

Appendix F – Margin and incentives

1.1 Overview

1. This section sets out DCC's proposals in relation to:
 - DCC's expected return for our work in relation to the Transitional Phase of the Switching Programme
 - the incentive framework for DCC's activities during the Transitional Phase.
2. DCC's proposed rate of return is based on proposals or analysis around a number of supporting features which collectively form DCC's margin proposal. These features are shown in Figure 1 below.

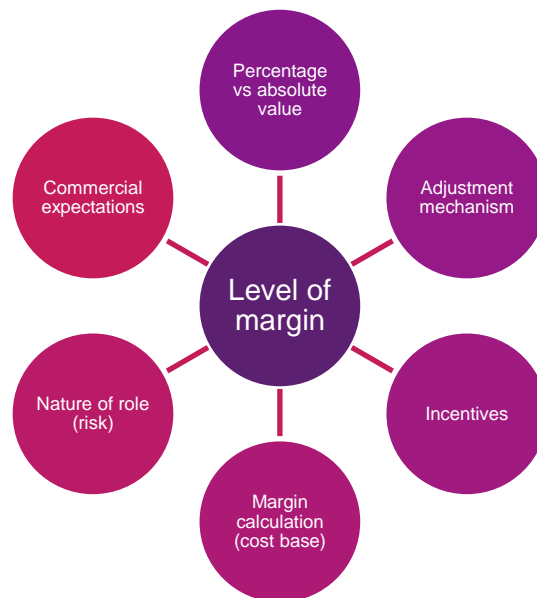


Figure 1 – Features of margin proposal

3. The margin, as discussed in this DCC Switching Business Case, represents a return to DCC for the delivery and management of DCC's role during the Transitional Phase of the Switching Programme. This margin will be recovered through DCC charges in effect from April 2017 onwards.
4. DCC expects that the DBT and Live Operations phases will present an opportunity to incorporate a meaningful incentive framework for DCC's activities. DCC's role will be critical to the successful implementation of change to the energy supplier switching process and, as such, DCC anticipates that a performance incentive framework will apply during those programme phases. Margin and incentives for DCC's role during the DBT and Live Operations phases of the Switching Programme will be set separately from this DCC Switching Business Case.

1.2 Agreed principles

5. Working collaboratively through the Price Control Design Team (comprising DCC and Ofgem representatives), DCC and Ofgem developed a set of principles relating to determining the margin proposals. The principles are that the margin should:
 - reflect the nature of the activities, the market returns for activities of this type and the level of risk to DCC of the Transitional Phase activities, e.g. specialist skills
 - be calculated by applying DCC's marginal rate of return on economic and efficient costs
 - be set ex ante in accordance with Ofgem's direction in early 2017
 - be directed by Ofgem with a mechanism for both DCC and Ofgem to apply for an adjustment.

1.3 Summary of margin proposals

6. Based on consideration of each of the factors outlined in Figure 1, DCC proposes a rate of return of **15%** to set the margin for the Transitional Phase of the Switching Programme. The overriding rationale for this proposal is that DCC considers this rate of return to be commensurate with the commercial expectations of the parent company and in line with benchmarked comparator organisations.
7. The other elements of DCC's proposal in relation to margin are summarised below. We propose that:
 - the margin is calculated as a fixed rate of return of 15% of revenue, based on all DCC costs in the Transitional Phase. This is calculated as 'margin' as opposed to a 'mark-up', where the margin value = $x/(1-y)-x$, where x = cost; y = % rate of return
 - the fixed rate of return is set ex ante for the entire Transitional Phase (RY 2016/17 – RY 2019/20)¹
 - the forecast margin is recovered via DCC charges in effect from April 2017 onwards (subject to any ex post adjustments following the ex post price control assessment)
 - there is a mechanism for both DCC and Ofgem to apply for an adjustment to the fixed rate of return in the event of a significant change to DCC's role and/or risk profile.
8. This proposal is based on the incentives framework outlined in Section 1.8 and DCC's assessment of the risks we face during the Transitional Phase, which is detailed in Section 1.10.

¹ Except for the margin relating to RY2016/17, which would be set during RY 2016/17 and be recovered during RY 2017/18

9. Based on the rate of return of 15% and the forecast costs associated with the baseline scope scenario, the forecast value of the margin to be recovered is set out compared to the forecast DCC costs in

(£k)	RY 16/17	RY 17/18	RY 18/19	RY 19/20	RY 20/21	Total
Total costs (including materiality threshold)	5,646	8,061	6,809	5,086	7	25,608
Margin	996	1,422	1,202	897	1	4,519

10. Table 1.

(£k)	RY 16/17	RY 17/18	RY 18/19	RY 19/20	RY 20/21	Total
Total costs (including materiality threshold)	5,646	8,061	6,809	5,086	7	25,608
Margin	996	1,422	1,202	897	1	4,519

Table 1 – Proposed margin values (based on forecast costs)

1.4 Margin calculation (cost base)

11. DCC proposes that the margin should be calculated as a fixed rate of return (%) of the total costs (CRS Internal Cost² plus CRS External Costs³). Note that the rate of return is calculated as a margin (rate of return = margin value/(margin value + total costs)) rather than a mark-up (rate of return multiplied by total costs). DCC would apply the rate of return to any external subcontractors e.g. external consultancy, which under the term in the licence would be defined as CRS Internal Costs. The only External Costs identified to date are those likely to be incurred by relevant Fundamental Service Providers (specifically, the Data Services Provider) in assessing the impact of the CRS design on the existing SMIP design and service.
12. This approach ensures that DCC is rewarded for the delivery of activity for which it is commercially accountable and is not incentivised to provide all required services in-house.

1.5 Fixed percentage rate of return

13. DCC proposes that the margin is calculated as a fixed percentage rate of return rather than a fixed absolute figure, as this allows the margin to flex with cost changes, reducing the need to

² means in relation to each Regulatory Year the sum of the costs (excluding Internal Costs, External Costs, Pass-through Costs, Centralised Registration Service External Costs and Centralised Registration Service Pre-Agreed Costs) that were economically and efficiently incurred by the Licensee for the purposes of the provision of Mandatory Business Services

³ means in relation to each Regulatory Year the actual amount of the costs that were economically and efficiently incurred by the Licensee in procuring Fundamental Registration Service Capability during that period.

reopen the margin. This approach is suitable for changes to costs relating to activities of a similar nature to those already anticipated, and to which the same rate of return is therefore applicable. This approach is particularly suitable given the uncertainty in relation to programme scope at this stage and it achieves the principles of simplicity and proportionality, given the relatively low cost base.

14. Under this approach, the forecast margin would be recovered through DCC charges. The final value would be calculated based on the Allowed Revenue as determined by Ofgem as part of its ex post price control assessment. Where there was a difference, this would result in a corresponding adjustment to the CRSPA term within Ofgem's direction on margin and incentives.
15. It is important to note that Ofgem would retain its power to disallow any costs that it deems to be inefficient, therefore neutralising any potential perverse incentive for DCC to increase costs in order to secure additional margin. Furthermore, under the ex post plus arrangement, Ofgem will be able to further scrutinise any changes to DCC's costs on a regular basis.

1.6 Adjustment mechanism

16. Notwithstanding the proposal for a fixed rate of return, DCC proposes that there should be a mechanism to reopen the rate of return itself in the event of a significant change. There may be events where there is a material change to the factors outlined in Section 1.1, such as:
 - a significant change to DCC's role within the Switching Programme, leading to a change in DCC's risk profile in relation to the Transitional Phase
 - a change to the incentive framework.
17. DCC considers that an adjustment mechanism is appropriate as it would ensure that the rate of return remains appropriate in relation to the nature of DCC's activities during the Transitional Phase. The mechanism could be initiated by either Ofgem or DCC and could result in an increase or decrease in the rate of return, where justified.
18. It is not envisaged that this mechanism would need to be used based on the scope changes that are reasonably foreseeable, however, it provides an element of protection for both parties in the event of significant unforeseen scope change.

1.7 Commercial expectations

19. There is a clear precedent for the parent company's (Capita's) expected rate of return for DCC activity. For example at the time of the application for the Smart Meter Communication Licence, the rate of return was set at 15% of Internal Costs and was established through competition. Therefore this is the closest example of the competitively set commercial expectations of the appropriate level of margin.
20. Switching is a complex national transformation programme, and it will become increasingly challenging as we progress through the Transitional phases. DCC's commercial expectations reflect the skills, effort and commitment that we invest in ensuring successful programme delivery.

21. The rate of return should be comparable to that expected by professional services organisations, should Ofgem have sourced these programme management, design, delivery and procurement services from the open market.

1.7.1 Internal margin benchmarking

22. The proposed margin also reflects the commercial decisions relating to the viability of this project compared to similar work elsewhere, that is, the opportunity cost for undertaking this activity.
23. As a comparator, Capita has reported underlying operating margins in the range of 13.4% and 14.2% over the last five years. In addition, Capita's Digital & Software Solutions division, which is most closely aligned to the IT transformation services which DCC is supplying to this programme, achieved an underlying operating margin of 24.8 and 25% in the last two years. This return reflects the balance of supply and demand for the skills and experience required to deliver complex IT programmes.

1.7.2 External margin benchmarking

DCC-wide benchmarking

24. DCC commissioned Europe Economics (EE) to provide advice on the assessment of DCC's rate of return for its core services and its role in developing and delivering the Central Registration Service (CRS) in support of Ofgem's Switching Programme. The full report has been provided to Ofgem under separate cover.
25. In order to assess DCC's allowed rate of return, EE employed a margins-based methodology. In doing so, it conducted a qualitative analysis of DCC's business model followed by a market analysis of actual net margins achieved by comparator firms. The identification of comparators was based on the key insights from the qualitative analysis, thus ensuring comparability and relevance in the comparator firms chosen. EE considered this to be a more robust approach, relative to applying a Weighted Average Cost of Capital (WACC) figure to an estimate of capital employed in DCC, given the asset-light nature of its business.
26. The margins-based approach has been adopted in regulated sectors in recent years and the required margin is normally estimated by examining the EBIT margins achieved by other similar asset-light businesses as the regulated entity in question. These businesses are used as comparators, potentially with adjustment for different levels of implied risks (e.g. operational risk, input cost risk etc.).
27. EE selected five benchmark organisations (TalkTalk; PayPoint; Worldpay; Onecom and Endava), based on analysis which highlighted characteristics similar to those of DCC:
 - Asset composition – whether the comparator is asset light or not.
 - Similarity of business model, including:
 - the nature of the business – whether the candidate comparator is IT heavy, has external contractors and is unique to the industry it operates in

- Geographical scale– whether it operates in the UK only
 - Client base – whether it has a regional client base consisting of both households and businesses
 - Risk profile – how similar are the risks faced to those of DCC?
28. The EBIT analysis of these organisations led EE to recommend a rate of return of between 15 to 17 per cent range for DCC’s core smart metering services, whilst a slightly (but not greatly) lower return should be expected for DCC’s role in the Switching Programme.

DCC Switching Programme Transitional Phase benchmarking

29. In order to provide benchmarking specifically aligned to the IT transformation professional services DCC is providing in the Transitional Phase of the Switching Programme, DCC has also analysed the financial performance of the firms on its Consultancy Services Framework. This analysis is summarised in Table 2.
30. This provides appropriate benchmark data, as these firms specialise in providing transformation services into large programmes and are supporting Ofgem and DCC in this capacity on the Switching Programme.

[Table redacted]

Table 2 - Professional Services margin benchmarking

1.8 Incentives

31. This section sets out the key elements of DCC’s proposed application of performance incentives to its activities during the Transitional Phase of the Switching programme. The proposal seeks to define an incentive framework that is practical to implement and supports the desired outcomes for the Switching programme.

1.8.1 Principles for incentives

32. Through the Price Control Design Team DCC and Ofgem developed a set of design principles against which potential incentives would be assessed. These principles have been designed to ensure that incentives are only applied where they bring genuine benefits to the programme. DCC wholly supports the use of incentive regimes when they are applied in an appropriate context.
33. It was agreed by the Design Team that any incentive should:
- ensure there is no duplication of rewards and penalties with existing incentives⁴ – e.g. under the Operational Performance Regime (OPR)⁵

⁴ These include:

a. Incentives to be economic and efficient, in order to avoid costs being disallowed through DCC’s annual price control regime - downside
b. Incentives not to over-recover costs from SEC Parties, through the penalty interest rate regime - downside

- encourage behaviour that is aligned with the desired outcomes for the Switching programme i.e. time, quality, cost
- be proportionate i.e. it would be disproportionate to develop a complex incentive regime for an immaterial financial value
- be capable of being measured objectively and unambiguously
- have quantified limits to risk as well as reward
- feature an upside incentive as well as downside, in order to balance risk and reward (note that this could apply to a package of incentives)
- not create perverse incentives, that is, incentivising one outcome in a way that creates an unintended consequence of compromising other key outcomes
- measure performance of activities which are within DCC's reasonable control.

1.8.2 Assessment of potential incentives

34. As part of the Price Control Design Team's planned work on incentives, DCC identified potential areas to which incentives could be applied and assessed these against the principles outlined above. The assessment is included as Appendix G – . DCC's analysis concluded that there was no compelling rationale for the application of incentives.
35. However, subsequently, Ofgem has expressed a preference for DCC to operate under a performance incentive regime with incentives relating to timeliness of product delivery and stakeholder satisfaction. DCC has some concerns with incentivising the timely delivery of activity as it may perversely encourage DCC to:
 - prioritise time over quality and lead to missed opportunities to improve quality and reduce time and cost in later phases of the programme.
 - be overly cautious in its planning to reduce the risk of late delivery, which may result in longer delivery timescales
 - make compromises in the procurement approach it plans to adopt such that it prioritises faster delivery over depth or breadth of competition
36. DCC's main concerns for incentivising stakeholder satisfaction are that:
 - the measurement of effectiveness is subjective
 - good programme delivery does not always equate to satisfied stakeholders. For example, it may be in the interests of the programme for DCC to challenge vested

c. Incentives to deliver quality, through potential granting of future contracts - upside
⁵ As set out in Schedule 4 of the Smart Meter Communication Licence

interests in relation to the current arrangements or to challenge the quality of the design work carried out by other parties, where doing so results in a more robust design that better meets the objectives of the programme

37. Due to these concerns, DCC considers that it would be preferable not to introduce incentives during the Transitional Phase. However, in order to support Ofgem's preference for performance incentives during the Transitional Phase, DCC has developed a proposal that seeks to:
 - mitigate some of the challenges of implementing incentives during the Transitional Phase
 - ensure that the incentives could be practically implemented and monitored.
38. DCC's proposals for time-based incentives and stakeholder satisfaction incentives are explained below.

1.8.3 Time-based incentive

Application of incentive

39. A time-based incentive places DCC margin at risk based on whether DCC delivers specific milestones by agreed dates.
40. In line with the principles agreed by the Price Control Design Team, the incentives should apply only to DCC activities where DCC has a high level of ownership and control. The incentive should therefore be applied to the activities underpinning DCC's specification and procurement of the CRS solution, and not to DCC's professional advisory activity supporting Ofgem in designing and planning for the delivery of end-to-end switching arrangements.
41. The overarching period in which incentives could be applied to DCC milestones is therefore from:
 - receipt of detailed switching design and delivery specification from Ofgem; to
 - award of major CRS contract(s).
42. DCC has considered which milestones are likely to be on the critical path, in order to identify where there may be benefit in incentivising delivery, and which programme products are already planned to be subject to assurance, in order to minimise the additional oversight required. DCC therefore proposes that incentives are applied to the following milestones:
 - CRS technical specification complete
 - CRS tender packs complete
 - Contract award recommendation reports approved.

43. DCC's current planning assumption is that DCC will run three procurement projects, which will likely include major and minor projects. An example of a major procurement project could be to source core software provision, whereas a minor procurement project could be to source professional services support e.g. systems integration.
44. DCC considers that applying incentives to milestones for each of the individual procurement projects would be disproportionately arduous to set up and monitor and would not provide any substantial additional benefit in terms of ensuring overall timely delivery of DCC's activities. DCC therefore proposes that the incentive should be applied only to the milestone that represents the cumulative end point of all major procurement projects, i.e. the point at which the final major procurement tender pack is complete and the point at which the final major procurement contract award recommendation report is approved.
45. DCC considers that it would be counterproductive to introduce a time-based incentive relating to the milestone for 'CRS contracts signed', as this is beyond DCC's reasonable control and quality should not be compromised for time for this activity. A time-based incentive relating to this milestone may also give the potential Service Providers disproportionate negotiating power.
46. Dates for milestones can only be agreed once:
 - Ofgem and DCC have undertaken a joint planning activity in order to develop a detailed baselined programme plan
 - DCC's Switching programme plan is integrated with Ofgem's overall Switching programme plan via an agreed series of inbound and outbound dependency milestones
 - DCC has commissioned expert assurance of the plan and deliverables to advise on its deliverability and has subsequently confirmed to Ofgem that the plan is deliverable and that it is possible to achieve the milestones linked to the incentives. DCC has assumed that an external provider will carry out this assurance.
47. DCC proposes that the incentive mechanism and the milestones to be incentivised should be defined within DCC's licence. However, to ensure that timely programme delivery is not hindered by disproportionate governance of incentives, DCC proposes that the detail underpinning the milestones, such as the due dates, acceptance criteria, and inbound dependencies, should be defined and managed outside of the licence.

Risk/reward of incentive

48. The time-based incentive is financial, that is, it places a proportion of DCC margin at risk based on whether specific DCC milestones are delivered by the agreed date. In line with DCC's overarching concern relating to the unintended consequences of incentivising time at the expense of quality, DCC does not propose that there should be an upside financial incentive if the milestone is delivered before the agreed date. The financial incentive therefore only has downside, i.e. DCC margin is at risk if milestones are delivered late.
49. In line with the principle that incentives should only apply to activities where DCC has a high level of ownership and control, DCC proposes that the margin placed at risk is proportionate to

the percentage of the cost base for DCC activities relating to delivery of the incentivised milestones, i.e. the cost of the CRS specification and procurement activities, and not the cost of DCC’s advisory services to Ofgem’s design and delivery planning for the end-to-end switching arrangements. The activities that DCC considers are directly related to delivery of the incentivised milestones are highlighted in the DCC Switching programme plan under the flag ‘Activities relating to incentivised milestones’. Based on the current forecast costs associated with the baseline scenario, around 25% of the cost base relates to activities to deliver the incentivised milestones.

50. DCC proposes that 100% of the margin associated with these activities is placed at risk. For example, where the cost of the activities leading to delivery of the incentivised milestones represents 25% of total DCC costs within the Transitional Phase, 25% of total DCC margin is placed at risk against the milestones.
51. DCC considers the amount of margin placed at risk should be distributed equally across all three milestones. That is, of the total amount of margin at risk, 33% of the margin would be at risk based on delivery of each of the three milestones. DCC envisages that each of these milestones will be on the critical path and therefore of equal importance in terms of timely delivery. In order to ensure the incentive encourages timely delivery overall, DCC proposes that the equal distribution of margin placed at risk is supported by a recovery mechanism (outlined below) that ensures that DCC is incentivised to deliver the final milestone by the agreed date even if earlier incentivised milestones are delivered late. DCC considers that the combination of placing an equal amount of margin at risk based on the delivery of each milestone, along with the recovery mechanism, provides the simplest approach to incentivising timely delivery of each milestone and incentivising timely delivery overall.
52. In addition, DCC proposes that the level of margin lost once a milestone is missed should be profiled as a reverse s-curve at each agreed milestone, as illustrated in Figure 2. This profile should mean that, if a milestone is missed by a short period of time, DCC is still incentivised to deliver the milestone in a timely manner. For example, if DCC was one day late in delivering a milestone, a high proportion of the margin would still be available to DCC and DCC would be incentivised to deliver as soon as possible as the amount of margin available would reduce if milestone delivery were to be further delayed. The exact profile of the reverse s-curve will be agreed between Ofgem and DCC before the incentive is implemented.

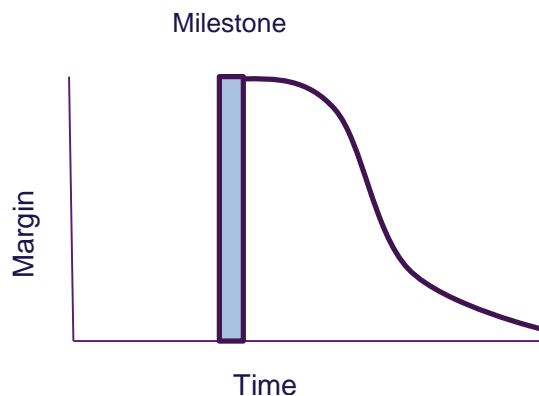


Figure 2 – Reverse s-curve margin profile

53. DCC proposes that a recovery mechanism is deployed which enables DCC to recover margin lost on a previous milestone if subsequent milestones are achieved on time. This would be similar to the recovery mechanism that applies to DCC's SMIP Implementation Milestones. The three proposed milestones are sequential and lead to the approval of the recommendation reports for award of the CRS contract(s), which is on the critical path for the end of the Transitional Phase, therefore a recovery mechanism would be well suited to these activities and would incentivise DCC to minimise delay to the Transitional Phase as a whole.
54. DCC proposes that the forecast margin is recovered through DCC charges. The final margin value would be calculated based on the Allowed Revenue as determined by Ofgem as part of its ex post price control assessment. Where there is a difference, this will result in a corresponding adjustment to the CRSPA term within Ofgem's direction on margin and incentives. Similarly, where there is an adjustment to the costs associated with the activity being measured under an incentives framework, this will also result in an adjustment to the margin placed at risk.
55. In addition to financial downside, there would be a negative reputational impact should DCC deliver its milestones late.

Measurement of incentive

Acceptance criteria

56. Milestone achievement would be based on whether the acceptance criteria defined in the product description have been met for the related product(s). This is intended to mitigate the impact of potential compromises on quality by ensuring a minimum quality level is defined.
57. DCC suggests that acceptance criteria should be unambiguously defined in each product description and the acceptance criteria are approved by both Ofgem and DCC in advance of the incentive arrangement coming into effect.
58. The acceptance criteria in the product description should comprise:
 - Time – date for product completion
 - Quality – objective criteria that the product must meet.
59. Existing relevant product descriptions should be revisited by DCC and Ofgem to ensure that they are sufficiently unambiguous such that they are capable of supporting the incentive mechanism. Where products cannot be defined in detail now, the product descriptions and acceptance criteria must be agreed by both parties before the incentive mechanism is finalised.
60. Approval of programme strategy and planning products is inherently subjective. However, Ofgem and DCC will jointly need to ensure that acceptance criteria are defined in as objective a manner as possible. Where there is disagreement on whether acceptance criteria have been met, it should be the responsibility of the reviewer to demonstrate why the product does not meet its acceptance criteria and provide a clear written explanation of the remedial action required.

61. All Ofgem or third party products on which incentivised DCC activities are dependent must also have unambiguously defined product descriptions with clear acceptance criteria.

Inbound third party dependencies

62. Any third party activities on which DCC milestone completion is dependent must be specified for each incentivised milestone. The inbound dependencies must be agreed by both Ofgem and DCC in advance of the incentive arrangement that relates to a specific milestone coming into effect. Inbound dependencies should be identified as milestones (with a clear definition, unique reference, and delivery date) in both the Ofgem programme plan and the DCC Switching programme plan once the dependencies have been agreed.

Governance

63. DCC considers that transparent governance of the product review process, that includes both identified reviewers and defined timescales for review, is an important element of the incentive mechanism. This should be tied into existing assurance points to reduce the programme overhead involved. Applicable comments will only be incorporated from reviewers named on the product description.
64. DCC proposes that wholly independent assurance is sourced by Ofgem (either technical or professional depending on the product to assure) to validate whether DCC has met the product acceptance criteria associated with the milestone. This would avoid any conflict of interest in situations arising where DCC considers it has been delayed from meeting its milestone due to delays to Ofgem-owned activity. The independent assurance body must not have been involved in the development of the products or in the Switching programme in any capacity that may prejudice its independence. The terms of reference for the assurance body should be agreed by both DCC and Ofgem in advance of the incentive arrangement coming into effect. Additional activity would be incorporated into DCC's programme plan to support this additional assurance activity. The independent assurance would be paid for by DCC and would be similar to the performance auditor role that assures delivery of DCC's incentivised Implementation Milestones under the SMIP.

Changes to incentive

65. Once the milestone dates have been agreed, DCC suggests that there should be a mechanism whereby both parties are able to request a change to an incentivised milestone (e.g. date, acceptance criteria or inbound dependencies), for consideration by the other party. The dates of incentivised milestone may need to be changed following implementation of the incentive mechanism as a result of factors including:
- need for change identified by Ofgem:
 - a top-down re-plan stemming from its overarching Switching business case
 - a change to DCC's role within the Switching Programme
 - notification of delay to an inbound dependency to a DCC milestone
 - need for change identified by DCC:

- identify an opportunity to increase quality or reduce the risk of error, resulting in a net benefit to the overall programme timeliness (including DBT and Live Operations), which is quantifiable (at least as a ROM)
- identify that another party outside of DCC’s control is likely to miss a milestone which is an inbound dependency to a DCC milestone, with a subsequent impact on DCC’s milestone date that is beyond DCC’s control.

The definition of conditions for change are to be further developed by Ofgem and DCC.

66. The incentive change mechanism must be responsive to the needs of the programme, therefore DCC proposes that changes to the dates and acceptance criteria of incentivised milestones should be managed within the wider programme change process (which is not yet defined). This should reduce the management overhead and minimise duplication. This approach will also ensure that any impacts on incentives are considered as part of the assessment of all change by decision makers.
67. DCC expects that a change process should follow the logical process outlined in Figure 3. This process will be further developed by Ofgem and DCC in the Programme workstream.



Figure 3 - Logical change process

68. The process must deliver decisions on requests for incentive changes within a maximum of one month from submission of the formal request, as it is critical that all parties are working from an accurate and authoritative programme plan.
69. There must be clearly defined Switching Programme roles that have the authority to approve changes, including those that impact incentive milestones.
70. DCC considers that industry engagement on changes to the detail contained within product descriptions associated with incentive milestones should only be through programme governance. A requirement for formal industry consultation would likely lead to significant programme delays and therefore be counter to the rationale for deploying a time-based incentive. However, where it is proposed to change the milestones to be incentivised or how the incentive mechanism operates, consultation would be appropriate.
71. Regular programme reporting by both Ofgem and DCC should identify where there is a risk that either the inbound dependency or the DCC product itself is at risk of not achieving an incentivised milestone.

Assumptions

- Ofgem and DCC will undertake joint planning activity to ensure that both Ofgem and DCC plans are integrated via an agreed series of inbound and outbound dependency milestones

- The incentive mechanism will be activated following confirmation by expert external assurance that the plan is deliverable and that it is possible to achieve the milestones linked to the incentives. DCC has assumed that this assurance will take place towards the end of the design phase
- The milestones proposed for incentivisation are on the critical path of the programme. Where this is not the case the milestones should be removed from the scope of the incentive arrangement as it is unlikely to be beneficial to the programme to incentivise accelerated delivery of milestones that are not on the critical path
- Ofgem and DCC are accountable for any third parties working under their respective control in the products they own, and for any delays these parties may cause.

1.8.4 Stakeholder satisfaction incentive

Application of incentive

72. DCC proposes that a reputational incentive is linked to feedback from participants in the Switching Programme on DCC's performance on the Switching Programme. Participants should include other design team members and industry participants at user groups and EDAG. The expected sample size is 50-100 and feedback will not include that of Ofgem as it may introduce a conflict of interests.
73. DCC proposes that a six-monthly survey is conducted to record feedback, comprising both quantitative scoring and qualitative explanations. DCC considers this frequency should allow a reliable baseline to be established and trends to be captured.
74. The survey should be designed and implemented by a third party who specialise in survey design with input from DCC and Ofgem.

Risk/reward of incentive

75. DCC proposes that the incentive has a reputational impact only and that no DCC margin is at risk. Where DCC achieves positive feedback it will support its aim of securing additional work on other energy programmes in future. The incentive could also form the baseline for a potential financial incentive in future phases of the Switching Programme.
76. The non-financial nature of this mitigates some of DCC's concern that there is the potential for vested interest amongst survey participants and that good programme delivery does not always equate to satisfied stakeholders.

Measurement of incentive

77. DCC proposes that the analysis of the results should be conducted by the third party survey organisation, as this ensures independence from any parties involved in the programme. An allowance for carrying out the survey has been included in DCC's non-staff costs.
78. Communication of the satisfaction results with industry should be conducted on an annual basis, aggregating survey results to date into a consolidated report. Both DCC and Ofgem should have the opportunity to discuss and challenge the analysis prior to the results being shared with industry.

Changes to incentive

79. Proposed changes to this incentive by either Ofgem or DCC should be submitted into the wider programme change process, in line with the arrangements outlined for the time-based incentive.

Assumptions

80. DCC has not identified any further assumptions in addition to those relating to the time-based incentive.

1.9 Nature of role (risk)

81. Whilst commercial expectations are the overriding factor in setting the proposed rate of return, DCC has also considered the risk associated with our activities during the Transitional Phase of the Switching Programme, based on the currently defined scope.
82. The risks that DCC faces are described under five categories. These are consistent with the risk categories set out in the DCC Risk Management Strategy⁶ which are:
- Programme risk
 - Economic risk
 - Regulatory risk
 - Reputational risk
 - Operational risk.
83. DCC recognises that during the Transitional Phase it does not face the risks that would be associated with an ex ante price control regime. However, there are a number of significant risks that DCC faces that have been taken into account in setting the proposed rate of return (in addition to the factors set out in the Commercial Expectations section). The risks that DCC faces are described in Table 3.

Risk category	Description	Mitigation
Programme	<ul style="list-style-type: none"> ▪ Risk of scope change and/or delivery complexity that is greater than anticipated resulting in changes to DCC's baselined plan and budget. This may have an impact on DCC's ability to recover the costs of additional activities. ▪ Risk of changes to the plan that are beyond DCC's control, which may have an impact on DCC's ability to meet the incentivised milestones and recover the margin associated with them. ▪ Absence of documented Ofgem Switching Programme governance and control processes increases 	<ul style="list-style-type: none"> ▪ Continued engagement with Ofgem Switching Programme workstreams ▪ Proposal for adjustment mechanism

⁶ DCC, 'DCC Risk Management Strategy', 19 December 2013:
https://www.smartdcc.co.uk/media/91857/risk_management_strategy_december_2013.pdf

Risk category	Description	Mitigation
	<p>DCC's uncertainty over its ability to deliver against its baselined plan and budget</p>	
Economic	<ul style="list-style-type: none"> ▪ Risk of cost disallowance through annual ex post price control. DCC has produced the DCC Switching Business Case in good faith based on a set of requirements that are currently under development and based on a number of assumptions. As Ofgem does not formally approve the DCC Switching Business Case, there is a risk that DCC's plans are not based on a full and complete set of requirements, which may have an impact on DCC's ability to recover costs ▪ Risk of losing margin if DCC misses incentivised milestones where the incentive mechanism does not recognize activities beyond DCC's control or is not responsive to a fluid set of programme requirements 	<ul style="list-style-type: none"> ▪ Regular regulatory reporting required by ex post plus price control arrangement should mitigate the risk of cost escalation through a misinterpretation of requirements and subsequent cost disallowance as this provides an opportunity for Ofgem to raise any concerns as they arise ▪ We will continue to work closely with Ofgem to develop the detail underpinning a challenging but achievable incentive regime ▪ Ofgem and DCC to manage milestones and dependencies against a jointly agreed programme plan
Regulatory	<ul style="list-style-type: none"> ▪ Risk of enforcement proceedings due to DCC failing to meet Ofgem's delivery expectations; this risk increases where there is increasing complexity and interdependency between various parties and workstreams and where Licence obligations are open to interpretation 	<ul style="list-style-type: none"> ▪ The likelihood of DCC not meeting its obligations is slim. We have mitigated this risk through ensuring traceability of requirements within the DCC Switching Business Case and regular dialogue with Ofgem to validate our interpretation of deliverables and plan
Reputational	<ul style="list-style-type: none"> ▪ The Switching Programme is a national, government mandated programme in the public eye. The switching process is critical to the operation of the competitive energy retail market. ▪ The reputational risk associated with DCC's activities increases as DCC takes on increased accountability in Ofgem's Switching Programme. The potential impact 	<ul style="list-style-type: none"> ▪ Continued engagement with programme workstreams

Risk category	Description	Mitigation
	<p>on stakeholder perceptions of DCC may impact Capita's ability to secure other contracts to deliver national programmes</p> <ul style="list-style-type: none"> ▪ The time-based incentives may encourage DCC to prioritise time over quality and lead to missed opportunities to improve quality and reduce time and cost in later phases of the programme. This may result in negative stakeholder perceptions that adversely impact Capita's ability to secure other contracts to deliver national programmes 	
Operational	n/a	n/a

Table 3 - DCC risk profile of the Transitional Phase of the Switching Programme

Appendix G – Assessment of potential incentives

84. DCC identified a number of potential incentives that could potentially be applied to DCC's involvement during the Transitional Phase of the Switching Programme. These are:
- Number of bidders
 - DCC participation in workstreams
 - DCC Switching Business Case quality
 - General product quality
 - Stakeholder engagement
 - Product timeliness
 - Time taken to transpose solution into technical specifications
 - Variance to DCC Switching Business Case forecasts / materiality thresholds.
85. We have assessed each potential incentive against the principles set out above. The summary of the assessment is set out below.
86. The points made in bold reflect a higher level of risk associated with a particular principle.

Number of bidders

87. Description of incentive: DCC is incentivised to attract a minimum number of companies to bid for the contract, who are key players in their field.

Principle	Positive or negative alignment to principle?	Rationale
No duplication	Neutral	<p>This does not directly duplicate any existing rewards or penalties</p> <p>However, DCC can already have uneconomic and inefficient costs disallowed through its annual price control which means it is incentivised to ensure it secures pricing from an appropriate number of suppliers</p> <p>DCC also has a natural incentive to deliver a high quality procurement as it will be responsible for delivering the CRS solution and will want to ensure that it does so successfully to demonstrates its ability to deliver new areas of work</p>
Encourage behaviour	Positive	<p>This incentive would encourage DCC to engage with a certain number of bidders.</p> <p>A larger bidder market should encourage lower</p>

Principle	Positive or negative alignment to principle?	Rationale
		supplier prices and higher quality outcome of the procurement
Proportionate	Negative	The cost of establishing and maintaining the incentive is likely to outweigh any benefit
Capable of being measured	Positive	Measuring the number of bidders is objective. The measurement should also take into account a pre-qualification assessment to ensure bidders are suitably qualified
Quantified limits	Positive	The limits of risk and reward can be easily applied by setting the bounds of the number of bidders i.e. a minimum and maximum. However, there may be some challenges in identifying the appropriate target number of bidders
Upside	Positive	Can apply rewards as well as risk e.g. above a certain number of bidders could be upside
Perverse incentives	Negative	This places excessive focus on the number of bidders, instead of the quality of the procurement process Diminishing marginal returns on the engagement of additional bidders – the costs of additional DCC procurement resource and upside incentives may outweigh the benefit of lower bidder prices
Reasonable control	Negative	DCC can only encourage suitably qualified bidders to bid for CRS, but cannot compel potential suppliers to bid. Dependent on the chosen solution, there may be such a small number of suitably qualified bidders that the minimum number of bidders is unachievable

Table 4 – Assessment of incentive for number of bidders

88. Because of the perverse incentives and lack of reasonable control, DCC considers that applying an incentive arrangement to this area would not be effective.

DCC participation in workstreams

89. Description of incentive: DCC is incentivised to participate to a specified quality level in Ofgem-led Switching workstreams.

Principle	Positive or negative alignment to principle?	Rationale
No duplication	Neutral	As a commercial organisation, DCC already has a strong commitment to its stakeholders with reputational incentives to achieve high levels of stakeholder satisfaction

Principle	Positive or negative alignment to principle?	Rationale
Encourage behaviour	Neutral	This incentive would encourage proactive participation in workstreams, ensuring DCC attendance and contribution; however there is unlikely to be a significant impact in addition to the existing commitment to stakeholders. This is not directly linked to achieving core Switching Programme outcomes.
Proportionate	Negative	The cost of establishing and maintaining the incentive (i.e. the cost of designing, running and analysing a survey) is likely to outweigh any benefit
Capable of being measured	Negative	Quality of participation is very difficult to measure objectively, therefore establishing parameters and measuring performance would be challenging
Quantified limits	Negative	It would be difficult to set limits for risk/reward due to the subjective nature of the assessments
Upside	Negative	It would be difficult to apply upside due to the subjective nature of the assessments
Perverse incentives	Negative	Good programme delivery does not always equate to satisfied stakeholders. For example, it may be in the interests of the programme for DCC to challenge vested interests in relation to the current arrangements or to challenge the quality of the design work carried out by other parties, where doing so results in a more robust design that better meets the objectives of the programme
Reasonable control	Positive	DCC would be in control of its participation in the programme and can plan accordingly

Table 5 - Assessment of incentive for DCC participation in workstreams

90. Because of the number of negative impacts, DCC considers that applying an incentive arrangement to this area would not be effective.

DCC Switching Business Case quality

91. Description of incentive: DCC is incentivised to produce a DCC Switching Business Case to a specified quality level.

Principle	Positive or negative alignment to principle?	Rationale
No duplication	Negative	The quality of the DCC Switching Business Case is already fully scrutinised under ex post plus price control arrangements and Switching Programme governance In addition, there is a natural existing incentive to develop a high quality DCC Switching Business Case as DCC wishes demonstrate

Principle	Positive or negative alignment to principle?	Rationale
		quality delivery in order to secure future work
Encourage behaviour	Neutral	Whilst it may incentivise a high quality DCC Switching Business Case document, which is an important enabler for the programme, this does not target the key outcome of successful Switching Programme delivery which can only apply to the DBT and Live Operations phases
Proportionate	Negative	An incentive value linked to the quality of the DCC Switching Business Case (a relatively immaterial cost) will not be proportionate to the cost of implementing the incentive
Capable of being measured	Negative	Quality is difficult to measure objectively, therefore establishing parameters and measuring performance would be challenging. This would require Ofgem to issue clear guidance on what constitutes high quality. Quality could mean that the business case is well reasoned.
Quantified limits	Negative	It would be difficult to set limits for risk/reward due to the subjective nature of the assessments
Upside	Negative	It would be difficult to apply upside due to the subjective nature of the assessments
Perverse incentives	Positive	DCC Switching Business Case quality does not carry any risk of perverse incentives
Reasonable control	Positive	The quality of the DCC Switching Business Case is within DCC's control

Table 6 - Assessment of incentive for DCC Switching Business Case quality

92. Because of the duplication with ex post plus governance arrangements and the lack of any other compelling positive case, DCC considers that applying an incentive arrangement to this area would not be effective.

General product quality

93. Description of incentive: DCC is incentivised to deliver its products to a specified quality level to minimise the number of reviews.

Principle	Positive or negative alignment to principle?	Rationale
No duplication	Neutral	This does not directly duplicate any existing rewards or penalties However, there is a natural incentive to do this already as DCC wishes demonstrate quality delivery in order to secure future work
Encourage behaviour	Positive	This should incentivise quality products, which are the foundation of the programme, therefore this

Principle	Positive or negative alignment to principle?	Rationale
		should be aligned to the right outcomes It should also ensure that products are on track to support wider Switching Programme milestones e.g. ready for planned consultation dates
Proportionate	Negative	The cost of establishing and maintaining the incentive is likely to outweigh any benefit
Capable of being measured	Negative	Measuring the number of required reviews would be easy to measure, however, the quality measure would be more subjective. This would require Ofgem to issue guidance on what constitutes high quality The scope of all the products and activities for the Transitional Phase is not yet clear so it would be difficult to set the incentives in advance.
Quantified limits	Neutral	Easy to set limits for risk/reward based on the number of review cycles for products It would be difficult to set limits for risk/reward for the subjective nature of the assessments
Upside	Neutral	Easy to apply upside to a desirable level maximum number of review cycles for products It would be difficult to apply upside due to the subjective nature of the assessments
Perverse incentives	Negative	DCC may be incentivised to withhold products from Ofgem until they are complete, reducing the early visibility of Ofgem to key thinking with which it may not agree. The failure to surface these debates quickly could result in nugatory work and delays to the overall Switching Programme
Reasonable control	Negative	Whilst DCC is in control of the products it is allocated, it is not in control of the Ofgem review process and how reviewer's interpret the acceptance criteria for products There are also dependencies on Ofgem for information to allow the completion of products to a satisfactory level

Table 7 - Assessment of incentive for general product quality

94. Because of the overriding number of negative impacts, DCC considers that applying an incentive arrangement to this area would not be effective.

Stakeholder engagement

95. Description of incentive: DCC is incentivised to engage with its stakeholders at the right time and in an effective manner.

Principle	Positive or negative alignment to principle?	Rationale
No duplication	Neutral	As a commercial organisation, DCC already has a strong commitment to its stakeholders with reputational incentives to achieve high levels of stakeholder satisfaction However, DCC is already required to engage with stakeholders under ex post plus price control reporting arrangements and Switching Programme governance e.g. design teams and user groups
Encourage behaviour	Neutral	This would encourage the collaborative and consultative behaviour desired by Ofgem. However, this does not directly target the key outcome of successful Switching Programme delivery
Proportionate	Negative	The cost of establishing and maintaining the incentive (i.e. the cost of designing, running and analysing a survey) is likely to outweigh any benefit
Capable of being measured	Negative	Quality of participation is very difficult to measure objectively, therefore establishing parameters and measuring performance would be challenging. The measurement of effectiveness will be subjective and parties may have vested interests around what they judge as effective engagement
Quantified limits	Negative	It would be difficult to set limits for risk/reward for the subjective nature of the assessments
Upside	Negative	It would be difficult to apply upside due to the subjective nature of the assessments
Perverse incentives	Positive	Good programme delivery does not always equate to satisfied stakeholders. For example, it may be in the interests of the programme for DCC to challenge vested interests in relation to the current arrangements or to challenge the quality of the design work carried out by other parties, where doing so results in a more robust design that better meets the objectives of the programme
Reasonable control	Negative	Ofgem controls the forums which DCC has with stakeholders for the Switching Programme

Table 8 - Assessment of incentive for stakeholder engagement

96. Because of the subjective nature of measuring DCC's effectiveness, the vested interests of assessing parties and the lack of any compelling other reasons, DCC considers that applying an incentive arrangement to this area would not be appropriate.

Product timeliness

97. Description of incentive: DCC is incentivised to deliver DCC products, for example impact assessments to time and to agreed quality standards (acceptance criteria).

Principle	Positive or negative alignment to principle?	Rationale
No duplication	Neutral	<p>This does not duplicate any existing rewards or penalties.</p> <p>However DCC has existing obligations in its licence to carry out its activities in support of the Switching Programme in a timely manner</p> <p>There is also a natural incentive for DCC to demonstrate timely delivery in order to secure future work</p>
Encourage behaviour	Neutral	<p>As long as minimum quality levels could be defined, the timely delivery of DCC products would support the timely delivery of the Switching Programme</p> <p>Difficult to target programme critical tasks, as the overarching Switching programme plan is not sufficiently detailed and stable to define the critical path activities. There would be no tangible benefit to incentivising accelerated delivery of activities which are not on the critical path</p>
Proportionate	Negative	<p>The cost of establishing and maintaining the incentive may outweigh any benefit. The associated requirement for close management of dependencies is likely to require additional management overhead, particularly in relation to defining acceptance criteria, managing change and determining the root cause of any delays.</p>
Capable of being measured	Negative	<p>Time of delivery of a product would be easy to measure, although measurement of quality would be more subjective. However, the overarching Switching programme plan is not sufficiently detailed and stable to define the critical path activities, therefore it is not possible to identify definitively which milestones would be suitable candidates for incentivisation</p>
Quantified limits	Positive	<p>It would be possible to apply limits of risk/reward e.g. setting bounds of time</p>
Upside	Positive	<p>It would be possible to apply rewards as well as risk e.g. if earlier there is upside</p> <p>However, this may exacerbate the potential perverse incentives</p>
Perverse incentives	Negative	<p>This incentive may encourage DCC to be overly cautious in its planning to reduce the risk of late delivery, which may result in longer delivery timescales</p> <p>This incentive may encourage DCC to make compromises in the procurement approach it plans to adopt such that it prioritises faster delivery over depth or breadth of competition, which may not support the best interests of the programme</p>
Reasonable control	Negative	<p>Many products will be dependent on timely Ofgem and industry stakeholders input. The associated requirement for close management of those dependencies is likely to require additional management overhead, particularly in relation to</p>

Principle	Positive or negative alignment to principle?	Rationale
		defining acceptance criteria, managing change and determining the root cause of any delays. Changes to the scope of a product will affect the timing of its delivery

Table 9 - Assessment of incentive for product timeliness

98. Because of the number of negative impacts and the key perverse incentive impact, DCC considers that applying an incentive arrangement to this area would not be effective.

Time taken to transpose solution into technical specifications

99. Description of incentive: DCC is incentivised to transpose the solution into technical specifications to time based on a specified quality level.

Principle	Positive or negative alignment to principle?	Rationale
No duplication	Neutral	This does not duplicate any existing rewards or penalties. However DCC has existing obligations in its licence to carry out its activities in support of the Switching Programme in a timely manner There is also a natural incentive for DCC to demonstrate timely delivery in order to secure future work
Encourage behaviour	Neutral	As long as minimum quality levels could be defined, the timely delivery of DCC products would support the timely delivery of the Switching Programme Difficult to target programme critical tasks, as there is no detailed programme plan (and resulting critical path) for the Transitional Phase. There would be no tangible benefit to incentivising accelerated delivery of activities which are not on the critical path
Proportionate	Negative	The effort associated with managing target delivery dates may be disproportionate to the level of benefit. The associated requirement for close management of dependencies is likely to require additional management overhead, particularly in relation to defining acceptance criteria, managing change and determining the root cause of any delays.
Capable of being measured	Negative	Time of delivery of a product would be easy to measure, although measurement of quality would be more subjective However, the overarching Switching programme plan is not sufficiently detailed and stable to define the critical path activities, therefore it is not possible to identify definitively which milestones would be

Principle	Positive or negative alignment to principle?	Rationale
		suitable candidates for incentivisation
Quantified limits	Positive	It would be possible to apply limits of risk/reward e.g. setting bounds of time
Upside	Positive	It would be possible to apply rewards as well as risk e.g. if earlier there is upside However, this may exacerbate the potential perverse incentives
Perverse incentives	Negative	By focusing on the time of delivery to a minimum quality level it might encourage DCC to do the minimum required and focus on speed rather than quality, which could have a negative impact on the overall Switching Programme objectives. This incentive may encourage DCC to be overly cautious in its planning to reduce the risk of late delivery, which may result in longer delivery timescales
Reasonable control	Negative	Changes to, or gaps within, the solution will affect timing. Many elements of the solution will not be produced by DCC and so will be beyond DCC's control The associated requirement for close management of those dependencies is likely to require additional management overhead, particularly in relation to defining acceptance criteria, managing change and determining the root cause of any delays

Table 10 - Assessment of incentive for time taken to transpose solution into technical specifications

100. Because of the number of negative impacts and the key perverse incentive impact, DCC considers that applying an incentive arrangement to this area would not be effective.

Variance to DCC Switching Business Case forecasts / materiality thresholds

101. Description of incentive: DCC is incentivised to ensure incurred spend is in line with its forecasts as set out in the DCC Switching Business Case.

Principle	Positive or negative alignment to principle?	Rationale
No duplication	Negative	The existing scrutiny and potential disallowance of costs through the ex post price control regime acts as a disincentive for unjustifiable spend An existing penalty interest regime on over recovery of DCC costs already exists to prevent

Principle	Positive or negative alignment to principle?	Rationale
		over forecasting
Encourage behaviour	Positive	This would further encourage DCC to accurately estimate its costs and to manage within that estimate, which would encourage behaviour in line with a target programme outcome of on-budget delivery
Proportionate	Negative	Additional incentives in this area would be disproportionate given the existing price control regime
Capable of being measured	Positive	Variance from forecast costs will be reported on as part of the ex post plus price control arrangements for this DCC Switching Business Case
Quantified limits	Positive	The limits to incentives could easily be implemented through the use of variation tolerance bands
Upside	Positive	An upside incentive could easily be applied using a variance tolerance which DCC should keep within
Perverse incentives	Negative	The focus on delivery against the forecast might disincentivise DCC from proactively identifying additional activities that would support the achievement of the core Switching Programme objectives, or from identifying additional savings
Reasonable control	Positive	DCC is in control of its cost base, where this is strictly tied to a fixed scope of work Where DCC is a participant in Ofgem-led activity, scope change would lead to cost base movement outside of DCC's reasonable control. There would therefore need to be protective measures put in place to recognise this lack of control

Table 11 - Assessment of incentive for variance to DCC Switching Business Case forecasts / materiality thresholds

102. Because of the significant negative impact of the existing ex post price control disincentives for DCC to either over recover or overspend, DCC considers that applying an incentive arrangement to this area would not be effective.