Requirements and Guidance on Conditional Cost Sharing

19 November 2021

About the Utility Regulator

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

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

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

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

Our mission

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

Our vision

To ensure value and sustainability in energy and water.

Our values

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

Abstract

This paper sets out the Utility Regulator's (UR's) guidance for operation of the conditional cost sharing (CCS) mechanism.

The guidance covers the scope of costs included, the annual process, methodology and requirements expected of SONI. The CCS mechanism allows the consumer to retain under-spends where these have been achieved at the expense of service quality. It also allows SONI to recover efficiently incurred overspends which are justified by virtue of improving standards of performance.

Audience

This document is likely to be of interest to SONI, NIE Networks, other regulated companies in the energy industry.

Consumer impact

The guidance is for the benefit of SONI in the completion of this work stream. There is not anticipated to be any impact on the consumer.

Conditional Cost Sharing guidance

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1. Introduction

1.1 This document sets out draft guidance on the application of the conditional cost sharing arrangements introduced as part of our final determinations on SONI's price control for the 2020 to 2025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

Structure of document

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

- We describe the scope and role 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 net financial 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 value to SONI, in respect of its performance in any financial year, to a maximum reward of £1.25m and a maximum penalty £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.

Future changes to this guidance

1.6 The UR may update this document to make any material changes in consultation with SONI and affected parties, in the light of experience. Any changes made to the guidance within the year which are material would not apply until the next year (unless there is agreement that a change is necessary, for example, to correct an error or to improve a process). The UR will also decide, subject to consultation whether the same overall process should be applied in the next price control, which is due to take effect from 1 October 2025.

2. Scope and role of conditional cost-sharing arrangements

2.1 The conditional cost-sharing arrangements refer to an 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 price control allowances for those costs.

2.2 This section describes the scope and role of the conditional cost sharing arrangements.

Scope of costs falling with conditional cost-sharing

2.3 For the purposes of the guidance on, and 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.

2.4 In broad terms, the costs falling within the scope of the conditional cost-sharing arrangements are those costs which are to be remunerated through ex ante allowances, subject to cost-sharing, with the exception of (i) those costs which are funded by hypothecated for new initiatives and have corresponding price control deliverables and (ii) those costs remunerated through the E_t and V_t uncertainty mechanisms.

2.5 More specifically:

- In respect of operating expenditure, the costs that fall within the scope of the conditional cost sharing arrangement are those costs which meet the definition of the AO_t term defined at paragraph 2.2(d)(ii) of Annex 1 to SONI's TSO licence, with the exception of: (i) costs that are reasonably attributable to the costs of the initiatives and sub-initiatives specified in the "hypothecated funding" tab of the spreadsheet "SONI FD deliverables.xlsx" which was published alongside the UR's final determinations for the 2020-25 SONI price control; and (ii) any costs incurred by SONI which fall within the scope of costs determined under sub-paragraphs 8.10(a) and 8.11(a) of Annex 1 to SONI's TSO licence.
- In respect of capital additions attributable to the buildings RAB or non-buildings RAB, the costs that fall within the scope of the conditional cost sharing arrangement are those costs which meet the definition of the AC_R_t term defined at paragraph 2.3(d)(iii) of Annex 1 to SONI's TSO licence (in respect of the corresponding RAB), with the exception of: (i) costs that are reasonably attributable to the costs of the initiatives and sub-initiatives

specified in the “hypothecated funding” tab of the spreadsheet “SONI FD deliverables.xlsx” which was published alongside the UR’s final determinations for the 2020-25 SONI price control; and (ii) any costs incurred by SONI which fall within the scope of costs determined under sub-paragraphs 8.10(a) and 8.11(a) of Annex 1 to SONI’s TSO licence.

2.6 All of the ex ante baseline allowance set in our final determinations for costs falling within the scope of the conditional cost-sharing arrangements are allowances for operating expenditure. There are no ex ante allowances for capital expenditure (e.g. additions to the buildings RAB or non-buildings RAB) falling within scope of the conditional cost-sharing arrangements. Nonetheless, the process set out in this document is designed to cover operating expenditure and capital expenditure (RAB additions), in order to avoid introducing unnecessary distortions in regulatory treatment between operating expenditure and capital expenditure. The practical effect is that SONI may report an over-spend (i.e. spend above zero) in relation to capital expenditure that falls within the scope of the conditional cost-sharing arrangements and this may feed through to RAB increases in respect of that expenditure. This approach allows, for example, for SONI to take action that substitutes from operating expenditure to capital expenditure solutions, without losing the benefits of the conditional cost-sharing approach.

Role of the conditional cost-sharing arrangements

2.7 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 price control calculations set out in SONI’s TSO 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.

2.8 This guidance is focused on the regulatory assessment under the second bullet above; it does not cover the first bullet. In broad terms, and subject to the materiality threshold specified in this guidance document, the role of regulatory assessment in the second bullet, in paragraph 2.7 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 during a financial year was not due to a reduction in costs that came at the expense of a deterioration in SONI’s service performance in that year.

- 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 SONI's service performance, it should be remunerated in full for those additional costs, rather than facing a penalty under the 25% cost-sharing - incentive rate.

2.9 We will implement the above by determining, through an annual process, the value of certain terms that are used as part of the calculation of SONI's price control revenues and RAB for the purposes of Annex 1 to SONI's TSO licence. Our determinations in relation to these terms represent decisions on whether to make adjustments (and, if so, by how much) compared to the position that would arise under an approach of mechanistic cost-sharing with a 25% incentive rate.

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

3. The annual process

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

3.2 The process will be an annual one.

Step 1: SONI's conditional cost-sharing submission

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

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

- Information on its outturn expenditure on costs that are within the scope of the conditional cost sharing arrangement.
- Information on its approach to determining the attribution/allocation of its expenditure to the scope of costs falling under 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 arrangements, for each of the following three categories of expenditure:

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

- capital additions attributable to the non-buildings RAB.

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

3.8 As part of this step, we may seek to review the way that SONI has determined the value of costs within the scope of the conditional cost sharing arrangements in the light of the definition of scope in section 2 of this guidance document. We may consider, for example, any potential mis-allocation of costs or potential differences in interpretation with regard to whether particular expenditure items should be considered to be in scope or out of scope. In the event that our assessment of the costs that fall within the scope of the conditional cost-sharing arrangements differs from the figures put forward by SONI, we will write to SONI to set out our figures. We will explain the basis for them and invite SONI to respond. We will review the response and, in the light of that, consider whether and how to revise our figures.

Step 3: Application of materiality threshold

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

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

3.11 We will determine whether the difference between the two amounts is greater than the materiality threshold we have specified for the conditional cost sharing arrangement. We have set the materiality threshold at £500,000.

3.12 If the materiality threshold is not met:

- We will publish a brief decision that (i) confirms that the materiality threshold has not been met, and (ii) sets out that there will be no adjustments to the price control revenues and/or RAB in light of any over-spend or under-spend against ex ante allowances for those costs that are within scope of the conditional cost sharing arrangements (i.e. no further adjustments beyond the application of 75% pass-through of any under-spend or over-spend).
- For the purposes of Annex 1 to SONI's TSO licence, the values of $CSBA_t$, CSC_BD_t and CSC_NB_t will be zero for financial year under consideration.
- The annual process will end at this step.

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

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

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

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

3.15 Our proposed decision will draw on our review of the evidence that SONI submitted in Step 1, and any other evidence, information or factors that we consider relevant to our assessment of the evidence and proposals submitted by SONI (Step 4A in process diagram below).

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

3.17 Before making a decision (see next step 5) we will engage with SONI in a timely manner setting out our minded to position and reasoning, and give SONI the opportunity to respond (Step 4B in process diagram). The opportunity will be for SONI to point to any errors we might have made, in the interpretation of the data and evidence that it submitted in earlier steps of the process. It is not intended to provide SONI with an opportunity to introduce new evidence to the assessment, which ought to have been provided in Step 1.

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

Step 5: Decision on conditional cost sharing adjustments

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

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

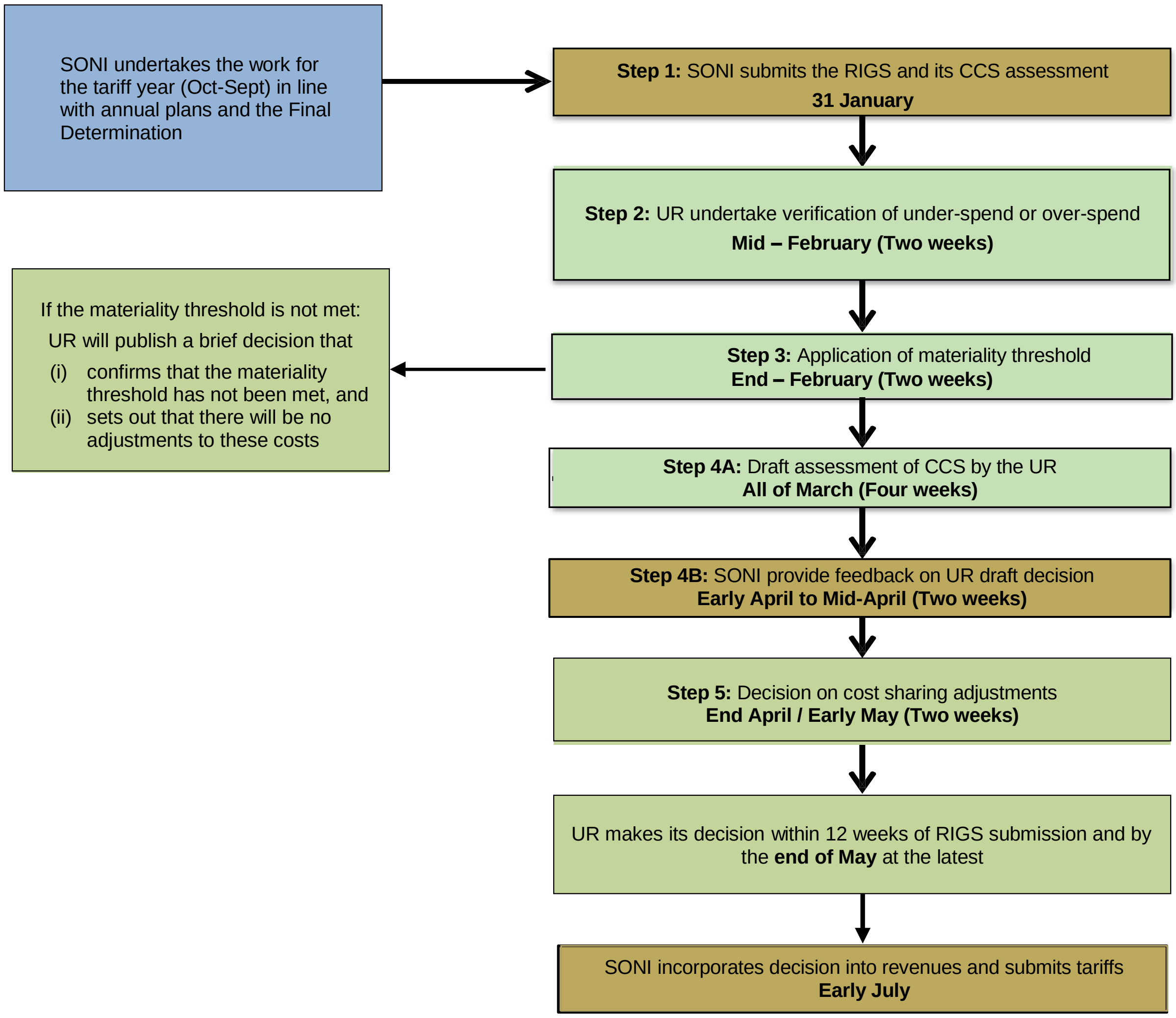
3.21 If we decide to make an adjustment for operating expenditure in respect of relevant year t, the value of that adjustment will determine the $CSBA_t$ term for the purposes of Annex 1 to SONI's TSO licence. If no adjustment is determined for operating expenditure for relevant year t then $CSBA_t$ will be zero.

3.22 If we decide to make an adjustment for capital additions attributable to the buildings RAB in respect of relevant year t, the value of that adjustment will determine the CSC_BD_t term for the purposes of Annex 1 to SONI's TSO licence. If no adjustment is determined for operating expenditure for relevant year t then CSC_BD_t will be zero.

3.23 If we decide to make an adjustment for capital additions attributable to the non-buildings RAB in respect of relevant year t, the value of that adjustment will determine the CSC_NB_t term for the purposes of Annex 1 to SONI's TSO licence. If no adjustment is determined for operating expenditure for relevant year t then CSC_NB_t will be zero.

3.24 The annual process and the link to tariffs is set out in Figure 1. This is an indicative timetable only, and it is possible that specific steps take longer, depending in particular on the quality of information provided by SONI.

Figure1: Timeline of the annual process



4. Methodology

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

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

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

Table 1 Mapping of subsections to steps in annual process

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

Verification of over- or under-spend

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

Costs within scope of the conditional cost sharing arrangements.

4.5 The set of costs that are within the scope of the conditional cost sharing arrangements, and so relevant to the calculation of the over- or under-spend, are as specified in section 2 of this guidance.

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.	Ex ante allowances for operating expenditure subject to conditional cost sharing in relevant year t given by the $\mathbf{BO_t}$ term at paragraph 2.2(b)(i) of Annex 1 to the SONI TSO licence. Ex ante allowances for capital additions attributable to the buildings RAB subject to conditional cost sharing in relevant year t given by the $\mathbf{BC\_BD_t}$ term at paragraph 2.3(d)(ii)(C) of Annex 1 to the SONI TSO licence. Ex ante allowances for capital additions attributable to the non-buildings RAB subject to conditional cost sharing in relevant year t given by the $\mathbf{BC\_NB_t}$ term at paragraph 2.3(d)(ii)(C) of Annex 1 to the SONI TSO licence.
2	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) * $CPIH_{\text{April year t}}$ / $CPIH_{\text{April 2019}}$
3	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 scope of costs subject to conditional cost sharing is as defined in section 2 of this guidance. 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.
4	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 (3)) – (Relevant item in (2)) 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.
5	Aggregate difference between outturn expenditure and ex ante allowances in	= Sum of items in (4) The number can be negative, zero or

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

Application of the materiality threshold

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

4.8 We have set the materiality threshold at £500,000 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 5 of Table 2.

Service performance

4.10 The methodologies to be used to assess potential adjustments in the event of an over-spend and in the event of an under-spend refer to a concept of SONI's "service performance". This should be interpreted as follows:

- Service performance concerns how SONI contributes to, and influences, the desired outcomes [see EPF guidance, para 2.4], via its role in the provision of its services and the carrying out of its functions.

- Service performance includes the quality of services that SONI provides directly to its customers, and the quality of the services and functions that it performs for the benefit of the NI electricity system and for participants in that system (e.g. the quality of system and network planning or the quality of its industry governance functions).

- This concept of SONI's service performance is concerned with the quality of service that SONI provides or (credibly) targets, before the effects of variable external factors. For instance, deterioration in a measure of service quality that is simply due to weather patterns that change from year to year would not represent a deterioration in service performance. Nonetheless, SONI's success in relation to the anticipation and mitigation of the effects of external factors would be relevant to its service performance.

- Service performance also includes SONI's performance in terms of its procurement and management of services from third parties which fall within the costs of system support services (payments and charges are paid or levied by SONI[1] or Dispatch Balancing Costs (these include constraint costs,

[1] These are defined on SONI's website as relating to payments for services necessary for the secure operation and restoration of the electricity system. Other System Charges are intended to incentivise the optimum performance of generators connected to ensure efficient use of the power system.

uninstructed balances and testing charges).

- Any aspect of SONI's services or activities that does not affect the desired outcomes should be treated as outside the scope of the assessment covered by this guidance.

4.11 Where this guidance refers to SONI's service performance being maintained, to an improvement in service performance, or to a deterioration in service performance, then the comparison should be made against a baseline for service performance which reflects SONI's service performance in 2019/20, plus the improvements to service performance that have been funded through the price control framework up to and including the relevant financial year for the assessment.

4.12 This is a conceptual baseline and the specific evidence and information that will be relevant for the purposes of assessing any changes in service performance will depend on the circumstances of the over-spend or under-spend.

Potential adjustments in the event of over-spend

4.13 Under the overall approach for cost-sharing as part of the 2020-25 SONI price control framework, the licence (and our RAB policy) will automatically pass through to regulated charges 75% of the value of any over-spend in respect of costs that fall within the scope of the conditional cost-sharing arrangements. 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.

4.14 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 5 of Table 2, is:

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

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

4.16 In making this determination, we will have regard to potential interactions between these categories (e.g. substitution between operating and capital expenditure) and we will consider the appropriate aggregate adjustment across all three categories rather than treating each in isolation. Furthermore, as part of the assessment, it may be relevant to consider data on expenditure at a more granular level than the three categories for which a determination is needed.

4.17 In the event of an over-spend at an aggregate level, (i.e. across the three

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http://www.soni.ltd.uk/customer-and-industry/general-customer-information/ds3-ss-osc/index.xml categories of expenditure), our decision on the value of the set of adjustments will be constrained by the following:

- The adjustments will be such that the aggregate value of the over-spend that SONI could recover would lie in the range of 75% to 100% of the value of the aggregate over-spend.
- The adjustments will be such that the over-spend that SONI could recover for each of the three categories of expenditure would lie in the range of 75% to 100% of the over-spend in that category.
- The adjustments will not have the effect of clawing back any under-spend that SONI may have achieved in any of the three categories of expenditure.

4.18 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) in the financial year was due to the efficient costs of justified improvements in SONI's service performance in that year, then we will set the adjustment as 25% of the efficient costs of those justified improvements .
- Otherwise (and for any remaining part of the over-spend), the adjustment will be 0%.

4.19 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 performance framework.

4.20 The assessment above concerns an over-spend in the financial year under consideration which was due to improvements in SONI's service performance in that financial year. If there is no identified improvement in SONI's service performance in that financial year, the adjustment should be zero. Nonetheless, we recognise that improvements in service performance in one financial year may, in turn, have effects on outcomes over a longer time horizon and these longer-term effects may be relevant to the question of whether those improvements (and their costs) are justified (e.g. value for money).

4.21 In the event that SONI overspent 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 overspent.

Potential adjustment in the event of under-spend

4.22 Under the overall approach for cost-sharing as part of the 2020-25 SONI price control framework, the licence (and our RAB policy) will automatically pass through to regulated charges 75% of the value of any under-spend in respect of costs that fall within the scope of the conditional cost-sharing arrangements. 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.

4.23 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 5 of Table 2, is:

- a negative number; and
- greater, in absolute terms, than the materiality threshold, as determined above.

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

4.25 In making this determination, we will have regard to potential interactions between these categories (e.g. substitution between operating and capital expenditure) and we will consider the appropriate aggregate adjustment across all three categories rather than treating each in isolation. Furthermore, as part of the assessment, it may be relevant to consider data on expenditure at a more granular level than the three categories for which a determination is needed.

4.26 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.

4.27 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.

4.28 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) in the financial year was *not* due to a reduction in costs that came at the expense of a deterioration in service performance in that year, 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.

4.29 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 performance framework.

4.30 The assessment above concerns an under-spend in the financial year under consideration and its potential effects on SONI's service performance in that financial year. We recognise that changes in SONI's costs or service performance in one financial year may affect outcomes in subsequent financial years and over a longer time horizon. Nonetheless, the primary focus of the assessment is service performance in the year in question. This helps keep the assessment targeted at what has happened in the past, rather than seeking to forecast effects in the future.

5. Evidence to be submitted by SONI

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

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

Identifying materiality of over or under-spend

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

- SONI's expenditure, for the relevant financial year, that falls within the conditional cost sharing arrangements, reported separately for each of the three broad categories of expenditure referred to at the start of this section.
- Reconciliation of this information on expenditure with information reported by SONI as part of its RIGS submission.
- Information on SONI's approach to determining the attribution/allocation of its expenditure to the scope of costs falling under the conditional cost sharing arrangement.
- SONI's ex ante allowance, for the relevant financial year, in respect of expenditure that are within the conditional cost sharing arrangements, reported separately for the three broad categories of expenditure.
- SONI's over- or under-spend in the relevant financial year, for each of the three broad categories of expenditure.
- SONI's assessment of whether the aggregate over- or under-spend across the three categories of expenditure lies within or without the materiality threshold.

Proposed adjustments for conditional cost sharing arrangement

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

- Its proposal for the adjustments to be applied to the cost sharing arrangements, for each of the three expenditure categories referred to under step 2 of section 3 above.

- Evidence in support of its proposed adjustments.

5.5 We turn to the evidence in support of SONI's proposed adjustments below. The nature of that evidence may be different depending on whether the proposed adjustment is made to reflect an under-spend or is made to reflect an over-spend. We take each of those cases in turn below, after some initial guidance that is relevant across both case.

Evidence on service performance

5.6 Evidence on service performance might include, for example:

- Metrics that directly concern service performance (e.g. aspects of SONI's service quality) and those that concern outcomes together with information on how SONI's service performance has contributed to these outcomes.
- Evidence on the levels of service performance that SONI targeted or planned to achieve, its approach to meeting those targets and the reasons for any variation between targeted and outturn performance.
- Evidence from stakeholders: for example, stakeholder surveys; evidence on stakeholders' views about any changes over time in SONI's service performance; or evidence on the absence of concerns being raised by stakeholders about specific aspects of SONI's service performance.
- Evidence on the capabilities, resources and working practices that drive SONI's service performance (e.g. staff inputs, software capabilities, internal processes and methodologies).

5.7 The need for evidence across the different types of examples above would depend on the strength of evidence in any one category. The relevance of different types of evidence is likely to depend on the circumstances. It is for SONI to determine what specific evidence is pertinent to support the submission that it is making.

5.8 The list of examples above recognises that if there is a lack of good information relating directly to the service performance achieved by SONI within a particular role or service, then information on the resources and approaches used to deliver services may support the overall understanding of whether/how service performance has changed. This would not be determinative in isolation, but could have weight if provided alongside other information (e.g. stakeholder views).

5.9 Evidence (including performance metrics) which directly concerns outcomes may help inform on SONI's service performance, but this evidence is not necessarily determinative of service performance. For instance, outcomes may be influenced by other parties besides SONI and by external factors, and there may be time lags between SONI's actions and their effects on outcomes. As indicated in the examples above, it would be relevant to complement information on outcomes with information on how SONI's has affected those outcomes.

5.10 More generally, information concerning service performance may in some cases be heavily influenced by external factors, which are beyond SONI's decision-making, actions and influence. In providing evidence on service performance, SONI's submission (and our assessment of that submission) should take account of the following:

- An apparent deterioration in SONI's performance by reference to a particular source of evidence (e.g. a measure of success or stakeholder satisfaction) may be consistent with SONI's service performance being maintained (or increased) if the deterioration seen in that source of evidence is explained by external factors or conditions.

- A lack of apparent improvement in SONI's service performance by reference to a particular source of evidence may be consistent with SONI's service performance having improved if this has been offset by worsening external factors or conditions affecting that source of evidence.

- An apparent maintenance of (or improvement in) SONI's service performance by reference to a particular source of evidence may be consistent with a deterioration in SONI's service performance if this deterioration is masked in that source of evidence by advantageous external factors or conditions.

5.11 Where SONI considers that external factors are important to its submission on its proposed adjustment, it would be relevant for it to set out its view of how external factors have had an impact and to provide evidence to substantiate that view. This may include information on what steps SONI took to anticipate the external factors and/or to mitigate their effects.

5.12 Similarly, where SONI is seeking to demonstrate that its service performance has been maintained or improved, it would be relevant for SONI to consider the possibility that this is due to external factors, rather than SONI's own actions. SONI's submissions might provide evidence relating to the influence (or lack of influence) of external factors and/or evidence that any improvement was due to SONI's decision-making, action and influence.

5.13 In the sub-sections below we comment further on the evidence that is relevant in the case of an over-spend and then on the evidence that is relevant in the case of an under-spend.

Evidence in support of adjustments to an over-spend

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

a) Evidence on the baseline level of service performance in those areas relevant to the over-spend and SONI's proposed adjustment (see paragraphs 4.11 and 4.12 above for further information on what is meant by the baseline level of service performance).

b) Evidence that SONI's actual service performance in the relevant year exceeded the baseline in the relevant areas

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

d) Evidence that the costs of the improvements that SONI made 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 review or via uncertainty mechanisms.

e) Evidence of the efficiency of the costs of the improvements that SONI made. This could include the presentation of evidence on SONI's approach to selecting the option it chose to deliver the improvements (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 of the improvements in service performance made by SONI, compared to the baseline, are justified by their contribution (or expected future contribution) to outcomes 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 made improve overall outcomes and provide good value for money. Where the effects on outcomes are not expected until future years, SONI should explain the basis on which it considers that a positive future contribution to outcomes should be expected and provide any evidence that supports the credibility of this view. 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 and potentially evidence on the capabilities, resources and working practices that drive SONI's service performance (note these same categories of evidence may apply where the outcomes are expected within the year in question).

5.15 This evidence on service performance should be targeted at the areas of its business that are relevant to the over-spend for which SONI is seeking an adjustment. It is not necessary for SONI to provide comprehensive information on service performance across all of its roles and services if the adjustment sought for an over-spend relates to improvements in specific areas of its business.

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

Evidence in support of adjustments to an under-spend

5.17 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:[2]

- Evidence that the under-spend is explained by specific factors other than a deterioration of service performance.
- Evidence that service performance has been maintained, or improved, across SONI's services and activities despite the under-spend.

5.18 If there is strong evidence on either one of these two types of evidence, there may be less of a need for the other.

5.19 In relation to the first type of evidence above, some examples of the types of factors that may be relevant are listed below, and where SONI refers to these as the reason (or part of the reason) for an under-spend, it should provide evidence to substantiate them:

- Genuine efficiency improvement.
- Stronger than anticipated performance on cost efficiency.
- Good luck lowering costs such as unanticipated changes in external factors that reduce costs.
- The ex-ante cost assessment used for the purposes of the price control review over-estimating the efficient levels of costs.

5.20 It may assist SONI presenting evidence on either of the two types of evidence above if it has previously provided to the UR resource plans (e.g. FTEs by role) and budgets for its use of the ex-ante allowance. 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 SONI's outturn service performance.

5.21 Similarly, it may assist SONI in providing evidence of stronger than anticipated performance on cost efficiency, good luck or external factors, if it has historical data and/or contemporaneous internal forecasts of costs (and perhaps assumed contingencies) in the specific areas that experienced an under-spend.

5.22 In seeking to explain the reasons for an under-spend, it would be important to recognise that an observed under-spend in a broad category of expenditure may reflect the net effect of several different factors, rather than any one single factor. There may be a mix of under-spends and over-spends across a number of more granular cost categories, Because of this, evidence that is intended to isolate and explain the source of an under-spend may need to show not only evidence of an under-spend in one or more cost categories but also evidence that there was not

[2] For further information on the concepts of deterioration, maintenance or improvement in SONI's service performance see paragraphs 4.11 and 4.12 above.

further under-spends in other cost categories.

5.23 If there is good evidence from historical data/or and internal plans to enable the source(s) of an under-spend to be isolated within specific areas of SONI's services and activities, then this should enable any evidence provided by SONI on its service performance to be targeted at those areas, rather than being comprehensive across the business.

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

5.25 If SONI presents evidence concerning the maintenance of its service performance, this would need to include:

a) Evidence on the baseline level of service performance in areas relevant to the assessment.

b) Evidence that service performance in the relevant areas and relevant year has not fallen short of the baseline.