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Dear Tricia,

British Gas response to Ofgem's DCC Price Control Consultation

Thank you for the opportunity to respond to this consultation on additional SEC content.

As the DCC's biggest customer we will pay the largest proportion of the DCC's costs in 2015/16. We are pleased, therefore, that Ofgem has completed its first review of DCC's price control and is challenging DCC on costs, where it is felt that they should be disallowed under the terms of their licence. We are broadly supportive of the proposals set out in this consultation but have highlighted some concerns below which we would be happy to discuss with you further.

1) **There needs to be greater transparency around DCC costs and change management processes**

   Ofgem should not assume that change costs have either been 'approved' by industry or have been managed efficiently or delivered in the most economic way. There is an over-riding concern here that the Licence Application Business Plan (LABP) may well have been an underestimate of true delivery costs and that Users will suffer from this by inflated change costs that are out of their control.

The DCC and, to a greater extent their service providers, have bid competitively for their respective contracts. Each service provider will have understood the risks and included some premium in their bid, understood the risks and chosen not to include any risk premium or may not have understood the risks at all. Our concern is that we will end up either paying twice for change as it was already factored into the risk premium for each service provider or we will effectively be rewarding those service providers for not adequately assessing the risks to begin with.

A number of cost increases have been the result of delays to the programme and DCC delivery. The DCC has continuously attributed these to DECC and the production of the GB Companion Specification (GBCS). We do not believe this to be accurate as, for example, there were significant delays to the production of design documentation, such as the User Gateway Interface Specification and the Self-Service Interface Specification. The production of these documents was not wholly reliant on the production of GBCS.

If the process for all DCC change was fully transparent, and had the involvement of DCC Users, this would help the DCC to be able to demonstrate clearly to Ofgem that any change in cost to their LABP has been incurred economically and efficiently.

2) Greater scrutiny and transparency is required on the procurement of services from the DCC's parent company and affiliates

We are concerned about the use of Capita Group services without a clear strategy or procurement process (i.e. for their service help desk). Although the use of a shared service provision from their parent company or an affiliate may be the most economical option, we do not believe this has been clearly demonstrated by the DCC. The DCC has spoken about not wanting performance targets for third party contracts. However, where no competitive tender process has been utilised, the DCC should be held accountable for their performance.

3) We have not had sufficient justification for the DCC's external cost increase of £35m

The consultation document does not provide sufficient evidence or confidence that Ofgem has scrutinised the £35m increase in DCC's external costs. The increase may only be 2% and be seen as acceptable or expected, but we would welcome further information about the makeup of the increase and some assurance that it was both unavoidable and that it could not have been lower.

Going forward, it is imperative that the DCC can demonstrate that it is 'cost-conscious' in everything that it does, providing the expected standard of service and clearly demonstrating value for money.

Our detailed responses to Ofgem's questions are attached in the Appendix. Please do not hesitate to contact me or Simon Trivella (simon.trivella@britishgas.co.uk) if you require any further detail on our response.

Yours sincerely

(*by email*)

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Question 1. **What are your views on our approach to assessing DCC's costs? And do you have any suggestions on where we can improve our approach?**

1.1 We agree with and understand Ofgem's rationale for treating the DCC's costs from their Licence Application Business Plan (which was competitively tendered) as a baseline. However, there needs to be greater transparency of all change and project request costs to allow users the opportunity to challenge and understand the impact of such requests. Currently change requests are being approved and progressed without any cost assessment being visible, when cost should be a fundamental aspect of the impact assessment.

1.2 DCC's own internal change requests can be initiated at industry level; for example, from a change in requirements that will have been dealt with through DECC's transitional governance at the Technical and Business Design Group (TBDG). Other DCC internal changes may be required for their own purposes; for example, to align their service provider contracts with their own deliverables under the licence or the Smart Energy Code (SEC). DCC Users do not get any visibility of the cost impact of either type of change request. This is something we have raised within the programme. Ofgem should not assume, therefore, that change costs have either been 'approved' by industry or have been incurred efficiently or in the most economic way. There is an over-riding concern here that the LABP may well have been an underestimate of true delivery costs and that it is the users who will suffer from this, by inflated change costs that are out of their control.

1.3 We believe it would benefit the DCC to be able to clearly demonstrate to Ofgem, and users, that any change in cost to their LABP has been minimised. The process for all DCC change should be fully transparent and have the involvement of DCC Users.

1.4 It appears that Ofgem has conducted considerable analysis on the salaries of the DCC staff. We agree that the DCC should not increase the scale and scope of their operation beyond what is necessary and efficient. Going forward, we believe that Ofgem could use comparators from organisations within the energy industry, such as Xoserve (with project Nexus), Gemserv and Elexon for comparators particularly by skill set and relevant grade. We also feel that National Grid Electricity Transmission (NGET) System Operator (SO) would be a useful comparator for Ofgem to use for both cost and incentive purposes.

Question 2. What are your views on our assessment of DCC's performance against the IMs?

2.1. We agree with Ofgem's assessment of the DCC's first 6 milestones. However, we are concerned about Implementation Milestone 12 (IM12) and the potential ability to ensure the DCC gains all milestone payments, regardless of prior performance. Our primary concern is the date to which IM12 is moved, following the second re-plan consultation. If the outcome of the re-plan is to include all the contingency periods then the milestone becomes far too comfortable and significantly erodes any incentive for the DCC to deliver without using such contingency. For the DCC to have initiated two industry re-planning events, to have utilised the maximum amount of re-plan contingency, and then to receive any missed milestone payments by successfully completing IM12 would be totally unacceptable, inappropriate and would not be best value for customers.

2.2. We also feel that the wording of the Implementation Milestones within Schedule 3 of the DCC's licence are ambiguous and therefore open to various interpretations. We request that Ofgem, in conjunction with the DCC and Users, tightens the definitions to give absolute clarity on the expected deliverables and the success criteria that will be used.

2.3. The formula within paragraph 38.5 of Licence Condition 38 of the DCC's licence contains the term $IM8_{t-1}$ twice. We believe that this is incorrect and should be removed from the licence drafting.

Question 3. Do you have any observations from the current incentive framework which can inform early thinking on developing an enduring framework?

3.1. We feel the current incentive framework, which is very task-orientated, gives the right criteria for reaching the milestone for live operations. The current regime means that the DCC is being rewarded for performing to their contract and delivering on time. They do not face any penalties for poor performance. Whilst we appreciate that the existing regime does provide the DCC with a delivery incentive we believe that the future arrangements should adopt a more balanced risk and reward approach. For example, delivery incentives could be retained along with the introduction of penalties for any sub-standard service performance.

3.2. We are keen that the enduring framework concentrates on the performance of the DCC's design and their service management areas, particularly as the Service Management helpdesk does not appear to have been competitively procured. We are keen that targets include value for money, customer satisfaction and transparency of charges, to avoid any monopolistic behaviour arising in the DCC.

3.3. We also expect the performance framework to include specific milestones for known DCC and industry deliverables, for example, the Enrolment & Adoption of SMETSv1 meters, the introduction of dual band Communications Hub and the centralisation of registration systems.

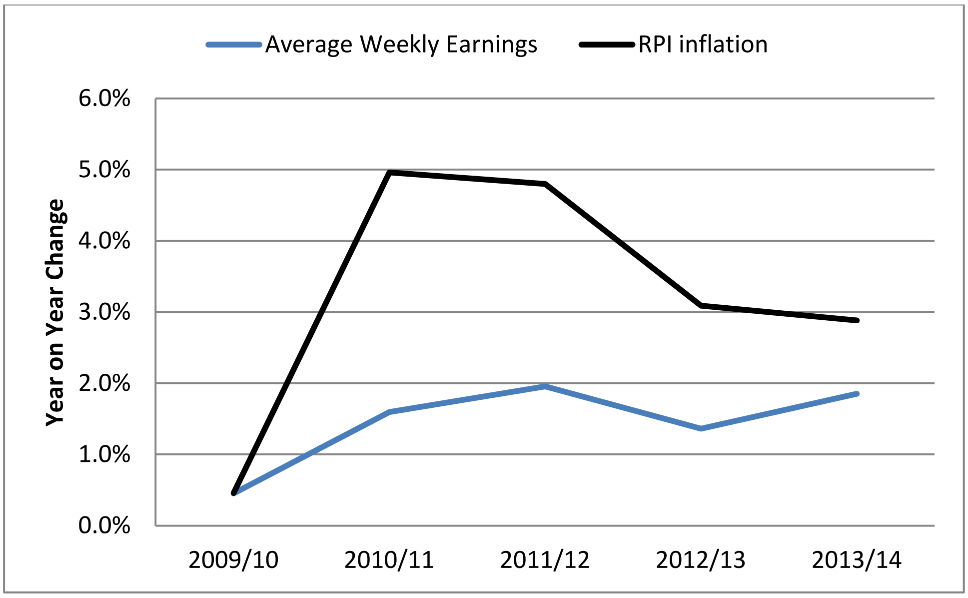
Question 4. What are your views on our proposal?

4.1 We agree that the use of contractors on a long term basis is not economic or efficient. Although a contractor strategy may well be a practical way of quickly gaining specialist knowledge and flexibility; this arrangement should transition to the use of permanent employees. As with the procurement of shared services, there is a risk that contractors may be sourced directly from the DCC's parent company or affiliates without any external benchmarking. This could lead to contractors not being economically sourced.

4.2 We would have expected the location costs associated with being in a prime central London office to have been reviewed by Ofgem. A central London location not only adds to office costs but also staff salaries, the need to compete with salaries paid to other employees in the area (e.g. banking staff), and additional overheads such as help with staff loans for annual travel cards. Whilst we appreciate the need for some DCC personnel to spend time in London this should not automatically mean that the entire company need to be centrally located.

4.3 We are concerned that a full RPI figure has been added to the base year to inflate the indices used within the ONS ASHE data. It has been widely reported that wages have not increased with inflation for the last few years and in using RPI Ofgem is over inflating the benchmark to compare DCC salaries to.

4.4 In the recent RIIO ED1 price control determinations Ofgem recognised this fact when reviewing the Real Price Effect requests from the networks. We are, therefore, disappointed that Ofgem has taken such an unrealistic approach for their review of the DCC salary costs. The chart below shows the difference between RPI and average earnings[1] in recent years and clearly demonstrates that using RPI to uplift the benchmark with which to analyse DCC salary costs will over inflate the benchmark.



Question 5. **Do you have any views on how the methodologies used for networks could be applied to DCC in future?**

5.1. We remain unconvinced that the RIIO framework is appropriate for the DCC or other regulated monopolies, primarily from the asymmetric information that Ofgem / customers have available compared to the networks. The RIIO theory will also be less useful to Ofgem when regulating the DCC as there are no equivalent comparators to easily benchmark the DCC against, unlike the DNO and GDN regimes.

5.2. We still feel that the targets given to the monopolies under the RIIO framework are too easy and do not rebase themselves quickly enough to offer customers real value for money.

5.3. We note from the minutes of the September GEMA meeting that all transmission companies have been able to spend less than allowances in the first year of RIIO T1 whilst reporting targets would be met. The gas distribution networks were also reporting a significant under-spend for 2013-14, the first year of RIIO GD1, and were forecasting continuing under-spends over the full review period.

[1] K54V AWE private sector including bonus

5.4. In our response to RIIO ED1 draft determinations we also provided analysis to Ofgem showing that we expected *average* returns of 11% for the electricity distribution networks for the RIIO ED1 period, 500 basis points higher than the baseline return of 6.0%.

5.5. This all demonstrates that the RIIO price control approach has failed, thus far, to deliver value for money for customers. This is when applied to established regimes with numerous comparators, so we do not consider that this approach can be appropriate for a DCC regime in its infancy.

5.6. The outputs from RIIO could be used under a performance regime within a price control review; however, we feel that Ofgem needs to fully consult with DCC stakeholders before setting target levels or expectations. Some suggested key output measures could be:

- Effective running of the priority service register. The DCC are in a unique position to help vulnerable customers in sharing data between suppliers, networks and government departments;
- Security and reliability of the whole DCC ecosystem from Communications Hubs, data flows and service incidents; and
- Customer satisfaction from DCC Users

5.7. The innovation areas for the DCC should come from how the DCC can expand the business, without affecting their core service deliverables, once the mass rollout and Enrolment and Adoption have been successfully completed.

Question 6. We are looking for ways to benchmark DCC costs. What other sources of data or potential comparators can you recommend for subsets of DCC costs?

6.1. Please see our answer to Question 1 above.

Question 7. What are your views on DCC's approach to the prudent estimate?

7.1. We disagree with the way the DCC uses the prudent estimate term in Standard Licence Condition 36 of their licence. The licence term means that the DCC should use care and avoid additional costs when estimating their expected allowed revenue, especially their internal costs. However, the DCC appear to use the prudent estimate as a way of adding costs to their LABP without improving transparency.

7.2. We are concerned that the prudent estimate will not be returned to service users as it is not an allowed revenue term. The DCC is also adding additional 'prudence' into the Communications Hubs' fixed and explicit charges which will adversely affect suppliers during early rollout. For example, the DCC are adding in prudence to the early Communications Hub monthly charge, meaning that suppliers who roll out early will be paying a higher monthly charge than those who start later, when volumes and Communications Hub variants are better understood. With a 2 year lag in the application of the correction factor, when it is applied it will be applied to a much higher volume of smart meters in a different ratio to how the prudence was applied. If a small supplier has a strategy for rolling out smart meters early to offer their customers the smart experience soonest, they would be particularly affected as larger suppliers mobilise and their proportion of installed smart meters rapidly declines. Once the prudence gets trued up, 2 years later, the smaller suppliers, or any early movers, will have a lower smart meter portfolio share over which to smear the correction.

Question 8. Do you agree that our proposals should take affect from April 2015/16?

8.1 In this instance we agree that they should apply from 2015/16. However, we are concerned that Ofgem are proposing a 2 year lag in recovering costs from the DCC. Given the uncertainty of charges, and the DCC's incorrect use of 'prudent estimates', we feel that a 2 year lag is too long and that the excess DCC revenue needs to be returned to DCC Users sooner.

Question 9. Do you agree with our assessment against the criteria in the licence?

9.1 We do agree with Ofgem's assessment against the licence criteria. We are disappointed that the DCC has inappropriately requested an additional £12m as a baseline margin adjustment. We see no justification for such a high value adjustment being applied to an organisation such as the DCC that has a relatively 'thin' structure and low internal cost base.

Question 10. **What are your views on our longer term strategy of moving towards a more ex ante price control? How might this be achieved?**

10.1. We believe that an ex-ante price control is not workable for the DCC and feel that the current ex-post review is the best way for Ofgem to control and review the costs of the DCC. Furthermore, we were not expecting the DCC's price control to move away from the ex-post arrangement during the term of their licence.

10.2. The ex-ante price control used in RIIO gives the networks considerable advantage over Ofgem as the real costs and performance are not transparent. We feel this imbalance in information would be particularly difficult for Ofgem to manage with the uncertainty around the programme, especially with future initiatives such as Enrolment and Adoption, centralised registration, faster switching, streamlined energy settlement and the potential for wider industry code consolidation.

10.3. An ex-ante review would also not be workable for the DCC as there are no direct comparators which would make benchmarking even more difficult.

10.4. In our submission to the Energy and Climate Change Select Committee we presented clear evidence of the high level of returns that have been enjoyed by virtually all network companies subject to ex-ante reviews. We have also highlighted earlier in this response evidence that networks have continued to significantly outperform allowances in the most recent price controls held under the RIIO approach (RIIO T1 and RIIO GD1) and that we expect electricity distributors to significantly outperform their RIIO ED1 allowances. Given an ex-ante approach has failed to deliver value for money for customers when applied to established regimes with numerous comparators, we do not consider that moving to such an approach for the DCC regime would be justifiable.

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