Technical annex: Cost remuneration and managing uncertainty

Final Determination

Annex 3

About the Utility Regulator

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

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

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

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

Our mission

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

Our vision

To ensure value and sustainability in energy and water.

Our values

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

Abstract

This document sets out our detailed response to stakeholder responses and our final determinations relating to cost remuneration and managing uncertainty. It corresponds to section 5 of the main FD document and is relevant to section 6 of the main FD document.

Audience

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

Consumer impact

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

Contents page

1. Introduction

1.1 This annex sets out our final determinations in three related areas of the SONI 2020-25 price control framework:

- Section 2 concerns the cost remuneration approach under the price control.
- Section 3 concerns enhanced cost transparency.
- Section 4 concerns specific uncertainty mechanisms.

1.2 There is overlap between the cost remuneration approach set out in section 2 and price control uncertainty mechanisms. Some of the uncertainty mechanisms we have decided on for SONI's costs are covered in section 2, as part of the broader explanation of the approach to a particular SONI cost category (e.g. transmission planning costs or pensions deficit repair). Section 4 explains the approach to uncertainty mechanism relating to SONI's costs which are not covered in section 2.

1.3 In addition, we set out our approach to an uncertainty mechanism for the corporation tax rate, as part of the allowed return for SONI, in Annex 5.

2. Approach to Cost Remuneration

Our review of the approach to cost remuneration

What we mean by cost remuneration approach

2.1 We use the term "cost remuneration approach" to refer to the price control arrangements that apply to SONI's costs, or to specific categories of SONI's costs, which determine how SONI is remunerated for those costs.

2.2 The cost remuneration approach concerns a range of interrelated regulatory policy questions for the design of the price control framework, such as:

- How does the price control remunerate SONI for the (efficient) costs of its services and activities?
- What is the role for financial incentives within the price control framework to encourage efficiency in the costs incurred by SONI?
- How does the price control framework protect customers from the costs of any inefficiency on the part of SONI?
- How does the price control framework protect SONI and customers from uncertainty, at the time of the price control review, about the efficient level of costs for SONI's services and activities over the price control period?

2.3 The cost remuneration approach overlaps to some degree with the use of uncertainty mechanisms for costs that are difficult to predict at the price control review and which are also discussed in section 4 of this annex.

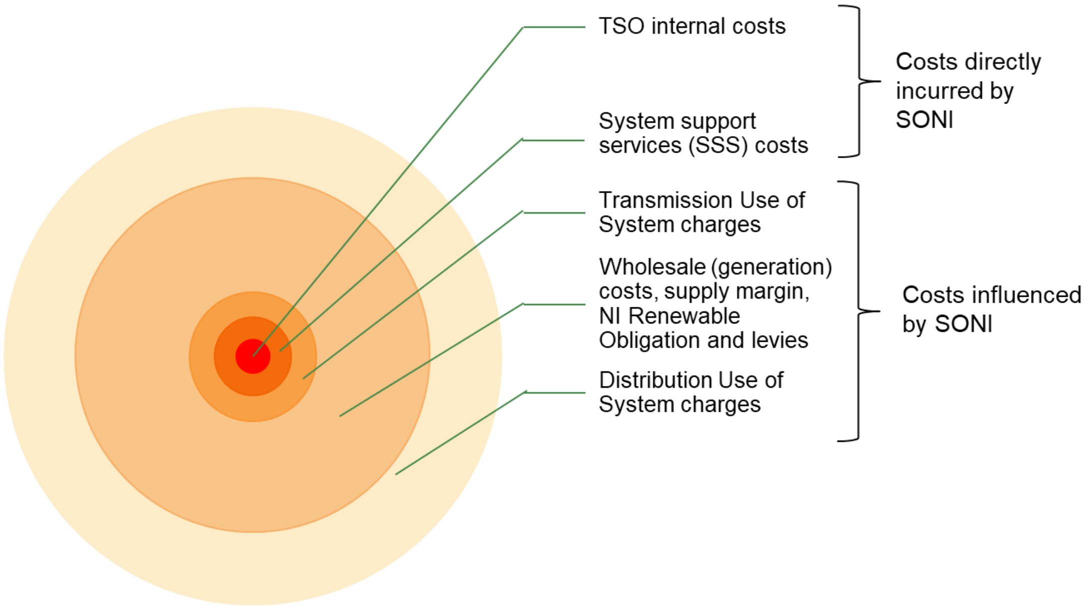
Context for our draft determinations

2.4 Under the 2015-20 price control framework, a significant element of the costs incurred by SONI in its TSO role is subject to conventional mechanistic financial incentive arrangements. By this we mean that the regulator sets an ex ante allowance for the efficient level of costs during the price control period, and any difference between the actual costs incurred by the company and the ex-ante allowance is shared in a fixed proportion (e.g. 50% each) between customers and the company (and its investors). This means that the regulated company gets a fixed share of the benefits from spending less than this amount (as a financial reward) and bears a fixed share of the costs from spending more than this amount (as a financial penalty). While this is a familiar approach within the context of UK RAB-based price control regulation, there are reasons to think that it may not be appropriate for a TSO such as SONI.

2.5 The SONI internal costs which have been the subject of "conventional" mechanistic financial incentives represent around 2% of the NI consumer electricity bill, but how SONI performs and delivers services can influence a much greater element of the total electricity bill, given its system wide influence. This is illustrated in Figure . By

SONI internal costs, we mean costs incurred by SONI in its TSO role which are not payments to third parties for various system support services or payments to NIE and Moyle in respect of transmission/interconnector use of system charges.

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



2.6 There is a serious risk that applying conventional price control cost incentives to SONI's internal costs could lead to small savings in these costs, at the expense of higher costs elsewhere in the system (e.g. increases in future transmission infrastructure costs due to worse quality network planning by SONI) and at the expense of desired outcomes besides costs (e.g. in relation to decarbonisation and service quality to SONI customers and other stakeholders). This risk is exacerbated by the lack of an established and effective regulatory framework for encouraging good performance from SONI in terms of the costs it influences in the system and in relation to desired outcomes beyond that of managing costs.

2.7 A further concern with the use of conventional mechanistic financial incentives for SONI's costs is that this places weight on a regulator's ex ante assessment of the efficient costs of SONI activities over the price control period. In some UK regulated sectors (e.g. electricity distribution and water supply), regulators can draw heavily on cost benchmarking analysis across regulated companies to support ex ante cost assessment. This helps supports the effectiveness of the financial incentives on costs and gives the regulator more information on the efficient costs of regulated activities to use when setting ex ante allowances. However, due to the relatively idiosyncratic nature of SONI (e.g. in terms of structure, role and size) there is a lack of close comparators for benchmarking its costs, which will tend to limit the power of mechanistic financial incentives as more reliance is place on SONI's own costs.

2.8 In relation to the price control regulation of the electricity system operator in Great Britain, National Grid ESO, Ofgem has already moved away from the use of mechanistic financial incentives on the ESO's external costs (e.g. GB electricity system constraint management costs) and has decided, as part of the RIIO2 ESO final determinations, to move away from the use of mechanistic financial incentives on the ESO's internal costs.

2.9 Over time, the SONI price control framework in Northern Ireland has moved some way from conventional price control cost incentives. For instance, under the 2015-20 price control, there are now special arrangements for transmission network pre-construction costs.

2.10 Furthermore, under the 2015-20 price control framework (and preceding price controls) a large proportion of the costs that SONI incurs in its TSO role are treated as pass-through costs, with SONI remunerated under the licence for the level of costs it actually incurs (e.g. costs of purchasing system support services). While the costs subject to conventional price control incentives have tended to get the most attention at price control review, these costs represent a minority of the total costs incurred by SONI each year.

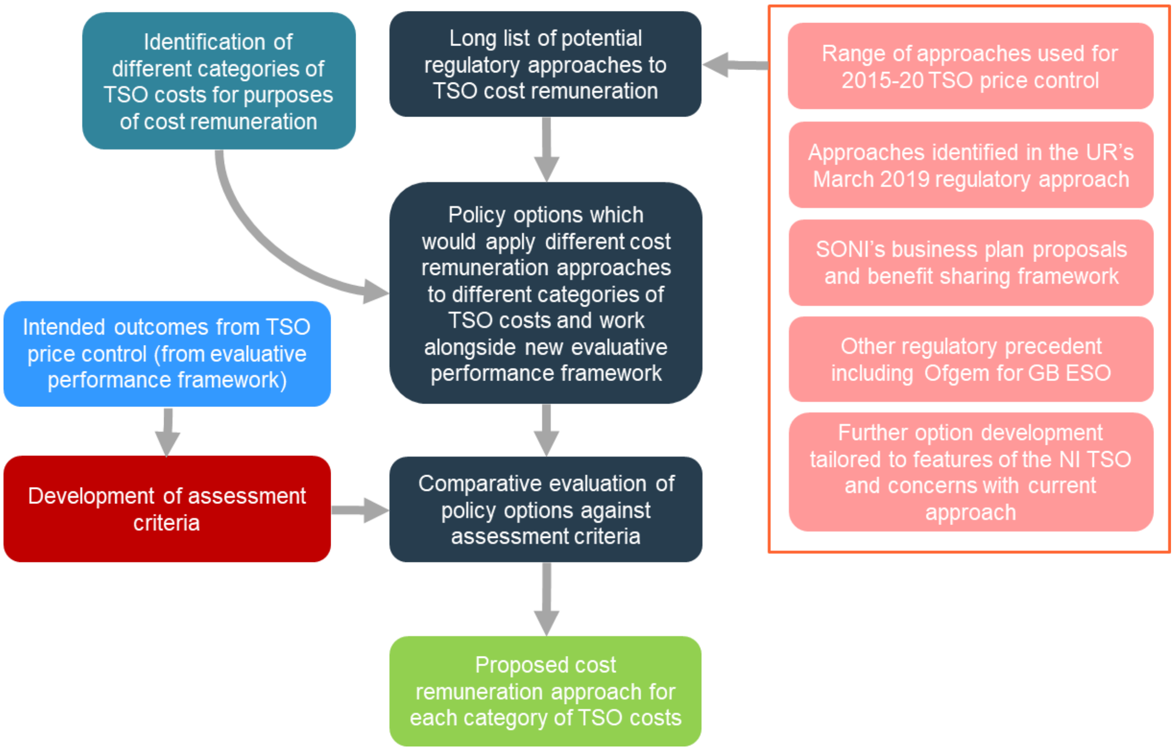
Recap on the process used for our draft determinations

2.11 In the context summarised above, we identified a fundamental question of whether the range of different cost remuneration approaches applied to different categories of SONI costs was logical and appropriate for the 2020-25 price control period. This was an area that we had marked out for further development in our SONI price control approach decision in March 2019.

2.12 For our draft determination, we carried out a detailed review of options for the cost remuneration approach for the SONI price control framework over the 2020-25 period, considering a range of potential approaches that could be applied across the various SONI cost categories.

2.13 Figure 2 provides an overview of the process we used for the option development and assessment as part of our review to the approach of cost remuneration under the TSO price control framework. Annex 5 to our draft determination describes in more detail the process we used, the different options that we considered, our assessment criteria and our overall evaluation of options.

Figure 2: Overview of process used for draft determinations option development and assessment



2.14 The outcome of this process was a set of proposals for the approach to cost remuneration for the SONI price control for the 2020-25 period, which would involve significant modifications to the existing arrangements. Our proposals would continue to apply different approaches to different areas of SONI's costs. Figure 3 below provides an overview of the approach to cost remuneration from our draft determinations, summarising the key elements of our preferred option from Annex 5 to our draft determination.

Figure 3: Draft determination proposals on Cost Remuneration

Majority of TSO "internal" costs

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

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

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

Transmission network development costs

Builds on current uncertainty mechanism for transmission network planning project costs

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

Costs of purchasing system support services

- TSO can recover the costs it incurs (no cap applies)
- The TSO's performance in relation to these costs taken into account as part of evaluative performance framework

Stakeholder feedback and further engagement

2.15 In general, where we received stakeholder comments on our draft determination proposals for the approach to cost remuneration, these concerned either the details of the arrangements proposed in specific areas (e.g. details of conditional cost-sharing) ,requests for clarification or guidance on how specific aspects would work in practice.

2.16 No stakeholder provided detailed comments on the process that we had used or identified further options that we should have considered.

2.17 The Consumer Council said that the detailed analysis in Annex 5 of the draft determination "belies the level of subjectivity and judgement" in the approach that we were proposing, particularly given the fundamental weaknesses in SONI's business plan, but added that, nonetheless, it appeared that the UR had ended up with a reasonable balance of high-level incentives on SONI.

Final determination position

2.18 We considered that the option development and assessment process that we used for our draft determination provided a sound foundation for our final determination. We did not identify any need to rerun the process or expand the set of options considered.

2.19 Where stakeholder comments concerned the details of the arrangements proposed in specific areas, or requests for guidance and clarification, we considered these on a case-by-case basis in each area. Furthermore, we recognised that within our preferred option, there were questions about how exactly this should be applied in practice. We considered these questions further for our final determination, taking account of relevant stakeholder comments.

2.20 There were some areas of expenditure that were not covered in detail within the review of the approach to cost remunerated presented in Annex 5 to our draft determination. We expand and clarify on these too in this section.

2.21 The remainder of this section takes the following areas of costs in turn, recapping on our draft determination, summarising stakeholder feedback and presenting our final determination:

- A new conditional cost-sharing approach for the majority of SONI's internal costs.
- The treatment of costs for new initiatives with hypothecated ex ante allowances.
- Transmission network planning costs.
- System support costs and market operation costs.
- Transmission use of system costs.
- New connections costs and income.
- Pension deficit repair.

2.22 At the end of the section we consider the scope of the demonstrably inefficient or wasteful expenditure (DIWE) provision.

Conditional cost-sharing for majority of SONI's internal costs

Recap on draft determination

2.23 In our draft determination, we proposed to adapt the mechanistic financial incentives that were applied to the majority of SONI's internal costs, under the 2015-20 price control framework, so that the financial incentives that apply to under or over-spend against ex-ante baselines are conditional, and on a targeted regulatory evaluation of evidence provided by SONI concerning the interactions between the costs it incurred and its wider performance. We called this new approach "conditional cost sharing" incentives.

2.24 In the options assessment set out in annex 5 to our draft determinations, this approach represented an intermediate position between the existing approach and the more radical approach of removing any form of direct cost incentive on SONI and remunerating SONI on the basis of the costs it incurs up to a cap. That alternative approach would place more reliance on the evaluative performance framework as a means to ensure SONI's cost control and efficiency, which did not seem appropriate, at least for the 2020-25 price control period in which the evaluative performance framework is introduced for the first time.

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

2.26 In Annex 5 to our draft determination we summarised the conditional cost-sharing approach as follows (and provided further information in an appendix).

2.27 The conditional cost-sharing approach can be seen to start from the perspective of a mechanistic cost-sharing incentive arrangement with a significant modification. This modification is designed to contribute to improved system-wide outcomes over the longer term and to fit better with an evaluative performance framework. Under this approach there would be specified ex ante cost baseline and a specified incentive rate. But any financial upside or downside to SONI would be conditional not just on the difference between outturn costs and the costs baseline, but also on a regulatory evaluation of evidence from SONI that is relevant to understanding that difference.

2.28 The modification we proposed had the following key features:

- A reduction in the cost-sharing incentive rate, where applicable, to 25%.
- In the case of an under-spend, SONI would only qualify for a financial reward from the cost-sharing 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 worse performance against the desired outcomes.
- 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 in performance against outcomes, it would be remunerated in full for those additional costs, rather than facing a penalty under the cost-sharing rate.

2.29 We proposed that the costs falling under the conditional cost-sharing approach would be excluded from the scope of the performance assessment under the evaluative performance framework.

2.30 We proposed that the financial incentives arising from the conditional cost-sharing approach would be subject to a single, combined cap (maximum penalty or reward of £1m per year) that covers the net position from these incentives and the outcome of the evaluative performance assessment. The use of a combined cap reflected what we had understood to be SONIs proposal for a combined cap across its proposed performance incentive framework and cost incentives, and we took account of the interactions between costs and wider performance.

2.31 We proposed that the scope of costs subject to conditional cost sharing incentives is defined as SONI TSO costs not subject to other specific remuneration arrangements (e.g. cost pass-through or remuneration up to a cap). More specifically, the scope of costs would exclude:

- Costs attributable to transmission network planning activities (including project scoping and feasibility activities or to transmission network preconstruction projects), with the exception of costs for support functions and overheads which are intended to be recoverable through the ex-ante allowances determined by the UR.

- System support services (ancillary services) costs and amounts payable by SONI for transmission use of system charges (TUoS).

- Pension deficit repair contributions.

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

2.32 In addition, we proposed that a number of specified items of costs would be excluded from cost-sharing with customers, and that SONI's investors would bear 100% of any deviations from our ex ante allowances.

Stakeholder views and further engagement

2.33 SONI's response to our draft determinations welcomed our recognition that it was appropriate to reduce the sharing rate (or incentive rate) on its internal costs. Furthermore, SONI's response did not seem to object to the principle of a move away from mechanistic cost-sharing incentives.

2.34 However, SONI said that that there were fundamental problems with the conditional cost sharing mechanism proposed in the draft determination, which could result in very asymmetric outcomes and increased uncertainty as the parameters of cost sharing can change ex post providing no clear framework up front.

2.35 SONI proposed modifications to the approach to address the specific problems that it had identified. It said that it would expect that, in order to secure symmetric outcomes, the burden of proof for any claw back of out-performance or under-spend against ex ante allowances would lie with UR, to evidence and demonstrate that any variance was to customer detriment against clear principles specified ex ante.

2.36 SONI said that it would expect the treatment of outperformance (or under-spend) to be consistent with the principles of the demonstrably inefficient or wasteful test under the current framework where: (i) the burden of proof lies with the regulator to demonstrate ex post that an adjustment is required; and (ii) outturn expenditure is presumed to be efficiently incurred and the hurdle rate for ex-post adjustment is high.

2.37 SONI said that it would welcome confirmation that:

- If SONI outperforms that the burden of proof (equivalent to the DIWE provision) would lie with UR to support application of a 100% cost sharing rate (i.e. the burden of proof sits with UR to demonstrate that any variance between ex-ante allowances and outturn expenditure has demonstrably resulted in a deterioration in customer outcomes).

- If there is cost under-performance, adjustments can only be made such that SONI bears 25% or to allow full pass through where justified.

2.38 SONI did not provide any detailed arguments or evidence to support this proposed modification to the conditional cost-sharing approach. But it said that this was important to ensure that the conditional cost sharing approach represents a fair bet, and to avoid the potential implication that UR is looking to assume micro-control of SONI's costs (which SONI said that it understand from engagement with the UR that the UR did not intend).

2.39 More generally, SONI raised concerns over lack of clarity about how the new conditional cost-sharing approach would be applied in practice, especially where this would involve regulatory assessment ex post. It said that this lack of clarity and specification means that the regulatory contract is incomplete and materially increases uncertainty and risk for SONI around cost recovery.

2.40 SONI said that previous CMA determination noted the importance of clear published guidance where regulatory discretion can be exercised such as in the application of DIWE and in relation to Dt and TNPPs.

2.41 SONI said that it had engaged extensively with UR since draft determinations over a series of workshops and welcomed the UR's commitment to develop additional guidance and provide further clarity to address SONI's concerns.

2.42 SONI also sought confirmation that cost performance covered under the conditional cost sharing approach would not be reflected in the outcome of the evaluative framework under any circumstances.

2.43 In addition to feedback from SONI, the Consumer Council commented on our overall proposals for cost remuneration and, more specifically, on conditional cost-sharing. The Consumer Council said that the draft determination had a reasonable balance of high level incentives on SONI, but questioned the changes to the cost incentives concerning SONI having to prove that under-spend was not at the expense of performance or outcomes, while for over-spend SONI would have to show that the extra spending would reduce whole system costs.

Final determination on introduction of conditional cost-sharing

2.44 We have decided that it is appropriate to introduce the type of conditional cost-sharing approach that we proposed in our draft determinations. Our reasoning for adopting this approach is as set out in our draft determinations, subject to further reasoning in the sub-sections that follow.

2.45 In deciding to adopt this approach we considered again whether it was necessary to introduce this new approach rather than just relying on the evaluative performance framework, which has been developed further since our draft determination. We did not consider that the evaluative performance framework would be sufficient. For instance, we did not consider that it would work well, at least in the initial implementation of the evaluative performance framework, to add to the role of the evaluation panel the responsibility for assessing SONI's cost control and efficiency across its whole business.

2.46 We can confirm that, in line with the clarification sought by SONI, our policy position on the conditional cost-sharing is that SONI's performance in relation to costs within scope of the conditional cost-sharing incentives (e.g. any over- or under-spend against ex ante allowances and the reasons for this) would not be within scope of the panel's assessment of SONI's performance under the new evaluative performance framework. For instance, the panel should not use its assessment to reward or penalise SONI simply for under-spend or over-spend on costs subject to conditional cost sharing. The draft guidance we have developed for that framework confirms this limitation on the scope of the evaluative performance framework.

2.47 To determine and clarify our policy for the application of the conditional cost-sharing arrangements in the 2020-25 period, we decided on six further aspects of the approach which we take in the sub-sections that follow:

- SONI's proposal on the burden of proof.
- The cap on upside and downside risk exposure.
- The granularity of the conditional cost sharing arrangements.
- The application of a materiality threshold.
- The scope of the conditional cost-sharing arrangements.
- Guidance on the conditional cost-sharing arrangements.

SONI's proposal on the burden of proof

2.48 We now turn to SONI's view that, in the event of an under-spend by SONI against ex ante allowances, the burden of proof should lie with UR to support application of a 100% cost sharing rate rather than allowing SONI to benefit from a financial incentive equivalent to 25% of the value of the under-spend.

2.49 While SONI said that it was seeking clarification on this matter, we consider that SONI's proposed approach would represent a clear and significant change to what we proposed in our draft determinations.

2.50 In our draft determinations (annex 5, appendix 1) we described our proposals for how the conditional cost sharing approach would work. We said that, in the event of an under-spend, SONI would qualify for a financial benefit (reward) as long as it can provide good evidence that the under-spend was not due to a reduction in costs at expense of worse performance affecting outcomes (higher costs elsewhere in the system or worse performance in relation to decarbonisation, grid security or service quality). We said that this evidence could take one of two forms (or perhaps both):

- Evidence showing that levels of performance have been maintained, or improved, across SONI's services and activities despite the under-spend.
- Evidence that the under-spend is explained by other factors such as genuine efficiency improvement, unanticipated changes in external factors, and/or by the ex-ante cost assessment over-estimating efficient levels of costs.

2.51 We said that, in the absence of such evidence, the full value of the under-spend would go to customers, rather than being shared between SONI and customers under the cost-sharing incentive rate.

2.52 We said that the design of these arrangements means that it is for SONI to provide evidence that under-spend has not come at the expense of wider performance, and for SONI to provide evidence that an over-spend is efficient and good value for money.

2.53 It is clear that the proposal from our draft determination required evidence from SONI before it could benefit financially from an under-spend, rather than the burden of proof lying with the UR to prevent SONI from benefitting from an under-spend as SONI proposed in its draft determination response.

2.54 We said in our draft determination (Appendix 1 to Annex 5, paragraph 6.66 and 6.677) that:

"The design of these arrangements means that it is for SONI to provide evidence that under-spend has not come at the expense of wider performance, and for SONI to provide evidence that an over-spend is efficient and good value for money. The UR would make a regulatory determination in the light of evidence provided by SONI. This process recognises that SONI will generally have much better evidence available, or reasonably available, to it than other parties (e.g. the regulator or other stakeholders) on why its costs differ from ex ante allowances and on whether under-spend or over-spend is attributable to variations in wider performance or service quality

Insofar as this process places evidential requirements on SONI, it is important to recognise that these relate to the ability of SONI to understand, and be able to demonstrate, how changes in its costs may have affected its performance – and how changes in its performance may have affected its costs. Understanding and being able to demonstrate these things seems a feature of a well-run system operator, rather than something that should properly be seen as regulatory burden."

2.55 We did not consider that SONI's response to our draft determination had properly responded to the points above, which provide an explanation for the approach we had proposed.

2.56 Because of the informational asymmetry in favour of SONI, we would be concerned that the benefits envisaged from the move to the conditional cost-sharing approach would be significantly reduced under the approach advocated by SONI.

2.57 This is particularly so given:

- The lack of detail that SONI provided on the relationship between its costs and the various services and activities it is engaged in (SONI was repeatedly unable to meet the requests we made for it to provide allocations of its costs by roles and/or services, even when we asked for this on a best endeavours basis).
- The lack of established service levels of performance baselines for SONI's various services and activities.

2.58 While SONI pointed to the need for a "fair bet", our view is that, in a context where SONI has (or should have) more detailed information about its costs, its performance, and the relationship between the two, the approach advocated by SONI would be asymmetric in favour of SONI. We did not consider that SONI's version of the approach could reasonably be seen to provide a fair bet in the context of the asymmetries in information.

2.59 We decided not to change this aspect of our proposal from the draft determination.

Final determination on the cap on upside and downside risk exposure

2.60 In our draft determination, we proposed that the financial incentives arising from the conditional cost-sharing approach are subject to a single, combined cap (maximum penalty or reward of £1m per year) that covered the net position from these incentives and the outcome of the evaluative performance assessment.

2.61 For our final determination, as explained further in annex 2, we decided that, for the evaluative performance framework, the maximum financial upside should be £1.25m per year and the maximum financial downside should be -£0.75m per year. We decided that revised caps of £1.25m on the upside and -£0.75m on the downside should apply to the net position, in respect of each financial year, across:

- The evaluative performance framework.
- The conditional cost-sharing arrangements.
- The 25% mechanistic cost-sharing incentives for costs of new initiatives or projects for which we provided hypothecated ex ante funding and set associated price control deliverables (see section further below).

2.62 If the cap bites it will need be applied through an adjustment to allowed revenues and/or RAB once the financial position on each of the three elements above has been confirmed.

Final determination on the granularity of the conditional cost sharing

2.63 One issue raised in SONI's response was that additional detail around how the UR intends to assess under-spend and over-spend across different cost categories is important. SONI said that if, overall, it was spending in line with ex ante allowances but it was outperforming on some cost categories and underperforming on others the application of the conditional cost-sharing approach could result in additional asymmetry.

2.64 Our draft determination was not clear on the level of granularity at which the conditional cost-sharing approach would be applied, in terms of various SONI cost categories, although it did envisage the potential for a financial upside to SONI, even if the overall spend was more than the baseline.

2.65 We considered the issue of granularity further for our final determination. Apart from the concerns about asymmetry that SONI raised, we considered that there was a risk of unnecessary complexity in the application of the conditional cost sharing approach if it required assessment of under-spends and over-spends for individual categories of expenditure which may cancel out in aggregate.

2.66 To make the implementation more practical and proportionate, while meeting the overall purposes of the conditional cost-sharing approach, we considered that it was sufficient for the assessment to be directed towards any under-spend or over-spend against the total ex ante allowance that is subject to conditional cost-sharing.

2.67 More specifically, we have decided that:

- In the event of an over-spend against the total ex ante allowance subject to conditional cost sharing within a specific financial year, there would be no process for the UR to determine adjustments under the conditional cost-sharing approach to clawback any cost savings that SONI may have achieved in specific sub-categories of costs.

- In the event of an over-spend against the total ex ante allowance subject to conditional cost sharing, the total amount of that over-spend that SONI could recover under the conditional cost-sharing approach would lie in the range of 75% to 100% of the value of that over-spend.

- In the event of an under-spend against the total ex ante allowance subject to conditional cost sharing within a specific financial year, there would be no process for the UR to determine adjustments under the conditional cost-sharing approach to increase price control allowances for an over-spend that SONI may have experienced in specific sub-categories of costs.

- In the event of an under-spend against the total ex ante allowance subject to conditional cost sharing, the financial benefit that SONI could obtain under the conditional cost-sharing approach would lie in the range of 0% to 25% of the value of that under-spend.

2.68 Subject to those conditions, we will assess potential adjustments separately for three broad categories of costs (operating expenditure falling under the conditional cost-sharing arrangements, non-building RAB additions and buildings RAB additions). These three categories correspond to the separate categories of cost to which cost-sharing incentives are to be implemented (e.g. operating expenditure over-spends feed in to adjustments to price control allowances for operating expenditure allowances and capital expenditure over-spends affect the calculation of the corresponding RAB additions). Any adjustments for over- or underspends under the conditional cost-sharing arrangements will be allocated reasonably to the category in which they arise.

Final determination on materiality threshold

2.69 In responding to SONI's request for guidance, we considered whether the process for SONI to provide evidence to the UR, and for the UR to make its assessment of that evidence, should be subject to a materiality threshold. We identified a potential concern that there could be a material resource requirement from SONI and/or the UR for what could be small amounts of money.

2.70 We decided that we should apply a materiality threshold such that, if the difference between SONI's outturn expenditure and its ex ante allowance, in aggregate over the set of costs within scope of the conditional costs, is less than the threshold in a financial year, the cost-sharing for any under-spend or over-spend should be the same as if conventional mechanistic cost-sharing incentives applied.

2.71 More specifically, we decided that, provided the threshold is not breached for a specific financial year:

- SONI would automatically retain 25% of any under-spend.
- SONI would automatically receive 75% of the value of any over-spend (and hence be exposed to 25% of the over-spend).
- SONI would not need to provide any evidence to the UR under the conditional cost-sharing arrangements, beyond evidence to show that the threshold was not breached.

2.72 If the threshold is breached, then the full value of any under-spend or over-spend would be assessed for the purposes of determining potential adjustments under the conditional cost-sharing arrangements.

2.73 Our initial view was that a threshold of the order of £300,000 would be appropriate. Given the 25% incentive rate, the maximum that SONI would retain for an under-spend before the threshold applies would be £75,000 and the maximum it would be exposed to for an over-spend before the threshold applies would be £75,000. A threshold of this scale seemed proportionate in the light of the purpose of the conditional cost-sharing approach and the likely scale and nature of administrative process required if the threshold is breached.

2.74 We decided that we should consult on the value of the threshold.. We considered that stakeholder feedback on the threshold was likely to be most useful and meaningful if the threshold was considered alongside the overall guidance and process for the conditional cost-sharing arrangements.

Final determination on the scope of the conditional cost-sharing

2.75 We have decided that the conditional cost sharing approach should not apply to those ex ante cost allowance which are hypothecated for new initiatives and have corresponding price control deliverables (see the separate sub-section on cost allowances for new initiatives below). For these costs, conventional mechanistic cost incentives will apply with a 25% incentive rate.

2.76 The application of more conventional cost sharing approach, in the case of hypothecated ex ante cost allowance for delivering (or achieving) specified price control deliverables, was envisaged in our draft determination, an exception to the way that conditional cost sharing approach would be applied (see Annex 5, paragraph 6.62). But on further consideration, and in light of SONI's feedback which indicated a lack of clarity on what we had proposed, we decided that it would be clearer to remove these types of cost allowances from the scope of the new conditional cost-sharing approach. For these costs, a mechanistic 25% incentive rate should apply in the case of both under-spends and over-spends. The different treatment for these costs reflects the protection that customers have from SONI being accountable for the price control deliverables.

2.77 On that basis, the new conditional cost-sharing approach will be focused on ex ante cost allowances for which there are not hypothecated allowances with associated price control deliverables.

2.78 Subject to this modification, we decided to adopt the scope of the conditional cost sharing approach proposed in our draft determinations and therefore that the scope of conditional cost sharing should also exclude:

- Costs attributable to transmission network planning activities (including project scoping and feasibility activities or to transmission network preconstruction projects), with the exception of costs for support functions and overheads which are intended to be recoverable through the ex-ante allowances determined by the UR.
- System support services (ancillary services) costs, market operation costs (e.g. imperfections charges and DBC costs), and amounts payable by SONI for transmission use of system charges (TUoS and GTUos) and the Moyle interconnector.
- Pension deficit repair contributions.
- Any other costs otherwise recoverable under the SONI price control through specific licence provisions.

2.79 In line with our draft determinations, we also decided that a number of specified items of costs should be excluded from the scope of outturn costs that are to be shared with customers, so that SONI's investors would bear 100% of these costs:

- Any costs that the UR determines at any time to be Demonstrably Inefficient or Wasteful Expenditure (DIWE).
- Costs reasonably allocated or attributed to activities or services subject to the SONI's connection charges (but excluding any overheads funded via price control operating expenditure ex ante allowances).
- Any costs reasonably allocated or attributed to a regulatory appeal to the CMA (including the costs of preparatory work for a potential appeal, whether or not this proceeds).
- Other costs of any description which the UR may determine in a published decision from time to time to be manifestly unreasonable to include in costs partially shared with customers.

Guidance on the conditional cost-sharing arrangements

2.80 We agreed with SONI that there would be benefit in a regulatory guidance document on the new conditional cost-sharing approach. We prepared a draft guidance document, for consultation, which we are publishing alongside our final determination.

2.81 This draft guidance builds on the initial guidance material provided in Appendix A to Annex 5 of our draft determination and reflects the policy positions set out above.

New initiatives with hypothecated ex ante allowances

Draft determinations

2.82 In our draft determination, we reviewed SONI's proposals for a series of initiatives that it had proposed as part of its business plan. We provisionally decided to include ex ante allowances for some initiatives within our overall price control allowances.

2.83 Under the broader approach to cost remuneration from our draft determination, these costs fell within the scope of the conditional cost-sharing incentives. However, as indicated above, it was also envisaged in our draft determinations that the treatment of these specific costs could work in the same way as mechanistic cost-sharing incentive, at least in the case of under-spends.

Stakeholder feedback

2.84 SONI's draft determination response raised a number of concerns about the potential for ex post regulatory review on its strategic initiatives. It said that the approach could encourage risk averse behaviour and undermine financeability. These concerns seemed to arise from a combination of our proposals on conditional cost-sharing and our proposals on the DIWE provision.

Final determination position

2.85 On further reflection we considered that, in the case of costs for specified projects or initiatives, the way we proposed and presented the introduction of conditional cost-sharing approach in our draft determination could create unnecessary perceptions of regulatory risk, and involved unnecessary deviations from more conventional price control arrangements.

2.86 As set out in the previous section on conditional cost-sharing, we decided that the conditional cost sharing approach should not apply to those ex ante cost allowance which are hypothecated for new initiatives and have corresponding price control deliverables

2.87 On that basis, where we set ex ante allowances for specific new initiatives as part of our final determinations:

- SONI's costs for these initiatives will be subject to mechanistic cost-sharing incentives with a 25% incentive rate.
- Any cost-sharing is subject to the exclusion of costs that are demonstrably inefficient or wasteful (see separate section further below on the scope of the DIWE provision).
- The ex ante allowances for new initiatives will be conditional on specified price control deliverables (or outputs). There will be potential for adjustments to SONI's price control allowances in the event of non-delivery, partial delivery or late delivery. Our policy on these adjustments is not part of our approach to cost remuneration and is instead set out in Annex 2.

2.88 SONI's performance in the delivery of specific outputs/deliverables will also be taken into account as part of the evaluative performance framework, but the level of costs it incurs in delivery (and the extent of any under- or over-spend against ex ante allowances for specific projects) will not form part of the assessment.

2.89 The approach above will also apply to any new initiatives for which we approve additional ex ante allowances during the price control period, via price control uncertainty mechanisms.

2.90 To implement this approach, it will be necessary for SONI to report separately its outturn costs on the set of new initiatives that we provide funding for. Apart from supporting the application of cost-sharing incentives this reporting will provide useful information on costs for the purposes of the next price control review.

Transmission network planning costs

2.91 This section concerns the general approach to cost remuneration for transmission network planning costs and the role for uncertainty mechanisms in respect of these costs.

Recap on draft determination

2.92 In our draft determination, we proposed to keep the uncertainty mechanism for transmission network planning projects from the 2020-25 price control framework, with the addition of a materiality threshold of £40k in line with other uncertainty mechanisms. This mechanism enables SONI to recover the costs it incurs on specific network planning projects up to the cap set by the UR for each project (subject to exclusion of costs that are demonstrably inefficient or wasteful).

2.93 We also proposed that transmission network planning costs would be taken into account as part of the evaluative performance framework, with potential financial reward or penalties for SONI's performance in relation to these costs. Since the costs that SONI incurs on transmission network planning are part of its overall performance (ultimately feeding into whole system costs) and since these were not subject to direct financial incentives (e.g. under a cost-sharing approach) we considered that it was appropriate to include them within the evaluative assessment. This was both as a means to encourage good performance on these costs but also to allow the evaluative assessment to take account of trade-offs between costs and other aspects of performance.

2.94 In addition, we proposed changes to the treatment of transmission network project scoping and feasibility costs, in light of some concerns raised by SONI about the existing arrangements for these costs. We proposed the following arrangements:

- All costs relating to transmission network project scoping and feasibility would be treated under the same type of cost remuneration approach as transmission network project costs, in which costs incurred are recoverable up to approved caps set by the UR (subject to potential exclusion for DIWE) and with potential for the level of these costs to be considered as part of SONI's performance under the evaluative performance framework.
- We would set at the price control review an initial approved cap for transmission network project scoping and feasibility costs for each year of the five-year price control period. The approved cap would not be tied to specific projects or potential projects.
- We would have discretion, during the price control period, to increase the approved cap for transmission network project scoping and feasibility costs.
- Our cap would include a contingency on top of an estimate of the level of costs required over the five-year period. SONI's outturn spend relative to the pre-contingency estimate would be considered as part of the evaluative performance framework.
- Once a project has been approved for the purposes of the existing uncertainty mechanism for transmission network planning projects no further costs on that project should be reported for scoping and feasibility.

Stakeholder feedback and further engagement

2.95 In its section on "Cost Recovery Mechanisms and the Management of Uncertainty", SONI's response said that the draft determination on transmission network planning (development) costs were consistent with the CMA framework. SONI did not propose any amendments or request any amendments to the mechanisms for cost recovery set out in the draft determination.

2.96 SSE said it supported the proposals to change how infrastructure projects are funded and approved but would encourage both UR and SONI to work together to speed up the approval process to facilitate faster develop of necessary grid infrastructure.

Final determination position

2.97 We decided to maintain the approach to transmission network planning costs set out in our draft determination, subject to one modification.

2.98 We decided that, at least for the 2020-25 period, we would not implement the proposal from our draft determination that SONI's performance in relation to the network planning costs it incurs (which are to be remunerated based on costs incurred up to a cap) would form part of the panel's assessment under the evaluative performance framework.

2.99 Our revised position reflects further consideration of the scope of the panel's assessment, and measures to improve the likely effectiveness of the evaluative performance framework, especially when first introduced. We considered that other safeguards in the price control framework, including the caps we set and enhanced transparency provided sufficient safeguards on costs, and that the panel's attention and assessment would be better directed at other areas of performance.

System support costs and market operation costs

Recap on draft determination

2.100 System support costs refers to the costs that SONI pays to third parties in exchange for various services that these parties provide it (e.g. frequency response or reactive power), to enable SONI to secure the stability of operation on the transmission system and/or the systems linked to the transmission system.

2.101 Under the 2015-20 price control framework, these costs are subject to a full pass-through approach, under which SONI can recover the costs it incurs through the maximum regulated SSS/TUoS revenue restriction. No cap applies.

2.102 Our draft determination proposed to maintain the existing approach, subject to the modification that SONI's performance in relation to system support costs would be taken into account as part of the evaluative performance framework.

Stakeholder feedback

2.103 In its section on "Cost Recovery Mechanisms and the Management of Uncertainty" SONI's response to our draft determination said that our proposals are consistent with the CMA framework and it did not propose any amendments or request any amendments to the mechanisms for cost recovery we set out.

2.104 SONI also made reference to a letter received from UR on 23rd of July in relation to

System Services which appeared to depart from the draft determination and suggested SONI was somehow at risk in respect of these costs. SONI said that if this is the case, then this additional risk needs also to be recognised.

Final determination position

2.105 We decided to maintain the approach to system services costs set out in our draft determination.

2.106 As a clarification for the purposes of our final determination, this approach will apply to system services costs and to market operation costs. By market operation costs we mean those costs which are remunerated on a pass-through rough basis under paragraph 2.2(a)(iii) of the current TSO licence conditions (these costs include for example imperfections costs).

2.107 We can confirm that it is not the UR's policy, for the 2020-25 price control period, to take any action that would conflict with the policy position of having a full cost pass-through of system services costs or market operation costs (coupled with coverage of these costs in the evaluative framework).

2.108 We reviewed the specific letter that SONI referred to in its response. The Single Electricity Market Committee has made it clear that it expects SONI and EirGrid to limit its expenditure to amounts that SONI and EirGrid have identified and voluntarily committed to. In addition there are processes available for the TSO's to maintain expenditure within this commitment. However the Single Electricity Market Committee did not put in place (or propose) any licence modifications to impose a cap on SONI TSO system service costs.

Transmission use of system costs

Draft determinations

2.109 In our draft determination, we proposed that the amounts payable by SONI for transmission use of system charges (TUoS) would be outside the scope of the conditional cost-sharing approach and remunerated under the price control according to the level of costs SONI incurs (i.e. full cost pass-through basis).

2.110 We also proposed that the level of transmission use of system charges paid by SONI would fall outside the scope of the evaluative performance framework.

2.111 We made separate proposals about the nature of SONI's role in relation to these costs, and the risks it bears, as part of our proposals on risk and return. This issue is not covered in this section: see Annex 5.

Stakeholder feedback

2.112 The approach we propose in our draft determination on the cost pass-through of transmission use of system charges paid by SONI is consistent with the treatment under the 2015-20 SONI price control framework. We did not receive any stakeholder comments on this application of cost pass-through. We discuss stakeholder responses on the separate issue of SONI's role in relation to revenue collection costs and risks in Annex 5.

Final determination position

2.113 Our final determination is to adopt of draft determination approach of cost pass-through. We add the clarification that this covers both TUoS and GTUoS, as well as payment SONI makes under the Moyle Interconnector Collection Agency Agreement (i.e. the CAIRt amount in the current TSO price control licence conditions).

New connections costs and income

Background

2.114 As part of its role, SONI is responsible for offering connections to the transmission system. SONI charges connection charges to customers seeking connections. SONI's income from connection charges is outside the scope of the TSO revenue control, which applies to SSS and TUoS tariffs.

Recap on draft determinations

2.115 In our draft determination (section 10) we said that our review of data and forecasts provided by SONI indicated unexplained differences between the forecast income from new connections (around £800,000 per year) and the costs that SONI identified for new connections (around £480,000 per year). SONI did not discuss this matter in its business plan.

2.116 We said that the scale of difference was evidence of *potential* double counting within the price control arrangements: our ex ante allowances are intended to cover the whole of SONI's overheads (e.g. HR and support functions, depreciation and return on capital for central IT investment). However, we would also expect SONI's connection charges to make some contribution to overheads used in the performance of connection activities. There was a risk that SONI would be remunerated twice for overheads associated with connections once through the SSS/TUoS regulated revenue stream and once through the connection charge income.

2.117 We proposed to address the connections issue above by including an adjustment provision within the revenue control calculation in the TSO licence, such that in each financial year a deduction is made for the part of SONI's actual connection charge income in that year that is reasonably attributable to overheads or any other costs funded through the SSS/TUoS revenue control.

2.118 For forecasting and modelling purposes at our draft determination, we made a high-level assumption on this amount, assuming that 50% of the difference between revenue and reported costs was a contribution to overheads.

2.119 We ask that SONI provided more detailed evidence and forecasts on this matter in its response to our draft determinations.

Stakeholder feedback and further engagement

2.120 In its response to our draft determination SONI said that:

"SONI feels that its overhead costs for any of its systems would not materially reduce if the connections business were taken away from the business as the need for the IT systems would still be within the business. SONI does not therefore charge any overheads as part of its application fees charge process; therefore, there is no double count of overheads in this

2.121 Furthermore, SONI said that it could not absorb a reduction in its price control cost allowances relating to connections overheads, as proposed in the draft determination, without a corresponding decline in the provision of this service.

2.122 SONI's response did not respond directly to the specific proposal in our draft determinations for an adjustment provision.

2.123 In Appendix D to its response, SONI provided some revised estimates of connections income and costs over the 2015-20 period. SONI also stated that its connections income is not guaranteed at the historical levels and has reduced in the last two years of the 2015-2020 period. SONI said that these levels of revenue within the connections part of the business will continue and will not be able to fund overheads at the level suggested in the draft determination.

2.124 We were confused by SONI's response, because it seemed to contradict the forecasts of connections income and costs from its business plan and the figures for historical costs from its business plan. We asked SONI a series of further questions on its connections income and costs.

2.125 SONI then provided revised figures for connections costs and income over the 2015-20 price control period. This showed that connections income exceeded the costs SONI had reported for connections by over £1.5m across the five years (against total connections income of around £5.9m in that period).

2.126 The difference between income and costs was lower in the last two years of the period compared to the first three years. SONI said that the high levels of income for 2015/16 to 2017/18 can be explained by a high number of connections applications relating to a high demand for connections applications as the Northern Ireland Renewables Obligation Scheme came to an end. SONI said that 2018/19 and 2019/20 have now shown a reduction in the number of connections applications, which are likely to represent a more normal, settled year and it is more appropriate to use these figures going forward.

2.127 We asked SONI various questions about the apparently high levels of profit from its connection charges, indicted by the extent to which its connection income exceeded its connection costs (both historically and in its forecasts). SONI did not provide a cogent explanation. SONI referred to the risks it takes from employing connection staff in a context where connection volumes are uncertain and it pointed to the high demand for connections in 2015/16 to 2017/18, but this did not seem to explain the level of apparent profit over the 2015-20 period.

Final determination position

2.128 In terms of setting the TSO price control, we considered that it was appropriate to adopt the proposal from our draft determination: to introduce an adjustment provision within the revenue control calculation in the TSO licence, such that in each financial year a deduction is made for the part of SONI's actual connection charge income in that year that is reasonably attributable to overheads or any other costs funded through the SSS/TUoS revenue control.

2.129 This approach is sufficiently flexible to accommodate both of the following scenarios:

- A scenario involving SONI's stated policy of setting connection charges in a way that makes no contribution to the overheads drawn on to deliver its connections activities (e.g. corporate IT systems and HR department). In this scenario the adjustment provision within the revenue control calculation would be zero.
- An alternative scenario in which connection charges are set in a way that makes a reasonable allocation to overheads. In this scenario the adjustment provision within the revenue control calculation would capture the contribution to overheads from connection charges and ensure no double counting across the price control allowances and connection charges.

2.130 SONI's response did not seem to recognise the flexibility in what we had proposed in our draft determination and did not provide any grounds for us not to adopt this approach.

2.131 It is not the purposes of our price control review to examine SONI's connection charging policy. Nonetheless, the treatment of overheads brings a significant interaction between connection charges and the TSO price control. We found SONI's explanation for its stated policy of not recovering any overheads from connection charges to be wholly unsatisfactory. It reflects an approach to internal cost allocation that is not good practice (and which may bring competition law and licence compliance risks for SONI).

2.132 We would expect SONI to revisit its treatment of overheads in connection charges during the 2020-25 period. Our adjustment provision allows for this.

2.133 For forecasting and modelling purposes for our final determinations we made assumptions that SONI's connection charges make no contribution to overheads for 2020/21 and 2021/22 and then provide £100,000 contribution in each subsequent year. These are forecasts and not allowances; the actual price control calculation will depend on the adjustment provision described above. The figure of £100,000 is an approximate assumption and should in no way guide SONI's determination of an appropriate allocation, which is likely to depend on the size of relevant overheads within SONI's cost base and the choice of an appropriate cost allocation methodology.

Potential refunds against historical connection charges

2.134 We found that SONI's explanations for the scale of difference between its connection charges income and the costs it reported for connection charges was unsatisfactory. The figures and forecasts provided by SONI suggested levels of profit from connections activities that raised questions about whether it had set connection charges too high. While SONI pointed to the impacts of variations in connections volumes over time, we found that income exceeded costs by a significant amount in each of the last five years, and it did not forecast any reversal of this situation in the subsequent five years.

2.135 In one query response SONI told us that it "issues refunds to customers where the income received up front [from connections charges] is materially more than the actual cost of the connection job".

2.136 In light of the figures SONI has provided on connections income and costs over the 2015-20 period, which indicated that income exceed costs by £1.5, it seems that SONI has a backlog of refunds to process. We look forward to SONI processing these refunds to the benefit of its connection customers, and we require SONI to confirm once this has been completed.

Pension deficit repair

Background

2.137 In line with other regulators, for the treatment of pension costs within price control reviews we consider it appropriate to make use of a set of principles and a broad approach that apply over a longer time horizon than a single price control period.

2.138 In December 2014, following the Competition Commission's determination in relation to the NIE price control reference, we published a policy paper: *Pension Deficit Recovery – A Utility Regulator Position Paper*. This included the following principles (amongst others):

- The historical pension deficit, up to a specified cut-off date, should be 100 per cent recovered from customers (and any incremental deficit after that date will be 100 per cent funded by the licensee).
- The cut-off point would be 31 March 2015, and this would apply to all our price controls.
- The amount of deficit accrued until that cut-off point would be recovered from consumers via that business's regulated entitlement over a period of not more than 10 years.
- Any deficit that the business's pension fund accrues after the "cut-off" date ("incremental" deficit) would be the responsibility of shareholders and cannot be collected from customers.

2.139 For the 2015-20 SONI price control, the treatment of pensions was a matter of contention and was not resolved in the same timescale as the remainder of the price control. In October 2017, we published final conclusions in relation to pension allowances for the 2015-20 TSO price control.[1] We decided that:

- It was right and appropriate for the UR's pension deficit recovery policy and principles (from December 2014) to apply to SONI in respect of the pension deficit relating to the SONI defined benefit scheme.
- As a specific variation on our general approach, we decided that the cut-off date for SONI's pension deficit under the TSO price control should be 31 March 2019.
- The pension deficit allowance for the 2015-20 period should be based on recovery of the deficit over a 10-year period.

Recap on draft determinations

2.140 In its business plan, SONI had proposed a 7-year recovery plan for its pension deficit over the 2020-25 period. In our draft determination (annex 6), we proposed allowances for SONI's pension deficit repair payments based on recovery over a 10-year period. Given the significant increase in the size of the pension deficit and the inherent volatility of financial markets, we considered an appropriate approach was that the current deficit within the scheme should be recovered over a 10-year period. We considered that this was a more proportionate burden on consumers, which helped ensure adequate deficit recovery but minimises any risk of consumers paying for a stranded surplus.

2.141 Our allowances were provisional pending updated information on the value of the deficit from the triennial valuation, which we expected SONI to be able to provide in time to take into account for our final determination.

2.142 Our use of a 10-year period was consistent with the previous decision in respect of the 2015-20 price control framework and, subject to that, our established pension principles.

2.143 We said that pension deficit repair costs would be excluded from the scope of costs falling under the conditional cost-sharing arrangements. This was necessary for consistency with our established pensions' policies. For instance, a 25% incentive exposure for SONI around ex ante allowances would conflict with the policy that the historical deficit would be 100% funded by consumers.

2.144 We did not propose any revisions to our established pension principles in our draft determination.

Stakeholder feedback

2.145 In Annex 4 we summarise SONI's draft determination response in relation to the

[1] https://www.uregni.gov.uk/sites/uregni/files/media-files/Pensions%20Conclusions%20and%20CIL%20Decision.pdf

allowances for pension deficit repair. In addition, SONI asked us to clarify the cost remuneration approach to be applied to pension deficit repair contributions.

Final determinations

2.146 We determine and explain our allowances for pension deficit repair contributions in Annex 4. In this section, we respond to SONI's request for clarification of the cost remuneration approach to be applied to pension deficit repair contributions. This essentially concerns the price control treatment of potential over- or under-spends by SONI, in the 2020-25 period, against the allowances for pension deficit repair that we set for that period in our final determination.

2.147 We provide the following additional clarification as follows:

- Neither mechanistic nor conditional cost-sharing incentives will apply to pension deficit repair costs.
- During the 2020-25 price control period, SONI will bear 100% of any under-spend or over-spend against the allowances for pension deficit repair that we set in our final determination.
- In setting the subsequent SONI price control(s) for price control periods from 1 October 2025 onwards, we will take account of any under- or over-spends against the 2020-25 pension allowances and make appropriate adjustments to price control revenue allowances in the light of these. Any adjustments will reflect our established pensions' principles, particularly the policy that the historical deficit up to the cut-off point (but not the incremental deficit) will be 100% recoverable from customers. We would expect to consult on any adjustments in the event of over- or under-spend as part of our consultation on the price control review.

2.148 We also considered whether there should be an additional uncertainty mechanism to allow adjustments to the pension deficit repair allowances in the 2020-25 period, if there are significant changes to historical deficit at the next triennial valuation. We decided that this would be appropriate, and that depending on the direction of any change in the deficit compared to expectations, this could lead to either an increase or decrease to the allowances for the remainder of the price control period.

Scope of the DIWE provision

Background

2.149 The 2015-20 TSO price control framework includes arrangements to protect customers from exposure to certain costs in the event that the UR finds these to be "demonstrably inefficient or wasteful expenditure" (DIWE).

2.150 The current TSO licence conditions define demonstrably inefficient or wasteful expenditure as follows:

"expenditure which the Authority has (giving the reasons for its decision)

determined having regard to such guidance as the Authority may from time to time issue, to be demonstrably inefficient and/or wasteful, given the information reasonably available to the Licensee at the time that the Licensee made the relevant decision about that expenditure. For the avoidance of doubt, no expenditure is demonstrably inefficient or wasteful expenditure simply by virtue of a statistical or quantitative analysis that compares aggregated measures of the Licensee's costs with the costs of other companies"

2.151 The current licence acts to exclude such expenditure from recovery by SONI through its tariffs, in respect of a subset of costs incurred by the TSO: the costs defined under the licence as "B_{TSOt}" costs, the costs of transmission network planning projects and the costs recovered under price control uncertainty mechanisms (the D_{TSOt} and Z_t provisions in the licence). The current licence does not apply the DIWE provision to the purchase costs of system support services or to the TUoS costs incurred by SONI.

2.152 The inclusion of the DIWE provision in the 2015-20 TSO price control framework reflected the introduction of a corresponding DIWE provision into the price control framework for NIE Networks, as a consequence of the CMA's price control determination for NIE in 2014.

2.153 The UR published its *Guidance on the interpretation and application of the Demonstrably Inefficient or Wasteful Expenditure (DIWE) Provision* in July 2017, following a phase of stakeholder consultation.

2.154 In the 2017 appeal to the CMA, the DIWE provision was considered by the CMA. SONI had alleged an error that there was an unjustified creation of uncertainty through failure to provide guidance on the application of the DIWE provision. The CMA noted that, during the course of the appeal the UR had published guidance on the DIWE provision, but in any event the CMA found that the UR was not wrong not to publish guidance at the time of the price control decision. The CMA said that the UR was not under any legal duty to publish guidance on the DIWE mechanism.

Recap of draft determination

2.155 For our draft determination, our proposal was that the DIWE provision would be retained for the 2020-25 period, and applied to the following cost categories:

- The set of costs subject to the new conditional cost-sharing arrangements (including costs of new initiatives funded via additional price control allowances).
- Transmission network planning costs (including project costs and initial scoping and feasibility costs).
- Any further costs allowed under price control uncertainty mechanisms (unless the costs fall under a cost category, such as system support costs that is excluded from the scope of the DIWE provision).

2.156 We did not propose any changes to the definition of the DIWE provision or the way that it would be applied in practice.

2.157 We proposed that, as under the 2015-20 price control framework, the DIWE provision would not apply to system support costs or the amounts payable by SONI for transmission use of system charges (TUoS).

Stakeholder feedback

2.158 We received feedback from SONI and the Consumer Council on the DIWE provision.

2.159 The Consumer Council said that it believed that the DIWE criterion imposes a very high threshold on the UR for disallowing SONI expenditure that is not in consumers' interests. It said that a lower threshold that avoided consumers paying for inefficient expenditure would be more appropriate, for example a requirement to show that expenditure is "used and useful" would be more in consumers' interests and should be what SONI is striving to achieve.

2.160 We considered the Consumer Council's proposal, which would amount to a substantial change in the nature of the DIWE provision. The DIWE provision was formally introduced to price control regulation in Northern Ireland by the 2014 Competition Commission (CMA) determination for NIE, and was upheld in the 2017 appeal by SONI to the CMA. We did not consider that the Consumer Council provided sufficient argument or evidence to support the degree of change that it had proposed.

2.161 Furthermore, it should be kept in mind that our approach to cost remuneration for the 2020-25 TSO price control framework is not to rely simply on the DIWE provisions to protect customer, but to use this as an additional safeguard to complement other provisions (e.g. conditional cost-sharing arrangements or the specification of cap on the maximum amount of costs that SONI can recover on a specific project).

2.162 SONI's draft determination response referred to the DIWE provision in several places.

2.163 We considered that some of SONI's draft determination response in relation to the DIWE provision reflected a misunderstanding of the nature of this provision and our draft determination. For instance, in its response to our draft determination (page 4-3), SONI said that:

> *"SONI's strategic initiatives represent innovative, first-of-a-kind projects which could result in trial and error costs which ex post and with the benefit of hindsight could appear unnecessary but which ex ante were reasonable and appropriate. This raises the question of whether SONI would, or would be in a position to, proceed with and invest in innovative projects without confidence that UR ex post and with the benefit of hindsight would consider an initiative to be efficient*

through DIWE review. This would be expected to encourage risk averse behaviour and limit the willingness of the business to undertake the innovative projects which will unlock value for customers. As a result it is important to secure an overall financeable package that the UR clarifies that it will not carry out ex post review with the benefit of hindsight".

2.164 We considered that it was sufficiently clear from the existing licence condition, and the guidance that the UR published, that the test for any DIWE is by reference to the information reasonably available to the Licensee at the time that the Licensee made the relevant decision about that expenditure. Our draft determination did not propose any changes to DIWE either in general or for strategic initiatives. We did not consider that SONI's arguments about the use of the "benefit of hindsight" were valid concerns, or that further clarification was necessary.

2.165 SONI said that the UR should clarify that any ex-post review on strategic initiatives would be conducted in line with its published DIWE guidance and would be carried out without the benefit of hindsight. Other aspects of SONI's response identified "material ex-post risk and uncertainty" in relation to the DIWE provision.

Final determination position

2.166 We recognise that the inclusion of the DIWE provision creates some ex post risk and uncertainty, compared to a hypothetical framework that does not include such a provision. But we consider that this risk and uncertainty is justified by the benefits of the DIWE provision, both as a means to help protect customers from exposure to wasteful expenditure and as a means to encourage the regulated company to avoid such expenditure in the first place.

2.167 Furthermore, we consider that, for an efficient and well-run company, this risk would be very small and it could well be immaterial. It seems quite possible, and arguably probable, that equity investors would back themselves to select a management team that is capable of reducing risk of adverse DIWE exposure to negligible levels.

2.168 Overall, while SONI's draft determination response referred to the DIWE provision as part of broader arguments, we did not identify a need to revise the approach proposed in our draft determination or produce further guidance.

2.169 We decided to maintain the approach to DIWE from our draft determination.

2.170 For the purposes of clarification, and to guide the licence modification process, we add the following additional clarifications:

- The DIWE provision will not apply to costs reasonably allocated or attributed to activities or services subject to SONI's connection charges (these charges are outside the scope of the revenue control on SSS/TUoS tariffs).
- All forms of transmission use of system charges will be excluded from the DIWE provision (including GTUoS and payments in relation to the Moyle

interconnector).

2.171 It is our intention to maintain the use of a regulatory guidance document for the DIWE provision.

3. Enhanced cost transparency

Draft determination

3.1 In our draft determination we said that there is a strong case for introducing additional cost transparency provisions on SONI. We said that enhanced cost transparency and cost reporting initiatives for SONI could support cost efficiency in a number of ways:

- Helping harness reputational incentives to encourage efficiency and avoid wasteful expenditure (e.g. excessive remuneration of senior staff).
- Helping to allow stakeholders to identify potential opportunities for SONI to operate more efficiently.
- Providing information that is useful to the assessment required for the purposes of the evaluative performance incentive framework for SONI or for assessments for conditional cost-sharing incentives.
- Improving opportunities for benchmarking between SONI and other organisations.
- Providing a more detailed evidence base to use when setting ex-ante cost baselines, or when making approvals of expenditure caps, for price control purposes.

3.2 We said that. as far as possible, while recognising the potential need for some redactions where justified on grounds of commercial confidentiality, we would envisage SONI publishing the data for the benefit of stakeholders rather than just providing to the regulator.

3.3 We said that we would develop more detailed reporting guidance, which would be subject to separate consultation.

3.4 We identified a range of potential areas for enhanced cost transparency and cost reporting:

- Reporting of costs incurred by SONI broken down by the individual services areas identified for SONI (or at a less granular level, the four SONI roles).
- Information on how key SONI resources (e.g. staff, consultant spend) are allocated across different roles and services, potentially with a detailed staff resource plan across the organisation.
- More granular reporting of the costs incurred for various different categories of system support services in Northern Ireland.
- Aside from system services costs, requirements to report in summary form (similar to requirements on public bodies), the spend under contracts with third parties that involve total costs over a specified threshold. This may be

especially relevant in relation to spend on regulatory engagement, as there could be concerns if this spend were excessive in relation to the benefits accruing to SONI's customers and the wider system, rather than benefits accruing to SONI's shareholders.

- Reporting of (anonymised) staff costs against the granular occupational categories used by the ONS and NISRA for the Annual Survey of Hours and Earnings (ASHE). This would allow for more like-for-like comparisons between the salaries of SONI staff and employees from other organisations, using published national statistics.

- Full reporting of methodologies for cost allocation within SONI and for calculation of intra-group recharges.

3.5 We proposed a package of enhanced cost transparency and cost reporting requirements on SONI in relation to its SONI activities, covering each of the elements listed above. We said that we welcomed feedback on this proposal, especially on how enhanced cost transparency could be designed to provide the most net benefits in relation to the desired outcomes from the SONI price control.

Stakeholder feedback

3.6 The Consumer Council said that it supported cost transparency as a way to allow closer monitoring of trends in SONI's performance and to highlight adverse movements. It also said that it is important for consumers that the information provided is as accessible and consistent as possible, so as to facilitate stakeholders engaging with the information provided. It said that the enhanced reporting requirements should include clear guidance on the presentation and accessibility of the information as well as the detail of what information is to be provided.

3.7 We did not identify in SONI's draft determination response any comments targeted at the cost transparency proposals in our draft determination.

Final determination position

3.8 We did not receive any stakeholder feedback that gave grounds for us to move away from our draft determination proposals.

3.9 We decided to adopt the full range of enhanced cost transparency measures proposed in our draft determination as set out above.

3.10 We agreed with the Consumer Council that it is important that information is presented in a way that enables stakeholders to engage with this information. We will seek to address this in our guidance.

3.11 We will produce guidance for consultation in due course. The purpose of the consultation will be to test and refine the detailed wording of guidance on the new cost reporting arrangements. It will not be the purpose of the consultation to revisit the policy question of whether it is appropriate to introduced enhanced cost transparency, which we have decided as part of our final determination.

4. Uncertainty mechanisms

4.1 This section presents our decision on a number of aspects of price control uncertainty mechanisms. It takes the following topics in turn:

- Uncertainty mechanisms available to allow additional price control funding to SONI (excluding in relation to transmission network planning).
- The balance of ex ante funding and uncertainty mechanisms.
- Treatment of licence fees, ENTSO-E and CORES costs.

4.2 This section is particularly, but not exclusively, relevant to the use of uncertainty mechanisms to provide increased allowances for SONI, during the price control period, for new initiatives that are not funded through allowances set at the price control review but which could improve overall outcomes for consumers.

4.3 This section does not cover the following areas which are dealt with elsewhere:

- The uncertainty mechanisms forming part of the overall approach to transmission network planning costs are considered in section 2 above.
- The uncertainty mechanism for pension deficit repair triennial review is considered in section 2 above.
- The full cost pass-through approach applied to a number of areas of SONI's costs (e.g. transmission use of system costs and system support costs) are considered in section 2 above.
- The uncertainty mechanism for the statutory corporation tax rate is considered in Annex 5.

Uncertainty mechanisms to allow additional funding

Recap of draft determination

4.4 In our draft determination, we said that we had not identified good reasons to move away from the approach under the 2015-20 price control framework that gives the UR flexibility to approve additional allowances for SONI during the price control period.

4.5 We said that, in considering any request for additional funding from SONI it would be important to consider whether there is already any implicit or explicit allowance within our price control determination for the relevant costs. We would also consider whether an uncertainty mechanism adjustment is necessary given the opportunity, under the conditional cost sharing incentives, for SONI to receive additional funding for over-spend attributable to the efficient costs of justified improvements in performance. We proposed to address these issues through regulatory guidance on the uncertainty mechanism and comment on them further below.

4.6 We proposed that additional funding approvals during the price control period for new initiatives (or other costs arising) would be remunerated primarily through one of two options:

a) Approving funding by setting an ex ante baseline for the efficient costs during price control period (which would be added to existing ex ante baselines), and these costs being subject to conditional cost-sharing arrangements.

b) Approving funding on the basis of remuneration of costs incurred, subject to an approved cap, with potential to take account of the costs incurred in this area as part of the wider evaluative performance incentive framework.

4.7 We said that we would also reserve the right to apply a version of (b) without specification of a cap, but would expect this to be by exception.

4.8 We said that, to limit risks of distortions to SONI's incentives and cost reporting, our starting position would be that the cost remuneration approach for any approval would be aligned with that used within the SONI price control for other similar costs. - We saw merit in allowing some flexibility to depart from this starting point. For instance recovery of costs up to a cap under (b) may make sense if it is difficult or not worthwhile setting an ex ante baseline.

4.9 We said that, in each case, cost recovery would be via adjustment to operating expenditure allowances and/or adjustment to the RAB (and in turn depreciation and rate of return allowances), depending on the mix of operating expenditure and capital expenditure in the relevant costs.

Stakeholder feedback

4.10 The Consumer Council made three proposals for the use of uncertainty mechanisms to allow for changes to SONI's price control funding:

- SONI should have to demonstrate that any changes are in consumers' interests and reflect consumers' requirements, and that only efficient additional costs are being allowed.
- There should be a process available to reduce as well as increase price control allowances.
- There should be clear accounting for the baseline and additional allowances and obligations, so that they can be properly reconciled at the end of the control period and any under-delivery accounted for in the subsequent control period.

4.11 The Consumer Council also suggested that SONI and the UR explicitly consider if there is a need for a specific focused re-opener relating to Covid-19 and/or Brexit.

4.12 SONI's response to our draft determination on uncertainty mechanisms was mainly focused on the arrangements in relation to funding what it called strategic initiatives.

4.13 SONI said that the draft determination highlighted that the (existing) Dt mechanism could be used to recover costs associated with strategic initiatives which crystallise during the price control period. On this, SONI said that:

- The Dt mechanism is asymmetric; costs expected to be recovered via the Dt mechanism would need to be priced through a premium for asymmetric risk of 3% based on the CMA framework.
- There is a need for additional protections under the Dt mechanism given risks associated with these projects as initial cost estimates are subject to change, and the timings for and scope of these initiatives could change in the course of the price control.
- Clarity and guidance around the process for inclusion of additional costs (e.g. changes to the cap under the Dt mechanism) would be useful in this regard. There may alternatively be scope for a band where the upper bound provides headroom, including contingency, rather than a hard cap given the nature of innovative strategic initiatives.

4.14 SONI said that it would expect that we would follow our published guidance on the Dt mechanism. SONI highlighted some extracts from the guidance that applies under the existing price control framework, and saw these as principles.[2]

4.15 SONI also said that, where costs are recovered through the Dt mechanism there is a risk that this could delay projects and reduce certainty and clarity for UR around the timing of delivery. SONI said that it would welcome further clarity and guidance from UR around the circumstances and conditions under which the Dt mechanism (rather than the conditional cost-sharing approach) would be used to recover costs.

Final determination on two types of uncertainty mechanisms available

4.16 We decided to adopt the approach to uncertainty mechanisms proposed in our draft determination and to update this for consistency with our final determination on the scope of conditional cost sharing incentives. This essentially means that we will have available two different types of uncertainty mechanisms (each covering the potential for both operating expenditure and capital expenditure adjustments):

- A provision to set increases to ex ante allowances which will then be subject to mechanistic cost sharing with 25% incentive rate (and generally accompanied by price control deliverables).
- A provision to allow remuneration of costs incurred up to a cap (with possibility to not set a cap if we consider this appropriate in specific circumstances).

4.17 For both mechanisms, and in line with the existing Dt provision, a materiality threshold of £40,000 will apply to any applications made by SONI.

[2] *Requirements and Guidance on Excluded SSS/TUoS costs: Exhibit 2 – Dt Guidance Document*

4.18 We clarify a number of aspects of our approach to these uncertainty mechanisms in the sub-sections that follow.

4.19 In addition, alongside our final determination, we have produced a draft guidance document, for consultation, for these two uncertainty mechanisms. This builds on the guidance for the 2015-20 price control period for the Dt mechanism, which SONI highlighted in its response to our draft determination.

4.20 We agree with the Consumer Council that there should be clear accounting for the baseline and additional allowances and obligations, so that they can be properly reconciled at the end of the control period and any under-delivery accounted for in the subsequent control period.

4.21 In addition, the Consumer Council said that SONI should have to demonstrate that any changes to allowances are in consumers' interests and reflect consumers' requirements, and that only efficient additional costs are being allowed. We generally agreed with this principle and considered that it would be incorporated into our approach and decision-making.

Further clarification: choice between two types of mechanism

4.22 There is a question of which of the two types of uncertainty mechanism above we would use.

4.23 To limit risks of distortions to SONI's incentives and cost reporting, our default position is that we will make the choice of mechanism in a manner which is consistent with the treatment of the broader category of costs which any additional costs fall under. For example, any increases to operating expenditure on SONI's system operation internal costs would as a default fall under the first approach above, which would allow alignment with the use of a 25% cost-sharing approach with the treatment of broader system operation internal costs.

4.24 However, we also decided that there was merit in allowing some flexibility to depart from this starting point. For instance, the approach of recovery of costs up to a cap may make sense if it is particularly difficult or not worthwhile overall setting an ex ante baseline for a specific new initiative. We expect this to be the exception.

Further clarification: price control deliverables and accountability

4.25 A key part of our approval process under the uncertainty mechanisms will be to ensure that there is sufficient accountability to be confident that SONI will deliver the proposed benefits from any additional allowance.

4.26 We generally expect to specify "price control deliverables" where uncertainty mechanisms are used to increase price control funding for SONI (whether by additional ex ante allowances or approvals for remuneration of costs incurred up to a cap). One exception to this approach to accountability is where the allowance is for the costs of additional obligations and SONI would not have discretion to avoid spending the additional costs claimed.

4.27 We set out in annex 2 how we will use price control deliverables more generally to ensure accountability, including their role within the evaluative performance framework and potential clawback of price control allowances in the event of non-delivery.

4.28 SONI's submissions for additional funding under uncertainty mechanisms should include proposed deliverables that meet the following requirements to ensure accountability for delivery:

- **Well-specified**: the submission should set out clearly what is to be delivered in practice, and/or how successful delivery would be measured, in order for delivery to be verified. This may require a significant amount of detail on the scope and quality of what is planned.

- **Time-bound**: the submission should contain clear dates for delivery, using milestones for initiatives which are to be delivered over several years.

Further clarification: increasing allowances for strategic initiatives

4.29 In its response to our draft determinations SONI said the process for increasing allowances for strategic initiatives (e.g. due to scope change) was not clear and that there is a need for additional protection given the risks around these uncertain strategic initiatives and the likelihood that the scope and costs could evolve over time.

4.30 We provide the following clarification on this matter for the case where we provide hypothecated funding for a new initiative on the basis of ex ante allowances subject to cost-sharing (rather than on the basis of remuneration of costs incurred up to a cap):

- The conditional cost-sharing approach will not apply to these costs and they will be subject to conventional cost sharing with 25% incentive rate.

- Our approach of ex ante allowances, and cost-sharing around them, recognises uncertainty in the level of costs required to deliver a new initiative. If we do not change the scope of price control deliverables/outputs that we set as part of our final determinations (or a subsequent uncertainty mechanism decision) there should be no expectation that increases in costs that SONI may incur should be subject to additional price control allowances (beyond the 75% cost sharing).

- We may decide, as part of our price control uncertainty mechanisms, to expand the scope of an existing initiative (e.g. to increase the quality of price control deliverables or to add further deliverables) and to provide increases to ex ante allowances to cover the efficient costs of the change in scope.

4.31 If we provide funding for new initiatives on the basis of costs remunerated up to a cap, we will have discretion to increase the cap (and the corresponding price control deliverables).

4.32 In addition to the arrangements above, it is possible that SONI could receive financial benefits from delivery that goes beyond the scope of price control deliverables via the financial rewards under the evaluative performance framework.

4.33 We would not consider the potential rewards under the evaluative framework a reason to reject otherwise strong submissions from SONI for additional funding under uncertainty mechanisms that are clearly in consumers' interests.

4.34 While the evaluative performance framework provides an opportunity, ex post, for SONI to receive increased revenue in respect of delivery that exceeds price control outcomes, we recognise that the outcome of the evaluation process is not possible to predict precisely and carries risk for SONI. We recognise that, from SONI's perspective, the evaluative performance framework is not a close substitute for ex ante regulatory approval.

Further clarification on interactions with conditional cost sharing

4.35 Some of SONI's comments, and requests for clarification and guidance on the uncertainty mechanisms concerned potential interactions with the conditional costs-sharing approach.

4.36 We have decided as follows: we would not consider the existence of the conditional cost-sharing approach as a reason to reject otherwise strong submissions from SONI for additional funding under uncertainty mechanisms that are clearly in consumers' interests.

4.37 While the use of the conditional cost-sharing approach provides an opportunity, ex post, for SONI to receive increased price control allowances for new initiatives that may improve overall outcomes, we recognise that this approach carries risk for SONI. We recognise that, from SONI's perspective, the conditional costs-sharing approach is not a close substitute for ex ante regulatory approval.

Further clarification: separation from evaluative framework processes

4.38 One area which we considered further for our final determinations concerns the interaction between the two uncertainty mechanisms above and the processes used for the evaluative performance framework.

4.39 In our draft determinations, we had envisaged that it might be possible to use a common set of processes for the consideration of any SONI requests for additional funding under price control uncertainty mechanisms as for stakeholder review of SONI's annual forward plan.

4.40 On further consideration, we were concerned that the timescales for approval decisions under uncertainty mechanisms might unduly delay processes around SONI's annual forward plan under the evaluative performance framework. We were also concerned about the potential for blurred responsibilities between the UR and the evaluation panel in relation to decisions and assessment in respect of requests from SONI for additional funding under uncertainty mechanisms.

4.41 We have decided for our final determinations that the uncertainty mechanisms should be applied through processes that are separate from the evaluative performance framework and that the decisions and assessment for these should be the sole responsibility of the UR.

4.42 Under this approach, where specific projects have already been approved under the uncertainty mechanisms, these may then feed into SONI's annual plan. But it is not the role of the forward plan to make the case for additional allowances under uncertainty mechanisms.

4.43 See Annex 2, and our draft guidance on the evaluative performance framework, for further discussion of how our decisions on uncertainty mechanisms may feed into the processes used for the evaluative performance framework.

Final determinations: potential uncertainty mechanisms to reduce allowances

4.44 We considered the suggestion from the Consumer Council that there should be a process available to reduce as well as increase price control allowances.

4.45 It is worth noting that the existing TSO licence conditions contain a change of law provision within the calculation of the revenue control. This provides a potential means for SONI's price control funding to be increased or decreased following the UR's assessment for the purposes of ensuring that the financial position and performance of the TSO is likely, so far as reasonably practicable, to be the same as if the relevant change of law had not taken place.

4.46 We did not propose to make any changes to this provision and have retained it for our final determinations.

4.47 We did not see the need to introduce any additional uncertainty mechanism to reduce SONI's price control allowances beyond the existing change of law provision.

4.48 The Consumer Council did not support its suggestion with examples of the factors that it would wish SONI's revenue allowances to be reduced for, or provide evidence of likely harm to consumers from the approach we had proposed.

4.49 Especially in the context of our overall approach to cost remuneration (including 25% incentive rate for cost-sharing which implies 75% cost pass-through to customers of any under-spend) we did not see the need for such a mechanism.

4.50 We were also concerned about compromising SONI's ability to plan its activities over the price control period if its ex ante allowances could be significantly reduced by decision of the regulator taken during the price control period.

Final determination on the need for a Covid-19 or Brexit re-opener

4.51 We considered the suggestion from the Consumer Council for a re-opener in relation to Covid-19 or Brexit. We decided that this was not necessary.

4.52 SONI is in a better position than the UR to know how its costs may be affected by Covid-19 and/or Brexit, but SONI has not put in a request for a specific re-opener for Covid-19 and/or Brexit.

4.53 Furthermore, the other price control uncertainty mechanisms included in our final determinations are sufficiently flexible to be able to allow for potential increases in costs that relate to Covid-19 and/or Brexit. In addition, as noted above, there is also the change of law provision.

Balance of ex ante funding and uncertainty mechanisms

Draft determinations

4.54 In our draft determinations, we said that we envisaged a price control framework for SONI in which we would be carrying out regulatory assessments (of need and cost) for initiatives proposed by SONI not just at the price control review, but also during the price control period.

4.55 We said that there is already a major role for within-period determinations under the current SONI price control (e.g. pre-construction projects, I-SEM implementation costs and Dt items). We said that our proposals on uncertainty mechanisms would provide significant flexibility to consider potential new initiatives during the price control period.

4.56 We added that a clear role for within-period cost assessment seemed well-suited in the context of SONI's business plan for the 2020-25 period. The plan contained a variety of initiatives that might bring net benefits to the system, but which seemed underdeveloped in areas such as the clarity on benefits/outputs and confidence on costing. We said that, in some cases SONI has simply not provided good enough evidence, but in other cases the lack of evidence also reflects the early stage in the development of an initiative. Rather than taking a binary decision on these projects at the price control review, we said that there was merit in enabling SONI to come back during the price control period with a more developed submission.

4.57 We recognised that we could become more engaged in cost assessment and approval processes during the price control review, but considered that this should be offset, to some degree at least, by the reduced risks to customers from making a decision based on underdeveloped information from SONI at the price control review, and by the benefits to SONI and customers from being able to make the case for new initiatives when better information on benefits and costs becomes available.

Stakeholder feedback

4.58 A number of stakeholders made submissions concerning the balance between ex ante funding for new initiatives set at the price control review, and the use of uncertainty mechanisms during the price control period

4.59 SONI's response argued that our draft determination provided too little upfront funding for new initiatives, relying too much on uncertainty mechanisms during the price control period, and that it is consumers who are harmed by delays to approval for new initiatives that can add value for consumers. SONI raised concerns about the use of uncertainty mechanisms impairing planning and management through optimisation, risking inefficiencies (e.g. through stop start on projects) and impeding comprehensive economic appraisals.

4.60 SONI said that our draft determinations does not strike the right balance between (i) setting ex ante cost allowances and (ii) ex post review and use of uncertainty mechanisms, which will encourage SONI to minimise costs, delay investment and adopt risk averse behaviours which are not in the consumer interest.

4.61 SONI said that costs should be provided for ex-ante where possible, to provide clarity and greater certainty around cost recovery and avoid a stop start process for cost adjustments, and to make clear the regulatory contract.

4.62 Some other stakeholders (e.g. renewable generators) also raised concerns about too little funding for new initiatives provided upfront in the draft determinations and the emphasis on uncertainty mechanisms:

- RES stated that, in principle, it supports the use of uncertainty mechanism as a means of offering value for money to the Northern Ireland consumer whilst permitting flexibility to allow SONI to make investments when the time is right. However, RES raised concerned that our draft determinations would place an over reliance on uncertainty mechanisms risking delay of delivery new renewable and flexibility projects that are critical to setting the path towards net zero.

- Business Alliance said that it was concerned that much of what needs to be done is likely to be addressed through a process of project approvals during the price control period that is likely to unnecessarily delay projects at the risk of foregoing consumer and environmental value. It said that greater clarity is needed at the outset as to the level of initiatives to be undertaken, to ensure the business can invest in advance in the staff needed to manage the initiatives and related risk.

- NIREG said that while appreciating that there are proposed measures to allow for cost adjustments during the price control period, it would be concerned that this could introduce delays or uncertainty to programmes that are essential for further renewable integration and would dampen investment signals for renewable generators in Northern Ireland.

Final determination position

4.63 To a large extent the stakeholder feedback above concerns the specific funding decisions that we make in our final determinations in relation to SONI's proposed new initiatives, which are addressed separately in Annex 4.

4.64 We are not seeking to determine the exact balance between ex ante funding and the use of uncertainty mechanisms within the approach set out in this annex. We consider that the nature of SONI's role, and the broader energy system context, mean that we should have uncertainty mechanisms available to approve additional funding during the price control period. But we do not have a policy position on what proportion of the costs of new initiatives should be allowed upfront rather than (expected to be) funded during the price control period. This will reflect the wider circumstances in which SONI operates, the nature of the opportunities available to it at a given point in time, the outcome of our cost assessment process and the quality of SONI's business plan and further submissions.

4.65 Further to this, we make some broader points of principle which we consider to be reflective of our overall approach to the final determinations.

4.66 In reaching a position on what specific initiatives to allow funding for in our final determination, rather than leaving to uncertainty mechanisms during the period, we recognised that there could be potential harm to consumers from factors such as: (a) delays to new initiatives that could benefit consumers; and (b) potential inefficiencies in delivery from not approving as much funding upfront. We considered any evidence provided by SONI on these matters and these risks more generally.

4.67 It is also important that to take account of the benefits of leaving approval for some initiatives to a point during the price control period, especially in a context of uncertainty and evolving opportunities. In particular:

- Even after the refinements and further submissions SONI made following our draft determinations, a number of SONI's proposals seemed insufficiently well-developed and thought out. Not only can further development of proposals improve the reliability of SONI's costings but, perhaps more importantly, it can help improve the extent to which the project is planned in a way that reaps the full opportunities available for consumers and is well-aligned with stakeholder expectations and requirements.

- We expect that, during the price control period, the evaluative performance framework that we are introducing for the 2020-25 period will bring benefits by better aligning SONIs proposals for new initiatives with the desired outcomes and stakeholder expectations. While the funding decisions under uncertainty mechanisms will be a matter for the UR to decide on, SONI will have potential financial reward under the evaluative framework if during the period it gains approval for projects that the evaluation panel consider to be ambitious and well-aligned with our strategic priorities and stakeholder views.

- Over the longer term, we consider that it is in consumers' interests for the regulatory framework to encourage regulated monopolies such as SONI, when making submissions for additional funding from customers, to provide good evidence and supporting analysis as part of their submissions. The incentives for SONI to do so would be reduced if we meet SONI's funding requests despite some of the poor-quality submissions it has provided to us.

4.68 More generally, we made clear in our approach to the TSO price control (March

2019) that SONI should be accountable for the quality of its business plan. Our view is that this accountability means that, rather than making general comments about the balance of ex ante funding, SONI should respond with evidence that is specific to the projects it is seeking funding for and with specific improvements to its project proposals and specifications to address our reasonable concerns.

Treatment of licence fees, ENTSO-E and CORES costs

Recap of draft determination

4.69 In our draft determinations, we proposed to set ex ante allowances for SONI's licence fees payable to the UR (as well as for ENTSO-E and CORES membership). This was a change for the existing approach under which these are remunerated via the Dt uncertainty mechanism, effectively on a cost pass-through basis.

4.70 We said that these costs were relatively uncontrollable but predictable: This approach would also avoid the need to submit/review costs within the annual uncertainty mechanism processes.

Stakeholder feedback

4.71 SONI said that it was relatively comfortable with the approach to allowance for licence fees, ENTSO-E and CORESO membership within our draft determinations, adding as long as these remain constant the recovery under this mechanism makes sense. SONI added that, ideally such costs would be pass through for SONI as it has no control over these.

4.72 SONI also said that, should there be any significant changes to these costs SONI, or additional costs relating to ENTSO-E that have been incurred since the Draft Determination, SONI would request that the Dt mechanism for recovery of material costs remain available.

4.73 NIE Networks referred to the draft determination proposal for ex ante allowance for some uncontrollable but predictable costs such as licence fees and says that it considered it best regulatory practice to provide allowances for uncontrollable costs on a pass-through basis.

Final determination position

4.74 We decided to retain the approach from our draft determinations.

4.75 This is subject to clarification that SONI will be able to make a submission for additional allowances under the Dt uncertainty mechanism in the event of material cost increases. We will consider any such submission on its merits and in line with any applicable regulatory guidance. Any such submission would need to exceed the materiality threshold.

4.76 We disagreed with NIE Network's view that it is best regulatory practice to provide allowances for uncontrollable costs on a pass-through basis. This seemed an over-simplification. The controllability of costs is one consideration. There are other considerations, such as the materiality of the uncertainty and risk if a pass-through approach is not used, the complexity of the overall price control framework, and the need for proportionality (including in the use of regulatory review processes during the price control period).

4.77 NIE Networks' interest in this aspect of our draft determinations may reflect its views on how licence fees and similar costs should be treated under the price control frameworks it faces. We have no intention that the approach we used for the TSO price control should be binding on our subsequent price control decisions, especially where there may be differences in the context and other factors.