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Dear Jakub

DCC REVIEW: PHASE 2 – PROCESS FOR DETERMINATION OF ALLOWED REVENUE

We welcome the opportunity to respond to your consultation on the process for the determination of Allowed Revenue for the DCC. Our answers to the consultation questions are set out in Annex 1.

In our response we have expressed support for the proposed change to an ex ante regime which is the position we have consistently advocated. We believe it is through this regime that stakeholders' historical concerns about the financial management of the DCC can be resolved.

We also welcome the proposed Customer Challenge Group and have provided observations on its proposed activities. We think there are pros and cons of the DCC carrying out its authorised business through a for-profit or not-for-profit model and we do not have a strong preference. Our main concern has always been a DCC that will work to the satisfaction of the industry and ultimately the consumer.

We look forward to the outcomes of the consultation and remain committed to supporting initiatives that seek to enhance the regulatory framework.

If you would like clarification on any of the matters raised in this response, please do not hesitate to get in touch.

Yours sincerely,



Richard Sweet
Director of Regulatory Policy

**DCC REVIEW: PHASE 2 – PROCESS FOR DETERMINATION OF
ALLOWED REVENUE – SCOTTISHPOWER RESPONSE**

Q1 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?

We welcome Ofgem's proposal to move towards a full ex ante cost control regime for all DCC's Allowed Revenue with either an annual true-up or uncertainty mechanisms to deal with residual uncertainty. This position reflects historical industry and stakeholder feedback that the DCC should be able to accurately budget its costs after eleven years of being in operation and carry out its functions within a pre-agreed cost envelope. This also represents a significant shift in the cost management approach for DCC moving towards a more predictable and structured regime, enhanced budget discipline and greater certainty and predictability for stakeholders. We also see the advantage in requesting the DCC to submit a Costed Business Plan as the majority of the DCC's activities are now associated with live operations and where new activities need to be carried out, we believe the DCC should be largely able to accurately forecast the costs associated with such programmes.

Q2 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

We support Ofgem's proposal for a multiannual cost cycle and the proposal to require the DCC to submit a costed Business Plan as part of its cost control submission to justify the DCC's forecasts and how it will deliver its mandatory business functions. We believe this will provide stakeholders and Ofgem a better oversight and gain greater visibility into cost drivers making it easier to identify inefficiencies and demand improvements on DCC's long term strategy. We also see value in requiring DCC to submit a costed Business Plan alongside a Business Planning Guidance provided by Ofgem setting out how DCC will deliver its Mandatory Business in the cost control period. This will ensure stakeholders receive a consolidated, comprehensive view of DCC's strategic and financial planning.

Q3 What are your views on the outlined general approach towards determining efficient forecast costs?

The outlined general approach to determining efficient forecast costs seems logical and builds on principles of transparency and evidence-based decision making. Requiring DCC to justify costs before they are incurred should ensure better planning and reduces the risk of unfounded costs being passed to stakeholders. However, potential concerns remain over DCC's historical forecasting issues and without stricter enforcement and clear penalties for inaccurate forecasts, these issues may continue. Also, the proposal does not introduce significant changes to how costs are assessed despite acknowledging inefficiencies in the current processes. We would also want to highlight that if Ofgem approves a not-for-profit DCC, after each price control period, stakeholders should be able to revisit/review DCC's activities and where Ofgem settles for a for-profit entity, profits earned should be redistributed amongst parties.

Q4 What are your views on flexibility within DCC's Allowed Revenue? At what level should DCC be afforded flexibility to manage overspend/underspend?

We recognise the importance of balancing operational flexibility with strong accountability mechanisms to safeguard stakeholder interest and ensure efficient cost management. Our approach to the proposals is highlighted below:

External costs

Our preference aligns with Option B for various reasons covering:

- **Accountability:** non-fungibility ensures traceability and visibility into cost overruns on individual contracts, reducing the risk of repeated overspends being obscured by unrelated underspends.
- **Stakeholder protection:** ensures stakeholders are not indirectly impacted by inefficient management of specific contracts. Each contract is held accountable within the budget.

While we support Option B, we recognise that limited flexibility at the Programme level (Option A) could be beneficial in specific cases particularly in a not-for-profit DCC provided that robust reporting mechanisms are in place to track reallocation of costs and DCC demonstrates that this flexibility will not dilute transparency or result in unforeseen customer impacts.

Internal Costs

We recognise the proposal to allow cross programme fungibility for resource related internal costs such as payroll, IT services and accommodation with a ringfence on non-resource costs like external services. Flexibility in resource related costs may enable the DCC to refocus its workforce dynamically to address changing priorities or emerging challenges. As highlighted in our response to the Price Control consultation, we remain concerned over the non-resource costs element of the DCC's internal costs mechanism.

We also strongly agree that any underspend should be returned to stakeholders promptly, reinforcing the principle that stakeholders should only pay for services received. To ensure trust and accountability, any reallocation of costs should be transparently reported with a clear audit trail.

Q5. 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

The proposal to allow DCC access working capital through a contingency set at 2% of its annual Allowed Revenue is a balanced approach given historical feedback from stakeholders regarding previously suggested thresholds. We also believe this level of contingency is more than sufficient for the DCC to finance its mandatory business. DCC's reported monthly cash balance analysis for RY23/24 suggests that the average and median cash flow mismatches are below 1% of Allowed Revenue.

However, while there is a requirement for DCC to justify its use of surplus funds when applying for a reopener, we would like to note that a standing surplus could lead to a "use it or lose it" mentality, where DCC consistently spends the full 2% rather than actively managing its budget and while we agree that there might be situations where DCC's allowed revenue does not

perfectly align to forecast costs, we would suggest a use of over-recovery set at a lower level of 1% of the annual allowed revenue with a reopener mechanism. We accept that a contingency fund is a prudent measure to ensure that DCC can continue to finance its Mandatory Business in the face of unexpected costs, however we believe a 1% contingency should be adequate to cover most unforeseen expenses and cash flow fluctuations in the short term. Additionally, we remain concerned about DCC's historical use of stakeholder funds. It is crucial to ensure that DCC's budget management practices align with consumer and stakeholder interests and any surplus funds are used efficiently and transparently.

On cash v accrual-based reporting, it is important to consider the pros and cons of each method. Cash based reporting provides a clear view of cash flow aiding short term liquidity management. However, it may not fully reflect DCC's financial commitments and liabilities. Accrual-based reporting offers a more comprehensive picture by recognising revenues and expenses when incurred, regardless of when cash is exchanged. We believe accruals-based reporting will offer better insights into the long-term financial health of DCC and will help in aligning financial reporting with the economic reality of transactions.

Q6. What are your views on the proposed three types of Uncertainty Mechanisms?

From our perspective, the best uncertainty mechanism would be one that ensures cost predictability and minimises unexpected charge increases, provides strict oversight to prevent unnecessary cost escalations and balances DCC's financial stability without excessive cash accumulation from stakeholders.

Our views on the proposed uncertainty mechanisms are highlighted below.

Automatic Adjustment Mechanism

This offers limited scope as it is only effective for costs with a clear volume-cost relationship, but may not cover more complex, uncertain cost fluctuations. There is also the potential for over recovery leading to excess charges. If DCC misjudges unit costs, there is no clear mechanism to correct it retrospectively.

End of Year reopener

This mechanism ensures DCC is held accountable for demonstrating efficiency before receiving additional funding and DCC cannot pre-emptively recover excessive costs from stakeholders as might happen under an automatic adjustment. Instead, it must justify and seek approval before passing on additional costs. Compared to an emergency reopener which allows immediate costs adjustments with little lead time, and end of year reopener gives Ofgem and stakeholders time to properly assess DCC's claims.

Emergency reopener

Our concerns with this stem from the moral hazard where the DCC may overly rely on emergency reopeners instead of proactively managing cost risks. We are also not entirely sure of what would constitute an emergency as on the consultation is states "*Impact of external factors on DCC's operations/supply chains – force majeure*". If Ofgem follows this route, will this be the only factor to be considered?

Q7. 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?

While a reopener mechanism might be necessary for managing cost uncertainty, it is critical to ensure sufficient controls over the process to prevent an over-reliance on the reopener process as DCC should instead be encouraged to be more proactive in its financial management. As highlighted in our response to Q6, there needs to be an established post-approval accountability system to verify efficient use of additional funding.

Q8. Do you agree with our proposal to require that all of DCC's Authorised should be carried out on a not-for-profit basis?

Our priority remains a fully functional DCC that effectively serves all stakeholders. The primary focus is on ensuring its successful operation, independent of whether it functions as a for-profit or non-profit entity. What matters most is that the DCC fulfils its purpose while leaving behind the challenges of the last eleven years.

Q9. What are your views on the proposal to allow DCC to apply for ringfenced funding to enable potential development of commercial or innovative services?

We would like to highlight a risk that if DCC diverts into new service areas, even within a not-for-profit model, there is a risk of diluting focus from mandatory business. Any exploratory projects should have strict criteria for approval and evaluation. If, however, this goes ahead, strong governance, clear criteria for project selection and measurable benefits/impacts to stakeholders must be in place.

Q10. 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?

If the future DCC will be required to present economic and efficient costs in its Business Plan, then the ECGS may be redundant. Ofgem and the proposed Customer Challenge Group should in theory ensure that cost savings are maximised without an additional incentive which could. Given that historically, ECGS has only delivered savings in few areas, it suggests it has not been a key driver of efficiency. We also welcome Ofgem's intention to consider introducing either open ended or set targets for future cost control cycles for internal costs. Internal costs are exclusively within DCC's control, and we believe set targets would provide needed clarity to DCC on expected outcomes, encourage costs discipline which has always been an area of concern and would create an objective benchmark for evaluating DCC's efficiency improvements.

Q11. What are your views on the proposed measures to be considered as part of any targeted incentive model on senior managers and staff?

We recognise the importance of ensuring that financial incentives drive efficiency, cost control and high-quality service delivery. Given that the consumer ultimately bears the financial burden of DCC's operations, we strongly support cost management as a core component of the incentive framework. We also welcome the proposal for a fully independent Remuneration Committee comprising sufficiently Independent Directors. However, we seek clarity on how success will be measured and what consequences will be in place for failure to meet cost targets. There should be explicit financial penalties for persistent cost overruns, similar to how performance-based incentives are structured.

Q12. 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?

We welcome the new proposed Customer Challenge Group under the SEC to play a formal role in the business planning process. We also recognise the importance of ensuring robust oversight and transparency in DCC's planning process. Given historical limitations in engagement, we are hopeful that the Challenge Group's proposed ability to scrutinise all cost components outside of SEC modification process would provide much needed visibility and help mitigate the risks of cost overruns. Also, a Challenge Group with formal reporting responsibilities to Ofgem could ensure that stakeholders feedback is considered in regulatory assessments and business plans aligns with industry priorities

Q13. What are your views on the Group's membership? Do you agree with our outlined core and non-core membership model?

We acknowledge the ambition behind the proposed membership structure. However, the absence of clear appointment processes could lead to inconsistencies or potential conflicts of interests. Implementing a structured nomination and selection criteria might help ensure fairness and transparency.

Q14. What is your view on the presented considerations for the scope, focus and responsibilities of the Group?

The Group's proposed role could be valuable in addressing historical industry concerns and ensuring that DCC's business plans aligns with stakeholder interests. The focus on procurement, cost assumptions and risk management could ensure that financial and strategic decisions undergo rigorous review. We also agree that any disagreement between the Group and DCC should be escalated to Ofgem for resolution.

Q15. Do you agree with the proposed outputs of the Group?

We concur with the proposed outputs of the Group and believe that its final reports should be submitted to Ofgem. However, we believe the Group should have the authority to review DCC's applications for reopeners within the cost control period and when the Group makes recommendations to Ofgem, we expect Ofgem to give them significant consideration in its assessment of reopener applications.

Q16. 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?

Our primary concerns are ensuring cost transparency, minimising transitional risks and maintaining accountability. We also welcome the proposed move to a three-year cost cycle from April 2028 for DCC2. Option A requiring DCC1 to prepare the first Business Plan to cover April 2026-March 2028 seems logical, however successful implementation would hinge on ensuring high quality forecasting and accountability and managing the business transfer and price control processes.

ScottishPower
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