Conditional Cost Sharing Guidance

SONI Response to UR Consultation

15 February 2021

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Key Messages

- **Licence Modifications:** This response contains SONI's initial views only. We will need to review the licence modifications to be able to assess the full effects of this guidance. We currently expect to append an updated version of this document to our response to the consultation on the licence modifications.

- **Changes from Draft Determination:** SONI welcomes the draft guidance on the Conditional Cost Sharing Mechanism and recognises that the UR has put a great deal of effort into developing the guidance. We appreciate that the UR has made a number of adjustments from the Draft Determination in order to make the framework simpler.

- **Proposed Edits to the Guidance:** SONI would like to work with the UR to ensure that the conditional cost sharing mechanism is defined in a way that means that it can be applied in a consistent and predictable manner and that the processes within it are transparent and proportionate. To that end, we have suggested edits to the guidance document and append this to our response.

- **Resourcing**: The UR's Final Determination indicates that additional processes and reporting will be introduced as part of the conditional cost sharing mechanism. SONI asks that the UR provides sufficient resources to ensure that the new processes and reporting are clearly defined and understood from the outset.

- **Asymmetric Approach:** SONI notes that the UR has retained the asymmetric approach for outperformance from the Draft Determination. This is likely to result in asymmetric outcomes for SONI as the cost sharing rates are effectively 75% (customers will contribute to overspend) and 100% (customers will benefit from under-spend) as a default. The current design of the CCS introduces unnecessary asymmetry and consequently SONI faces additional uncertainty and financial risk.

- **Introduction of Threshold Margin**: This concept was not raised at draft determination stage. SONI has noted the impact this has on some existing Dt costs. We highlight this material change as it would have influenced our response to the draft determination, had it been signalled at that time. SONI is now exposed to an additional cost risk due to this new introduction. We have proposed some remedies within our response as we consider this as an unintended consequence. We also comment on the range of the proposed threshold margin.

- **Scope of Costs within Condition Cost Sharing Mechanism:** SONI notes that the guidance allows the UR discretion on what costs are within the scope of the CCS mechanism. For this mechanism to be successful, it is important that there is transparency and clarity upfront in terms of the treatment of costs under this mechanism. SONI requests that the guidance provides the level of specificity necessary to avoid such 'differences in interpretation'.

- **Development of a Baseline:** The lack of a defined baseline within the guidance is a significant gap. The baseline needs to be clearly defined and SONI is willing to work with the UR to develop this. SONI's preference is that this requirement is removed from the guidance and request further engagement on this aspect.

- **Cap/Collar Calculation and Link to Tariff Prices:** SONI requests that further clarity is provided in relation to how this mechanism feeds through to the cap/collar calculation and the tariff process.
- **Interaction with other price control mechanisms:** SONI requests further clarification on how the UR sees this mechanism interacting with the Evaluation Performance Framework. In addition, it is unclear what role stakeholders will have in the relation to the conditional cost sharing mechanism.

1 Introduction

1. SONI is pleased to be able to provide this response to the Conditional Cost Sharing (CCS) guidance consultation that the Utility Regulator (UR) has undertaken. The UR raised CCS as a proposal at the Draft Determination (DD) stage of the recent price review. Our response at that stage highlighted some important points that the UR incorporated into its Final Determination (FD) recommendations. Not all of our recommendations were adopted.

2. This consultation provides an important opportunity for the proposed mechanism to be evaluated and discussed further. This is important for the development of transparent, appropriate and proportionate regulation. The CCS is an important new mechanism which needs to be robust and resilient to possible industry developments over the medium-term.

3. Establishing the correct mechanism on cost recovery is critical as it ensures appropriate incentives for SONI and encourages us to be agile and ready to adapt to emerging issues. The transparency and accuracy of the cost recovery mechanism plays an important role in achieving the objectives of a good price control framework. Imperfect cost recovery mechanisms create limited or perverse incentives for the business and prevent efficient service delivery for customers.

1.1 About SONI

4. SONI Ltd. is the licensed Electricity Transmission System Operator (TSO) in Northern Ireland. SONI is responsible for planning and operating the electricity transmission system safely and securely to ensure a reliable supply of electricity for Northern Ireland consumers. SONI also operates the all-island wholesale electricity market with EirGrid plc through the Single Electricity Market Operator or SEMO (a joint venture with EirGrid) which has been in operation since November 2007.

5. SONI fulfils an essential and critical role which is central to the wider Northern Ireland economy and community. Between 2015 and 2020, Northern Ireland met the challenge of providing 40% of our electricity needs from renewable sources. This realised some 1,600MW of energy from renewable sources being accommodated on the system. The period of this Price Control 2020-2025 will result in even greater change as the energy transition begins in order to realise a trajectory to net zero carbon emissions by 2050.

6. SONI has a central role in delivering the transformation of the power system which will need to be operated in a more dynamic and responsive way. SONI is committed to realising the full benefits of this transformation for consumers through enabling the opportunities for the Northern Ireland economy in striving to have all of our energy needs met from renewable and low carbon energy sources. In this price control SONI is challenging itself (subject to funding) to be in a position to deliver up to 70% (or as otherwise advised upon finalisation of the NI Energy Strategy) of our energy from renewables by 2030 accompanied by 95% of non-synchronous penetration of wind on the system at any one time.

7. SONI notes that the UR states in its consultation on its Forward Work Plan 2021/22 that *"In practice this [the energy transition] may mean that regulators are less prescriptive, more pragmatic, focussed more on principles and outcomes, adopt new approaches to*

accommodate innovation and a more diverse stakeholder environment". SONI recognises the importance this pragmatic approach, which is focused on principles.

8. The CCS Mechanism is a key feature of the SONI price control 2020-25 and smooth operation of it will be critical to the overall delivery of Northern Ireland's energy transition. It will need to be able to be applied in a consistent and predictable manner without adding an excessive burden on either SONI or the UR.

9. SONI has focused on these key objectives when reviewing the UR's proposed guidance document and proposed changes to it that will ensure that it provides a robust foundation for the new price control.

1.2 Consultation Process

10. The UR has made some material changes to the design of this mechanism that were not signalled within the Draft Determination and for which no reasons have been provided. The effects of these have also not set out in a consultation paper. In this paper we highlight one material change that would have influenced our response to the draft determination, had it been signalled at that time.

11. Although the UR had originally indicated that the consultation on the guidance would overlap with the licence modification process, this has not transpired. We note that the process followed to consult on this draft CCS mechanism guidance and the associated documentation provided fall short of the standards set by the UR for itself, as defined in its publication of January 2010[1].

12. In the absence of information about how the new terms will be included within SONI's licence we have had to make certain assumptions, which we set out in the relevant sections below.

1.3 Structure of this Response

13. SONI starts this response by summarising its view of the changes made by the UR following its consultation on the Draft Determination. This includes highlighting our enduring concerns and also identifying an area where our response would have differed if this information had been available at the time.

14. We then provide comments on the text of the draft guidance and complete this response by appending a proposed mark-up version of the guidance.

[1] https://www.uregni.gov.uk/sites/uregni.gov.uk/files/media-files/Consultation_Guidance.pdf

2 Movement from Draft Determination

15. The UR has made two types of movement from the Draft Determination, the first is in direct response to the consultation exercise; however, there have been some changes that were not signalled before the publication of the FD and draft guidance.

16. In this section SONI responds to both sets of changes in turn and we also highlight our continuing concerns about the one aspect of the design of this mechanism.

2.1 Changes Due to Consultation Responses

17. The UR has accepted many of SONI's responses to the DD proposals and we acknowledge and welcome the regulator's openness in developing these proposals. The table below sets out the key proposals that SONI raised in its response to the DD with corresponding actions taken by the UR in FD.

Table 1: Changes to the CCS adopted by UR in the FD

SONI Comments on CCS	Utility Regulator Response
SONI requested that the asymmetric cap (for maximum penalty and reward) be applied to the net position for each financial year.	UR decided that revised caps of £1.25m on the upside and £-0.75m on downside will be applied.
SONI requested further guidance and clarification on CCS.	UR has published draft guidance on CCS.
SONI requested confirmation that cost performance under CCS would not be reflected in the outcome of the evaluative framework under any circumstances.	UR confirmed that SONI's performance in relation to costs within scope of the CCS incentives would not be within scope of the panel's assessment of SONI's performance under the new evaluative performance framework.
SONI requested UR to explain how it intends to assess different cost categories. Outperformance in one category and underperformance in another may result in additional asymmetry.	UR considered that the assessment would be relative to the total ex ante allowance that is subject to CCS and not separately for specific sub-categories of costs.
SONI requested UR to explain the assessment of CCS for new initiatives.	UR explained that CCS should not apply to those ex ante cost allowance which are hypothecated for new initiatives and have corresponding price control deliverables.
SONI requested UR to specify that the burden of proof for any claw back of out-performance or under-spend against ex ante allowances under the CCS would lie with UR in line with DIWE test.	UR has not confirmed this and based on the consultation it appears that SONI continues to be exposed to asymmetric risk.

18. SONI welcomes the UR's consideration of SONI response and the fact that significant aspects of it have been reflected in the Final Determination and the Draft Guidance. However, we continue to have concerns about the asymmetric nature of the burden of proof and also the level of ambiguity within the draft guidance.

2.1.1 Asymmetric Risk

19. One of the key principles for assessment of cost sharing mechanisms is to provide clear ex ante rules that incentivise the right behaviour, encourage innovation and the best outcomes for customers.

20. The price control should ensure that cost sharing mechanisms represent a 'fair bet' and are appropriate for the nature of the business – for example, the asset light nature of SONI explains the asymmetric downside/upside cap. This is not the case under UR's proposed CCS mechanism which appears to be inherently asymmetric by design and skewed against the company.

- If SONI outperforms and underspends, effectively 100% of the saving is passed to consumers unless SONI can prove that performance has not been affected; and
- If SONI underperforms and over-spends, then the company automatically receives 75% of the additional costs but can only receive 100% of efficient costs if the over-spend is linked to performance improvement.

21. The conditionality of the cost-sharing implies that efficient costs allowed would depend on regulatory discretion and judgment where the default position is that SONI would need to provide evidence to justify over-spend and to avoid claw back of under-spend.

22. This is likely to result in asymmetric outcomes for SONI as the cost sharing rates are effectively 75% (customers will contribute to overspend) and 100% (customers will benefit from under-spend) as a default. The current design of the CCS introduces unnecessary asymmetry and consequently SONI faces additional uncertainty and financial risk.

23. It may be complex to demonstrate the efficiency of expenditure and that performance has improved or not deteriorated, particularly where not all aspects of performance are directly controllable by SONI. In this context uncertainty over how regulatory judgment will be applied on CCS (particularly if SONI is required to justify both over-spend and under-spend) is likely to have a material impact on SONI's decision-making.

24. Ideally, SONI would prefer to see a mechanism implemented that does not bring about an incentive for SONI to only spend within the threshold which is unlikely to be good for consumers in the medium-term. There is the opportunity for the mechanism to be considered further. SONI's proposal is:

- The default is a balanced approach where the 75:25 split is applied mechanistically;
- If SONI wishes to recover any over-spend compared to its allowances it would make a submission to the UR for its consideration – detailing the evidence of the efficiency of the expenditure and the benefits for consumers;

- If the UR considers that any underspend is not efficient and there is a clear drop in the up-front agreed and transparent metrics, then the UR can request additional information; and
- In both cases the UR would publish its findings with the rationale for allowing further recovery from consumers (for over-spend) or further transfer of savings to consumers (for under-spend).

25. SONI finds the UR position as surprising and will need to consider this approach further when reviewing the licence modifications.

2.2 Changes that were Not Indicated through the Draft Determination Process

2.2.1 Materiality Threshold

26. The draft guidance states that the CCS calculation would be subject to a materiality test where the sum of outturn expenditure in the three categories is compared to the ex-ante allowance. If the difference is:

- Less than £300,000 then there is no further analysis and the pass-through is limited to 75% - i.e. the company retains 25% of any under-spend or has to meet 25% of any over-spend; or
- Greater than £300,000 then there is further analysis to determine whether SONI should receive the 25% reward/penalty.

27. While we are supportive of a materiality threshold, what is not clear to us is:

- The basis on which the £300,000 has been chosen – this equates to exposing SONI to an impact of £75,000 or above (based on the 25% which is at risk applied to the threshold level of £300,000);
- How this relates to the annual cap?; and
- Why these are nominal figures rather than a real threshold?

28. We note that the consultation on the draft CCS guidance has not included an explanation of how these thresholds have been set. We reflect on this in our comments about the process followed. We also set out below the impact the introduction of this threshold would have had on our response to the Draft Determination, had it been signalled at that point.

2.2.2 Impact of Materiality Threshold on European Costs

29. The materiality threshold was not proposed before the Final Determination and this guidance was published. Therefore SONI had assessed the inclusion of licence fees, CORESO Membership and ENTSO-E membership within the baseline opex on the understanding that any increase in these costs that was efficiently incurred would be recoverable through the conditional cost sharing mechanism. These costs were £212k in 2019/20, but are expected to increase over the next five years as the role of ENTSO-E and the scope of the services provided via CORESO both increase.

30. In this context it is important to highlight that the actual costs for these items is expected to be in the region of £305k, which for a business of SONI scale is already above the amount expected when the baseline opex allowance was calculated by the UR. SONI has no discretion around the scope of work that these costs cover or the level at which they are set.

31. These have been consistently treated as Dt items across all relevant previous price controls due to the lack of control SONI has on the level these costs are set to. This means that the actual costs have been recoverable.

32. The increases in these costs are expected to remain within the threshold and therefore SONI will be expected to fund 25% of the increase. In addition, these increases may offset genuine efficiencies which would dilute the incentive for SONI to identify and deliver efficiency initiatives.

33. SONI considers that this is an unintended consequence of the late introduction of a materiality threshold and requests the UR to reconsider the impact of the unavoidable increase in these costs. SONI requests that these costs remain within the definition of "excluded costs" as set out in the Annex to our licence and that the baseline opex allowances are adjusted accordingly as part of the licence modification process. SONI welcomes further discussion with the UR on this aspect.

2.2.3 Range of Materiality Threshold

34. SONI would welcome an opportunity to discuss the choice of materiality threshold with the UR, to ensure that it strikes an appropriate balance between the additional workload inherent in the assessment and the strength of the incentive provided by the mechanism.

35. In this section, SONI has assumed that the UR will look favourably on the concerns raised in relation to the ENTSO-E and CORESO costs above and these will be excluded from the conditional cost sharing arrangements.

36. SONI considers the materiality threshold should be set at an appropriate level to ensure that the CCS calculations are applied to material amounts and the cost of the regulatory burden (on the UR and SONI) is not higher than the benefit to customers.

37. Based on the annual opex allowances defined in the FD, the threshold equates to a margin of 2.4% which SONI considers is low. SONI proposes that the UR considers a higher margin of up to £500k (4%).

38. SONI is conscious of the additional regulatory interactions that are imposed in the FD and considers that a higher threshold will allow the UR and SONI to focus on the more material aspects of the price control but will still allow for the CCS process to be invoked for the higher costs scenarios.

39. We also consider that the threshold should be treated as per the price control allowances and adjusted to nominal terms each year to ensure the mechanism is consistent over the lifetime of the price control.

40. SONI looks forward to further engagement with the UR on the materiality threshold.

3 Clarification on Guidance

41. In this section, we summarise our main concerns around the draft guidance. We look forward to working with the UR to resolve these issues. Our comments focus on ensuring that the guidance is transparent and understood from the outset. We have proposed remedies to the concerns raised where possible.

3.1 Scope of Costs within Conditional Cost Sharing Framework

42. SONI notes that the guidance does not provide a clear view on what cost elements are within the scope of the CCS. We are aware that we have not yet been able to review of the price control licence modifications which may bring the clarity required in terms of the scope of costs falling within the CCS framework. However, SONI considers that the scope of costs needs to be clearly defined and understood from the outset, even if this is summarising the position that is defined legally within the updated Annex to our licence.

43. Given that this guidance document's main purpose is to underpin predictable and consistent application of the licence algebra, SONI asks that it provides clarity on the scope of costs where the CCS applies.

44. In particular, SONI has concerns about the drafting of paragraph 3.8 which states that the UR will decide on what costs are included under the CCS:

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

45. For this mechanism to be successful, it is important that there is transparency and clarity upfront in terms of the treatment of costs under this mechanism. SONI requests that the guidance provides the level of specificity necessary to avoid such 'differences in interpretation'.

46. We look forward to discussing this further with the UR to ensure the necessary clarity is in place from the outset.

3.2 Calculations of Conditional Cost Sharing Mechanism

47. In the draft guidance the guidance states that potential adjustments will be assessed separately for three broader categories:

1. Operating expenditure under CCS;

2. Non-building RAB; and
3. Building RAB.

48. It is not clear why the UR would wish to assess costs separately against these categories, as it could potentially create wrong incentives and distort optimisation across operating and capital costs.

49. The draft guidance states that the assessment would be applied to under-spend or over-spend against the total ex ante allowance that is subject to CCS and not for specific sub-categories of costs. However, it is not clear from the guidance how the UR would envisage this assessment being undertaken in practice using only total costs in three categories.

50. In addition, this approach does not align with the requirements (see section 3.4) to consider performance as part of the assessment. It is unclear how this will work in practice. This is discussed further below.

51. SONI requests clarity from the UR and encourages the UR to develop worked examples to aid the demonstration of how the framework will work in practice. SONI looks forward to working with the UR to ensure the guidance is able to be applied in a consistent and predictable manner.

3.3 Baseline Performance

52. The draft guidance refers to the use of performance metrics as part of the CCS framework. SONI has a number of concerns in relation to this approach. These include:

a) There is a lack of information in the guidance (and within the FD) as to which metrics the UR intends to use to assess the performance/quality of service provided by SONI. These metrics will need to be set out in a transparent manner so that customers and SONI understand the approach and criteria used by the UR.

b) There appears to be an assumption that changes in expenditure will have an immediate impact on performance/quality of service. There may be occasions where under- and over-spend could be associated with a lagged impact. How the UR will approach this should be set out within the guidance document.

c) TSO expenditure is not the only factor that will drive changes in performance; therefore, SONI would welcome the inclusion of the UR's approach to separating the impact of other factors on the metrics from any change in expenditure. SONI welcomes further clarification from the UR, however we note that it will be difficult to identify metrics that allow the isolation of expenditure impacts from other factors.

53. We have raised similar concerns in our response to the consultation on the Evaluative Performance Framework guidance paper. SONI considers that clear and transparent definitions of any baseline measures, which are agreed upfront, are a fundamental element of the 'regulatory contract'.

54. SONI's preference is that the performance metrics are not included in the CCS mechanism as it will over complicate what should be mechanistic calculations and increase the resource requirements within both UR and SONI, without providing equivalent additional value for

consumers. However, SONI will work with the UR on the definition of the baseline metrics as required.

3.4 Interaction with other Mechanisms and Link to Tariff Process

55. The guidance sets out the process to be followed to implement this mechanism, however some aspects remain unclear. SONI would welcome further clarity on the timing of the annual calculations and how this calculation feeds into the Cap/Collar calculation and then into the tariff process.

56. In all cases it would be beneficial to have a flow chart or timeline for these calculations and processes which explain how these feed into the tariff cycle.

57. Other queries include:

- How does the 10-week period for the decision to be made on the CCS calculations align with the annual tariff process?
- Can the UR explain the references to revenue and RAB adjustments within the guidance and how these will work in practice?
- What process will be followed for the cap and collar calculation and when this will take place?
- What role will stakeholders have in the calculation of the CCS? And is this practical or appropriate?
- It is unclear to SONI how the annual EPF processes would feed into the CCS calculation and what evidence would be appropriate, can UR please clarify?

58. It may be that these points are captured in the updated licence algebra and associated definitions, but in the absence of these, we are including these queries as part of our response and look forward to engaging with the UR on clarifications for these.

3.5 Lack of Clarity on Guidance

59. Transparency and clarity of the mechanism is one of the key indicators of a good regulatory practice and is especially important for cost recovery and ex-post reviews. The UR proposes an evidence-based assessment of CCS but with no clear requirements defined upfront for the evidence required. In response to the DD, SONI raised concerns over the lack of clarity of CCS approach and asked the UR to provide detailed guidance on CCS and how it would work in practice.

60. The UR has provided the guidance on CCS approach, including the list of possible evidence to be submitted by SONI. However, the guidance provides limited explanation on a number of aspects. It is not explicit on what evidence is required and how demanding the standards for the evidence are, or whether the ability for SONI to justify underspend or overspend will undermine the incentives to be efficient.

61. To ensure that the CCS mechanism works in a transparent and predictable manner SONI would expect the guidance to include clarity about:

- The metrics that are used for measurement and how any change is assessed;
- The information required for establishing efficiency and, if these differ from information already provided via the RIGs, definitions for the information; and
- The process through one or more worked examples of information and assessments that could happen under the CCS.

It will also be important to provide clarity about what recourse SONI would have if it disagreed with the UR's decision.

62. We welcome further engagement with the UR on the CCS guidance to ensure that the final guidance provides the necessary clarity for all parties. In the interests of progressing the guidance, SONI has provided a marked-up version with some specific comments and suggestions to bring further clarity.

3.6 Future Amendments to this Guidance

63. SONI notes that the draft CCS guidance does not refer to the processes the UR will follow with regard to future updates of this document. This is a fundamental omission and does not provide any comfort for SONI around the approach to the consultation exercise. We ask that the draft CCS guidance is updated to include the process for future updates, including a reference to UR's own consultation policy[2], or any other applicable standard to ensure that future changes are transparent and fully consulted on in line with good regulatory practice.

[2] https://www.uregni.gov.uk/sites/uregni.gov.uk/files/media-files/Consultation_Guidance.pdf

Attachment: Mark-Up Version of Guidance

[Draft] Conditional Cost Sharing guidance

Contents page

1. Introduction

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

Structure of document

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

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

Interactions with cap on SONI's financial rewards and penalties

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

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

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

Comment [A1]: SONI would welcome clarity on where the 'cap/collar' calculation are defined and propose that this follow on activity is signposted from the guidance document.

We cannot comment further without sight of the licence modifications.

2. Overview of the conditional cost sharing arrangements

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

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

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

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

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

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

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

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

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

Comment [A2]: SONI is unclear why the term *'and/or RAB'* is included here. SONI welcomes further clarification on what RAB adjustments the UR anticipate occurring as part of this mechanism

We cannot comment further without sight of the licence modifications.

Comment [A3]: It is essential that the scope of these arrangements is clearly defined in the licence.

We cannot comment further without sight of the licence modifications.

Comment [A4]: SONI agrees with this approach but would welcome further clarity on the treatment of out turn capex under this mechanism.

SONI considers that the guidance would benefit from the inclusion of a worked example.

SONI looks forward to engaging further with the UR in this regard.

paragraph 2.6 above, is that:

- In the case of an under-spend, SONI should only qualify for a financial reward, from the 25% cost-sharing incentive rate, if it can provide good evidence to the UR that the under-spend was not due to a reduction in costs that came at the expense of SONI performing worse in terms of the services delivered or the outcomes (likely to be) achieved.
- In the case of an over-spend, if SONI can provide good evidence to the UR to show that this was due to the efficient costs of justified improvements to aspects of their performance, it should be remunerated in full for those additional costs, rather than facing a penalty under the 25% cost-sharing incentive rate.

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

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

Comment [A5]: SONI considers that further clarity is required in terms of how the UR anticipate assessing the performance of services and outcomes achieved.

These are not specified in the guidance. SONI would welcome further clarity on this aspect and comments further below in Section 5.

Comment [A6]: SONI is unclear why the term *'and/or RAB'* is included here. SONI welcomes further clarification on what RAB adjustments the UR anticipate occurring as part of this mechanism

We cannot comment further without sight of the licence modifications.

3. The annual process

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

3.2 The process will be an annual one.

Step 1: SONI's conditional cost-sharing submission

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

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

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

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

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

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

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

3.7 The value of any under-spend or over-spend identified in this step will feed into the application of the materiality threshold in step 3 below and, subject to that, our

Comment [A7]: SONI is unclear why the term *'and/or RAB'* is included here. SONI welcomes further clarification on what RAB adjustments the UR anticipate occurring as part of this mechanism

We cannot comment further without sight of the licence modifications.

Comment [A8]: SONI would welcome further clarity on the timing of the annual calculations and how this calculation feeds into the Cap/Collar calculation and then into the tariff process.

SONI notes that this may be explained in the licence mods, however the guidance would benefit by the inclusion of a timeline for the annual process and duration estimates for each step in the process.

We cannot comment further without sight of the licence modifications.

Comment [A9]: SONI are unclear why this is included in the CCS guidance. SONI would expect that these costs are included in the RIGs submission, however, they are not relevant to the CCS calculations.

SONI requestsd that this bullet is deleted to avoid any confusion.

assessment of the potential adjustments for the purposes of conditional cost sharing.

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

Step 3: Application of materiality threshold

~~3.9~~3.8 On the basis of the figures arrived at in Step 2, we will calculate SONI's aggregate expenditure on costs that are within the scope of the conditional cost sharing arrangement, in the relevant financial year. This will be the aggregate across all three categories of expenditure listed above.

~~3.10~~3.9 We will compare the aggregate outturn expenditure with the sum, across those three categories of expenditure, of the ex-ante cost allowances for expenditure within the conditional cost sharing arrangements for the specific financial year. The measure of aggregate outturn expenditure and the sum of the relevant ex ante allowances will both be expressed in nominal terms.

~~3.11~~3.10 We will determine whether the difference between the two amounts is greater than the materiality threshold we have specified for the conditional cost sharing arrangement. We have set the materiality threshold at £300,000.

~~3.12~~3.11 If the materiality threshold is not met:

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

- The annual process will end at this step.

~~3.13~~3.12 If the materiality threshold is met, we will proceed with the remaining steps of the annual process.

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

Comment [A10]: SONI are unclear why this sentence is included.

As defined in paragraph 2.3, 'The set of costs that are within the scope of these arrangements is specified in SONI's licence'

In addition, paragraph 4.5 points to all costs being in scope unless defined as being excluded in the licence.

Therefore, SONIs expectation is that there will be no risk of 'differences in interpretation'

SONI are concerned that this paragraph gives the UR discretion to change the scope of the costs that fall within the CCS.

SONI considers that in line with good regulatory practice, the scope of costs within the scope of the CCS should be clearly defined upfront in the licence.

SONI therefore requests that this paragraph should be removed from the guidance.

Comment [A11]: In the response paper, SONI has proposed an alternative value for the materiality threshold and looks forward to discussing this aspect further with the UR.

Comment [A12]: SONI expects that the materiality threshold is in the same price base as the allowances. It will also need to be expressed in nominal terms as part of the calculation.

SONI also expects the value of the materiality threshold to be a defined term in the licence.

We cannot comment further without sight of the licence modifications.

Comment [A13]: SONI is unclear why the term *'and/or RAB'* is included here. SONI welcomes further clarification on what RAB adjustments the UR anticipate occurring as part of this mechanism

We cannot comment further without sight of the licence modifications.

~~3.14~~3.13 This step is concerned with making a proposed decision on:

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

~~3.15~~3.14 Our proposed decision will draw on our review of the evidence that SONI submitted in Step 1~~, and any other evidence, information or factors that we consider relevant~~.

~~3.16~~3.15 Our proposed decision will set out (i) whether we propose to make an adjustment in respect of operating expenditure, capital additions attributable to the buildings RAB and capital additions attributable to the non-buildings RAB, and if so (ii) our proposed values for those adjustments.

~~3.17~~3.16 Before making a decision (see next step 5) we will engage with SONI in a timely manner setting out our minded to position and reasoning, and give SONI the opportunity to respond. The opportunity will be for SONI to point to any errors we might have made, in the interpretation of the data and evidence that it submitted in earlier steps of the process. It is not intended to provide SONI with an opportunity to introduce new evidence to the assessment, which ought to have been provided in Step 1.

~~3.18~~3.17 We provide further information on our assessment under this Step 4 ~~with~~in Section 4.

Step 5: Decision on conditional cost sharing adjustments

~~3.19~~3.18 We will make a decision on the adjustments for the conditional cost sharing ~~arrangements within~~arrangements within 10 weeks of the submission of RIGS, or such later date we consider appropriate,

~~3.20~~3.19 We will decide whether to make an adjustment, and if so for what amount, in respect of each of (i) operating expenditure; (ii) capital additions attributable to the buildings RAB and (iii) capital additions attributable to the non-buildings RAB.

Comment [A14]: SONI is unclear why the term *'and/or RAB'* is included here. SONI welcomes further clarification on what RAB adjustments the UR anticipate occurring as part of this mechanism

We cannot comment further without sight of the licence modifications.

Comment [A15]: SONI requests clarity on what the UR mean by this comment.

The guidance should be clear on how the UR plan to undertake their assessment and SONIs expectation is that it should be based on the SONI submission.

SONI requests that the highlighted text is removed from the guidance.

Comment [A16]: As highlighted in paragraph 3.2, SONI considers that the guidance would benefit from the inclusion of timeframes for each step in the process.

Comment [A17]: As highlighted in paragraph 3.2, SONI considers that the guidance would benefit from the inclusion of timeframes for each step in the process.

In addition, SONI considered that the calculations should be made in a timeframe that aligns with the annual tariff process.

4. Methodology

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

Comment [A18]: SONI is unclear why the term *'and/or RAB'* is included here. SONI welcomes further clarification on what RAB adjustments the UR anticipate occurring as part of this mechanism

We cannot comment further without sight of the licence modifications.

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

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

Table 1 Mapping of subsections to steps in annual process

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

Verification of over- or under-spend

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

Costs within scope of the conditional cost sharing arrangements.

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

Comment [A19]: We cannot comment further without sight of the licence modifications.

Calculations

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

Table 2 Calculations to verify under- or over-spend

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

Comment [A20]: The allowances should be defined in the licence.

SONI requests that the reference to the Price Control FD is removed from the guidance.

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

Application of the materiality threshold

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

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

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

Potential adjustments in the event of over-spend

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

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

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

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

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

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

Comment [A21]: SONI expects that the materiality threshold should be in the same price base as the allowances. It will also need to be expressed in nominal terms as part of the calculation.

SONI also expects the value of the materiality threshold to be a defined term in the licence.

We cannot comment further without sight of the licence modifications.

Comment [A22]: SONI seeks clarity on what is meant by 'our RAB policy' and how this is captured in the licence mods.

SONI welcomes further clarification on what RAB adjustments the UR anticipate occurring as part of this mechanism

We cannot comment further without sight of the licence modifications.

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

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

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

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

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

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

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

Potential adjustment in the event of under-spend

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

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

- a negative number; and

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

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

Comment [A23]: SONI considers that further clarity is required in terms of how the UR anticipate assessing the performance of services and outcomes achieved.

These are not specified in the guidance. SONI would welcome further clarity on this aspect and comments further below in Section 5.

Comment [A24]: SONI seeks clarity from the UR on how this approach will work in practice.

SONI see the CCS as a standard process (as described in this guidance. It is unclear what role stakeholders will have in the calculation of the CCS and whether this is practical or appropriate

In addition, it is unclear how the annual EPF processes would feed into the CCS calculation and what evidence would be appropriate.

SONI welcomes further engagement with the UR on these aspects of the guidance.

~~4.20~~4.19 ~~We will also determine how that aggregate adjustment will be divided for the purpose of adjusting the cost sharing in each of those three categories of expenditure~~ We will determine whether to make an adjustment (and if so, what amount) for each of the three categories of expenditure.

~~4.21~~4.20 In the event of an under-spend at an aggregate level (i.e. across the three categories of cost), our decision on the value of the set of adjustments will be constrained by the following:

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

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

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

~~4.22~~4.21 In the event that SONI underspent at the aggregate level, the effect of the set of constraints above will be to focus our assessment of the evidence on those expenditure categories within which SONI underspent.

~~4.23~~4.22 Subject to the constraints above, we will assess the case for an adjustment as follows:

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

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

~~4.24~~4.23 We provide information in Section 5 on the type of evidence SONI would need to put forward for such an adjustment. Further to that information provided by SONI, we expect that our assessment would also draw on evidence that stakeholders may submit to us, as well as any relevant evidence emerging from the assessment carried out by the panel as part of the evaluative framework of performance.

Comment [A25]: SONI proposes that the wording is consistent for the both the over-spend and under-spend processes.

To ensure consistency with paragraph 4.12, SONI proposes that the highlighted text in paragraph 4.19 and 4.20 is replace by:

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

Comment [A26]: SONI is unclear why the term *'and/or RAB'* is included here. SONI welcomes further clarification on what RAB adjustments the UR anticipate occurring as part of this mechanism

We cannot comment further without sight of the licence modifications.

Comment [A27]: SONI considers that further clarity is required in terms of how the UR anticipate assessing the performance of services and outcomes achieved.

These are not specified in the guidance. SONI would welcome further clarity on this aspect and comments further below in Section 5.

Comment [A28]: SONI seeks clarity from the UR on how this approach will work in practice.

SONI see the CCS as a standard process (as described in this guidance. It is unclear what role stakeholders will have in the calculation of the CCS and whether this is practical or appropriate

In addition, it is unclear how the annual EPF processes would feed into the CCS calculation and what evidence would be appropriate.

SONI welcomes further engagement with the UR on these aspects of the guidance.

5. Evidence to be submitted by SONI

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

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

Comment [A29]: See earlier comments about references to licence mods.

Identifying materiality of over or under-spend

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

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

Comment [A30]: SONI would expect to present costs that fall outside the CCS arrangements as part of the RIGs submission.

SONI will work with the UR to provide any necessary reconciliations.

Proposed adjustments for conditional cost sharing arrangement

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

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

Comment [A31]: SONI assumes that the expenditure categories refer to the 3 broad categories – namely:

(i)operating expenditure;
(ii)(ii) capital additions attributable to the buildings RAB and
(iii)(iii) capital additions attributable to the non-buildings RAB.

SONI requests the UR to clarify this point.

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

Evidence in support of adjustments to an over-spend

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

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

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

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

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

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

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

5.7 As part of its submission, and in support of its case, SONI may need to provide

Comment [A32]: SONI has concerns that this baseline is not defined within the guidance. A similar concern has been raised in the SONI response to the EPF draft guidance.

SONI considers that it is fundamental to the successful implementation of the CCS mechanism that an agreed baseline is defined upfront.

SONI looks forward to working with the UR to ensure that a baseline is clearly defined and that SONI understand the criteria of assessment from the start of the price control.

Comment [A33]: SONI would welcome further clarity on how the UR envisage this working in practice.

SONI assumes that the reference to expenditure categories refer to the 3 broad categories.

In most cases, it will be difficult to present a direct correlation between one of the 3 broad categories and a performance metric. In addition, the expenditure may result in a future performance improvement that may not be realised within the assessment time period.

SONI would welcome further engagement on the evidence SONI would need to provide and how this will be assessed.

SONI considers that this section of the guidance would benefit from worked examples.

Comment [A34]: As highlighted above, the expenditure may result in a future performance improvement that may not be realised within the assessment time period.

SONI welcomes further engagement on this section.

evidence on its approach to its allocation of costs across different expenditure categories.

Evidence in support of adjustments to an under-spend

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

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

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

Comment [A35]: SONI would welcome further clarity on how the UR envisage this working in practice.

In most cases, it will be difficult to present a direct correlation between one of the 3 broad categories and a performance metric. In addition, the expenditure may result in a future performance improvement that may not be realised within the assessment time period.

SONI would welcome further engagement on the evidence SONI would need to provide and how this will be assessed.

SONI considers that this section of the guidance would benefit from worked examples.

Comment [A36]: SONI considers that resource planning and budgeting are management activities.

It is unclear how this aligns with an assessment across the 3 broad categories defined in the guidance.

SONI requests that this paragraph is removed from the guidance.