴ We received SONI's business plan on 31 October 2019 after agreeing to SONI's request for a three month extension. We have undertaken assessment of the business plan following further engagement with SONI and other stakeholders. This draft determination sets out our price control proposals.
- 2.3 This draft determination is also a precursor consultation to a decision that will ultimately need to be subject to statutory consultation for the purposes of an Article 14 (Electricity Order) modification. Decisions in relation to it are to be made by the application of the principal objective and general duties at Article 12 of the Energy Order. We have applied our principle objective and general duties to shape all of the proposals that are set out in this document.

Background

- 2.4 SONI is an asset light provider of TSO services which can benefit Northern Ireland (NI) electricity customers and consumers. As a monopoly business, SONI does not face the same pressures to continuously drive efficiency and improve service and innovate, as a normal business might. We set a price control framework as a proxy for supporting SONI to perform as if it were operating in a well-functioning competitive market.
- 2.5 We agreed fixed objectives with SONI and other stakeholders as part of this review, which are grounded in our statutory principal objective and general duties. These were set out in our March 2019 regulatory approach document:
- **SONI's service meets customer expectations and is aligned with system wide interests.** We signalled that SONI should take a customer focused approach and that it could play a lead role in enabling system wide change during the energy transition.
 - **SONI is providing high quality service and performance which**

³ We see customers as the direct users of its services who use the electricity system. This is distinct from end consumers (e.g. domestic or business electricity consumers).

⁴ <https://www.uregni.gov.uk/publications/soni-price-control-final-approach>

improves over time.

- **Costs should be reasonable and efficient.** Consumers should be protected from inefficiency arising from SONI's internal costs of running the business, and should demonstrably benefit from wider system cost reduction which SONI can influence.
- **SONI service and cost should be transparent**
- **Framework should provide SONI investors with a fair package of remuneration and risk**

2.6 As part of our March 2019 approach we also set out a range of approach proposals. These included how we would encourage business plan quality, incentivise whole system performance, adapt our approach to cost remuneration, and align risk and return.

Structure of remainder of this document and annexes

2.7 The main body of this document is structured as set out in the table below. We firstly set out the context for what we are trying to achieve and why in light of the change that is predicted over the forward look and beyond. We then summarise our views on SONI's business plan, before identifying our framework and building block proposals on performance, cost remuneration and uncertainty, cost allowances and risk and return. Finally, we bring these together, by setting out the revenues we are proposing to allow SONI, how these affect consumer bills, and how the framework supports the energy transition.

Table 1: Draft Determination document structure

Main Body Section	Contents
3. Strategic approach	This section puts our objectives and price control strategy in the context of the forward look of this price control period.
4. Business plan assessment	This section set out some of the high level themes from our business plan assessment. This includes areas of good practice from SONI and where we think things could be improved.
5. Evaluative performance framework	This section sets out an overview of our proposals for an annual evaluative framework to incentivise SONI performance.
6. Cost remuneration and managing uncertainty	This section provides an overview of the arrangements that apply to the SONI's costs, or to specific categories of SONI's costs, which determine how SONI is remunerated for those costs. It also sets out how uncertain costs are remunerated.
7. Cost allowances	This section provides an overview our capex and opex allowances for the cost of SONI to run its business (we call these internal costs).

8. Risk and return	This section sets out our proposals for remunerating equity capital and debt finance
9. SONI RAB	This section summarises the decisions we propose to take on the historical SONI RAB up to and including the financial year 2019/20, for the purposes of setting the 2020 to 2025 SONI price control, and how we have made other estimates and forecasts of the RAB for the purposes of our modelling analysis. It also sets out the related rules we intend to apply.
10. Revenues and consumer bill	This section provides an overview of the revenues we propose for SONI and their impact on consumer bills
11. Proposals fit with energy transition	This section summarises the specific elements of our proposals which support the energy transition.

2.8 We set out detailed technical analysis in our annexes. These also include guidance, where relevant, on how the proposals should be interpreted and the process for SONI to follow particularly on Evaluative performance framework, Annex 4 and Cost remuneration and uncertainty, Annex 5. Many of the technical annexes build on the various main sections above and so we explain the interactions below.

Table 2: Supporting documentation

Technical Annexes	Content and relationship to main body content
Annex 1 and 2 on business plan assessment and stakeholder views	Annex 1 sets out a summary of feedback from stakeholder SECG feedback on SONI's business plan and Annex 2 sets out our methodology in assessing the business plan, our more detailed assessment of the business plan and proposed score. These annexes largely expand on the main body section 2 (business plan assessment)
Annex 3: Delivering service and outcomes	This annex sets out more detail on our business plan assessment of test area 2 on delivering service and outcomes. It expands further on our business plan assessment annex 1 and 2 and main body section 2 for this test area.
Annex 4: Evaluative performance framework	This annex sets out more detailed work on the design and guidance for our proposals for an annual evaluative framework to incentivise SONI TSO performance. It expands further on our main body section 3 and relevant analysis in business plan assessment annex 2.
Annex 5: Cost remuneration and managing uncertainty	This annex 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 4 and relevant analysis in business plan assessment annex 2.

Annex 6: Cost allowances	This annex provides more detailed analysis of our approach and proposals for cost allowances. It expands on the main body section 5 and relevant analysis in business plan assessment annex 2.
Annex 7: Risk and return	This annex sets out our proposals for risk and return. It expands on the main body section 6 and relevant analysis in business plan assessment annex 2.
Annex 8: SONI RAB	This annex expands on analysis on main body section 7.
Annex 9: GHD cost assessment	We asked consultants GHD to review SONI's expenditure on the service initiative allowances, and their report is set out in this annex.
Annex 10: GHD whole system service initiative international case studies	We asked consultants GHD to provide an overview of some good practice TSOs in other jurisdictions have undertaken relating to whole system type initiatives, with a particular focus on SONI's network investment and system planning role area. Their case studies are set out in this annex This supports our work in main body section 2 on business plan assessment, annex 3 on delivering service and outcomes, and annex 4 on performance framework (see service expectations).

Interlinkages with other UR work

2.9 Our 2019 to 2024 corporate strategy sets out three strategic objectives which the SONI price control cuts across:

- Promoting markets that deliver effective competition, informed choice and fair outcomes.
- Enabling 21st century networks.
- Enabling security of supply and low carbon future

2.10 We are also undertaking work within a number of other areas which have interdependencies with this price control. Within this document we account for:

- Review of SONI governance.
- System services. We will be commencing a project reviewing the approach to system services.
- Work supporting DFE energy strategy.

Interaction between the price control and the review of SONI governance

2.11 Following a Call for Evidence, the UR is separately developing a consultation paper on proposals for changes to SONI's governance arrangements. The governance review complements our price control work. This is because good governance

supports the delivery of service and efficiency expectations by helping to drive appropriate behaviours by a regulated monopoly company which is remunerated by customers. In particular, it helps build and maintain collaborative relationships with a wide range of stakeholders. For a public interest company, these relationships can only be successful and enduring if they are based on trust, confidence and mutual benefit, as well as appropriate accountability. Furthermore, good governance is the keystone for effective arm's length regulation of a monopoly regulated enterprise.

- 2.12 The UR wishes to ensure that SONI TSO's governance is appropriately designed and implemented so as to:
- Secure the protection of the interests of consumers and other stakeholders, including generators and suppliers, in Northern Ireland (NI);
 - Allow for the implementation of UR regulatory policy, including the requirements of the SONI TSO licence;
 - Enable SONI to play its role in the implementation of the policy of the UK Government and/or Northern Ireland Executive, and in particular to facilitate the industry's energy transition based on NI priorities; and
 - Maintain cross-jurisdictional relationships necessary to facilitate the SEM;

while also:

- To the extent compatible with the above requirements, permitting appropriate synergies and efficiencies that stem from SONI's position as part of the EirGrid group.
- 2.13 We plan to publish our governance consultation proposals in July so that they may be considered alongside our price control proposals. In this draft determination our proposals for cost allowances and risk and return do not take account of any future governance changes we may propose. To the extent that our governance proposals do have an impact in these areas, we will set this impact out in the consultation on governance. We envisage that decisions on the price control and governance will be taken together in November.

Timelines

- 2.14 The timelines for the price control determination are set out below:

Table 3: Price control process timeline

Activity	Timing
Draft determination consultation closes	14 September 2020
Final determination and statutory licence modification consultation publication	18 November 2020

Statutory licence modification consultation closes	16 December 2020
Statutory licence modification statement	28 January 2021

- 2.15 The price control timetable has been delayed by approximately 6 months. We agreed to a request from SONI for an additional 3 months to submit its business plan. We have also published the draft determination 3 months later than expected due to the impact of COVID 19. We have already agreed arrangements with SONI to roll-over the price control for 3 months, as is consistent with the SONI licence, to account for SONI's request for additional time to submit the business plan. In keeping with SONI's licence, we propose a similar approach to implement the remainder of the delay.
- 2.16 We also plan to continue to engage with SONI during the consultation. This will be on our proposals and also on licence modification changes which may be required. As part of this, we also encourage SONI to use the query process we have set up to ask any technical questions of clarification where necessary. As well as engaging at a working level, we have set up a SONI and UR Board sub-group. We look forward to engaging with SONI through this forum.
- 2.17 We welcome engagement with other stakeholders during the period and we plan to hold another Stakeholder Expert Challenge Group (SECG) session. We would particularly value stakeholder feedback on upfront services expectations that we propose for SONI (see our Annex 4, Evaluative performance framework). Many of these were informed by stakeholders but we expect refinement and would welcome views.

COVID 19 impact

- 2.18 We welcome evidence and justification from SONI and other stakeholders as to whether and how the impact of COVID 19 affects SONI during the 2020 to 2025 period and/or our proposals set out as part of this consultation.

How to respond to this consultation

- 2.19 We have not set out consultation questions but we welcome response to any aspect of this consultation. We ask that you respond to Ciaran.maccann@uregni.gov.uk and SONIUREGNI@uregni.gov.uk by **14 September 2020**.
- 2.20 You can ask us to keep your response, or parts of your response, confidential. We will respect this, subject to obligations to disclose information. If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you do wish to be kept confidential and those that you do not wish to be kept confidential. If necessary, we may follow up to ask you which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why. We will publish non-confidential responses on our website.

3. Our strategic approach

- 3.1 The energy transition is expected to bring rapid changes during the forward look of this review as part of the energy transition. To date the main energy using sectors have operated in a relatively independent way. A key feature of the energy transition is that energy systems are becoming increasingly interlinked so that decisions taken in one part of the energy system have implications elsewhere in the system. Going forward, it will be important to have an integrated whole systems approach. This requires a price control framework which can adapt to and support this change.
- 3.2 Regulators, government and other stakeholders, including SONI, are working together to support good outcomes for consumers as part of the transition. Department for the Economy (DfE) has recognised the need for an integrated whole systems approach in its December 2019 call for evidence. DfE published its call for evidence in December 2019.⁵ We are inputting into this.

Figure 1: Whole system approach

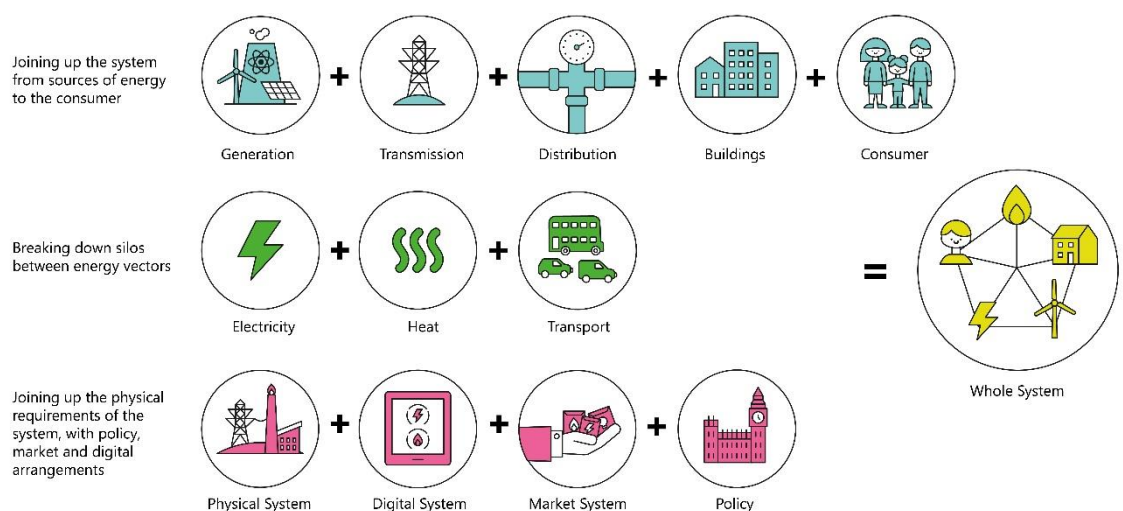


Image credit: Energy Systems Catapult

Greater whole system collaboration and engagement

- 3.3 A whole system approach requires greater collaboration between stakeholders. We have been playing our part within the price control from the early stages by inviting stakeholders to debate and challenge our proposals and also SONIs' business plan in a constructive way. We set up the Stakeholder Expert Challenge Group (SECG)

⁵ <https://www.economy-ni.gov.uk/energy-strategy-call-for-evidence>

forum to support this aim.

- 3.4 We are pleased with the quality of input from SECG, including SONI's willingness to use the initiative, especially as this is the first time we have used this type of forum. We were particularly pleased to hear fresh perspectives and insights from customers about their priorities and how these may benefit consumers. We have drawn on these in our work and will also seek feedback from the group on lessons learnt for the future. We thank SONI and stakeholders for their input and we recognise all parties' contribution in our assessment. We believe SECG represents a good basis for engagement to build from.
- 3.5 We agree with stakeholders that an integrated whole system approach presents an opportunity for SONI to build on its current approach. We and stakeholders recognise that SONI can play a leadership role in the energy transition. We agree that SONI is well placed to do so given its visibility and influence across the whole system.
- 3.6 An important message from stakeholders is that SONI can play a lead role as a whole system coordinator and collaborator to meet their varied expectations. As part of this role we think SONI should be breaking down information barriers by swiftly enabling much greater market participation. We intend to fully support SONI in carrying out its role effectively during this price control and beyond.

Supporting SONI to deliver system change

- 3.7 We recognise the benefits that SONI's service proposition has brought to consumers to date and welcome its ambition to move beyond the status quo. This is clear from its ambition to plan for a higher renewable electricity consumption target, as being proposed by DfE, which received stakeholder backing. We also welcome the positive actions it has taken over time in areas like development of system and balancing tools. We will support SONI as it builds on its existing service proposition.
- 3.8 To support SONI in its whole system coordination and collaboration leadership role we see value in providing clearer service expectations than we have in previous controls, particularly in terms of what a whole system perspective may entail. At the same time, we are mindful of allowing SONI and its customers enough space to innovate together. Getting the right balance is a clearly a complicated task, but we have been mindful of designing the framework to support a sufficient balance.
- 3.9 Playing a collaboration and coordination role will require a renewed focus and clarity from SONI about where and how exactly it can add as much value as possible. We see a number of interlinking service expectations for SONI to focus on in order to build on its existing service and deliver whole system outcomes:
- Collaborating and coordinating through a robust, transparent and open approach to data.
 - Developing markets through competition and stakeholder engagement and collaboration.

- Collaborating and coordinating across system boundaries with 3rd parties, and NIE Networks across its various roles as DSO, DNO and TO.
- 3.10 We explain these a bit more in section 4 below and also in more detail as part of our evaluative performance framework, Annex 4. Our service expectations are largely based on relevant Northern Ireland stakeholder feedback and best practice from other jurisdictional close comparators (such as National Grid ESO and Ofgem GB). We think that in many instances SONI could provide more confidence around service provision by making a more plausible case for what is working well in other jurisdictions and then justifying why this might work in a NI context. SONI's overall approach may involve it fast following in some areas, as well as leading and building on certain aspects of its existing approach in others.
- 3.11 On this basis, we can see significant opportunities for SONI to innovate during this period. We are prepared to fully fund new capital and operational investment during this period where we can be sufficiently confident that SONI service will provide whole system benefits. As a first step in supporting this commitment, we are proposing to uplift SONI's staff allowance to support it in developing some of the new framework proposals. We will also provide meaningful, yet proportionate, financial performance rewards to incentivise SONI service to go beyond business as usual.
- 3.12 In addition to these measures to support SONI, we are prepared to fund allowances for certain business plan initiatives, beyond those we propose to allow in this draft determination. This is subject to receiving more appropriate justification and evidence than we have to date. We note that the plan represents a significant step change in cost request compared to previous plans. While the business plan contains a variety of initiatives that have the potential to bring net benefits to the system, many seem under-developed at this point.
- 3.13 A strong rationale for consideration of an enhancement to service is important, but we also need a sufficient standard of evidence and justification across a range of other parameters. This is so there can be confidence that our regulatory decisions are in the interests of consumers. Further transparency is also required to understand how and where SONI is performing. The underlying principles we apply in considering allowances are in line with regulatory best practice.
- 3.14 In some instances it can be complex for SONI to propose an enhancement to service as the transition is uncertain. Expectations from customers may change. We are, therefore, concerned that a framework that is too target based and mechanistic may not work as well for consumers as SONI's quality of service can be difficult to measure. This is especially the case when there is significant uncertainty in predicting how the system will evolve over the 2020 to 2025 period. Instead, we propose a framework which is flexible enough, and has proper accountability, to support SONI in meeting whole system outcomes during a time of change.
- 3.15 We are in favour of an approach to cost remuneration and performance which is more evaluative, and is sufficiently joined up, to deal with whole system change and evolving stakeholder views. This framework would largely operate on an annual

basis. We also already make extensive use of uncertainty mechanisms and seek to continue to use them in way which is more aligned to the approach to cost remuneration and performance framework.

- 3.16 We provide guidance across our cost remuneration, uncertainty mechanism and performance framework areas to encourage predictability and certainty. The principles on performance incentives draw heavily on what is working in GB, through Ofgem's ESO model, but tailored to local circumstances. For example, we are not requiring the same frequency of reporting from SONI as National Grid ESO under the Ofgem framework. We are prepared to work positively with SONI and stakeholders to assist us in making proportionate yet robust regulatory decisions to further enhance certainty and predictability.
- 3.17 We recognise that, in accounting for change, we must ensure that the framework works as a whole: from the performance, through to how we remunerate costs, through to aligning risk and return. We are mindful of being proportionate in deciding on how to build on the existing regulatory framework. We have done so by choosing areas of framework that we think need modernised where they can provide real value to consumers.
- 3.18 We are also cognisant of the desirability of our proposals being consistent, where possible, with the Competition and Markets Authority (CMA) decisions concerning the existing SONI price control (and indeed other prior CMA cases). In particular, we have built on our proposals for aligning risk and return, in a way which is consistent with the previous CMA decisions concerning the existing SONI price control.

4. Business plan assessment themes

- 4.1 This section discusses the key themes that emerged from our assessment of SONI's business plan assessment. We highlight areas of SONI's plan which demonstrate good practice and areas where we feel that there is scope for improvement. Our view on business plan quality also provides context for proposals and interventions that we are making across key framework areas in the sections which follow.
- 4.1 More information on our methodology for business plan assessment and our reasoning for each test area score is set out in Annex 2, Business plan assessment, interventions and actions.

Context for our work on business plan assessment

- 4.2 As part of our March 2019 regulatory approach we set out a framework to improve the level of business plan quality. We set out our expectations across the different areas on which we proposed to test SONI's performance (test areas), the categories we would apply for assessment of SONI's business plan, and we proposed a reputational incentive for SONI. We explained that this presented SONI with an opportunity for reduced regulatory intervention, and that it would support SONI in taking more ownership to deliver a high quality business plan.
- 4.3 We examined the business plan across eight test areas. These test areas were built up from SONI's response to various test questions within each of the test areas published as part of our March 2019 regulatory approach.
- 4.4 We then carried out an 'in-the-round' categorisation of the business plan on its merits as submitted on 31 October 2019.

Our overall view of business plan quality

- 4.5 We welcome the effort that SONI has put into the plan. In assessing SONI's plan we found elements of useful information and analysis that has supported our work. This will be of benefit over the 2020-25 price control period. We have accounted for this in our assessment and interventions. In particular, we welcome the strong justification and quality of evidence in certain aspects of its risk and return analysis. We also welcome a focus on clarifying service and on outcomes.
- 4.6 While we recognise more effort and improvement in certain areas, there were a number of material areas where we felt that the proposed price control proposals were skewed too far in SONI's favour. Some material areas were also insufficiently supported or developed to translate directly into the proposals without our significant intervention.
- 4.7 We recognise that this is the first time we and SONI have undertaken such an approach. There is an element of judgement required and so we welcome stakeholder feedback on the assessment.

Delivering value for money

- 4.8 Our March 2019 regulatory approach asked SONI to set out business plan proposals which contribute to desired outcomes for consumers and to be clear on how it affects different parties. We said that its tariffs should also allow for a fair balance of charges between current and future customers.
- 4.9 SONI proposed some potentially worthwhile initiatives. Some of these demonstrated a strong rationale for consideration and are sufficiently developed to accept now. We accept that the ability of SONI to fully develop these areas is affected by the level of uncertainty the organisation may face, and so some initiatives could also potentially be funded during the price control period as they may provide net-benefits when properly scoped. We also recognise that SONI has provided useful cost information as part of its response and that this part of the plan is generally more developed than service and benefits side.
- 4.10 However, we found that there were a large number of areas of material consumer interest which fell well short in terms of value for money. Some of the key areas of concern we have are:
- **Step change in cost request which is not supported by clear evidence and strong justification of value:** we have particular concerns around proposed service initiatives potentially not reflecting reasonable customer priorities; insufficient clarity on cost; insufficiently developed benefits; insufficient confidence that the correct option has sometimes been chosen to support energy transition opportunities; and more often than not, service initiatives do not yet seem to be ambitious enough to go beyond business as usual and/or meet the opportunities associated with the energy transition.
 - **Significant concerns with respect to cost remuneration and performance framework:** some key aspects of SONI's proposals in these areas risk significantly undermining good outcomes for consumers during a period of change.

Delivering service and outcomes

- 4.11 We are placing much more emphasis on SONI delivering high quality service and outcomes for consumers through its performance. As part of our March 2019 regulatory approach, we proposed an evaluative performance framework, with financial rewards and penalties to incentivise good outcomes, to cope with a period of change. As noted above, while we are pleased to see SONI beginning to take a more service and outcomes focused approach, we found significant issues.
- 4.12 We found evidence and justification of good practice:
- **Excellent description of type of service SONI offers and useful analysis of linkage to good outcomes.** We welcome the methodical and comprehensive work SONI set out in its Appendix A setting out its existing service portfolio. We also welcome SONI's useful work on mapping services

to outcomes (through for example its 'heat map'), setting out how its service can influence good outcomes for consumers.

4.13 Choosing service can be complex in an uncertain environment. There are outstanding government policy questions which may determine the nature of the energy transition. This, in turn, can affect the types of service initiative SONI chooses to undertake. But we also believe, after engaging with stakeholders, that there is significant ground work that SONI can be doing now to plan for the energy transition and manage the uncertain environment. We intend to work closely with SONI and other stakeholders to support good outcomes. Below are some of the areas SONI could build on:

- **Service initiative ambition could be clearer, stronger and more appropriate:** we found that the plan ambition could be stronger as it was in many cases a re-alignment of SONI's existing approach. For example, the approach to stakeholder engagement and elements of grid security strategy did not seem to correlate with a whole system perspective. We also received feedback from stakeholders that SONI could take a broader perspective of decarbonisation in developing its service. We also found that ambition risks being inappropriately focused as it was too often proposing, without clear justification, to undertake new roles which may belong to 3rd parties and not considering how it could effectively involve 3rd parties appropriately within its roles and service proposition. Important areas like performance commitments and benefit assessment were significantly under-developed. This made it challenging to understand what had influenced SONI's choice of service and to have confidence in the ambition of its proposed improvements to service quality.
- **SONI can build on its role as whole system collaborator and coordinator:** In as far as it relates to stakeholder engagement, SONI's proposed service initiative approach is largely focused on supporting timely development of network build projects. We recognise this is a SONI role and the good engagement and collaboration that SONI already undertakes in this area. We also recognise that SONI describes the drivers of the energy transition change at a high level. But we agree with stakeholders that SONI should be demonstrating how it is going to collaborate more widely with its diverse base of stakeholders, across its service portfolio, in more modern, innovative and yet meaningful way, to influence this energy transition change. A more detailed perspective is set out as part of our review and SECG comments on test area "engaging customers, consumers and other stakeholders" and our related assessment.
- **Further accountability and flexibility is required to incentivise good outcomes:** we are concerned that while SONI's incentive framework proposals (benefits sharing framework) contains some useful elements, it does not sufficiently engage with our proposed regulatory approach. It is also significantly under-developed and poses material accountability risks for consumers. We expand on these points further in our section 5 below, and also in more detail in our Annex 3, Delivering service and outcomes.

However, a key concern is that the framework SONI proposes is too mechanistic given the type of service SONI provides and the uncertainty assumed under the energy transition.

- 4.14 In light of the issues we have found around service initiative ambition, we think SONI should be bridging the gap in service expectation over the price control forward look. From listening to stakeholders, we feel that we need to provide more expectation of the type of service that may benefit consumers. We have set out upfront service expectations in our Annex 4, Evaluative performance framework.
- 4.15 These service expectations inform our view of what a baseline level of performance should be. In other words, how a TSO which is reasonably well-run and reasonably efficient should perform. The service expectations comprise behaviours and examples of activity SONI could undertake, in the form of guidance. These maybe subject to change over time, as stakeholder expectations change, and so we are open to updating them. We welcome further stakeholder views on these.
- 4.16 The idea here is not to be unduly prescriptive. SONI should innovate to develop stretching and challenging initiatives which build on these baseline expectations. We see it as fundamental to the success of the framework that we can work with SONI and stakeholders to support SONI in continuing to innovate.
- 4.17 The box below provides an overview of key areas SONI should be considering further, particularly in terms of taking a more whole system perspective during an energy transition. Many of these have been developed based on sessions and input from SECG. We think that SONI should build on its areas of success to date, like control centre and system service engineering tools, but also develop service through development of commercial frameworks, market engagement and whole system collaboration and coordination.

Figure 2: Examples of areas for SONI focus to support energy transition

Collaborating and coordinating through a robust, transparent and open approach to data

SONI's service proposition could be enhanced by taking a more open approach to sharing and use of data. We note the work that regulators, government and the Energy Data Taskforce have been doing in GB in this regard. Data sharing should be a key part of SONI's role, for example, to maximise information in the market to enable participants to minimise transaction and investment system wide costs. SONI's information should be user friendly, comprehensive and up to date.

Developing markets through competition and stakeholder engagement and collaboration

The way SONI designs and procures system services and its approach to dispatch and scheduling can affect providers' ability to compete and revenue available, and affect price signals and cost in wholesale market. SONI should be ensuring the design, rules and/or processes for procuring system services (and dispatch and scheduling where relevant) maximise competition, where possible, and are fair and transparent. We see a more active role for SONI collaborating with 3rd parties.

Collaboration with 3rd parties and NIE Networks across its various roles as a TO, DNO and DSO

SONI should be clarifying its roles and responsibilities, build a common understanding of where actions taken by one system/network operator could have cross-network impacts, identify and implement actions that optimise synergies, and develop processes with NIE Networks that ensure optimal resource utilisation.

- 4.18 We are strongly committed to funding further allowances during the period to develop innovative service initiatives which deliver whole system outcomes as part of our approach to cost remuneration and managing uncertainty. This is in addition to proportionate yet meaningful financial incentives for bringing forward innovation.
- 4.19 As a first step in demonstrating our commitment, we see value in SONI developing strategy on how it will further take a whole system perspective (including how it will account for local issues), its approach to digitalisation (open use of data) and its approach to engaging stakeholders. This could comprise a major part of its draft to be submitted in May 2021 annual performance plan as part of our proposed performance incentive framework. We discuss what could be included in these as part of our draft up front service expectations in our Annex 4, Evaluative performance framework. We welcome stakeholder feedback on the types of things

that SONI could consider.

- 4.20 We recognise that developing these service expectations through strategies, and working up our proposed performance framework, will impose administrative costs on SONI which are not covered in SONI's plan as they are obligations that we are proposing. So to support SONI in its efforts we propose an up-lift to its baseline staff cost allowance, not proposed in SONI's business plan, to cover these costs.
- 4.21 Finally, SONI should be rewarded if it can develop quality service which goes beyond its baseline. We propose an evaluative performance incentive framework with financial rewards and penalties, in line with that proposed in our March 2019 regulatory approach. We feel that this framework provides more effective accountability and is more flexible than SONI's benefit sharing framework proposals. Given this, we expect that it will be better suited to the type of environment that this price control will cover and beyond. This will better incentivise SONI to in developing better outcomes whilst protecting consumers from poor outcomes at the same time.

Securing cost efficiency and managing uncertainty

- 4.22 While SONI's internal costs of running its business are relatively small compared to most other companies we regulate through price controls, the costs are still significant. In addition, how SONI chooses to deploy these costs has material implications for whole system outcomes.
- 4.23 Our March 2019 regulatory approach challenged SONI to justify its cost remuneration structure and engage with our approach proposals. We expected well evidenced, justified, explained, ambitious and challenging proposals for cost efficiency. We asked SONI to demonstrate innovation which contributes to greater cost efficiency. We also asked it justify its uncertainty mechanisms.
- 4.24 We welcome that some aspects of analysis were a noticeable improvement from previous submissions. For example:
- **Well-structured and sound analysis as part of managing certain aspects of uncertainty relating to network development.** We found that Appendix I on Funding for Project Scoping and Feasibility is well structured, presented, and has a sound, detailed analysis of the problem and need (although the options analysis is not as developed as it could be).
- 4.25 However, we found material issues across most of the test questions. We took a proportionate approach to assessing costs in line with the step change in cost increase and issues we found in terms of justification and evidence.
- **Cost remuneration structure proposals did not demonstrate sufficient engagement with our approach and justification in material areas:** We are concerned that the approach risks being too mechanistic, particularly in light of the energy transition. It also does not sufficiently align with promoting whole system outcomes. We expand on these points further in section 6

below and also in more detail in our Annex 5, Cost remuneration and managing uncertainty.

- **Costs explanation and justification could be significantly improved:** There are significant issues with SONI's justification and evidence across a large proportion of the cost request. This is particularly the case across its service initiative enhancements. SONI undertake an internal challenge process, supported by use of consultancy. While the challenge process seems reasonable it was very difficult to understand its full rigour in terms of application.

- 4.26 While we are proposing to disallow some initiatives as these have not yet been sufficiently evidenced, we recognise the presence of a strong rationale for consideration. For some of these initiatives, it should be feasible for SONI to provide further evidence at this point in time.
- 4.27 Where this is not the case, our approach to cost remuneration and managing uncertainty provides a flexible and reasonable means for SONI to request allowance upon further development. We set out actions for SONI to provide evidence to allow us to make informed decision. We look forward to receiving these from SONI as part of its consultation response.

Aligning risk and return

- 4.28 For this test area we look at how well the business plan balance the interests of SONI as a company and investors with those of the consumer.
- 4.29 We are pleased that SONI's business plan had a number of positive aspects for this test area:
- **Clear set of remuneration channels set out** which are in line with our March 2019 price control approach.
 - **Relevant and useful evidence to inform the assessment across a number of aspects of the pre-tax WACC for SONI.** This includes recent UK regulatory precedent and further analysis carried out by SONI's consultants. While we did not agree with all aspects of the analysis and proposals provided by SONI, the plan made a valuable contribution to the evidence base.
 - **Some cost of capital parameters we could adopt.** We found that, for our draft determinations, we did not need to intervene, and could adopt, some of the specific parameters proposed by SONI for the calculation of the appropriate allowed return for SONI. These include the estimates of the total market return and risk-free rate, and the benchmark rate for the cost of debt.
- 4.30 However, we did find material issues with certain important aspects of the analysis. For example, the extent to which SONI has explained and justified its assumed capital structure for a notional efficient TSO licensee is insufficient. We have

considered alternative notional capital structure assumptions to that proposed by SONI, considering cost to customers and other benefits that different structures may entail.

- 4.31 On further analysis we also found that some of SONI's proposed values for other aspects of the allowed return (e.g. asset beta for the notional TSO, or premium on the cost of debt for issuance and arrangement costs) are not justified or appropriate. We apply our own estimates in these cases, which leads to significant reductions in the estimated cost of capital.
- 4.32 While SONI analysis provides some useful scenario analysis to consider downside risks scenarios, it does not meet our request for analysis of potential upside and downside risk to equity returns in the notional TSO (i.e. analysis of impacts on RoRE for different scenarios). Furthermore, SONI did not share its financial modelling, underpinning different strands of its analysis. This would have provided greater transparency on SONI's approach and assumptions for the results and findings presented in its business plan.

Engaging customers, consumers, and stakeholders

- 4.33 Our March 2019 regulatory approach asked to see a step change in quality of engagement from SONI given its role as a whole system coordinator and collaborator during the energy transition. We said that we expected better quality engagement, demonstrable integration into the business plan and evidence of excellent on-going activities. This is an important test area as performance here affects and feeds into many other test areas, particularly delivering service and outcomes and cost efficiency, and ultimately value for money.
- 4.34 Overall, while we see some positive practice, the response to this area is poor. We note that SECG members voice particular concern around this aspect of performance.
- 4.35 We welcome some good practice such as:
- **SONI's willingness to recognise and participate within SECG:** we welcome that SONI has taken responsibility for the SECG business plan development phase. It used approaches to engage with group (e.g. combination of webinars and face to face combination) which were reasonable given the time limitations.
- 4.36 However, we consider that SONI could further develop in certain areas:
- **Two-way collaboration could be further developed:** SECG members are concerned at the extent to which SONI is adopting an educational role as opposed to a more collaborative style. While we note that a more educational style may be appropriate for certain aspects of what SONI does today, it does not seem like a well-suited approach to taking advantage of energy transition opportunities across most of its service area.
 - **Greater demonstration of understanding needs across a wide service**

portfolio: we found little evidence of how SONI is demonstrating this appropriately and proportionately across its whole service provision. For example, we found SONI is too focused on traditional landowner engagement activity, within its broader network planning role. It proposes to base its 2020 to 2025 engagement expenditure on this area with insufficient justification. SONI already has developed significant experience of this service activity over time.

- **Greater engagement with more diverse needs:** the plan and feedback from SECG shows a gap in being responsive to the needs of newer technologies in a variety of service areas.
- **A more critical perspective by bringing together information from a variety of engagement sources:** it was often unclear how SONI has brought together engagement from its engagement sources, and turned these into appropriate business plan proposals. SECG is a regulatory initiative and not intended to be a substitute for engagement yet the plan seemed to over- focus on SECG as an input. In any case, the line of sight between SONI's engagement and how it had come to a justified business plan proposal was also often unclear.

- 4.37 We would have expected SONI's plan to set out a more appropriate stakeholder strategy for the energy transition. In light of our concerns, we request that SONI develops a whole system stakeholder strategy. It should work with stakeholders to develop one as part of its first performance framework forward plan.

Ensuring resilience and governance

- 4.38 We expect SONI to demonstrate that it has effective governance arrangements in place to deliver on its business plan. It should also be demonstrating an understanding of the range of risks and that it has effective arrangements in place to mitigate and manage these risks.
- 4.39 Overall, we are concerned that there is no evidence of effective governance arrangements in SONI: SONI governance is not addressed in its own right. Business plan governance (wholly) and risk management (largely) relate to the EirGrid PLC level. There is also no explanation as to why this is effective. We are due to publish our consultation on governance review in July which will set out proposals on SONI governance.
- 4.40 Overall, SONI's resilience is somewhat well evidenced but undermined by a proper explanation of risk management, notably clarity in roles and responsibilities as responsibility appears to rest both in EirGrid and in SONI.

Accounting for past delivery

- 4.41 Our March 2019 regulatory approach asked SONI to set out the areas of strength and weakness in performance, to justify financial adjustments and explain its outturn. Performance in this area demonstrates mixed quality evidence and

justification.

- 4.42 We welcome that SONI provides more information than in previous price control business plan submissions. The business plan sets out high level overview of key achievements, cost trends, increasing complexity of operation, new obligations and potentially improved outcomes. While we recognise this improvement, we feel the work lacks a critical perspective.
- 4.43 SONI provides a high level analysis of cost trends and explanation of performance against allowance. Some important detail is missing; for example, the impact on service provision of capex underspend. However, we recognise that SONI provides more relevant information than it has in the past, albeit at a high level. For example, comparing actual costs versus the regulatory allowance within Appendix B of the SONI business plan.

Securing confidence and assurance

- 4.44 Our March 2019 regulatory approach asked for a well-justified and high quality business plan to provide board and governance assurance, high data quality, effective accountability to stakeholders, and high transparency of information.
- 4.45 We find one element that is excellent, along with elements of performance that are mixed quality:
- **The Company's board provided a statement that its plan is financeable on both an actual and a notional basis.** This is clear and has no mitigating limitations and so is excellent.
 - **SONI's track record on data quality and regulatory submissions has elements of good quality, but we did find some material issues.**
 - **Data quality is reasonable, more often than not, but we do find some issues.**
- 4.46 We have more material concerns around other aspects of SONI board and governance assurance. We are also particularly concerned about the **poor level and timeliness of business plan publication and transparency of business plan information** to SECG for information which is not confidential or commercially sensitive. This is despite publication and information sharing being a regulatory approach requirement. We also have **material concerns with SONI's incentive and cost treatment framework** (benefits sharing framework), including the fact that it is presented to us as significantly under-developed.

Summary of our views on the process

- 4.47 This is the first time that we and SONI have undertaken this type of business plan assessment approach. We have found the process very useful and expect that there are learnings that both we and SONI can take forward. We hope that our assessment can help support SONI in terms of providing clarity on our expectations

of good practice. We are considering how we can incorporate this type of approach in other UR price controls going forward.

5. Evaluative performance framework

- 5.1 This section provides an introduction to the new evaluative performance framework that we have developed for the SONI price control. This is a key element of our draft determinations, to improve the SONI's service quality and ensure accountability for SONI's performance.
- 5.2 We provide our detailed our proposals for the evaluative performance framework in Annex 4.

Context for our work on evaluative performance framework

- 5.3 Our March 2019 regulatory approach explained that the way SONI delivers service across the electricity system is important and likely to become more so. We discussed how opportunities to incentivise performance may be missed as the SONI price control regulatory framework is currently under-developed in this respect. We said that there should be a stronger role for the regulatory framework to offer incentives to SONI to deliver high quality service.
- 5.4 We proposed to adopt an ongoing, evaluative approach to encourage and incentivise good performance from SONI across a range of services and outcomes. We set out an outline of a new approach which included the following elements:⁶
- SONI could receive a significant financial reward, or face a significant financial penalty, according to its performance under an evaluative performance framework.
 - The determination of the SONI's performance, and the application of any reward or penalty, would depend on a regulatory assessment of a range of evidence, including quantitative and qualitative evidence. We considered this to be more appropriate for SONI than mechanistic financial incentives against pre-specified performance metrics.
 - This regulatory assessment would draw heavily on input from stakeholders.
 - The evaluation of the SONI's performance, and the application of any financial reward or penalty, would be done on an ongoing basis during the five-year price control period (e.g. annually) rather than at the end of the price control period.
- 5.5 In its business plan, SONI recognises the need for a new approach to performance and accountability as part of the SONI price control arrangements. SONI puts forward a new "benefit sharing framework" which is intended to provide it with enhanced and coherent financial incentives in relation to its performance.
- 5.6 We carried out a detailed view of SONI's submissions on its benefit sharing framework. SONI's benefit sharing framework does not seem well aligned with the

⁶ UR (2019) March 2019 regulatory approach decision, page 31 to 37.

proposals from our March 2019 regulatory approach and SONI does not engage with some of the key issues we raised. SONI's proposed framework involved a greater use of mechanistic financial incentives than we envisaged.

- 5.7 We also found SONI's proposed benefit sharing framework to be under-developed in its business plan submissions. It contains some useful elements but is not close to something that we can implement in practice. The material that SONI provides does not provide confidence that, if further work was done to put it into practice, the benefit sharing framework would work well to hold SONI to account and encourage ongoing improvements across desired outcomes.
- 5.8 The scope of the benefit sharing mechanism is unduly narrow. SONI's proposals also show limited awareness of the practical difficulties and risks of unintended consequences that arise in applying mechanistic financial incentives for an electricity TSO. Our view on this is reinforced by the further submission that SONI provided in late February 2020, which contains more detailed proposals for its benefit sharing framework.
- 5.9 In line with our March 2019 regulatory approach, we propose a new evaluative performance framework for this price control. Although we do not consider that SONI's proposed framework is close to being fit for the purpose of the SONI price control, we find some elements of the approach, and the supporting material that SONI provided, to be useful. In particular, SONI's submissions includes useful input on matters such as:
- The high-level outcomes that SONI's performance can influence.
 - The extent to which SONI's activities under different service areas can influence performance in relation to different outcomes.
 - Potential performance metrics (which could form part of the evidence base considered as part of an evaluative assessment).
 - The weighting of different high-level outcomes (SONI's benefit areas) as part of the overall calibration of financial incentives for SONI performance.
 - The maximum downside risk that SONI should bear.
- 5.10 We drew on these elements in the development of our proposals for the evaluative performance framework. In addition, we drew heavily on the developments in Ofgem's regulation of the GB electricity system operator, which involves an evaluative performance framework.
- 5.11 In the sections that follow we highlight some of the key features of the evaluative performance framework we are proposing as part our draft determinations (further detail is provided in the Annex 4).

SONI service outcomes

- 5.12 As part of the introduction of a new evaluative performance framework for SONI, it

will be useful to establish a set of outcomes from our regulation of SONI that we want to influence through the performance framework.

5.13 Drawing on material from SONI's business plan, and our own further consideration, we propose to define four high-level outcomes:

- **Decarbonisation.** The Northern Ireland electricity system supports government decarbonisation policy and targets.
- **Grid security.** Northern Ireland electricity customers receive secure and reliable electricity supplies.
- **System-wide costs.** Northern Ireland electricity consumers get good value for money which reflects efficiency within, and across, different parts of the Northern Ireland electricity system, over the short term and the longer term.
- **SONI service quality.** SONI provides an appropriate range and quality of services to participants in the Northern Ireland electricity system and other stakeholders.

5.14 We welcome stakeholder feedback as to whether these are appropriate before we make our final determinations.

5.15 These are high-level outcomes, and it may be possible to identify further intended outcomes that apply at a more detailed level and contribute to the high-level outcomes (e.g. specific outcomes intended from a new initiative from SONI).

Regulatory guidance for the performance framework

5.16 Our proposed evaluative performance framework would involve an annual review process governed by upfront regulatory guidance. We propose a suite of regulatory guidance documents that would underpin the performance framework. The main areas of guidance that we propose to provide are illustrated in Figure 3 and summarised in Table 4.

Figure 3: Key areas of guidance for the performance framework

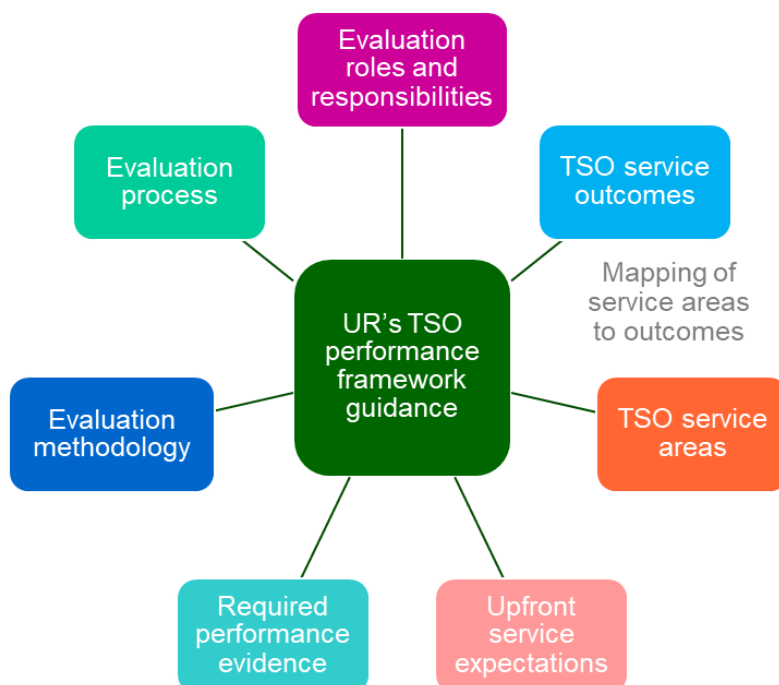


Table 4: Description and role of guidance within the framework

Area of guidance	Summary
Evaluation roles and responsibilities	This specifies the roles of different parties in the evaluation process, including the role of the evaluation panel.
SONI service outcomes	These reflect the desired outcomes from SONI and provide a basis on which to assess SONI performance.
SONI service areas	<p>These are categories which provide a breakdown of the different types of service that SONI provides to customers (or to the system as whole).</p> <p>We propose to specify 11 separate SONI service areas</p>
Mapping of service areas to outcomes	<p>This provides a mapping between SONI service areas and SONI service outcomes, which identify which service areas affect which outcomes and indicates the relative degree of influence that each service area has on each of the outcomes.</p> <p>This plays an important role in the evaluative framework by setting out expectations of which areas of SONI activity we should be looking at for evidence of potential good or bad performance against each of the outcomes.</p>

Upfront service expectations	<p>This provides guidance to SONI, and to the evaluation panel, on aspects of the baseline level of performance that we would expect from a well-run, competent TSO (i.e. a level that would not qualify for either financial rewards or penalties).</p> <p>It sets out what a good TSO would do and/or achieve in relation to specific aspects of the SONI's activity under each service area, taking account of each area's influence on, and contribution to, SONI outcomes. Separate specification for each of the 11 service areas.</p> <p>Not intended to be a comprehensive description of the role and requirements of SONI in each service area or as a replacement for licence obligations; the focus is on issues and aspects identified for purposes of SONI performance framework within the SONI price control framework.</p> <p>Should be revised over time in light of learning from experience, and adaption to new developments.</p>
Required performance evidence	<p>This is an upfront specification of performance metrics, and other relevant evidence, that is expected to be informative on SONI's performance in relation to the outcomes.</p> <p>The metrics would not be used mechanistically to determine any financial rewards or penalty; they would be part of the overall evidence base for the evaluation of performance, taken into account alongside other information.</p> <p>The required evidence would apply at two main levels: (i) evidence relating to SONI service outcomes that is relevant across service areas; and (ii) evidence that is particularly relevant to performance in specific SONI service areas. The requirements would include evidence on the SONI's costs incurred in relation to each service area.</p>
Evaluation methodology	<p>The evaluation methodology would set out the approach to the scoring of SONI's performance across a number of individual areas of its performance. It would also set out how any financial penalty or reward is to be calculated in the light of the scores in individual areas.</p>
Evaluation process	<p>This would specify the timetable for the annual performance cycle, including when key documents are required from SONI, and other aspects of the administrative process.</p>

- 5.17 We would not expect the regulatory guidance documents to vary substantially from one year to the next, but we would expect them to be further developed and improved on over time. This could include potential revisions during the price control period to build on experiences from the application of the approach. Any

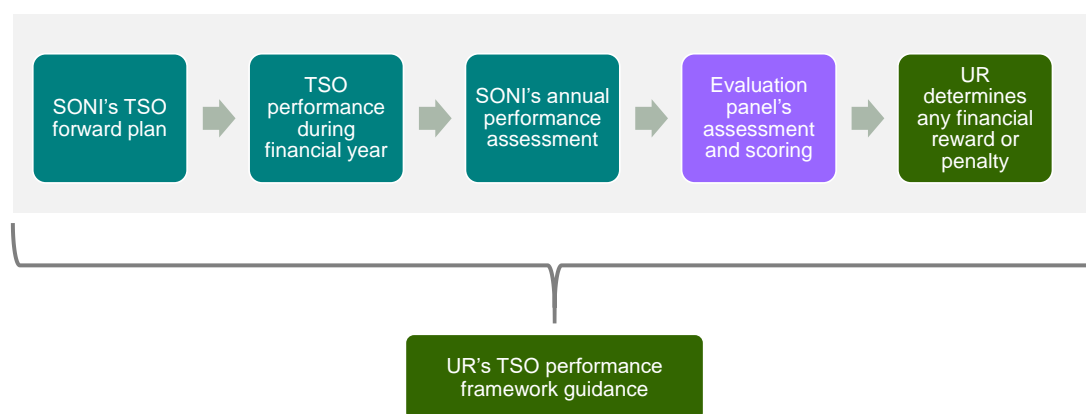
material revisions would be subject to stakeholder consultation. Key aspects of the framework (e.g. SONI service outcomes and the maximum financial reward or penalty) would be fixed for the duration of the five-year price control period and specified in our final determinations.

- 5.18 We are sharing preliminary material for the guidance documents in the Annex 4. The annex also provides our proposals for what elements would be fixed in our final determinations for the duration of the five-year price control period. We intend to engage with SONI in developing these further during the consultation period and based on this work and responses we will consult on a final version along with the Final Determination (FD).

Overview of the annual performance process

- 5.19 The annual performance review process would be governed by the regulatory guidance set out in advance. In broad terms, we envisage that, for each price control financial year (i.e. running 1 October to 30 September); the process would work through the key steps illustrated in Figure 4.

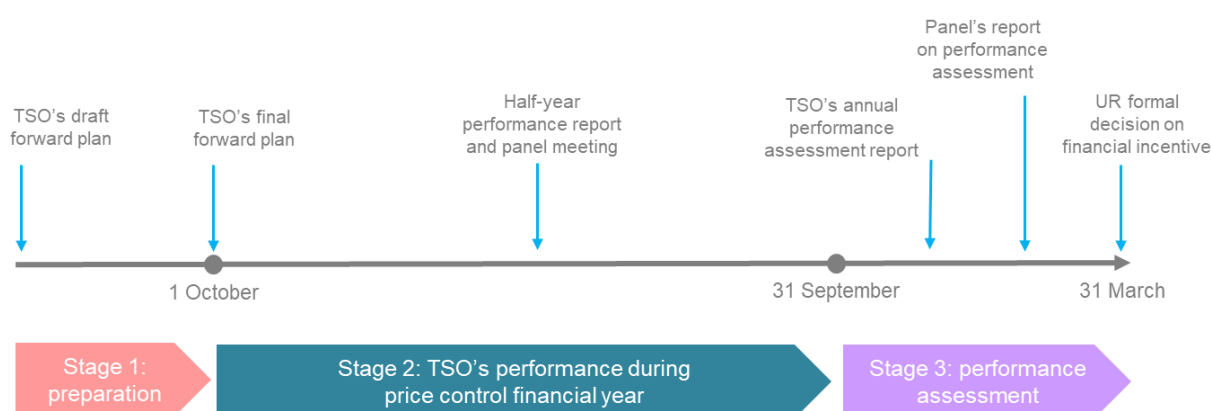
Figure 4: Overview of key steps in the annual performance process



- 5.20 The first step in this annual process is the forward plan produced by SONI. SONI would provide a strategy and plans for each service area, explaining how it will meet expectations and contribute to desired outcomes. The plan would involve a period of stakeholder consultation before finalisation.
- 5.21 Following the end of the financial year, SONI would produce its annual performance assessment for the UR and other stakeholders. This would set out SONI's assessment of outturn performance in each service area, covering performance in relation to:
- Delivery against the strategy and plans contained in its forward plan.
 - Reporting against the required performance evidence from the UR's guidance documents.
 - Other evidence and analysis of performance that SONI considers relevant.

- 5.22 For the purposes of evaluation, we propose to establish a “SONI evaluation panel” comprising individuals with a range of relevant knowledge and perspectives. We propose that panel will be chaired by an independent member but that UR will provide the secretariat support. The panel’s performance assessment would form a recommendation that goes to the UR Board. The UR Board would make the decision on any financial reward or penalty. It is important to note that we do not see the panel as a substitute for wider stakeholder input.
- 5.23 The SONI evaluation panel would produce its assessment of SONI performance in accordance with the scoring system set out in our evaluation methodology. The panel would draw on SONI’s performance assessment, opinions and evidence from stakeholders, and input from the UR.
- 5.24 We would take account of the panel’s assessment and scoring of SONI performance when determining any applicable financial reward or penalty, in accordance with the approach specified in the evaluation methodology. Our draft determination of any reward or penalty would be subject to stakeholder consultation before finalisation. To be clear, the final decision would rest with the UR Board, and the panel would not have any formal decision-making powers.
- 5.25 Figure 5 provides an overview of the timetable we envisage for the annual process for the performance framework. This involves three stages: a preparation stage involving the development of SONI’s forward plan; the delivery and performance stage over the course of a price control financial year; and then a performance assessment stage. We provide a more detailed draft timetable in Annex 4.

Figure 5: Overview of proposed timetable for annual process



- 5.26 As explained in the evaluative performance framework Annex 4, in light of implementation issues we propose that the performance framework and evaluation process (including performance panel evaluation) are applied as far as possible for the price control financial year running from 1 October 2020 to 30 September 2021. However, we consider that no financial reward or penalty is set in light of the scores produced for this first year. We provide clarity on what we expect from SONI during the remainder of the first year of the framework in Annex 4. The framework would apply in full with respect to performance in the financial year running from 1 October 2021 to 30 September 2022.

Evaluation methodology and financial rewards or penalties

- 5.27 We propose an evaluation methodology in which SONI's performance is given explicit scores in specific areas of assessment. This helps the transparency of the evaluation and supports its coverage across a range of relevant areas of performance. Specifically, we propose that the panel determines a separate score for each of four main SONI roles across each of the four SONI outcomes. The four main SONI roles are:
- System operation and adequacy.
 - Independent expert.
 - Network development and system planning.
 - Commercial interface.
- 5.28 Taken together, with the four SONI outcomes introduced earlier in this section, this provides for 16 individual areas of assessment.
- 5.29 Our proposed scoring system is dependent on the concept of baseline (performance) expectations which acts as a reference point. The baseline level of performance would be that from a well-run, efficient, competent TSO that improves over time. This is not a historical baseline: SONI would not receive a score of 4 or 5 simply from making improvements compare to its own historical levels of performance. The upfront service expectations in Annex 4 elaborate on what we expect from SONI achieving the baseline level of performance (but are not intended to be comprehensive).
- 5.30 In each assessment area, the evaluation panel would determine a score between 1 and 5, drawing on a range of evidence and information sources. A score of 3 would apply if there is sufficient evidence provided to the panel to give confidence that, on balance, SONI is meeting baseline performance expectations (but insufficient evidence that, on balance, it is exceeding performance baseline expectations). A score below 3 would indicate worse performance than the baseline, and a score above 3 would indicate better performance than the baseline.
- 5.31 The determination of any financial reward or penalty would be a matter for the UR, in light of the evaluation report provided by the evaluation panel. We would decide whether to accept in full the scoring of the evaluation panel, or to use adjusted scores in specific areas. If we decided to adopt an adjusted score rather than the evaluation panel's score in a specific area, we would need to explain why we have taken a different view to the evaluation panel. We would expect to use adjusted scores in limited circumstances. In any event, our formal decision on any financial reward or penalty would be subject to stakeholder consultation before finalisation.
- 5.32 We propose a cap on the maximum financial reward, and the maximum financial penalty, under the evaluative performance framework of £1.0m per year. In setting this amount we have taken account of the desire to provide meaningful financial incentives to SONI. We have also taken account of the interactions between the

SONI's financial exposure under the performance framework and price control allowances for remuneration of its equity capital and debt finance.

- 5.33 We set out in our Annex 4 more information about how an overall financial reward, or penalty, would be calculated from the scores across the 16 individual areas of assessment, including the weights we propose to apply to each area.

6. Cost remuneration and managing uncertainty

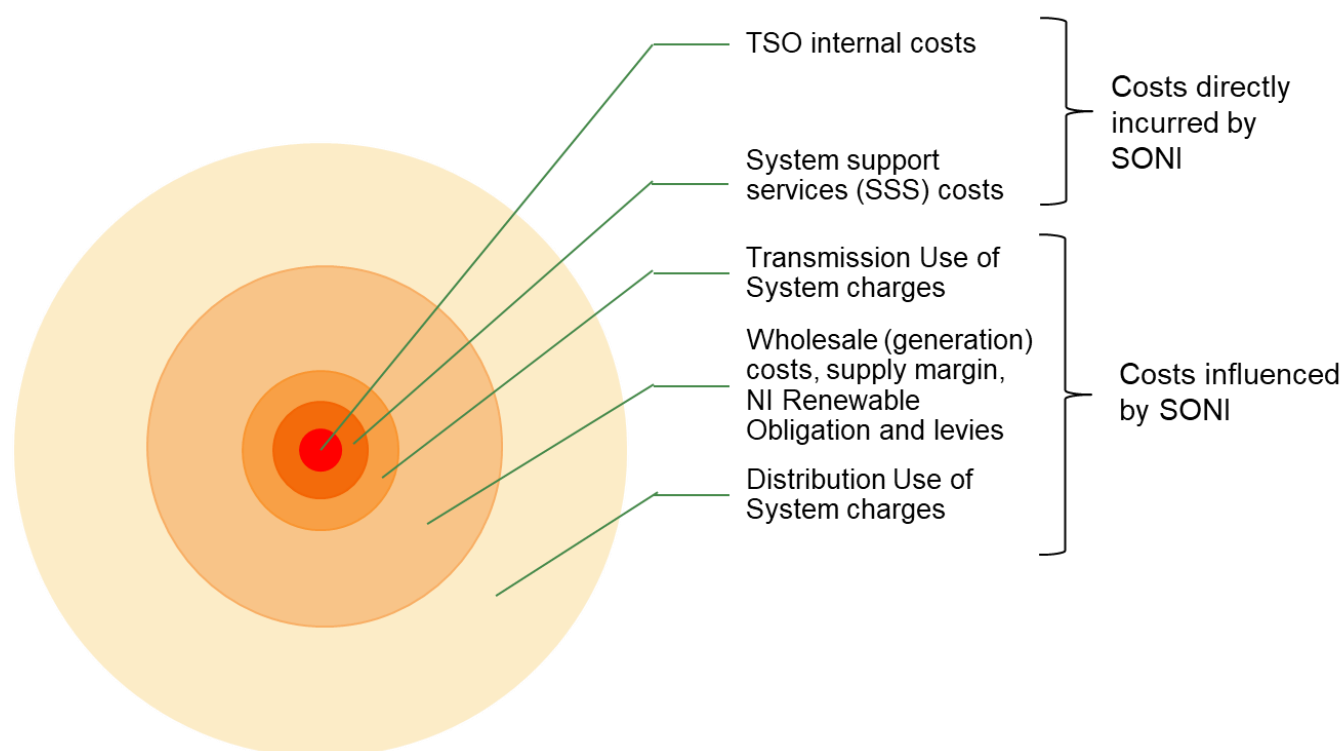
- 6.1 “Cost remuneration approach” refers to the price control arrangements that apply to SONI’s costs, or to specific categories of SONI costs, and determine how SONI is remunerated for those costs.
- 6.2 The cost remuneration approach concerns a range of interrelated regulatory policy questions for 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?
- 6.3 In this section we briefly summarise our draft determinations on the cost remuneration approach for this price control. We provide full details of our proposals in Annex 5 cost remuneration and managing uncertainty.
- 6.4 The cost remuneration approach overlaps with the use of uncertainty mechanisms for costs. We summarise our draft determinations on the use of specific uncertainty mechanisms relating to cost uncertainty within this section.

Context for our work on SONI cost remuneration approach

- 6.5 SONI’s operating environment is experiencing rapid change. This means there is need for a NI TSO to respond to these changes swiftly and more ambitiously. We have concerns with aspects of the existing cost remuneration approach for the SONI price control, especially given the importance we are attaching to SONI’s role in contributing to desired outcomes across the Northern Ireland electricity system. At the same time, we recognise the need for arrangements which provide for an appropriate and proportionate amount of pressure on SONI’s cost efficiency.
- 6.6 A significant element of the costs incurred by SONI in its TSO role are, 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 based on its assessment of the efficient level of costs during the price control period, and any differences between the actual costs incurred by the regulated company and the ex-ante allowance is shared in a fixed proportion (e.g. 50% each) between customers and the company (and its investors).

- 6.7 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.
- 6.8 The SONI costs which have been the subject of “conventional” mechanistic financial incentives represent around 2% of the NI consumer electricity bill, but how SONI performs and delivers services can influence a much greater element of the total electricity bill (wider system costs), given its system wide influence. This is illustrated by the diagram below.
- 6.9 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 by SONI on behalf of NIE Networks and Moyle. This distinction is useful because the current price control treatment of these internal costs is very different to that for other SONI costs.

Figure 6: Costs incurred by SONI and other costs it influences



- 6.10 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. For example, this could lead to increases in future transmission infrastructure costs due to worse quality network planning by SONI. This could also be at the expense of desired outcomes besides costs, such as decarbonisation and service quality to SONI customers and other stakeholders.
- 6.11 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 cost assessment. This helps support 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.

- 6.12 However, due to the relatively idiosyncratic nature of the Northern Ireland TSO, for example in terms of structure, role and size, there is a lack of close comparators for benchmarking some of its costs, which will tend to limit the power of mechanistic financial incentives and increase the risk of ex-ante allowances being set too high (or too low).
- 6.13 In relation to the price control regulation of the electricity system operator in Great Britain, National Grid ESO, Ofgem moved away from the use of mechanistic financial incentives on the ESO's external 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.
- 6.14 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 SONI price control, there are special arrangements for transmission network pre-construction costs. And there has always been separate regulatory treatment of the costs incurred by SONI in purchasing system support services.
- 6.15 Finally, as set out in section 5 above, we are proposing the introduction of a new evaluative performance framework for SONI. There are important interactions between the cost remuneration approach under the SONI price control and our proposed evaluative performance framework. This raises further questions as to whether the current approach to cost remuneration is appropriate for the 2020-25 SONI price control.
- 6.16 The approach to SONI cost remunerations is an area we had marked out for further development in our March 2019 regulatory approach and, given the issues above, we considered it to be high priority for our draft determinations.

Our March 2019 regulatory approach on cost remuneration

- 6.17 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 this price control framework. These are summarised in Table 5 as reproduced from our approach document. It shows how different approaches (or structures) are used for different SONI activities (or types of costs).

Table 5: Current cost remuneration approaches for the SONI price control

Existing structure	Allowance setting	Activity
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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.

6.18 Our approach decision proposed to apply a mix of structures across SONI'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.

SONI's business plan proposals on cost remuneration

6.19 SONI's business plan proposes a reduction in the incentive rate, from 50% to 15%, for those SONI costs which are currently subject to mechanistic financial incentives, which is a subset of the total SONI costs incurred by SONI. SONI's proposed reduction is consistent with the proposal from our March 2019 regulatory approach, although SONI does not provide specific analysis or evidence to support its view that 10% to 20% was the appropriate range.

6.20 This point aside, we do not consider that SONI's business plan engages in detail with the issues we raised in our March 2019 regulatory approach on the appropriate price control treatment of different categories of SONI costs. SONI's proposals for the price control treatment of its costs were part of its proposed holistic benefits sharing framework. These are under-developed and the material SONI provides does not give confidence that its framework would achieve good outcomes if put

into practice (see Annex 3, Delivering service and outcomes). SONI's work on its proposed benefits sharing mechanism does not engage sufficiently with the challenging issue of how to better align SONI's incentives on its (internal) costs with wider system outcomes.

- 6.21 SONI's business plan recognises 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 recognise that no feasible approach is perfect, the proposed benefits sharing framework SONI proposes do not offer a realistic prospect of achieving these benefits.
- 6.22 Turning back to some of the points made in our March 2019 regulatory approach, it becomes apparent that SONI moves in the wrong direction by focusing on the development of a holistic framework that makes greater use of mechanistic financial incentives than at present. It overlooks the potential opportunities from an approach that departs from mechanistic financial incentives.
- 6.23 SONI's plan does not provide a good basis for, and does not allow for the level of uncertainty faced in relation to, the approach to cost remuneration for the 2020-25 price control. We therefore carried out further policy development, building on our March 2019 regulatory approach and a further stage of option development and assessment.

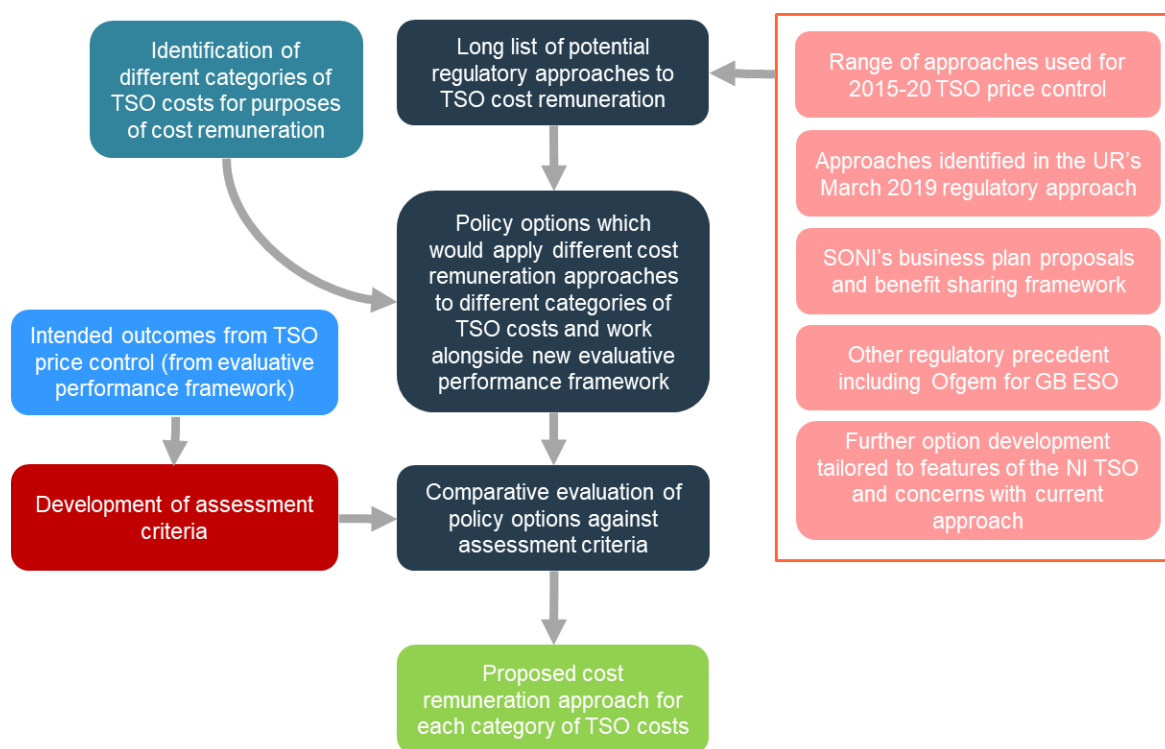
Overview of proposed approach to SONI cost remuneration

- 6.24 Annex 5 on Cost remuneration and managing uncertainty explains the process we used to develop and assess options for cost remuneration.
- 6.25 This was a relatively complicated exercise. One reason for this is that the policy question to be addressed for the purposes of the price control framework is not which regulatory approach to cost remuneration should be applied to the costs in this period. Rather, the question concerns which regulatory approach should be applied to each category of costs (and how those cost categories should be defined). As highlighted earlier in this section, the current price control framework for the 2015-2020 period applies quite different types of approach to different categories of expenditure.
- 6.26 We provide an overview of the main elements of the process we used for option development and assessment in Figure 7. We provide full details of this process in the Annex 5, Cost remuneration and managing uncertainty, which includes:
- The detailed specification of a long list of potential regulatory approaches that could be applied to specific categories of costs;
 - The categorisation of costs;
 - How we took account of interactions with the evaluative performance framework;
 - The specification of policy options which represent packages of cost

remuneration approaches across the cost categories;

- The set of assessment criteria we used; and
- Our comparative assessment of policy options.

Figure 7: Overview of process for cost remuneration approach



6.27 In the light of the evaluation of policy options, we identified a strong case for moving away from the current approach to cost remuneration. Even with the separate introduction of an evaluative performance framework, we were concerned about the implications of this type of approach for performance across different outcomes.

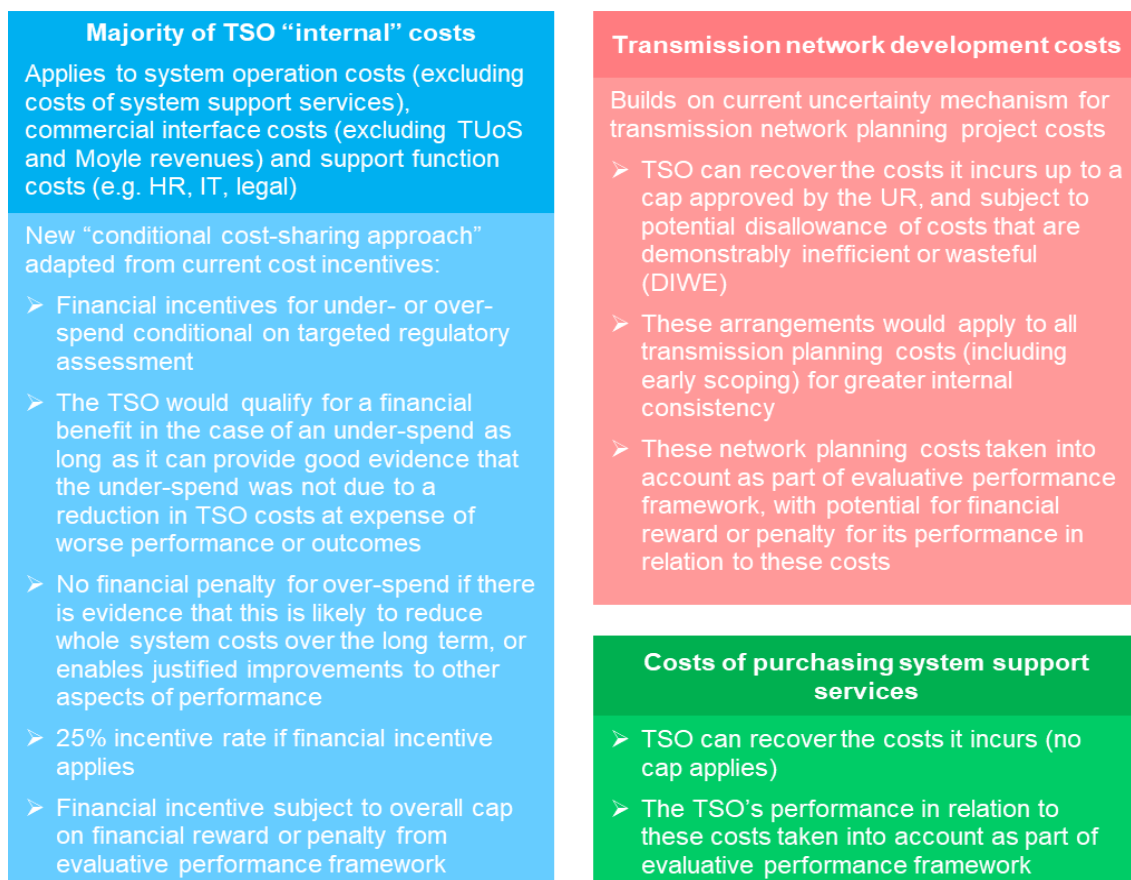
6.28 Following comparison of policy options, we selected a preferred approach to propose as part of our draft determinations. This approach can be seen as an incremental adaptation of the existing arrangements, rather than radical change. In particular:

- It would maintain the current situation in which different cost remuneration approaches are applied to different categories of costs.
- It involves adapting the mechanistic financial incentives that are currently applied to the majority of the internal costs, so that the financial incentives that apply to under or over-spend against ex-ante baselines are conditional on a targeted regulatory evaluation of evidence provided by SONI concerning the interactions between the costs it incurred and its wider performance. We call this new approach “conditional cost sharing incentives”.

- It builds on the current cost remuneration approach for transmission network planning project costs, but extends this to cover a wider set of transmission network planning and development costs. And it allows for the performance in relation to these costs to be taken into account, alongside other information, under the evaluative performance framework.
- It maintains an approach of remuneration of the costs incurred for the external costs (costs of purchasing system support services), but allows for SONI performance in relation to these costs to be taken into account, alongside other information, under the evaluative performance framework. This is at least insofar as this would not conflict with any incentives or performance arrangements imposed on these costs on an all-island basis by the SEM Committee.

6.29 We present an overview of our proposed approach in Figure 8.

Figure 8: Overview of proposed approach to cost remuneration



6.30 The move away from mechanistic cost-sharing incentives to conditional cost-sharing incentives is intended to protect against the risk that the price control framework provides SONI with financial incentives to reduce or limit its own internal costs at the expense of higher costs or worse outcomes across the wider electricity system.

6.31 The coverage of transmission network planning costs and system support services

costs in the evaluative performance framework recognises that SONI's performance in these areas is a relevant aspect of performance that matters to desired outcomes and is not covered by the conditional cost-sharing incentives.

- 6.32 We recognised the potential for additional regulatory and administrative burden under our proposed approach compared to the current approach. However, to a large extent this arises from the need for the regulated company to better understand, and 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 is a feature of a well-run system operator, and we would expect this to contribute to our desired outcomes.
- 6.33 Within the set of policy options that we identified, we also reviewed an alternative option involving more extensive changes to cost remuneration under the SONI price control framework. This option would not involve either mechanistic or conditional cost-sharing incentives for any categories of costs. These costs would instead be treated in the same way as transmission network planning costs in the approach summarised above.
- 6.34 This approach has some positive features, such as:
- Greater consistency in the regulatory treatment across different categories of costs which reduces the risks of distortions and gaming;
 - Less complexity from the greater consistency across cost categories and from the replacement of the regulatory evaluation under the conditional cost-sharing arrangements with assessment within the broader evaluative performance framework; and
 - More integrated approach to financial incentives for costs and other aspects of SONI performance.
- 6.35 However, compared to our proposed approach, we were concerned about the scale of change from existing arrangements under this alternative option, and the risk of insufficient safeguards against inefficiency by SONI in its internal costs. For instance, the alternative option would place more weight on the evaluative performance framework, and on the role of the evaluation panel. This presents risks given that the evaluative performance framework is a new proposal that has not yet been tested for SONI. Furthermore, the successful application of the evaluative performance framework to a wider category of costs would depend on substantial enhancements to SONI cost reporting. We are making proposals on this as part of our draft determinations (see separate section below) but it may take time before new cost reporting arrangements are working well.
- 6.36 We considered the choice between this alternative option and our proposed option to be quite finely balanced. We are especially keen to receive stakeholder input on this aspect of our draft determinations.
- 6.37 Finally, we should highlight that our proposed approach reflects the context for this price control, and provides a platform for further developments in the future. For

example, once our proposed evaluative performance framework has been developed and tested further through use in practice, and once there is more granular information available on SONI's costs, there may be greater opportunity to either:

- Adopt the alternative option highlighted above, which would help simplify the price control framework and bring greater consistency across different aspects of it; or
- Apply more mechanistic financial incentives for some specific service areas, without significant risk of this compromising relevant aspects of SONI performance.

Role for enhanced cost transparency

6.38 In addition to the changes to the cost remuneration approach summarised in the previous section, we are proposing enhanced transparency in relation to the costs. Enhanced cost transparency and cost reporting initiatives can support cost efficiency in a number of ways:

- They can help harness reputational incentives to encourage efficiency and avoid wasteful expenditure (e.g. excessive remuneration of senior staff).
- They can help allow stakeholders to identify potential opportunities for SONI to operate more efficiently.
- They can provide information that is useful to the assessment required for the purposes of the evaluative performance framework for SONI or for assessments for the conditional cost-sharing incentives.
- They can improve opportunities for benchmarking between SONI and other organisations.
- They can 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.

6.39 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 it to the regulator. We note that other regulated companies, such as water companies regulated by Ofwat, published detailed information on their costs across different activities or services, as part of their annual regulatory reporting.

6.40 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 price control because of two factors. First, there are very limited opportunities for cost benchmarking analysis for SONI using the

type of aggregated cost data that SONI currently reports on. Second, the limited applicability of mechanistic financial incentives for cost efficiency within the price control framework means there is a greater need for enhanced transparency than in other sectors.

- 6.41 We provide further details on our proposals for enhanced cost reporting in Annex 5, Cost remuneration and managing uncertainty. We welcome stakeholder feedback on these proposals, especially on how enhanced cost transparency can be designed to provide the most net benefits in relation to the desired outcomes from the price control.

Uncertainty mechanisms

- 6.42 In this section we briefly set out a summary of our proposed approach to price control uncertainty mechanisms. The approach is intended to help deal with uncertainty, at the time of the price control review, about SONI's efficient level of costs over the five-year price control period. This includes uncertainty mechanisms to deal with uncertainty about the projects and initiatives that it would be desirable or efficient for SONI to carry out during this period. We provide further information, including a summary of our March 2019 regulatory approach and our review of the business plan, in Annex 5, Cost remuneration and managing uncertainty.
- 6.43 We propose to keep the current uncertainty mechanism for transmission network planning projects, with the addition of a materiality threshold of 40k. This was subject to detailed consideration as part of SONI's appeal to the CMA appeal in 2017. In addition, and in light of SONI's business plan submission in this area, 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.
- 6.44 We explain in Annex 5, Cost remuneration and managing uncertainty, our proposed arrangements to address this funding gap. These include:
- (i) Setting, at the price control review, an initial approved cap for transmission network project scoping and feasibility costs over the five-year price control period; and
 - (ii) Flexibility for us to increase the approved cap during the price control period.
- 6.45 We also considered the arrangements that should apply for areas of costs that do not fall under the current uncertainty mechanism for transmission network planning. Some key aspects of our proposed approach are summarised below:
- We did not identify good reasons to move away from an approach that allows flexibility for us to approve additional allowances during the price control period. This currently works through the *Dt* and *Zt* provisions of the SONI price control licence conditions, and we propose to build on, and refine, these provisions (and the regulatory guidance that supports them).

- We propose to bring more consistency between the types of cost remuneration approach used for approvals made during the price control and the approach used for cost allowances set at the price control review. Drawing on our wider proposals for cost remuneration set out earlier in this section, we consider that approvals during the price control period would primarily involve one of two regulatory approaches for additional cost allowances: (i) setting an incremental ex-ante baseline reflecting an estimate of the efficient level of costs, with the costs incurred by SONI being subject to conditional cost-sharing incentives; or (ii) allowing for remuneration of costs incurred, subject to an approved cap, but with potential to take account of the costs incurred by SONI as part of the evaluative performance incentive framework.
- 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.
- We propose additional regulatory guidance on the process to be used for approval of additional cost allowances, to help reduce risks of double counting with costs already funded under the price control, and to ensure that SONI is held accountable for delivery and performance in relation to the anticipated benefits resulting from the approved costs.
- Where we approve additional cost allowances during the period, we would determine the outputs or deliverables that SONI would be accountable for achieving or delivering.

6.46 On this basis, we envisage a price control framework for SONI where we would be carrying out regulatory assessments for initiatives proposed by SONI not just at the price control review, but also during the price control period. There is already a major role for within-period determinations under the current price control framework (e.g. pre-construction projects, I-SEM implementation costs, other *Dt* items). Our proposed approach would provide significant flexibility to consider potential new initiatives during the price control period.

6.47 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 or customers, 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.

6.48 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. We consider that this approach should help contribute to our desired outcomes

7. Cost allowances

Context and March 2019 approach on cost allowances

- 7.1 While SONI's costs of running its business do not represent a large part of the electricity bill consumers that pay, the costs are still significant. This means that we expect them to be clear, reasonable and efficient. In line with our business plan quality guidance on assessment we assess SONI's plan in terms of how well evidenced and well-explained its costs are. We also assess how ambitious and challenging the proposals are in terms of securing cost efficiency for the benefit of NI consumers. Finally, we assess how well SONI has demonstrated innovation that contributes to greater cost efficiency.
- 7.2 We are particularly interested in the choices SONI makes in deploying its resource, in terms of how it enhances service. This is because SONI's choice of service affects how it can positively influence whole system outcomes and bring resulting benefits for consumers.
- 7.1 There are a number of key components, or building blocks, which make up SONI's cost allowance which we explain further below. As part of our approach to assessment we apply more scrutiny based on materiality (increase and size of costs) and where there is weaker justification and evidence.
- 7.2 In making our assessments for service enhancement (and Business as Usual (BAU) initiatives) we typically consider a range of factors in our assessment:
- Rationale for considering an initiative and whether the full need has been established. For example, whether the scope has been sufficiently defined and it aligns with customer priorities.
 - Option justification and how timing and risk has been considered. So, for example, whether a 3rd party may be better placed to deliver and initiative.
 - Evidence that costs are reasonable and efficient. For example, evidence underpinning the cost sources and evidence broken down at a suitable level provides more confidence than a high level description.
 - Clear evidence of benefits and fully developed, relevant and stretching commitments to performance. This is so we are able to fully understand the value for money to consumers and whether there are net-benefits to accept an enhancement.
 - Clear distinction between what is an enhancement and why it is not already covered within another proposed enhancement, and how it is additional to service for which historical expenditure has been allowed.
- 7.3 SONI is an asset light company. We want to be confident that its salaries are commensurate to the high value it can bring, whilst being mindful that they are broadly reasonable for a company like SONI. While this can be challenging to

assess, we look at relevant benchmarks, historical information and other relevant information to check for reasonableness.

- 7.4 We also provide an allowance for Real Price Effects (RPEs) and take account of productivity. Productivity captures the improvement in cost efficiency compared to comparable companies and sectors, and RPE's capture the difference between input price inflation and the price index used (CPIH) to index revenues during the price control period. The total scope for efficiency gains is the combined effect of RPE's and productivity.
- 7.5 We also review SONI's assumptions and approve allowance on pensions. This area was reviewed as part of the CMA appeal determination of the existing price control. The principles applied by the CMA are instructive in informing our approach to assessment for this review.

SONI'S Business plan cost request

- 7.6 SONI's business plan request represents a significant increase compared to previous plans. To put the request into historic context, the table below details the business plan compared to projected spend in the current control. The table also details the proportional increase from current price control allowances (post the CMA referral decisions).⁷

Table 6: SONI cost request context

	UR Allowance ⁸ 2015-20 £000s	SONI Spend ⁹ 2015-20 £000s	BP Request 2020-25 £000s	Proportional Increase %
Opex	62,591	70,473	94,791	51%
Capex	7,703	5,739	26,007	238%

- 7.7 SONI has submitted a five-year business plan requesting internal opex of c. £95m¹⁰ over the period split as follows:

Table 7: SONI opex cost request 2020-25¹¹

Opex Category	2020-21 £000s	2021-22 £000s	2022-23 £000s	2023-24 £000s	2024-25 £000s	Totals £000s
Payroll	10,504	10,489	10,543	10,443	10,449	52,428

⁷ Figures in this table excludes all revenue relating to PCG, margin and asymmetric risk.

⁸ Allowances reflect those following CMA referral and decisions.

⁹ It should be noted that this refers to projected spend as the period has not yet finished.

¹⁰ All costs in this annex are in April 2019 prices unless otherwise stated.

¹¹ This table excludes the opex associated with the re-openers (*Dt/Zt* items), Parent Company Guarantee (PCG), revenue collection margin and asymmetric risk. These items are discussed separately.

IT & Comms	3,720	4,076	4,476	4,806	4,792	21,871
Other Opex	2,755	2,757	2,617	2,956	2,578	13,663
Pension Deficit	936	936	936	936	936	4,680
Real Price	204	314	427	553	651	2,149
Feasibility	0	0	0	0	0	0
Total	18,119	18,572	18,999	19,694	19,407	94,791

7.8 Whilst no formal request has been made within the business plan data tables, SONI has also made proposals for a new ex-post regime regarding feasibility studies which may be required as part of the network planning process. The estimate cost of such work is c. £1.8m, an average of £0.36m per annum. It is however recognised that such costs are subject to fluctuation depending on levels of demand.

7.9 On the capex side, SONI has requested £26m split by project as follows:

Table 8: SONI capex request 2020-25

Project (BAU and enhanced service initiatives)	2020-21 £000s	2021-22 £000s	2022-23 £000s	2023-24 £000s	2024-25 £000s	Totals £000s
IS Infrastructure	454	459	333	188	151	1,586
Corporate Systems	522	544	423	510	477	2,476
EMS	865	865	865	865	865	4,324
Facilities improvements	150	100	60	70	80	460
Telecoms	293	259	266	274	275	1,366
Data & Analytics	89	0	0	0	0	89
All Island Metering	585	229	23	23	23	884
Smart Outage	210	126	101	23	23	484
Alternative DRBC Site	1,745	0	0	0	0	1,745
Physical Security	187	402	204	241	189	1,223
Cyber Security	38	45	27	27	27	163
Control Centre Training	179	336	224	45	45	828
Capacity Market	465	465	0	0	0	929
DSU Compliance	412	412	0	0	0	824
Cloud Adoption	67	68	292	247	74	747
Operating Model	83	101	0	39	0	222
Control Centre Tools	1,047	656	656	846	760	3,964
Renewables strategy	1,813	918	582	134	134	3,581

Clean Energy Package	22	22	22	22	22	112
Total	9,225	6,004	4,078	3,554	3,146	26,007

Review of SONI's proposals on securing cost efficiency

- 7.10 Our approach to business plan quality assessment is one important factor, amongst others, in determining our views on allowances. We welcome improvements in the structure and presentation of SONI's analysis and recognise some good justification and evidence in certain areas. However, we are concerned about the overall quality of evidence and strength of justification.
- 7.11 Our concerns particularly relate to the proposed service initiative enhancements given the size of the cost request increase and issues we have with business plan quality in this area. This area is where the majority of our focus in terms of cost allowance assessment has been apportioned. For example, we have drawn on specialist IT consultancy support from GHD on many of the enhancement initiatives. We have also drawn on stakeholder views from SECG. For example, we have taken account of SECG views of SONI's 'Enhancing partnership and engagement' service initiatives, as we consider that this is an area that SECG can meaningfully and reliably comment on.
- 7.12 More detailed views specific to each initiative and the outstanding actions/gaps are set out in Annex 6, Cost allowances. Generally speaking:
- The analysis is high level with data sources and assumptions quite often unexplained.
 - It is very unclear as to whether robust insight and careful judgement has been used to draw together proposals. For example:
 - Optionality justification is sometimes poor as in many cases we have concerns that viable and important options have not been considered.
 - Benefits and service levels are often ill-defined with relatively little explanation of base levels or the impact that the initiative will have. There is no attempt to quantify benefits for any service initiatives making it very challenging to understand the value of business case.
 - A reasonable case for considering the basic rationale for considering many initiatives, but the full needs case has not always been established.
 - SONI has often not detailed the basis for cost increases and provide evidence that these are reasonable. This is an essential step given the materiality of the cost request increase.
 - It is somewhat unclear that plans represent the views or priorities of

customers in many cases. Indeed, in some cases the SECG seem to be of the view that initiatives are either not needed or misdirected.

- A major issue has been how to distinguish between whether an initiative is new or whether it has been accounted for within another proposed enhancement or has been funded under the existing price control.
- Whilst the plan represents progression in providing service transparency, significant gaps still remain. We note that no mapping has been provided between costs and services that provides stakeholders a high degree of transparency and is a basis for ongoing engagement. This is despite this being a clear requirement as part of our March 2019 regulatory guidance.
- There is mixed quality evidence that cost proposals are supported by a range of different sources, including well explained benchmarks.
- Sources and justification for cost estimates in Appendix K sometimes seem reasonable and sound (i.e. benchmarking, quotes, market pricing, similar project experience). However, these sources are merely asserted and seldom evidenced as part of the business plan.

7.13 We also found it difficult to assess the ambition of cost proposals as service levels were not provided. Without such detail, ambition of cost efficiency is underdeveloped and so difficult to judge. While we welcome that SONI has implemented a challenge and assurance process, SONI has not fully demonstrated its effectiveness. It also sought no challenge from stakeholders on its costs during business plan development. We agree with the thrust of the review undertaken by GHD. This suggests that, while the review undertaken appears reasonable, because the business plan contains little evidence of how it was applied, it is difficult to have confidence in its robustness.¹²

7.14 SONI provides some examples of initiatives which could be innovative and contribute to cost efficiency. On the one hand, we agree with some SECG members that there is often not enough evidential demonstration of how these will contribute to cost efficiency and concerns members have around SONI's approach to innovation. On the other hand, we note SECG member points that some of these initiatives have the potential to result in credible net-benefits.

Allowance proposals

7.15 We have built up allowances across service initiative decisions, salary benchmarking, pension assessments, productivity challenge and real price effect forecasts. Our detailed deliberations in all of these areas are fully set out in Annex 6, Cost allowances.

Service initiatives (IT and Telecoms BAU and service enhancements) cost

¹² See section 3 of GHD report.

allowance

- 7.16 SONI requested allowances for the service initiatives capex and opex (include proposed IT and telecoms BAU). This is the most material element of SONI's request in cost terms. SONI splits its business plan into four main areas: IT and telecoms BAU, Sustainability and Decarbonisation, Grid and Market Development and Security, and Partnership and Engagement.
- 7.17 The main driver for differences between SONI's request and our proposed allowances is that we propose to reject service initiatives where we fail to see a rationale for consideration or a need for (and/or which there is insufficient evidence that these are enhancements above and beyond historical expenditure and/or allowed for within other proposed business plan service initiatives). We also provide partial or non-allowance of service initiatives which require further justification or information to support an allowance (either at the price control stage or via an uncertainty mechanism).

Full allowances (£4.2m)

- 7.18 These reflect projects where we are content with rationale for consideration and need, the proposed option, and we consider that the benefits are likely to outweigh costs. We propose to allow most of the IT BAU (including BAU Cyber Security) and also some proposed enhancements elsewhere such as 'Transition to Cloud', 'Smarter Outage Management', 'System Planning',

Partial or non-allowance of projects which require further justification or information to support further allowance (£15.0m out of £39.9m)

- 7.19 These include projects for which a partial allowance has been provided. Generally speaking, this is where we have allowed part of the expenditure because we are supportive of SONI's basic rationale for consideration, need for action is established, and we have sufficient confidence that that the benefits are likely to outweigh the costs, for certain aspects within an initiative. We have disallowed part of the expenditure where this isn't the case for other aspects within the same initiative.
- 7.20 We illustrate this point by elaborating on our reasoning with respect to SONI's 'Renewable Strategy' and 'Control Centre Tools' initiatives given the strategic materiality of these initiatives. SONI requested £7.6m of capex for control centre tools and a renewable strategy initiatives for dispatch and balancing and system service activity. We propose to allow £0.9m capex.
- 7.21 Most of the components are largely at conceptual design stage and it was unclear what services and tools are required for most items. We are also concerned that some components could be undertaken by 3rd parties. This means that the needs, options and risk to consumers (and as a result the costs) cases are insufficient to justify approval for most of the capex.
- 7.22 However, we recognise there is a strong overall rationale for consideration for these particular initiatives, and there are potential material net-benefits. So we have,

pragmatically, provided for nearly all of the opex allowance for SONI's 'Renewable Strategy and Control Centre tools' request to support SONI in research, development and implementation. SONI will need to engage effectively with stakeholders to ensure the needs of its diverse customer base are prioritised. SONI may also need to consider that the right balance of resource specialisms is deployed to meet the concerns voiced by members of SECG.

- 7.23 There are also initiatives where we have not provided any allowance at this point. This is because while there is a sufficiently clear and persuasive rationale for consideration, the full need for action (for example, the scope of design and quality) and/or cost case has not yet been fully justified across the initiative. We are not yet confident that SONI has demonstrated that the benefits will outweigh the costs. For example, 'Disaster Recovery Site', 'Physical Security' and 'Enhanced Cyber Security'.

No allowance (£0m out of £6.3m)

- 7.24 These reflect projects where, unlike the broad categories of allowance above, we disagree that there is a rationale for further consideration. It is also unlikely that the benefits will outweigh the costs. While we found it difficult to demarcate between whether allowances are genuine enhancements or are already covered under existing price control allowances across the plan more generally, we found particular issues across certain areas such as SONI's 'Partnership and Engagement' initiatives. SECG did not have a favourable view of SONI's initiatives under the 'Partnership and Engagement' theme, and we have taken account of these views in making our proposals. SONI is free to make further representations but it would seem hard to support these projects. Some examples of these are 'Cross Border State Aid', 'Market Related Governance', 'Education and Engagement'.

Service initiative deliverables and performance accountability

- 7.25 In our Annex 3, Delivering services and outcomes, we propose an approach for the SONI price control which means that where we approve funding for new initiatives we would establish deliverables (and/or performance commitments). These deliverables can be used to hold SONI to account for delivery or for the achievement of the proposed benefits of the initiative.
- 7.26 We have published a draft of these alongside this draft determination. We will engage with SONI on this between DD and FD as we consider some aspects could be further refined (for example, the specification of some of the deliverables/performance commitments and how they align with roles and services).

Salary, Pension, RPE's and Productivity

- 7.27 The main differences between SONI's business plan and our proposed allowance relates to:
- Difference in salary proposals for staff based on a regional price adjustment.

- Some changes to pension allowances, though we recognise that these are likely to change subject to submission of the actuary's report.
- Slight amendments to the assessment of real price effects and productivity.

7.28 Besides the allowances and disallowances above, we have made three other adjustments to our allowances. This includes the following:

- We have provided a provisional allowance of £0.75m (includes contingency) within baseline opex for network planning feasibility studies. However, we would welcome further discussion on this issue.
- Certain relatively predictable costs such as licence fees, ENTSO-E¹³ and CORESO¹⁴ membership have been provided for as part of base costs as opposed to being subject to an uncertainty mechanism request each year. However, the possibility of retaining these items under the proposed uncertainty mechanism exists, subject to convincing argumentation by SONI or other stakeholders.
- We have provided two additional FTEs to cover the resource required to enable SONI to undertake the relevant proposals, monitoring, analysis and reporting associated with the new performance evaluation framework.

UR cost allowances

7.29 Our proposals are as follows:

Table 9: UR opex and capex cost allowance 2020-25

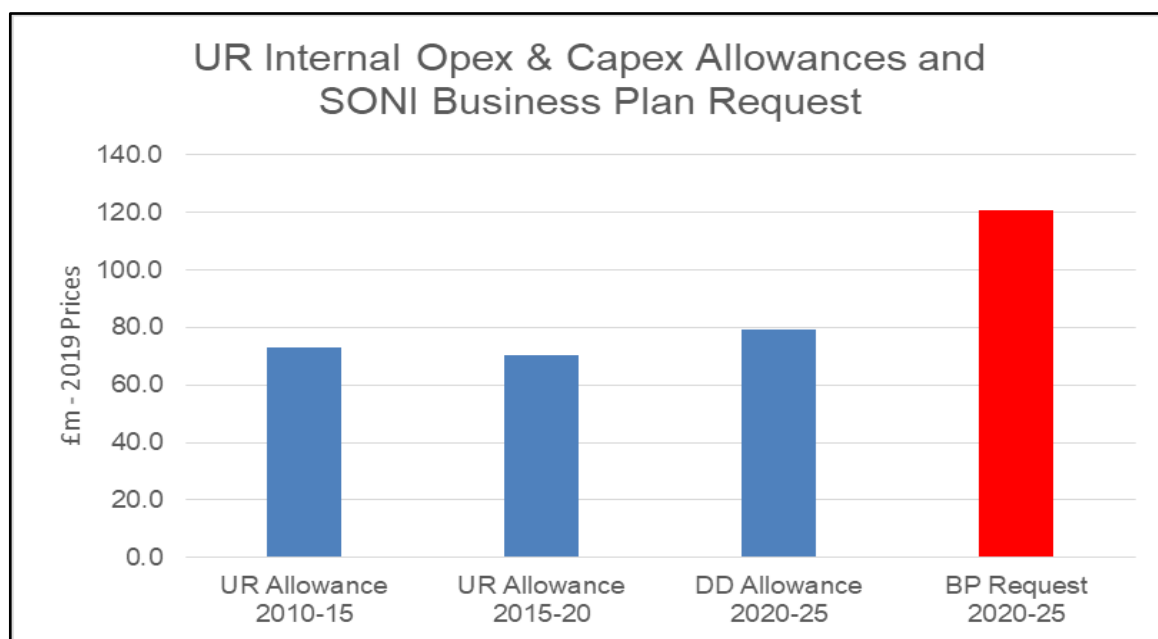
	2020-21 £000s	2021-22 £000s	2022-23 £000s	2023-24 £000s	2024-25 £000s	Totals £000s
Total Opex	13,791	13,814	14,290	14,857	13,403	70,154
Total Capex	2,350	1,881	1,725	1,535	1,463	8,955

7.30 We have provided 74% of SONI's opex request and 38% of the capex provision. However, to give the figures some historic context, the figure below details requests and allowances against the previous price control and SONI's request. The figure also indicates that we are proposing to allow 12% more opex and 16% more capex on top of that allowed within the existing price control allowance.

¹³ ENTSO-E = European Network of Transmission System Operators for Electricity.

¹⁴ CORESO = Co-Ordination of Electricity System Operators.

Figure 9: SONI internal costs progression over time



- 7.31 As noted above, there is an opportunity for SONI to justify further allowance subject to appropriate evidence being submitted as part of our Final Determination (FD) or through our approach to managing uncertainty. We also commit to provide further allowances during the period for high quality service enhancements which deliver real whole system net benefits for consumers.

8. Risk and Return

- 8.1 In this section we summarise our draft determinations on the remuneration of equity capital and debt finance under the 2020-25 price control. This includes our proposed WACC allowance and proposals for other elements of the overall allowed return. We provide a more detailed explanation of our proposals in Annex 7, Risk and return.
- 8.2 Our broader approach to the price control puts more accountability on SONI for the quality of its price control business plan than has been the case in the past. In line with this approach, our starting point for the review was SONI's proposals for different components of the overall remuneration of equity capital and debt finance, and the evidence and justification provided in support of these.
- 8.3 We carried out a preliminary review of the relevant aspects of SONI's business plan which indicated that there was enough relevant evidence and consideration of issues behind SONI's proposals for it to be reasonable to take its business plan as a starting point.
- 8.4 On that basis, the primary question addressed by our review was which specific aspects of SONI's proposals for the remuneration of equity capital and debt finance we should use for our draft determination and which aspects we should "intervene" on, to adopt an alternative approach or alternative figures.
- 8.5 In this context, a decision not to intervene on a particular aspect of SONI's business plan proposals is not necessarily a full endorsement of the approach used by SONI, or the figure it had proposed. Our decision may reflect other considerations such as the need for proportionality and prioritisation across different parts of our draft determinations, taking account of SONI's proposals, the materiality of the issue and the availability of other sources of information.
- 8.6 Further to the interventions, we identified some specific actions for SONI to address as part of its response to our draft determinations. These concern targeted updates to its analysis for more recent data and resolving gaps in the information we had asked for in SONI's business plan.

Approach to remuneration of equity capital and debt finance

- 8.7 In our March 2019 regulatory approach, we summarised the main aspects of our proposed approach for the remuneration of equity capital and debt finance as part of the price control. This, in turn, drew on the outcome of SONI's appeal to the CMA in 2017. For the most part, SONI's business plan was well-aligned with the high-level approach we envisaged.
- 8.8 SONI's business plan endorsed the approach we set out in March 2019, that the remuneration for its equity capital and debt finance under the price control should be determined for a notional TSO licensee, which may have a different capital structure to SONI. This approach is consistent with wider UK regulatory precedent.

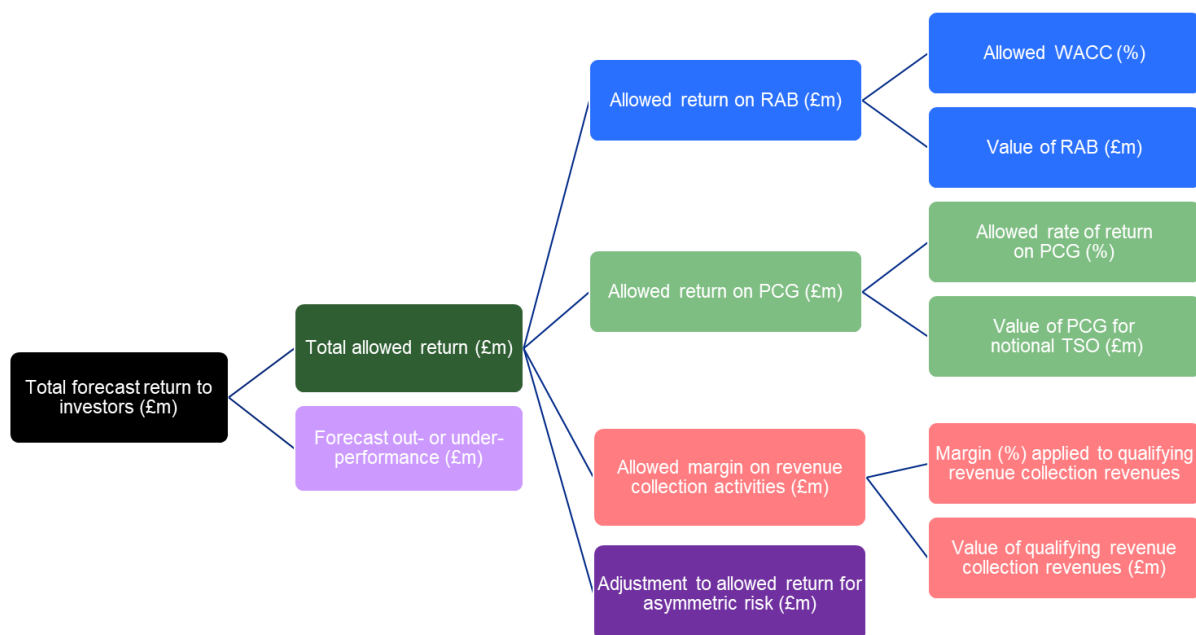
8.9 Based on our March 2019 regulatory approach and SONI's business plan we can decompose the overall allowed return sought by SONI into four main components (leaving aside the return to investors achieved through inflation-linked indexation of the RAB). The overall remuneration can be seen as the sum of allowances from four remuneration channels, insofar as they are applicable to the notional TSO licensee assumed for the purposes of the price control:

- **Allowed return on the RAB.** The allowed return on the RAB (regulatory asset base) is determined by applying an allowed weighted average cost of capital (WACC) to the value of SONI's RAB. The WACC is intended to cover remuneration for equity capital (i.e. providing a reasonable return for equity investors) and to cover the costs of efficient debt finance, and its calculation reflects the balance, or weighting, between these two elements. For the price control, we determine the allowed WACC on a pre-tax basis, which includes an allowance for the corporation tax liabilities arising on the profit expected to be generated by SONI over the price control period.
- **Allowed return on parent company guarantee (PCG).** Historically SONI's parent company EirGrid has been required to provide a parent company guarantee in support of SONI's TSO activities. This represents an additional form of equity investor capital beyond equity captured in the SONI RAB. We identify a separate remuneration channel to provide for a rate of return on any parent company guarantee required from the notional TSO licensee.
- **Allowed margin on revenue collection activities.** Some of the activities covered by the revenue control can be seen to involve a revenue collection role, with SONI collecting substantial amounts of money from participants in the Northern Ireland electricity system. Following precedent from the CMA's determination in the 2017 SONI appeal, we provide a separate remuneration channel to allow for a margin on revenue collection revenues for which the notional TSO licensee would bear material risk.
- **Adjustment to allowed return for asymmetric risk.** The allowed return on RAB channel above involves an allowed WACC which is based, in part, on estimates of the cost of equity using the capital asset pricing model (CAPM). These estimates of the cost of equity are most relevant in cases where the regulated company in question faces a reasonably balanced profile between upside and downside financial risk. Following precedent from the CMA's determination in the 2017 SONI appeal, we provide a separate remuneration channel to provide an additional return if the notional TSO licensee would face significantly asymmetric risk under the price control framework, to the detriment of SONI equity investors. By the same token, if there is significant asymmetry in favour of SONI equity investors, and to the detriment of customers, this channel could involve a negative adjustment applied in the calculation of the overall allowed return.

8.10 Figure 10 provides a high-level illustration of how the total allowed return is to be derived from these four remuneration channels. It shows, for instance, that the allowed return on the RAB is to be calculated by applying an allowed WACC (%) to

the prevailing value of the SONI RAB. It also recognises that the total forecast return to investors under the price control framework will reflect not just the total allowed return used to calculate price control revenue allowances, but also a forecast of the net effects of any financial out-performance or under-performance by SONI under the price control framework (e.g. out-performance from positive net rewards under price control incentive schemes, or under-performance from exposure to costs in excess of allowances).

Figure 10: Overview of remuneration channels for debt and equity



Summary of our proposals for each remuneration channel

- 8.11 We use the structure set out in the figure above to present a summary of the main findings from our review for each of the four remuneration channels. We then provide a more detailed summary in relation to the pre-tax WACC element of the allowed return on the RAB.

Table 10: Summary of initial review of SONI's proposed cost of capital components

Element of allowed return	SONI proposal and its estimated annual allowance based on this	Proposed intervention (where applicable) and estimated annual allowance post intervention
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Allowed return on RAB	<p>Pre-tax WACC of 5.08%</p> <p>Estimated allowance of £2.0m based on forecast RAB of £40m on average over period.</p>	<p>Intervention on a subset of the components feeding into the pre-tax WACC estimate.</p> <p>Pre-tax WACC of 3.79%</p> <p>Based on forecast average RAB of £35 million this would imply average annual allowance of £1.34 million.</p>
Allowed return on PCG	<p>PCG of £10m remunerated at rate of 0.175% nominal</p> <p>Implies £175,000 (nominal) per year.</p>	<p>We have not identified a good basis for assuming that a notional efficient TSO would be under a regulatory obligation to maintain a £10m PCG over the 2020-25 price control period</p> <p>We propose a pre-tax WACC for a notional efficient TSO that has lower gearing (i.e. higher equity capital invested in its RAB). We plan to remove the regulatory obligations on SONI to procure a PCG from its parent company EirGrid in relation to TSO activities. On that basis, PCG remuneration would be £0m.</p>
Allowed margin on revenue collection activities	<p>Margin of 0.6% applied to revenue collection revenues for DBC/imperfections charges; TUoS revenues; and system support costs.</p> <p>Based on SONI's forecast average annual revenues of £173m, this implies a margin allowance of £0.9m per year.</p>	<p>We did not consider that SONI provided a good justification for an increase to the margin rate for revenue collection determined by the CMA in the 2017 SONI appeal (0.5%) and propose to retain that rate.</p> <p>We propose to change the licence arrangements that determine the SONI's role in relation to TUoS revenue collection on behalf of NIE Networks, so that any risk lies with them rather than SONI (as is case for Moyle, for which CMA applied zero margin) and enable customers to avoid the need to pay a margin on TUoS revenue collection.</p> <p>Applying a margin rate of 0.5% to our forecast of annual average qualifying revenue (SSS and imperfections charge, not TUoS) of £97m gives a forecast remuneration of £0.5 million per year.</p>

Adjustment to allowed return for asymmetric risk	3% margin applied to qualifying costs. Estimated at £220k per year.	<p>We do not propose intervention on this aspect, and propose a 3% margin on the forecast amount of costs subject to remuneration up to approved cap.</p> <p>Our forecast of the costs subject to remuneration up to approved cap is £4.4 million per year on average over the 2020-25 period and on this basis we propose an allowance for asymmetric risk of £132k per year.</p>
Total allowed return (forecast)	£3.3m per year.	£1.99m - £2.04m per year.

- 8.12 We now turn to the pre-tax WACC in more detail. We carried out a targeted review of SONI's proposals, considering the analysis and evidence that SONI provided to support its proposals, comparisons with recent regulatory precedent (where relevant), and some additional quantitative analysis.
- 8.13 One preliminary issue which affects the assessment of the pre-tax WACC for the SONI price control is the choice of inflation index for the SONI RAB. For our March 2019 regulatory approach, we took a decision, following stakeholder consultation, to switch from RPI indexation to either CPI or CPIH indexation of the SONI RAB and revenue control for the 2020-25 period.
- 8.14 In its business plan, SONI agrees with the rationale for the transition to CPI or CPIH, and considered CPIH to be the most appropriate index. SONI provides useful evidence on the choice of CPIH and we identified no reason to intervene on this. Unless otherwise stated, all figures for components of the pre-tax WACC presented in our draft determinations are on a "CPIH-stripped" basis, which is relevant when providing an allowed return within the price control calculations on a CPIH-indexed RAB.
- 8.15 Table 11 lists the main components (parameters) feeding into SONI's estimation of the pre-tax WACC for this price control and compares these to recent regulatory precedent. We report both point estimates and ranges provided for the regulatory precedent. In our March 2019 regulatory approach, we said that the benchmarking of cost of capital proposals against those made by other UK regulators, and by regulated companies, is an important part of the evidence base. We recognised that there are areas in which SONI is different in some ways to other regulated companies, but said that the CMA appeal also confirmed the applicability of the WACC*RAB approach, which allows for comparisons across various UK regulated sectors.
- 8.16 Table 11 provides comparisons for both pre-tax WACC, where relevant, and also the vanilla WACC. The vanilla WACC does not include remuneration for

corporation tax and is used for the WACC determinations for some other UK price controls (which involve a more complex approach to setting separate allowances for corporation tax liabilities). Most of the recent precedent in the table is on a CPIH-stripped basis, and we identify the exceptions on an RPI-stripped basis with the note of “1” besides relevant figures. The difference in forecast RPI vs CPIH is about 1% per year and so, for example, the current SONI price control WACC of 5.05% on an RPI-stripped basis corresponds to a WACC of approximately 6.05% on a CPIH-stripped basis.

Table 11: Comparison of SONI proposals versus recent precedent on WACC parameters (CPIH-stripped unless otherwise stated)

	SONI current price control 2015-20	SONI Business plan proposals (2020-25)	Ofwat PR19 FD (2019)	Ofgem RIIO-2 final methodology (2019)	Ofcom BT Open-reach (2019)	CAA NERL (2019)
Notional gearing assumption	55%	55%	60%	60%	40%	60%
Total market return	6.50% ¹	6.50% (6.00% to 7.00%)	6.50%	6.25% to 6.75%	6.70%	5.40% ¹
Risk-free rate	1.25% ¹	-0.60%	-1.39%	-0.75%	-0.50%	-1.70% ¹
Equity risk premium	5.25%	7.10% (6.60% to 7.60%)	7.89%	7.25%	7.20%	7.10%
Asset beta	0.60	0.57 (0.54 to 0.61)	0.36	0.35 to 0.40	0.55	0.46
Debt beta	0.10	0.15	0.125	0.10 to 0.15	0.10	0.10
Cost of debt	2.95% ¹	2.14%	2.14% ²	1.93%	2.1%	0.86% ¹
Pre-tax WACC	5.90% ¹	5.08%	N/A	N/A	7.10% (nominal)	N/A
Vanilla WACC	5.05% ¹	4.42%	2.96%	2.88%	N/A	2.68% ¹

Notes: (1): Figure on RPI-stripped basis rather than CPIH-stripped basis and expected to be about 100 basis points higher than a corresponding CPIH-stripped figure; (2) Ofwat also applied a small company premium of 40 basis points in some cases; (3) Cost of debt allowance indexed rather than fixed at price control review; (4) WACC on a nominal basis and expected to be about 200 basis points higher than a corresponding CPIH-stripped figure.

- 8.17 We would expect the estimates of the three market-wide parameters (total market return, risk free rate and equity risk premium) to be most similar across sectors and across different regulatory decisions. There may be good reasons why other parameters differ (e.g. potential for a higher asset beta for SONI than Ofwat

assumed for regulated water companies in England and Wales, due to a higher operational gearing).

- 8.18 Nonetheless, the recent regulatory precedent provides a useful reference point to help understand and review each aspect of SONI's proposals, since we would expect a good explanation for cases where SONI's proposals diverge significantly.
- 8.19 Table 12 provides a summary from our review of SONI's proposed WACC parameters, drawing on the regulatory precedent and further analysis. Our review is presented in terms of our proposed interventions, where applicable, to help tackle identified shortcomings and limitations in the analysis and proposals provided by SONI in its business plan.

Table 12: Summary of SONI's proposed WACC parameters and our draft determinations

Element of pre-tax WACC	SONI proposed value/range	Proposed intervention where applicable	Our proposal
Notional gearing assumption	55%	We did not consider that SONI's proposals on the notional gearing assumption were sufficiently justified and SONI showed limited consideration of alternatives. We carried out further analysis to inform the appropriate notional gearing assumption.	30%
Total market return	6.50% (6.00% – 7.00%)	SONI's approach and proposal is in line with recent regulatory precedent. No intervention. This is on grounds of proportionality and prioritisation for the SONI price control.	6.50%

Risk-free rate (CPIH stripped)	-0.60%	<p>No intervention. SONI's reported estimation approach is in line with recent regulatory precedent, and its estimate is similar to some recent regulatory precedent, although it differs from some precedent that use more recent data. We did not identify clear problems with SONI's methodology and we recognise that the relevant data could change again before our final determinations. For the purposes of our draft determinations, there does not seem sufficient reason to intervene. For our final determinations we plan to take account of more up-to-date data.</p> <p>Action: we ask that SONI updates its analysis (using same methodology) for more recent data, so that more up-to-date information can be used for our final determinations.</p>	-0.60%
Equity risk premium	7.10% (6.60% – 7.60%)	No intervention. SONI's approach to the estimation of the equity risk premium seems in line with recent regulatory precedent.	7.10%
Asset beta for notional TSO	0.57 (0.54 – 0.61)	<p>SONI's proposed asset beta is calculated by taking estimates of the asset beta for comparator companies (regulated water companies) and applying an adjustment for SONI's higher operational gearing</p> <p>Following detailed review of SONI's methodology and calculations for the operational gearing adjustment we found problems which affected the results and we obtained revised figures from this approach</p> <p>We also considered it appropriate to take account of a wider set of evidence for the SONI asset beta, rather than focusing on the results from application of a specific type of adjustment for operational gearing</p> <p>This evidence included analysis of the balance of financial risk and allowed return to equity investors for SONI for different assumptions on the SONI asset beta, and review of how this would compare with information on the balance of risk and return for equity investors in regulated water companies in England and Wales</p> <p>We propose intervention to use an asset beta of 0.50, based on further analysis and review.</p>	0.50

Debt beta for the notional TSO	0.15	SONI did not provide a justification for its debt beta assumption which is at the top end of recent regulatory precedent. We propose to intervene to use a debt beta assumption of 0.125.	0.125
Corporation tax rate	17%	We agree with SONI's proposal to use the statutory corporation tax rate. We propose that the allowance for pre-tax WACC in the SONI price control licence conditions is set to vary mechanistically according to any changes in the headline corporation tax rate. We have assumed a forecast tax rate of 17% for presentational purposes; this is the rate assumed by SONI for its WACC calculations.	17% (subject to adjustment mechanism)
Cost of debt: benchmark rate	1.14%	No intervention. We had some concerns with SONI's approach to estimating the benchmark rate, in particular the weight given to historical and backward looking estimates of debt costs. However, given that we have used a notional gearing assumption of 30% for our draft determinations, we did not think that our concerns had a significant impact.	1.14%
Cost of debt: small company premium	Premium of 0.40% applied to benchmark rate	We had concerns about the tension between SONI's proposal for a small company premium uplift, and SONI's governance arrangements which imply a high degree of integration with SONI's parent company EirGrid. Consequently, we did not think that NI customers should fund a small company premium unless SONI can make appropriate changes to its governance arrangement to show that it is sufficiently independent of its parent to warrant a premium on the cost of debt. However, a consultation on SONI's governance arrangements will be published in July. That consultation will include an assessment of whether, in consequence of any proposals on governance we make, a premium on the cost of debt is warranted. This would only payable once required changes in governance are made by SONI and verified by the UR, e.g. via approval of a compliance plan.	0%

Cost of debt: issuance and arrangement costs	0.60% of value of notional debt	<p>We did not consider that SONI had justified its claim for an uplift of 0.6% for issuance and arrangement costs</p> <p>We had some concerns about double counting and, putting these aside, estimated that an allowance based on some more recent regulatory precedent would not have a material impact on our estimated WACC</p>	0%
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- 8.20 Overall, the suggested interventions produce a pre-tax WACC of 3.79% on a CPIH-stripped basis before any proposed governance changes are taken into account.
- 8.21 As indicated in the table above, these figures for the pre-tax WACC are made under the assumption of a statutory corporation tax rate of 17% during the price control period. We are proposing an uncertainty mechanism to adjust the pre-tax WACC used to calculate the SONI revenue control according to the applicable rate of corporation tax, so what matters for SONI's revenue allowances would be the applicable statutory corporation tax rate rather than the assumption we made in our draft or final determinations. Our assumption is consistent with SONI's assumption of 17% from its business plan, which allows for a direction comparison with SONI's proposed pre-tax WACC. However, government policy on corporation tax has changed and the planned reduction from 19% to 17% has not been implemented. If we assumed 19% rather than 17% for the corporation tax rate, the pre-tax WACC would be 3.88% before any proposed governance changes are taken into account.
- 8.22 The difference to SONI's proposed pre-tax WACC of 5.08% (CPIH-stripped) reflect a combination of the interventions above. We draw particular attention to the following points.
- 8.23 The lower asset beta for SONI explains around 50 basis points of the difference compared to SONI's proposals. We highlight two points on this:
- Our proposed asset beta of 0.50 is less than the asset beta of 0.6 used for the 2015-20 SONI price control. We consider that a reduction in the TSO asset beta to be understandable given the reduction in SONI's operational gearing in the 2020-25 period (reflecting growth in the forecast RAB from around £20m on average in the 2015-20 period to around £35m in the 2020-25 period).
 - While SONI proposed an asset beta for the 2020-25 period of 0.57, we carried our further analysis and found that this figure was not supported by the available evidence. In any event, SONI had proposed a higher risk price

control framework than we put forward in our draft determinations (e.g. SONI propose a maximum £1.5m incentive penalty per year under its performance framework while we propose £1.0m); we consider that, all else equal, a lower risk framework should translate into a lower SONI asset beta.

- 8.24 Two other factors contributing to the difference between our proposed WACC and SONI's proposed WACC are:
- Our lower notional gearing assumption was 30%, while SONI had proposed 55%. This in turn gives less weight to SONI's benchmark cost of debt allowance of 1.14% (CPIH-stripped), which was based on historical corporate bond yields (as a proxy for historical interest rates) and which is high compared to expected bond yields over the 2020-25 period and the end of the 2015-20 period. For comparison, the CMA's recent provisional determination in the NERL price control reference involved an estimated cost of newly raised debt of around 0.3% on a CPIH-stripped basis.
 - Our decision not to allow SONI's proposed uplift on the cost of debt of 0.6% for issuance and arrangement costs. We found this to be unjustified.
- 8.25 We are satisfied that we have understood the reasons for our proposed pre-tax WACC being lower than SONI's proposal, and that our pre-tax WACC is reasonable in the light of the overall evidence base for our draft determinations.

Insight from debt financeability metrics and RoRE analysis

- 8.26 As part of our review we have carried out further analysis to check the robustness and internal consistency of our proposals for draft determinations. In particular, we considered:
- Financial modelling to provide analysis of debt financeability metrics.
 - Analysis of the potential impacts on equity return under hypothetical upside and downside scenarios for a notional efficient TSO's performance and costs during the price control period.
- 8.27 As set out earlier in this section, we have proposed some significant interventions on the price control remuneration of SONI's equity capital and debt finance, and we are separately proposing variations to SONI's cost allowances as part of our draft determinations. In this context, it would not be appropriate to rely exclusively on the assessment of debt financeability metrics, or downside scenarios, presented in SONI's business plan as direct evidence in support of these interventions. We carried out updated analysis which took account, where relevant, of the methodology and metrics considered by SONI.
- 8.28 Analysis of debt financeability metrics, for the notional efficient TSO, is a useful and important exercise as part of the determination of the SONI price control (at least if the notional gearing assumption includes some debt rather than being 100% equity). This analysis we carried out did not indicate any problem with our draft

determinations for the various elements of the SONI allowed return, including the pre-tax WACC.

- 8.29 We found the RORE upside and downside analysis helpful in two main ways. First we used it to help with the calibration of the financial incentives under our proposed price control framework, including on the maximum downside penalty under the evaluative performance framework and the incentive rate for the conditional cost sharing incentives. Second, we made comparisons of the estimated RORE upside and downside risk for SONI against Ofwat's recent assessment of RORE upside and downside risk for regulated water companies, and took account of this as part of our considerations on the SONI asset beta.

9. SONI RAB

- 9.1 As part of our draft determinations for the 2020-25 price control, we needed to take some decisions, and make some forecasts, relating to SONI's RAB.
- 9.2 In broad terms, the value of the regulated asset base (RAB) of SONI in any year represents the value of accumulated investment which is allowed to be recoverable through the price control framework; but which SONI has not yet recovered through tariffs to customers (via the depreciation elements of its revenue allowances).
- 9.3 The RAB evolves over time according to price control allowances for capital expenditure, the outturn capital expenditure of SONI and rules and policies determined by us as part of our price control determinations (e.g. rules on the additions to be made to the RAB and the depreciation to be deducted from it).
- 9.4 The 2015-20 SONI price control recognises four main types of RAB, or RAB components, based on the nature of the investment and differences in the rules that apply in relation to the RAB. These are summarised briefly below.
- **Building assets RAB.** Additions to this RAB relate to capital expenditure by SONI on buildings, facilities and premises. Additions to this RAB are depreciated over 25 years (straight line).
 - **Transmission network pre-construction projects (TNPP) RAB.** Additions to this RAB relate to expenditure by SONI on TNPP projects. Additions to this RAB are not depreciated and they remain in the SONI's RAB until the value is transferred to NIE Networks (or written off the RAB and charged to SONI's customers, with our permission).
 - **Special Projects RAB.** Additions to this RAB relate to expenditure by SONI on special projects approved by us from time to time. The special projects RAB has been used so far for I-SEM and DS3 implementation costs as well as some control room tool costs. This expenditure is depreciated over five years.
 - **Non-building assets RAB.** Additions to this RAB relate to all other capital expenditure. Additions to this RAB are depreciated over 5 years (straight line). This RAB includes, for example, capital expenditure on IT that does not fall under any of the other RABs above.
- 9.5 We propose to retain each of these four RAB types for the 2020-25 period.¹⁵
- 9.6 For the purposes of the 2020-25 SONI price control we need to determine, or make forecasts of, values for the historical RAB for each year in the period up to and including the financial year 2019/20. In addition, for some of the modelling analysis

¹⁵ In addition the 2015-20 price control determination allowed for depreciation on a special capex overspend RAB, which provided our allowance for SONI's over-spend in the 2010-2015 period. This RAB was limited to this purpose and fully depreciated by the end of 2019/20. We do not propose to use this RAB in the future.

used as part of our draft determinations, we need forecasts relating to the RAB over the 2020-25 price control period.

- 9.7 We set out our proposed approach in Annex 8, SONI RAB. We briefly summarise here some of the main points covered in that annex. We first discuss our approach to the building and non-building RABs, and then turn to our approach to the TNPP and special projects RAB. These two sets of RABs are treated quite differently in the current SONI licence and they raise different issues. We also highlight below a further issue covered in Annex 8, which relates to the transition from RPI indexation of the RAB to CPIH indexation of the RAB.

Building and non-building RABs

- 9.8 Our starting point for the RAB values for the building and non-building RABs was the financial model that we used to implement the 2015-20 price control determination, after the revisions made to implement the outcome of the CMA appeal in 2017. We refer to this as the post-CMA financial model.
- 9.9 We considered how we might need to update some of the RAB figures in the post-CMA financial model (e.g. for outturn capital expenditure data). We also reviewed the proposed RAB values that SONI included as part of its business plan submission, and asked SONI some follow-up questions relating to its RAB figures.
- 9.10 For the period before the start of the 2015-20 price control period, we found some discrepancies between the RAB values in the post-CMA financial model and the RAB values implied by SONI's submissions. We did not consider that SONI had provided evidence or explanation for its figures and we propose to use the values from the post-CMA financial model, updated for RPI inflation indexation.
- 9.11 For the financial years 2015/16 to 2019/20 we updated the post-CMA financial model for several factors: RPI indexation; implementation of the 50:50 cost-sharing incentives in the light of outturn capital expenditure (and forecast capital expenditure); and estimates of the RAB depreciation recovered (or to be recovered) through tariffs in respect of the 2015-20 price control period.
- 9.12 We found SONI's RAB figures for the financial years 2015/16 to 2019/20 to be unexplained and we did not use them. SONI's RAB figures did not appear to implement the 50:50 cost-sharing incentives, and SONI did not provide sufficient explanation of its RAB depreciation figures.
- 9.13 For the financial years 2020/21 to 2024/25, we made forecasts of RAB values, taking account of our proposed capital expenditure allowances (from section [5] above).
- 9.14 In our Annex 8, we also set out some information on our proposed RAB policies and rules for the 2020-25 period (e.g. RAB depreciation policies).

The TNPP and special projects RABs

- 9.15 The current SONI licence sets out, in the form of detailed algebra, the calculations

to be used to determine the opening values, additions, depreciation (in the case of special projects only) and closing values of the TNPP and Special Projects RAB in each year of the 2015-20 price control period. This is a different approach to the calculation and updating of the RAB compared to that used for the building and non-building RAB.

- 9.16 For our draft determinations, we are not proposing any formal determinations in respect of the calculation of TNPP and Special Projects RAB for the 2015-20 period. We consider there to be sufficient specification in the post-CMA TSO licence conditions. As an effective way in reducing unnecessary regulatory burden, we propose to set a de-minimis amount for TNPP submissions and would welcome stakeholder views on amount proposed.
- 9.17 For the purposes of some of the modelling analysis used for our draft determinations we needed to make estimates or forecasts of the TNPP and Special Projects RABs over the period 2015-20. For both the TNPP RAB and the special projects RAB we put aside the forecasts of RAB values from the post-CMA financial model and sought to use more up-to-date information. We started from SONI's business plan submissions and we subjected these forecasts to some further review. For the 2020-25 period, we adopted a similar approach of starting with SONI's forecasts and subjecting these to review.
- 9.18 For the most part we used SONI's estimates and forecasts, but we made several adjustments where we identified concerns with SONI's figures.
- 9.19 Subject to consequential effects of any other aspects of our draft determinations, for the 2020-25 period we are not proposing changes to the current approach to the calculation and updating of the TNPP and special projects RABs for the 2020-25 period, which is specified in the current SONI licence (though the scope of costs to be included in the TNPP RAB is to be extended slightly as explained in our Annex 5, Cost remuneration and managing uncertainty).

The transition from RPI to CPIH indexation of the RAB

- 9.20 We have decided to move from indexing SONI's RAB using the RPI inflation measure to indexing using the CPIH inflation measure, for the price control period from 1 October 2020 to 30 September 2025.
- 9.21 In Annex 8 we consider the approach to the transition from RPI indexation to CPI indexation and the calculation of the new CPIH-indexed opening values of the TSO's RAB in 2020/21. We briefly comment below.
- 9.22 In its business plan submissions, SONI proposed a specific methodology, and set of calculations, to be used to make the transition from RPI indexation of the RAB to CPI indexation. We reviewed these in detail.
- 9.23 We did not consider that SONI had justified the need for the relatively complicated approach it had proposed. Furthermore, if combined with a CPIH-stripped WACC (as proposed by SONI in its business plan and as we propose), we consider that it would lead to excessive returns to SONI at the expense of customers.

- 9.24 We identified a simpler approach that we considered to be reasonable for the purposes to the transition to CPIH.

10. Allowed Revenues and Bills

Revenues

- 10.1 In this section we draw on our draft determinations, and our financial modelling, to present an estimate of the maximum regulated revenue for SONI under the SONI price control, before turning to consider potential impacts on bills.
- 10.2 SONI faces a revenue restriction on the aggregate of revenue it raises from charges for System Support Services (i.e. revenue from SSS tariffs) and from charges for the use of the All-Island Transmission Networks (i.e. revenue from TUoS and GTUoS charges). These sources comprise the majority of SONI's revenues; some other sources of income (e.g. new connections income) are not covered by this regulatory revenue control.
- 10.3 It is important to emphasise at the outset that the SSS/TUoS revenue control that SONI is subject to is not a fixed amount, determined in advance, but is dependent on what happens during the price control period. In particular:
- Even where we set ex ante allowances (i.e. for opex and capex falling under the conditional cost-sharing approach), the revenue control will be adjusted in light of any differences between the ex-ante allowance and SONI's outturn expenditure (so that some proportion of the variation in costs is shared with customers).
 - For transmission network planning scoping and feasibility costs, our approach is to allow SONI to recover the costs it actually incurs, up to approved caps, rather than to determine ex ante allowances for these costs.
 - Under our approach to uncertainty mechanisms, certain other costs are recoverable through the SSS/TUoS revenue control up to approved caps.
 - The depreciation and allowed return provided on SONI's RAB is not a fixed amount because: (i) the value of the RAB each year will depend on SONI's outturn capital expenditure; and (ii) we propose that the pre-tax WACC applied to the RAB adjusts according to prevailing corporation tax rate.
 - A large amount of the maximum regulated SSS/TUoS comprises the pass-through of "external cost" incurred by SONI in its TSO role, and the revenue control adjusts to allow for the actual level of these costs that arises. The external costs are the charges paid by generators and suppliers for use of the transmission network (which SONI collects and passes on to NIE Networks) and the costs incurred by SONI in making payments to other parties (e.g. generators) for their provision of certain network services (system support services or ancillary services).
- 10.4 It is also worth highlighting that, for the majority of transmission network planning costs, SONI does not recover these costs through the SSS/TUoS revenue control. Instead, they are added to its TNPP RAB and the SSS/TUoS revenue control

simply funds a temporary return on capital for these costs. This applies until network planning projects are transferred to NIE Networks, at which point SONI recovers the upfront costs through fees paid by NIE Networks and they are removed from the RAB. Only in the event of project costs being abandoned and not transferred to NIE Networks would the upfront costs be recoverable under the SSS/TUoS revenue control.

- 10.5 In the table below we present a forecast of the maximum regulated revenue under the SONI price control, given other parts of our draft determinations (as indicated above, we are not determining the maximum regulated revenue for SONI).

Table 13: UR regulated revenue forecast under draft determinations (April 2019 CPIH price base)

Revenue item (central forecasts)	2020-21 £000s	2021-22 £000s	2022-23 £000s	2023-24 £000s	2024-25 £000s	Totals £000s
Revenue allowance for TSO internal costs						
Opex subject to conditional cost-sharing						
Payroll	7,811	7,805	7,845	7,769	7,743	38,972
IT & Communications	3,112	3,109	3,509	3,718	2,562	16,010
Other Opex	1,832	1,855	1,878	2,303	2,029	9,897
Real Price Effects	20	30	41	54	58	203
Forecast additional opex approved during price control period	347	434	434	434	434	2,083
Adjustment for overheads funded by connections income	-164	-164	-164	-164	-164	-821
Allowance for pension deficit repair	529	529	529	529	529	2,646
Network planning costs remunerated up to cap & expensed						
Project scoping and feasibility costs	438	437	437	433	432	2,176
Uncertain costs remunerated up to cap & expensed						
ENTSO-E ITC costs	100	100	100	100	100	500
Section 75 Pension Costs: expensed in year	143	143	143	143	0	572
Forecast of other potential uncertain costs allowed	120	120	120	120	120	600
RAB depreciation allowances						
Non-building RAB depreciation	1,800	2,268	2,622	2,898	3,018	12,605
Buildings RAB depreciation	167	169	170	170	171	846
TNPP RAB depreciation	N/A	N/A	N/A	N/A	N/A	N/A
TNPP abandoned project costs written off	0	0	0	0	0	0
Special projects RAB depreciation	5,199	5,236	5,271	5,301	179	21,186
Allowed return (excluding revenue collection margin)						
Pre-tax WACC applied to non-building RAB	219	278	289	277	249	1,311

Revenue item (central forecasts)	2020-21 £000s	2021-22 £000s	2022-23 £000s	2023-24 £000s	2024-25 £000s	Totals £000s
Pre-tax WACC applied to building RAB	93	88	83	77	70	410
Pre-tax WACC applied to TNPP RAB	538	674	761	680	440	3,093
Pre-tax WACC applied to special projects RAB	687	498	305	111	13	1,613
Allowance for asymmetric risk	132	132	132	132	132	661
Remuneration of parent company guarantee (PCG)	0	0	0	0	0	0
Sub-total: Revenue allowance for TSO internal costs	23,122	23,738	24,505	25,087	18,114	114,565
Revenue allowance for TSO external costs						
Costs subject to remuneration of costs incurred (no cap)						
System support services (SSS) costs	38,715	48,472	49,723	50,013	50,296	237,221
Amounts payable to NIE for TUoS (including GTUoS)	39,550	40,050	40,250	40,300	40,300	200,450
Moyle Collection Agreement costs	30	30	30	30	30	152
Margin applied to qualifying revenue collection activities						
Margin on SSS costs & imperfection charge revenues	446	495	502	503	505	2,451
Sub-total: Revenue allowance for TSO external costs	78,742	89,048	90,505	90,847	91,131	440,273
Total forecast regulated SSS/TUoS revenues	101,864	112,786	115,009	115,934	109,245	554,838

- 10.6 The figures in the table above assume that SONI achieves a neutral or baseline position on price control incentive arrangements (e.g. no penalty or reward under the evaluative performance framework and expenditure in line with our ex ante allowances for costs falling under the conditional cost-sharing arrangements). They also leave aside any revenue adjustments to SONI for past under- or over-recovery of regulated revenues in previous price control periods.
- 10.7 In the table above we have included a negative adjustment for overheads funded by connections income. SONI's income for provision of new connections is outside the SSS/TUoS revenue control. Our review of data and forecasts provided by SONI indicated unexplained differences between the forecast income from new connections (around £800k per year) and the costs that SONI identified for new connections (around £480k per year).
- 10.8 SONI did not consider this matter in its business plan. Our view is that the scale of difference is evidence of *potential* double counting within the price control arrangements: our ex ante allowances are intended to cover the whole of SONI's overheads (e.g. HR and support functions, depreciation and return on capital for central IT investment). However, we would also expect SONI's connection charges to make some contribution to overheads used in the performance of connection

activities. There is a risk that SONI is remunerated twice for overheads associated with connections one through the SSS/TUoS regulated revenue stream and once through the connection charge income.

- 10.9 We propose to address the connections issue above by including an adjustment provision within the revenue control calculation in the TSO licence, such that in each financial year a deduction is made for the part of SONI's actual connection charge income in that year that is reasonably attributable to overheads or any other costs funded through the SSS/TUoS revenue control. For forecasting and modelling purposes we made a high-level assumption on this amount, assuming that 50% of the difference between revenue and reported costs is a contribution to overheads. We ask that SONI provides more detailed evidence and forecasts on this matter in its response to our draft determinations.
- 10.10 It is not straightforward to compare our forecast maximum regulated revenue with that implied by SONI's proposals, because of differences in the structure and operation of the price control. For instance, we propose an approach in which there is substantial flexibility for SONI to request additional price control funding for new initiatives that benefit customers, whereas SONI proposed that we approve large increases to expenditure allowances at the price control review. The table above includes forecasts of where we might make additional approvals during the price control period but these are simply forecasts rather than confirmed approvals for additional funding. If we strip out forecasts of additional allowances that are not yet approved, our forecast of the revenue allowance for SONI internal costs from the table above falls from around £115m to £109m in total over the five-year period.
- 10.11 SONI said that it could not share with us the financial modelling that it used in developing its business plan. It is difficult in this context to make direct comparisons between our forecasts of the revenue control and SONI's.
- 10.12 However, in appendix R to SONI's business plan it provided a forecast of the "SSS revenue minus K factor and System Services". We consider that this is broadly comparable to the figures above for "Sub-total: Revenue allowance for SONI "internal costs" plus the revenue collection margin. SONI's forecast on this basis is around £155m over the five-year period, which compares to our central forecasts of £117m (including the margin)
- 10.13 The lack of transparency in SONI's modelling means that we could not do a full reconciliation, but the differences in request versus allowance are largely explained by the following factors:
- Reduced staff and payroll allowances.
 - Partial allowance for IT and other opex costs.
 - Lower capital depreciation and return revenue due to lower WACC and fewer acceptances of the capex for new project initiatives.
 - Removal of both PCG requirements and margin on the TUoS element of revenue collection.

Impact on customer bills

- 10.14 Within Appendix R of the business plan, SONI estimates that its controllable costs in 2019-20 translates to £10.50 in an average domestic electricity bill of roughly £535 per year. It further estimates that business plan proposals will increase average SSS revenue by £6m above the 2019-20 level. This results in the following impact on bills for domestic and industrial / commercial customers:

Table 14: Impact on bills of SONI business plan proposals

Customer Group	Average Consumption (kWh) ¹⁶	Unit Cost (p/kWh)	Annual Equivalent (£/year)	BP Increase £/year	BP Increase %
Domestics	3,430	15.6	£535	£2.76	0.52%
Very Small [I&C < 20 MWh]	6,809	15.9	£1,083	£5.47	0.51%
Small [I&C 20 – 499 MWh]	72,040	13.8	£9,942	£57.89	0.58%
Small / Medium [I&C 500 – 1,999 MWh]	906,838	13.1	£118,796	£729	0.61%
Medium [I&C 2,000 – 19,999 MWh]	4,995,215	11.2	£559,464	£4,014	0.72%
Large / Very Large [I&C = 20,000 MWh]	36,743,263	9.8	£3,600,840	£29,527	0.82%

- 10.15 SONI argues that any bill increases will be outweighed by the benefits delivered to customers from its proposed service initiatives and from its existing day to day to role. It did not seek to quantify these but listed them instead as set out below:

- Savings in constraint costs once the second interconnector is energised;
- Savings in capacity market costs due to a change in algorithm;
- Avoided costs related to cyber security incidents or other threats;
- Improved decision making that results from better control centre training;
- Shorter times to obtain consents for grid infrastructure.

- 10.16 Whilst it is the case that SONI internal costs are a relatively small part of the electricity bill, the business plan proposals do represent a material increase. SONI estimates the £6m average uplift to be a 24% increase above 2019-20 revenues for SONI. If compared to the average existing price control allowances, the business

¹⁶ Consumption figures are derived from the 2018 Annual Transparency Report ([ATR](#)) but adjusted by SONI's assumption of NI consumption remaining flat at 7,500 GWh.

plan increase is much greater.

- 10.17 Such increases could be justified if we had confidence that the benefits of new initiatives outweigh the costs. Such certainty does not yet exist as many of the initiatives are not fully scoped or the service level impact is ill-defined.
- 10.18 SONI has also based its customer impact calculations on changes against 2019-20 revenues. Whilst not unreasonable, we think it better to contrast decisions against the last price control average as opposed to a single year. We have also shown the impact on bills before and after removing special projects (*Zt* items) as they are ad hoc and have a material impact. The results are as follows:

Table 15: Impact on bills of UR draft determinations

Customer Group	Average Consumption (kWh) ¹⁷	Unit Cost (p/kWh)	Annual Equivalent (£/year)	DD Ave Increase £/year	DD Ave Increase (excl. <i>Zt</i>) £/year
Total Domestic	3,430	15.6	£535	£1.76	£0.35
Very Small [I&C < 20 MWh]	6,809	15.9	£1,083	£3.49	£0.69
Small [I&C 20 – 499 MWh]	72,040	13.8	£9,942	£38.94	£7.25
Small / Medium [I&C 500 – 1,999 MWh]	906,838	13.1	£118,796	£465	£91
Medium [I&C 2,000 – 19,999 MWh]	4,995,215	11.2	£559,464	£2,562	£503
Large / Very Large [I&C = 20,000 MWh]	36,743,263	9.8	£3,600,840	£18,843	£3,700

- 10.19 The figures excluding special project allowances are the most relevant. This is due to the fact that while special project costs were provided for in this control period, most of the revenue is recovered in the next period and represents a material sum. Such should therefore be excluded to give a more appropriate comparison between the price control periods.
- 10.20 The table indicates that the draft revenue decisions will increase **domestic bills** by approximately £0.35 against the current price control allowances when the special project allowances are removed. This increase is much less than that requested by SONI but should be seen in the context of a lower WACC, removal of certain obligations (i.e. requirement for a PCG) and reduction in risk (i.e. TUoS collection).
- 10.21 The table also sets out the impact of decisions on non-domestic customers of varying size and consumption. As with domestic bills, the decisions will result in relatively small increases in non-domestic bills.

¹⁷ Consumption figures are derived from the 2018 Annual Transparency Report ([ATR](#)) but adjusted by SONI's assumption of NI consumption remaining flat at 7,500 GWh.

11. Regulatory proposal fit with the energy transition

11.1 This table sets out the most relevant proposals that will support our energy transition and the specific elements that will support it.

Table 16: Energy transition proposals

Area	Proposal	Fit With Energy Transition
Delivering service and performance	Evaluative based performance financial reward or penalty of £1m p.a assessed annually with stakeholder input.	<p>To date there has been little to no financial or reputational incentivisation of SONI across all its interlinking services. The proposal will support energy transition outcomes in the following ways:</p> <ul style="list-style-type: none"> • Scope covers all SONI TSO activities, except where we have proposed otherwise. This supports a more whole system and joined up approach. • Meaningful yet proportionate financial incentives, along with reputational incentives (through for example stakeholder and panel engagement). This provides a more meaningful combination to support SONI in innovating and improving service quality key to the energy transition. • Focus on outcomes (along with service expectations) rather than simply outputs will better support and capture the range of behaviours we want SONI to avoid over-focusing on certain outcomes. • An evaluative style assessment and determination, rather than a mechanistic approach, will allow more flexibility to take account of change during the energy transition. • Our service expectations form part of the baseline service, and include aspects that relate to the energy transition themes. • We are asking SONI to develop energy transition stakeholder, whole system and digitalisation (open data) strategies again reflecting energy transition themes.

Cost remuneration approach	Remuneration of cost incurred up to approved cap, subject to Demonstrably Inefficient Wasteful Expenditure (DIWE); 25% financial incentive on under- or over-spend, conditional on regulatory assessment and subject to cap/collar; and remuneration of costs incurred subject to approved cap.	These proposals are less mechanistic than the existing approach, better linked to whole system energy transition outcomes, and incentivise SONI to invest more in energy transition outcomes rather than over-focusing on internal cost spend. Annual cost assessment provides more flexibility.
Uncertainty mechanisms	Retention of existing Transmission Network Planning Process, and incremental ex-ante baseline reflecting an estimate of the efficient level of costs, with the costs incurred by SONI being subject to conditional cost-sharing incentives, and allowing for remuneration of costs incurred, subject to an approved cap.	Our uncertainty mechanisms align with the cost remuneration approach above and so support energy transition. The approach provides significant flexibility for SONI to account for uncertain change.