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Dear Jakub,

Consultation on DCC review: Phase 2 – Process for determination of Allowed Revenue

Thank you for the opportunity to respond to this consultation.

Since the start of the smart meter programme Electricity North West Limited (ENWL) has held regular bilateral meetings with the Department for Energy Security and Net Zero (DESNZ) and its predecessors to support progress with the rollout, and help ENWL customers realise benefits from smart meters.

We have engaged with Ofgem's review of DCC's regulatory model because we share Ofgem's concerns about the performance of the existing DCC under the existing model; and because DCC's role is critical to the success of MHHS delivering consumer benefits and progress towards Net Zero.

We agree that *ex ante* pricing will provide much improved incentive for DCC to work efficiently, transparently and more closely aligned to better quality forecasts. And we welcome the focus on customer engagement in the Business Plan process.

I'd like to bring your attention to our comments on working capital below. The proposals may not provide sufficient cash to cover working capital from day one, and they would see an accumulation of customer charges over the year, beyond the Business Plan, retained as a cash balance. This doesn't encourage efficient use of cash. Indeed working capital doesn't generally increase over the course of a year, but rather varies from day to day, to meet liabilities when due. We suggest the level required is assessed using a daily cashflow forecasting model (a normal financial process in most businesses). We also provide some comments below on funding the initial and variable levels of cash required.

We have responded at Appendix 1 to your detailed analysis.

I hope these comments are helpful. Please do not hesitate to contact me or Mark Bellman (07385 009419) if you would like to follow up on any particular aspect of our response.

Yours sincerely,

pp. Paul Auckland
Head of Economic Regulation

Appendix 1 – ENWL detailed responses to each of the consultation questions

The following table includes our views on the consultation:

<table>
<tr><th>Ref.</th><th>Question</th><th>Response</th></tr>
<tr><td colspan="3">Cost control scope & cycle</td></tr>
<tr><td>1</td><td colspan="2">What are your views on our proposal to move towards a multiannual, ex-ante cost control with uncertainty mechanisms? Do you agree with our proposal to require from DCC a costed Business Plan to form part of its cost control submission?</td></tr>
<tr><td colspan="3">ENWL agree with Ofgem’s proposals to
- implement a fully ex ante multi-annual price control with uncertainty mechanisms, and
- require from DCC a costed Business Plan to form part of its cost control submission

We believe the uncertainty mechanism, if not suitably robust, could dilute the incentive on DCC to meet strict cost controls, but acknowledge their necessity in some form due to the proposed Not-For-Profit (NFP) arrangement, under which ‘shortfall’ would have to be recovered from DCC customers (rather than being treated as a ‘loss’ as it would be in a For-Profit model). See more at Q4.

The Business Plan is an essential submission under the ex ante price control, as without it there is no base cost with which to compare outturn. Even though shortfalls would be recovered from customers (and cannot be ‘disallowed’ as it can under the existing For Profit model), for transparency’s sake, it’s essential that the discipline of explaining any shortfall is imposed on the Board.

It’s important that the Business Plan includes an estimate of the working capital requirement and sensitivities (see later questions for more on this).</td></tr>
<tr><td>2</td><td colspan="2">What are your views on the length of the cost control cycles under the Successor Licence? What are your views on the interaction between the Business Development Plan and a costed Business Plan?</td></tr>
<tr><td colspan="3">ENWL agree with the proposal for an initial 2 year ex ante cycle April 2026 to March 2028 (i.e. to the end of DCC1’s tenure) because it’s important to hold DCC2 to its own Business Plan from as early a date as possible.

From April 2028 we believe that a 3-year period would be preferable to 2-year for the reason, cited by Ofgem, that it forces a longer term view based on more considered and better quality forecasts to be used.

We would also note that a 3-year price control provides more certainty for DCC customers (albeit with the attendant risk of re-openers) and also, importantly, it would ensure DCC appears lower risk for 3rd party providers of finance (see working capital response below).

We believe that it’s appropriate for a mature business of this size to include Business Development activities as part of an all-encompassing Business Plan. We agree with Ofgem that DCC needs to demonstrate a more financially disciplined forecasting and planning process. In this regard it might be useful to consider an obligation on DCC to hold an annual Strategic Planning Day with all members / representatives of the Customer Challenge Group (see Q. 12).</td></tr>
<tr><td colspan="3">Managing risks and uncertainty</td></tr>
<tr><td>3</td><td colspan="2">What are your views on the outlined general approach towards determining efficient forecast costs?</td></tr>
</table>

ENWL agree with the general approach towards determining efficient forecast costs and specifically the requirements outlined at 3.14 – 3.16 for External and Internal Costs . ENWL agree that in considering forecasts, costs should be both "economic and efficient" and "significantly more likely than not to occur". And that any outturn variance or movement in the forecast is fully justified. Furthermore ENWL would consider it unacceptable to define the costs to be included in forecast on any basis other than that on which it is reasonably expected they are to be incurred. To this end, we agree that the practice of the current DCC (outlined in 3.9) to use different bases for different forecast purposes (e.g. charging statement vs price control) must be stopped.	
4	**What are your views on flexibility within DCC's Allowed Revenue? At what level should DCC be afforded flexibility to manage overspend/underspend?**
ENWL agree that DCC should be allowed a degree of flexibility to manage total costs to budget provided that transparency of cost performance at each line is not compromised. As noted in our response to Q1, being a Not-For-Profit means that 100% of costs incurred will need to be recovered from customers. This limits the role of fungibility only to inform i) where a variance requires justifications and ii) where variances would impact Board members' Cost incentives (fungibility ensures no adverse impact on incentives from overspends; where fungibility is not allowed, but the variance is justified, Ofgem might consider "allowing it" so it has no adverse impact on cost incentives (e.g. variances arising from justified inter-Programme transfers) We agree that fungibility could apply to Internal Costs and to External Costs <u>within</u> each 'Programme' but not between Programmes. We believe this is Option B (non-fungibility of External Costs). The current programmes appear to be: • SMETS2 • SMETS1 Enrolment and Adoption • Enduring Change of Supplier (ECoS) • 4G Comms Hubs & Networks • Test Automation Framework (TAF) ENWL suggest that, going forward, Programmes should be defined as **high level** and with **independent** cost-drivers so that a variance in one Programme is unlikely to have an equal and opposite variance in another Programme. If activity has to be moved from one Programme to another for sound project reasons, the equal and opposite variances arising should be justified (because they will be non-fungible across Programmes) but Ofgem might reasonably "allow", post-justification, such a variance for Cost Incentive purposes. ENWL agree with Ofgem's statement that "If efficiencies can be achieved on a contract, DCC should seek to drive those regardless of whether it faces challenges in managing another contract." but this needs to be subject to having an overall expectation of benefits.	
5	**What are your views on our proposal to allow DCC to access working capital through a contingency set at 2% of its annual Allowed Revenue? Would this level of contingency be sufficient to manage risks to DCC's ability to finance its Mandatory Business? What are your views on the risk and benefits of cash v accruals-based reporting of Price Control information?**
ENWL believe Option A presents too much uncertainty in costs for customers and so should not be considered. We don't support Option B1, agreeing with Ofgem's conclusion that 'allowing' recovery of a surplus of 5% is too high a figure and could become a default allowed overspend.	

We don't support Option B2 because the default overspend argument above applies (albeit to a lesser extent) and it's not clear that 2% would be sufficient (especially in the first days/months of application). Ofgem note that:
"the average and the median difference between monthly incomings and outgoings are equivalent to less than 1% of the Allowed Revenue for that year. We are however cognisant that throughout the year there might be specific months with a greater shortfall".
However this does not indicate how cashflows could vary from day to day, without which the maximum requirement for cash on a day can't be reasonably estimated.

Critically though, ENWL are not in favour of the proposal to fix a % annual allowed revenue surplus, invoiced to customers monthly, because working capital requirement doesn't accumulate like expenditure over the course of a year. If the figure is sufficient in the first days, DCC will continue to accumulate an increasing surplus of customers' cash over the year. This proposal does not incentivise efficient use of cash.

ENWL would support a proposal that involves a one-off amount of cash being made available for working capital, plus a flexible short-term borrowing for day-to-day shortfalls such as an overdraft. The amount required for the one-off sum should be modelled by DCC using daily cashflow forecast and assumptions based on their upcoming *ex ante* Business Plan. This provides transparency and should inform Ofgem's proposals. It should also consider appropriate sensitivities such as supplier failure to ensure that the proposed overall potential funding requirements are understood and can be put in place (whether drawn on or not).

For a business of DCC's size, better mechanisms than the proposed options to finance working capital would be through bank loans, government loans, industry participant loans or commercial debt. ENWL suggest Ofgem reach out to 3rd parties to assess their appetite ENWL believe that the relatively secure nature of the licensed allowed revenues for DCC could make it attractive proposition, especially if underwritten by HM Government. It might also be feasible for such an initial fund to be made available from HM Government sources.

Any such arrangement should be spread across a few institutions to insure against their failure presenting a risk to funding of industry operations. Repayment of the loans could be funded over say 10 years from a transparent premium on DCC's charging statement. There is precedent for recovery of funding from industry participant of investment in industry developments when competition was introduced into the domestic market in 1998.

ENWL believe that a fully accrued P&L is essential for all financial reporting and planning purposes including for price control and performance management, particularly for a business the size of DCC and with the high proportion of External Cost and with some very large contract payments.

The risk of cash accounting is that an 'underspend' can appear when it is simply a delayed invoice or an 'overspend' due to a prepayment being made. This can be particularly prevalent around contract changes. Cash basis should not be considered.

6	**What are your views on the proposed three types of Uncertainty Mechanisms?**

ENWL are pleased to see the distinction in Scenario B between temporary and permanent variances. This is a particularly important distinction to consider for Fungibility which should not be applied where the variance (under or overspend) is temporary. i.e. they should be justified to Ofgem so that the expected reversal is accounted or in future periods. If justified, Ofgem could consider that they are allowable for the Board members' Cost Incentive scheme.

To be confident that temporary and permanent distinctions are correctly identified, it's critically important that financial performance is based on fully accrued P&L. Otherwise an underspend can appear when it is simply a delayed invoice or an overspend due to a prepayment being made. This can be particularly prevalent around contract changes.

In 3.3 <u>Scenario A</u> should include <u>phasing differences</u> (in the same way as in 3.4 Temporary under Scenario B) because underspends, in the same way as overspends referred to in Scenario B, cannot be assumed to be permanent. Table 3.3 highlights items for which there could be a need for the Uncertainty Mechanism. i) *Force majeure* is cited under External Costs to Operate; this could equally apply to Internal Costs to Operate. ii) we assume DCC is self-insured so the costs of both Repair to Physical Assets and Recovery from Cyber Attack should be included under Corporate Overheads - Internal Costs. As should the Costs of Meeting and Making Legal Claims.	
7	**What are your views on the reopener process, criteria and risks? What are your views on the trade-off between allowing DCC a more flexible approach to receive additional Allowed Revenue?**
ENWL do not agree with the recovery of a modest surplus noted in 3.66. We do not consider it an appropriate mechanism to fund working capital as noted in our response to Q4. Noting that ⇨ contingency is expected to be allowed in the Business Plan, and ⇨ fungibility is allowed for both Internal Cost and for External Costs within Programmes, and ⇨ inflation is allowed for in the Business Plan ⇨ there is a proposed re-opener mechanism for Year 2 there should be no need for further surplus beyond the Business Plan to be billed to customers. ENWL do agree that a re-opener mechanism could be allowed and that could be allowed in Year 2 of the initial 2-year Business Plan. It might also be allowed in Q1 of Year 3 of subsequent 3-year Business Plan. However ENWL note that for the effective delivery by DCC and to provide certainty to DCC customers on costs, such re-opener mechanism should start and finish within a reasonably short period, say 3 months.	
Financial incentives	
8	**Do you agree with our proposal to require that all of DCC's Authorised Business should be carried out on a not-for-profit basis?**
ENWL notes that Ofgem's Phase 1 view was DCC's "Core Mandatory Business" should be carried out on a not-for-profit basis and the current proposals to extend this to include all DCC's Authorised Business. ENWL agree with the need to avoid selective management focus on for-profit activities that would inevitably occur in a partial not-for-profit model, as highlighted by Ofgem in 4.13. Management attention needs to be on the entire Authorised business.	
9	**What are your views on the proposal to allow DCC to apply for ring-fenced funding to enable potential development of commercial or innovative services?**
Regardless of whether such services would be not-for-profit or for-profit, this facility should be limited and it should not be allowed to cause any distraction from the core smart meters based purpose. This DCC should "stick to the knitting" and get that right as the exclusive priority, as repeatedly echoed by many stakeholders. It could be a different conversation in time when DCC achieves necessary improvements and the service is stable and reliable. ENWL suggest that Ofgem could specify date before which no such funding would be approved, unless it is projected to reach very high bar of benefit to cost/risk, limited to working with existing assets and low in scale. Prior to and beyond this date, any such initiative/service should be considered on its merits, and approved, by Ofgem and not be left to DCC to determine.	

There are considerable risks to core licensed services if management attention is diverted to more rewarding, high profile or exciting activities. ENWL suggest in any case, to protect DCC's Authorised Business from distraction, there should be a strict limit to the scale of such developments, they should be closely aligned to existing capability, and fully resourced within the ring-fence without drawing substantially on existing core internal or contracted resources.	
10	**Do you agree with our proposal to remove the ECGS mechanism from the Successor Licence? What are your views on considerations to introduce open ended or set stretch efficiency targets on DCC in respect of its External and Internal costs for a future cost control cycle? What other mechanisms or approaches could be effective to drive cost efficiencies?**
Removing the ECGS mechanism is consistent with running the business on a not-for-profit basis. Leaving it in place runs the risk of skewing management attention towards ECGS-eligible contracts and away from other services. We agree therefore with Ofgem's proposal to remove ECGS for the first Business Plan cycle, noting the option to re-introduce it for subsequent Business Plan cycles for either or both of Internal Costs (option B) and External Costs (option C2). It might be useful for the Customer Challenge Group to be involved and advise on such future amendments as part of a future Business Plan cycle. ENWL believe that in the not-for-profit model the main incentive mechanism is through individual performance targets and reputation. Publication of DCC performance might be a useful mechanism. Independent appraisal of the Board's performance is essential as are clear, objective measurable targets.	
11	**What are your views on the proposed measures to be considered as part of any targeted incentive model on senior managers and staff?**
ENWL agree with the 4 areas proposed for targeted incentive model, namely Customer satisfaction, Performance and delivery, Business Planning and Cost management. However we believe the Customer Satisfaction survey should be run every year, not as proposed every two years. The reason for this is that Customer Service (via its many vectors) can impact dramatically and very quickly through acts or omissions of DCC and should therefore be monitored closely. For the same reason the first survey should be carried out towards the end of the first year following Business Handover (not in the second year as proposed). The proposal means the new service provider could be delivering for two years before survey feedback is able to influence their performance. This would allow a baseline to be established for the second and third year performance targets.	
Customer engagement	
12	**Do you agree with our proposal to set up a customer challenge group under the SEC to have a role in the business planning process?**
ENWL strongly agree that the customer engagement group should have a role in the DCC Business Planning process and, if suitably constituted and empowered, would significantly improve DCC plans, performance and costs. However we believe that operating under the vires solely of SEC (Ofgem's preferred Option C) could limit its effectiveness, noting that its remit and scope of interest should be wider than SEC (including for example contract change and procurement, CRS, Quarterly Finance Forum, etc). We agree that the Independent Group (Option B) might provide insufficiently robust scrutiny.	

ENWL believe that the weakness of the current Customer Challenge Group (Option A) is not in the make-up of the group but in how its constituted, being at DCC's discretion how to engage, as Ofgem note in 5.11. The engagement forums cover the required ground but insufficient powers to compel DCC to account for stakeholder views. ENWL prefer a hybrid option to constitute the Customer Challenge Group (CCG) under the DCC licence, obliging DCC to engage and account for CCG views, and giving CCG the power to compel DCC to engage in such sub-committees from time to time constituted by the CCG. This ensures that the vires of the group covers the widest scope of interest in all DCC's Authorised Business, including CRS (which is governed under REC) without limiting it to the vires of one particular code. The negative feedback reported by Ofgem in 5.7 about the effectiveness of the Quarterly Finance Forum (QFF) could be addressed by extending its scope to include engagement on and reporting of project/programme estimation/forecasting to address the negative feedback. The inception of QFF was welcome and remains an essential channel for customers. ENWL can see that Option C provides Ofgem a route to mandate the CCG quicker than if it was constituted under the licence. If Ofgem select this option ENWL would support Ofgem's suggestion in 5.22 'Integrity of Reports' that reporting from CCG should be direct to Ofgem, rather than via SEC Panel. Members should be independent of SEC Panel and exclude SEC Panel members. ENWL would also note Option C constitutes the CCG under SEC and that the governance of SEC will change under Energy Code Reform. ENWL suggest that if Option C is selected initially that this is reviewed prior to award of the new licence to DCC2 and once the Code Administrator's licence terms are known. Periods of CCG membership should be staggered across years and price control periods to retain "corporate memory". The required skills, knowledge and experience should be specified for both core and non-core expert members. DCC should be obliged under Licence to consult, and reflect the views of, the CCG on strategic planning and horizon scanning, annually, as part of their Business Planning cycle.	
13	**What are your views on the Group's membership? Do you agree with our outlined core and non-core membership model?**
Yes. ENWL believe it's important to ensure a degree of continuity of membership from existing Panels, Quarterly Finance Forum and any other relevant groups, and this should be taken into account when selecting members for the group. ENWL don't agree with the reference in 5.26 to core members "(with prescribed minimal representation of DCC customers and consumers)". However the membership in Table 5.1 is reasonable, where DCC Customers and Consumers representatives account for 7 members.	
14	**What are your view on the presented considerations for the scope, focus and responsibilities of the Group?**
We agree with the list of areas of focus in 5.35, although note that they have a distinct orientation towards Business Planning and Cost Management. Whilst principle requirements the Group would be well placed to monitor more closely the other two areas relating to the senior management and staff incentive scheme, namely Performance and Service Delivery metrics and Customer Satisfaction. In addition contract changes and programme progress could fall into scope too.	

15	Do you agree with the proposed outputs of the Group?

ENWL agree that outputs of the Group should include

- ⇨ a report to Ofgem on the Business Plan, including observations on year-on-year movements and DCC's justifications.
- ⇨ Commentary on DCC's re-opener applications and their justifications for variances, whether fungibility appears to have been correctly applied and whether, in the cases where fungibility is not allowed, whether variances due to phasing or inter-Programme movements should not impact on staff incentive scheme.

In view of our comments above about additional areas in the scope of scrutiny, outputs should include

- ⇨ commentary on the process for obtaining customer satisfaction score and the scores themselves, including on DCC reasons for the scores; and whether previous plans have had the desired impact
- ⇨ commentary on Performance metrics such as availability, response times, etc.

Implementation of the first Business Plan

16	What are your views on our proposed implementation approach, the requirements on the first Business Plan and the interaction with the current Price Control process?

ENWL agree with Ofgem's conclusions about Option B and we believe it is not tenable as DCC1 will have no 'skin in the game' following Business Transfer Date. And Option C leaves a 2-year hiatus in Business Plan scrutiny, meaning that as Ofgem notes in 6.12, DCC1 would not be engaged in the first Business Plan cycle and therefore potentially delay any benefits that might otherwise have arisen.

We agree that Option A could provide cost certainty for customers from April 2026 through the period to March 2028. It is assumed that the Business Plan would also be available to DCC2 and provide useful insight, ideally before submission of their DCC2 tenders. We agree DCC2 Business Plan could not be produced meaningfully until after Business Transfer Date for confidentiality reasons.