SONI Consultation Response
Price Control 2020-25
UR Draft Determination

Main Response Document

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Executive Summary

Executive Summary

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.

Chapter 1

Overview of SONI Response

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1 Overview of SONI Response

1.1 Introduction

1.1. SONI welcomes this opportunity to respond to the Utility Regulator's (UR's) Draft Determination on the SONI Business Plan submission which detailed the funding requirements for SONI over the five years from October 2020 to September 2025. The UR's Final Determination setting out funding levels for SONI is scheduled to be published on 18 November 2020.

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

1.3. SONI fulfils an essential and absolutely critical role, and the capability and financeability of the SONI business is central to the wider Northern Ireland economy and community.

1.4. The period 2015 to 2020 met the challenge of providing 40% of our electricity needs from renewable sources. This realised some 1,600MW of energy from renewable sources being accommodated on the system. This period also saw SONI become a world leader in achieving 65% of non-synchronous penetration of wind on the system at any one time. This period delivered a newly designed and integrated Single Electricity Market (ISEM) compliant with pan European trading. This in effect introduced a more competitive market with real time trading of electricity on the island of Ireland and across the interconnectors. This has resulted in downward pressure on electricity prices.

1.5. The period of this Price Control 2020-2025 must realise even greater change if we are to fulfil our purpose of transforming the power system for future generations and play our part in realising a trajectory to net zero carbon by 2050.

1.6. SONI has a central role in delivering the transformation of the power system which will need to be operated in a more dynamic and responsive way. This will require an end-to-end solution incorporating user experience, as well as improvements to infrastructure, power system operational practices, and market design and operation. SONI is committed to realising the full benefits of this transformation for consumers through enabling the opportunities for the Northern Ireland economy in striving to have all of our energy needs met from renewable and low carbon energy sources. In this price control SONI are challenging itself to be in a position to deliver up to 70% (or as otherwise advised upon finalisation of the NI Energy Strategy) of our energy from renewables by 2030 accompanied by 95% of non-synchronous penetration of wind on the system at any one time.

1.7. SONI's actions influence investment decisions and markets worth billions of pounds and it is therefore crucial that this price control ensures the right outcomes for Northern Ireland consumers. It is critical that the price control incentivises the right behaviours and more than ever encourages and supports SONI to be innovative. This is essential if SONI is to go after the much greater value for consumers it is capable of rather than have its primary focus on short-term cost reduction to ensure expenditure is within ex ante allowances.

1.8. The SONI Price Control allowance and regulatory framework must ensure the right outcomes for Northern Ireland consumers through the provision of:

- An overall package that will ensure that SONI is financeable and that its financeability is sustainable;
- Adequate operating revenue to allow SONI to maintain a safe, secure and reliable supply of electricity and that will enable SONI to respond flexibly to the needs of the industry;
- Adequate funding for strategic initiatives and innovation to realise a trajectory towards net zero by 2050 with circa 95% of renewables on the system at any one time; and
- A regulatory framework which protects consumers ensuring that SONI is facilitated to strive for maximum benefit for consumers by a regulatory framework which incentivises the right behaviours and supports innovation through this period of significant transformation of the industry.

1.9. In this context, SONI has a number of fundamental concerns with the proposals as set out in the Utility Regulator's Draft Determination consultation paper. There are significant gaps in all areas between the SONI business plan submission and the UR's proposals.

- First and foremost the draft determination proposals do not render SONI financeable. SONI is most concerned by the UR's departure from the CMA determination and framework that addressed the non-financeability of SONI for the 2015-2020 Price Control and which was the subject of much detailed consideration.
- Secondly, the imposition of significant reductions in allowances for operational costs which will limit the ability of SONI to deliver a core level of service never mind the level of engagement which the regulator itself and industry will expect and require of it at a time of significant change and development.
- Thirdly, if the very low level of funding for strategic initiatives persists, it will prevent SONI from developing a vision and subsequently defining and giving effect to pathways for the change required to facilitate the energy transition. This in turn will prevent SONI from collaborating and co-ordinating views and perspectives from key partners and stakeholders, something again that the UR states it wants us to do. We simply will not realise the pace of change necessary over this critical period to deliver net zero by 2050.
- Fourthly the UR has developed the regulatory framework for this Price Control which introduces new safeguards for customers and incentivises SONI to focus on wider outcomes instead of its internal cost base. While we welcome the introduction of an evaluation performance framework we are concerned that it fails to focus on strategic outcomes, is overly complicated and burdensome. In addition the framework gives rise to a level of increased risk to the SONI business, risk which is not elsewhere compensated or accounted for. With this framework, together with additional measures to manage costs, we are surprised that the UR has taken such a conservative

approach to the assessment of our business plan, which may be perceived as controlling.

1.10. The Final Determination must recognise a significant step change and reflect the increasing importance and criticality of the role that SONI fulfils in Northern Ireland.

1.11. This response relates to business conditions that pertained when we made our submission, which was before the Covid-19 pandemic. We expect any adverse resultant implications and impacts to be within the scope of uncertainty mechanisms and that DIWE will also be assessed on that basis.

1.12. Given recent developments in the Brexit process, we would reiterate that both our business plan submission and this response to the Draft Determination assume that EU law and all associated provisions remain in force in Northern Ireland for the duration of this price control. Any change to this situation would require a significant review of our funding.

1.13. Both our Business Plan and this response to the Draft Determination assume the status quo regarding the continued realisation of synergies arising from and integrated working within the EirGrid Group Structure.

1.14. We note in the Draft Determination that it was the UR's stated intention to publish its consultation on SONI governance in July so that it could be considered alongside the price control draft determination. It was furthermore stated that the URs proposals for cost allowances, and risk and return did not take account of any future governance changes that the UR may propose. It also stated that, to the extent that your governance proposals do have an impact in these areas, you would set this impact out in the consultation on governance. SONI notes that at that time, UR envisaged that decisions on the price control and governance would be taken together in November.

1.15. As there has been no publication to date of the URs governance consultation, both our business plan and response to the Draft Determination reflect no change in this regard for SONI. Any additional costs that may arise from the outcome of the governance review, will if required be the subject of a supplementary cost submission.

1.1.1 SONI – UR Engagement

1.16. SONI submitted its business plan to the Utility Regulator on the 31 October 2019 and received the draft determination on the 6 July 2020. There was very limited engagement during this eight month period. This led to a number of surprises for SONI within the Draft Determination, a move away for the CMA methodology for determining SONI's financeability; proposed changes to aspects of roles between SONI and NIE Networks and sight for the first time of the UR proposals for an Evaluative Performance Framework.

1.17. Over the ten week period between receipt of the draft determination and close of the consultation on the 14 September, the UR has accommodated a level of engagement to enable both parties to understand and explore the other's position and concerns for which we are grateful. SONI proposed a number of workshops and meetings, which has resulted in a total of 13 events over the consultation period. The workshops focused on financeability, funding for SONI's core remit (Business as Usual) and strategic initiatives.

1.18. Engagement has also focused on the UR's proposed Evaluative Performance Framework. We appreciate the UR's commitment to continue to engage with us on this, post the Draft Determination response, with a view to ensuring that its final form is proportionate, effective in incentivising the right behaviours and delivers measureable outcomes for consumers.

1.19. We believe, as reflected in the body of this report, that this engagement has been important and beneficial for both parties. It has clarified misunderstandings and enabled SONI to hone additional information requirements and to explain in some cases why such information cannot be provided at this time.

1.2 Structure of SONI's Response

1.20. The main document of our response is structured into seven chapters:

- **Executive Summary** – This highlights the key issues and concerns we have with the UR Draft Determination.
- **Chapter 1** – This introductory chapter provides an overview of SONI's response and reflects on the level of engagement which took place with the regulator between the submissions of our business plan on 31st October 2019 to the submission of this response on 14th September 2020.
- **Chapter 2** – Given the criticality of this price control period for setting the trajectory for achieving net zero by 2050, we outline the strategic context both in terms of the developing Northern Ireland Energy Strategy and SONI's own strategy for the same period. We also relay our concern regarding the limited level of ex ante funding (13%) provided for our strategic initiatives.
- **Chapter 3** – This chapter discusses the Evaluative Performance Framework proposed by the UR in its Draft Determination and compares aspects of it with the Benefits Sharing Framework proposed by SONI in its business plan submission. It hones in on keys aspects for success, and discusses areas for further engagement and development with the Utility Regulator which SONI welcomes.
- **Chapter 4** – Given the importance of this period for SONI in facilitating the energy transition and in doing so ensuring that Northern Ireland benefits from associated economic opportunities, we have dedicated a chapter to cost recovery mechanisms. This is to ensure that the regulatory framework encourages SONI to be proactive and forward looking, not risk adverse with a dominant focus on living within ex ante allowances or being micro managed.
- **Chapter 5** – There is currently a significant gap in Business as Usual funding provided in the Draft Determination and SONI's Business Plan submission. However, SONI has had very positive discussions with the UR in the time since the Draft Determination was published and sets out in this chapter the additional information discussed to help clarify our submission and enable the UR to make informed decisions in the Final Determination.
- **Chapter 6** – There is currently a significant shortfall in funding for strategic initiatives provided in the Draft Determination, the need for which the UR accepts in many cases.

This chapter addresses the UR's concern that we are not taking a whole system approach; elaborates on our partnership working with NIE Networks. It also sets out our proposed approach to digitalisation and customer stakeholder strategies. It also fundamentally focuses on the additional evidence sought by the UR for individual initiatives where we are able to provide such information, much of which is included in appendices.

- **Chapter 7** – This chapter considers the overall financeability of SONI. It is SONI's view that the proposals within the Draft Determination would not render SONI financeable. It discusses and elaborates on the flaws within the UR approach to, and departure from, the CMA principles which determined a holistic approach for SONI's financeability in 2017 for the 2015-2020 price control.

1.21. Given the emphasis placed on providing the necessary evidence to the Regulator to further support the funding sought in our business plan, annexes for many of the chapters are also included.

Chapter 2
Criticality of 2020-2025 for Achieving Net Zero

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2 Criticality of 2020-25 for Achieving Net Zero by 2050

2.1 Key Messages

2.1. 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. 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.

2.2. While the Department of the Economy is in the process of developing a new energy strategy for Northern Ireland, it is not expected to be published until late 2021. The existing 2020 target of 40% of electricity from renewable sources, which has been met in Northern Ireland, is certain to be increased as part of the new energy strategy. The work that SONI needs to do to prepare the network for the energy transition remains the same, regardless of the exact target for 2030.

2.3. While meeting these targets is critical for tackling the climate emergency, there are also important implications for the economic growth and development of Northern Ireland. In order to attract investment, Northern Ireland has to be equally competitive as neighbouring markets in Great Britain and the Republic of Ireland. Currently it is at a disadvantage due to the lack an energy strategy and absence of a support scheme for renewables.

2.4. The UR's Draft Determination does not provide SONI with the funding it needs in order to take the necessary steps, together with the Irish TSO as part of the all-island network, to facilitate the network and market changes needed to deliver 2030 targets. Only 13% of the requested funding for strategic initiatives was provided in the Draft Determination. If this funding shortfall is not addressed, it will have significant consequences for Northern Ireland and its ability to deliver its share of the UK's net zero commitment, as well as for the economic wellbeing of the country.

2.2 NI Energy Strategy and SONI Strategy for 2020-2025

2.5. On 27 June 2019, the UK put into law a commitment to cease its contribution to global warming by 2050. The law enacted the recommendations made in the Climate Change Committee report published in May 2019[1]. In practice, it means reaching a target of net zero greenhouse gas emissions by 2050 and all regions of the UK, including Northern Ireland will be required to contribute to the achievement of this goal.

2.6. The period from 2020-2025 is a critical one if Northern Ireland is to deliver its portion of greenhouse gas reductions to meet the UK goals. The context for energy has changed significantly since the development of the Strategic Energy Framework in 2010. Northern Ireland has been operating in a policy vacuum with no energy policy beyond 2020 and the

[1] https://www.theccc.org.uk/publication/net-zero-the-uks-contribution-to-stopping-global-warming/

support schemes for renewable energy projects have closed. As a result, the number of renewable energy projects connecting to the system has plateaued and the country will need to act swiftly if it is committed to delivering its contribution to net zero by 2050.

2.7. The Department of the Economy (DfE) is in the process of developing a new energy strategy for Northern Ireland, which will be published by the end of 2021. In developing an Energy Strategy, DfE is taking a holistic view of the power system and considering all possibilities in the development of its policy. It is certain that the target for renewable energy on the system will be increased from the 2020 target of 40% which has been achieved. It is also probable that this target will align with that of other regions of the UK (2030 targets are 100% in Scotland, 70% Wales, and 75% for the entirety of the UK) and the Republic of Ireland target of 70%. There is also a logic to aligning the targets in Northern Ireland and the Republic of Ireland, as for the previous 40% target, given the context of the all island Single Electricity Market (SEM).

2.8. The new strategy will look beyond the power system to consider how heat and transport can reduce their emissions, the expectation being that these sectors will look largely to renewable electricity to reduce their carbon footprint. The DfE is progressing this work through five thematic working groups of which the power system is one. SONI's work on Tomorrow's Energy Scenarios[2] is informing the development of the NI Energy Strategy through the development of three credible energy scenarios for reaching 60%, 70% and 80% of our electricity from renewable sources. In conjunction with the electrification of these sectors, the use of emerging technologies, such as the production of renewable hydrogen fuels for sectors that are typically hard to decarbonise (e.g. shipping, heavy goods transport, isolated population clusters) are also being contemplated.

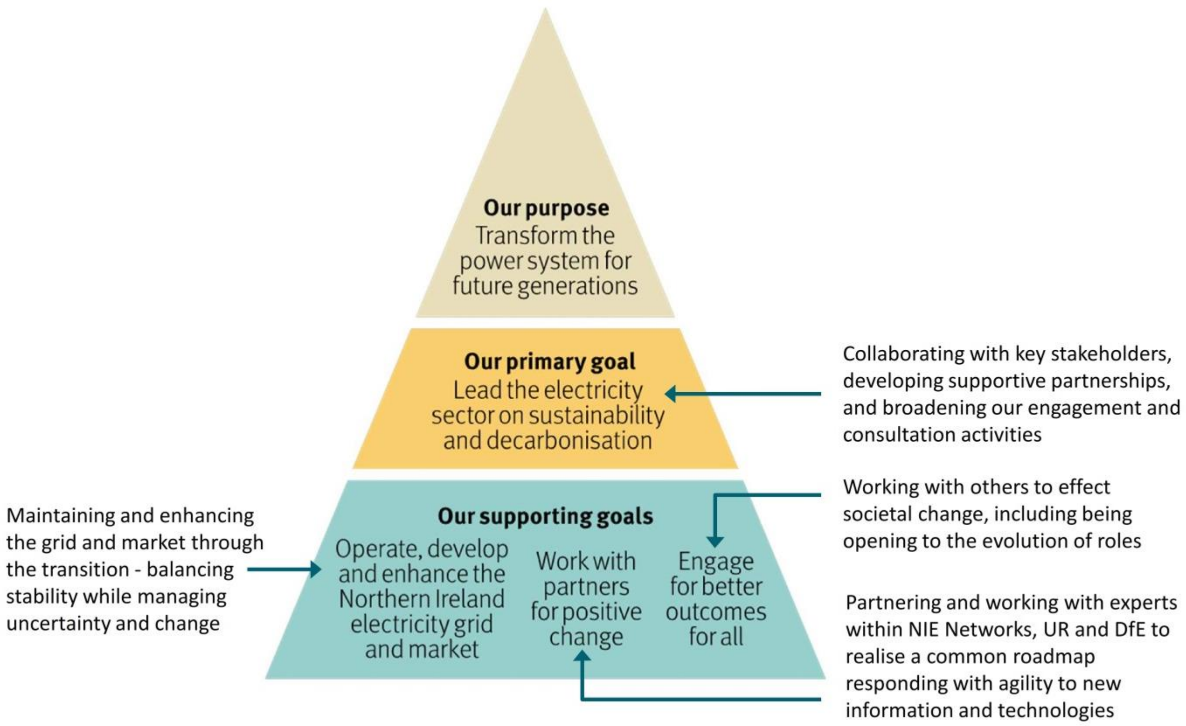
2.9. The 2020-25 period will be critical if we are to realise a trajectory towards net zero by 2050 with circa 95% of renewables on the system at any one time. SONI has a unique role in the electricity sector, being responsible for planning the transmission system, as well as operating the system to ensure security of supply and running the wholesale market which includes managing the flow of energy by way of interconnection.

2.10. The power system of the future will need to be operated in a more dynamic and responsive way. This will require end to end solutions incorporating user experience, improvements to infrastructure, power system operational practices, and market design and operation. Working together, these changes will make the power system stronger and more flexible. This will be achieved with a combination of innovative solutions with proven technologies and practices.

2.11. SONI in its unique position, fulfilling three roles has a responsibility to ensure that the vision and pathways for the future send the right signals to current market participants and to potential investors and to society if we, collectively are to rise to the net zero challenge. This has informed out strategy depicted below in Figure 2.1.

[2] http://www.soni.ltd.uk/customer-and-industry/energy-future/

Figure 2.1. SONI Strategy Goals for 2020-2025



2.12. That is why SONI, together with EirGrid, has embarked upon a Vision 2030 project, which will look to define pathways to 2030 across the three dimensions of the electricity system: networks, power system operation and electricity markets. The aim of this study is to develop an integrated vision of the 2030 power system and all island electricity market. In doing this we have placed societal needs at the core of our investigations. In collaboration with the Distribution System Operator (DSO), NIE Networks, we are looking to ensure our visions and roadmaps for the future align and provide a common voice and consistent bases for informing, supporting and implementing the NI Energy Strategy.

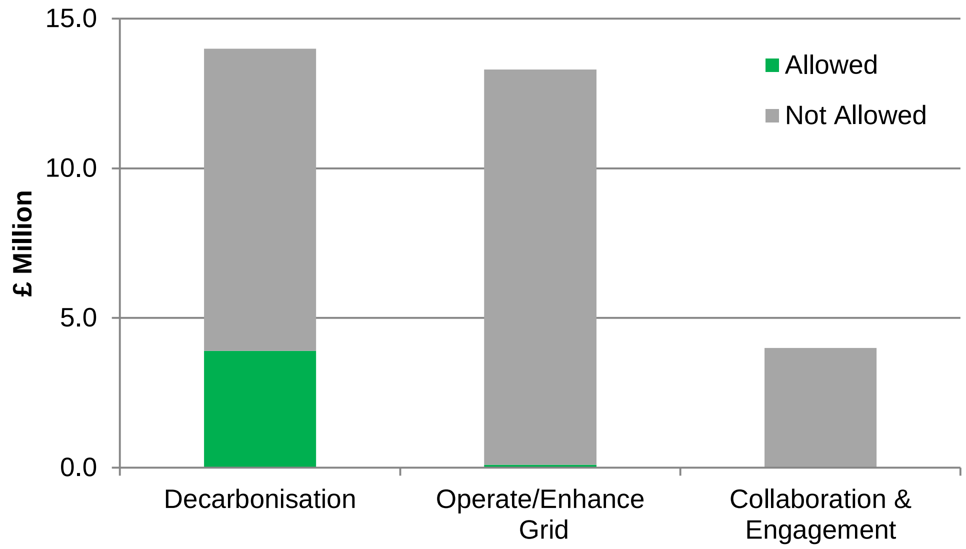
2.13. We cannot however wait until the end of 2021 to make progress, we know the direction of travel, we know the required outcome, and it is the responsibility SONI and other expert organisations (e.g. UR and NIE Networks) to ensure that we have a power system ready for the energy transition. This will meant that the Northern Ireland economy can avail of the opportunities arising from the move to increasing levels of renewable electricity, and that Northern Ireland is open for business and is as attractive to investors as neighbouring electricity markets in Great Britain and Republic of Ireland.

2.3 SONI's Strategic Funding Requirements for PC 2020-25

2.14. SONI submitted its Price Control business plan for 2020-25 to the UR in October 2019. The diagram below shows the ask for this Price Control period to support the strategic initiatives emanating from our assessment of what is required to set Northern Ireland on the right trajectory for 2050. This includes the ambition of accommodating 70% of renewables on the system by 2030 with the capability of deploying 95% of renewable power on the system at any one time. We are focused on ensuring that we develop a vision and define pathways to have the power system ready for the transformation that needs to happen.

2.15. We defined our initiatives under the goals identified in our strategy document as shown below. As you can see in Figure 2.2, the UR has provided for only 13% of the funding sought for these initiatives in its ex-ante Draft Determination allowances.

Figure 2.2. Allowances for Proposed Initiatives



2.16. While acknowledging the need for most of the initiatives, the level of allowance will simply not enable SONI to advance the change and outcomes required in this period.

2.17. In Chapter 6 of this response, together with more detail in Annex H, SONI has sought to provide the additional information requested by the UR in its Draft Determination. However, we are concerned by the level of certainty that the UR seems to seek in some cases, as well as the continued apparent focus on internal expenditure rather than the added value that can be delivered for customers and the Northern Ireland economy. Such limited up front allowances will result in risk averse behaviour and an inefficient stop/start approach to progressing these strategic initiatives. This approach will result in unnecessary carbon emissions from Northern Ireland.

2.18. The UR has developed the regulatory framework for this Price Control which introduces new safeguards for customers and incentivises SONI to focus on wider outcomes instead of its internal cost base. It is therefore surprising that the UR has taken such a conservative approach to the assessment of our business plan, which could even be perceived as controlling. These new features include risk sharing mechanisms and an evaluation process with an associated penalty or reward. We would therefore ask the UR to utilise and rely upon these additional protections, particularly were we are developing world leading solutions and therefore are not able to provide the information or cost estimates with the high level of precision that the UR appears to expect. SONI has commented on the UR's assessment of our Business Plan submission in Annex A.

2.19. We would also ask that the UR consider the wider implications of not funding these strategic initiatives up front when making the Final Determination. Consequences which would include:

- Delays to the mitigation of risks to security of supply in Northern Ireland;

- A dilution of Northern Ireland's influence over the direction of all-island initiatives, noting that NI consumers are only being asked to pay c.28% of the collective ask of all island initiatives included in this Price Control while receiving the full benefits;
- A loss of cost efficiencies, where Norther Ireland specific solutions would need to be developed because SONI does not have the certainty of funding necessary to commit to all-island procurement of solutions;
- The lost opportunity for growing a green economy in Northern Ireland resulting in less investment and fewer jobs; and
- The lost time and therefore the heightened likelihood of Northern Ireland not being able to contribute its share of the UK's net zero commitment.

2.20. We emphasise that we considered a whole system approach to the energy transition when identifying the strategic initiatives we have included in the SONI Business Plan. SONI can confirm that we have only requested funding for the work that is within our remit under the current Northern Ireland legal framework. This is reinforced by SONI's unique perspective having responsibility for planning the transmission network while also operating the system and market.

2.21. In looking to the future, our Tomorrow's Energy Scenarios for Northern Ireland and our Vision 2030 project could not be more embracing of a whole system approach. Through our Vision 2030 project we are collaborating with NIE Networks and others, with an explicit intention of exploring all possibilities, including changes in roles. We are surprised by the UR assertion that we have not taken a whole system approach, and we elaborate on our approach in this regard as well as on our level of ambition in Chapter 6 - Delivering a Future Energy System.

2.22. We note the UR's apparent pre-empting of changes in roles, particularly between ourselves and NIE Networks. However, SONI believes it is too early to assume any changes that may come. It is important to note that to make such changes without careful consideration may have serious unintended consequences.

2.23. It will be important to socialise, plan and manage any such change in an open and transparent way, in line with good regulatory practice. Any such change should be informed by input from the affected parties Any such change should also be designed to implement the new NI Energy Strategy and resultant policies, and therefore should be developed in that context.

2.24. Two of the changes proposed by the UR in the draft determination which impact both NIE Networks and SONI were not discussed with either party in advance. This is not consistent with good regulatory practice and, in our view it would be important to follow due process involving formal consultation exercises which are clearly about these proposals. These are the collection and treatment of Transmission Use of System Charges (TUoS) which is addressed in Chapter 5, Section 5.4; and the management of Telecoms between the two organisations which is addressed in Chapter 6, Section 6.5 with further information provided on Telecoms provided in Annex H, Section H2.8.

2.25. We welcome the UR call for SONI to 'build on its role as whole system collaborator and co-ordinator'. SONI is committed to collaborating more formally with a wide range of stakeholders to receive their views and inputs, which we will use to further shape and inform roadmaps for the future. This engagement is a fundamental aspect of this project's programme, because successful transformational change requires societal buy in and participation.

2.26. The scale of change required exceeds that of the redesign of the Single Electricity Market introduced in October 2018. This change also needs to happen in a much shorter timeframe. Collaboration, consultation and engagement across a wide spectrum of stakeholders and at various levels of technical detail is urgently required. We are therefore concerned by the absence of funding provided by the UR for engaging our stakeholders. We are also concerned by the criticism of our current level of engagement and would refer the regulator to Annex B which details the extensive, perhaps more technical engagement and consultation carried out by SONI. We would also refer to Annex A of our original business plan which explicitly listed the engagement undertaken in the delivery each of our roles and services.

2.27. We understand from feedback from stakeholders and the SECG, that in addition to our current more targeted technical engagement we need to broaden our stakeholder engagement activities in order to effect the change required. We concur with these views and would like to emphasise that funding for this additional strategic engagement is required in this period if SONI is to fulfil these ambitions. We have listened to the feedback provided and refined our approach to stakeholder engagement and reframed the funding sought for same, see Annex C.

2.28. In order to facilitate the transformational change needed for the energy transition, we need to act upon the outcomes from our Tomorrow's Energy Scenario work and will need to further consider and enact the outcomes that arise from our Vision 2030 work. The strategic initiatives included in this business plan are essential to create the platform these changes require. The new system services and the competitive market approaches will come together with the control room tools of the future to enable decarbonisation while operating the system safely and reliably. We therefore stress the need for an upward shift in the dial of ex-ante funding for these strategic initiatives within the Final Determination.

2.4 Ensuring Value for Consumers in a Period of Uncertainty

2.29. SONI acknowledges that there is an inherent level of uncertainty within the electricity industry in Northern Ireland associated with the scale of change required through this price control period together with the absence of the specific details that will come from the NI Energy Strategy. However, it is important to also acknowledge that there is a collective responsibility to ensure that the power system in Northern Ireland is ready for the energy transition. This is critical if Northern Ireland is to play its part, but more importantly in order to avail of the economic opportunities that will come with the energy transition.

2.30. We welcome the UR's acknowledgement of the "*serious risk that applying conventional price control cost incentives to SONI's internal costs could lead to small savings in the these costs, at the expense of higher costs elsewhere"* and "*at the expense of desired outcomes besides costs, such as decarbonisation and service quality to SONI customers and other stakeholders"*. Notwithstanding this acknowledgement, the UR has sought to allow only allowed a small amount of ex ante funding for our Strategic Initiatives. This is insufficient to sustain the current and ongoing progression of endeavours to be ready for the energy transition. If this were to be replicated in the Final Determination, SONI would have to suspend some work and focus to work within our allowances. We would need to take a conservative approach to innovative ideas in order to protect and maintain our core activities. This would delay the realisation of the value that the UR itself highlights that SONI can deliver for customers. Given the need for external investment in renewable generation and supporting technologies, a delay to SONI's part of the transition risks the success of the entire switch to a green economy for Northern Ireland.

2.31. We welcome the UR's additions to its regulatory framework, its different approaches to the treatment of costs (addressed in Chapter 4) and its introduction of an evaluation framework with accompanying penalties and incentives. The UR should rely on these additional risk mitigation measures and consider the following factors when revisiting the level of funding for the Strategic Initiatives as part of the Final Determination:

- Our exchange of information and discussion between the Draft Determination and this response, together with the additional information submitted with this response;
- The level of certainty of the need, and the benefits to be delivered for consumers versus the level of risk of not guaranteeing delivery at the lowest cost together with the loss of value because of the delay;
- The all island nature of the initiatives and the alignment of funding between the two jurisdictions to ensure that the outcome is optimised for all consumers on the island of Ireland and that markets remain fair and competitive;
- That the merits and practicalities of applying a two staged approach for scoping and costing a project prior to substantive funding are considered alongside the added protection mechanisms introduced by the UR for this Price Control period; and
- The potential for the adoption of a risk-averse approach by SONI fearful that investment that exceeds the UR's view of appropriate ex-ante costs, may lead to an incentive penalty or disallowance.

2.32. The treatment of costs during this period is crucial to ensure that SONI is facilitated to seek and deliver opportunities to add value for consumers. In Chapter 4, Cost Recovery Mechanisms and the Management of Uncertainty, we examine the treatment and funding of costs for more certain strategic initiatives and uncertain strategic initiatives. We welcome the UR's statement that they are 'strongly committed to funding further allowances during the period' but emphasis the need for a significant upward shift in the 13% level of ex-ante funding indicated in the Draft Determination.

2.33. The regulator in its Draft Determination proposes to apply an Evaluative Performance Framework, which we respond to in Chapter 3 of this submission. SONI is supportive of the concept of a performance framework that incentivises the right behaviours and outcomes, and proposed a framework with our business plan submission. There are two critical aspects for any framework to be effective and ensure that it incentives the right behaviours.

1. Success in each area of the framework must reflect a clear and defined outcome so that SONI, the UR and the evaluation panel knows what good and excellent looks

like. We accept that there will be both a quantitative and qualitative aspect in the delivery of a good outcome for consumers. To ensure such clarity and the success of the incentive we believe there should be a measureable portion and a performance portion associated with any reward or penalty.

2. The company must be able to bear the downside of any penalty given the context of SONI's asset light nature and yet critical role it plays. Equally important is that the upside incentive value is sufficient to motivate excellent performance. We believe that this should reflect a ratio of 1:2.5.

Chapter 3
Evaluative Performance Framework

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3 Evaluative Performance Framework

3.1 Key Messages

3.1. There is no clarity as to what good looks like associated with the UR evaluative performance framework. This being the case the independent assessment panel has no baseline or benchmark against which to judge success. This means the framework will fail to maximise outcomes for consumers:

3.2. SONI and UR have both proposed frameworks for incentivising performance for the benefit of consumers, which are:

- The SONI Benefits Sharing Framework proposed that 80% of the reward or penalty be allocated to specific targets set for each of the three strategic outcomes relating to decarbonisation; grid security and cost to the consumer. We linked the success of these three outcomes to ensure that SONI took a balanced approach to delivering against any one area. We proposed that the remaining 20% should relate to SONI's overall performance the subjective assessment of an independent panel.
- The UR Evaluative Performance Framework proposes that the independent panel assesses the portion of any penalty or reward based on 100% subjective reflection of SONI's performance. That this be informed by the weighting across a 16 box matrix of SONI services for which the individual inputs and outcomes are unclear and overlapping.

3.3. 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. The UR emphasis that its proposals draw heavily on what is working in GB, through Ofgem's ESO model and yet this model applies a 1:2.5 ratio for penalty and awards assessed against three defined roles. For the ESO the downside is £6m with an upside of £15m per annum. Ofgem has set the penalty so that the company can bear the risk given its essential services and light asset base; Ofgem has set the reward significantly higher to ensure there is a large enough upside incentive to encourage the system operator to put a strong emphasis on its output incentives. Further SONI's financial assessment of the UR Draft Determination indicates that SONI could not bear the £1m penalty in all the years of this price control and therefore the framework as proposed undermines SONI's financeability.

3.4. The proposed approach is not proportionate for the Northern Ireland context and scale which represents 3% of the UK power usage. While acknowledging that the UR has allowed revenues consistent with two additional staff to assist in the application of the Evaluative Performance Framework, we remain concerned by the requirement to produce a number of publications and consultations on an annual basis which would need inevitably to relate to the 16 category scoring system. We believe this will put pressure on already limited resources and distract from a focus on strategic outcomes and delivery.

3.5. The framework, in any form, should have a clear link between SONI performance and the potential level of reward for both the measurable and evaluative portions of the framework.

3.6. Getting the performance framework right is vital to unlocking greater value for customers. The UR has indicated that they wish to work with SONI to further develop this framework. SONI welcomes this and is committed to engaging further with UR on this important element of the price control.

3.2 Introduction

3.7. In its approach paper[1], the UR set out its desire to develop a regulatory framework to incentivise SONI to deliver a high-quality service. It emphasised the need for this framework to provide confidence that outcomes and on-going improvements would be delivered.

3.8. SONI proposed a Benefits Sharing Framework in its business plan submission to the UR which included a penalty and reward incentive with a ratio of 1 downside to 2 upside. This proposal was 80% based on measurable outcomes or metrics, and 20% based on qualitative evaluation by an independent panel (further details of this proposal are set out in Section 3.4). The components of SONI's proposal were carefully designed to be in natural tension with one another, in order that SONI would be incentivised to look at the benefits to customers as a whole rather than focusing on one component to the detriment of another. SONI engaged with the UR on its proposal on a number of occasions in advance of the business plan submission.

3.9. The UR has expressed concerns that SONI's proposed Benefits Sharing Framework is too mechanistic and will not incentivise the right behaviours.

3.10. In its Draft Determination, the UR has proposed its own evaluative performance framework, which SONI saw for the first time upon receipt of the UR document. The UR's framework is largely based on elements of existing frameworks in place in Great Britain, as developed by Ofgem and Ofwat. The UR proposes that an independent panel is established to undertake an annual assessment of SONI's performance on a purely subjective evaluative basis, applying a reward or penalty which is symmetrical having a 1:1 ratio. However, the latter ratio of penalty and reward differs from the Ofgem evaluation framework which applies a penalty/reward ratio of 1:2.5, stating the importance of placing a strong emphasis on output incentives. Additionally noted by Ofgem, and equally important, is that SONI must be able to bear the risk and cost of the penalty given the essential nature of the service.

3.11. SONI is concerned that UR's proposed framework is complex and burdensome, and loses focus on key strategic outcomes, applying a formula on 16 subjective inputs to decide the overall penalty and reward. SONI cannot bear the downside penalty proposed and the upside incentive is weak and not fully realisable.

3.12. There are however a number of key principles that are similar between the two proposals:

- That SONI's internal costs should not be the focus, but rather the added value which SONI can unlock for customers.
- That SONI activities can influence the following strategic outcomes relating to:

[1] SONI price control 2020 2025 Draft Determination. Available at: https://www.uregni.gov.uk/sites/uregni/files/media-files/SONI%20TSO%20price%20control%20final%20approach.pdf

    - Energy system decarbonisation (reduction in GHG Emissions);
    - Grid security; and
    - Whole system costs.
- That the framework should include an upside to incentivise investment in value adding activity and a downside to protect consumers.

3.13. Both UR and SONI agree the current regulatory framework would benefit from an incentive framework with a focus on performance outcomes rather than internal costs. Both organisations are committed to engaging further to develop a framework which is proportionate, encourages the right behaviours, has a focus on outcomes and is clear about what good look like.

3.14. Given the absence of engagement prior to the publication of the Draft Determination and the limited 10 week period of the consultation, we are supportive and appreciate the UR's commitment to continued dialogue with us to ensure the success for all, the UR, SONI and the consumer, of the final form of the Evaluative Performance Framework.

3.15. For the remainder of this Chapter we share our views on the UR's proposed framework, reflect on the rationale and approach for developing our own Benefits Sharing Framework and set out what we consider to be factors for success for the application of an Evaluative Performance Framework which we are very supportive of.

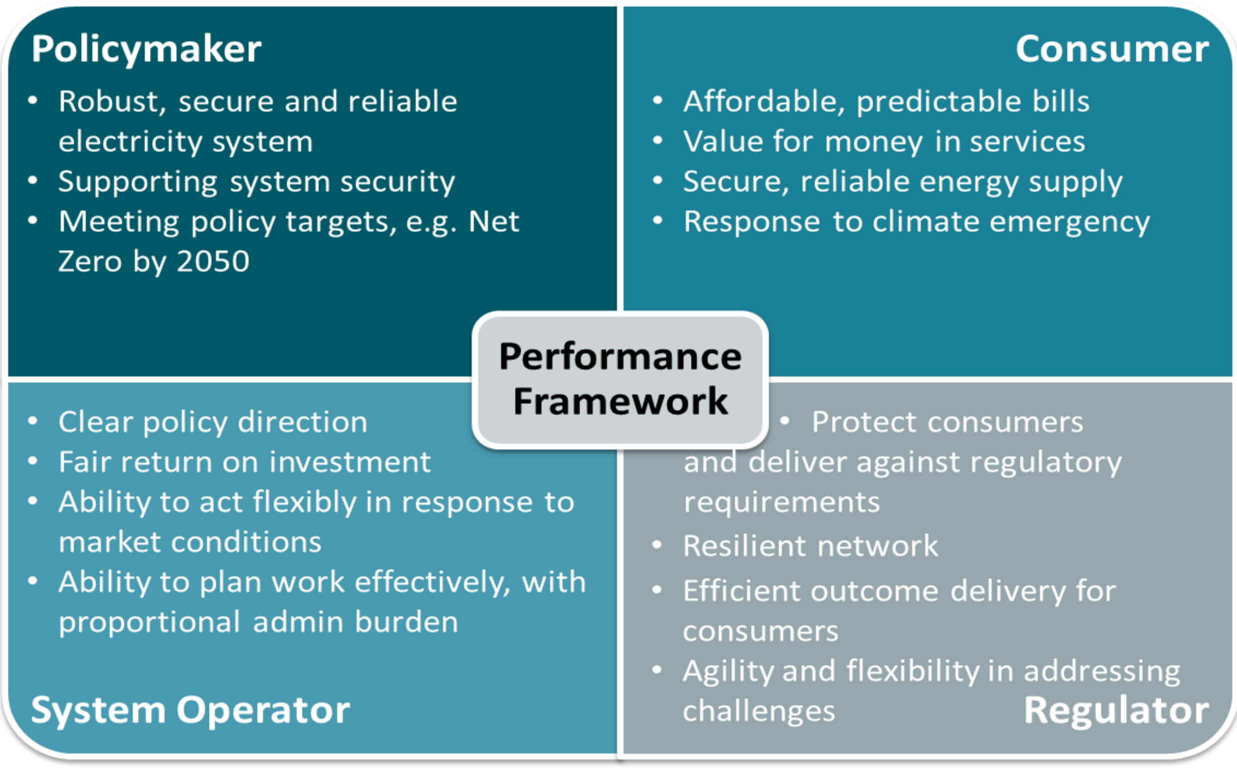
3.3 Outcomes Focus of Evaluative Performance Framework

3.16. The activities of a system operator support the wider energy system both in the day-to-day delivery of electricity to end consumers, but also in the preparations for the electricity system in meeting the needs of the future. SONI considers there to be two main aspects for this framework to focus on, incentivise and assess in deciding to apply a penalty or award.

- The essential role which the TSO's fulfils focusing on the core activities necessary to operate and plan the electricity network for Northern Ireland; and
- The critical delivery of strategic initiatives, during this period to facilitate the trajectory of the power system for Northern Ireland to successfully deliver its share of the Net Zero target by 2050.

3.17. In developing our proposal, SONI gave a lot of consideration to what this means for our different segments of stakeholders, what their expectations are regarding performance and how these principles can be used to assess the proposed framework. We set out the principles used in Figure 3.1 below.

Figure 3.1. Expectations of Stakeholders for Performance Framework



3.18. It is critical that any framework which serves to assess SONI's performance is suitable for SONI and its operations, whilst encapsulating other stakeholders' requirements. In evaluating both frameworks, we have posed questions as outlined below:

Outcomes Focused	• appropriately support **decarbonisation** of energy system and **Net Zero** legislation? • take appropriate measures to ensure **system resilience** of customers' electricity supplies?
Promotes Agility and Innovation	• **promote innovation** and **enhancements** which lead to consumer benefits? • encourage **dynamic responsiveness** to structural demand changes, bringing products to market and promoting cross-sector collaborations? • facilitate a market mechanism which **mirrors competitive markets**, supporting investment in activities to enhance services, whilst protecting consumers?
Provides Financial Balance	• ensure **risks** are sustainable and consistent in supporting investments? • ensure that the company is **financeable**? • **provide certainty of costs** prior to activities, enabling comprehensive economic appraisals? • minimise scope for different evaluators to reach different conclusions from the same set of inputs?
Practicalities	• incur **administrative burden proportionate** to available reward? • **deliver value for money** for consumers, and is deliverable?

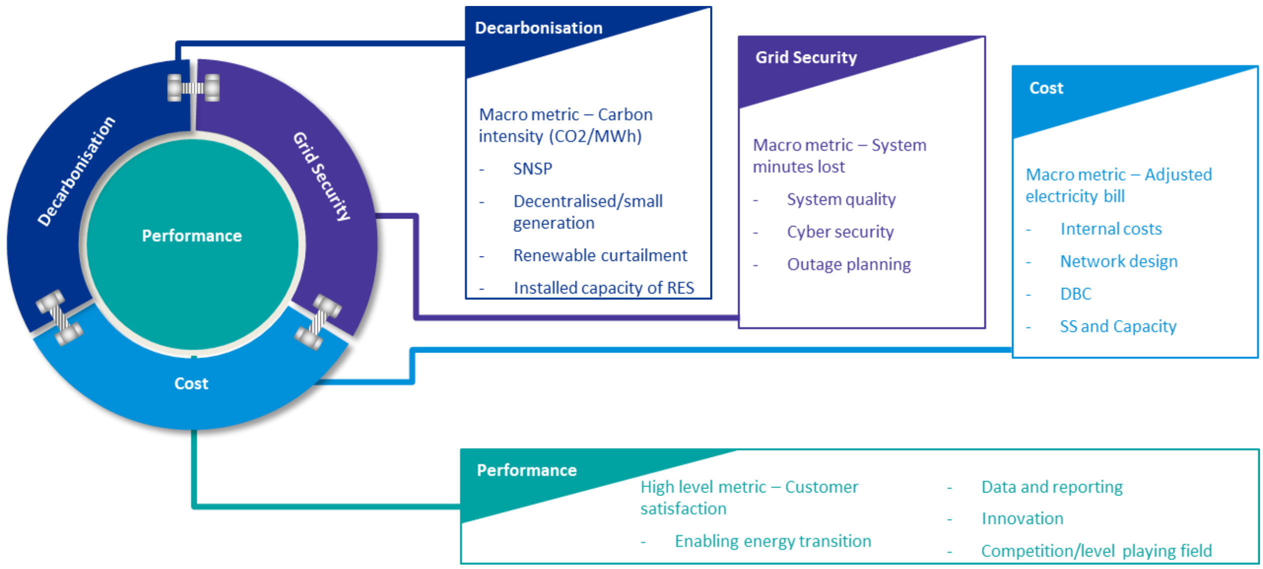
3.4 SONI Proposed Benefit Sharing Framework

3.19. As part of our Business plan submission on 31 October 2019 we proposed a framework which incentivised SONI by allowing it to share in the benefits created for customers arising from our activities.

3.20. The proposed Benefit Sharing Framework looked to create a holistic package which brings together the elements of benefit that are important to consumers and embed efficient cost management across all the areas.

3.21. In the design of the benefit sharing framework the following principles were key:

- **Customers are better off:** Any incentive package would be designed to ensure customers are better off (on an expected basis) than they would have been without the benefit sharing mechanism.
- **It creates alignment between company and consumers:** By designing the incentive package in such a way that incentivises SONI to deliver incremental value for customers, SONI's success is aligned with benefits to customers.
- **It allows companies to take risk in order to deliver greater value for consumers and helps to simulate market outcomes:** Incentives create a framework which simulates a competitive market where the company is able to take risk and commit its own capital to deliver better outcomes for consumers.
- **It encourages innovation and new ways of working:** Rewarding outcomes rather than setting allowances based on inputs encourages SONI to be innovative and look for alternative, better ways of delivering. The performance incentive framework would also therefore help unlock the benefits of innovation.



3.22. The proposed framework set out 4 'benefit areas': decarbonisation, grid security, cost and performance.

3.23. To ensure the framework measures the overall value delivered to customers rather than specific KPIs linked to isolated roles within SONI, each benefit area has a small suite of measurable outputs which measure the delivery of outcomes for customers and therefore value created for customers.

3.24. These measurable outputs were proposed to be the basis of the incentive available to SONI through a primarily quantitative assessment for the decarbonisation, grid security and cost benefit areas. This quantitative assessment would account for 80% of the overall reward and penalty proposed with the remaining 20% being assessed through a qualitative assessment of SONI's performance.

3.25. There is natural tension between the outputs being incentivised but by measuring them all in the same framework it requires SONI to think holistically to unlock overall value for consumer rather than focusing on some areas at the detriment of another.

3.26. The proposed reward and penalty for the Benefit Sharing Framework was +£3m and -£1.5m which SONI believed represented a meaningful upside and a financeable downside (given the parameters proposed for the whole regulatory framework in the SONI Business Plan).

3.27. The SONI proposed framework was strategically focused and yet balanced the need to deliver against the two main criteria, that of delivery on our core activities and on supporting the transformation of the power system. The outcomes are known, clear and measurable and include a subjective independent assessment of overall performance.

3.5 SONI Consideration of UR Proposal

3.28. UR's Evaluative Performance Framework proposes using an independent evaluative panel who would apply a subjective approach to the assessment of SONI performance, informed by a mechanistic 16 box service outcome scorecard approach.

3.5.1 Points of Agreement

3.29. As noted previously, there are some areas of agreement between the UR's evaluative performance framework proposal and SONI's Benefit Sharing mechanisms. It is also important to note that the intentions of both frameworks are strongly aligned.

3.30. The following key principles are present in both;

- The internal costs of SONI's activities should not be the dominant area of focus, rather the focus should be on the wider value SONI can unlock for customers - UR states that *"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 as 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."*[2]
- There is a need for an upside to incentivise investment in value adding activity for customers – UR states that the evaluative framework supports the energy transition by

[2] DRAFT Annex 4: Evaluative performance framework for SONI, Draft Determination, Utilities Regulator, July 2020, pg. i. Available at: https://www.uregni.gov.uk/sites/uregni/files/consultations/Annex%204%20Evaluative%20performance%20framework.pdf

having a *“meaningful yet proportionate financial incentives, along with reputational incentives (through for example stakeholder and panel engagement). This provides a more meaningful combination to support SONI in innovating and improving service quality key to the energy transition.”*[3]

- The framework should be output and outcomes focused rather than input focused. Outcomes, defined as “*The impacts or consequences (for consumers, the community or the environment) of the activities undertaken*”[4] have been outlined and form the basis of the UR’s proposed assessment framework. The UR’s four proposed outcomes are highly aligned to the ‘benefit areas’ proposed in SONI’s Benefit Sharing Framework, listed below. However, SONI proposed targeted, measurable and metricised outcomes for the first three areas aligned with 80% of incentive with the remaining 20% being awarded by subjective judgement of the evaluative panel. UR proposed 100% subjective judgement for all four areas by the evaluation panel informed by an analysis of its 16 box matrix of services.
    - Energy System Decarbonisation;
    - Grid security;
    - Whole System costs; and
    - SONI service quality.

3.5.2 Assessment of Both Frameworks

3.31. In reviewing the UR’s proposal we have reflected on differences between it and our proposed Benefits Sharing Framework. Our assessment of the two frameworks is set out in the Table 3.1.

Table 3.1. Assessment of Proposed Frameworks

Criteria	SONI’s Benefit Sharing Framework (BSF)	UR’s Evaluative Performance Framework (EPF)
Outcomes Focused	Provides a framework that is outcomes-driven and measurable with a suite of metrics focused on strategic outcome delivery to customers. The BSF links the financial reward and penalty directly to the benefit created for consumers. The focus of outcomes for customers rather than inputs of activities allows for flexibility in how the benefit to customers is delivered. It enables both UR and SONI to take a more holistic and strategic focus in our activities to create value for customers. SONI is	The EPF recognises the importance of outcomes and combines this with SONI services. The performance outcomes are assessed through an evaluative process however there is limited guidance on what the baseline expectation, and therefore what a ‘good’ or ‘excellent’ performance looks like for these outcomes. Complexities arising from the proposed weighted scoring, based on SONI Roles and

[3] SONI price control 2020 2025 Draft Determination, pg. 82. Available at: https://www.uregni.gov.uk/sites/uregni/files/consultations/SONI%20price%20control%202020%202025%20draft%20determination.pdf

[4] DRAFT Annex 4: Evaluative performance framework for SONI, pg. 10.

Criteria	SONI's Benefit Sharing Framework (BSF)	UR's Evaluative Performance Framework (EPF)
	encouraged to invest where outcomes will be delivered. The BSF is 80% associated with delivery of specific outcomes and 20% evaluative. As proposed the stakeholder input was limited to the 20% evaluative portion, which will not be as strong a driver of behaviours as the EPF. The BSF is strongly linked to delivering decarbonisation, as well as in ensuring system resilience while balancing cost to the consumer. The key principle in designing the BSF was to incentives strategic activities through the measurement of clear outcomes which ensured everyone goes into the process knowing what success looks like.	services, results in 16 areas of outcomes and is likely to result in a loss of strategic focus for delivering better outcomes. The involvement of stakeholder feedback will capture the views of the industry and the changing expectations of customers. The evaluative nature of the EPF will encourage a culture within SONI which puts benefits for NI consumers and performance at the forefront of day to day work The subjective inputs with little clarity on what is a successful outcome across a 16 box matrix loses strategic focus and is difficult to know what success looks like.
Promotes Agility and Innovation	Since there is a primary focus on outcomes rather than activities, the BSF inherently promotes agility and innovation of the TSO. Factoring in the inclusion of costs in different outcomes, SONI is supported in its commercial decisions in becoming more agile and innovative in the delivery of benefit and value for consumers.	Through the use of an annual planning cycle, the EPF allows for some flexibility and agility to a changing system, underpinned by the energy transition. However, a subjective ex ante review of activities could lead to uncertainties surrounding discretionary investments, due to an asymmetric risk-return profile. This could prove detrimental to consumers, who typically benefit from investment activities in the system.
Provides Financial Balance	Given the parameters in SONI's business plan the BSF provides a better financial balance from expected returns on new investments. This better encourages companies to take risk in order to deliver greater value for consumers and helps to simulate market outcomes. The package in the BSF was designed to be challenging but financeable, both by reference to the calibration of the collar but also concerning SONI's level of control over the risk that the maximum downside would be realised.	The EPF, as proposed, does not provide a fair financial balance since the downside scenario is not financeable, both in terms of the overall calibration of the collar but also in terms of the subjectivity in the risk that it may be realised, and, given the other parameters set out in the Draft Determination, whilst the upside is not material enough to encourage investment to deliver desired outcomes.
Practical and Deliverable	The proposed framework set out 4 'benefit areas': decarbonisation, grid security, cost and performance. This more strategic and simplistic framework, benefits from its practicality and deliverability as it is less	The assessment process proposed for the EPF is overly burdensome and may distract from strategic focus.

Criteria	SONI's Benefit Sharing Framework (BSF)	UR's Evaluative Performance Framework (EPF)
	distractive for management and provides better focus. SONI benefit areas are consistent with outcomes concerning the regulator's primary duties.	

3.6 Engaging with UR to Optimise and Customise a Performance Framework for Northern Ireland

3.32. Whilst SONI recognises that a lot of development has gone into the UR's Evaluative Performance Framework, there are a number of areas which we believe can be refined to better meet the needs of stakeholders and deliver for Northern Ireland customers.

3.33. We also recognise the UR's acknowledgement of the need for further development of the framework and willingness for collaborative engagement with SONI to shape the final framework. To assist in this collaboration, the following sections set out in more detail the concerns SONI has with the current proposal. We also identify potential areas for discussion to address some of the assessment shortfalls identified in the table above.

3.34. We are committed to continuing our engagement with UR to develop this framework in order to deliver real outcomes for the benefit of customers.

Outcomes Focused

3.35. The UR framework has acknowledged the link between outcomes for customers and SONI activities and the importance of delivering these outcomes for customers is at the forefront of the design of the Evaluative Performance Framework. These outcomes are built into the scoring process which should therefore encourage behaviour which generates value for customers from SONI activities.

3.36. However, in its current form, there is limited guidance on what the baseline expectation is, and therefore what a 'good' or 'excellent' performance looks like for these outcomes. Clarity in these expectations is very important to allow both the UR and SONI to go into this new process with shared understanding and ensure the framework is working in a way that delivers the right benefit for customers.

3.37. The UR's proposal relies heavily on views from today's stakeholders through ongoing evaluation of SONI performance by industry experts. This seeks to ensure that the current needs of the sector and the customers are reflected in the assessment of SONI's performance. However, if we agree the critically of this period for transforming the power system, then it is important to assess the delivery of strategic outcomes in a real and measurable way. The question is then one of balance of reward between known outcomes and the subjective assessment of performance of activities as viewed by the industry.

3.38. SONI also have concerns about the strength of focus on the SONI services in the scoring system proposed and the potential impact this system could have on discouraging holistic thinking across the SONI. The focus being on being able to evidence delivery outcomes to maximise the performance ratings over the 16 categories.

Promotes Agility and Innovation

3.39. It is clear that the energy transition is underpinning a change in the sector, which is driving a dynamic market that is rapidly evolving to changing technologies and customer expectations. This, in turn, creates a need for SONI to operate in a different way to the past; becoming more agile and responsive to changes which are unlikely to fit with a 5-year price control planning window. It also means bringing new and innovative solutions to market at an accelerated pace.

3.40. This creates a challenge for traditional ex-ante regulation which is premised on market certainty and stability. The framework therefore needs to adapt to this changing external environment and allow SONI to emulate these conditions which are more typically found in different sectors.

3.41. In many markets, from technology to pharmaceuticals, initial investments are made in multiple solutions to a consumer demand. Some of these will fail very quickly, others will progress further, before being deemed unsustainable and others will progress to production and success. This type of investment approach required for first-of-a kind and transformational activities is fundamentally different to that typically deployed in the regulated infrastructure sectors but is clearly observable in many competitive markets and therefore is efficient for those types of products.

3.42. Given this is the position in which SONI now finds itself, the framework needs to allow for this type of investigative and exploratory culture to pervade in order to deliver the rapid innovation that the sector demands. This will provide the confidence that SONI is supporting in trying new initiatives where the intention is to deliver additional or better outcomes for customers, and therefore justified, even if these initiatives fail.

3.43. Therefore, the concept of focusing on outcomes rather than inputs, as set out by UR, is absolutely right. However, the proposed combination of an ex-post review on costs with a discretionary performance assessment on outcomes is contradictory to that ambition.

3.44. It is easy when an initiative, or indeed several initiatives, have failed to determine that the cost was inefficiently incurred and to focus on the cost and outcome of the successful initiative alone. Whereas in reality, at the point of incurring the costs, it is impossible to know which initiative will succeed and which will fail and, hence, it is efficient to make some investment in some initiatives even when they are uncertain.

3.45. Under the UR's proposal at the point of investment, SONI knows that for any given initiative it will struggle to recover all of its costs in the case of failure and in the case of success it will only cover its costs and receive a modest quantum of income. It is therefore highly unlikely to approve that investment.

3.46. Effectively the company is forced to be highly risk averse and only bring forward products and services which are almost certain to succeed, which is not the way an efficient market operates for these types of innovative and agile companies.

3.47. If this is the case, discretionary investments, which individually or collectively would significantly benefit consumers will not be made leading to a detrimental outcome.

Provides Financial Balance

3.48. When defining the levels of penalty and reward, it is important that the potential penalty facing SONI does not jeopardise financeability. As proposed by the UR, the maximum penalty of £1 million is not financeable given the other parameters in the Draft Determination and this is discussed further in Chapter 7.

3.49. In addition to a financeable downside, the upside or reward available to SONI should be meaningful, enabling appropriate management focus and investment of discretionary capital. In the Draft Determination the UR has stated that they *"did not see good grounds for an asymmetric financial incentive structure as proposed by SONI for the new performance framework. An asymmetric structure as proposed by SONI would present risks of being (and being perceived as being) unduly generous to SONI at the expense of customers".*[5] This symmetry in the proposed reward and penalty has led to a small upside compared to the significant benefit and value for customers able to be unlocked by SONI activities.

3.50. This likely reward is further reduced as the UR has stated that it considers the +/- £1m to be extremes, "in practice it is probable that rewards for strong performance (but not excellent performance) would be significantly below the maximum reward, while penalties for weak (but not terrible) performance would be significantly below the maximum penalty."[6]

3.51. The limited potential reward on the table, combined with the proposed approach of 16 assessment categories, has led to a very low incentive for SONI to take additional risk in our activities, which will likely result in a lower level of investment being made in discretionary but value adding activities.

Practical and Deliverable

3.52. In implementing this framework, it is important that both UR and SONI get the balance right so that there are no unintended consequences that would be detrimental to the Northern Ireland consumer.

3.53. While UR has modified the framework so that there are less deliverables across the annual cycle, there is still a significant amount of work that will need to be put in to the development and consultation on the annual forward plan.

3.54. The proposed annual process for the evaluative performance framework will require inputs from across SONI as well as EirGrid. SONI is a small organisation and in implementing the framework, it will be important to ensure that resources are not diverted to the evaluative performance framework to the detriment of the delivery of SONI's core remit. A scoring approach with 16 categories would instinctively imply a high burden of reporting that is of concern to SONI.

3.55. We note that the UR has allowed for two additional headcount to manage the framework which is appreciated; however, the associated burden across all areas of SONI needs to be given the same consideration as the framework develops.

[5] DRAFT Annex 4: Evaluative performance framework for SONI, pg. 29.
[6] DRAFT Annex 4: Evaluative performance framework for SONI, pg. 30.

3.56. Given the points above regarding the likely burden of the framework on SONI, it is important to consider whether the UR's proposal is proportionate.

3.57. SONI also notes that many of UR's service expectations include areas that are all-island in nature or those managed by SEMO, however this overlap in responsibilities is not acknowledged. While we accept UR's desire to focus on SONI, it is critical that the evaluation framework reflects the all-island nature of the work that we carry out with EirGrid. This joint working provides significant benefit to the Northern Ireland consumer and it does need to be given due regard in the framework so as not to lead to impractical and unintended consequences.

3.6.1 Loss of Strategic Focus

3.58. It is important that the framework put in place for this price control allows SONI to focus on delivering projects that are of strategically important to customers, tackling the issues that are most critical at the time and those that unlock the most value for Northern Ireland customers.

3.59. To do this SONI should be incentivised to think and act strategically rather than be constrained by an overly granular assessment approach which could act to distract focus from what is really needed.

3.60. The scoring system approach with 16 categories has the potential to be a significant distraction from this strategic approach. There will be some years where the best thing to do for a particular outcome within a SONI role is SONI's "business as usual" activities and focus on delivering value in other areas which are most needed at the time. However, by looking at the outcomes in the silos of the SONI roles, this mentality is discouraging.

3.61. A consequence of the proposed granular scoring approach is to encourage SONI to spread its activities and efforts across all areas rather than take the strategic approach necessary to be agile and adaptive to the transforming electricity system.

3.62. Conversely, the proposed granular scoring approach risks not fully capturing the benefit to customers SONI does unlock through transformational and strategic initiatives. An example of this would be a new initiative which fundamentally changes the capacity for new low carbon generation to be managed on the system. This would have a sizeable benefit to consumers but has the risk of only being captured in 1 of the 16 scoring categories (likely to be System Operation and Adequacy Decarbonisation). This initiative would be a significant undertaking and would unlock material benefit to customers but the 5% of the overall potential reward available for this category is not truly reflective of the ultimate effort and value involved.

3.63. At this stage this is just an illustrative example of our concerns in this area and SONI welcomes the opportunity to discuss this in further detail with the UR in the ongoing development of the framework.

3.7 Proposals for Success

3.64. To address the concerns SONI has identified in their assessment of the Evaluative Performance Framework, a number of changes are proposed for consideration. SONI believes that incorporating these changes into the Evaluative Performance Framework will improve its suitability and support SONI and UR in delivering increased value for customers.

3.7.1 Reducing Complexity

3.65. SONI considers the proposed approach of measuring performance across both outcomes and services overly complex and detrimental to delivering the desired outcomes for customers. As such, SONI proposed that the approach taken forward is option (b) outlined by the UR in 6.24 of Annex 4, separate scores for each of the four SONI outcomes, with explicit weights to produce an overall score.

3.66. The UR identified six different options for a scored assessment of SONI performance, which range in their levels of granularity. In assessing its evaluation approach, the UR recognises the importance of the level of granularity chosen, for regulatory discretion and flexibility, predictability for SONI and application in practice.

3.67. Moving to option (b), and therefore reducing complexities in the assessment process, would help ensure scores and associated weights are assigned in a transparent and implementable way. This approach also allows both the UR and SONI to act flexibly within each outcome area, focusing on the activities that are important at the time.

3.68. This could facilitate better coordination for SONI's operations, while remaining flexible in responding to changes in the regulatory process, and other external factors which influence SONI's activities. Conversely, an evaluation approach that is highly granular and therefore more complex by construction, can reduce the transparency of the evaluation framework and potentially result in subjective weightings being assigned to SONI's costs.

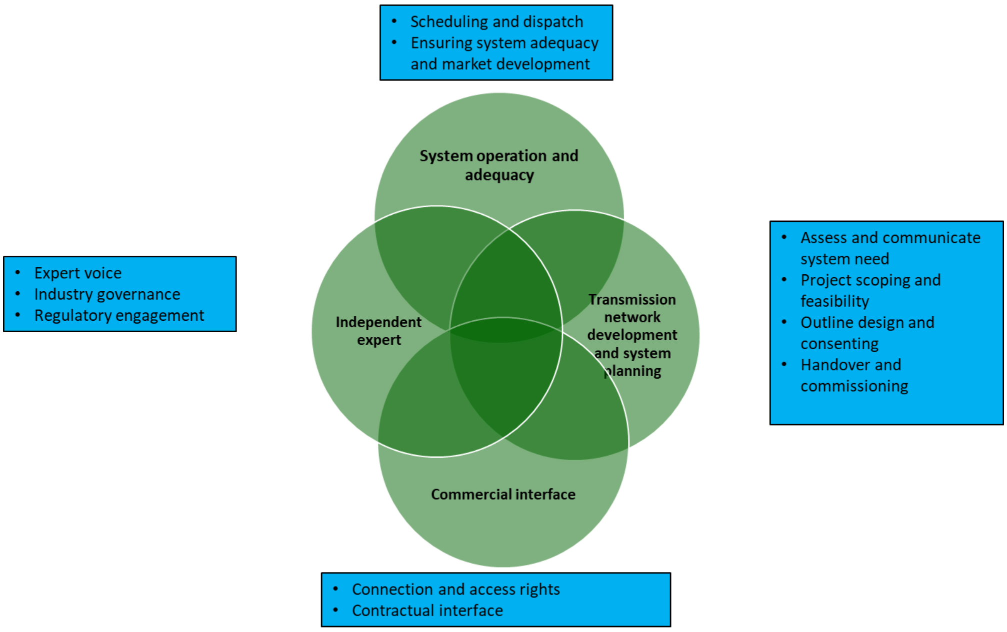
3.69. An evaluation approach which scores based on the four SONI outcomes[7] provides a method that is consistent with the primary duties of the regulator, to protect the interests of consumers of electricity, as this allows scores and weights to be assigned on the premise of outcomes that directly impact consumers and other stakeholders (e.g. performance, service quality and support for decarbonisation[8] are direct outcomes from SONI's operations).

3.70. The UR has recognised that all four SONI roles have substantial overlap and that some of the activities it undertakes fall across multiple roles. Given this overlap (shown in Figure 3.2), submitting evidence of performance for each role against each outcome will become an overly complex task to ensure there is no double counting whilst attempting to reflect the performance in each area.

[7] DRAFT Annex 4: Evaluative performance framework for SONI, pg. 11.

[8] DRAFT Annex 4: Evaluative performance framework for SONI, 2.9 - **Decarbonisation**. Northern Ireland electricity system supports government decarbonisation policy and targets.

Figure 3.2: Graphic from UR presentation at SECG in August



3.71. In addition to the high level of granularity proposed by the UR, SONI also has concerns about the weights applied to each of the 16 categories. SONI recognises that there is no easy way to define weightings that accurately reflect the potential benefit to consumers in each role and outcome. However, the UR's proposal appears to be overly simplistic and we do not believe it truly reflects the roles SONI has to play in these outcomes. Nor does it reflect the year on year variation in focus that might be expected. For example, improving connection and access rights may be a key focus for SONI in one or two years of the price control if this area is being reviewed. However, it is unlikely to require the same level of focus across all five years.

3.72. In order to illustrate this, SONI has completed an exercise which looks to apportion the weights based on the average influence scores outlined in the UR's heat map (included in the Draft Determination[9]), to the SONI outcome weightings across the roles. Using this methodology, the below weightings were calculated:

Table 3.2. KPMG analysis of Table 1, Annex 4 of Draft Determination: Modified version of SONI influence heat map

SONI					
	Decarbonisation	Grid Security	System-wide Costs	TSO Service Quality	Sub-total
System operation and adequacy	6.1%	6.5%	11.8%	2.8%	27.3%
Independent expert	5.0%	3.0%	11.1%	5.2%	24.4%
Network development and system planning	5.5%	5.9%	10.4%	4.9%	26.6%

[9] DRAFT Annex 4: Evaluative performance framework for SONI, pg. 15.

SONI					
	Decarbonisation	Grid Security	System-wide Costs	TSO Service Quality	Sub-total
Commercial interface	3.4%	4.6%	6.7%	7.1%	21.7%
Sub-total	20.0%	20.0%	40.0%	20.0%	

Source: KPMG analysis, based on UR Draft Determination

Table 3.3. Spread between UR and SONI Weightings

	Decarbonisation	Grid Security	System-wide Costs	TSO Service Quality	Sum of Total Spread
System operation and adequacy	-1.1%	-1.5%	0.7%	2.2%	0.2%
Independent expert	0.0%	2.0%	-3.6%	-0.2%	-1.9%
Network development and system planning	-0.5%	-0.9%	2.1%	0.1%	0.9%
Commercial interface	1.6%	0.4%	0.8%	-2.1%	0.8%

3.73. As set out above, using this methodology offers a different set of weightings to the UR proposals. However, there are several shortfalls even in using this approach to score and assign weights to SONI activities. Influence scores are themselves subjective and sensitive to change over the course of a price control period. This is a crucial consideration to factor into the evaluative assessment framework, as the framework must be flexible and agile in responding to changes in the energy system.

3.74. This level of granular scoring is highly sensitive to changes in stakeholder expectations in SONI roles and outcomes. As stakeholder expectations are subject to change over time, in line with SONI outcomes, this would change the evolution of potential benefit to be gained by each role in each outcome as well as the extent to which the roles overlap. SONI outcomes are also highly influenced by a broad range of external factors, including the regulatory landscape, climate commitments, the evolving NI Energy Strategy, the economy and societal factors. Therefore, a highly granular approach to scoring is likely to suffer from rigidity and be inflexible in reflection of changes due to external factors.

3.75. Furthermore, if a weighting approach across 16 scoring categories is to be considered, it must be recognised that the final allocation will result in small weightings in each category. As a result, the materiality of £1m divided across 16 categories will be very low in value. This acts to devalue the incentive of SONI to remain outcomes-focused. This will ultimately be to the expense of customers.

3.76. Considering the above, SONI believe the approach proposed by the UR, of scoring across both outcomes and roles, is highly restrictive and has greater potential to incorrectly represent the benefit available for customers in each outcome by SONI activities. SONI would advocate for an approach that scores across the four outcomes alone, which will better support both SONI and UR in the delivery of system-wide and strategic initiatives.

3.7.2 Reducing Subjectivity

3.77. To reduce the subjectivity of the framework, SONI propose to include measurable outcomes as part of the annual forward plan which should also relate to the five-year period of the price control, not all outcomes being deliverable within a one year timeframe. In addition, SONI suggests that there should be clear, upfront expectations for the evaluative portion of the framework. There should also be a clear link between SONI performance and the potential level of reward for both the measurable and evaluative portions of the framework. This is critical so that the UR, SONI and the Performance Panel have a clear and shared understanding of how SONI will be measured against the evaluation criteria and therefore, how it will perform against the financial reward/penalty. By setting this out upfront, and receiving feedback midway through the annual process, it means that there should be no surprises to SONI in the outcome of the scheme.

3.78. When setting out the annual forward plan, SONI proposes to set out clear objectives, some of which should be linked to quantitative metrics. The quantitative outcomes should relate to the measurable portion of the evaluation reward, which we proposed accounted for 80% of the incentive with the more qualitative aspects relating to the evaluative portion of the reward, which we proposed accounted for 20% of the incentive. The latter qualitative measures should include an agreed definition and guidance of what constitutes a 'good' and an 'excellent' performance to ensure a shared understanding going into the performance process.

3.79. In the UR's Draft Determination, it is stated that they "do not propose to determine any quantitative performance baselines for specific metrics, above which SONI would automatically earn a financial reward and below which SONI would automatically face a financial penalty."[10]

3.80. However, SONI believe that this baseline setting is a vital part of ensuring a common understanding of performance expectation and therefore should play an important role in the evaluative performance framework.

3.81. With the fully subjective and discretionary approach that has been put forward by the UR, there is a risk of the biases impacting the ex post review of SONI activities. The benefit of hindsight will introduce a bias to how the decisions made by SONI in the past were the best option. After the event, it is hard to account for the level of uncertainty involved in that decision at the time and hindsight fails to capture the unknown information and the choices available when the decision was made. If the decision does not result in a sizeable positive outcome for customers when coming to assess SONIs performance ex-post then this bias will likely result in a score which does not reflect the intention behind a decision to 'do the right thing' at the time.

3.82. This will lead to SONI taking less risk when considering new initiatives which have the potential to increase value for customers.

3.83. Therefore, to provide SONI with confidence that delivering outcomes for customers will result in a favourable assessment of its performance, there needs to be a more structured

[10] DRAFT Annex 4: Evaluative performance framework for SONI, pg. 22.

approach in the evaluation process. This will involve an agreement of "what good looks like" upfront and therefore what needs to be achieved to get the rating of "good" or "excellent".

3.84. SONI therefore proposes the following process:

1. As part of the annual forward plan, SONI outlines the key performance metrics it will be measuring and the expected levels of these metrics as well as other more qualitative outcomes under a "baseline", "good" and "excellent" performance level.
2. The UR will consult the stakeholder group on the plan and the agreed measures will form part of the performance evaluation process.
3. At the midpoint of the year, SONI and UR will discuss any externalities which mean these measures are no longer an appropriate representation of performance.
4. In SONI's annual performance assessment, SONI will report the performance against these metrics as well as supporting evidence for other performance indicators, including evidence outlined by UR in the Draft Determination response.

3.85. This process is analogous to typical employee or executive performance review processes. As part of these annual cycles it is common to set expectation of performance up front, setting measurable targets where possible. To account for factors outside of the control of the individual, the process often allows for flexibility throughout the review process to adapt to uncertainty from external factors and a "check in" half-way through the period to allow for feedback and update if necessary. At the end of the year, the individual self-assesses their performance and highlights areas where external circumstances have impacted their performance. The crucial concept here is of clear, but mutually flexible performance expectations such that both sides are agreed on broadly what levels of performance will result in what outcome, while maintaining the flexibility to adjust for externalities in a dynamic way.

3.7.3 Increasing Power whilst Maintaining Financeability

3.86. As discussed above, it is vital that the framework offers SONI the opportunity to achieve a meaningful reward whilst having a level of downside that is financeable for the business. Without these two criteria being met, the framework will 1) not work to incentivise the right behaviour from SONI and 2) will be impossible for SONI to sign up to, as a critical service provider.

3.87. Given that the design of the incentive framework is contingent on the downside SONI is able to bear without jeopardising financeability which is in turn depends on the overall regulatory framework it is difficult to state what downside is acceptable for SONI but it is imperative that whatever level is set is financeable for the business.

3.88. The UR's Draft Determination provides extremely thin financial headroom, meaning that the downside risk SONI can bear in relation to its BAU system balancing business is between £500k-£900k. The range reflects the fact the cap and collar have been mostly calibrated to reflect BAU costs with limited weight assigned to TNPP in the assessment grid and limited ex-ante provision on Dt. The lower bound of the range assumes that TNPPs are given a limited weight, whereas the upper bound assumes the weight is more meaningful. The available buffer for BAU activities will depend, inter alia, on the final decision about the weightings in the grid.

3.89. Nevertheless, the range upper bound is below £1m collar specified in the Draft Determination and therefore is unable to be borne by SONI. Alternatively, under the CMA established framework, which was reflected in the Business Plan, SONI is able to bear £1.5m downside.

3.90. To ensure the framework is meaningful enough to incentivise SONI to take additional risk where necessary to create value for customers, SONI proposed the maximum reward is increased in line with what was put forward by SONI in the Benefit Sharing Framework proposal (+£3m).

3.91. Asymmetry in the reward and penalty has been included as an important element of the GB ESO incentive framework. In the recent Draft Determination for National Grid ESO published in July 2020, Ofgem state that *"The ESO can deliver substantial consumer benefit through its actions. It is important to have an upside incentive value that is sufficient to motivate excellent performance. Our main rationale for setting a greater upside than downside is that we do not believe £6m [the proposed downside] would be a large enough upside incentive to encourage the ESO to put a strong emphasis on its output incentives. We consider a value of £15m would provide strong incentives on the ESO to place delivering consumer benefits at the forefront of its decision-making."*[11]

3.92. Asymmetry in reward and penalty has also been put forward for EirGrid's current price control where the proposed reward and penalty of + €6.6m and - € 3.3m has been proposed in the CRUs recent Draft Determination. Considering EirGrid operate on the same 'All-Island' system and there is a sizeable amount of collaboration required between the TSOs to deliver an effective system, the misalignment of risk profiles across the system could lead to perverse incentives.

3.93. SONI, like the GB ESO, also has the potential to deliver substantial benefit to its customers but this arbitrary and low cap on reward able to be achieved through an 'excellent' performance is not proportional to this potential benefit. The UR's concern about a large upside for SONI being *"unduly generous to SONI at the expense of customers"*[12] fails to account for the significant value that is capable of being unlocked by SONI activities.

3.94. When considering the value for customers being left untapped, we should consider the incremental costs versus the incremental benefit of both the public (the customers) and the private body (SONI).

3.95. The UR states in the Draft Determination, "in practice it is probable that rewards for strong performance (but not excellent performance) would be significantly below the maximum reward, while penalties for weak (but not terrible) performance would be significantly below the maximum penalty."[13] This further reduces SONI's confidence that the upper limit of the

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[11] RIIO-2 Draft Determinations – Electricity System Operator, pg. 30. Available at: https://www.ofgem.gov.uk/system/files/docs/2020/07/draft_determinations_-_eso.pdf

[12] DRAFT Annex 4: Evaluative performance framework for SONI, pg. 29.

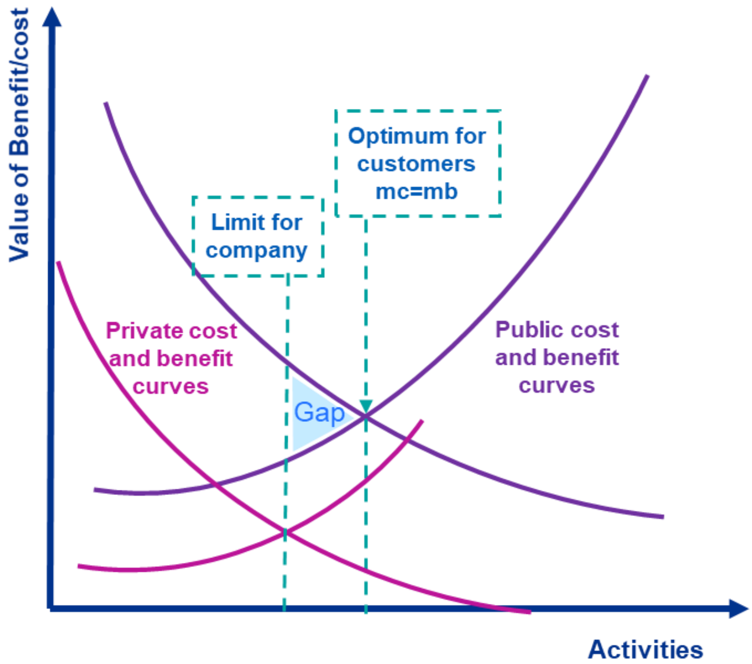
[13] DRAFT Annex 4: Evaluative performance framework for SONI, pg. 30.

reward is in fact achievable, and therefore weakens the incentive to put in substantial more effort when the top reward is unrealistic.

3.96. National Grid ESO raised the same concern in their response to their draft determination that *“Experience of the scheme to date suggests that scores and rewards tend towards the middle of the range, with scores around 3 out of 5 … This is unsurprising given the subjective elements in the scheme. If mid-range scores continue to be expected, the scheme will have a weak motivational effect on performance.”*

3.97. Like NG ESO, SONI is seeking an asymmetric reward and penalty but acknowledge that the above issue of those extremes still exist within an asymmetric scheme, particularly if a score of 3 still equates to a £0 financial reward. This issue must be addressed. For it to be overcome, a fundamental is a clear and defined link between outcomes and financial reward or penalty. This is critical to the success of the framework.

3.98. There is a point at which the public incremental cost and incremental benefit curves cross which is the optimum balance of quality and cost. In a competitive market, it would be expected that the private incremental cost and benefit curves would cross at the same point, therefore in a monopolistic market, the regulatory regime should seek to do the same.



3.99. However, by setting the upper limit of reward at a low level, there is a substantial gap between private benefits and public benefits and if this gap persists, the likelihood is that value to the customer is left behind.

3.100. The UR have stated in the Draft Determination that whilst they would “take account of” the scoring of SONI’s performance by the panel when determining the financial reward or penalty, they are clear that the final decision would rest with the UR. This adds another level of discretion to the process. This final step in the discretionary approach has been utilised by Ofgem for the ESO performance panel where a panel recommended a reward which was significantly higher than the reward that Ofgem finally determined. As a result, National Grid

ESO stated in their RIIO-2 Draft Determination response that *"Significant changes will be required in the RIIO-2 period to restore confidence in the scheme"*.

3.8 Independent Evaluation Panel

3.101. The makeup of the evaluation panel, including the independence, knowledge and expertise of the chair deserves careful consideration. Given that the network and energy markets will become more intertwined, SONI believes that a member of the UR's markets team should be involved in the development of this framework and have input or be part of the panel. This is important to ensure a whole system perspective is reflected in the assessment.

3.102. The need for expertise and knowledge of the members of the panel increases proportionally with the percentage of subjective assessment employed in the process. If the framework is based on a higher percentage of subjective evaluation, then it is critical that the members of the expert panel have expertise across the various functions that SONI fulfils. This includes grid development, connections policy, development and use of system services, capacity and energy markets, market competition and customer service performance. In a more subjective assessment, it will be critical that the panel members are truly independent (e.g. academia, NGO, umbrella organisations). Equally, members will need to understand the all-island context and market as there are crucial differences to the Great Britain market. This will be difficult to achieve in Northern Ireland, given its small size and close knit nature.

3.103. As stated at the outset of this chapter, getting this right is vital to unlocking greater value for customers. We appreciate the strong indication from UR that they wish to work with SONI to further develop this framework. SONI welcomes this and is committed to engaging further with UR on this important element of the price control.

Chapter 4

Cost Recovery Mechanisms and the Management of Uncertainty

Table of Contents

4 Cost Recovery Mechanisms and the Management of Uncertainty

4.1 Key Messages

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

- **Conditional cost sharing (CCS) could result in asymmetric outcomes:** There are fundamental problems with the new conditional cost sharing mechanism, 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. This is particularly the case if where SONI under-spends relative to allowances this is clawed back ex post and where SONI over-spends or underperforms it is exposed to 25% of the variance. In addition efficient baseline costs have not been provided for under the Draft Determination and imply SONI would have to assume under-performance in the base case which it cannot bear under CCS.
- **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 regulatory assessment 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:** It is critical that SONI's regulatory framework incentivises the right behaviours and encourages innovative approaches to deliver key strategic objectives. 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 (allowed ex ante or recovered via uncertainty mechanisms) could encourage risk averse behaviour and undermine financeability:** 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.

- **Process for increasing allowances for strategic initiatives e.g. due to scope change is not clear:** 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. Additional clarity and guidance around the process for requesting additional costs (whether the costs are subject to CCS or recovered via the Dt uncertainty mechanism) is critical to avoid delay and support recovery of efficient costs.

4.2. 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.

Table 4.1. Summary of Clarifications and amendments Required by Cost Category

Cost Category	***Clarifications and Amendments Required to Cost Recovery Mechanisms***
Internal BAU[1] *costs*	— Additional guidance on the rules for CCS and how it would work in practice to limit such asymmetric outcomes. SONI would welcome confirmation that: o if SONI outperforms that the burden of proof (equivalent to the principles UR applies in its DIWE test) would lie with UR to support application of a 100% cost sharing rate, consistent with the principles of the DIWE test o if there is cost underperformance, adjustments can only be made such that SONI bears 25% of expenditure above ex ante allowances or to allow full pass through where justified — Clear guidance on evidence required to support full pass through of any over-spend compared to ex ante allowances — Additional detail around how UR intends to assess over-spend and under-spend across cost categories — Ex ante provision for all efficient costs to avoid under-performance in the base case
Strategic initiatives – ex-ante	In addition to the points raised on BAU costs — Clarity and guidance - consistent with DIWE guidance - around the scope of the ex-post review, its application in practice and codification is necessary if these projects are subject to CCS. In particular, clarity is needed that the ex-post review will be based on ex-ante information and options available to the company when the project is undertaken. — Clarity and guidance around the process for the inclusion of additional costs under the CCS, for example due to changes in scope. SONI understands that this could be achieved through applying a 100% sharing factor for these costs.

[11] Cost categories listed in Table A under the Bt licence term specified in the SONI licence (February 2019)

Cost Category	*Clarifications and Amendments Required to Cost Recovery Mechanisms*
Strategic initiatives – subject to uncertainty mechanisms	— Clarity and guidance around the process for inclusion of additional costs (e.g. changes to the cap under the Dt mechanism). 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. — Clarification that UR guidance on the Dt mechanism will apply. — 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.
Transmission network development costs	— No action required
System support services	— No action required

4.2 Introduction

4.3. Over the next few years, the energy sector will go through a period of widespread, disruptive change. New technologies combined with new market structures and the coalescing of platforms, will change the face of the energy sector and the activities within it.

4.4. Delivery of key strategic outcomes will require innovative approaches and first-of-a-kind projects to deliver net-zero carbon emissions and the energy strategy that the DfE is currently developing. There is also likely to be some uncertainty around the timing and scope of certain initiatives required to deliver SONI's strategic outcomes.

4.5. For SONI to perform at the highest level in this environment and to play its role in delivering the energy transition and transformation of the sector, its operations and activities need to be flexible, agile and customer focused. To support this, the regulatory regime should have the same characteristics:

- **Flexibility -** The price control should allow SONI to respond to the changing needs of the customers and technology developments that have an impact on the requirements of the system.
- **Agility -** The pace of change of technology and needs in the electricity industry is fast and SONI needs to respond to these rapidly to avoid falling behind the curve and limiting customers benefit from technology developments.
- **Customer delivery focused -** Customers benefit from having an innovative and proactive TSO and the regulatory regime should be focused on the value added to the customers rather than the internal costs of delivering that value.

4.6. The focus on SONI's internal costs under the current framework, which has a small impact on customer's bills, means that the other benefits for customers remain largely untapped leading to missed opportunities.

4.7. Internal costs are not material compared to the value SONI can unlock for customers in:

- Energy system decarbonisation;
- Grid security; and
- Whole system costs.

4.8. The customer benefit associated with improved outcomes is disproportionately large relative to the private benefit to networks of delivering these improvements. The non-provision upfront for innovative projects means risk and increased costs to customers and could result in an inability to deliver on key strategic objectives[2], and it is therefore particularly important that mechanisms support cost recovery for these projects. It is critical that the cost recovery mechanisms available to SONI are flexible, incentivise the right behaviour and enable SONI to be agile and innovative.

4.9. In this context SONI welcomes UR's recognition that it is appropriate to reduce the sharing rate on internal costs and its commitment to working with SONI through this consultation process to develop and clarify the safeguards and risk sharing mechanisms that it has added to SONI's cost recovery mechanisms at Draft Determination.

4.10. It is important given SONI's critical role and the value that SONI can unlock for customers to strike the right balance between ex-ante specification of costs and use of uncertainty mechanisms. 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. In addition this establishes and makes clear the regulatory contract. However the Draft Determination does not provide ex-ante allowances for a significant proportion of costs for strategic initiatives:

- Insufficient ex-ante allowances give rise to risks that projects will not be undertaken or will be delayed to customer detriment, impair planning and management through optimisation, risk inefficiencies (e.g. through stop start on projects) and impede comprehensive economic appraisals.
- Ex-ante allowances do not risk significant additional costs to customers when compared with the disbenefits of these projects not being carried out or being delayed. The high likelihood that the benefits exceed the costs should be sufficient to provide for costs ex-ante.

4.11. The delivery of strategic objectives in line with changing risk circumstances and customers' needs is hindered by a more piecemeal agreement of activities and granular assessment of costs and deliverables.

- There is a risk that cost recovery mechanisms if miscalibrated could dampen incentives to proactively address issues before they arise, as they could encourage a "wait and see" approach.
- Similarly there is a risk that uncertainty mechanisms could disincentivise SONI from developing new approaches where cost recovery is contingent on ex-post assessment

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[2] UR, Appendix C- Statutory Duties, *"to promote research into, and the development and use of, new techniques by or on behalf of persons authorised by a licence to generate, supply, distribute or participate in the transmission of electricity"*, https://www.uregni.gov.uk/sites/uregni/files/media-files/Appendix_C_-_Statutory_Duties.pdf

of costs and the burden of proof with respect to efficiency require companies to justify whether additional expenditure or efficiencies achieved are warranted.

- 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.

4.12. In order to demonstrate the potential risks of delay and disbenefit to customers, we have considered a counterfactual scenario where SONI altered its behaviour and did not commit capital to operationalising I-SEM based on timescales agreed with SEM-C. The potential outcome would have resulted in customer disbenefits including:

- Higher costs to customers – as an example the first year of capacity market savings for Northern Irish customers is estimated to be £50m[3]; it follows that customer bills would have been increased by £137,000 for every additional day of delay. In this scenario customers would not have benefitted from lower prices resulting from increased efficiency and competition in new markets.
- Resilience of service – the lack of ability to trade across borders would limit the access to supply and optimisation of power available on the island of Ireland[4].

4.13. This chapter is structured as follows:

- **Section 4.3** sets out the key principles for assessment of cost recovery mechanisms
- **Section 4.4** compares the Draft Determination cost recovery mechanisms and the SONI business plan and identifies the key changes
- **Section 4.5** assesses the key changes to cost recovery mechanisms introduced at Draft Determination (Section 4.3) based on the key principles (Section 4.4), including identification of concerns and areas where additional clarity and guidance around how key mechanisms will function in practice is required.

4.3 Key Principles for Assessment of Cost Recovery Mechanisms

4.14. Figure 4.1 below sets out key principles for the design of cost recovery mechanisms, which are based on regulatory precedent, economic principles, incentive theory and the conditions required to support financeability. These principles inform SONI's assessment of the changes made to cost recovery mechanisms in the Draft Determination.

[3] https://www.uregni.gov.uk/news-centre/utility-regulator-comments-isem-capacity-auction-outcome
[4] https://www.semcommittee.com/news-centre/new-all-island-wholesale-electricity-market-goes-live

Figure 4.1. Key Principles for Assessment of Cost Recovery Mechanisms

Clear ex-ante specification of the mechanisms for cost recovery	— Cost recovery mechanisms should provide a clear ex ante framework for recovery of costs — The absence of full specification of the regulatory contract could introduce additional risk and downside exposure, introduce inefficiency and encourage risk averse behaviour.
Incentivises the right behaviour	— The price control should encourage innovation, agile behaviour, best outcomes for customers and delivery of strategic policy objectives o It is critical that the price control enables SONI to make the right decisions at the right time to avoid delay and customer detriment o Risk aversion would not be in the customer interest where this hinders delivery of strategic outcomes and the unlocking of value for customers
Simulates competitive market outcomes	— The price control should where possible approximate competitive markets and simulate efficient market outcomes — UR has a statutory duty to *"Promote competition, where appropriate, in the generation, transmission and supply of electricity"*. This statutory duty is common across economic regulators and is typically interpreted as structuring regulation to reflect market outcomes
Fair bet	— Cost recovery mechanisms should represent a fair bet and not result in a loss on an expected basis, as no reasonable investor would invest in business activities that are expected to generate losses. It is critical that ex-ante allowances are achievable for SONI to ensure that the price control is a fair bet and to avoid an expected loss up front.
Financial resilience	— Risk exposure implied by cost recovery mechanisms should be consistent with financial resources available for management of risks

4.4 Comparison of Draft Determination Cost Recovery Mechanisms and the SONI Business Plan

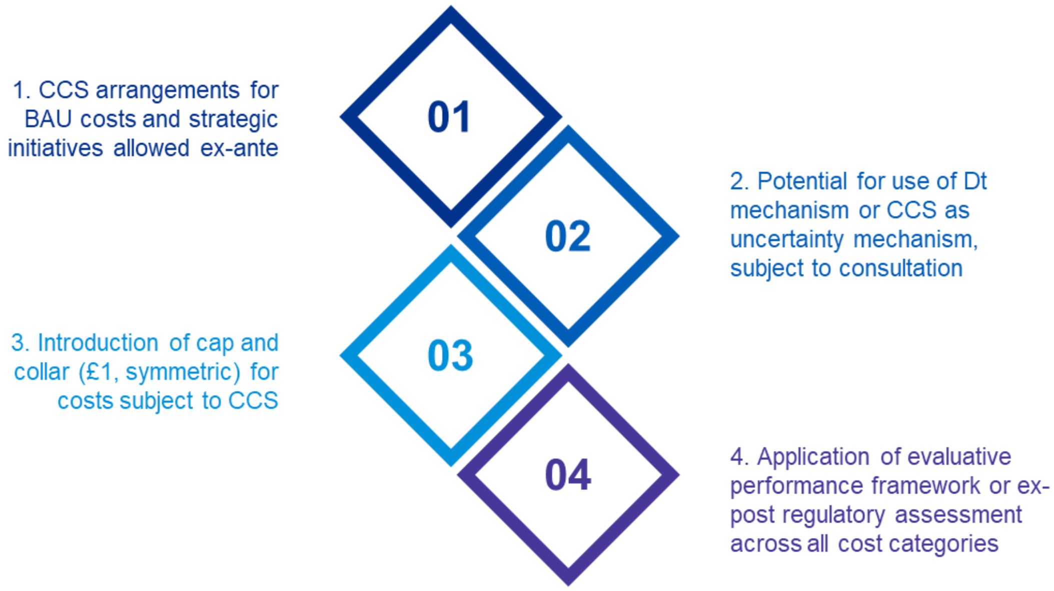
4.15. This section sets out a summary by cost category of the cost recovery mechanisms in the Draft Determination and compares these mechanisms to the assumptions in the SONI Business Plan.

Table 4.1. Comparison of Draft Determination Cost Recovery Mechanisms and the SONI Business Plan

Cost categories	*UR Draft Determination*	*SONI BP*	Key differences
1. Internal BAU costs	Conditional cost sharing ('CCS') arrangements, which comprise of: — 75/25 sharing factor up to the £1m cap and collar, conditional on regulatory assessment — 0% sharing factor on any overspend that can be demonstrated to improve performance against outcomes — 25% sharing factor on any underspend that can be justified as genuine efficiency — Any costs determined to be DIWE are excluded from CCS	85/15 cost sharing factor up to cap of £3m and collar of £1.5m	DD cost sharing factors are similar to those proposed under the SONI BP. However, the conditionality of the mechanism implies material ex-post risk And uncertainty through application of regulatory assessment and DIWE Cap and collar are lower under the Draft Determination and symmetric (with limited scope for upside)
2. Strategic initiatives – ex-ante	Same as above	Same as above	Same as above
3. Strategic initiatives – subject to uncertainty mechanisms	Uncertainty mechanisms are still under development for strategic initiatives that are uncertain or unknown but may crystallise during the price control period. UR is considering: — Dt mechanism subject to evaluative performance framework — Ex-ante baseline set for efficient costs set during the price control subject to CCS — Potentially deeming additional funding requests unnecessary given the arrangements under CCS to recover justified overspend DIWE provision would apply unless costs fall under system support cost category	Dt mechanism	The options considered in the Draft Determination incorporate ex-post review in addition to DIWE (already specified under Dt), as performance is subject to the evaluative performance framework The option to increase ex ante allowances and include additional initiatives within the CCS exhibits the differences to the SONI BP set out above.
4. Transmission network development costs	TNPP mechanism subject to the evaluative performance framework	TNPP mechanism	No change to cost recovery mechanism proposed. Performance is now assessed via the evaluative performance framework
5. System support services	Pass-through with the application of the evaluative performance framework	Pass through	No change to cost recovery mechanism proposed. Performance is now assessed via the evaluative performance framework

4.16. There are four key changes to SONI's cost recovery mechanisms set out the Draft Determination, which are assessed in the following section, as shown in Figure 4.2.

Figure 4.2. Key Changes to Cost Recovery Mechanisms

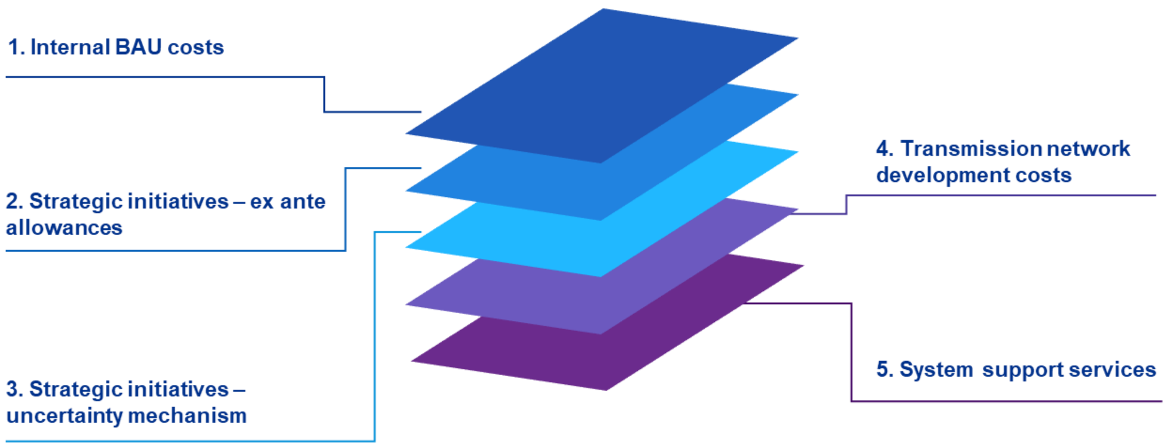


4.5 Assessment of Changes to Cost Recovery Mechanisms Implied by the Draft Determination

4.17. This section assesses the key changes to cost recovery mechanisms implied by the Draft Determination, taking into account the key principles in Section 4.3.

4.18. The assessment of the cost recovery mechanisms set out in the Draft Determination is structured by cost category as set out in the figure below:

Figure 4.3. Structure of the Assessment by Cost Category



4.5.1 Internal BAU Costs

Changes to Cost Sharing Rates

4.19. The Draft Determination recognises the need to adjust sharing rates in order to reflect the scale of cost uncertainty faced by SONI across PC2020-25. The UR's approach paper also acknowledged this and signalled the consideration of lower sharing rates.

4.20. We are pleased to note that this is consistent with the approach adopted by SONI in its business plan, which commented that: *"A lower benefit share helps manage uncertainty. Effectively with a lower benefit share customers are better protected from either SONI or the UR mis-forecasting that which ultimately required for the period... Ultimately SONI believes the appropriate benefit share lies somewhere between 10% and 20%. In this business plan submission SONI is proposing this is set at 15%."*

4.21. The cost sharing rates reflect UR's recognition that SONI's asset light structure increases the sensitivity of its profits to cost variances and its risk exposure should be reduced to *"no more than necessary to encourage efficiency"*[5].

Conditionality of the Sharing Mechanism and Implications for Asymmetry

4.22. The conditionality of the cost sharing arrangement as proposed by Utility Regulator in the Draft Determination increases exposure to regulatory assessment and means that despite cost sharing rates appearing symmetric ex-ante, the mechanism could result in significantly asymmetric outcomes as the parameters of cost sharing can change ex post providing no clear framework up front. This is particularly the case if where SONI under-spends relative to allowances this is clawed back ex post and where SONI over-spends or underperforms it is exposed 25% of the variance. In addition efficient baseline costs have not been provided for under the Draft Determination and imply SONI would have to assume under-performance in the base case which it cannot bear under CCS.

4.23. There is limited guidance as to how conditional cost sharing and the ex post regulatory assessment 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. The 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

4.24. SONI cannot rely on symmetric outcomes from the CCS arrangements as set out in the Draft Determination. As a result it is necessary that the UR provide guidance to specify ex ante how CCS would work in practice to limit exposure for the business to asymmetric outcomes.

4.25. In particular SONI would expect that in order to secure symmetric outcomes that guidance would specify that the burden of proof for any claw back of out-performance or under-spend against ex ante allowances under the CCS would lie with UR, to evidence and demonstrate that any variance was to customer detriment against clear principles specified ex ante. This is important to ensure that the CCS represents a fair bet, and to avoid the potential implication that UR is looking to assume micro control of SONI's costs (which we understand from recent discussions that UR does not wish to do).

4.26. SONI would expect the treatment of outperformance (or under-spend) to be consistent with the principles of the 'Demonstrably Inefficient or Wasteful' test[6] typically applied under the current framework where (1) the burden of proof lies with the regulator to demonstrate ex-post that an adjustment is required; and (2) outturn expenditure is presumed to be efficiently incurred and the hurdle rate for ex-post adjustment is high.

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[5] UR (2019), Price Control for NI TSO 2020-2025 - Final Approach

[6] UR states in respect of DIWE that *"the starting point is therefore that expenditure which is potentially subject to DIWE is presumed efficient; unless and until the UR establishes that it is not."*

4.27. It is critical that UR provides additional guidance on the rules for CCS and how it would work in practice to limit such asymmetric outcomes. SONI 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; and
- If there is cost under-performance, adjustments can only be made such that SONI bears 25% or to allow full pass through where justified.

4.28. Additional detail around how UR intends to assess under-spend and over-spend across cost categories is also important. For example if SONI overall was spending in line with ex ante allowances but outperforming on some cost categories and underperforming on others the application of CCS at this granular level could result in additional asymmetry.

Interplay Between the CCS and the Evaluative Performance Framework

4.29. UR has suggested that there will be no formal adjustment to the outcome of the evaluative performance framework. SONI would welcome confirmation that cost performance under CCS would not be reflected in the outcome of the evaluative framework under any circumstances.

4.5.2 Strategic Initiatives – Ex-ante Allowances

Commentary on Cost Recovery Mechanisms for ex ante Strategic Initiatives

4.30. Overall SONI would expect the cost recovery mechanism to closely mirror the framework for internal costs set out above, and that ex ante allowances for strategic initiatives would be governed by the CCS. Notwithstanding this there are characteristics of strategic initiatives which could exacerbate the concerns articulated above around potential asymmetric outcomes, given the innovative and first-of-a-kind nature of a number of these projects.

4.31. In innovative industries there is recovery of trial and error costs through unlimited upside on genuine innovation. The nature of SONI's strategic initiatives (e.g. new first-of-a-kind IT systems) is such that the appropriate solution is likely to be innovative and to involve trial and error costs that may be considered unnecessary ex-post with the benefit of hindsight but appear reasonable ex-ante.

4.32. 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; this could encourage risk averse behaviour and limit the willingness of the business to undertake the innovative projects which will unlock value for customers.

4.33. It is critical for the regulatory framework to arrive at the efficient market outcome in order to support financeability and avoid disincentivising future investment:

- Efficient market outcomes for innovative projects involve recovery of trial and error costs and additional scope for upside proportionate to value added.

- In order to simulate a competitive outcome, the ex-post assessment will need to be based on ex-ante information and choices available to the company, in line with DIWE guidance.
- The scope for innovation is constrained where trial and error costs can be disallowed ex-post with the benefit of hindsight.
- SONI must also have sufficient upside incentives under the evaluative performance framework to undertake innovative projects consistent with incentive theory.

4.34. As part of the overall package which aims to provide for a financeable proposition and protects the interests of customers through progressing initiatives which drive customer value 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.

4.35. We understand from the Draft Determination engagement that UR would apply DIWE in line with its published guidance. We would expect that the following principles would apply[7]:

- *"…where the UR decides that expenditure which has already been incurred is to be disallowed as DIWE, the UR must be able to demonstrate that the expenditure which was incurred was inefficient or wasteful"*
- *"Where the UR chooses to inquire into whether certain expenditure may be DIWE, it will take into account all the relevant circumstances…*
- *(c) The extent to which the Licensee was, or ought to have been, able to control the relevant expenditure…*
- *(d) The information that was reasonably available to the Licensee and/or its third party contractors, at the time that it and/or they made any relevant decisions in relation to expenditure or the control of expenditure."*
- *"Where it identifies expenditure that it considers may be DIWE, the UR will invite the Licensee to make representations, and will take those representations into account before making its final determination."*

4.36. In addition – particularly given the risks and cost uncertainty associated with strategic initiatives – clarity and guidance around the process and evidence required for the inclusion of additional costs under the CCS, for example due to changes in scope – is critical. SONI understands that this could be achieved through applying a 100% sharing factor to these costs.

4.37. SONI is unlikely to proceed with projects and spend beyond ex ante allowances without a clear process for engaging with UR around changes in scope and the evidence required amending ex ante allowances or ensuring that the 100% sharing factor would be applied. SONI will not be able to progress with projects where there is an unfunded change in scope and does not ex ante expect that it will be able to recover its efficient costs. SONI would welcome clarity and guidance around the process for the inclusion of additional costs under the CCS.

[7] Utility Regulator (2017), Guidance on the interpretation and application of DIWE provision

4.5.3 Strategic Initiatives – Uncertainty Mechanisms

4.38. By nature, some strategic initiatives are more and others less certain and will require further information and developments before they crystallise.

4.39. The Draft Determination highlights that the Dt mechanism could be used to recover costs associated with strategic initiatives which crystallise during the price control period.

4.40. 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.

4.41. 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.

4.42. 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.

4.43. We would expect that UR would follow its published guidance on the Dt mechanism; this considers the following principles[8]:

- *"We note that some Dt applications largely fall outside of SONI's control, for example, because they relate to statutory obligations or are needed to satisfy public policy perspectives. Where appropriate, these costs may be treated more akin to a managed pass through."*
- *"The UR recognises that some Dt costs can be uncertain or outside SONI's control. In the event that the approved cost cap will be breached, SONI may submit an application to increase the cap. SONI can make such variation requests at any time, but should endeavour to do so in advance of the cap being exceeded."*
- *"If required, UR approvals will signal if a Dt submission is considered uncontrollable expenditure. If this designation is given, variation applications must still be made for spend above the initial cap. However, such applications will be allowed in all instances as specified in the approval."*
- *"In conducting the review, the UR will consider whether the amounts are not greater than or below the cap and that none of the expenditure is demonstrably inefficient or wasteful (DIWE). This review will be conducted in line with the guidance and procedures published by the UR on DIWE"*

4.44. Finally, 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 would welcome further clarity and guidance UR around the circumstances and conditions under which the Dt mechanism (rather than CCS) will be used to recover costs.

[8] UR (2018), Requirements and Guidance on Excluded SSS/TUoS costs: Exhibit 2 – Dt Guidance Document

4.5.4 Transmission Network Development Costs

4.45. UR's Draft Determination proposals are consistent with the CMA framework and we do not propose any amendments or request any amendments to the mechanisms for cost recovery set out in the Draft Determination.

4.5.5 System Support Services Costs

4.46. UR's Draft Determination proposals are consistent with the CMA framework and we do not propose any amendments or request any amendments to the mechanisms for cost recovery set out in the Draft Determination.

4.47. SONI notes the 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. If this is the case, then this additional risk needs also to be recognised.

Chapter 5
Funding for Business as Usual

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5 Funding For Business as Usual

5.1 Key Messages

5.1. SONI considers that there is currently a significant gap in BAU funding provided in the Draft Determination and its Business Plan submission. However, 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. SONI has worked with the UR to help clarify its submission and enable the UR to make informed decisions in the Final Determination.

5.2. Without closure of the gap between SONI's requested level of funding for core business and that allowed for in the Draft Determination measures will have to be taken to live within allowances and inevitably result in a reduction in the standard of services provided.

5.2 Introduction

5.3. SONI's Business as Usual (BAU) ask in its Business Plan Submission related to three main areas – BAU Opex, Pension Deficit Repair and Real Price Effects. SONI considers it fundamental that these areas receive appropriate levels of funding to ensure that SONI can effectively carry out its day to day activities to lay a solid foundation for the exciting and challenging industry wide changes to come in the near future.

5.4. This chapter addresses the areas of funding shortfall and provides clarification and additional information to support the Utility Regulator to make further informed decisions on the level of funding for these areas in its Final Determination.

5.3 Funding for Core Remit

5.3.1 SONI Baseline Costs

5.5. SONI identified a funding shortfall of £2.3m per annum in the Draft Determination against its ask for BAU Opex activities, as shown in Table 5.1.

Table 5.1. Shortfall in BAU Allowance

Opex Area	Shortfall (£m)
I-SEM	1.3
Recharges	0.8
Average FTE Salaries & Other Staff Costs	0.2
Total	**2.3**

5.6. A summary of each of these areas is provided below, while further detail is provided in Annex D.

5.3.2 I-SEM Costs

5.7. Since the I-SEM went live, SONI incurs new costs of £1.3m relating to Capacity Market activities and I-SEM systems that have to be undertaken by SONI as the TSO. The costs specifically relate to payroll, IT software maintenance and support, audit of the scheduling and dispatch process as required by the Licence, as well as some Nominated Electricity Market Operator (NEMO) costs that are borne by the TSO.

5.8. These costs were subject to and approved by the UR as part of a D_t request in 2018, following the introduction of I-SEM. These enduring costs are now included as B_t Opex for the 2020-25 Price Control. It would appear that the I-SEM costs required within BAU costs have been omitted in the Draft Determination.

5.9. Chapter 4 of SONI's Business Plan submission included a table for SONI's baseline costs totalling £14.4m. However, the table did not separate out the additional I-SEM costs for the baseline year and therefore didn't expressly identify the reason for the step change required moving into the 2020-25 Price Control. Table 5.2 below addresses this and shows the breakdown as well as the required step change of £1.3m relating to the I-SEM costs.

Table 5.2. SONI Baseline Costs

Opex Area	BAU (£m)	I-SEM (£m)	Total (£m)
Payroll and Pension	8.0	0.5	8.5
Staff Related Costs	0.4	0.1	0.5
Total Telecoms & IT Costs	3.0	0.6	3.6
Total Professional Fees	0.7	0.1	0.8
Total Facilities Costs	0.6	0.0	0.6
Net Recharges	0.1	0.0	0.1
Total Operating Costs	0.3	0.0	0.3
Total Bt Opex	**13.1**	**1.3**	**14.4**

5.10. These significant I-SEM costs totalling £1.3m per annum are essential to the running of the SONI business and SONI requests that the UR provides for this in the Final Determination.

5.3.3 SONI Recharges – Net Group Payroll Recharges

5.11. SONI engaged with the UR following the Draft Determination to clarify their submission and has subsequently reclassified the payroll tab (Annex F) to show in more detail the expenditure being requested.

5.12. SONI receives a net recharge (cost) in for Group Payroll Recharges across all the entities of the Group. Group payroll recharges are calculated based on the Group Recharge Allocation Policy[1], which SONI agrees with and has signed up to. All staff that work on all-Island roles are identified and their subsequent costs allocated to the correct area of the Group based on actual payroll costs.

[1] Submitted as Annex L of the SONI Business Plan Submission

5.13. Two significant areas within the all-Island business that much of the recharging relates to are the Innovation and Planning Directorate and the People and Information Directorate. Much of this relates to areas where there are all-Island tariffs and services such as System Support, System Performance, and IT Infrastructure where all-Island teams ensure that both control rooms and support staff are adequately supported in their day to day jobs. Many of these roles create synergies across the Group.

5.14. In some other areas SONI has small teams and benefits from leveraging their counterparts in other areas of the Group. SONI staff also benefit from the larger Group structure in obtaining employee service benefits for their development and wellbeing.

5.15. It should be stressed that there are also areas in which SONI staff lead the way within the Group and other areas of the Group receive this benefit and therefore are recharged for this.

5.16. SONI requests UR to provide fully for Group Payroll Recharges of £1.1m per annum in the Final Determination.

5.3.4 SONI Average FTE Salaries

5.17. SONI has reclassified its payroll submission in order to ensure that an accurate Full Time Equivalent (FTE) average salary can be calculated. Using the information in this reclassification results in a reduction to the UR's estimated average salary included in the Draft Determination and in line with SONI's total costs per FTE as per its Business Plan submission.

5.18. SONI considers that the ASHE data used for benchmarking in the Draft Determination contains a number of shortcomings when it comes to making comparisons to companies such as SONI because job categories will not fit skills and activities. The data do not explicitly control for experience or education, and the data do not control for the level of unionisation of the workforce or impact of shift patterns on pay. Therefore, the ASHE data cannot be considered to be a good direct comparison to SONI as it is unclear what level of wage adjustment would be expected in order to appropriately compare to the job types reflected in the ASHE survey.

5.19. However, SONI acknowledges that benchmarking is relevant in any Price Control and has therefore reviewed the salary figures provided in the previous and current Price Controls along with trends in ASHE to give an indication of its views on the salary rates provided in the Draft Determination.

5.20. SONI's review of these trends indicated the following:

[redacted]

- SONI's basic salary and total cost per FTE is lower than its nominal 2015-20 Price Control allowance; and
- SONI's basic average salary has decreased over the 2015-20 Price Control period, while all ASHE salary bands have increased over the same period.

5.21. SONI notes that the UR has departed from its methodology in the 2015-20 Price Control period and adjusted to reflect for Northern Ireland labour costs. This is despite its previous acknowledgement that ASHE NI was not considered an adequate benchmark. SONI note that DfE has also reported that there is relatively low confidence in the ASHE NI data for more disaggregated job categorisations compared to the UK dataset. SONI considers that an adjustment for Northern Ireland salaries is not therefore justified.

5.22. SONI considers that the trends presented in Annex D indicate that the requested salary costs are both efficient and reasonable. SONI would emphasise the specialist nature of the roles fulfilled by employees in SONI, the scarcity in the market place for such resources and the critical service for which SONI is responsible. SONI requests that the requested FTE salaries are provided as per the reclassified submission.

5.3.5 Other Areas

Connections Overheads

5.23. The Draft Determination introduced the concept of SONI's connections income making a contribution to the overheads of the business such as HR and support functions, depreciation and return on capital for central IT investment. This would have the effect of further reducing SONI's BAU Opex allowance which is already considered by SONI to be inadequate.

5.24. 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 area.

5.25. This was discussed with the UR following receipt of the Draft Determination. SONI considers that the original BAU request remains justified and cannot absorb a further reduction relating to connections overheads as indicated in the UR Draft Determination without a corresponding decline in the provision of this service.

Payroll Reclassification

5.26. On receipt of the Draft Determination, it became apparent that further clarification of the payroll lines submitted and included in the financial model would be beneficial in enabling the UR to understand and substantiate the funding being sought.

5.27. SONI engaged with the UR following receipt of the Draft Determination and has reclassified its payroll to ensure that its request in the Business Plan submission was clearly understood. SONI presented this reclassification to the UR. The detail relating to this can be found in Annex D.

5.28. None of the above reclassifications have changed the amount requested by SONI as part of its BAU Business Plan Submission. However, it had a significant effect on the average FTE salaries as detailed in Section 5.2.4. The payroll reclassification was presented to and sent to the UR. It will also form part of the resubmission of the SONI financial model.

Other Staff Costs

5.29. The Draft Determination provided reduced allowances relating to the following:

- Overtime and Standby Allowances; and
- Indirect staff costs.

5.30. These reductions were based on SONI's requested FTE allowances against allowed FTEs. However, neither of these areas were submitted on the basis of total FTE and SONI is requesting that the submitted costs are allowed for in full.

Defined Benefit Employer's Contributions

5.31. Following receipt of the final version of SONI's Triennial Valuation of its Defined Benefit Pension Scheme to 31 March 2019, SONI has reduced its pension contributions in line with the required percentage.

RAB

5.32. SONI is generally content with the majority of suggested treatment of its RAB in the Draft Determination. However, additional adjustments are required to the projections related to RAB in order to reflect accurate and up-to-date historical data on additions and depreciation, the new policies in 2020-25 and to accurately to reflect the transition from RPI to CPIH. These adjustments have not been applied in the current modelling. SONI will engage with the UR before the Final Determinations on these issues. SONI will provide additional representations on this matter shortly.

5.4 Change in Roles

5.4.1 Telecoms Changes

5.33. In relation to telecoms the UR stated in its Draft Determination that the OTN assets used in the field should be in the ownership of the TAO and remunerated via their price control mechanisms. As such it has proposed to provide SONI with the pass-through telecoms Opex for the remainder of NIE Networks RP6 price control period (2023-24) and excluded the OTN allowance from RP7 onwards (2024-25). SONI has responded to this in Chapter 6.

5.4.2 TUoS Risk Transfer

5.34. In its Draft Determination, the UR has stated that the collection agent risk for TUoS in Northern Ireland should transfer to NIE Networks. This was not discussed with SONI before publication of the Draft Determination. Furthermore, within the Draft Determination there is no consideration of the practicalities or issues that would arise from such a change.

5.35. Instead the UR points to a consultation undertaken by Ofgem for GB, which contains a significant amount of detail around the practicalities of such a change in GB and which was undertaken in advance of the draft determination of both the ESO and TAO price controls. The Ofgem consultation was undertaken in the context of the GB market rules and tariff setting process, which differs from that in Northern Ireland and the SEM. SONI did not review or respond to the consultation in GB because it relates to matters that are devolved.

5.4.3 TUoS Risk Transfer - Comparison with Moyle Arrangements

5.36. The UR states that this change will not impact NIE Networks as TAO because a similar change was possible for the revenue that SONI collects for Moyle. This situation is not equivalent because:

- The revenue SONI collects for Moyle is a relatively small top-up, which is only required in unusual circumstances. In most years the CAIRt call has been zero.
- Moyle is funded through low risk bonds, and is operated for the benefit of electricity customers in Northern Ireland. It will be returning money voluntarily to customers during the 2020/21 tariff year.
- Moyle is not affiliated to any parties that compete in the supply or generation markets on the island of Ireland; therefore it can be involved in calculating the tariff that SONI sets to calculate the revenue top-up without creating an actual or perceived conflict of interest. This is evidenced through the correspondence between SONI, Moyle and the UR detailing the CAIRt calculation for 2020/21.
- NIE Networks is part of a vertically integrated utility, with affiliates competing in the generation and supply markets in Northern Ireland and the SEM. If it was to provide the same input into the tariff setting process that was followed for Moyle in 2020/21, this would give rise to a conflict of interest. This would damage confidence in the level playing field, even if it was not acted upon and only remained a perception.
- Moyle pays SONI to collect the CAIRt revenue. SONI is acting as Moyle's agent and acting on their behalf when collecting any revenue top-up. SONI does not receive any additional rights in the years when it collects revenues for Moyle. This is a fee that is only paid by Moyle to SONI when the collection agent service is provided.
- Conversely SONI pays NIE Networks the Transmission Services Charge as consideration within the contract that provides SONI with the right to operate NIE Networks' assets. NIE Networks does not pay SONI to collect revenue for it. In this case SONI is making a payment to NIE Networks in exchange for rights to operate the transmission system.

5.4.4 Issues Raised in GB

5.37. The Draft Determination does not give any consideration to the responses that Ofgem received to its consultation on the transfer of TUoS collection risk to TAOs. Ofgem received six responses to its consultation. The issues raised include:

- The two Scottish TOs state that the cashflow risk presents an additional, and unquantified, risk for the TOs which has not been accounted for in their finalised RIIO-T2 Business Plans;
- SPT said new (costly) treasury policies would be required and the risk would need to be reflected in its cost of equity;
- DNO WACC is set in the context of the DNO setting the tariffs (which provides an ability to mitigate risk) therefore the TAO WACC would need to be higher because they cannot mitigate the risk. Alternatively they would need to have a significant input to the tariff setting process;
- TOs would be exposed to TSO forecasting inaccuracies; and
- TSO risk would not be removed completely – bad debt risk is left with NG ESO under the Ofgem proposals.

5.38. It is important to note that the Ofgem consultation explicitly set out how the risk was being allocated and stated clearly that the WACC for the TOs would be adjusted to reflect this change. The UR consultation did not explain how the risks related to GTUoS revenue collection would be treated and assumes that the current WACC for NIE Networks transmission RAB is appropriate for this situation. This would imply that NIE Networks would have an input to the TUoS tariff setting process that is equivalent to its role in the DUoS tariffs, which would introduce an actual and/or perceived conflict of interest.

5.39. Based on reactions to the Ofgem consultation on the new price controls in GB, this is clearly not a settled issue.

5.4.5 Issues that should be considered for the TUoS risk transfer in Northern Ireland

5.40. If this risk is to be transferred, we would expect the UR to undertake a clear and transparent consultation exercise, to allow all market participants to input. In SONI's opinion, this should consider, as a minimum:

- How the risks associated with all-island GTUoS revenue collection is shared, including any currency risk where generators in Ireland are paying towards the Northern Ireland revenue requirement under the locational charging mechanism;
- How the proposals that the UR is currently consulting upon change the scope of the GTUoS revenue calculation impact on the risk sharing calculation;
- How the increase in TAO risk is reflected in NIE Networks' WACC, or if the current WACC will be maintained, any mitigation measures that would be introduced to ensure that the risk profile mirrors the DUoS collection risks;
- How the UR will assess the potential for conflicts of interest arising from this change;
- How the revenue restrictions in the SONI and NIE Networks Transmission Licences will be updated to ensure that the 1 year and 3 year restrictions reflect any changed circumstances, including the difference in reporting years between SONI and NIE Networks; and are appropriate for the changed circumstances, including the difference in reporting years between SONI and NIE Networks;
- Any issues raised through the transfer in Great Britain, including potential opinions expressed by the CMA through any appeals that may be lodge; and
- Any issues raised through the transfer in GB, including potential opinions expressed by the CMA through any appeals that may eventualise.

5.5 Pension Deficit

5.41. The UR has stated in its Draft Determination on SONI's 2020-2025 price control that it will only allow for deficit contributions as if they were calculated over a ten year period. The Trustees and SONI agreed that the deficit revealed at the 31 March 2019 valuation would be paid off over seven years from the valuation date – i.e. by 31 March 2026. This results in a timing and funding requirement issue for SONI.

5.42. The UR's position does not directly affect the funding of the Defined Benefit Pension Scheme (hereafter referred to as Scheme) – the agreement between the Trustees and SONI will remain in place until both parties agree an alternative. However, the Trustees have an interest in ensuring that SONI is appropriately funded. As such, SONI has set out a number of points in relation to UR's proposal in this note having consulted with their Scheme Actuaries.

5.43. SONI believes that the seven year recovery period agreed as part of the valuation is a sensible plan for the Scheme given its circumstances. The Scheme is maturing quickly and this makes it important for the Scheme to close the deficit in a timely manner to maintain the security of members' benefits and reduce the risk in the Scheme.

5.44. The valuation itself is based on the assumption that the employer covenant is "strong". In other words, the Trustees' assumptions reflect that they have a strong degree of confidence that if the deficit increases because of the risks they are taking, SONI will be able to pay the required contributions. If the UR's decision means that SONI cannot afford anything shorter than a ten year recovery plan, then the Trustees may have to reconsider their employer covenant assessment. This could result in different assumptions being adopted for the valuation, reflecting the reduced confidence in SONI, a higher pension deficit and in turn a higher funding requirement for SONI.

5.45. It would be highly likely that The Pensions Regulator (TPR) would be concerned by a ten year recovery plan in these circumstances. TPR's data shows that only around 20% of schemes have a recovery plan length of ten years or longer and that these are mostly from covenants described as "weak".

5.46. In its consultation on the new Defined Benefit Funding Code of Practice[2], TPR discusses a proposal to include the recovery plan length as a part of the "FastTrack" regime. It is highly likely that a ten year recovery plan would be seen as too long by TPR and therefore invite scrutiny of the valuation agreement.

5.47. The risk of a "stranded surplus" noted by UR is very low in the opinion of SONI's pension advisors. If a Scheme's funding position improved significantly the deficit recovery plan would be renegotiated. If the Scheme was ahead of target the contributions could be reduced, or the recovery plan shortened, to reduce the risk of overfunding the Scheme.

5.48. The funding target set by the Trustees still contains a significant amount of risk, and so it would be sensible for the Trustees to try to reduce that risk over time as the Scheme matures.

5.49. Even if the Scheme's ongoing funding position improves to the point of a surplus, the chance of there being a surplus on a buy-out basis, or another form of low risk basis, within the near future is remote.

5.50. SONI requests that a Pension Deficit Recovery of £861k per annum is provided for in the Final Determination.

[2] https://www.thepensionsregulator.gov.uk/en/document-library/consultations/defined-benefit-funding-code-of-practice-consultation

5.6 Real Price Effects and Productivity

5.51. As a business SONI must strive to make itself more efficient each year, this helps ensure that customers receive the lowest sustainable price possible. This challenge needs to happen in an environment where adjustments for costs that are outside of SONI's control are made. Otherwise customers are not charged sustainable prices and, as a business, SONI will not earn its required rate of return. All other things being equal if that happens the fair bet principle underlying UK regulation will be breached.

5.52. Within this context SONI was pleased to see that UR had adopted its approach to Real Price Effects (RPEs), the mechanism for addressing material costs outside our control, in its Draft Determination. While SONI agrees with the UR's position on labour costs it does not agree with the way that UR has applied this methodology to non-labour costs.

5.53. Setting the right ongoing productivity challenge for a business like SONI is not straight-forward. The limitations placed through the fact that it is an asset-light business means that the challenge has to be realistic otherwise SONI faces a financeability problem. UR's proposed ongoing productivity challenge is unrealistic, failing to appreciate both the constraints faced by SONI as a business, as well as the realities of the pandemic created recession. Annex E provides a realistic ongoing productivity challenge for its business.

5.54. Failing to address both the RPE and ongoing productivity issues identified in SONI's response to the Draft Determination would be a serious issue and would introduce errors into the Final Determination that could materially affect its business. UR has an opportunity to put this right and we expect them to ensure that the Final Determination is realistic and leaves us as a financeable business.

5.55. A separate report has been prepared by KPMG LLP (Annex E) which should be read in conjunction with this part of our Draft Determination response.

5.56. SONI is happy to work with the UR to determine an appropriate true-up mechanism. Again, SONI's status as an asset light company should be a consideration as this could have a significant impact on its net cash-flow during the price control period. Proposals for how the true-up mechanism work should be included in the Final Determination.

5.57. To ensure that SONI does not face efficient sustainable costs and revenues the Final Determination needs to:

- Set an ongoing productivity challenge at 0.3% pa consistent with regulatory precedent and the constraints facing SONI; and
- Allow a non-labour RPE of 0.6% pa based on the evidence of the wedge between CPIH Services and CPIH.

Chapter 6

Delivering a Future Energy System

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6 Delivering a Future Energy System

6.1 Key Messages

- 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.
- 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 because it will be easier and less risky to invest in GB or Ireland.
- The Draft Determination introduces unnecessary risks to the security of the transmission system and seeks to micro-manage SONI's investments in a way that will impede efficient and successful delivery.
- If the substantial short-fall 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 UR's Draft Determination fails to take into account the additional safeguards created with the price control design to protect customers from SONI making a windfall from essential investments.

6.2 Introduction

6.1. SONI considered the needs of the future energy system when developing its business plan and identified the areas where its services need to transition to meet expectations beyond 2025. We divided the work that is required to meet these expectations into 35 initiatives. Seven of these cover investment that is required to maintain current capability (five related to IT, one to facilities and one to Telecoms), referred to as initiatives to maintain business as usual and essential to provide the foundation for the 28 strategic initiatives that are required to deliver the first steps towards the future energy system.

6.2. These are designed to deliver the step change in performance that the UR and SONI's wider stakeholder base have identified as being important. They also cover the work that SONI expects to be asked to deliver to contribute to the UK Government's commitment to net-zero carbon emissions and the energy strategy that the DfE is currently developing.

6.3. We welcome the UR's acknowledgment of the need for most of these initiatives and the full funding provided for 5 of them. We also welcome the clarity provided around the information that the UR requires for the remaining initiatives.

6.4. We have provided this additional information, where it is available to SONI at this point in the project lifecycles. This is presented in a separate annex because it contains commercially sensitive information. However, this is not available in all cases at the level of certainty expected by the UR due to the need for SONI to complete the scoping phases of the projects before firm costs are available. The challenge in these cases will be ensuring a balance between providing sufficient funding for projects whose need is accepted but for which a level of uncertainty remains.

6.5. In this chapter of our response to the Draft Determination we provide high level context around the development and assessment of our strategic initiatives and an overview of the information provided in the separate detailed annex for each of the initiatives that the UR did not provide funding for in full.

6.6. SONI has met with the UR during this consultation period and has held five workshops related to the initiatives that we have requested funding for. The information provided at those workshops is formally documented within the detailed annex.

6.3 Regulatory Framework and UR Assessment of SONI's Initiatives

6.7. When determining SONI's funding for maintaining and improving the services it provides, we would expect the UR to rely on the safeguards and risk sharing mechanisms that it has added to the regulatory framework funding mechanisms for the 2020-25 price control.

6.8. These include a significant reduction in the amount of any efficiency savings that SONI can retain. Under the 2010-15 price control, SONI could retain 100% of any savings; this has reduced to 25% of any savings over the 2020-25 period. Furthermore, the incentive framework introduces penalties to protect customers from under performance by SONI. The principle of "no double funding" is confirmed through this control to ensure that customers do not pay twice for any initiatives delayed into the subsequent control period.

6.9. Where the need for initiatives is clear but the cost estimates cannot be provided with the high level of precision that the UR appears to expect, SONI asks the UR to consider both the protection provided by the new safeguards alongside the wider implications of not funding these initiatives up front when making the Final Determination. These consequences would include:

- Delays to the mitigation of risks to security of supply in Northern Ireland;
- A dilution of Northern Ireland influence over the direction of all-island initiatives;
- A loss of cost efficiencies, where Northern Ireland specific solutions would need to be developed because SONI does not have the certainty of funding necessary to commit to all-island procurement of solutions;
- Fewer jobs created in Northern Ireland; and
- Investor perception of Northern Ireland as a place that is difficult to connect to the grid and therefore a less desirable place to invest than Ireland or GB.

6.10. We note that the UR has highlighted a potential for duplication between initiatives or with the baseline activities. SONI was very aware of the risk that this could happen when an ambitious business plan is being prepared and therefore put in place robust governance measures to challenge the requests and ensure that they do not duplicate each other. It also ensured that there were no gaps between the initiatives.

6.11. The stages of challenge were:

- Within business unit challenge by subject matter experts and management;
- Regulation specialists ensuring that requests were within scope of SONI's licence;
- External advisor, critical friend challenge;
- Executive directors challenge;
- Regulation Governance Board review and challenge; and
- The final business plan was signed off by the SONI Board.

6.12. These challenges removed more than £2 million from the requests made by business units. They also identified gaps, for example the essential supporting input from subject matter experts which secures value through the scoping and testing of new systems was excluded from the business cases because these staff do not meet the standard set by the UR for capitalisation within a regulatory approved project. This was corrected by the addition of initiative G12: Operational Support for IT Projects.

6.13. SONI can confirm that it has again reviewed all of the initiatives where the UR has raised concerns about potential duplication and can confirm that these initiatives are all unique and are all additional to the activities included within the our baseline request.

6.14. We note that the UR has divided our initiatives into specific service areas as part of its draft determination. SONI is uncomfortable with this approach because it presumes that these only provide benefits in one aspect of our work. This is an incorrect assumption which risks minimising the benefits that can be secured though a more joined up, whole system approach. A whole system approach which the Utility Regulator wishes to ensure we take.

6.15. Most of SONI's initiatives provide benefits across a range of the services that we provide. Therefore in this chapter and the associated appendices, we continue to use the categorisation from our business plan, which focuses on the strategic outcomes that can be obtained for customers through implementation of our initiatives.

6.16. The impact of the shortfall in funding is exacerbated by the UR's draft determination on real price effects. SONI has not included any inflationary adjustments within the cost of these initiatives, if these are not reflected elsewhere within the price control the allowances should be updated to ensure that they are realistic and appropriate.

6.4 Funding for Strategic Initiatives

6.17. SONI welcomes the amount of funding provided for our business as usual initiatives , but would caution that without full funding for all of these foundation activities, the strategic initiatives will be impacted and will either cost more or will be deferred.

6.18. 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. 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.

6.19. 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 because it will be easier and less risky to invest in GB or Ireland.

6.20. This 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.

6.21. If the substantial short-fall in fund 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.

6.22. The UR's Draft Determination fails to take into account the additional safeguards created with the price control design to protect customers from SONI making a windfall from essential investments.

6.23. Given recent developments in the Brexit process, we would like to reiterate that both our business plan submission and this response to the Draft Determination assume that EU energy law and all associated provisions remain in force in Northern Ireland for the duration of this price control. Any change to this situation would require a significant review of our funding.

Table 6.1. Overview of the UR Draft Determination

Area	Amount Requested	Amount Allowed £m	%	Comments
Business as Usual (incl. Telecoms)	18.9	16.5	87%	Essential items are currently not funded.
Sustainability and Decarbonisation	14.0	3.9	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	0.1	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	0.0	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.

6.5 Investment to Maintain Current Capability

6.24. SONI welcomes the fact that the UR has provided for most of the capital investment requested to maintain the current levels of capability. We have reviewed the detailed information that the UR says it needs to approve the remaining funding and have provided it within the detailed annex to this response.

6.25. These investments provide the foundation that our strategic initiatives are built upon. Any shortfall in funding here will have implications for the delivery of our baseline obligations.

6.26. We welcome the constructive engagement that we have had with the UR staff during this consultation period on these initiatives and are happy to address any remaining questions once the UR has been able to assess the information provided with this response to the Draft Determination.

6.5.1 Initiatives to secure BAU capability

6.27. SONI included five initiatives that ensure we can maintain our current IT capabilities and one related to our facilities. We have provided the information requested by the UR in the Draft Determination. In summary our response in the annex sets out:

- **D1 - End of Life Assets:** SONI has provided further information to clarify the request. We note there is a clear risk that SONI will need to incur higher costs than those provided to deliver these asset replacement projects. We therefore highlight the importance of a balanced provision across all of the initiatives to ensure that the overall allowance is not biased towards the bottom end of the combined cost expectations.
- **D2 - Cloud Adoption:** We welcome the 100% funding provided by the UR in its draft determination.
- **D3 - IT Operating Model:** We welcome the 100% funding provided by the UR in its draft determination.
- **D4 - IT Standardisation:** we are concerned that the UR has not included funding for SONI's mandatory delivery of data to fulfil obligations under the REMIT and European Transparency Platform. These data provide transparency of system conditions for all market participants and secure a level playing field which underpins competition in the wholesale market. These data provide clear benefits to customers and are specified at a European level. We also note the UR's concerns regarding the potential for duplication of items within this initiative and have reviewed the scope of work. We can confirm that the items funded here are not requested anywhere else in our business plan.
- **D5 - Cyber Security:** We welcome the 100% funding provided by the UR in its draft determination.
- **D6 - Workplace BAU:** SONI has reviewed the work undertaken on our boilers during the 2010-15 period and can confirm that the funding provided then was used to upgrade the boilers to avoid replacing them when we extended Castlereagh House. The boilers are now approaching the end of their useful life and will have to be replaced before 2025. We would be very concerned if the UR deducted funding that was spent on its intended purpose. We have provided the information requested for this investment within the annex and would draw the UR's attention to the SECG's opinion on SONI's management of its internal carbon footprint.

6.5.2 Telecoms BAU

6.28. SONI sought necessary funding for telecoms roles and responsibilities it currently fulfils. Within the Draft Determination allowances were reduced in line with UR proposals for changes in roles and responsibilities between SONI and NIEN. While we do not object to reviewing the allocation of such roles we do not agree that to introduce such a proposal for the first time within a draft determination is appropriate. The proposed change has significant implications and in our view should be part of a robust process of engagement and consultation. We outline our perspective further below.

6.29. The roles and responsibilities around transmission telecoms and data collection were put in place when Northern Ireland's electricity needs were mostly met by three large power stations and communications technology did not have the current functionality.

6.30. We agree with the UR that this model may not be the optimum way to manage the communications and data collection infrastructure that is required to support the energy transition.

6.31. We have reviewed the UR's proposals for a sudden switch in the responsibilities around the assets included within SONI's scope of capital investment. We note that the proposals are not mirroring those in GB or Ireland. Our initial review has also highlighted wider consequences that could arise if this change is made without full assessment.

6.32. We are also concerned that this change was not signalled within the main text of the Draft Determination and that the principles expressed verbally in our workshops with the UR go beyond those included within Annex 6.

6.33. We therefore propose that engagement takes place with NIE Networks and SONI so that proposals can be discussed and considered in detail and that subsequent to this a full consultation exercise is undertaken to ensure that unintended consequences are avoided and that all stakeholders are aware of these proposals.

6.34. To avoid prejudicing the outcome of this consultation exercise and to ensure that SONI would be able to finance its obligations if this does not result in a change in responsibilities, we request that the funding sought by SONI in its Business Plan submission is provided, so as to enable us to meet our current obligations set out in SONI's licence. Full funding should be provided out to the end of September 2025, and should a change occur before then, this can be amended as appropriate in accordance with paragraph 8 of Annex 1 and in line with any amended licence obligations.

6.35. Given the magnitude of changes to the industry framework documents that will be required to implement any change to these roles and responsibilities, the funding within SONI's licence can be updated to reflect the outcome of the review as part of that exercise.

6.36. We would be happy to provide a report setting out the investigations that we have completed to date, should the UR instigate a call for evidence.

6.5.3 Initiatives which will Support Sustainability and Decarbonisation

6.37. We have reviewed the UR's draft determination for these initiatives and are very concerned about the implications for Northern Ireland if this position is carried forward. We have provided the information that we have available to respond to the UR's actions and will be happy to engage further to secure the funding that will unlock Northern Ireland's share of the benefits of the energy transition.

6.38. In summary, SONI's response to the draft determination for this group of this initiatives is:

- **F1 - Renewables Strategy DS3+:** SONI has reviewed and updated the business case for the implementation of the renewables strategy to incorporate the progress made in this area over the year. Up front funding is essential to secure SONI's influence over the shape of these investments and to minimise the cost to customers in Northern Ireland. SONI is confident that the costs outlined for this work are in the correct range and we would urge the UR to have confidence in the new safeguards that have been added to this price control to protect customers.
- **F2 - Control Centre Tools:** SONI's own experience of developing new tools to accommodate emerging issues on the transmission system means that it has a world leading insight into the costs and complexities associated with this initiative. The nature of the technical challenges that will need to be overcome is clear and driven by the physics of electricity transmission. Including this within the ex-ante funding for the 2020-25 period will minimise the cost of these essential changes to accommodate the more complex generation portfolio that will be required to deliver the DfE's strategy at the lowest cost to consumers in Northern Ireland.
- **F3 - Smarter Outage Management** – We welcome the 100% funding provided by the Utility Regulator in the Draft Determination.
- **F4 - EMS IP Migration**: The UR has assumed that this initiative is included within the investment associated with the transfer of roles and responsibilities related to telecoms. SONI has discussed with the UR and hereby confirms that this initiative relates partly to investments within the control centre at Castlereagh House and SONI's internal systems and the remainder is additional to items requested elsewhere in SONI's business plan. This workload would currently fall within SONI's remit and was therefore not requested by NIE Networks as part of RP6. It therefore should be allowed and provided for as part of the ex-ante allowances, noting that some of the funding may move to NIE Networks following a review of roles and responsibilities.
- **F5 - Data Services (initial) –** SONI has provided further information about this initiative within the annex. We would like to highlight the importance of the funding for this initiative to facilitate the delivery of the data transformation that will underpin the energy transition. This funding will allow SONI to initiate work with NIE Networks that will scope the data solutions that the electricity industry and consumers in Northern Ireland require.
- **F6 - System Planning** – We welcome the 100% funding provided by the UR in the Draft Determination.
- **F7 - Promoting Change** – The SECG highlighted the importance of SONI managing its own carbon footprint. This small investment in a share of an FTE responds to these requests.
- **F8 – Clean Energy Package**: We welcome the 100% funding for the initial work in this are provided by the UR in the Draft Determination.

6.6 Operate, Maintain and Enhance the Grid and Market

6.39. SONI will also need to ensure that it is able to invest to minimise risks to system security over the period to 2025. As TSO we are also responsible for funding the developments to the capacity market, which secures the capacity required across the island at the lowest possible cost to consumers. Keeping pace with developments and challenges in these areas is vital to deliver the expectations of customers in Northern Ireland.

6.40. SONI needs to be able to progress these initiatives in a structured and efficient way to secure the maximum benefits for Northern Ireland. If funding is delayed, risks will be perpetuated and costs are likely to increase above the amounts stated in our business submission, which assumes a holistic investment programme.

6.41. In summary, SONI's response to the draft determination for this group of this initiatives is:

- **G1 - Disaster Recovery Site:** SONI has provided the information available to it at this stage in this project's cycle within Annex H. While we agree with the UR that the estimated size of the Disaster Recovery Site may turn out to be less than $500m^2$, experience during the current pandemic has highlighted the importance of bio-security arrangements, including providing the back-up control room with its own access and facilities. While the provision made for establishing a node on the telecoms network may be underestimated, we believe that the overall cost of this initiative is broadly appropriate. We would be concerned that a delay to funding for this project would perpetuate risks to security of supply which far outweighs any payment to SONI through the risk sharing mechanism.
- **G2 - Control Centre Training:** SONI is obliged to expand its control centre training beyond the levels currently funded through the baseline. This will provide an environment where control room staff can confidently continue to minimise the cost of balancing the system under situations which would currently result in more defensive operation, avoiding higher costs to customers.
- **G3 - Physical Security:** It is essential that the security around Castlereagh House Control Centre keeps pace with external threats. SONI will provide UR access to the relevant assessments to provide the UR with confidence around the importance of these investments that will protect the security of this critical infrastructure.
- **G4 - Cyber Security Enhancement:** it is imperative that SONI's IT systems are protected from the increasing levels of cyber security threats. SONI will provide the UR with access to the relevant assessments to provide the UR with confidence around the importance of these investments that will provide the expected standard of protection.
- **G5 - Network Codes:** In response to the Draft Determination, SONI has reviewed the list of obligations within the network codes that result in enduring workload that is expected to be allocated to us. In Annex H we include a summary of the obligations within the Network Codes that directly increase our workload and can confirm that this request is additional to the workload reflected within the baseline funding.
- **G6 - CRM** – **Secondary Trading**: The funding provided within the Draft Determination would not be sufficient to allow SONI to deliver the modification to the capacity market code that is currently being progressed. In the annex we provide information around

the scope of work and also the benefits that can be obtained for customers through timely evolution to the enduring functionality, which will be efficiently realised with ex ante funding.

- **G7 - CRM – DSU State Aid Compliance**: SONI is aware that the scope of some of the aspects of the work required to comply with these obligations are still to be defined. We therefore agree that this may be suitable for funding through the uncertainty mechanisms. We do include some information about the changes to metering functionality and the processing of meter data that are already known because if this could be funded ex-ante it would be possible to provide value for customers at an earlier date than if the entire project is delayed by being subject to the Dt/Zt administration process.
- **G8 - MIP Solver:** The SEM Committee is asking SONI and EirGrid to implement this change to the Capacity Market algorithms, with work on the project being imminent. As the decision on funding through this PC process will not be known before the end of November, we are proceeding with the submission of a request for the funding for this initiative under the Dt/Zt mechanism given that we do not wish to have any delay in delivering the expected reductions in the cost of capacity to customers.
- **G9 - State Aid – Cross Border Capacity:** The recent developments in the Brexit negotiations indicate that this initiative is unlikely to be required in advance of the effective operation and associated forward trading of the Celtic Interconnector. We therefore agree that this should be moved to the Dt/Zt mechanism if work starts before the end of September 2025.
- **G10 - Market Related Governance**: Experience of operating the new trading arrangements has shown that the governance and compliance requirements have resulted in the need for greater oversight that is included in our baseline. This ensures that audits can be supported effectively, increasing transparency for stakeholders.
- **G11 - Metering System:** We agree with the UR that there is an overlap with some work included in the 2015-20 price control, however that request was for £104k which is substantially less than the cost of the work required over 2020-25. We will work with the UR to calculate the amount that SONI has retained under the 50/50 risk sharing mechanism to ensure that there is no double payment and that the value accorded SONI is simply the value of deferral.
- **G12 - Operational Support for IT:** The need for this input was identified through SONI's verification process that was designed to ensure that there is no duplication or gaps within the business plan. Under the UR rules for capitalisation of staff time, these subject matter experts would not be included within the RAB additions. However the expertise provided by the staff that will be using the systems is vital for the successful delivery of the projects.
- **G13 - Balancing Guideline:** this was included in the business plan for completeness to ensure that it was clear that it is not included within the scope of the ex-ante allowances

- **G14 - Multi-NEMO Arrangements:** this was included in the business plan for completeness to ensure that it was clear that it is not included within the scope of the ex-ante allowances.

6.7 Partnership and Engagement for Better Outcomes

6.42. When SONI was consulting with stakeholders around the changes that it needed to make to support and provide relevant leadership for the energy transition in Northern Ireland, it became clear that we needed to focus on the way in which we interact with our current stakeholders, potential customers and other audiences.

6.43. Since the submission of our business plan we have been considering SONI's strategic approach to partnership and stakeholder engagement. Three related strategy documents are in development and will underpin SONI's approach to stakeholder engagement approach. These are:

- Communications Strategy;
- Public Engagement Strategy; and
- Enhanced Customer and Stakeholder Engagement Strategy.

6.44. These strategies are however still being developed and are not therefore included in this submission, however we will be pleased to share and discuss them with the UR in due course. It should be noted that the final form and scope of these strategies is dependent on the level of funding provided as part of the final determination. SONI places significant weight on the need for effective and collaborative stakeholder engagement for this price control period. It is important to note that SONI will continue to work within the EirGrid Group structure and will, where appropriate, work to realise synergies across the group where they are beneficial.

6.45. We are working to address the feedback received from UR and the SECG, however SONI's ability to do so is reliant on the Final Determination noting that no costs were allowed in the Draft Determination. The strategy documents being referred to having been developed within the Group and will need to be honed for the Northern Ireland context.

6.46. We have taken note of the concerns raised by the UR within its Draft Determination and have updated some of the business cases to reflect this and the views expressed by the SECG. These changes are set out in Annex C.

6.47. The information provided for developing our partnership and engagement initiatives in our Business Plan submission included:

- **H1 Rebranding (superseded):** this request has been reviewed by SONI and this initiative has been removed, we will however continue to consider the merits of same.
- **H2 Education & Engagement** (superseded): this request has been reviewed by SONI and has been removed.
- **H3 Pre-application Process**: SONI has included this initiative in response to expectations set out by potential customers. The aim is to facilitate investment in Northern Ireland. We have reviewed the resources that are currently providing support

to parties considering connection to the transmission network here and can confirm that the tasks and information provision set out in this initiative is clearly additional to that which can be delivered by the resources included in SONI's baseline expenditure. We have checked the potential to include this within the connection charges defined within our licence and can confirm that this work and information provision is not within that scope.

- **H4 Industry Partnerships (superseded) –** this request has been reviewed by SONI and this initiative has been removed.
- **H5 Industry Consultations (superseded) –** this request has been reviewed by SONI this initiative has been removed
- **H6 Customer Account Team:** SONI is aware that the UR has raised a number of concerns about our communications with customers in Northern Ireland. Our customers and stakeholders have also identified areas for improvement. While a small part of this additional role may be chargeable to connecting customers, the bulk of the work is outside the scope of these charges as defined in our licence.

6.48. A number of initiatives in Appendix H have been removed as a result of feedback. These have been superseded with a single, new initiative which is presented in Annex C to this submission:

- **H7 (Updated) Transforming our Partnership and Stakeholder Engagement Activities**: this request has been updated taking on board the feedback received from the UR and SECG in the Draft Determination. It focuses on understanding the needs of each segment of our stakeholders, improving and widening SONI's engagement with each of these segments as needed, and using our knowledge and expertise to support a number of key partners as Northern Ireland moves into the energy transition.

6.8 Strategies Requested Through the Draft Determination

6.49. When reviewing the UR Draft Determination we noted the emphasis on taking a whole system approach and the request for a number of strategies to be developed by SONI. These include:

- **Enhanced Customer and Stakeholder Engagement Strategy –** Section 6.7, above, refers to three strategies that are in development following the submission of our business plan in October 2019. These together with consideration of the feedback from the SECG and the Utility Regulator have resulted in our reshaping our engagement proposals and ask of the Utility Regulator in this response to the Draft Determination. The SONI Enhanced Customer and Stakeholder Engagement Strategy will also have an implementation plan associated with it; however, the level of ambition in this plan will be informed by the outcome of the final determination.
- **Whole System Strategy** – SONI's multi-faceted role in the electricity sector, being responsible for planning the transition grid, operating the system to ensure security of supply and running the Single Electricity Market means that we are ideally placed to take a whole system approach when looking to envisage and manage the energy transition. Many the strategic initiatives arise from our taking a whole system

approach, however in responding to the UR we have provided a section to cover this below.

- **Data Strategy** – SONI have been working in recent years to make more data available to the public. We currently publish data on the power system on the SONI website, the SmartGrid Dashboard – which provides a Northern Ireland, Ireland and all island view of power system metrics. In addition extensive data sets are available on the SEM-O website. We also deliver a range of information feeds to the ENTSO-E and ACER platforms at required frequency and formats. We do however recognise that there is scope to extend the reach of our published data and a need to drive an increase in data quality.

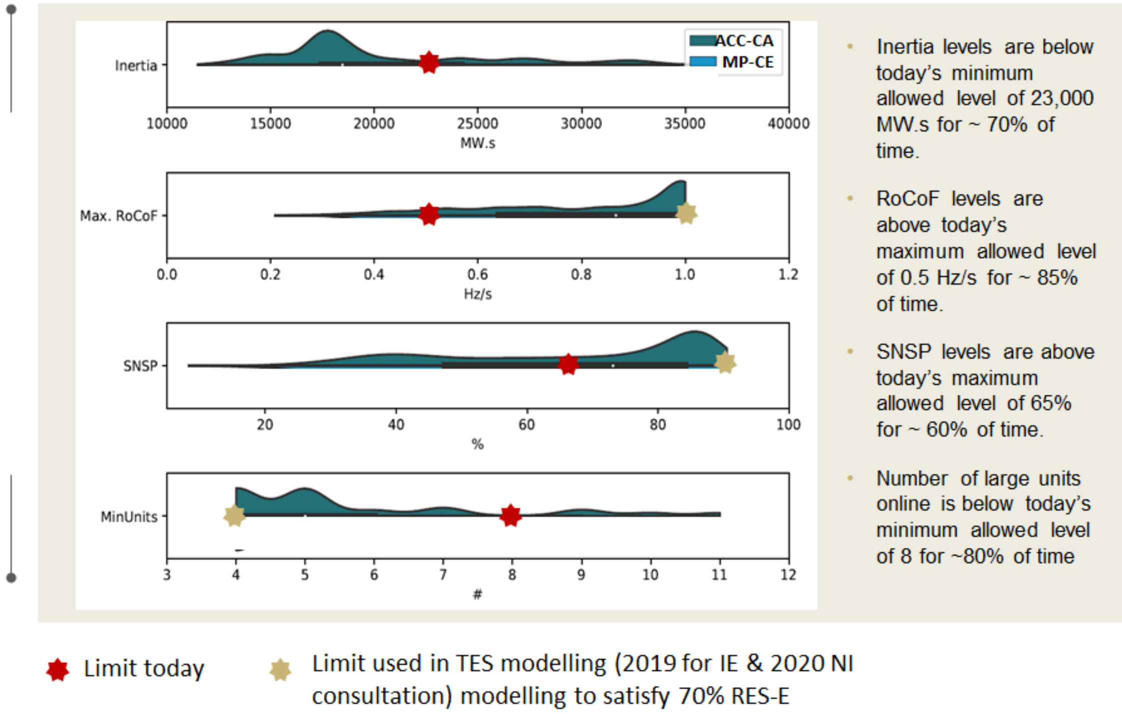
6.50. The UK Energy Data Taskforce published a Strategy for a Modern Digitalised Energy System which focussed around two key principles – **filling in the data gaps** through requiring new and better-quality data, and maximising its value by embedding the **presumption that data is** open. The initial work in SONI on this topic echo these findings very strongly. Our IT Strategy is elaborated upon in section 6.8.2 of this chapter.
Whole System Strategy

6.51. SONI has adopted a Whole System Approach to ensure that we are developing the power system in a manner that is consistent and aligned with changes in other energy sectors. We are doing this through our involvement in the ENTSO-E Ten Year Network Development Scenario Building process, and more recently through the development of Tomorrow's Energy Scenario's Northern Ireland and Vision 2030 across the EirGrid Group

6.52. In the development of Tomorrow's Energy Scenarios Northern Ireland we have worked collaboratively with a key partner in the electricity transition – NIE Networks to ensure alignment on key assumptions in relation to electrification of the heat and transport sectors, in the form of heat pumps and electric vehicles respectively. The individual connections of heat pumps or electric vehicles to the electricity system will occur on the distribution system, but collectively and at scale, these technologies will have an impact on the operation of the power system, particularly in terms of an increase in electricity demand over the evening peak period. This alignment between SONI and NIE Networks is important as it ensures that development of the transmission and distribution networks are progressing from the same base.

6.53. SONI is also developing an integrated vision of the power system and market for 2030 encompassing the network, operation and market. The aim is to establish the basis for the most economic and deliverable solution for 2030 which achieves the RES-E targets in Northern Ireland, and to enable us to articulate the pathways for its delivery while creating the framework for an informed discussion with stakeholders in Northern Ireland.

6.54. As part of this work we have identified some of the significant operational challenges which are required to reach RES-E levels of the order of 70% on an all-island basis.



6.55. We have presented updates on this project to NIE Networks as it has progressed and likewise NIE Networks has presented to SONI its roadmap for evolving from a DNO into a Distribution System Operator (DSO). We are agreed with NIE Networks that both of these initiatives may have dependencies with, and impact on, each other's system.

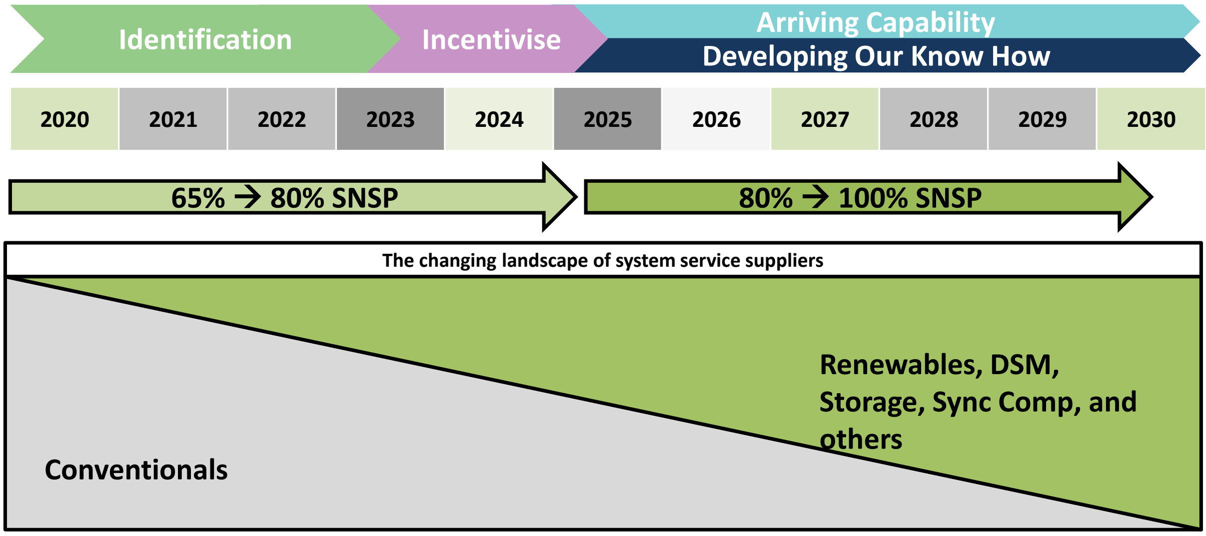
6.56. We are confident that through close collaboration, SONI and NIE Networks, as TSO and DSO can implement solutions that deliver optimal outcomes for Northern Ireland's electricity consumers whilst meeting respective license obligations. By taking a partnership approach, solutions to common problems can be identified and resolved in a coordinated fashion. We are committed to developing a shared vision for the power system with NIE Networks in our TSO-DSO engagement, and based on this shared vision we aim to develop a programme of TSO-DSO work where we will work together on initiatives which have inter network implications and achieve the best whole system solution for NI consumers.

6.57. SONI is also working to develop the DS3+ programme. This programme is a follow on to the hugely successful DS3 programme which was a key enabler in the delivery of the 40% RES-E target for Northern Ireland by 2020. NIE Networks was a partner in the DS3 programme, particularly in relation to the work to increase the Rate of Change of Frequency (RoCoF) settings for generation from 0.5 Hz/s to 1 Hz/s. SONI envisages that NIE Networks as DSO will need to have an even more central role in the work involved in the DS3+ programme, as more and more generation will be connected in a decentralised manner and more services to ensure the safe and secure operation of the transmission system are procured from distribution connected generation and demand. TSO-DSO is one of the pillars of the DS3+ programme per the figure below.

6.58. In terms of transmission system services, 12 services have been procured to date (ranging from reserve services, ramping services, inertia, and reactive power services) to ensure SONI is able to operate a safe and secure electricity system at high RES-E levels. In total, 1073 services have been procured from 179 service providers on an all-island basis (136 in Ireland and 43 in Northern Ireland). 64% of currently contracted service providers are non-conventional units. 60% of service providers in Northern Ireland are distribution connected.

6.59. As part of the DS3+ programme we will need to identify the technical scarcities on the power system which result from operating at almost 100% non-synchronous generation on an instantaneous basis to ensure delivery of RES-E targets of circa 70% on an annual basis. Some of the challenges to be overcome include lack of inertia, lack of system strength, lack of dynamic reactive power, lack of capacity due to congestion, lack of steady state reactive power, lack of synchronising torque and damping torque, insufficient reserves and ramping capability.

6.60. In solving the technical challenges on the transmission system, the optimum outcome for the NI consumer will involve a significant portion of services being delivered via the distribution network from distribution connected generation customers and demand right down to the residential level. The provision of these services to the TSO may have an impact on the DSO and we will work collaboratively with NIE Networks to ensure the optimum solution for the consumer in terms of the cost of the energy transition. The figure below demonstrates how the system service provision landscape will change over the next 10 years.



6.61. We will also work with NIE Networks to understand if there are technical scarcities on the distribution network which need to be addressed also – for example congestion – which may give rise to customers who could provide a similar service to both operators depending on the need at a given point in time.

6.62. We are working in partnership with NIE Networks on the Flex Tech initiative which seeks to break down barriers to the integration of renewables.

6.63. Through our vision 2030 programme we are working with NIE Networks both in its capacity as Transmission Asset Owner and Distribution System Operator. In terms of the transmission assets we will work with NIE Networks to identify the optimum pathway for delivery of transmission infrastructure required to ensure continued security of supply for Northern Ireland and to allow Northern Ireland to reach decarbonisation targets. This work will also consider whether infrastructure developments can be avoided on the transmission system if congestion management services can be obtained from distribution connected customers. The DS3+ programme will include the operational and market aspects of flexible grid. The DSO may also have internal congestion issues that they wish to solve – a collaborative approach will find the optimum whole system solution.

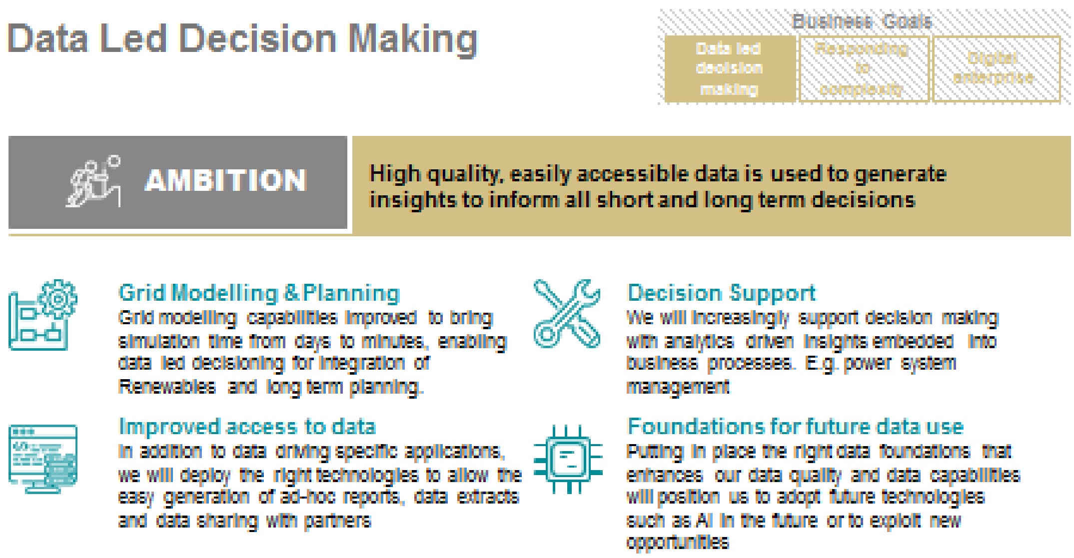
6.64. In summary, SONI is convinced that if Northern Ireland is to achieve 2030 targets on a pathway to net zero emissions by 2050 (noting that it is widely accepted that the electricity system will need to be net zero well before 2050 if the broader UK economy is to be net zero by 2050), the TSO and DSO will need to work collaboratively to overcome shared challenges (and many individual challenges for each operator) to ensure the energy transition is affordable for the NI consumer.

6.8.1 Data Strategy

6.65. SONI have been working in recent years to make more data available to the public. We currently publish data on the power system on the SONI website, the SmartGrid Dashboard – which provides a Northern Ireland, Ireland and all island view of power system metrics. In addition extensive data sets are available on the SEM-O website. We also deliver a range of information feeds to the ENTSO-E and ACER platforms at required frequency and formats.

We do however recognise that there is scope to extend the reach of our published data and a need to drive an increase in data quality.

6.66. The UK Energy Data Taskforce published a Strategy for a Modern Digitalised Energy System which focussed around two key principles – **filling in the data gaps** through requiring new and better-quality data, and maximising its value by embedding the **presumption that data is** open. The initial work in SONI on this topic echo these findings very strongly. Our IT Strategy outlines the following:



6.67. Our intention is to now develop a focussed Data Strategy which will build on the new SONI Business and Information Technology strategies. This will initially focus on internal data governance and quality to provide a platform for our contribution to the joined up Northern Ireland Strategy. SONI's Data Strategy will be:

- A driver to the digitalisation of our business;
- Incorporate the potential changing roles associated with the energy transition;
- Outline how we propose to engage with other stakeholders in particularly NIE Networks to ensure that published datasets can be aligned; and
- Define our open data strategy for the coming years.

6.68. This implementation of the SONI Data Strategy will initially have an internal focus. Within our initial work on creating a data strategy, it is our intention to:

- Focus on turning information into data;
- Understand and catalogue our extensive data stores;
- Define the ownership and governance of this data with a focus on data quality, master data management, metadata management and data integration;
- Identify the critical data that supports our key business deliverables;
- Develop a data catalogue for internal use to streamline the identification of correct sources for data;

- Streamline the process of extraction, transformation and load through the use of standardised, capable tools.
- Invest in tools which are capable of analysing data at scale. We will also take advantage of the cloud and the flexibility that it affords us – flexible processing power and tools
- Invest in data science skills so that we have the capability to use the tools and technology to analyse extensive datasets and draw out key business information
- Focus on data sharing and open data – drive improvements in Northern Ireland in line with the UK Energy Data Taskforce recommendations (i.e. presumption that data is open as outlined above)
- Review and assess the data which we currently publish;
- Set out a roadmap to increase the scope and scale of this to deliver benefit for our stakeholders;
- Set out challenging KPIs with reference to the level of data that we will publish;
- Work with our partners and stakeholders to maximise the value of our data i.e. engage on relevant datasets and identifiers; develop a plan to publish the data
- Develop a data catalogue in conjunction with partners
- Enable power system modelling capability in the cloud – making extensive use of the flexible processing power available in the cloud and flexible access to licence capacity.
- Develop a digital vision for SONI by identifying ways to advance our business through digitalisation, assess our digital maturity and set out a roadmap to provide useful and reliable insights for stakeholders and investors.

6.69. This roadmap will be informed by stakeholder engagement.

6.70. The costs outlined are not duplicated in BAU costs – this is a very specific focussed and crucial workstream which will standalone. We will take advantage of work done to date in streamlining our interfaces in particular to ENTSO-E and ACER – however our normal BAU operations will not deliver a Data Strategy.

6.71. While this initial work is focused on developing a foundation, it will then move to an outward facing agenda. As outlined above there will be a significant advantage to the energy industry and end consumers in Northern Ireland following the implementation of the data strategy[1]. The benefits will include enhanced data insights from our data, faster analysis of unusual occurrences on the power system, increased data sharing and transparency with a strong focus and drive to transforming us to a digital business.

[1] Note – the cost of implementing the strategy is not included in SONI's business plan because the quantum is currently unknown.

Chapter 7

Risk, Uncertainty and Financeability

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7 Risk, Uncertainty and Financeability

7.1 Key Messages

7.1. 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 making the business not financeable and not viable to deliver on its requirements.

7.2. SONI is not financeable based on the financial projections implied by the Draft Determination given 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, or regulatory precedent.
- Important components of the capital committed to the business, as well as risks associated with this capital, are not recognised and/or appropriately 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 Draft Determination proposals is not consistent with financial returns available to SONI for mitigation and management of risk and volatility.
- The combined impact of the allowed returns and risks that SONI would be exposed to under the Draft Determination implies that the returns that can be reasonably expected are materially short of the required returns on an ex ante basis. This violates the 'fair bet' principle and means that the business cannot reasonably expect to earn returns required to remunerate its capital.

7.3. The key errors in the Draft Determination are predominantly driven by:

1. Material departures and misinterpretations of the principles required for financeability established by the CMA, as well as material omissions from the CMA framework;
2. Flaws and inconsistencies in the proposed methodology for estimating the cost of capital; and
3. Limited and inadequate financeability assessment, short of the requirements established by the CMA, which does not consider the implications of key changes to SONI's risk exposure for SONI's financial position.

7.4. Each of these points is discussed in this chapter and additional detail is included in Annex J.

7.1.1 Departures from the Financeable Framework Established by the CMA and Material Omissions

7.5. In order to address the non-financeability of SONI based on the UR's PC 2015-20 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'.

7.6. The CMA corrected errors identified under the regulatory framework and provided for additional allowances to align return assumptions with risks faced by SONI. The CMA decision did not provide for 'more' than that which rendered SONI financeable – indeed it would itself have been in error had it done so. The CMA provided an overall tailored approach which holistically looked at the specific and particular characteristics of the SONI business to develop the framework it adopted. It is disappointing that in this, the next available determination, the UR has not adhered to this framework. Indeed the very act of amending it in itself gives rise to uncertainty for SONI and its investors.

7.7. The CMA decision provides the benchmark as to what constitutes a financeable regulatory determination for SONI. Adherence to the CMA's principles established at the previous price review is key. The Draft Determination has departed from the CMA framework in four key areas specifically:

- **Parent Company Guarantee (PCG):** the UR has not recognised the claim on equity capital to manage risks reflected in the £10m PCG. The remuneration of this equity capital is necessary irrespective of whether it is a licence requirement, however, this additional equity capital is not recognised or remunerated under the Draft Determination. Moreover the PCG was introduced not by UR but by its SEM Committee. Therefore, it is SONI's view that any proposal to remove the PCG from licence is a matter not for the UR but for its SEM Committee
- **Collection agent margin:** the UR has not appropriately analysed and, as a result of that, not remunerated the risks associated with the TUoS collection agent role. The Draft Determination included incorrect assumptions made to reduce allowances. The UR's proposals have misinterpreted the build-up of the collection agent margin in a manner inconsistent with the CMA decision and inconsistent with what it has elsewhere proposed in terms of treatment of TUoS.
- **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. UR has adopted new and flawed approaches to beta estimation that were not considered as part of the CMA appeal this is set out in detail in our response and in the note prepared independently by Professor Alan Gregory (Annex K).
- **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. In addition, new cost recovery mechanisms could result in very asymmetric outcomes, which could increase unpriced asymmetric risk implied by the Draft Determination. This results in a material decrease to expected returns on ex ante basis and violates the 'fair bet' principle.

7.1.2 Flaws and Inconsistencies in UR's Methodology for Estimating the Cost of Capital

7.8. There are also fundamental issues with the UR's methodologies for estimating certain cost of capital parameters. These parameters are material for the overall cost of capital. Collectively, these flaws and inconsistencies in the methodology set out in the Draft

Determination result in a material reduction in remuneration on the 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 the CMA precedent, which did not adopt lower notional gearing to address financeability constraints (despite it being proposed by UR). In any case, a change in the gearing assumption cannot have an impact on the overall level of risk of the business or on the required remuneration, which remain short of requirements regardless of the notional gearing assumption.

- **Cost of capital – small company premium:** failure to recognise the Small Company Premium for SONI means that the business cannot cover its efficient costs of financing and investors cannot expect to earn their required cost of capital.

  Not recognising the small company premium is inconsistent with the direct evidence from SONI's financing in the market, where the company has efficiently raised debt at c.100bps above than the iBoxx benchmark (where this benchmark is used to set the cost of debt). This is not consistent with the financeability of SONI on a standalone basis and established regulatory precedent.

- **Cost of capital – transaction costs:** material transaction costs faced by SONI that the business cannot avoid under the assumed financial structure are not recognised under the Draft Determination. These costs are not under SONI's control. No regulator has previously disputed the need to recognise transactions costs as these are normal costs for a business and are normally priced in charges to customers.

7.1.3 Limited and Inadequate Financeability Assessment

7.9. The Draft Determination assessment which does not consider the implications of key changes to SONI's risk exposure for SONI's financial position is limited and inadequate as a result and short of the requirement established by the CMA.

7.10. SONI's overall risk exposure is increasing materially in the forthcoming price control due to market factors, industry transformation, 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.

7.11. This increase in risks, which directly follows from the energy sector transition, evolving role of the system operator, associated new challenges as well as the regulatory framework, is not reflected in the allowed returns. This results in a fundamental imbalance between risk and return, which are not in equilibrium as required for efficient market outcomes that the regulatory determination must seek to simulate under standard economic theory and fundamental principles of good regulation.

7.12. The lack of balance and correspondence between risks and returns is exacerbated by the new conditional cost-sharing approach, which can result in very asymmetric outcomes (the fact it could result in asymmetric outcomes is key, and has to be factored in the assessment and consideration of risk ex ante). This results in increased uncertainty as the parameters of cost sharing can change ex post providing no clear framework up front, and implies additional regulatory risk which investors would share and would need to be priced.

7.13. There is also limited guidance as to how conditional cost sharing will work – this lack of clarity and specification means that this new regulatory mechanism materially increases uncertainty and risk of SONI's cost recovery where SONI has no financial resources available to manage or mitigate these risks.

7.14. SONI's financeability is further 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 business objectives and deliver on its obligations for customers and all stakeholders.

7.15. The draft allowances under-price cost trends, such as non-labour RPEs, whilst at the same time assume a step change in ongoing productivity based upon a flawed analysis of the potential for capital substitution.

7.16. All of this effectively means that SONI would have to assume underperformance and under recovery 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 under the Draft Determination.

7.17. The risks and uncertainties mentioned above are not captured in UR's financeability assessment, which relies on a narrow and incomplete RoRE analysis to assess financial resilience and equity financeability. In particular UR's risk analysis does not consider risks associated with the collection agent role, DIWE risks on internal costs, considers only limited cost risk on uncertainty mechanisms such as Dt or downside risk on transmission network pre-construction projects and does not apply its risk analysis consistently across its cost of capital and financeability analysis.

7.18. UR has not given proper consideration as to SONI's financial resilience in the event plausible downside shocks occurred. This is compounded by over-stating financial resources available to SONI in its financial model (for example UR's financial model omits expected cost disallowances arising from asymmetric risk) and insufficient adjustments to RAB to reflect the transition from RPI to CPIH.

7.19. 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. Given SONI's business characteristics, which require capital committed beyond the RAB, RoRE does not represent a robust measure of returns on equity committed at the whole enterprise level. 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.

7.20. UR's analysis cannot therefore be considered to be a meaningful test of whether SONI is able to finance its activities and planned investments.

7.21. 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. SONI has engaged extensively with the UR on these issues following the Draft Determination and welcomes UR's willingness to engage on the implications of all aspects of its Draft Determination for financeability and financial resilience. Significant changes are however necessary.

7.22. We now consider and elaborate on the errors within the UR approach for each of the key areas following the structure as shown in Figure 7.1 below.

Figure 7.1. Key Areas of Consideration for SONI Financeability

7.2 Evolution of SONI Risk Exposure

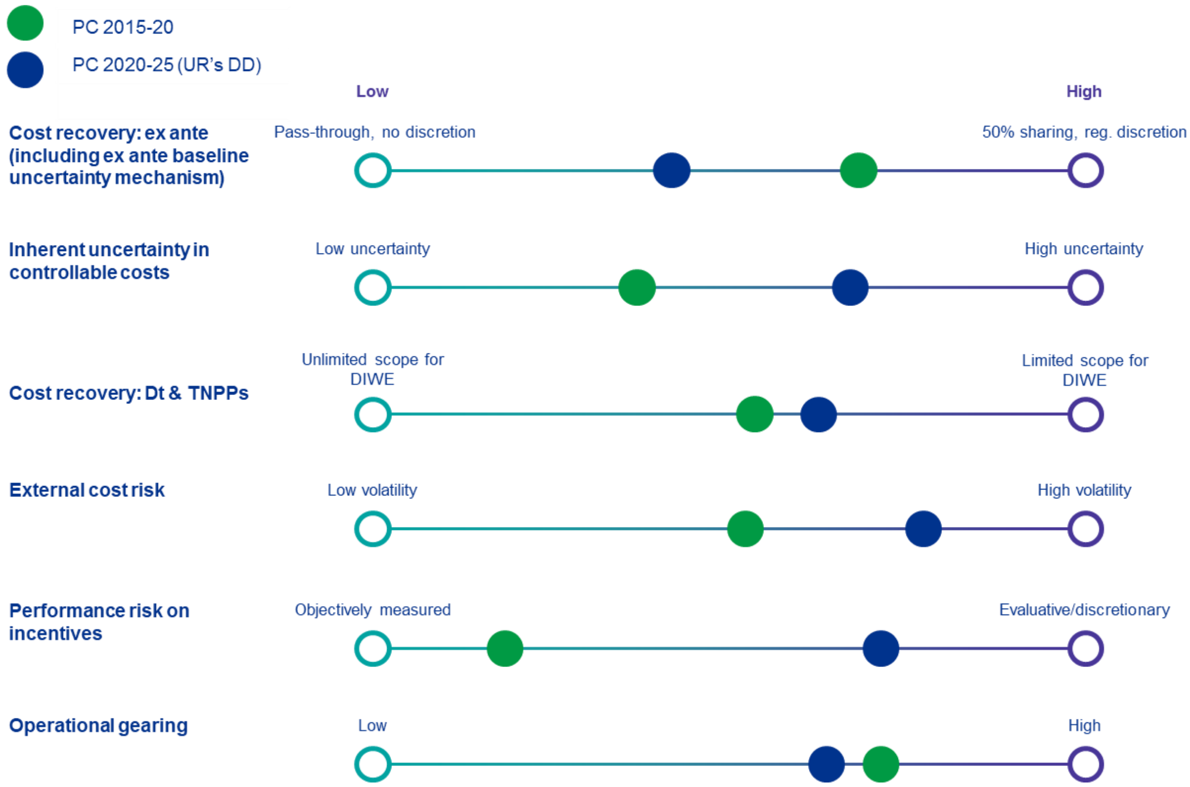
7.23. It is important to consider the evolution of SONI's risk exposure between the current and forthcoming price controls for SONI as this could have significant implications for how the overall framework is calibrated and how returns should be set.

7.24. Overall, the TSO faces a material increase in risks over the forthcoming price control. All else equal, this implies a higher remuneration requirement for SONI. In contrast and counter-intuitively, the Draft Determination assumes a material reduction in the allowed return across each remuneration building block.

7.25. In the chart below we have set out key risks related to SONI's different business activities (e.g. external cost risk for collection agent activities) and considered how SONI's risk exposure during PC 2020-25 compares to that during PC 2015-20.

7.26. Each risk has been mapped on a low to high spectrum (Figure 7.2). The spectra collectively imply that whilst risks associated with cost recovery have reduced, new risks relating to the evaluative performance framework, risks relating to other business activities and overall risk exposure are expected to increase materially in the forthcoming price control.

Figure 7.2. Evolution of SONI Risk Exposure



7.27. We comment on evolution of each of the key risks and relevance to SONI's related business activities below.

7.2.1 Cost Recovery: Internal TSO Costs

7.28. The change in risk exposure compared to PC 2015-20 is driven by:

- The lower sharing rate for costs subject to conditional cost sharing ('CCS'), which we consider to have reduced risk;
- The conditionality of CCS to ex post regulatory assessment on the efficiency of spend; and
- Potential application of DIWE under CCS without the provision of the asymmetric risk premium.

7.29. On balance, cost recovery risk is likely to have reduced at Draft Determination compared to PC 2015-20, although the conditionality of CCS on regulatory assessment and DIWE largely offset the benefit of a lower sharing rate. We have separately - in Chapter 4 of our Draft Determination response - raised queries on how the conditionality of CCS would work in practice with the real risk it would give rise to asymmetric outcomes.

7.2.2 Inherent Uncertainty in Controllable Costs

7.30. The scale of SONI's controllable costs is projected to increase materially relative to PC 2015-20, driven by a significant number of strategic initiatives designed to meet government policy objectives. These initiatives are not only larger in scale but also significantly more uncertain – they are innovative and first of a kind in nature. The inherent riskiness of the projects is further heighted by the transformation of the energy sector, which will require flexibility to meet continuously evolving requirements, require innovation to achieve objectives and could result in changes to scope and specification.

7.2.3 Cost Recovery: Dt and TNPPs

7.31. The mechanism for recovering Dt and TNPP costs – recovery subject to an approved cap and DIWE and with the asymmetric risk premium as determined by the CMA applied – is largely consistent with the CMA framework.

7.32. The Draft Determination proposes that performance on these costs will now be taken into account as part of an evaluative framework, however, the reward / penalty will be subject to the overall £1m cap and collar, thereby constraining risk.

7.2.4 External Cost Risk

7.33. The mechanism for recovering external costs has not changed from a pass-through arrangement but is now subject to reward / penalty from the evaluative framework[1]. Risk exposure arising from the regulatory framework is limited to the £1m cap and collar. The inherent risk exposure on the overall collection agents cashflows themselves is expected to increase over the forthcoming price control, as illustrated in Figure 7.3.

Figure 7.3. Evolution of Collection Agent Risks

Evolution of risks	Reputational / fiduciary responsibility	Income variation risk	Cost variation risk
TUoS	—	↓	—
System Services	↑	↑	↑
Dispatch Balancing Costs	↑	↑	↑
Overall	↑	↑	↑

7.34. While the removal of TUoS cashflow timing risk in the Draft Determination implies a reduction to income variation risk on TUoS, all other risks are expected to increase or remain the same across the collection agent function. This is due to the increasing scale and complexity of these cashflows created through the introduction of I-SEM and the drive to increase renewables penetration in the system. As a result, the overall collection agent function is expected to be inherently riskier to undertake in the forthcoming price control.

7.35. Overall the external cost risk is projected to increase compared to PC 2015-2020.

[1] Although SONI notes the letter received from UR on July 23rd 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. If this is the case then this additional risk needs also to be recognised.

7.2.5 Performance Risk on Incentives

7.36. The incentive regime is novel, untested and predominantly evaluative/discretionary. The new evaluative performance framework has introduced up to £1m of downside risk per annum (compared to limited downside risk exposure on incentives in PC 2015-20), which materially increases systematic risk for SONI.

7.37. This is a significant departure from the incentive framework at PC 2015-20 both in terms of the regulatory judgement involved, lack of ex ante specification as to how the evaluation will work in practice, and the scale of potential downside. The subjective and discretionary nature of the mechanism also reduces degree on control that SONI has over the outcomes of the evaluation process. The range of possible outcomes is materially wider for the upcoming price control.

7.2.6 Operational gearing

7.38. Overall operational gearing has not changed materially compared to PC 2015-20, with lower RAB expected based on the Draft Determination than at the end of the current price control period.

7.3 Parent Company Guarantee (PCG)

7.39. The proposal to remove the obligation for the PCG directly contravenes the CMA's rationale for recognising and pricing the PCG. The equity capital committed to SONI is necessary given the nature of SONI's exposures, but is not recognised or remunerated under the Draft Determination.

7.40. SONI requires a claim on equity reflected in PCG in order to manage potential extreme downside risks and to ensure liquidity and financial viability in downside scenarios – given the increased likelihood the PCG will now be drawn the level of remuneration arguably needs to be higher, but there is no provision for remuneration of the PCG in the Draft Determination.

7.41. SONI has a very limited capital base recognised by the regulator compared with its operations and compared with asset heavy networks. SONI's RAB is small and there are no allowances for other capital and its remuneration (other than the PCG).

7.42. UR considers in the Draft Determination that the PCG is not necessary and should not be remunerated as it states (1) equity investors should be willing to inject further equity into SONI's TSO business up to the value of their RAB investment; and (2) this equity has increased due to the higher forecast RAB in the 2020-25 period and the lower gearing assumption (reduced from 55% to 30%). This position is not justified for the following reasons:

- The capital in the RAB is fully employed in fixed assets and hence not available in liquid form for other activities or for risk and financial management. As the RAB is small and volatile, and given UR's methodology, projected free cash flows are very limited and insufficient to manage risks that the business is exposed to. The nature of SONI's operations requires contingent capital given the scale and nature of its financial flows and exposures. It cannot be assumed that investors will just provide additional capital, which has not been provided for or remunerated – there is no reason or rationale why investors would put more capital at risk. Any additional contingent capital such as that secured with the PCG has to be remunerated and its providers have a reasonable expectation to earn the necessary and appropriate returns.

- The change in notional gearing does not address the imbalance between risks and return because this balance is about the overall risk of all activities and assets on the one hand and return on the capital on the other hand. A change in notional gearing cannot improve financeability per se because it only changes an assumption about the mix of different sources of financing.
- CMA explicitly considered UR's position at the time that the treatment and pricing of the PCG for SONI should take into account the equity investment in the RAB. The CMA stated that "we are not persuaded that this has a material effect on the market value of the guarantee for SONI. The UR has continued to require EirGrid to maintain a guarantee to SONI as TSO notwithstanding that it has for the purposes of this Price Control assumed that SONI is funded 100% with equity. As indicated in SONI's submissions on priority, the first call on capital where there are losses, after the allowance for the return on the RAB, is the PCG." The CMA did not attach weight to UR's arguments that the equity capital in the RAB would impact on the need for the PCG. UR's position that a reduction from 55% to 30% gearing would obviate the need for the PCG directly contradicts the findings of the CMA, which considered that the PCG was required even under a 100% equity structure.

7.4 Collection Agent Margin

7.43. The UR's approach to estimating the collection agent margin is inconsistent with the approach adopted by CMA, inconsistent with UR's other proposals on the treatment of TUoS and does not price the increasing risks to which SONI is exposed.

7.44. UR has proposed to transfer some TUoS risks to NIE Networks. It has argued that this is sufficient basis to remove the 0.5% margin from the TUoS cash flows.

7.45. However, TUoS is the least risky of the collection agent cash flows to which the margin is applied[2] and removal of TUoS risk would increase the margin required for the remaining collection agent activities (system services, DBC). UR recognises this difference in risk profile however does not make a corresponding adjustment to the margin.

7.46. The CMA estimated a weighted average margin of 0.5% across collection agent activities with different risk profiles. The CMA stated in its Final Determination that: *"we are aware that there are differences between the level of risk for SONI in respect of its different revenue collection activities. In particular, the DBCs appear to have a greater risk for SONI than the activities of collecting and onward payment of transmission charges.*[3]*"*

[2] SONI recognises the margin is designed to remunerate it for the fiduciary and other responsibilities associated with CAIRt but is not explicitly applied to CAIRt but rather calibrated overall.
[3] SONI Limited v NIAUR: Final Determination, November 2017. Section 12.145.

7.47. The CMA recognised that different collection activities implied different levels of risk; the UR's approach to estimating the collection agent margin is inconsistent with the approach adopted by the CMA. No rationale has been set out by UR.

7.48. As a result, the pricing of remaining collection agent cashflows is materially under-stated and does not correspond to the underlying risk exposure. This is exacerbated as the risks SONI faces have increased since the previous price control.

7.49. SONI is exposed to greater income variation risk due to the increased scale of cashflows and heightened challenges in forecasting as well as greater cost variation risk driven by increasing cashflow volatility. These increases in exposure are not reflected in UR's Draft Determination.

7.50. Moreover, UR assumes that by transferring a proportion of cash flow risk to a third party all risks associated with TUoS are transferred and this risk would no longer need to be priced in for SONI. This is not the case as SONI would still be exposed to residual risks e.g. exchange rate risk as part of All Island GTUoS.

7.5 Cost of Capital

7.5.1 Asset Beta

7.51. The UR places significant weight on a comparison with water companies' risk and equity returns to set the asset beta. This approach is not appropriate as it implies the systematic risk for SONI is the same as water companies and results in an inconsistent interpretation of risk between the estimates of asset beta and notional gearing.

- The UR appears to use a RoRE approach to the estimation of asset beta, which assumes that the systematic risk of SONI is identical to that of water companies.
- The UR's estimate of asset beta is – with limited justification – based solely on water companies which have the lowest risk of all utilities and are not comparable. This creates an inconsistency with UR's own rationale for adopting a lower notional gearing for SONI.
- The UR does not seek to estimate equity betas, choosing instead to rely fully on Ofwat's methodology at PR19, which is flawed, subject to a number of ongoing CMA appeals and cannot be relied upon as input measures in the SONI analysis.
- The UR is clear that it regards water utilities' gearing levels as inappropriate because SONI's operations are higher risk, as indicated by its risk analysis.

7.52. The UR cites the BT Openreach and NERL – both with a notional gearing of 30% - as examples of companies with lower gearing due to higher risk than other utilities. The UR is implying that NERL and Openreach are legitimate proxies for calibration of gearing. Professor Alan Gregory notes in Annex K that *"the corollary must be that if 30% is deemed to be the appropriate gearing level, then the BT Openreach and NERL asset betas represent legitimate comparators."*

7.53. Evidence from regulatory judgements on Openreach Copper (Ofcom, 0.59) and NERL (CMA 0.52-0.62) is simply discounted. When restated to debt beta of 0.125 included in the Draft

Determination, these asset betas have a mid-point of 0.59 and a value of 0.60 respectively, suggesting an average asset beta 0.595 to be consistent with the assumed gearing.

7.54. Professor Alan Gregory comments that this *"assumes away all the flaws in Ofwat's approach to beta estimation. It further ignores other suitable proxies for NI utility risks, in particular NERL and Openreach, which are clearly relevant given the gearing discussion. Finally, it completely side-steps the operational gearing issue, despite having acknowledged its importance. In short, I can find no justification for this approach whatsoever."*

7.55. An alternative approach could be (as applied for PC 2015-20) to apply an adjustment for operational gearing to the asset beta for listed utilities (correcting for any errors identified by CMA for listed water companies). The UR has considered this adjustment; however, its calculation of the required operational gearing adjustment includes errors. In any event it is not clear how the calculation feeds into the final beta estimate set out in the Draft Determination; this introduces a departure from the current framework and is not consistent with the analysis of operational gearing considered by the CMA. This approach (when applied on a consistent basis over time, adopting a broader range of comparators than water companies) implies an asset beta of at least 0.59.

7.5.2 Notional Gearing

7.56. 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 (although this was proposed by UR, which suggested a 100% equity structure). A change in the gearing assumption cannot have an impact on the overall level of risk of the business or on the required remuneration.

7.57. The UR has applied an arbitrary reduction in notional gearing from 55% to 30% to reflect its analysis that SONI is exposed to more risk than asset heavy utilities such as water companies. This is based on a flawed RoRE analysis which is distorted because of the difference in gearing between SONI and water companies and is incomplete as it does not capture all the risks that SONI is exposed to.

7.58. The UR has considered adopting a 30% gearing assumption, inter alia, due to the existence of *"some recent regulatory precedent for a 30% notional gearing assumption for UK regulated companies (e.g. CMA DDs for NERL and Ofcom BT Openreach)"*[4]. However, this approach is not consistent with the approach adopted for setting asset beta, where these companies are not considered to be appropriate proxies for SONI's risk exposure.

7.59. The reduction in gearing is assumed to reduce the WACC by c.20bps. However, the Modigliani-Miller Capital Structure Irrelevance Proposition stipulated that the cost of capital of a firm is invariant to the level of gearing. This is due to the UR's choice of debt beta of 0.125 at 30% gearing, which compares to a debt beta of 0.15 at 50% gearing in the SONI Business Plan. Professor Alan Gregory notes in Annex K that *"one would reasonably expect the range of difference to be considerably greater than 0.025."*

7.60. The reduction in gearing is used to justify the removal of PCG. However, assuming a lower gearing cannot be a substitute for addressing underlying financeability problems – an

[4] SONI Draft Determination, Annex 7 Risk and Return, Section 2.18

assumption of a higher proportion of equity capital invested in the RAB does not mean a larger buffer for risk – risk must be commensurate with the overall returns. Changes in gearing do not address the imbalance between risks and return because this balance is about the overall risk of all activities and assets on the one hand and return on the capital on the other hand.

7.61. Changes in notional gearing were not employed by the CMA to address the financeability constraints for SONI during the PC 2015-20 appeal, although this was proposed by UR, which suggested a 100% equity structure.

7.5.3 Cost of Debt – Small Company Premium (SCP)

7.62. Failure to recognise the Small Company Premium for SONI means that investors cannot expect to earn their required cost of capital. Not recognising the small company premium is inconsistent with direct evidence from SONI's financing where the company has efficiently raised debt at c.100bps above than the iBoxx benchmark used to set the cost of debt. This is not consistent with the financeability of SONI on a standalone basis and established regulatory precedent.

7.63. As a small company SONI faces higher financing costs driven by:

- Higher transaction costs;
- Lack of access to some forms of capital;
- Cost of carry due to less frequent issuance; and
- Higher direct cost of financing.

7.64. CMA found there was c.40bps gap between the yield on small and large water company debt at PR14.

7.65. The empirical assessment of SONI's recent debt issuance vs the benchmark index implies a small company premium of at least 100bps.

7.66. The premia for SONI is greater than that observed for small water companies; 40bps is likely to under-estimate the size of the adjustment required.

7.67. The UR does not engage in its Draft Determination with the evidence provided that SONI as a small company incurs higher debt costs, as it considers these additional financing costs should not be provided given SONI's existing governance arrangements. SONI should be financeable on a standalone basis and able to recover efficient financing costs for a small company. The SCP is not contingent on the governance process.

7.68. Failure to recognise the efficient cost of debt including SCP would imply that investors could not expect to earn their cost of capital – this is not consistent with the financeability of SONI.

7.5.4 Cost of Debt – Transaction Costs

7.69. SONI has incurred material transaction costs on its financial instruments, but these costs are not recognised under the Draft Determination. No regulator has previously disputed the need to recognise transactions costs. There has been consistent recognition and treatment of transaction costs across all regulatory reviews, confirmed and recognised by the CMA.

7.70. Transaction costs are normal costs for a business which are priced in charges to customers; their remuneration is consistent with extensive regulatory precedents. An efficient notional company would still incur unavoidable transaction costs in its debt and equity raising.

7.71. Transaction costs capture all relevant costs – e.g. arrangement fees, liquidity costs, legal fees – other than the cost of remunerating capital.

7.72. The regulatory regime needs to allow for these efficiently incurred costs, which would be fully priced in competitive markets. This is clearly recognised in regulatory precedent – UK regulators and the CMA have consistently allowed for such costs across price controls and sectors.

7.73. UR considers that transaction costs may not be material. In practice transactions costs for a business like SONI are particularly high due to (1) small scale, (2) unique business characteristics, (3) shorter term/higher refinancing costs than for long term financing – the tenor of past borrowings by SONI has been 5-6 years.

7.74. SONI's I-SEM term loan required 0.75% arrangement fees – which would equate to at least 0.15% uplift in each year of the price control. However, these costs cannot be recovered under the Draft Determination and have not been provided for.

7.75. UR states that it considers that SONI could have recovered these costs through another regulatory mechanism. This is not the case.

7.6 Financeability

7.76. Overall SONI is not financeable based on the financial projections implied by the Draft Determination given its characteristics, activities and risk exposure for the following reasons:

Reason 1

7.77. The cost of capital allowance proposed by the UR for SONI is not consistent with market benchmarks, corporate finance theory and practice, or the regulatory precedent. This is driven by the departures from the CMA principles for remunerating the operational gearing exposure for SONI through asset beta and flaws and inconsistencies in the methodology applied to estimate notional gearing and the cost of debt (SCP, transaction costs).

Reason 2

7.78. Important components of the capital committed to the business (such as the claim on equity capital reflected in the PCG) as well as risks associated with this capital (for the collection agent role) are not recognised and/or appropriately remunerated.

Reason 3

7.79. 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.[5]

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[5] The Draft Determination base case financial projections have been developed by making targeted adjustments to UR's modelling assumptions:

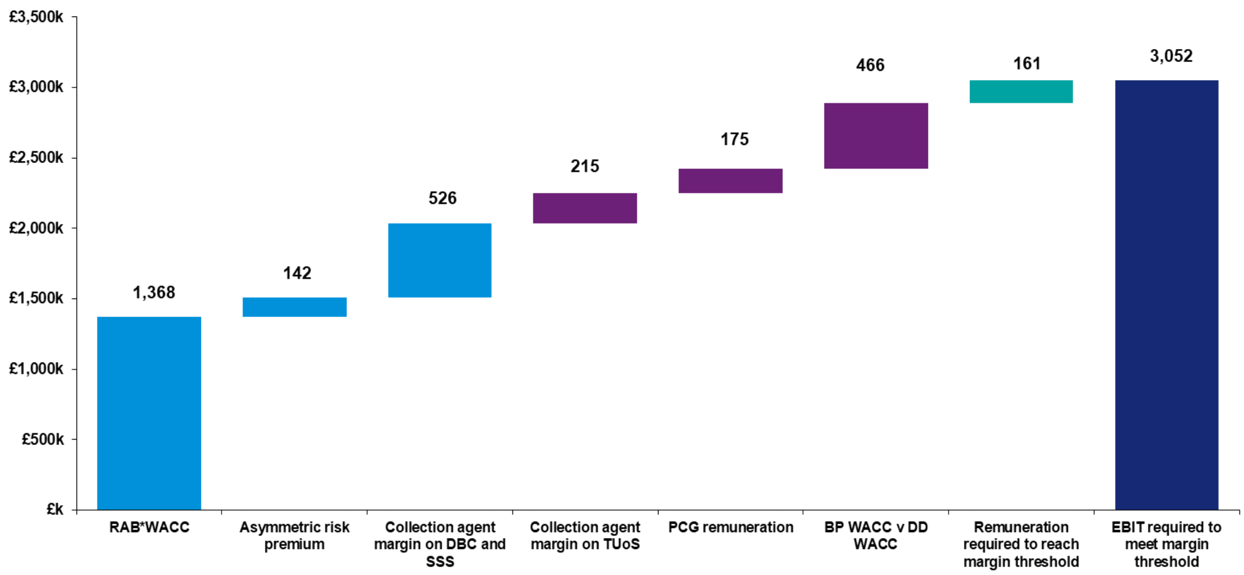
- Cost of debt is assumed to be in line with the BP in order to accurately reflect standalone borrowing costs for a company like SONI;

Table 7.1. Projected Financial Metrics under the Draft Determination Base Case

Draft Determination Base Case	2020/21	2021/22	2022/23	2023/24	2024/25	*Average*	Threshold
EBIT margin (controllable revenue)	**8.82%**	**8.75%**	**9.25%**	**6.32%**	**6.46%**	**7.92%**	**10%**
EBIT margin (total revenues)	**1.35%**	**1.29%**	**1.44%**	**1.20%**	**1.03%**	**1.26%**	**1.5%**

7.80. The financial projections imply that remuneration of £3.1m on average is required (total returns plus asymmetric risk premium) to achieve the minimum level of profitability required to meet the thresholds. As shown in Figure 7.4, there is a funding gap between the remuneration provided by the Draft Determination (RAB*WACC, asymmetric risk premium and collection agent margin on DBC and SSS) and that required to meet the required threshold EBIT margin of c.£1m related to the CMA layers of PCG and collection agent margin on TUoS and the flaws in the estimation of the cost of capital.

Figure 7.4. Bridge from WACC x RAB to EBIT Required to Meet Margin Threshold



Reason 4

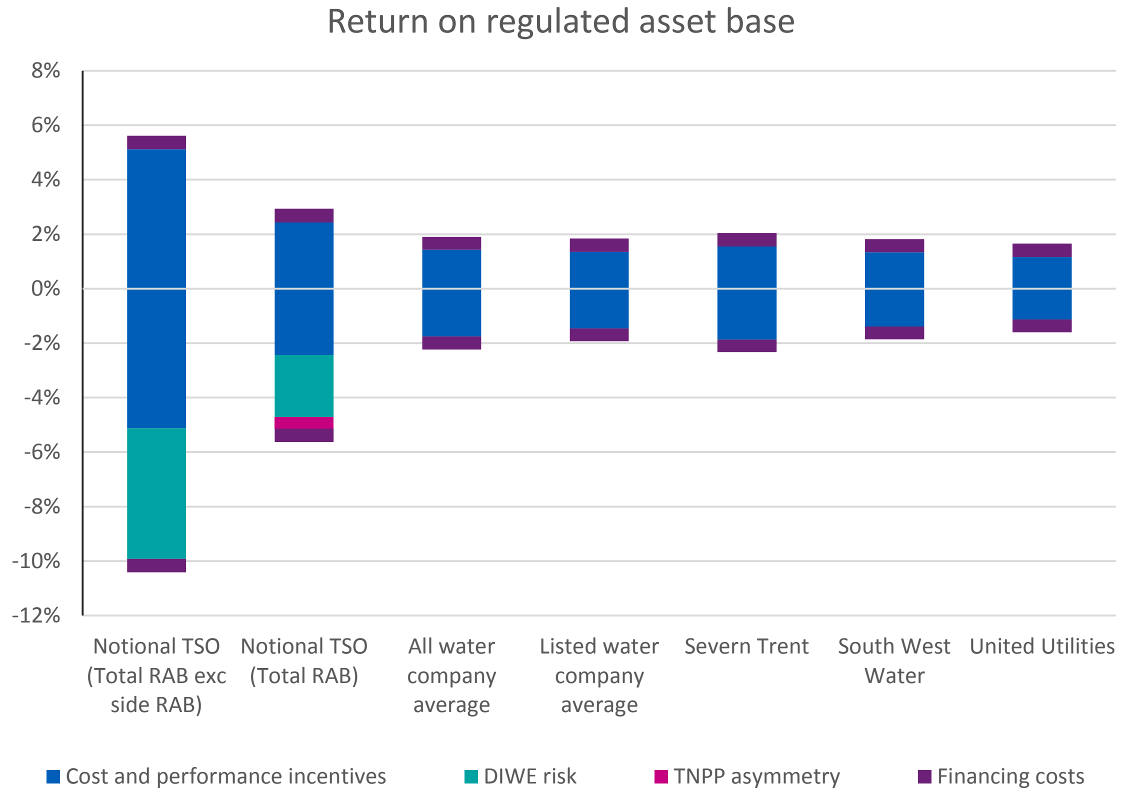
7.81. The risk exposure implied by the Draft Determination proposals is not consistent with financial returns available to SONI for mitigation and management of risk and volatility.

- SONI's overall risk exposure is increasing materially in the forthcoming price control due to market factors, industry transformation, 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.

- Cost equal to the premium for asymmetric risk has been modelled to reflect the mean expected position for SONI; and
- The RCF is assumed to be drawn at 30% throughout the price control period to similarly reflect the expected position and cash flow volatility.

- This increase in risks, which directly follows from the energy sector transition, evolving role of the system operator, associated new challenges, as well as the regulatory framework, is not reflected in the allowed returns. This results in a fundamental imbalance between risk and return, which are not in equilibrium as required for efficient market outcomes that the regulatory determination must seek to simulate under standard economic theory and fundamental principles of good regulation.
- UR has assumed that capping the exposure from the evaluative framework to +/-£1m is sufficient to ensure SONI's financeability and financial resilience. However, the UR's risk assessment is not complete and does not take into account all risks e.g. downside risks on Dt and TNPP costs.
- The UR's analysis of SONI's RoRE compared to water companies is misleading due to (1) the differences between the UR's assumed notional gearing of 30% and the 60% for UK regulated water companies.
- We have, with the assistance of our advisors KPMG, replicated the UR's analysis based on the RAB as a whole rather than regulated equity. This is a more appropriate comparison as (1) the level of regulated equity is not distorted by the assumed level of gearing; and (2) changing the level of notional gearing does not alter the asset risk that the business faces. To enable like-for-like comparison with the UR's analysis we have excluded the risks and the capital associated with these activities.
- The corrected RoRE ranges in Figure 7.5 show that the risk exposure for SONI materially exceeds that of water companies before the risks and capital related to collection agent activities are captured – these would need to be reflected in the analysis in order to stress test the regulatory settlement for the notional TSO as a whole.

Figure 7.5. Comparison of Estimated Return on RAB Risk for TSO (including and excluding side RAB) and Water Companies



Reason 5

7.82. The combined impact of the allowed returns and risks that SONI would be exposed to under the Draft Determination implies that the returns that can be reasonably expected returns are materially lower than the required returns on an ex ante basis. This means that the business cannot reasonably expect to earn returns required to remunerate its capital. This violates the 'fair bet principle'. The lack of balance and correspondence between risks and returns is exacerbated by:

- The new conditional cost-sharing approach can result in very asymmetric outcomes (the fact it could result in asymmetric outcomes is key and has to be factored in the assessment and consideration of risk ex ante). This results in increased uncertainty as the parameters of cost sharing can change ex post providing no clear framework up front, and implies additional regulatory risk which investors would share and would need to be priced.
- There is also limited guidance as to how conditional cost sharing will work – this lack of clarity and specification means that this new regulatory mechanism materially increases uncertainty and risk of SONI's cost recovery where SONI has no financial resources available to manage or mitigate these risks.
- The CMA applied a premium to costs exposed to asymmetric risk (Dt and TNPP costs). The Draft Determination assumes that only £5m of Dt costs are expected across PC 2020-25 (compared to £22m for PC 2015-20), which does not capture

projected costs for strategic initiatives and as a result under-estimates on an ex-ante basis SONI's exposure to asymmetric risk. This will result in a loss on an expected basis for SONI.

- 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 business objectives and deliver on its obligations for customers and all stakeholders.
- The draft allowances under-price cost trends, such as non-labour RPEs, whilst at the same time, assume a step change in ongoing productivity based upon a flawed analysis of the potential for capital substitution.
- All of this effectively means that SONI would have to assume underperformance and under recovery 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 under the Draft Determination.

7.83. There are fundamental problems with new conditional cost-sharing approach, which is highly subjective and although it appears symmetric-ex ante could result in very asymmetric outcomes.

7.84. The risks and uncertainties mentioned above are not captured in UR's financeability assessment, which relies on a narrow and incomplete RoRE analysis to assess financial resilience and equity financeability. In particular UR's risk analysis does not consider risks associated with the collection agent role, DIWE risks on internal costs, considers only limited cost risk on uncertainty mechanisms such as Dt or downside risk on transmission network pre-construction projects and does not apply its risk analysis consistently across its cost of capital and financeability analysis.

7.85. UR has not given proper consideration as to SONI's financial resilience in the event of plausible downside shocks occurred. This is compounded by over-stating financial resources available to SONI in its financial model (for example UR's financial model omits expected cost disallowances arising from asymmetric risk) and insufficient adjustments to RAB to reflect the transition from RPI to CPIH.

7.86. 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. Given SONI's business characteristics, which require capital committed beyond the RAB, RoRE does not represent a robust measure of returns on equity committed at the whole enterprise level. 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.

7.87. UR's analysis cannot therefore be considered to be a meaningful test of whether SONI is able to finance its activities and planned investments.