



# Ofgem's Consultation on the Draft Business Plan Guidance

## Smart DCC Response

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# 1. Executive Summary

DCC is pleased to have the opportunity to review Ofgem's consultation on the draft Business Plan Guidance for DCC.

Much of the document is very clear and detailed. There are, however, two inter-related concerns that impact understanding of the document:

Clarity on Licensee Affected. The first is that the document reads as impacting the Licensee's Allowed Revenue. However, in the first ex ante cycle, the current Licensee is preparing a business plan on behalf of the Successor Licensee. The draft Business Plan Guidance does not recognise the distinction between the current Licensee as developer of the business plan and the Successor Licensee as the implementer of the business plan. Several of our comments reflect this concern, which is important because for the first price control it is not the submitting Licensee who will bear the consequences of the quality of the business plan or the allowances funded to deliver it.

Clarity on 1<sup>st</sup> Ex Ante Cycle. Secondly, there are elements of the document which are relevant to the second ex ante business plan cycle but not the first, but this is not always clearly labelled. At this point in time, clarity for the first ex ante business planning cycle must be the priority and it would be helpful for this to be delivered in the final Business Plan Guidance. We have referenced several areas in which the text refers to arrangements which we do not think will apply for the first cycle, but which are not labelled as such.

DCC1 Deferred Expenditure. A further concern is the absence of guidance on how Ofgem proposes to handle deferred expenditure by DCC1 which DCC2 subsequently has to incur. At the point the first ex ante business plan is submitted, it will not be possible to include forecasts for such deferred expenditure so there will need to be a suitable mechanism to accommodate such requirements. One option would be for DCC1 to flag in its response to the Draft Determination where such an alteration to DCC2's allowance may be required, although there may be a risk of subsequent deferrals of expenditure by DCC1 after the response is submitted. If further adjustments were to be required, Ofgem should allow DCC2 to use the emergency re-opener to request any further adjustments to reflect expenditure deferred by DCC1. It would be helpful if the final Business Plan Guidance could set out how an adjustment to DCC2's allowance should be addressed in the case of deferred expenditure by DCC1.

In terms of specific content in the guidance, we have a handful of key concerns of which use of the contingency funding facility is perhaps the most important.

Use of Contingency Funding. There are several references in the draft guidance which suggest that DCC must first demonstrate that it has utilised (or is unable to utilise) contingency funding to address new costs (eg. in relation to new code modifications or other legitimate calls on a re-opener). The grounds for use of contingency funding in Ofgem's consultation and subsequent decision were limited to mitigating the cash position and handling minor cost overruns<sup>1</sup>. However, the inference in the guidance is that wherever there is a requirement for new funding, DCC should first look to utilise contingency funding. Where the requirement is to fund new scope, this is not consistent with Ofgem's decision and it risks undermining DCC's liquidity and ability to handle genuine cost overruns. It also risks making it difficult for DCC to demonstrate that it can deliver a defined set of outputs within a defined cost envelope. If

<sup>1</sup> [DCC Review: Phase 2 – Process for determination of Allowed Revenue \(conclusions\)](#), paragraph 3.36, page 33

Ofgem expects DCC to seek recourse to contingency funding as the default, DCC will face the reputational risk of being an organisation that cannot operate within its means.

Seeking an Undertaking. Ofgem also indicates there may be situations in which it determines costs which are insufficient to meet legal and regulatory requirements, with DCC then required to submit an undertaking (presumably in its draft determination response) seeking additional funding on the grounds it cannot meet the cost commitments from the contingency fund, fungibility allowances or efficiency savings. Aside from the implications of not being funded to meet compliance obligations, DCC has concerns about Ofgem's view that DCC should first demonstrate these funding channels are not available and would welcome further discussions to clarify the implications. We provide more detail on our concerns in our detailed comments on paragraph 5.39(a).

Unquantifiable Uneconomic Costs. Ofgem references situations in paragraph 5.40 in which it might not be able to quantify its view of uneconomic costs, yet still might require an undertaking from DCC in respect of the impacted costs. As an organisation focused on continuous improvement, DCC will always be open to addressing perceived process deficiencies. However, we are concerned about the prospect of cost disallowances where Ofgem has not been able to demonstrate a strong and clear logic for how uneconomic costs are determined. We would welcome further discussion on how Ofgem envisages this working in practice.

Draft Determination Consultation. We would also emphasise the importance of retaining eight week consultations on Draft Determinations, which is especially important as new regulatory processes are being embedded and considering the need for Board-level engagement prior to issuing our response.

Sharing Information with the CCG. Finally, we believe there may be an opportunity to provide more information to the Customer Challenge Group (CCG) than envisaged in the guidance. Subject to addressing commercial sensitivities, DCC's preference would be to provide the CCG with as much of the business plan suite of documents as possible to deliver a clear picture of proposed expenditure and to facilitate the process of engagement between DCC and the CCG. We set further detail in our comments on chapter 4.

## 2. Detailed Comments on the Draft Guidance

### Chapter 1 - Introduction

Paragraph 1.6 Ofgem refers to the licence giving it ‘power to issue, and from time to time revise, guidance about the procedure we will follow and the matters we will take into account when considering whether, and to what extent, to exercise our power in relation to giving a direction that costs that we consider are not economic and efficient and are to be excluded from any calculation of the Licensee’s Allowed Revenue’.

In this instance, the Allowed Revenue being determined is not for the current Licensee but for the Successor Licensee, and the paragraph should be amended to make it clear that it is the Successor Licensee’s Allowed Revenue that will be affected.

Recognising the critical point that the current Licensee is being asked to prepare a business plan for the Successor Licensee, it is also important that the appeal rights of the Successor Licensee in relation to Ofgem’s determination of efficient allowances are clarified quickly. There must be a viable route to appeal Ofgem’s conclusions on the 1<sup>st</sup> ex ante business plan that can be exercised by the Successor Licensee.

### Chapter 2 - The Business Plan Process

Paragraph 2.10 This paragraph refers to guidance in section 4, but that guidance only appears to relate to the final business plan. It would be helpful for Ofgem to be explicit about which parts of the draft business plan (of the elements shown in figure 4.1 on page 26) it expects DCC to publish.

Paragraph 2.14 As per paragraph 2.10 it would be helpful for Ofgem to be clear on which parts of the draft business plan it expects DCC to share with Ofgem.

Paragraph 2.21 Under the current licence, consultations on the proposed determination of Allowed Revenue have involved a response period of eight weeks and DCC would expect Ofgem to continue with this practice, not least because DCC’s proposed response typically involves engagement with the Board.

Paragraph 2.22 As per paragraph 1.6, Ofgem’s determination will not be of the ‘Licensee’s Allowed Revenue’. The determination will be of the Successor Licensee’s Allowed Revenue.

Paragraph 2.24 It will not be for the current Licensee to ‘ensure that it delivers to the approved Plan...’. It will be for the Successor Licensee to perform these requirements and the text should be amended accordingly.

Paragraph 2.24 It would be helpful for Ofgem to set out the required format and specific requirements envisaged for the six monthly reporting and end of year reporting requirements. Paragraph 3.51 of Ofgem consultation decision<sup>2</sup> provides very limited guidance on requirements for six monthly reporting and no further details are provided in the draft Business Plan Guidance. Examples of what should be included in end of year reporting are provided in paragraphs 5.49 and 5.50 of the draft Business Plan Guidance but it is not clear if there are wider requirements and there is no detail on the required format for either document.

<sup>2</sup> [DCC Review: Phase 2 – Process for determination of Allowed Revenue \(conclusions\)](#) pp35-36

## Chapter 3 - Mandatory Contents of the Business Plan

Paragraph 3.1b As per similar references to the Licensee, this paragraph should be amended to make clear the costed Business Plan is for the purposes of setting the Successor Licensee's Allowed Revenue.

Paragraph 3.3 As currently drafted, this paragraph suggests it is for DCC and the CCG to agree what level of cost information should be provided by the former to the latter. DCC suggests that it would be sensible for greater clarity to exist upfront and DCC proposes that it should share the whole of the business plan (development plan, costed business plan and appendices) with a view to delivering greater transparency and reducing the need for subsequent requests for information. We make similar comments on relation to paragraph 4.2.

Paragraph 3.5 Ofgem refers to 'the Successor Licensee's Required Revenue'. This term is not explained in the Glossary but is referred to in the proposed licence condition 34 in the statutory licence consultation<sup>3</sup>. Does the 'Required Revenue' term have a different meaning to the definition of 'Allowed Revenue' set out in the Glossary?

Paragraph 3.18 Ofgem refers to services provided by a Related Undertaking. At this stage is not clear who will become the Successor Licensee, so we will not know if there will be services provided by a Related Undertaking.

Paragraph 3.25 Ofgem refers to the Licensee applying for an adjustment as part of its annual re-opener application for other inflationary impacts. Given that the annual re-opener will not be available in the first ex ante cycle, it would be helpful for Ofgem to set out how changes for other inflationary impacts will be managed.

Paragraph 3.29 (g) It is not clear what the purpose is of this requirement. Ex ante price controls are designed to set an allowance for a defined scope of activities, with uncertainty mechanisms used to adjust allowances. Given there is no recourse to an annual re-opener in the first ex ante cycle, it is not clear why Ofgem requires further procurement information after the final business plan is submitted. It would be helpful for Ofgem to set out what types of information it expects to see, why and when the information is required.

Paragraph 3.31(b) With regard to ringfenced funding, it would be helpful for Ofgem to define what it classes as supporting the delivery of a public policy objective.

Paragraph 3.31 (d) It is not clear why the scope of a request for ringfenced funding should be immaterial, and nor is it clear how 'immaterial' is quantified. While DCC would not expect to spend large sums on any such requests, the key consideration ought to be the benefit derived for the associated cost.

Paragraph 3.31 (e) It is not clear why DCC must be capable of providing the activities '*without procurement of Relevant Service Capability*'. If the ringfenced funding proposal meets criteria 3.31 a, b and c, and is supported by stakeholders, it would make sense for cost-benefit analysis to determine whether it would be appropriate to procure additional capability.

<sup>3</sup> [Modifications to the Smart Meter Communication Licence for transition to ex-ante cost control and other changes required for Licence closure | Ofgem](#)

Paragraph 3.32 (b) Ofgem refers to feedback from stakeholders on ringfenced funding proposals. Does there need to be unanimous support for a funding proposal or can DCC submit its case in the event that some stakeholders do not support funding a project?

Paragraph 3.33 The guidance states that *'Any unused funds must be returned to the funding parties.'* DCC would wish to retain scope to move unused funds between regulatory years, if delivery of the project has been delayed for any reason. It would be helpful therefore for the guidance to be amended to state that *'at the end of the price control period any unused funds must be returned to the funding parties.'*

Paragraph 3.41 DCC interprets the guidance as meaning DCC must submit all business cases, both past and current, which justify proposed expenditure in the price control period. This will mean DCC providing a large volume of documents. It would be helpful for Ofgem to clarify how it wishes to receive these documents eg) by email, upload to a sharepoint site.

## **Chapter 4 - Presentation and Structure of the Business Plan**

Paragraph 4.2 and Figure 4.1 As set out in our response to the CCG Terms of Reference and in our response on paragraph 3.3, DCC believes there is an opportunity for it to potentially provide more information to the CCG than envisaged in Ofgem's draft Business Plan Guidance. Ofgem has indicated in Figure 4.1 in the draft Business Plan Guidance that DCC should only submit the Development Plan and Costed Business Plan, and that the CCG may seek additional evidence. DCC believes it will aid the understanding of the business plan if DCC also provides proposed appendices. This may also support the efficiency of the process by reducing the number of clarification questions that the CCG needs to raise.

## **Chapter 5 - Cost Assessment**

Paragraph 5.22 In relation to code modification costs, DCC is concerned by the suggestion that it *'should in the first instance attempt to accommodate the additional costs using budgetary flexibility and contingency.'*

Budget flexibility is designed to address under and overspends on activities which have been pre-approved in Ofgem's final determination, rather than to accommodate new areas of expenditure. As Ofgem sets out in paragraph 3.31 of its decision on fungibility arrangements in its consultation response on Determination of Allowed Revenue<sup>4</sup>, *'DCC's costed Business Plan is a commitment to undertake a set of activities and/or deliver a set of outcomes for a fixed price'*. New code modification costs would not constitute part of that set of activities and should therefore not be within scope of the fungibility arrangements.

As set out in paragraph 3.36 of Ofgem's consultation response on Determination of Allowed Revenue<sup>5</sup>, contingency arrangements have been put in place to support liquidity and to account for minor cost overruns on activities that have already been approved. Funding of new requirements under code modifications would represent new scope that has not been previously approved and therefore DCC would not expect to draw on contingency funding (i.e. it would not represent a minor cost overrun).

Given the absence of an end of year re-opener in the 1<sup>st</sup> ex ante price control period, DCC would expect to seek funding through an emergency re-opener or otherwise seek funding in the second ex ante business plan cycle for code modifications. In our consultation response,

<sup>4</sup> [DCC Review: Phase 2 – Process for determination of Allowed Revenue \(conclusions\)](#) pp31-32

<sup>5</sup> Ibid, p33.

where we referenced the use of contingency funding on advanced work it was in the expectation that an annual re-opener would fund the whole cost of the modification – in effect replenishing the contingency fund where advanced expenditure had taken place. This will not be possible in the first ex ante cycle owing to the absence of the end of year re-opener, so use of the contingency fund for new scope would present a risk to the liquidity of DCC.

Paragraph 5.23 (c) This paragraph refers to using the end of year re-opener process to adjust the forecast for Year 2 of the price control. However, there will not be an end of year re-opener in the first ex ante business plan cycle, so there will be no ability for DCC to revise costs for RY27/28. This is an example of text which applies to later planning cycles but not the first cycle.

Paragraph 5.27 Given that there will be no end of year re-opener, DCC would need to defer Licensee-led costs of change until the second ex ante business plan, unless it deemed the requirement to be of sufficient urgency to warrant an emergency re-opener.

Paragraph 5.39(a) In the event that Ofgem's Draft Determination proposes to award allowances which are insufficient to meet legal or regulatory cost commitments, DCC would be faced with the prospect of operating in a non-compliant manner and the possibility of enforcement action. In seeking an undertaking from Ofgem to cover the delta between proposed funding and the costs required to meet legal and regulatory requirements, Ofgem indicates that DCC would need to demonstrate why any delta cannot be met from '*contingency funding, fungibility allowances or efficiency savings.*'

DCC believes this is misleading. There will be no fungibility allowances. Fungibility is a mechanism to allow overspend to be offset by underspend and the opportunity for such offsets will only reveal themselves in the course of the price control period. Likewise, DCC will set out proposed efficiencies in its business plan so efficiency savings will already have been taken into account when Ofgem sets out its determinations. That leaves only the contingency fund as a possible route for funding. In effect, the contingency fund would be used to address cost overruns that are inbuilt from the outset, and using it in this way would carry implications for how DCC manages liquidity risk.

Ultimately, Ofgem would need to fund the shortfall through an undertaking or DCC would need to overspend using the contingency fund. The result would be the same for customers with the impact in both instances being higher charges. However, the risk with using the contingency fund is that it would constrain DCC's options to address the two specific challenges the fund was identified to address: liquidity risk and in-period minor cost overruns.

Paragraph 5.40-5.41. DCC is unclear what objective Ofgem is seeking to achieve in these paragraphs. Ofgem seems to suggest that because of a shortfall in process DCC might incur costs that it should not but for which it lacks a clear methodology for calculating the cost impact. There is a clear danger that if Ofgem cannot clearly determine the proportion of costs which it deems are not economic or efficient any related disallowance would be poorly grounded.

If Ofgem has not found it possible to '*quantify a portion of uneconomic costs*' it is also not clear what a '*remediation plan*' or '*undertaking in respect of impacted costs*' would be required to cover. DCC accepts there may be instances where it ought to review its processes to ensure they operate effectively, but it is concerned about the potential to have to provide an undertaking to resolve a cost efficiency issue which Ofgem itself has been unable to quantify.



Paragraph 5.44 and paragraph 5.46 In the first ex ante business plan cycle there is no access to an end-of-year re-opener.

Paragraph 5.48 This paragraph presumably only applies for the second ex ante business plan cycle onwards as there is no Business Plan delivery measure in place for the first ex ante cycle.

Paragraph 5.49 The requirement to submit end of year reporting before the end of March would mean reporting before the relevant reporting year has even finished. In DCC's current ex post price control regime and in other regulatory price controls, end of year reporting is required by 31 July following the end of a Regulatory Year and DCC requests that this practice is continued.

Paragraph 5.54 DCC assumes Ofgem's requirement in this paragraph is to be handled through the remuneration policy. If Ofgem is expecting specific evidence to be provided in the business plan this should be made clear.

Paragraph 5.55 The actions set out in this paragraph refer to reporting of actual contingency expenditure, which cannot be covered in the first ex ante business plan. For subsequent business plan cycles, it would be helpful for this paragraph to be clear in which reporting output Ofgem expects to see this information set out.

Paragraph 5.56 and 5.56(h) This paragraph refers to determining '*whether costs were economically and efficiently incurred*' and '*assurances that goods paid for have been received*.' Given that Ofgem will be reviewing forecast expenditure that has not yet been incurred, these sections of text should be amended to reflect the ex ante nature of Ofgem's review.

Paragraph 5.81 It would be helpful for Ofgem to clarify whether this paragraph on targeted incentives performance applies only from the second ex ante business plan cycle onwards. There is no guidance yet on the four new incentive measures announced in Ofgem's consultation response on the Determination of Allowed Revenue<sup>6</sup>.

## **Chapter 6 - Uncertainty Mechanism Guidance**

Paragraph 6.9 The guidance should note that this paragraph on end of year re-opener applications does not apply in the first ex ante business plan cycle. It is also not clear that the examples in paragraph 6.9 (f) should apply for an end of year re-opener as force majeure is the primary rationale for an emergency re-opener in Ofgem's consultation response on the Determination of Allowed Revenue<sup>7</sup>.

Paragraph 6.24 (c) The inference of this paragraph is that if contingent funding were sufficient DCC ought to be able to use these funds rather than seeking funding through a re-opener application. DCC is concerned about the potential implications of such an inference. Firstly, DCC does not want to be an overspending organisation with the reputational implications that brings so we will want to use the contingency funding sparingly. Secondly, where expenditure relates to new scope that was not agreed in the original business plan, DCC will want to ensure that suitable authorisation is provided for the scope and related expenditure. DCC does not believe it is in customers interests for it to be able to change the scope of activities and impose charges on customers without first securing agreement that those costs should be incurred.

<sup>6</sup> DCC Review: Phase 2 – Process for determination of Allowed Revenue (conclusions) paragraph 4.48, page 59

<sup>7</sup> DCC Review: Phase 2 – Process for determination of Allowed Revenue (conclusions) paragraph 3.54, page 37



Paragraph 6.29 In relation to contingency funding, this paragraph indicates '*the Licensee will be required to justify how it has managed the surplus*' when applying for a re-opener. As indicated above, DCC is concerned by the suggestion its first course of action ought to be to spend the allowed contingency before seeking a re-opener. DCC must always ensure that it maintains liquidity so it cannot aim to consume the contingent surplus first.

Paragraph 6.30 Provision of a template for re-opener applications would help facilitate high-quality submissions.

Paragraph 6.41 Ofgem refers to the need for DCC to initiate discussions with the CCG in October on any planned re-opener application but does not set out when we need to share the re-opener application with the CCG (and nor do the CCG TORs) or how the ensuing engagement process will work. DCC believes there may be value in defining a clear timetable for re-opener applications upfront so all parties have clarity on how the process will work.

DCC proposes a schedule along the lines of the timetable set out below may be helpful, which would enable Ofgem to publish its re-opener consultation by end of Jan/early Feb.

**Table 1 Proposed Timetable for End of Year Re-opener Applications**

Deadline	Action
Q2 CCG Review in October	DCC signals intention to raise re-opener applications to CCG, and notifies Ofgem in parallel.
Penultimate Friday of November	DCC shares its re-opener application with the CCG for review and feedback.
1st Friday of December	DCC attends a review session with the CCG (if required) and CCG issues its clarification questions.
3rd Friday of December	DCC replies to all clarification questions.
31 December	DCC submits its re-opener application.
2 <sup>nd</sup> Friday of January	CCG submits its report on the re-opener application