SONI Consultation Response
Price Control 2020-25
UR Draft Determination
Executive Summary

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The 2020-25 period is critical for the energy transition in Northern Ireland and SONI has a vital role to play.

Northern Ireland will need to deliver its share of greenhouse gas emission reductions as part of the UK's legal commitment to net zero emissions by 2050. To deliver what is necessary, the energy sector will go through a period of widespread, disruptive change. As such, the 2020-25 period is a critical one for the energy sector in Northern Ireland if it is to be ready to facilitate the energy transition.

SONI's role is pivotal for transforming the power system and delivering strategic outcomes such as 70% of our energy from renewables by 2030. We are at the heart of the system with responsibilities for planning the transmission network; power system operation and electricity markets.

It is critical given SONI's role in the transformation of the sector that the regulatory framework provides adequate allowances upfront for delivery of core objectives and strategic initiatives to ensure that SONI can recover efficient costs in the base case:

- Ex ante allowances provide clarity and greater certainty around cost recovery and are a pre-condition for a financeable framework for SONI.
- A clear regulatory framework which defines the mechanisms for cost recovery (particularly where there is uncertainty around the timing and scope of certain initiatives required to deliver strategic outcomes) and specifies ex ante how incentives will reflect SONI's performance are core components of a complete regulatory contract for SONI.

The regulatory contract will not be complete and SONI business will not be financeable in the absence of (1) adequate allowances; (2) well specified uncertainty mechanisms for cost recovery; and (3) a clearly defined incentive framework.

The Draft Determination for PC 2020-25 does not meet these criteria and as a result the SONI business is not financeable. SONI's financeability is undermined by the fact that UR's proposed allowances are unachievable for SONI to deliver the expected outputs, and do not provide ex ante allowances for costs required to deliver core objectives, obligations and strategic outcomes. This means that SONI would have to assume underperformance in the base case. No reasonable investor would invest in business activities that are expected to generate losses on this basis.

We respond to the Draft Determination for Price Control 2020-2025, which the Utility Regulator (UR) published on 6th July 2020, in this context.

Financeability

There are fundamental aspects of UR's Draft Determination that SONI cannot accept because they would significantly undermine its financeability and its ability to deliver for customers.

SONI is not financeable based on the financial projections implied by the Draft Determination, given the company's characteristics, business activities and risk exposure, for the following reasons:

- The cost of capital allowance proposed by the UR for SONI is not consistent with market benchmarks, corporate finance theory and practice, and regulatory precedent.
- Important components of the capital committed to the business, as well as risks associated with this capital, are not recognised and remunerated.
- The overall level of expected profitability implied by the Draft Determination is not consistent with the minimum thresholds required for debt and equity financeability – as implied by relevant market benchmarks.
- The risk exposure implied by the Draft Determination proposals is not consistent with financial returns available to SONI for mitigation and management of risk and volatility.

The issues in the Draft Determination are predominantly driven by (1) material departures and mis-interpretations of the principles required for financeability established by the Competition and Markets Authority (CMA), as well as material omissions from the CMA framework; (2) flaws and inconsistencies in the proposed methodology for estimating the cost of capital; (3) limited and inadequate financeability assessment, which does not consider the implications of key changes to SONI's risk exposure for SONI's financial position.

The Draft Determination materially departs from the financeable framework established by the CMA and contains material omissions

In order to address the non-financeability of SONI based on the UR's PC2015-20 determination, the CMA established a framework for SONI by considering the total capital employed and committed to the business, its specific business characteristics and risk drivers, and considering financeability of the business 'in the round'.

The CMA decision provides the benchmark as to what constitutes a financeable regulatory determination for SONI. It is disappointing that in this, the next available determination, the UR has not proposed to adhere to this framework. Indeed, the very act of amending the framework in itself gives rise to uncertainty for SONI and its investors.

The Draft Determination has departed from the CMA framework in four key areas:

- **Parent Company Guarantee (PCG)**: the UR has not recognised the claim on equity capital to manage risks reflected in the £10m PCG.
- **Collection agent margin**: the UR has not appropriately analysed and, as a result of that, not remunerated the risks associated with the collection agent role.
- **Operational gearing adjustment**: the UR has not appropriately reflected the impact of operational gearing on the cost of capital through the adjustment to beta, which formed a key component of the overall framework at the CMA.
- **Asymmetric risk:** material costs for strategic initiatives could be recovered via uncertainty mechanisms such as the Dt mechanism, however these costs are not priced in.

There are fundamental issues with the UR's methodologies for estimating certain cost of capital parameters. Collectively, these flaws and inconsistencies in the methodology set out in the Draft Determination result in a material reduction in remuneration on RAB capital which in turn undermines SONI's financeability:

- **Cost of capital – notional gearing:** arbitrary and artificial changes to the assumption about notional gearing for RAB capital are assumed to reduce the cost of capital, remove the requirement for the PCG, and enhance SONI's ability to manage risks. This approach is inconsistent with CMA, which did not adopt lower notional gearing to address financeability constraints.
- **Cost of capital – small company premium:** failure to recognise a Small Company Premium for SONI means that investors cannot expect to earn their required cost of capital.
- **Cost of capital – transaction costs:** material transaction costs faced by SONI are not recognised under the Draft Determination.

The UR's financeability assessment is limited and inadequate and does not consider the implications of key changes to SONI's risk exposure for SONI's financial position:

- SONI's overall risk exposure is expected to increase materially in the forthcoming price control due to new risks relating to the evaluative performance framework, increased volatility of collection agent income and costs and uncertainty around the scope, timing and recovery of costs required to deliver SONI's strategic objectives. The risks and uncertainties mentioned above are not captured by UR's financeability assessment.
- UR has not given proper consideration as to SONI's financial resilience in the event plausible downside shocks occurred.
- UR has failed to conduct an adequate assessment of SONI's financeability given its limited focus on applying financial ratio and RORE tests to RAB investments.
- UR has not considered an overall cross-check on allowed returns based on total profitability (such as EBIT margins) and as a result has not carried out meaningful analysis of equity financeability.

Overall and for the reasons outlined above, SONI could not accept the Draft Determination proposals as they would lock-in methodologies that depart from the financeable framework set out by CMA for SONI, result in a material under-estimate of allowed returns, would not take into account the increase in risks for SONI, and would significantly impair SONI's financeability and its ability to deliver for customers.

Funding for Business as Usual and Delivering a Future Energy System

Business as Usual Costs

UR's allowances are unachievable for SONI, which does not provide ex ante allowances for costs required to deliver core objectives, under-prices cost trends such as non-labour RPEs and effectively means that SONI would have to assume underperformance in the base case. This exacerbates the financeability issues above.

Table 1.1: Shortfall in funding for Business as Usual costs

Area	Shortfall (per annum) £m	Comments
I-SEM costs	£1.3m	Enduring costs relating to Capacity Market activities following the introduction of the new I-SEM are not funded
Other baseline costs	£1.0 m	Shortfall in funding relating to payroll recharges from the Group and other staff costs driven by differences in average FTE
Pension deficit repair costs	£0.3m	Pension deficit repair costs, which are assumed in the Draft Determination to be recovered over a 10 year period. This does not match the 7 year contribution period which aligns with the Pension Regulator and best practice and as agreed with the Trustees.
Cost trends	£0.4 m	The Draft Determination does not provide for adequate operating costs for cost trends such as non labour real price effects, whilst at the same time assuming a step change in ongoing productivity based upon a flawed analysis of the potential for capital substitution.

Failing to address these – which equate to a shortfall in funding of £3.0m per annum – would be a serious issue and would introduce errors into the Final Determination (FD) that could materially affect delivery for customers and financeability.

SONI notes that it has had very positive discussions with the UR in the time since the Draft Determination and is confident that this gap can be closed.

Delivering a Future Energy System

The UR has only provided certainty of funding for 13% of the money that SONI will need to invest to ensure that we are able to deliver the strategic initiatives that are necessary out to 2025. This is not sufficient to commence this ambitious and essential programme with any certainty.

If the substantial shortfall in funding is not reversed, SONI will not be able to shape the direction of investments that impact across the island, and will therefore not be able to represent the interests of Northern Ireland consumers:

- The very low level of funding for strategic initiatives will prevent SONI from analysing and developing a whole system vision and accompanying pathways for change. We will not be in a position to effectively collaborate, co-ordinate views so as to inform, support, shape and implement the out workings of the Department for the Economy's Energy Strategy for Northern Ireland.
- Without certainty of funding SONI is not able to recruit and develop the skills that are necessary to support the transition to a green economy in Northern Ireland and will have limited ability to influence all-island procurement exercises.
- The Northern Ireland Executive has highlighted the importance of the green economy for our recovery from the current recession. The funding and mechanisms proposed in

the Draft Determination would deter investment in renewable generation and supporting technologies in Northern Ireland.

- The Draft Determination introduces unnecessary risks to the security of the transmission system. Without funding for critical projects like a replacement for the Disaster Recovery Site, cyber security enhancements or physical security, SONI will not be able to provide the level of robustness necessary to mitigate threats and risks.

Table 1.2: Shortfall in Funding for Delivering a Future Energy System

Area of Strategic Imitative Investment	Amount Requested	Amount Allowed		Comments
		£m	%	
Business as Usual (incl. Telecoms)	£18.9 m	£16.5 m	87%	Essential items are currently not funded
Strategic Initiatives				
Sustainability and Decarbonisation	£14.0 m	£3.9 m	28%	This would result in unnecessary carbon emissions and inhibit NI's transition to a green economy
Maintain, Operate and Enhance the Grid & Market	£13.3 m	£0.1 m	1%	This would have serious consequences for the cost and security of electricity in NI, if it continues to the Final Determination
Partnership & Engagement	£4.0 m	£0.0 m	0%	The Draft Determination reduces NI's ability to attract investment in renewable generation and the supporting technologies. SONI has updated some items requested here to address the feedback from UR and the SECG.

Cost Recovery Mechanisms

UR has proposed changes to the cost recovery mechanisms in the Draft Determination, regarding which SONI has significant concerns:

- **The new Conditional Cost Sharing (CCS) is likely to result in asymmetric outcomes:** There are fundamental problems with the new conditional cost sharing mechanism, which could result in very asymmetric outcomes and result in increased uncertainty as the parameters of cost sharing can change ex post providing no clear framework up front.
- **Lack of clear ex ante specification of CCS and incomplete regulatory contract:** There is limited guidance as to how conditional cost sharing and the ex post review will work – this lack of clarity and specification means that the regulatory contract is incomplete and materially increases uncertainty and risk for SONI around cost recovery. SONI requires clear guidance as to how the CCS will be applied in practice to limit exposure to asymmetric risk.
- **Scale of ex post review and uncertainty mechanisms implied by the Draft Determination does not incentivise the right behaviours:** UR recognises in its Draft Determination that SONI's costs are minimal compared to the value that can be

unlocked for customers. However as it stands the Draft Determination does not strike the right balance between (1) setting ex ante cost allowances and (2) 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.

- **Application of ex post review with the benefit of hindsight for strategic initiatives could encourage risk averse behaviour and undermine financeability:** SONI's strategic initiatives represent innovative, first-of-a-kind projects which could result in costs which ex post and with the benefit of hindsight could appear unnecessary but which ex ante were reasonable and appropriate. 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.
- **Process for increasing allowances for strategic initiatives e.g. due to scope change is not clear:** Additional clarity and guidance around the process for requesting additional costs is critical to avoid delay and support recovery of efficient costs and support the flexibility and agility of SONI's investment decisions for PC 2020-25.

SONI has engaged extensively with UR on these issues across three workshops and welcomes UR's commitment to develop additional guidance and provide further clarity to address SONI's concerns.

Evaluative Performance Framework

SONI is supportive of and included a proposal for an evaluative performance framework in its business plan, however we have a number of key concerns with the Draft Determination proposals:

- **Lack of clear ex ante specification around what good looks like and incomplete regulatory contract:** There is no clarity as to what good looks like associated with the UR evaluative performance framework. As a result the independent assessment panel has no ex ante baseline or benchmark against which to assess outturn SONI performance. This increases exposure to subjective outcomes and regulatory discretion and could result in ex post 'with the benefit of hindsight' assessments of performance. This lack of clarity will fail to incentivise the right behaviours in SONI and maximise outcomes for consumers.
- **Upside potential is not meaningful, achievable in practice or proportionate to customer benefits.** There is no a clear link between the customer benefits delivered by SONI and the potential level of reward under the evaluative framework, which results in misalignment of incentives. Value add for customers significantly outweighs costs of the incentives to customers (the potential value add is a different order of magnitude as recognised by UR in the Draft Determination), however this is not reflected in the calibration of potential upside, which moreover UR has indicated that SONI is unlikely to achieve in practice.
- **Complexity of the performance framework is likely to dilute incentives**. The UR proposes a symmetrical +/- £1m penalty and reward as part of its framework, however

the strength of the reward incentive is diluted when accounting for weighting allocations proposed by the UR across its 16 assessment categories. This will discourage right behaviours and increase administrative burden.

- **Inconsistency with recent regulatory precedent, which provides higher upside than downside potential to encourage focus on output incentives**, for example the NG ESO or EirGrid TSO incentive frameworks Which recognise the importance of a strong upside which in the case of Ofgem apply a 1:2.5 ratio for penalty and rewards.
- **Calibration of downside exposure (£1m collar) is not consistent with financeability.** The level of the collar is set not against the backdrop of the stability of the CMA framework and places greater downside risk upon the SONI business than SONI can bear (for example SONI does not have the PCG to call upon should the maximum downside eventuate). The level of subjectivity and discretion within the framework reduces SONI's ability to take actions necessary to manage the risk in relation to significantly adverse outcomes.

Potential Consequences of the Draft Determination

Significant shortfalls in costs will limit the ability of SONI to deliver a level of service which the industry will expect of it at a time of significant change and development.

Insufficient ex-ante allowances will result in a failure to deliver core objectives and give rise to risks that strategic and other projects will not be undertaken or will be delayed to customer detriment, impair planning and management through optimisation and risk inefficiencies (e.g. through stop start on projects). The delivery of strategic objectives in line with changing risk circumstances and customers' needs will be hindered by more piecemeal agreement of activities and granular assessment of costs and deliverables.

Cost recovery mechanisms if miscalibrated will dampen incentives to proactively address issues before they arise, encourage a "wait and see" approach and risk averse behaviours.

Where there is a lack of detail around how key mechanisms will function in practice this could have a significant adverse impact on SONI's ability to manage its business activities, since it will not provide a transparent link between management action, customer outcomes and allowed revenue.

When combined with a subjective and complex evaluative performance framework SONI is not incentivised to do the right thing at the right time based on the Draft Determination.

Overall the material under-provision of costs, lack of clarity and specification around cost recovery mechanisms and uncertainty around outcomes from the new evaluative performance framework increases risk and effectively means that SONI would have to assume underperformance in the base case. No reasonable investor would invest in business activities that are expected to generate losses on this basis as a result of required spend being greater than the business revenue potential under the Draft Determination.

Adjustments Required to the Draft Determination

The final determination for SONI must provide:

- Provision of efficient Business As Usual operating costs associated with the conduct by SONI of those activities it is obliged to carry out. This will ensure that the business does not incur an expected loss.
- Ex ante funding for strategic initiatives required to deliver a future energy system based on additional evidence provided in response to UR queries and requests.
- Clear specification of mechanisms for cost recovery, including conditional cost sharing, to ensure that the regulatory contract is complete and the business is financeable. This should include guidance and codification around how these mechanisms will work in practice.
- Adjustments to the evaluative framework which reduce subjectivity and risk to specify what good looks like on an ex ante basis, provide meaningful upside that is achievable in practice and support financeability.
- A financeable business with adequate remuneration of layers of capital which are required to be employed in the business and risk exposure. This should be based on the financeable framework carefully calibrated by the CMA:
    - Remuneration for the equity capital reflected in the PCG of at least 1.75%
    - Collection agent margin of at least 0.5% applied to those elements of SONI's collection agent role consistent with the framework adopted by the CMA
    - Premium applied to all costs expected to be exposed to asymmetric risk
    - Asset beta of at least 0.59 to reflect SONI's high operational gearing
- The final determination must recognise and provide for the cost of capital including appropriate calibration of notional gearing and beta, the small company premium and transaction costs.
- Total profitability consistent with market benchmarks and levels that would attract investor capital the business.
- An assessment of SONI financeability on an overall basis.