Friday, 22 January 2016

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By email only

Dear Laura,

Reference: DCC Price Control Consultation: Regulatory Year 2014/15

Thank you for the opportunity to respond to the above consultation and for the short submission extension. This response is non-confidential.

Utilita specialises in smart prepayment, and has argued strongly that smart meters offer great advantages to prepayment customers, and that continuation of existing functionality for smart prepayment customers is essential.

We support Ofgem's activities in overseeing and scrutinising the DCC price control and welcome the robust approach to cost disallowance where poor justification is provided.

We set our below our submission in response to the questions raised

Question 1: What are your views on our approach to assessing DCC's costs?

Utilita partially agrees with Ofgem's approach to assessing the DCC's costs and supports the approach that any costs incurred by the DCC over and above acceptable thresholds must be removed from the LABP. Utilita would like to highlight that over-charging could cause volatility in supplier charges which will impact end users. It is paramount that this is considered whenever these price control evaluation exercises take place; with particular reference to managing the predictability of charges to suppliers in advance to ensure these can be properly considered by suppliers. The latest forecast in the document predicts that the DCC will cost £2 billion over the 12 year licence period. Given the level of these forecast charges, it is essential that any cost increases (or costs which are poorly substantiated) must be scrutinised closely to ensure customers receive value for money.

Utilita would like further explanation as to how Ofgem intends to ensure that these costs are removed from the LABP. Utilita is concerned that the DCC has not fully explained or justified all of their additional costs or provided sufficient evidence to demonstrate value for money. Further to this, although Ofgem states £11.7 million should be removed from the LABP it also has stated that these costs can be recovered should the DCC be able to justify them in the next price control exercise. We would like to question the efficacy of this undertaking, where the DCC could still be allowed to re-coup its costs ex post. This approach will contribute to unpredictability in supplier charges.

We would also like to highlight the need for greater clarity with regard to the DCC's policies and procedures, which, according to independent assurance, provide 'value for money'. Since initiating the project to be involved in the Smart Meter Roll-Out, Utilita has expended considerable resource assessing how the DCC costs are calculated and to what extent these are passed onto SEC Parties.

We would like to see evidence from Ofgem on actions to try and improve DCC value for money. We fully support the objective that the DCC should demonstrate cost-effectiveness and value for money. We believe that further processes will be needed in place to scrutinize ever more closely these figures.

Question 2: Do you have any suggestions on where we can improve our approach?

Utilita supports the view that Ofgem should maintain an active and thorough approach to scrutiny to keep the DCC' costs under control. Introduction of the DCC has created another monopoly without the benefit of competition in terms of driving costs down. While there may be no direct comparators, Ofgem should draw strongly on its experience in benchmarking the networks and also seek comparators for aspects of the DCC activity in other areas. Even if a comparator for all DCC activities is not established, where benchmarking can be used it should be.

Ofgem should ensure that wherever possible competitive approaches are employed, and that the DCC activities support competitive licensees as required. In particular, Ofgem should require that the DCC delivers adequate services to ensure that where customers have benefited from smart meter rollout and competition, that such customers should not be disadvantaged by the DCC approach. When conducting price control exercises, Ofgem should also consider that smart meter rollout delays within the DCC may cause external supplier prices to increase, for example, EDMI charges, which suppliers have to pay.

The Grant Thornton forensic audit suggested that there were processes by which the DCC is trying to ensure value for money. However, the audit also suggested that some of these processes were not being rigidly followed. Utilita welcomes this transparency. The majority of internal cost increases result from recruitment and change requests in relation to non-fundamental service provider costs.

Utilita is aware that ex-post price controls are a valid way for Ofgem to analyse incurred costs. We would also like to encourage Ofgem to initiate further processes ex-ante by which costs can be kept within the prudent estimate prior to official review. Stakeholders would have greater confidence in Ofgem's ability to regulate through the DCC price control if the DCC departmental budgets were subject to transparent scrutiny prior to the creation of charging statements or the incursion of £30 million further internal charges such as those expected in 2016/17. Utilita believes that such a large increase in costs could have been identified or communicated earlier, and that appropriate processes could have been implemented sooner to assess the impacts this would have on suppliers via charging statements.

Ofgem notes in the consultation that DCC lack experience of these price control processes and that improvement is needed. Utilita also suggests that DCC must improve cost forecasting and transparency at all times. If DCC expect prices to increase so dramatically – they should be informing stakeholders of possible price increases as early as possible to improve predictability, so suppliers can manage their budgets effectively. It may be that an incentive/penalty structure would be appropriate to ensure that if forecasting and transparency are outside a narrow bandwidth, DCC would be penalised. Similarly, a robust approach must be taken to poorly justified costs, whether forecast or not. Network companies, as monopoly providers, are expected to perform to a high standard in this way and DCC should be no different.

Question 3: What are your views on our assessment of DCC's performance against IM7?

As part of this consultation process, Utilita spent a time extensively researching the supporting documentation linked to IM7. This documentation was stated to be the basis of the acceptance that IM7 had been fulfilled and the criteria met, however in this instance, we were not able to locate the following documents:

- The baselined Service Management System Design Document (SD11), which was produced by the Data Services Provider and was given full approval by the Licensee (through issuing an Authorisation to Proceed certificate to the Data Services Provider).
- The baselined Data Design (SD14), which was produced by the Data Services Provider and was given full approval by the Licensee (through issuing an Authorisation to Proceed certificate to the Data Services Provider).
- The baselined Service Management Interface Specification Document (SD4.7), which was produced by the Data Services Provider and was given full approval by the Licensee (through issuing an Authorisation to Proceed certificate to the Data Services Provider).

Without access to this documentation Utilita is unable to comment on the assessment of the criteria for IM7. However, Ofgem has stated that the evidence provided clearly demonstrated that the DCC had met its obligations under the licence. Utilita accepts that Ofgem has performed this assessment rigorously and that the DCC is entitled to the baseline margin attached to this milestone (£0.314m).

Separately, Utilita notes that the Secretary of State directed changes to the Implementation Milestone Regime on 15 November 2015. As a result, the other IMs due for delivery within reporting year 2014/15 were adjusted to fall into different reporting years - meaning that IM7 was the only IM due for delivery during year 2014/15. Utilita therefore expects the DCC to fulfil this IM against the new criteria, given that it was the only one due for delivery within this reporting year. The reduction in the number of implementation milestones due for delivery during this regulatory year enabled the achievement of this milestone with greater ease than had there been a greater number of IMs to deliver.

Utilita also notes the potential to recover any revenue which is lost due to an unachieved IM, by fulfilling a future dated IM early. While early delivery of future IMs could be beneficial, this should not be a route by which DCC can make up revenue for other failures. There is a potential risk that this might create a perverse incentive for the DCC to deliver future dated implementation milestones which are potentially less complex, and less relevant at that stage of the SMIP, in order to receive the associated baseline margin. The framework should lead to delivery of the IMs which are relevant and due within a given regulatory year, in accordance with plans, rather than risking diverting resource in an effort to deliver future IMs. Utilita is not wholly supportive of the incentive which exists in the DCC licence to be able to regain lost margin by delivering future dated IMs.

Question 4: What are your views on our cost proposals?

Utilita has no additional comments to make on this question.

Question 5: We are interested in feedback from stakeholders and industry parties on DCC's external engagement. What were your experiences of engaging with DCC in regulatory year 2014/15?

Utilita's engagement with DCC during regulatory year 2014/15 has included both positive and less positive experiences. The Industry Days that were provided within this year were very helpful, in which a lot of information was shared and knowledge gained. However, separate to the Industry Days, our team has noted that the DCC engagement was less consistent in approach, some responses lacked transparency and in some cases query responses were either delayed or not received.

Separately, Utilita noted that the DCC staff responsible for engagement in some cases lacked understanding of prepayment issues and failed to provide access to the skillsets required to respond to queries which are more specific to prepayment customers. This is critical for Utilita's business, our customer portfolio comprises over 99% prepayment customers.

Utilita has noted that the entire concept of the prepayment smart market has not been given the same level of importance by the DCC as the credit market. This has led to a detrimental experience for Utilita and risks more serious detriment being experienced by customers who have engaged with smart meters already. The prepayment functionality is being released last during the go live scheduled releases. This deprioritises prepayment customers and places Utilita in a less advantageous position than a supplier who specialises in credit customers. In addition, based on current information available, SMETS1 customers can expect to lose functionality as a result of the DCC approach. Utilita has argued consistently that prepayment customers stand to gain the most from smart meters, and to remove functionality which is valued by a traditionally poorly served market sector further inconveniences these customers.

Utilita believes that DCC should urgently allocate additional resource to specialise in prepayment and address the expected deficiencies. This would help to minimise the adverse impact on SMETS1 prepayment customers, help ensure a smooth transition for go live, and provide the support required by suppliers who supply prepayment customers.

Conversely, Utilita would like to acknowledge that the channels of communication/engagement with the DCC have improved somewhat over the last year, and we hope this improvement will continue.

Question 6: We welcome views on DCC's benchmarking methodology, including on what you consider the appropriate percentile that DCC should use when carrying out benchmarking, and approach the benchmarking benefits?

We acknowledge that DCC have actively taken to seek professional advice on benchmarking with the Hay Group and think that this is positive step forward. We understand that DCC is a specialist company and that there can be few direct comparisons. However, it is our view that it is still possible to make comparisons for the roles of employees within DCC. When considering Ofgem's analysis through ASHE that many senior roles were as high as the 75^{th} percentile, we believe this is too much and should be closer to 50^{th} percentile.

Noting Ofgem's concerns over the benchmarking benefits of the percentage applied not matching the actual level received, it would be useful to have sight of some quantitative evaluation on this. We would like the values of the benefits calculated by DCC and the actual benefit allocation to be made available. Please also note our comments under question 2 above.

Question 7: No response - We are looking for ways to further benchmark DCC costs, what other sources of data or potential comparators can you recommend for subsets of DCC costs?

Elements of the DCC's activity may be benchmarked compared with other price controlled entities. If there are no direct comparisons in energy, as per our comments under question 2, Ofgem could consider whether individual activities have comparators in other regulated industries.

Question 8: Do you agree with our approach to real price effects?

Utilita has no additional comments with regards to this question.

Question 9: What are your views on DCC's approach to the prudent estimate?

We believe that there are many benefits of using a RIIO model and would ask why this has been discounted so early. The RIIO model is more in line with other monopoly companies in the energy sector and is well understood, which would help to make the DCC arrangements more accessible and transparent. It also encourages accurate forecasting in an ex-ante fashion, which will help suppliers to understand DCC's costs and with sufficient transparency would improve predictability of the future path of costs. Otherwise we echo Ofgem's concerns that there are already protections in place that should help DCC with unexpected rises, without having to pass them straight on to suppliers. DCC really should be able to take responsibility to account for these.

If the Prudent Estimate method is to continue, we would support the approach of a penalty interest rate incentive and await the decision on the July 2015 consultation. We believe that a penalty interest rate would incentivise DCC accuracy in the Prudent Estimate. However, we do have concerns that unless an incentive is carefully structured and on both sides of the estimate, the approach might lead to perverse incentives with the DCC overestimating to avoid penalty interest.

Question 10 Do you agree that our allowed revenue proposals should take effect from April 2016?

Utilita is supportive of Ofgem's allowed revenue proposals taking effect from April 2016.

Question 11 Do you agree with our assessment against the criteria in the licence?

Utilita has no additional comments with regards to this question

Question 12: What margin do you think should apply, 10% or 15%?

It is our view that no more than a10% margin should apply. We have detailed our explanation in our answer to question 13.

Q13: Do you have any views on the rate of return methodology we have developed?

In this case, net margin should be derived from the cost of capital. Given that the DCC is a government mandated monopoly, it should not generate super-normal profit i.e. a return on capital employed in excess of the cost of capital. It is therefore the cost of capital and return on capital employed that we consider to be an appropriate measure of profitability. Given the low risks associated with the operations of the DCC, the monopoly nature of the business and the 12 year licence, we expect the cost of capital to be low.

We agree that risks are largely mitigated due to external service providers and the fact that DCC is a monopoly. We therefore expect the cost of capital to be close to the current risk free rate of return (c.1%). It is not possible for us to translate this into a net margin % without knowing the expected capital employed and total costs, but it would be surprising if this resulted in a net margin of as much as even 10%.

In the rate of return methodology developed by Ofgem, there were several companies with whom baseline margins were compared. It would be of value to explain how these other companies calculated their baseline margins, particularly the regulated retail companies in other sectors.

We hope that this submission has been helpful, and if you would like to discuss any points in more detail, please do not hesitate to contact me, either by e-mail or on 01962 891182.

Yours sincerely,

By email only

Louise Porter
Major Projects Manager