

# Draft direction on margin and incentives for DCC's role within the Transitional Phase of the Switching Programme

## Consultation

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### Overview:

This document sets out the proposed margin that the Data Communication Company (DCC) can expect in relation to its role within the Transitional Phase of the Switching Programme. We propose that DCC's margin is set as a fixed percentage for the duration of the Transitional Phase of the programme. We propose and seek your views on a methodology for determining the level of margin, including appropriate comparators. Our initial analysis suggests a margin range, commensurate to the degree of associated risk, of 8%-12%.

The allowed margin will be specified within the Centralised Registration Service Performance Adjustment (CRSPA) term in DCC's licence. The proposed margin will be commensurate to the degree of associated risk. An incentives framework will be incorporated to mimic competitive pressures and encourage behaviour that supports the delivery of the broader programme.

The document also sets out the proposed framework for a time-based incentive which places DCC's margin at risk and we invite views on the appropriateness of the incentive and the activities it relates to.

The DCC, service users, customers and their representatives and other interested parties should read this document.

## Context

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The Switching Programme aims to improve customers' experience of switching, leading to greater engagement in the retail energy market, by designing and implementing a new switching process that is reliable, fast and cost-effective. In turn, this will build consumer confidence and facilitate competition, delivering better outcomes for consumers.

Smart DCC Limited (the Data and Communications Company (DCC)) is a central communications body appointed to manage communications and data transfer for smart metering. The Department for Business, Energy and Industrial Strategy ('BEIS'), formerly the Department for Energy and Climate Change ('DECC') granted DCC the Smart Meter Communication Licence<sup>1</sup> ("the licence") on 23 September 2013.

Following consultation in December 2015 DCC's licence was modified in May 2016<sup>1</sup> to give DCC new obligations and set out the funding arrangements for its role in the Switching Programme. Our May 2016 decision document also set out that DCC can reasonably expect a margin for its Switching Programme activities which are commensurate with the degree of associated risk. We anticipate that a margin allowance will be incorporated within DCC's allowed and regulated revenues via a direction specifying the Centralised Registration Service Performance Adjustment ('CRSPA') term within the licence.

## Associated documents

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Consultation on the draft DCC business case for DCC activities during the Transitional Phase of the Switching programme. Ofgem, 24 November 2016

<https://www.ofgem.gov.uk/publications-and-updates/draft-dcc-business-case-dcc-activities-during-transitional-phase-switching-programme>

DCC Price Control Consultation: Regulatory Year 2015/16. Ofgem, 17 November 2016


[https://www.ofgem.gov.uk/system/files/docs/2016/11/dcc\\_1516\\_price\\_control\\_consultation\\_2.pdf](https://www.ofgem.gov.uk/system/files/docs/2016/11/dcc_1516_price_control_consultation_2.pdf)

Decision: DCC's role in developing a Centralised Registration Service. Ofgem, 17 May 2016

<https://www.ofgem.gov.uk/publications-and-updates/decision-dccs-role-developing-centralised-registration-service>

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<sup>1</sup> Decision: DCC's role in developing a Centralised Registration Service. Ofgem, 17 May 2016  
<https://www.ofgem.gov.uk/publications-and-updates/decision-dccs-role-developing-centralised-registration-service>



Draft direction on margin and incentives for DCC's role within the Transitional Phase of the Switching Programme

DCC Price control Decision document 2014/15. Ofgem, 25 Feb 2016

<https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-decision-regulatory-year-201415>

DCC's role in developing a Central Registration Service and penalty interest rate proposals. Ofgem, 28 July 2015

<https://www.ofgem.gov.uk/publications-and-updates/dccs-role-developing-central-registration-service-and-penalty-interest-rate-proposals>

Moving to reliable and fast switching: updated Target Operating Model and Delivery Approach: Decision. Ofgem, 17 November 2015

<https://www.ofgem.gov.uk/publications-and-updates/moving-reliable-and-fast-switching-updated-target-operating-model-and-delivery-approach>

Moving to reliable next-day switching: Decision. Ofgem, 10 Feb 2015

<https://www.ofgem.gov.uk/publications-and-updates/decision-moving-reliable-next-day-switching>

Switching Programme – Blueprint phase: Commercial Workstream: Draft Terms of Reference

[https://www.ofgem.gov.uk/system/files/docs/2016/06/tor\\_cws\\_updated.pdf](https://www.ofgem.gov.uk/system/files/docs/2016/06/tor_cws_updated.pdf)

Smart Meter Communication Licence

<https://epr.ofgem.gov.uk/Document>

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## Executive Summary

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Ofgem is leading a programme to deliver reliable and faster switching arrangements underpinned by a new Centralised Registration Service (CRS)<sup>2</sup>. We expect DCC to have a crucial role in developing the new registration and switching arrangements<sup>3</sup>, including the procurement of the CRS.

This document sets out our proposal for DCC’s allowed margin as part of the price control regime for its role during the Transitional Phase of the Switching Programme.<sup>4</sup>

Ofgem anticipate that the Transitional Phase of the Switching Programme will run to 2018/2019 with the possibility to extend to 2019/2020 and the margin direction will relate to costs incurred from 2016/2017. The margin awarded to DCC will be recovered through charges in effect from April 2017 onwards.

Price control arrangements restrict DCC’s revenues, to counter its monopoly position. Under its licence DCC has to submit cost, revenue, and incentive reporting to the Gas and Electricity Markets Authority (the Authority).

### Proposal summary

Ofgem’s proposed margin that DCC can expect to earn in relation to its role within the Transitional Phase of the Switching Programme is made up of an appropriate margin and an incentives package that places margin at risk. A draft of the direction specifying the Centralised Registration Service Performance Adjustment (‘CRSPA’) term is included within this document.

### Margin

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<sup>2</sup> The ‘switching arrangements’ are the processes by which a consumer switches from one gas or electricity supplier to another.

<sup>3</sup> “Transitional phase” refers to the Blueprint, Detailed Level Specification, and Enactment phases of the Switching Programme.

<sup>4</sup> The Office of the Gas and Electricity Markets Authority (Ofgem) supports the Gas and Electricity Markets Authority (‘the Authority’) in its day to day work. In this document, ‘us/we’, ‘Ofgem’ and ‘Authority’ are often used interchangeably.

We propose that DCC's margin be a fixed percentage set for the duration of the Transitional Phase and applied to DCC's Internal Costs. We do not propose to include an adjustment mechanism for this fixed percentage margin. Our initial analysis suggests a margin range of 8-12%. The final margin figure will be determined based on the sales margin methodology outlined.

Taking on board suggestions for comparators from this consultation and expanding on our initial work, we will determine the margin value to include within our direction on margin and incentives in February 2017.

### **Incentives**

We propose that DCC's margin be placed at risk based on its ability to achieve certain Delivery Milestones to a required quality by a set date. We further propose to monitor stakeholder satisfaction via a 6-monthly survey, however we do not intend to place margin at risk based on stakeholder feedback at this stage in the programme as we believe reputational risk to be a sufficient driver. We propose, if appropriate, to use the information gathered during the Transitional Phase to act as a baseline to introduce a satisfaction / performance based financially linked incentive during later phases of the programme.

### **Next steps**

We welcome views on this consultation and in particular in relation to the questions outlined with this document. We will take into consideration all comments received in making our final decision on an appropriate margin for DCC. This will be made in our final direction and decision document in February 2017.

Please send responses to [switchingprogramme@ofgem.gov.uk](mailto:switchingprogramme@ofgem.gov.uk) by 12 January 2017.

# 1. Introduction

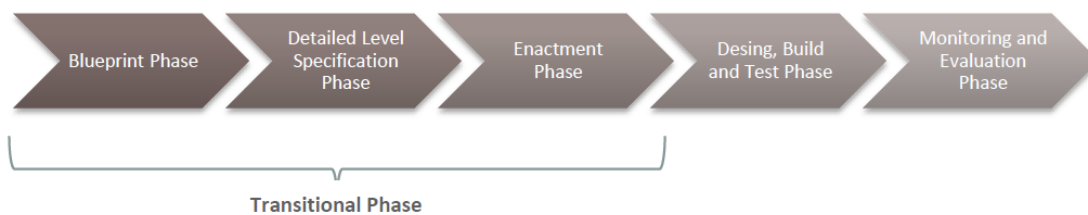
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## Programme background

1.1. The Switching Programme aims to deliver reliable and fast switching for consumers on a new Centralised Registration Service (CRS). Data and Communications Company (DCC) is required by the Smart Meter Communication Licence<sup>5</sup> ('the licence') to make all relevant preparations to procure the CRS<sup>6</sup>.

1.2. We have identified five phases for the Switching Programme. This document covers the margin and incentive proposals relating to DCC's activity during the first three phases we refer to collectively as the "Transitional Phase". This takes the programme to the point of Centralised Registration Service contract signature. See figure 1 below.

**Figure 1: Phases for the Switching Programme<sup>7</sup>**



1.3. As the procuring body for the new CRS, DCC has a clear role in helping design and define the specifications and supporting the design of the end-to-end switching arrangements for the new service. It will also contribute with Ofgem and industry stakeholders to the development of the price control and charging arrangements for implementing and operating the new service, as part of our Commercial Workstream.

1.4. Our May 2016<sup>8</sup> document on DCC's role in developing the CRS set out DCC's new obligations and the funding arrangements for its role in the Switching Programme. That document also set out that DCC can reasonably expect a margin for its Switching Programme activities which is commensurate with the degree of associated risk. In the same document we described our decision to modify DCC's

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<sup>5</sup> The Smart Meter Communication Licences granted pursuant to Sections 7AB (2) and (4) of the Electricity Act 1989 and Sections 6(1A) and (1C) of the Gas Act 1986. Those licences are together referred to as 'the licence' throughout this document

<sup>6</sup> Appendix A: Requirements Traceability Matrix of the draft DCC Business Case

<sup>7</sup> Figure is illustrative aspects of the Transitional Phase can run in parallel

<sup>8</sup> Decision: DCC's role in developing a Centralised Registration Service. Ofgem, 17 May 2016  
<https://www.ofgem.gov.uk/publications-and-updates/decision-dccs-role-developing-centralised-registration-service>

licence to include a performance adjustment term, providing DCC with a margin allowance - including any adjustment to margin for any outcome-based delivery incentives. This term would be set by direction (published in draft alongside this document). We also indicated that the direction would specify any such delivery incentives.

### **Commercial workstream**

1.5. The objective of the Commercial Workstream (CWS) is to develop proposals for how the new CRS run by the DCC will be charged for, funded and procured. The workstream covers price control and procurement activities.

1.6. The workstream has worked to support the development of the principles used to determine the margin allowance and delivery incentives for DCC during the Transitional Phase. The commercial workstream has also developed the principles and approach for the Draft DCC Business Case for DCC activities during the Transitional Phase of the Switching Programme ('the DCC Business Case'). The DCC Business Case has been developed by DCC as part of the commercial workstream and is being consulted on in parallel to this document. As part of the Business Case DCC has outlined their proposal on margin and incentives and these sections are provided within this document as Appendices 2 and 3.

1.7. The Commercial Workstream consists of:

- Design Teams<sup>9</sup> made up of Ofgem, DCC and external subject matter experts. The price control design team has iterated the DCC Business Case, developed the incentives proposal and outlined the principles for DCC's margin
- Ofgem Peer Review Group made up of a selection of subject matter experts within Ofgem with whom principles and approaches can be tested
- Commercial User Group made up of representatives from Ofgem, the industry, consumer representatives and other subject matter experts who review proposals and provide guidance on appropriate approaches.

### **Data Communications Company (DCC)**

1.8. DCC is a central communications body licensed to provide the smart metering communication service for smart metering. It is responsible for providing the data communications service that links smart meters in homes and small businesses with the systems of energy suppliers, network operators and other companies.

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<sup>9</sup> Covering price control and procurement. This document relates to price control design team work



1.9. BEIS granted the licence to DCC on 23 September 2013 following a licence competition. The Licence is for 12 years and will remain in place until 22 September 2025, unless it is extended or revoked. BEIS also established price control arrangements that restrict DCC's revenues, to counter its monopoly position.

1.10. The May 2016<sup>7</sup> document also set out our intention for DCC's price control framework for its switching/CRS activities to operate under an ex post plus regime. This approach, which we have agreed with DCC, involves additional reporting from DCC and enables earlier review of proposed costs and activities. Under the ex-post plus approach, DCC will set out its planned activities in a published business case which will be used as a baseline for DCC to justify costs against through its annual ex post price control submission. It will also report regularly throughout each regulatory year. Our final decision on DCC's acceptable costs will remain ex-post. A similar approach was used successfully for National Grid Electricity Transmission (NGET) to fund its development work for its Electricity Market Reform (EMR) delivery role.

## Context

### Margin

1.11. The licence awarded to DCC for managing the communications and data transfer for smart metering (the Smart Meter Implementation Programme – 'SMIP') was the result of a tender process, organised by BEIS. Capita plc ('Capita'), DCC's parent company, successfully bid to earn a defined margin which was subject to meeting certain Implementation Milestones and an operational incentive regime once operational services began. The defined margin was calculated on the basis of a 15% rate of return applied to baseline Internal Costs as set out in DCC's Licence Application Business Plan (LABP). DCC's activities relating to the Switching Programme and the CRS were not within the scope of the licence at bid. The CRSPA term was added to the licence as a mechanism to adjust DCC's allowed revenue to incentivise delivery against its obligations under the Switching Programme.

1.12. The margin as discussed in this document represents a return to Capita for the delivery and management of DCC's role during the Transitional Phase of the Switching Programme. The margin will be decided on and directed in February 2017 and will be recovered through DCC charges in effect from April 2017 onwards.

1.13. In our May 2016 decision document we set out our expectation that DCC's business case submission include details on "DCC's proposals for a margin allowance and delivery incentives, and the basis and justification for its proposals."<sup>10</sup> That document also set out that DCC can reasonably expect a margin for its Switching Programme activities which is commensurate with the degree of

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<sup>10</sup> *Ibid* Appendix 1, para 1.10

associated risk. DCC's costs, on which it will earn the margin, are subject to review by Ofgem to ensure they are economically and efficiently incurred.

1.14. The CRSPA term was introduced into DCC's licence as a mechanism to adjust DCC's allowed revenue. We intend to specify DCC's margin via direction of the CRSPA term and DCC will recover its regulated revenues based on this direction. A draft of the proposed direction is included in Appendix 2.

## **Incentives**

1.15. Well-designed incentives can be used to mimic competitive pressure for companies, such as DCC, which operate in a monopoly environment. Incentives should be used to help ensure DCC efficiently manages its costs whilst delivering on time to an appropriate quality of service. These should ultimately provide benefit to the consumer. We propose that the performance adjustment term within DCC's license places baseline margin at risk tied to meeting certain Delivery Milestones (DMs). These DMs have been set out by Ofgem and will be assessed by Ofgem as part of its determination of Allowed Revenue.

The key desired outcomes from applying incentives are to help ensure delivery of:

- quality procurement and support to the Switching Programme
- timely procurement and support to the Switching Programme
- economic and efficient procurement and support to the Switching Programme.

1.16. DCC's proposal for incentives has been included in Section 13 of the DCC Business Case and as Appendix 3 of this document. The DCC proposal on incentives has, in line with the expectation set out with the decision document, been informed and developed with Ofgem as part of the CWS using the joint Ofgem DCC Price Control Design Team and has taken on board feedback from the CWS User Group, External Design Advisory Group (EDAG) and Switching Programme Delivery Group.

1.17. The incentives outlined here will apply to the Transitional Phase of the Switching programme only and incentives for DCC's role during the Design, Build & Test and Live Operations phases of the Switching Programme will be set separately.

## 2. Proposal for DCC's margin

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### Chapter Summary

A number of principles were developed with DCC with which to assess an appropriate margin. DCC has proposed a margin consisting of 15% on Internal and External Costs for the length of the Transitional Phase with an adjustment mechanism. Although we agree with aspects of their methodology we do not agree with their final proposal.

We propose that DCC's margin be a fixed percentage set for the duration of the Transitional Phase and applied to DCC's Internal Costs. We do not propose to include an adjustment mechanism. Our initial analysis suggests a margin range of 8-12%, reflecting that the nature of the work is significantly different to DCC's smart metering activity. The subsequent chapter outlines further the methodology we intend to follow in determining the final margin value. The draft direction included in appendix 2 reflects our proposal.

### Margin principles

2.1. Ofgem has worked with DCC through a joint Price Control Design Team to agree principles to follow in developing a margin proposal. The principles established, and which were shared with the Commercial User Group, were that the margin should:

- reflect the level of risk to DCC relating to its role and responsibilities during the transitional phase of the Switching programme
- reflect the nature and expected market returns of the activities carried out by DCC and the specialist skills provided by DCC
- be calculated by applying DCC's marginal rate of return on economic and efficient costs
- be directed by Ofgem with consideration for the need for Ofgem or DCC to apply for an adjustment

### Ofgem perspectives on DCC Business Case proposal

2.2. In DCC's Business Case, a proposal is made for a margin fixed at 15% of Internal and External Costs<sup>11</sup> with an adjustment mechanism for the duration of the

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<sup>11</sup> Section 13.4 of the draft DCC Business Case

Transitional Phase of the Switching Programme. DCC views this to be in line with Capita's commercial expectations and the margin earned by benchmarked professional services comparators. DCC states these two factors provide the overriding rationale for their proposed margin and are of greater influence than the risk profile.

2.3. Although we agree with aspects of DCC's methodology we do not believe their margin proposal to be commensurate to the degree of associated risk. We outline below our review of DCC's proposal.

### **Capita's commercial expectations**

2.4. DCC provided evidence for Capita's commercial return expectations by reference to the 15% margin secured in the competitively tendered Smart Meter Communication Licence. DCC also reference the return expectation based on the opportunity cost which is set by Capita's own returns.

2.5. As already noted, Capita successfully bid for the Smart Meter Communication Licence with a defined margin that was calculated on the then expected Internal Costs set out in their Licence Application Business Plan. In their Switching Programme Business Case DCC states "this is the closest example of the competitively set commercial expectations of the parent company" (para 348). However, we believe that DCC's role and activities in SMIP are significantly different from those in the Switching Programme and are not directly comparable. For example, the risk profile and complexity in building a GB-wide integrated communications network with unrivalled coverage, including oversight of equipment in every consumer premise<sup>12</sup>, would be very different to that in the Transitional Phase of the Switching Programme.

2.6. As indicated above, the Switching Programme is, in general, less risky than SMIP (as acknowledged within the DCC commissioned report by Europe Economics<sup>13</sup>). The risks in relation to DCC's role in the Transitional Phase of the Switching Programme consist primarily of reputational risk. This is explored further in chapter 3. It is also likely to be less technically challenging based on the current assumptions for the solution as it is delivering a function that already exists. As outlined within the roles and responsibilities in Section 7 of our consultation on DCC's Business Case, DCC will be less reliant on parties out of its control for the delivery of the Transitional Phase.

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<sup>12</sup> DCC is responsible for providing the data communications services that link smart metering equipment in the home to the business systems of users. Apart from the Communications Hub, DCC is not responsible for the equipment itself.

<sup>13</sup> Europe Economics: Consultancy on Assessment of Rate of Return for Data Communication Company's Activities. Not publicly available.

2.7. DCC's internal margin benchmarking references Capita's reported operating margins as well as those of Capita's Digital and Software Solutions division. With operating margins for the former ranging from 13.4% to 14.2% over the last five years, and the latter being between 24.8% and 25% in the last two years. However, we note that DCC sits within Capita's Integrated Services division<sup>14</sup> which had an underlying operating margin of 11.3% (14.9%) in the 2015 (2014) financial year.

## External benchmarks

2.8. DCC provided external margin benchmarks from two sources: (1) DCC analysis intended to specifically align to Switching Programme activities; and (2) Europe Economics'<sup>15</sup> analysis which reflected DCC's activity as a whole (i.e. both SMIP and Switching Programme). We consider each of these external benchmarks below.

2.9. DCC's external margin benchmarking uses a range of firms from their Consultancy Services Framework, in order to align the margin to the "IT transformation professional services DCC is providing in the Transitional phase of the Switching Programme" (DCC Business Case, para 358). DCC's external benchmarking exercise led DCC to propose a 15% margin.

2.10. Some of the activities of these firms have similarities to DCC's role under the Switching Programme. They may, therefore, be suitable benchmarks but differences in risk profile, business model, company structure, asset composition, and sector focus should be recognised and accounted for in determining the appropriate margin.

2.11. In Europe Economics' assessment of DCC's margin which applies across both its Smart and Switching Programme activities, the companies chosen (TalkTalk Plc., PayPoint Plc., WorldPay Plc., Onecom Ltd. and Endava Ltd.) to benchmark a net margin for DCC are B2B or consumer contract businesses and do not represent regulated monopoly entities nor do they fulfil a role closely aligned to that of DCC during the Transitional Phase of the Switching Programme. Whilst we recognise elements of the margin based approach set out by Europe Economics ('EE'), the assessment of these benchmarks is based on the full scope of DCC's role for the full Switching Programme and not just the Transitional Phase.

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<sup>14</sup> CAPITA Plc. Annual Report and Accounts 2015. Available at: <http://investors.capita.com/reports-and-presentations/2015>

<sup>15</sup> Europe Economics: Consultancy on Assessment of Rate of Return for Data Communication Company's Activities. Not publicly available.

## Ofgem's proposal

### Margin characteristics

Percentage or absolute margin

2.12. Taking into consideration the uncertainties in programme costs and the exact scope of DCC's role within the Switching Programme we propose a fixed percentage value be applied for the Transitional Phase of the programme.

2.13. All other things being equal, our preference would be for a fixed absolute figure based on DCC's forecast Internal Costs. However, when considering the scope of DCC's work will remain uncertain until a decision is taken on the scope of the CRS in the second half of 2017 it would not be in the best interests of consumers to set an absolute value at this stage of the programme. Although an absolute value would ensure an upper bound there is a risk that DCC's role may have been over-scoped by Ofgem or the complexity of the chosen CRS solution may have been over estimated. Including an adjustment mechanism, as with the DCC's smart metering activities, could mitigate this uncertainty but would likely involve disproportionate work from Ofgem and DCC. As such, and considering cost and programme uncertainties, a fixed percentage will be more dynamic and allow for efficient programme delivery without the overhead of adjusting an absolute value. DCC's incurred costs will still be subject to economic and efficient price control review with regular reporting as part of the ex post plus regime. This is aimed to help ensure cost management.

2.14. The fixed percentage margin figure will be applied to the Transitional Phase of the Switching Programme. Based on Ofgem planning this is anticipated to relate to the regulatory years 2016/17 to 2018/19 (with possible extension into 2019/20).

2.15. For clarification, DCC's margin is calculated and applied as a margin value rather than as a 'mark-up' or return on costs. This reflects the chosen methodology for baselining DCC's margin i.e. the margin percentage value is relative to the gross revenue (Internal Costs + margin) for DCC's example of 15% margin this represents a return on costs of 17.65%. In relation to DCC's Internal Costs (excluding margin) the margin value will represent

### Equation 1: Margin and rate of return

$$\frac{\text{CRS Internal Costs}}{(1 - \% \text{ rate of return})} - \text{CRS Internal Costs}$$

2.16. The margin within DCC's licence is defined as the amount above the licensee's costs and therefore reflects a rate of return. The value used in the direction will reflect the percentage mark-up applied to DCC's Internal Costs.

#### Cost base

2.17. For clarification, the margin will apply to CRS Internal Costs (defined by the CRSIC term) only. We propose that DCC will not earn margin on External Costs. Internal Costs, as defined in the licence, would include external contractors and consultants. External Costs are defined as those relating to relevant Fundamental Service Providers e.g. the procured service provider for the delivery of the CRS. This replicates the arrangements between the DCC and its Fundamental Service Providers for smart metering.

#### Adjustment mechanism

2.18. As a fixed percentage value is being applied for the full Transitional Phase any changes in cost will result in a change in margin and, therefore, we do not see a requirement for an adjustment mechanism. Although the scope of DCC's role may change we do not anticipate a significant change in the nature of the role DCC plays or the risk it faces within the Switching Programme. Therefore a fixed percentage margin would be appropriate despite potential programme variations. If the scope of DCC's role were to change significantly it would result in DCC's business case being rebaselined, this is outlined further in section 12 of DCC's Business Case. The use of a fixed percentage and no adjustment mechanism will be in the best interests of efficient programme delivery and therefore represent best value to the consumer.

#### Margin range

2.19. We have carried out initial high-level analysis based on comparator sales margins<sup>16</sup> to conclude a range of figures that we believe the margin value should fall within. From this we conclude that an appropriate range for the margin value is 8-12% (return on costs of 8.7-13.6%). Based on the cost forecast outlined in DCC's Business Case this would represent absolute values of GBP 2.2-3.5m (gross cost to industry of approx. GBP 27.8-29.1m). Our supporting analysis is outlined in more detail in chapter 3.

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<sup>16</sup> This approach is consistent with the approach adopted for DCC's baseline margin adjustment for its role in SMIP in 2015/16. DCC Price Control Decision: Regulatory Year 2014/15: <https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-decision-regulatory-year-201415>

**Table 1: Margin values**

<b>Margin</b>	8.0%	9.0%	10.0%	11.0%	12.0%
<b>Rate of return</b>	8.7%	9.9%	11.1%	12.4%	13.6%
<b>Absolute margin value</b> (based on current DCC cost estimate) <sup>17</sup>	£2.2m	£2.5m	£2.8m	£3.2m	£3.5m

2.20. As both DCC's business and the programme itself are unique in character it is hard to objectively identify and justify comparators. Recognising this, we have outlined in chapter 3 our proposed approach to determine an appropriate margin for DCC. We would appreciate suggestions as to appropriate comparators and measures to use in determining DCC's margin.

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<sup>17</sup> Rate of return applied to DCC's base costs. For illustrative purposes the £ 25.6m as outlined in the draft DCC business case is used



## 3. Approach to determining DCC's margin

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### Chapter Summary

This chapter outlines potential methodologies to explore in setting our final proposal. From this we conclude that a return on sales methodology is most appropriate for DCC's role in the Switching Programme. It also outlines our initial qualitative analysis of DCC's risk profile and the high level analysis we have undertaken to reach the 8-12% margin range.

We will determine DCC's margin allowance based on the sales margin methodology outlined in detail below and seek input from industry for further appropriate comparators to consider. This approach is consistent with the approach adopted for DCC's baseline margin adjustment for its role in SMIP in 2015/16. Taking on board suggestions for comparators from this consultation and expanding on our initial work we will determine the margin value to include within our direction on margin and incentives in February 2017.

### Question box

**Question 1:** Do you agree with the proposed methodology for assessing DCC's margin, including the proposal to use EBT or net profit as the comparable measure? If not, please justify an alternative methodology.

**Question 2:** Do you agree with our proposed assessment of DCC's risk? If there are further aspects to this which you feel have not been covered, please specify.

**Question 3:** What further comparators would you suggest we use in establishing DCC's margin? Please justify any proposed comparators and the suitability of using their corresponding industry.

### Potential methodologies

3.1. In this section we outline and assess two potential approaches to setting an allowed rate of return for DCC's activities in the Transitional Phase of the Switching Programme – a return on assets approach and a return on sales approach.

#### Return on assets approach

3.2. Economic regulators are most commonly faced with the task of setting returns for network infrastructure companies. These companies, characterised by

economies of scale arising from fixed costs, are typically asset intensive. For such companies, regulators usually allow a return by applying a Weighted Average Cost of Capital (WACC) to an asset value.<sup>18</sup>

3.3. The WACCs set by UK regulators from 2013 to 2015 ranged from 3.44% (set in 2014 by the Utility Regulator in Northern Ireland for water and sewerage services) to 5.6% (set in 2014 by Ofcom for wholesale broadband access).<sup>19,20,21</sup>

3.4. The ability to apply a return on assets approach relies on being able to obtain an appropriate value for assets employed. This is not practical for DCC's Switching Programme activities as:

- there is no historical cost information on which to base a valuation of assets and we would be reliant on forecasts for future activities
- DCC is an asset light company.

3.5. In establishing asset values, an economic rather than accounting view should be used. One common difference between the two views is that certain (most particularly intangible) assets may not be included in the balance sheet. This is particularly relevant for asset light companies - as stated in the Competition and Market Authority (CMA)'s guidelines for market investigations<sup>22</sup>. In such cases, subject to certain criteria being met,<sup>23</sup> CMA states that it can be appropriate to add in such intangible assets. DCC does not have typical intangible assets which can be easily quantified. This is further complicated by a lack of historical information on DCC's activities.

3.6. In our February 2016 price control decision<sup>24</sup> for DCC's SMIP activities we noted the challenge of applying a return on capital approach to assessing DCC's return, in part because of its asset light nature. We envisage establishing an appropriate asset value for DCC's Switching Programme activities would be equally challenging.

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<sup>18</sup>The WACC is the opportunity cost of the investment, i.e. the rate of return an investor could make from investing the money elsewhere at the same risk.

<sup>19</sup> Chapter 3, <http://www.ukrn.org.uk/wp-content/uploads/2016/07/2016MarCoCAnnulUpdateReport.pdf>

<sup>20</sup> Note: Ofcom set a nominal, pre-tax WACC which UKRN converted to a real, vanilla WACC for the purposes of comparison.

<sup>21</sup> Both expressed as real vanilla WACCs

<sup>22</sup> Annex A, para 12,

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/284390/cc3\\_revised.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/284390/cc3_revised.pdf)

*"In industries with a relatively low level of tangible assets, such as service and knowledge-based industries, the book value of capital employed may bear little relationship to the economic value because of the presence of significant intangible assets."*

<sup>23</sup> Annex A, para 14, *ibid.*

<sup>24</sup> Para 6.8,

[https://www.ofgem.gov.uk/system/files/docs/2016/02/dcc\\_price\\_control\\_decision\\_req\\_year\\_1415.pdfv](https://www.ofgem.gov.uk/system/files/docs/2016/02/dcc_price_control_decision_req_year_1415.pdfv)

## Return on sales approach

3.7. Where regulators need to set a return for asset light activities (typically supply), a return on sales or margin approach is often used. This approach involves identifying several comparable companies or sectors and collecting either the actual margins achieved and /or the allowed margins set by their regulators. The similarities and differences in the risks of these comparator companies to the regulated entity can then be considered before using the collected margins to inform the decision on an appropriate return.

3.8. Recent examples of regulatory determinations using a sales margin approach include:

- Ofwat setting a net margin for retail services of 1% for households in England and for households and non-households in Wales, and of 2.5% for non-households in England.<sup>25</sup> These were informed by EBIT margins on a range of comparators compiled by their consultants.<sup>26</sup>
- Ofcom proposing a return on sales as more relevant than a return on capital for Royal Mail and proposed an EBIT range of 5% to 10% as appropriate in assessing medium term financial stability.<sup>27</sup>

3.9. The CMA also estimated margins (as well as return on capital employed) as part of its energy market investigation. CMA reported that annual EBIT margins on domestic supply averaged across the big six energy firms as between 0.0% and 4.5% in the period between FY07 and FY14.<sup>28</sup>

3.10. In our November 2015 price control consultation<sup>29</sup> for DCC's smart metering activities we proposed the use of a sales margin as the most appropriate measure of DCC's return. In that context,<sup>30</sup> we used the risks and margin of comparator companies, as well as DCC's expected margin, to inform consideration of the appropriate margin.

3.11. The ease of interpretation of a return on sales approach and the availability of data to apply the approach makes it useful in determining an appropriate return for an asset light company. As already noted, there is regulatory precedent for its use. As the risks are rarely identical, the margins of comparable companies do not provide a definitive, objective margin for the return of the regulated entity. A

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<sup>25</sup> A7.4.3.2, [http://www.ofwat.gov.uk/wp-content/uploads/2015/10/det\\_pr20141212riskreward.pdf](http://www.ofwat.gov.uk/wp-content/uploads/2015/10/det_pr20141212riskreward.pdf)

<sup>26</sup> [http://www.ofwat.gov.uk/wp-content/uploads/2014/01/rpt\\_com20140214pwcnetmargins.pdf](http://www.ofwat.gov.uk/wp-content/uploads/2014/01/rpt_com20140214pwcnetmargins.pdf)

<sup>27</sup> Para 5.25, [https://www.ofcom.org.uk/\\_data/assets/pdf\\_file/0029/74279/Securing-the-Universal-Postal-Service-statement.pdf](https://www.ofcom.org.uk/_data/assets/pdf_file/0029/74279/Securing-the-Universal-Postal-Service-statement.pdf)

<sup>28</sup> Table 5, <https://assets.publishing.service.gov.uk/media/576bcc46ed915d622c00007d/appendix-9-13-retail-profit-margin-comparators-fr.pdf>

<sup>29</sup> Para 6.21

[https://www.ofgem.gov.uk/sites/default/files/docs/dcc\\_price\\_control\\_consultation\\_regulatory\\_year\\_2014\\_15.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/dcc_price_control_consultation_regulatory_year_2014_15.pdf)

<sup>30</sup> The context was setting the adjustment to DCC's baseline margin, which requires us to have regard to the expected return on DCC's activities (Licence condition 36, Appendix 2, para A10).

reasoned judgement is still required as to the appropriate return. This judgement can be improved by an understanding of the difference in risks of the comparators and the regulated entity.

## Approach to setting the margin level

3.12. We propose to adopt a return on sales approach. We believe it is appropriate in the absence of a competitive process to take the approach of considering the appropriate margin in the context of the risks and margins of comparator companies. Below we set out the methodology used in determining an appropriate margin range and in the following section conduct an initial analysis based on these steps. We intend to apply these steps based on suggestions for appropriate comparators.

3.13. In developing this approach, we have taken into account the unique nature of DCC's ex post regulatory framework, and its limited fixed and intangible assets. We have also considered the definition of baseline margin in the licence as an amount above the licensee's costs i.e. reflecting a rate of return or mark up. We consider margin (or its earnings as a proportion of revenue) to be the most appropriate measure of DCC's return.

### Step 1. Describe and analyse DCC's risk.

3.14. The purpose of this step is to understand the risks faced by DCC in relation to its Switching Programme activities (to which the margin will be commensurate) and to support a qualitative analysis of the risks of comparator companies (see Step 4). Our initial qualitative consideration of DCC's risks is presented further below in this Chapter.

### Step 2. Identify potential comparators

3.15. We do not expect to find margin data for companies that are directly comparable to the activities DCC will be conducting under the Switching Programme. However, we do expect to identify comparators that have a number of the same characteristics as DCC. The more that a comparator has in common, the more reliance we would expect to place on it. A degree of judgement is still required in selecting the comparators and their significance in determining the margin. Key characteristics that we consider to be relevant include:

**Asset light:** DCC's Switching Programme activities are asset light, i.e. we expect DCC to require relatively few tangible assets in performing its activities. Accordingly, we have sought comparators that are also asset light.

**Scope of services:** DCC will be providing a range of services, covering professional services, contract management, procurement and ICT. Potential comparators provide similar services.

**Regulated activity:** DCC operates within the network infrastructure sector under a price control regime. We have sought to identify comparators that are subject to price controls and, where possible, have the same financial protections as DCC in infrastructure and non-infrastructure sectors. We have also considered potential non-regulated comparators in infrastructure sectors.

**Geography:** DCC Switching Programme activities are in relation to Great Britain (GB). Where possible comparators are GB based, or have significant activities in GB.

### Step 3. Collect benchmark data

3.16. Having identified potential comparators on the basis of having some common characteristics with DCC, we have collected margin data for these companies, along with background information to assess their comparability to DCC. Key areas to consider in determining the benchmark margins include:

#### *The appropriate measure for DCC's margin*

3.17. There are several potential measures of profit on which margins can be based, including Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA), Earnings Before Interest and Tax (EBIT) and net profit. As already noted, DCC's switching programme activities are asset light and therefore there would be little difference between the EBITDA and EBIT for these activities. However, some of the comparators companies may have proportionally more fixed assets, resulting in a greater difference between EBITDA and EBIT. The use of EBIT is preferable to EBITDA as this removes the effect of differences in asset levels. Paragraph 3.8 notes where EBIT margins have been used by other regulators.

3.18. The margin as paid to DCC is an income attributed to Capita without any further adjustment on DCC's side. In that sense, the margin made on the CRS Programme could be argued to represent an untainted monetary profit, compatible with the metrics as found on the lower lines of an income statement. Therefore we believe there is merit in exploring the use of Earnings before Tax (EBT) and net profit as potential measures.

**Table 2: Options for measuring DCC's margin**

Measure	Rational and considerations
EBIT margin	<ul style="list-style-type: none"> <li>EBIT is an established measure and as outlined above regulatory precedent exists for its use.</li> <li>This may not account for the finance provisions within the ex post plus regime that DCC sits under and the relationship between DCC and Capita.</li> </ul>

EBT margin	<ul style="list-style-type: none"> <li>• As DCC operates under an ex post price control regime the Switching Programme is not subject to the same costs of finance that other companies encounter. The difference between EBIT and EBT for the Switching Programme should be minimal.</li> <li>• Comparator companies are likely to rely on debt or other forms of finance with an associated cost of capital to deliver projects. This would suggest that DCC's margin for the Switching Programme is more aligned to the EBT measure on comparator income statements.</li> <li>• We have taken into consideration the parent indemnity provided to DCC as part of its financial stability and security obligations and the keep-well deed/revolving facility agreement. Any interest on the keep-well deed is a pass-through cost, and hence has no impact on DCC's EBIT or EBT.</li> <li>• There is limited precedent for this measure and there may be low availability of data for EBT particularly at the industry level.</li> </ul>
Net profit margin	<ul style="list-style-type: none"> <li>• DCC operates "on a £nil profit model"<sup>31</sup> and therefore has nil taxable profit, and hence nil tax at the UK Corporation rate of 20% differentiating the EBT margin from the net profit margin.</li> <li>• The revenues passed from DCC to Capita are not subject to taxation at DCC's end. These revenues are however subject to taxation within Capita where corporation tax will be paid out across the full financial position of Capita not just DCC.</li> <li>• Although DCC's margin reflects a net profit margin this may not be a fair assessment of the margin from the perspective of Capita.</li> <li>• Net profit margin is a more standardised accounting term relative to EBIT and therefore there will be a high availability of data at the firm and industry wide level.</li> </ul>

3.19. We would appreciate input as to which measure seems most appropriate for DCC (along with the justification) and are open to receiving suggestions for alternative measures. After taking into consideration the comments we receive we will decide on the measure(s) to use in determining an appropriate margin based on the methodology outlined.

*The period over which to measure margin*

3.20. Margins fluctuate over time as a result of numerous factors including adverse shocks, distinct business decisions (e.g. engaging in M&A, interest or dividend payments), and cyclical factors. For the purposes of setting a return, taking an average of margins over several years, rather than from a single year, will smooth these

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<sup>31</sup> Smart DCC Limited: Annual report 2016:  
<https://beta.companieshouse.gov.uk/company/08641679/filing-history>

fluctuations. Taking into account the anticipated length of the Transitional Phase of the programme we propose averaging values over a 4 year period (subject to data availability).

#### **Step 4. Decide on the appropriate margin**

3.21. Informed by an understanding of DCC's risks, the margins of comparable companies and a qualitative assessment of the risks of these companies to DCC, we will decide on an appropriate margin.

### **Risk characterisation**

3.22. We believe that DCC faces minimal risk for its role within the Transitional Phase of the Switching Programme. DCC operates as a monopoly provider, and further to this, whilst operating in an ex post price control regime DCC does not face the risks that would be associated with an ex ante regime. DCC's costs are covered through charges to industry which are paid in advance and the inclusion of contingency accounts for foreseeable eventualities. These costs are paid by suppliers who are mandated to pay through the regulatory framework on a pay now dispute later provision. Any bad debts accumulated are socialised across other parties. Based on this we would envisage DCC falling at the lower end of any comparator range.

3.23. We provide below our assessment of the risks faced by DCC during the Transitional Phase, although we do not believe these to be significant. We do not believe it appropriate to reward for eventualities which are within DCC's control.

#### **Programme risks**

3.24. This relates to any factors outside of DCC's control which mean DCC cannot deliver the programme as outlined or the risk profile for DCC's role changes.

3.25. DCC and Ofgem are working together to develop a Programme Plan with agreed delivery dates. However this plan may be subject to change by Ofgem as our understanding develops with the programme. DCC and Ofgem will agree a change control and governance process and have agreed to a collaborative working relationship to deliver the programme. This will mean that DCC is sighted of all programme changes outside of its control and will have the opportunity to input into any decision making process regarding these changes. This should mitigate any risk that DCC may not be able to deliver the requirements associated with the changes (e.g. products or timelines).

3.26. Although DCC's scope of work may change within the Transitional Phase of the programme, the nature of DCC's role and its responsibility should not. We therefore believe programme risk to be minimal.

### **Economic risks**

3.27. This risk would relate to instances where DCC cannot recover its costs or margin is unfairly placed at risk. Ensuring costs are economically and efficiently incurred is within DCC's control.

3.28. The working relationship between DCC and Ofgem within the switching programme will limit the likelihood of DCC incurring cost disallowance based on DCC misinterpreting requirements. This risk will be further mitigated through the regular reporting as part of the ex post plus price regime provides Ofgem with the chance to flag any areas that raise concern.

3.29. DCC's ability to meet milestones is largely within its control. The incentives framework may be misapplied through an oversight in the initial design. This could result in DCC losing margin relating to incentivised milestones for reasons out of its control. We believe that any potential risk relating to this is mitigated as the incentives framework has been developed collaboratively with DCC in a way that means it is dynamic to changes outside of DCC's control and therefore limits the likelihood of being unfairly penalised. Furthermore the level of margin at risk in relation to incentivised milestones relates only to directly incurred costs.

### **Regulatory risks**

3.30. The risk of enforcement proceedings is largely within DCC's control and any enforcement action requires evidence that DCC has not taken all reasonable steps to meet its obligations and would be with regard to external dependencies. There may be a risk that following due process additional requirements may be added or existing requirements changed by the regulator but this should be predictable and transparent. DCC should be dynamic, anticipating changes and working to adapt and taking all reasonable steps to continue to meet its obligations.

### **Reputational risks**

3.31. This relates to DCC's ability to secure future work e.g. limiting DCC's future business opportunities to take on value-added services. However DCC's own reputational risk is limited through its position as a monopoly provider, and its relatively limited scope of potential business expansion.

3.32. There may be wider reputational impacts for Capita's other activities based on its association with DCC and the high-profile nature of the programme. DCC has a level of control in the outcome of the Transitional Phase of the Switching Programme through leading on the procurement and therefore the management of this risk is within DCC's (and Capita's) control. We also hope that the collaborative



relationship between DCC and Ofgem in delivering the programme will mitigate this risk. We acknowledge there is a reputational risk to Capita but also believe that the successful delivery of the Transitional Phase provides a potential upside to DCC and Capita in securing future projects.

3.33. Through the increased transparency of the scope and risks involved in the Transitional Phase of the CRS and greater control of the procurement process, we conclude that based on an assessment of risk the DCC required margin for the CRS should be lower than in the case of SMIP.

3.34. We conclude that the main risk DCC faces is reputational risk. It could be argued there is a residual risk that DCC may be penalised for circumstances outside of its control. We hope that the joint working dynamic developing between DCC and Ofgem within the Switching Programme will mitigate much of this and provide a real potential for reputational upside through the successful delivery of the Transitional Phase. In concluding as part of our methodology to reach a conclusion on an appropriate allowance for DCC's margin we will quantify these risks.

3.35. We welcome comments from stakeholders as to whether the above assessment of the risk profile faced by DCC is fair, e.g. are there any risks or mitigating factors that we have not considered.

## Initial analysis

3.36. This section sets out an initial high-level analysis. Following the response from this consultation on proposed comparators we will follow the 4 steps above in more detail to determine the final margin allowance.

### Potential close comparators

3.37. DCC and the Switching programme operate in a unique space and it is hard to find exact comparators. For context we have outlined below the margins achieved by UK companies and regulated sectors operating in a similar field to DCC.

Whilst DCC lacks direct competitors we believe that Xoserve Ltd. and ElectraLink Ltd. operate in a similar line of business to DCC in supporting the exchange of data in the gas and electricity industry. Both are regulated Central Bodies delivering transaction services and maintaining the databases of gas and electricity meters and network distribution details. However, these companies are regulated differently and have different ownership and business structures. Therefore these companies operate in a different risk environment to DCC. They are referenced here in relation to their line of business and potential synergies to the overall Switching Programme.

## Xoserve

- Xoserve<sup>32</sup>: EBIT margin 9.54%, Net profit margin 9.06%

3.38. Xoserve is not licenced or price controlled itself, but operates as the Transporter Agency, funded, to date, predominantly, as a sub-set of the licencees' (Gas Transporters 'GTs') price controls. Going forward Xoserve will continue to be a delivery body, neither directly licenced or price controlled. Any surplus will only be allowed to be utilised for the benefit of core customers (GTs) which could in due course make the EBIT level irrelevant.

## ElectraLink<sup>33</sup>

- Regulated and non-regulated activities: EBIT margin 25.34%, Net profit margin 20.25%
- Regulated (data transfer service) activities: EBIT margin 12%<sup>34</sup>

3.39. ElectraLink's overall EBIT margin has varied greatly over the past 5 years (from -2 to 20%) driven by change in business focus and wind down in asset amortisation costs and therefore limits its use as a direct comparator. It also operates a number of unregulated services (accounting for approximately 30% of its business) unlike Xoserve and DCC. The margin on regulated activities varies depending on best estimates of cost and over a number of years would average out to a negligible return.

## Comparators based on commercial expectations

3.40. Acknowledging the lack of perfect comparators we have considered the commercial expectations across companies providing similar services to the role DCC will fulfil during the Transitional Phase of the Switching Programme i.e. what margin we might expect to pay if we were to determine the margin via a competitive bidding process. The analysis presented below is based on sector-wide averages and accounts for steps 1-3 of the methodology outlined above. No assessment of relative risk has been applied. Based on input from this consultation for appropriate measures and comparators we will carry out in full steps 1-4 in determining an appropriate margin.

## Comparators based on operating, risk or regulatory profile (EBIT)

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<sup>32</sup> <https://beta.companieshouse.gov.uk/company/05046877/filing-history>

<sup>33</sup> <https://beta.companieshouse.gov.uk/company/03271981/filing-history>

<sup>34</sup> Inferred from published accounts and confirmed by company

3.41. We have considered the sales margins (EBIT) achieved or allowed by the relevant regulators for a number of UK companies with a similar operating, risk or regulatory profile<sup>35</sup>. This range spans from -3 to 16%.

- Service providers operating a network, such as rail service operators and asset-light telecoms service providers (-3 to 16% margin).

*These companies can have low fixed assets and a large proportion of their charges can consist of pass-through costs. As pass-through costs in the Transitional Phase of the Switching programme will be minimal this limits the comparability of this sector.*

- IT systems providers in the energy sector (6 to 10% margin).

*These companies facilitate energy market processes as DCC does and either have regulated charges or face limited competition.*

- Contract management companies (-1.5 to 6%).

*These companies have a similar business model to DCC of earning margin for managing large-scale contracts and often procuring physical infrastructure from third party providers*

- Regulated retail companies in other sectors such as water, transport operations, and telecommunications (1-10% margin).

*These companies share aspects of DCC's cost and revenue protections.*

3.42. We acknowledge that these sector comparators have limitations, e.g. are more established companies with different operating structures. However, we still believe this analysis is relevant for setting context in establishing a range for DCC's margin. We believe that DCC's operating environment most closely aligns to IT systems providers in the energy sector but note that many of these companies are more established than DCC and therefore may operate more efficiently.

Comparison based on sector averages (net profit)

3.43. Based on the unique nature of DCC's operations and lack of directly comparable companies we have analysed industry wide benchmarks<sup>36 37</sup> for financial year 2015 to be used to guide an initial range. Due to the availability of net profit margin as a measure for sector wide averages we have considered the net profit margin as the appropriate measure in this instance. We will use this data as a guide only in assessing specific comparators and to assess an appropriate lower bound value.

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<sup>35</sup> Based on research carried out for DCC's proposed baseline margin adjustment. This was extended to consider the Transitional Phase of the Switching Programme. <https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-consultation-regulatory-year-201415>

<sup>36</sup> [http://pages.stern.nyu.edu/~adamodar/New\\_Home\\_Page/datafile/margin.html](http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/margin.html)

<sup>37</sup> [https://biz.yahoo.com/p/sum\\_qpmd.html](https://biz.yahoo.com/p/sum_qpmd.html)

3.44. The use of sector wide figures averages out any company specific trends or anomalies. Due to data availability and our wish to look at a broad basis in order to average out company specific trends we considered sector wide margins for US listed peers. Although ideally we would use UK-only peers there are not enough data points available to average out company specific trends. We believe this to be sufficient to use as a guide to an appropriate range.

**Table 3: Net profit margins for sector comparators<sup>39</sup>**

Industry	Net profit margin
Information services	14.00%
Software (system and application)	11.84%
Business software and services	13.80%
Processing systems and products	11.80%
Information technology services	9.20%
Technical and system software	8.50%
Telecom services	6.40%
Contract management services	4.00%
Staffing and outsourcing services	3.10%
Diversified communications services	1.00%

3.45. DCC's business environment could be viewed as similar in nature to that of the IT Service industry,<sup>38</sup> (net profit margin of 9.20%), as the firms in this sector tend to be asset light and can operate under a regulated framework. Equally there is some similarity to the Telecom Services industry (net profit margin 6.4%) in terms of the regulated environment and a rapidly changing landscape with the pace of innovation remaining high to satisfy the evolving requirements of the market which is not dissimilar to the environment DCC works in.

3.46. We have analysed the net profit margin across a range of 10 sectors (Table 3<sup>39</sup>). When reviewing the complete list of benchmark industries with varying degrees of relevance the median of the various industry net profit margins is 8.85% (mean 8.36%) with a range between 1-14%. On considering which benchmark sectors most closely align to the role of DCC and the environment that DCC operates in we concluded a range of 8-12%. We were not able to collect the same level of data to compare EBIT or EBT margins.

Comparison based on firm approach using DCC suggested comparators

3.47. In making this proposal, we have taken into consideration DCC's analysis that its general role during the Transitional Phase correlates to a professional

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<sup>38</sup> Sectors and companies making up sector average as defined at [https://biz.yahoo.com/p/sum\\_qpmd.html](https://biz.yahoo.com/p/sum_qpmd.html)

<sup>39</sup> Sectors and data as defined at: [http://pages.stern.nyu.edu/~adamodar/New\\_Home\\_Page/datafile/margin.html](http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/margin.html)  
[https://biz.yahoo.com/p/sum\\_qpmd.html](https://biz.yahoo.com/p/sum_qpmd.html)

services firm. Using the firms provided by DCC (redacted table in Section 13.7.2 of the DCC Business Case and Appendix 3 of this document) the median margin range for each year (2012-15) ranges from 9-13%. Taking the median across all 4 years suggests a margin of 12% which we will use to define the upper bound of the range. We have chosen to use a median as the data is skewed by outliers<sup>40</sup> and therefore is a more appropriate measure of the average.

3.48. Further to this we have analysed the net profit for the same comparator professional services firms suggested by DCC over the 4 financial years from 2012-15. Net profit values ranged from 7-9% with a median across all 4 years of 8.1% which we will use to define the lower bound of the range. This further supports a range of 8-12% depending on the measure chosen.

**Table 4: Professional service returns as suggested by DCC**

	2015	2014	2013	2012
EBIT median (%)	13	13	9	11
Net profit median (%)	8.5	8.5	7	8

3.49. The figures for each company represent a blended average across a portfolio of projects with a variety of risk profiles. Based on the risk assessment outlined earlier for the Transitional Phase of the Switching Programme we would expect the Switching Programme to be towards the lower end of any portfolio. Before these examples can be used in determining the margin for DCC the margins must be weighted relative to the specific risks faced by DCC during the Transitional Phase of the programme. We would also aim to account for any differences in structure (i.e. those operating as a Limited Liability Partnership).

### Minimum required return

We have also assessed the lower bound of our range against the minimum required returns (based on a weighted average cost of capital) across the relevant sectors and the 8% sits to the upper end of this range (6-8%)<sup>41</sup>. This analysis is being used to assess the relevance and feasibility of the lower bound of the range only.

### Summary

3.50. Taking in to consideration the data assessed above we conclude that it aligns to a range of 8-12%.

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<sup>40</sup> The mean, median and mode are not equal. The mean is skewed by the existence of outliers falling more than 2 standard deviations from the mean

<sup>41</sup> Sectors and data as defined at:

[http://pages.stern.nyu.edu/~adamodar/New\\_Home\\_Page/datafile/margin.html](http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/margin.html)  
[https://biz.yahoo.com/p/sum\\_qpmd.html](https://biz.yahoo.com/p/sum_qpmd.html)

## **Next steps**

3.51. Based on the input from this consultation to appropriate measures and comparators we will further our analysis using the methodology above. We will use this to determine the margin we use in our final direction which we anticipate making in February 2017. The draft direction is included in Appendix 2 (figures are illustrative only).

## 4. Incentives approach

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### Chapter Summary

This chapter outlines the principles and approach which were taken to develop the incentives proposal. The incentive proposal is outlined in more detail in the subsequent chapter.

### Process in developing incentives

4.1. A set of principles against which any potential incentives should be assessed were developed jointly by Ofgem and DCC through the Switching Programme Commercial Workstream (CWS) Price Control Design Team. These principles were discussed further with CWS User Group and the External Design Advisory Group (EDAG). These principles have been designed to ensure that incentives are only applied where they bring genuine benefits to the programme and consumers.

- ensure there is no duplication of rewards and penalties with existing incentives – e.g. under the Operational Performance Regime (OPR) for smart metering activities
- encourage behaviour that is aligned with the desired outcomes for the Switching programme balancing time, quality and 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
- be practical to implement and manage
- have quantified limits to risk as well as reward
- as a package of incentives should allow for a balance of risk and reward
- 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.

4.2. A number of areas for which incentives could be applied were explored by the Price Control Design Team and assessed against the agreed principles.

4.3. DCC's assessment of the main incentivised areas discussed is reproduced in more detail in Appendix 3. Areas analysed for the application of incentives included the number of bidders in the procurement process, product quality, timeliness and stakeholder engagement. This assessment was shared with the CWS User Group where the importance of incentives being in place was noted. However, it was also noted that it would be challenging to develop incentives to apply during the Transitional Phase given the uncertainties within the Programme and ensuring the right balance between time, quality and cost.

4.4. Ofgem concluded that, from a programme perspective, the application of incentives would provide an extra level of accountability for DCC to deliver on activities within its control and therefore extra assurance of delivering value to the consumer. To this end DCC and Ofgem have worked collaboratively to develop a package of incentives that help ensure DCC efficiently manages its costs whilst delivering on time to an appropriate quality of service. This collaborative working is reflected by the similarities between the draft DCC proposal within the Business Case (included here as appendix 3) and the Ofgem proposal.

## Existing incentives

4.5. Before considering incentives to apply it should be noted that DCC is already subject to incentives (financial and otherwise):

- DCC is subject to licence obligations, with potential consequences via enforcement for any breach
- to the extent DCC has a role after the Transitional Phase in delivering and operating what it procures it arguably has an incentive to ensure that it works towards and procures a quality product
- DCC has reputational incentives from its work on the Switching Programme– heightened by our ex post plus regime which includes regular reporting
- DCC wishes to secure future work and is therefore arguably incentivised through this to demonstrate quality delivery
- DCC's costs in the Transitional Phase are subject to an ex-post price control review of whether expenditure was economic and efficient which drives cost management

4.6. The three primary areas that incentives are designed to encourage, in line with their principles and the achievement of programme objectives, are as follows:

- quality procurement and support to the Switching Programme
- timely procurement and support to the Switching Programme
- economic and efficient procurement and support to the Switching Programme

4.7. We consider that the existing incentives on DCC as set out in para 4.5 above are effective in ensuring economic and efficient procurement and support to the Switching Programme and therefore help ensure value for money for the consumer. The ex post price control already provides incentives for DCC to deliver value for money by ensuring that its allowed revenue includes only economic and efficient costs year on year. Additionally, under the ex post plus regime, DCC will report monthly against its detailed baselined Business Case and the overall delivery of the programme.



4.8. We therefore consider that incentives should focus on incentivising time and quality in a way that creates an equal balance between these and cost.

### **Proposed Incentives for DCC in the Transitional Phase**

4.9. As detailed in chapter 5 we plan to apply incentives based on:

- timely delivery of key milestones to a specified quality
- stakeholder satisfaction

4.10. Only the incentive linked to timely delivery has a potential impact on margin and therefore the performance adjustment term which is the subject of the direction. We do not intend to direct that margin is at risk on stakeholder satisfaction during the Transitional Phase.

4.11. Ofgem does not consider it to be appropriate to provide an upside reward in assessing timely delivery as this risks over incentivising time at the expense of quality with limited or no benefit to the overall delivery of the programme. It would also create inappropriate incentives in an ex-post price control environment. The directed margin will represent the maximum that DCC can earn as the identified package of incentives places DCC margin at risk with no financial upside.

4.12. Given the early stage of development for the Switching Programme, certain specific details of the incentives are not complete, where this is the case we have outlined what information is yet to be confirmed and this is highlighted within the draft direction (included as appendix 2). These details will be published on the Ofgem website following review by relevant programme stakeholder and governance bodies and referenced within the final direction. This will include the change control / governance process, the jointly agreed programme plan and product acceptance criteria for delivery of a Delivery Milestone ('DM').

### **Industry recovery of margin**

4.13. The forecast margin is recovered through DCC charges with the final margin value calculated based on the Allowed Revenue as determined by Ofgem as part of the 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 for the regulatory year under review i.e. a missed milestone in 2018/19 would be adjusted in the 2020/21 charges.

4.14. For clarity, changes to margin for delivery incentives would not apply to the current (2016/17) year, as they were not in place to influence behaviour and outcomes and should not be applied retrospectively.

## 5. Time-based incentive

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### Chapter Summary

The purpose of this Chapter is to outline the delivery incentives that we intend to apply from April 2017 in respect to the Transitional Phase of the Switching Programme

We propose to link the CRSPA term within the Licence so that DCC's margin is tied to meeting certain DMs set by Ofgem within the jointly agreed programme plan. These DMs will be assessed by Ofgem as part of its determination of Allowed Revenue.

This chapter outlines the key principles behind the time-based incentive and how margin will be placed at risk. For completeness this chapter also covers the stakeholder engagement incentive. This incentive will not be linked to DCC's margin during the transitional phase but will be used to develop a base so that this can be rolled out in future phases if deemed appropriate. This is included for awareness only.

### Question box

**Question 1:** Do you agree with our minded to position for the shape of the margin at risk curve? Does it adequately address the desire to ensure DCC is motivated to deliver on time or as soon as possible thereafter? If not, please explain why and how it can be improved.

**Question 2:** What is your view on our proposed position to determine the appropriate length of time after which 0% of margin is granted for each milestone? (What is the "X" in "T1+X"?) Please provide justification for any alternative suggestions.

**Question 3:** Is 100% of the previously lost margin appropriate for the recovery mechanism where the final milestone is met on time? If not, what proportion would be?

**Question 4:** Do you have a preference for the mechanics of the recovery mechanism (table 9) and whether recovery should be based on absolute or relative delay? Please support any suggestions.

### Summary and next steps

The time-based incentive is financial in nature and places DCC's margin at risk based on whether specific DCC milestones are delivered to the specified quality to agreed dates. A draft direction for the proposed incentive mechanism is included in Appendix 2. Taking into consideration the feedback from this consultation we intend to issue our final direction in February 2017.

## Rationale

5.1. Timely and quality delivery of critical path milestones will be crucial in ensuring the successful delivery of the Switching Programme. However, no existing financial incentives are in place to ensure this beyond the natural desire of DCC to deliver on the programme. To this extent, the inclusion of an incentive that balances timely delivery with quality delivery of key DMs has been developed.

5.2. The incentive is structured to ensure timely delivery of key DCC milestones that will affect:

- the overall timescales of the Transitional Phase of the Switching Programme
- when the Design, Build and Test and Live Operations phases can commence

5.3. In line with the principles for incentives outlined above we feel that incentives should apply to activities where DCC is taking a lead role with a high-level of ownership and control. Based on the scope of DCC's role, as outlined in the DCC Business Case, this relates to activities developing the technical specification for the CRS and those underpinning its procurement. This falls within the time period between DCC receiving detailed switching designs for delivery specifications from Ofgem (this may occur in stages) and the award of major CRS contracts. We also intend to incentivise milestones which fall on the critical path of the Transitional Phase as these will best correlate to timely programme delivery. The DMs identified should also be tied to existing assurance points to reduce the impact of programme overhead.

5.4. The incentive is structured to encourage DCC to deliver milestones by the target delivery date wherever possible. However, if DCC cannot meet the target delivery date for reasons within its control, the mechanism should still incentivise DCC to deliver as soon as possible after the target delivery date. It is also the intended outcome that DCC deliver outputs that meet minimum quality criteria by these specified dates.

5.5. Quality of delivery will be measured through assessing DCC products against objective acceptance criteria recorded within product descriptions. The use of acceptance criteria should ensure the right quality is delivered as a product will not be deemed as completed until the acceptance criteria are met. Timely delivery will be encouraged through the reduction of margin in the event of late delivery of a completed DM.

## Potential issues in implementing the incentive

5.6. DCC has raised questions about how a time-based incentive may negatively impact on the programme. We have outlined these below and how we believe the proposed framework addresses some of these concerns.

5.7. The incentive 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. The measures outlined in the Governance and change control section (from 5.47) for dynamic programme controls should mitigate this risk and will encourage DCC to raise any opportunities identified at a programme level so it can be considered in the context of the overall delivery of the programme.

5.8. The incentive may lead DCC to be overly cautious in its planning to reduce the risk of late delivery, which may result in longer delivery timescales. The delivery plan will be jointly developed and agreed between Ofgem and DCC as being realistic and achievable. Independent assurance of the plan to assess that the milestone dates are achievable should also assess if any timings within the plan appear overly cautious.

5.9. The incentive may mean that DCC makes compromises in the procurement approach it plans to adopt such that it prioritises faster delivery over depth or breadth of competition. This will form part of the acceptance criteria for approving the contract award recommendation report

## Next steps

5.10. Taking on board the feedback received from this consultation we will develop the details to form the final direction which we anticipate making in February 2017. We will feedback via the programme governance groups, including the Commercial User Group.

## Delivery Milestones

5.11. In order to ensure incentives remain proportional to the scale and short time period for the Transitional Phase of the Switching Programme it is appropriate to focus incentives on critical path deliverables which would already be subject to assurance. This will minimise additional oversight.

5.12. As the procurement process will likely consist of a number of major and minor projects, Ofgem believe that the deliverables to incentivise will be best aligned to the desired outcomes of the programme if they relate to the delivery of major projects. Any dates set for achieving DMs would be linked to the latest date of major procurement projects for the delivery of each milestone. This is a more proportionate application than looking at each procurement project individually.

5.13. The exact definition of major projects will not be confirmed until we have a better idea of the chosen solution architecture. As an indication, major projects could relate to sourcing core software provision and minor could relate to sourcing professional services support e.g. system integration.

5.14. The plan has been assessed by DCC and Ofgem and three sequential critical path products have been identified. We anticipate DCC to have a high-level of control over these products.

**Table 5: Identified delivery milestones**

Milestone	Title	Summary	Completion date <sup>42</sup>
<b>Delivery Milestone 1</b>	Completion of the CRS technical specification	Specifies for each of the CRS components to be procured the functional requirements to be supported, non-functional requirements (e.g. performance and reliability), service management requirements (e.g. incident management) and delivery plans	DM1  Anticipate between April - September 2018 <sup>43</sup>
<b>Delivery Milestone 2</b>	Completion of the CRS tender packs for the final major procurement project	Comprises the documents that will be issued to potential service providers including the statement of requirements, evaluation methodology and the main contract terms	DM1 + 4 months
<b>Delivery Milestone 3</b>	Approval of the contract award recommendation report for the final major procurement project	Assurance that correct process and methodology has been followed in reaching a recommendation of which party(ies) to award the contract to. This is ahead of contract award and contract signature	DM2 + 6 months

5.15. There is no incentive relating to contract signature. We believe that it would be detrimental to incentivise this as it would potentially give service providers

<sup>42</sup> Dates are indicative and based on the dates outlined within DCC's draft programme plan. This is included within the consultation on DCC's Draft Business Case. Ofgem and DCC will work to finalise these dates within the plan baselined in March 2017. We do not anticipate a significant change in the relative timings between these milestones. The dates will be defined within the direction with reference to the published programme plan.

<sup>43</sup> Earlier delivery date is as based on Ofgem's current plan and the later date on DCC's plan included within their draft Business Case. DCC's work on this milestone should commence approximately 7 months prior to this.

disproportionate power in any negotiation and therefore be counter-productive in ensuring value to consumers. DCC has outlined measures within the Procurement Framework<sup>44</sup> to help address potential concerns that this process could become unnecessarily elongated. We will aim to set a clear expectation on DCC for the date by which the procurement should be concluded and will consider whether it is necessary to explore options to provide a backstop to prevent the final commercial processes from becoming unnecessarily elongated.

## Measurement of the incentive

5.16. DMs will be assessed on their quality and will have to meet pre-defined acceptance criteria before they assured as complete. When the DMs have been assured as complete they will be assessed against the delivery dates outlined within the programme plan which should reflect the anticipated date for assurance approval<sup>45</sup>.

### Acceptance Criteria

5.17. We believe it is vital to ensure there is a balance between time and quality. Taking this in to consideration the DMs will only be viewed as complete once they have been assessed and independently assured against acceptance criteria. The acceptance criteria and product descriptions will be developed in collaboration with DCC before work on the product commences. The acceptance criteria and product descriptions for the incentivised DMs will be defined within the direction via reference to the published documents. Acceptance criteria in relation to independent assurance will be objective and pass / fail criteria will be clearly identified. In the event that a milestone cannot be assured as complete, clear remedies should be outlined. The approval process will be outlined within the product descriptions and will identify reviewers, their level of review / approval and timings for review.

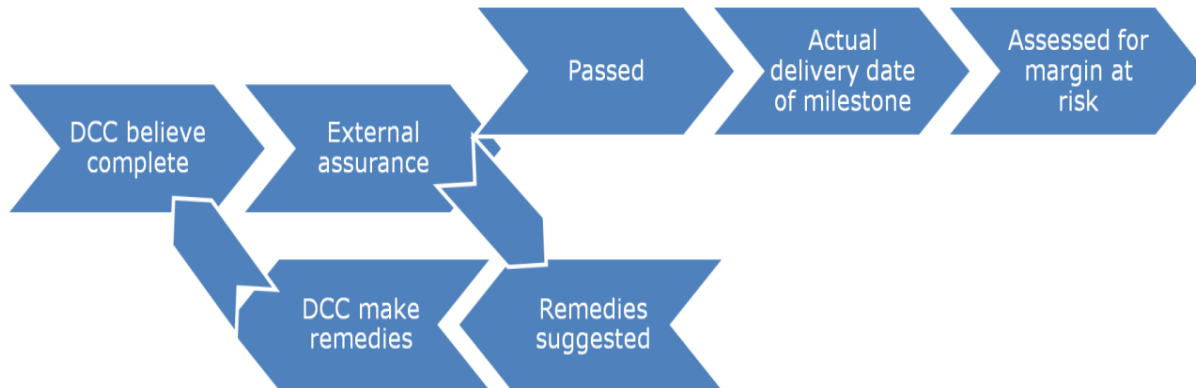
5.18. This proposal will mean that the acceptance criteria are important in ensuring quality delivery of the programme. Acknowledging this, we intend for the acceptance criteria to be jointly developed by DCC and Ofgem, with input from the relevant industry forums including user groups, EDAG, Programme Board or their equivalent successor governance bodies. The acceptance criteria and product descriptions will be agreed by both DCC and Ofgem. For transparency we will publish the agreed acceptance criteria for incentivised DMs.

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<sup>44</sup> To be published on the Ofgem website in December 2016

<sup>45</sup> We anticipate the time allowance for assurance to be based on an assumption that the finished product meets the acceptance criteria

Figure 2: Diagram of approval process



5.19. We believe that the above measures and illustrated approval process will mitigate the risk that quality is compromised and will help ensure the successful delivery of the Switching Programme.

### Independent assurance

5.20. Independent assurance will be sought to validate that acceptance criteria have been met for all milestone products. This would be similar to the performance auditor role that assures delivery of DCC's incentivised Implementation Milestones under the SMIP. The assurer will be a wholly independent third party external to the programme but with the required specialist knowledge and skills (technical or professional). The independent assurer will be procured by Ofgem and paid for by DCC. We are considering how stakeholder views can be represented when procuring the independent assurer; this may include a stakeholder representative feeding in to in the decision process, agreeing the required skill set and reviewing of the terms of reference for the independent assurer.

### Milestone dates

5.21. Given the early stage of the Transitional Phase there are still a number of uncertainties within the programme plan. This includes dates and timings. As we wish to ensure the programme can be efficiently delivered we have structured the incentives in a way that we believe will not hinder the dynamic nature of the programme.

5.22. To manage this concern we propose that the dates for the DMs are defined within the programme plan and referenced within the direction. This will mean that as our joint working with DCC on finalising the plan progresses the delivery dates can move with this without the need to amend the direction. This will be a more efficient and a less resource intense method than stating absolute dates within the direction. This will allow us and DCC to focus on successful programme delivery.

5.23. An initial draft of the plan is included as Appendix C within the DCC Business Case. The incentivised milestones are highlighted within the plan by the column titled 'Incentivised milestone', for the avoidance of doubt based on our proposal the incentivised milestone date would fall after independent assurance has been achieved. This plan has been developed by DCC on a bottom-up basis, with DCC making assumptions (presented in Appendix E of their Business Case) on the nature and scale of the various tasks they will be responsible for based on current Ofgem planning. There are a number of areas which need to be progressed with joint working between Ofgem and DCC. In relation to the DMs we anticipate changes to apply only to delivery dates and specifics of the acceptance criteria.

5.24. Dates for the milestones will be agreed following detailed joint planning between Ofgem and DCC to develop a baselined plan that both sides agree to be realistic and achievable. Expert and independent assurance of the plan will be sought at this stage to advise on the deliverability of the plan. This will include confirmation that the milestone dates are achievable and ensure effective and efficient delivery of the programme.

5.25. Once the agreed plan has been assured it will be published and industry will be made aware of the key dates within the plan. We anticipate that this will be early in regulatory year 2017/18 and potentially more than 12 months ahead of the first milestone due date. This baselined published plan will be used for assessing DCC's achievement of the incentivised DMs where any changes can only be made through the change control and governance process outlined below from paragraph 5.49 We expect DCC to maintain a separate plan for their actual delivery.

## Margin calculation

### Margin at risk

5.26. In line with the principle that incentives apply to activities where DCC has a high-level of ownership and control, we propose that the margin placed at risk is proportional to the total cost base for the activities required to deliver the three milestones.

5.27. For the three milestones identified this would include:

- all costs relating to procurement including the development of the procurement framework and plan
- activities that relate directly into the development of the CRS technical specification (including delivery specification).

5.28. The remaining costs relate to programme management and DCC providing advisory services to Ofgem and we do not believe margin placed at risk due to timely delivery should applied to these activities.



5.29. The cost base outlined above will be identified within the programme plan. The plan included within the DCC Business Case flags these costs in the column labelled 'Activities relating to incentivised milestones'. These costs will continue to be updated as the plan develops and will be reported on as part of DCC's ex post plus price control regime. The assured published plan will flag the associated activities which drive the costs calculated within DCC's cost model and Business Case.

5.30. Based on the current draft plan approx. 25% (approx. GBP 6m) of total DCC costs are associated with these activities. This will continue to flex as the plan is finalised. We propose that 100% of this margin be placed at risk i.e. if DCC were not to achieve any of the DMs set out up to 25% of DCC's total switching-related margin would be lost. The cost base for the margin at risk will be dynamically linked to DCC's actual costs with any required corrections being made via the correction factor (K factor). This will mean that the level of margin at risk will increase if related costs increase.

5.31. As each of the identified DMs are critical path activities of equal importance to the delivery of the Transitional Phase of the programme we propose that the margin at risk should be split evenly across all three DMs i.e. one third of the margin at risk would be attributable to the delivery of each milestone. We believe that this will help ensure timely delivery of the Transitional Phase of the programme.

#### Relationship to time

5.32. We propose that margin at risk should increase gradually between stated time points. This is in order to ensure that DCC is still motivated to deliver the milestone as soon as possible after the initial target delivery date has passed. The design used to determine the relationship of margin at risk to time is captured in a margin loss curve. This is the profile that would apply to each of the milestones, and although each milestone would have the same shape, the gradient could differ given the difference between the time points.

5.33. We have considered a range of options for the shape of the margin loss curve including a rounded reverse s-curve, a 4 point reverse s-curve, and a stepped profile. These options were ruled out on the bases of feasibility, the addition of disproportionate complexity for marginal gain. An immediate drop off in margin was also considered and was dismissed as it was felt this would not incentivise delivery at the earliest opportunity after the DM date was missed.

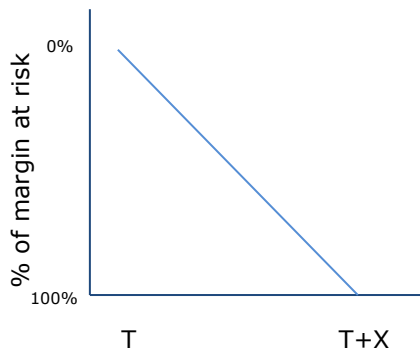
5.34. We believe that the 3 point reverse s-curve and 2 point straight line present the best options for shape as they are simple by design, but still ensure DCC is motivated to deliver. The table below outlines Ofgem's review of these two options.

5.35. The table and figures below illustrate the two options for the relationship between margin loss and time. These are a 3 point reverse s-curve and a 2 point straight line gradient.

**Table 6: Proposed margin loss options**

Option	Summary	Review
<b>1</b>	2 point See figure 3	<p>This design is simple and feasible to implement. The gradual drop off in margin will work to motivate DCC to deliver in a timely manner even if the initial DM date (T) has been missed.</p> <p>By not changing the gradient of the curve to be steeper from an intermediary time point, DCC will still be incentivised to keep up momentum in delivering a product. In options with more than 2 points, the reward is more dramatically reduced when the gradient gets steeper.</p>
<b>2</b>	3 point See figure 4	<p>This proposed profile will mean that DCC is incentivised to deliver the milestone and not penalised for missing a milestone by a short period.</p> <p>However, this design does require more complex management and it is difficult to define point 2.</p>

**Figure 3: Margin loses profile of a 2 point straight line**

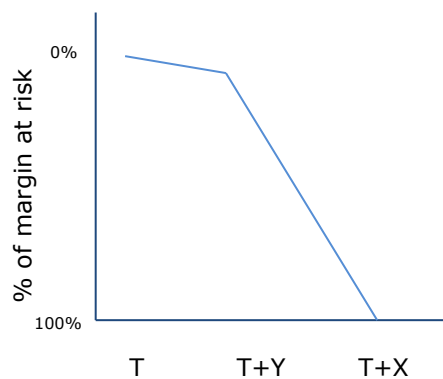


Where:

T - Delivery time / date that relates to the critical path date within the plan

T+X – Delivery time /date after which 100% of margin at risk is lost.

**Figure 4: Margin loss profile of a 3 point reverse s-curve**



Where:

T<sub>1</sub> – Delivery time / date believed to lead to the most effective and efficient delivery of the programme. Potentially representing any prudent slack (although this may not exist which makes this point hard to define)

T+Y – Delivery time /date relating to the critical path date in the plan

T+X – Delivery time /date after which 100% of margin at risk is lost

5.36. The margin at risk for the achievement of each of the three DMs is in equal proportions (a third) of the total cost base for activities relating to incentivised DMs. The figures are illustratively drawn for one DM but the same shape and time point interpretations would apply to all DMS.

5.37. T will be defined within the direction with reference to the programme plan<sup>46</sup> which can be amended following the change control process outlined below and relates to the dates at which assurance of quality is received (figure 2). Defined as T1, T2 and T3 respectively for each DM.

5.38. Ofgem is minded to direct on option 1 (a 2 point straight line margin loss curve) as this approach is believed to balance a relatively simple design with the outcome of penalising DCC for late delivery whilst still incentivising delivery at the earliest possible date.

Determining the value for X and Y

5.39. X and Y (if applicable) will be stated as an absolute value (in weeks) within the direction. We intend to set these values based as a proportion of the time period of work to deliver each independent milestone<sup>47</sup>. This will be determined through programme discussions taking into consideration feedback from this consultation. We feel that it would be appropriate for this time period to reflect between 15-25% of the length of time of work to deliver each milestone. This range is based on our assessment of what feels appropriate given the nature and scope of the activities. The value within the direction will be based on working weeks and an overview of the values in weeks is provided in Table 7.

**Table 7: Values for X – period for margin to drop to 0%**

Milestone	Time to deliver each milestone <sup>43</sup>	15% of delivery time (% of assigned margin for each DM lost per week delay)	20% of delivery time (% of assigned margin for each DM lost per week delay)	25% of delivery time (% of assigned margin for each DM lost per week delay)
<b>1 (X1)</b>	7 months	4 weeks (25.0%)	5.5 weeks (18.2%)	7 weeks (14.3%)
<b>2 (X2)</b>	4 months	3 weeks (33.0%)	3 weeks (33.3%)	4 weeks (25.0%)
<b>3 (X3)</b>	6 months	4 weeks (25.0%)	5 weeks (20.0%)	6 weeks (16.7%)

<sup>46</sup> A draft of the programme plan is included in Appendix C of the consultation of the draft DCC Business Case

<sup>47</sup> As outlined within DCC's draft plan (Appendix C of the draft DCC Business Case) - DM1: 7months, DM2: 4 months, DM3: 6 months

5.40. We would appreciate input from industry on an appropriate length of time over which that margin should drop off to zero (i.e. the value of x). For illustrative purposes we have based the draft direction on 4, 3, 4 weeks for delivery of each DM respectively (25%, 33%, 25% drop off in assigned margin at risk / week).

### Recovery mechanism

5.41. To further ensure DCC is motivated to support the delivery of the overall programme, including subsequent phases, we further propose that a recovery mechanism should be incorporated. A recovery mechanism will allow DCC to reclaim a portion of any margin previously lost if the final milestone is delivered to the target delivery date for DM3. This will mean that DCC is incentivised to deliver the final milestone by the originally agreed date even if earlier DMs have been missed. This is line with the principle of incentives promoting the overall successful delivery of the programme.

5.42. Although each of the milestones is of equal importance within the Transitional Phase the completion date of the final milestone sits on the critical path for subsequent phases of the programme. We believe that the use of the identified milestones with a recovery mechanism on the final milestone will correctly incentivise delivery of the Transitional Phase and the wider Switching Programme.

5.43. Due to the sequential nature of the milestones (work on DM2 cannot start until DM3 is complete) and the tight timings between milestones<sup>48</sup> it is unlikely that any delay can be made back.

**Table 8: Proposals for the design of the recovery mechanism**

Option	Summary	Review
1	Equal weighting between all milestones with a 100% recovery mechanism	DCC will be motivated to deliver earlier milestones by natural commercial desire to gain certainty of margin. The interim milestones provide extra discipline. The 100% recovery mechanism will provide a strong incentive to recover time lost on earlier milestones. 100% of the previously lost margin would only be achieved if DCC delivered to the target delivery date for DM3 as stated within the baselined plan.
2	Equal weighting between all milestones with a <100% recovery	The level of margin that can be required is a careful balance to correctly motivate delivery of the final milestone whilst not being at the expense of delivering earlier milestones. As this balance is hard to achieve we would appreciate input as to an appropriate percentage to

<sup>48</sup> As currently outlined within DCCs draft plan included within our consultation on DCC's Business Case: DM1 to DM2 = 4months and DM2 to DM3 = 6 months.

	mechanism	<p>choose.</p> <p>If &lt;100% of the margin was available to be recovered DCC may be more motivated to deliver earlier milestones. However, this would not fully recognise the importance of the final milestone in the delivery of the full Switching Programme.</p>
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5.44. We are minded to direct based on option 1 (equally weighted milestones with a 100% recovery mechanism) as we believe this approach creates the best balance to motivate DCC to secure earlier margin whilst not over incentivising the final milestone. However as this is a careful balance to achieve we would appreciate input on the outlined options.

**Table 9: Proposals for the mechanics of the recovery mechanism<sup>49</sup>**

Option	Recovery based on relative delay	Recovery based on absolute delay
<b>Summary</b>	<p>This mechanism only recovers lost margin if proportionate time lost on DM1 and DM2 is made up at milestone 3. The recovery is based on the proportion of catch-up from DM1 to DM3, plus the catch up from DM2 to DM3.</p> <p>The proportion of catch-up means that if the final milestone is proportionally less late than one or both of the interim milestones, then the proportion of margin that can be recovered on either interim milestone will match the proportional improvement in delivery at DM 3.</p>	<p>This mechanism mirrors the margin loss profile for DM3. We assume that option 1 for margin loss profile is followed (2 point straight line. See figure 2). Lost margin on both DM1 and DM2 can therefore be recovered up to the point X3 where DM3 loses 100% of margin on that milestone (and correspondingly no recovery on previous margin is made).</p> <p>Although simpler in its design, this mechanism allows for recovery on an interim milestone even if DM3 is delivered later than the interim milestone. This would undermine the purpose of using the recovery mechanism as an incentive to make up for lost time.</p>
<b>Equation</b>	<p>Recovery = <math>M1 * (1 - \frac{TA3/X3}{TA1/X1}) + M2 * (1 - \frac{TA3/X3}{TA2/X2})</math></p> <p>See figure 5</p>	<p>Recovery = <math>(M1+M2) * (1 - TA3/X3)</math></p> <p>See figure 6</p>

<sup>49</sup> Based on options 1 or 2 in Table 8. This can be applied irrespective of if 100% of margin can be recovered or not.

**Where:**

*TA<sub>i</sub> is the actual delivery time in weeks after the agreed date for milestone i (i=1,2,3);*

*M<sub>i</sub> is the margin lost at milestone i;*

*X<sub>i</sub> is the period of time to drop off from 100% to 0% for each milestone;*

*If TA values are greater than X, then the value of X will be used.*

*Applies if:*

*(TA<sub>3</sub>/X<sub>3</sub>) < (TA<sub>1</sub>/X<sub>1</sub>); (TA<sub>3</sub>/X<sub>3</sub>) < (TA<sub>2</sub>/X<sub>2</sub>)*

*Where TA<sub>i</sub> is greater than X<sub>i</sub>, TA<sub>i</sub> = X<sub>i</sub>*

**Worked example**

Assumes X = 4,3,4 for milestones 1,2,3 respectively and 100% recovery

TA<sub>1</sub> = 4 (100% late at DM1)  
TA<sub>2</sub> = 2 (67% late at DM2)  
TA<sub>3</sub> = 2 (50% late at DM3)

DM1 was 100% late (TA<sub>1</sub> = 4 and X<sub>1</sub> = 4) and therefore earned no margin at delivery. DM3 was 50% late (TA<sub>3</sub> = 2 and X<sub>3</sub> = 4), meaning that DM1 is able to recover 50% of M<sub>1</sub> as the 2 week improvement on DM3 is a 50% improvement on the delay incurred at DM1 (100% to 50%).

DM2 was 67% late (TA<sub>2</sub> = 2 and X<sub>2</sub> = 3) and therefore earned 33% of its available margin on delivery. In order to reflect the improvement of delivery at DM3 from 67% down to 50%, 25% of DM2 is recovered (with 67% decreasing by 25% to 50%). In total 50% of the margin available at DM2 is recovered (33% + 25%\*67%).

50% of M<sub>3</sub> is also earned. Across all three milestones 50% of margin would be achieved once the recovery mechanism is taken into account.

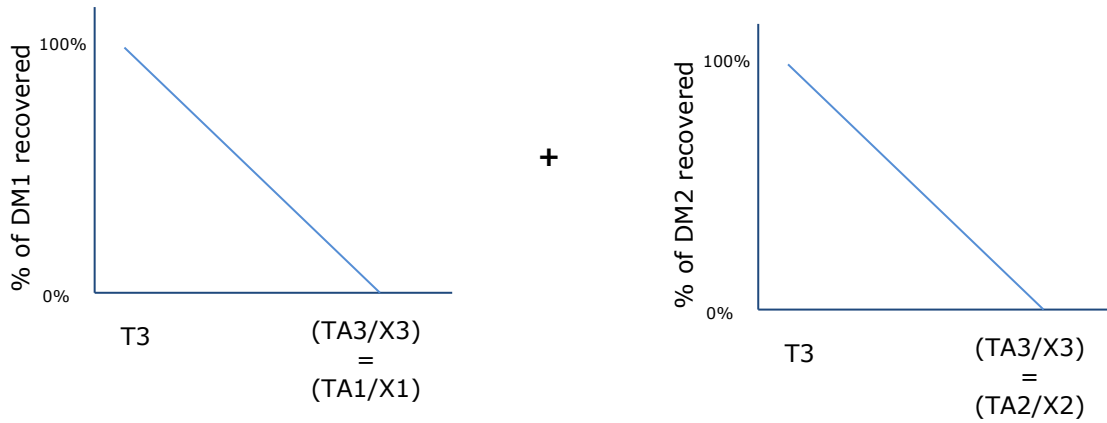
The concern with this approach is that DCC could be overly penalised for delays which have a manageable impact on the programme i.e. if DCC were 1 week late in achieving DM1 and maintained this 1 week delay across DM2 and DM3 DCC would still lose approximately 28% of its margin at risk

By improving delivery by 2 weeks at DM3, the recovery mechanism is at 50% of all lost margin at the first two milestones (M<sub>1</sub> + M<sub>2</sub>). This is because it follows the margin loss curve for DM3, where TA<sub>3</sub> = 2 and X<sub>3</sub> = 4.

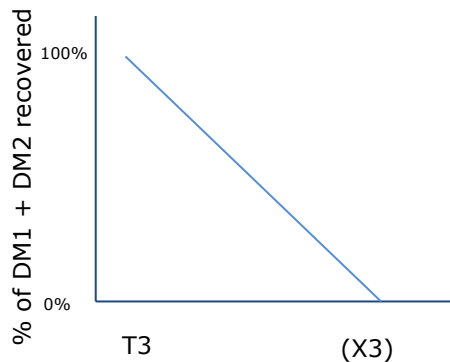
Therefore 50% of M<sub>1</sub> is earned for DM1. DM2 earns 33% of its total margin at delivery and then 50% of M<sub>2</sub> through the recovery mechanism at DM3, meaning DM2 earns a total of 67% of the total available margin for DM2 (33% + 50%\*67%). 50% of M<sub>3</sub> is also earned.

The concern with this approach is that interim milestones can recover margin disproportionate to the amount of time that is made up to achieve M<sub>3</sub>. It is possible for time to be added in achieving M<sub>3</sub> and margin recovery still occurring.

**Figure 5: Recovery based on relative delay**



**Figure 6: Recovery based on absolute delay**



5.45. Either of the above options can be applied whether 100% of lost margin is available for recovery or a lower proportion. We would appreciate your opinion on which option encourages timely delivery without overly penalising delays which have limited impact on the programme.

### Management of margin loss under price control

5.46. When DCC misses a delivery milestone some of its margin will be lost. The amount of margin lost will depend on the factors described above, including how late delivery is, the cost base (to which the percentage margin is applied) and any recovery of margin at the final milestone.

5.47. We propose that this reduction in margin is effected through our ex-post price control review of DCC and that the Fixed Charge, as set out in DCC's licence, paid by users is subsequently reduced. The effect of the reduction in margin will, therefore, be reflected in DCC's revenues with a two year lag. For example, if DCC delivers a product late in 2018/19, the consequences of this will be considered as part of the ex-post price control review for that year, which will be conducted in 2019/20, and the resulting reduction in margin will be reflected in a correction factor affecting the Fixed Charge (and DCC's revenues) in 2020/21.

5.48. As outlined previously in this document we expect to allow DCC a margin on all Internal Costs that we assess to be economic and efficient following our ex-post price control review. This means that if DCC incurs additional costs that are economic and efficient, we will allow a margin on these.<sup>50</sup> In the case of the DCC's Switching Programme costs our assessment of costs will be supported by the additional reporting under our ex-post plus regime. In our assessment of economic and efficient costs, we will pay particular regard to any additional costs that DCC incurs to due to delays in delivery for reasons within DCC's control.

## Governance and change control

5.49. Taking into account the dynamic nature of the programme we propose that a programme governance process is used to manage any changes to the delivery dates, acceptance criteria or product descriptions. Managing these changes at a programme level will allow for effective and efficient delivery of the programme while taking into consideration the best interests of stakeholders and the consumer. Ofgem are currently developing the governance and change control process for the programme. This will be developed with input from DCC and the relevant governance groups will have the opportunity to review. For transparency we intend to publish the final agreed governance and change control process.

5.50. Proposed changes may arise from:

An Ofgem identified need including:

- required changes to the scope and delivery approach of the Switching programme
- change in the roles and or responsibilities assigned to DCC within the Switching Programme
- Ofgem is required to alter the date or criteria of an identified inbound dependency

A DCC identified need including:

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<sup>50</sup> As with the change in margin from late delivery of a product, the change in margin, arising from an increase in the economic and efficient cost base, will affect DCC's revenues with a two year lag.



## Draft direction on margin and incentives for DCC's role within the Transitional Phase of the Switching Programme

- identification of an opportunity to increase the quality or reduces the risk of error which will deliver net benefits to the Switching Programme as a whole including future phases
- DCC identification of scope change or creep
- delay in delivering an inbound dependency by a third part outside of DCC's control
- an unfair delay, not due to concerns in quality, by the independent assurer

5.51. Any proposed changes will be considered in a responsive manner by the programme and the appropriate governance bodies before any decision is made. Any decision will take into consideration the overall impact on incentivised milestones along with the net impact on the Transitional Phase and the Switching Programme as a whole whilst always bearing in mind the best interest of the consumer. Stakeholders will be kept informed of any proposed changes along with the justification for the change through the relevant programme governance bodies and relevant Ofgem updates. Once a decision has been made the relevant published documents (e.g. the acceptance criteria or plan) will be updated and republished on the Ofgem website.

5.52. The full programme governance and change control process has not been exhaustively defined but should include the appropriate stakeholder governance groups e.g. user groups, EDAG, SPDG or their equivalents. The agreed programme governance process will be published and, as relevant, we will incorporate the aspects relating to incentivised milestones as a schedule to the Direction. We anticipate that this will be in place ahead of the final direction on incentives in February 2017. The programme change control process will clearly identify the roles and authorities of relevant stakeholders to approve any change, the timings for considering any proposed change and how the change will be communicated.

5.53. For clarity, any changes to the definition of incentivised milestones identified or the mechanism for how the milestone operates will be put out for public consultation before any decision or change is made. This would include changes to:

- number or nature of the DMs in scope
- proposed calculation for margin at risk
- recovery mechanism
- any of the terms defined within the direction
- the length of the direction

## 6. Stakeholder satisfaction incentive

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### Chapter Summary

This chapter outlines how we propose to monitor stakeholder satisfaction during the Transitional Phase of the Switching Programme. This incentive has no financial element and is not linked to DCC's margin allowance. We therefore do not intend to direct on this but include an overview for awareness. Our intention is to take the lessons learned during this phase to roll out as a financial incentive during later phases of the programme.

### Overview

We believe that stakeholder engagement at the correct time and in the right manner is an important tool for the successful delivery of the Switching Programme. We intend to assess this based on the feedback Switching Programme participants provide on DCC's performance on the programme. For the Transitional Phase of the programme DCC is required to engage with stakeholders under ex post plus price control reporting arrangements (periodic summary reports) and Switching Programme governance e.g. design teams and user groups.

Although we do not intend to financially incentivise DCC on this measure during the Transitional Phase of the programme we see an increasingly important role for DCC in this in later phases.

### Measurement of the incentive

6.1. Selected participants will respond to a biannual survey to respond to questions around areas of DCC's performance. We propose developing the areas that should be covered by questions with input from user groups. The survey will be designed and administered by a third party survey organisation to participants comprising primarily of other design team members and industry participants at user groups and EDAG. We do not envisage this feedback including responses from Ofgem. We would ideally anticipate that the sample will total 50-100 responses, of both quantitative scoring and qualitative explanations.

6.2. The third party organisation will be procured based on joint agreement between DCC and Ofgem and will be paid for by DCC. The third party survey organisation will also analyse the results of the survey, aggregating them into an annual report to be reviewed by DCC and Ofgem before release to industry.

## **Margin at risk**

6.3. We propose to place no margin at risk for DCC, having a reputational impact only. We believe the reputational impact of this incentive for a commercial organisation, such as DCC, to be a greater motivator.

6.4. For more subjective areas of assessment, including satisfaction, that cannot be easily measured or incentivised through more established mechanistic regimes, Ofgem often uses a discretionary reward scheme with the companies we regulate to encourage and drive performance areas. The value of any discretionary financial penalty / reward would be immaterial in driving behaviour beyond existing reputational motivators. Given the subjective nature of the incentive and potential response bias it would be complex to design an incentive that can be fairly and transparently applied.

6.5. In line with the agreed principals around incentive design, the planning and implementation of a complex incentive should be proportional to its financial value. We believe it be in the best interest of efficient programme delivery for a simpler, non-financial incentive to apply.

6.6. The purpose of the incentive, given its small value, lays with the fact that participant satisfaction and engagement lays important foundations for future phases of the programme. We anticipate using the information gathered in this phase of the programme to act as a baseline to benchmark future performance against in order to apply financial incentives during DBT and Live Operations Phases.

## **Developing for future phases**

6.7. Our intention is to develop an incentives framework for future phases of the switching programme which links stakeholder satisfaction to DCC's margin. The lack of existing baseline is one of the key reasons we are keen to ensure that we report on a broader set of metrics which could provide a sufficient baseline to track performance against if these metrics were to be incentivised with margin at risk in future phases.

6.8. DCC has a concern that 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. The survey will focus on engagement and communication with targeted questions that should partially account for this bias. The transitional phase will allow us to ensure the surveys are structured appropriately and relevant questions are being asked.

6.9. It is intended that the reports generated during the transitional phase will be used as a baseline for future phases of the programme. Future incentives related to this and linked to margin will take into consideration the improvement rates on previous reports. Any target setting methodology will take into account previous years' / phase performance which should further mitigate the concern.

6.10. We will work with DCC and industry to further develop an incentives framework that will allow for this measure to be linked to DCC's margin in future phases of the programme.

## 7. Next Steps

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### **Views on our proposals**

7.1. We welcome views on the proposals in this document. We will consider any views provided when we take our decision. Please send responses to [switchingprogramme@ofgem.gov.uk](mailto:switchingprogramme@ofgem.gov.uk) by 12 January 2017. We intend to publish our decision on DCC's margin and incentives framework in February 2017.

## Appendices

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## Appendix 1 - Consultation Response and Questions

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1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.3. Responses should be received by 12<sup>th</sup> January 2017 and should be sent to:

Natasha Sheel  
Switching Programme  
Ofgem  
9 Millbank  
London  
SW1P 3GE  
020 7901 7206  
Switchingprogramme@ofgem.gov.uk

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website [www.ofgem.gov.uk](http://www.ofgem.gov.uk). Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Next steps: Having considered the responses to this consultation, Ofgem intends to publish its final decision and direction in February 2017.

### **CHAPTER: Three**

**Question 1:** Do you agree with the proposed methodology for assessing DCC's margin, including the proposal to use EBT or net profit as the comparable measure? If not, please justify an alternative methodology.

**Question 2:** Do you agree with our proposed assessment of DCC's risk? If there are further aspects to this which you feel have not been covered, please specify.

**Question 3:** What further comparators would you suggest we use in establishing DCC's margin? Please justify any proposed comparators and the suitability of using their corresponding industry.

#### **CHAPTER: Five**

**Question 1:** Do you agree with our minded to position for the shape of the margin at risk curve? Does it adequately address the desire to ensure DCC is motivated to deliver on time or as soon as possible thereafter? If not, please explain why and how it can be improved.

**Question 2:** What is your view on our proposed position to determine the appropriate length of time after which 0% of margin is granted for each milestone? (What is the "X" in "T1+X"?) Please provide justification for any alternative suggestions.

**Question 3:** Is 100% of the previously lost margin appropriate for the recovery mechanism where the final milestone is met on time? If not, what proportion would be?

**Question 4:** Do you have a preference for the mechanics of the recovery mechanism (table 9) and whether recovery should be based on absolute or relative delay? Please support any suggestions.



## Appendix 2 – Draft Direction

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**A draft of version of the proposed direction for the CRSPA term is included for reference within this Appendix. It is intended that the final direction for the CRSPA will issued in February 2017 taking on board feedback from this consultation. Terms in square brackets are subject to consultation and may differ in the final direction.**

**To: the holder of the smart meter communication licences  
DIRECTION ISSUED BY THE GAS AND ELECTRICITY MARKETS AUTHORITY  
PURSUANT TO PARAGRAPH 10 OF CONDITION 36 OF THE CONDITIONS OF  
THE SMART METER COMMUNICATION LICENCES GRANTED PURSUANT TO  
SECTIONS 7AB(2) AND (4) OF THE GAS ACT 1986 AND SECTIONS 6(1A) AND  
(1C) OF THE ELECTRICITY ACT 1989**

**WHEREAS**

1. The company to whom this Direction is addressed ("the licensee") holds the smart meter communication supply licences granted, or treated as granted, pursuant to sections 7AB(2) and (4) of the Gas Act 1986 and sections 6(1A) and (1C) of the Electricity Act 1989 in which condition 36 (Determination of Licensee's Allowed Revenue) has effect ("the licence").
2. Paragraph 9 of condition 36 of the licence provides that the total amount of the licensee's Centralised Registration Service Revenue (CRSR) will be calculated for Regulatory Year t in accordance with the following formula:

$$CRSR_t = CRSEC_t + CRSIC_t + CRSPC_t + CRSCA_t + CRSPA_t$$

3. The Gas and Electricity Markets Authority ("the Authority") has the power pursuant to paragraph 10 of condition 36 of the licence to amend the value of the term "CRSPA<sub>t</sub>", which would otherwise be zero.
4. On 24<sup>th</sup> November 2016, the Authority consulted on the contents of the direction and has carefully considered the responses to that consultation.

**NOW THEREFORE**

5. The Authority hereby directs that the value of CRSPA<sub>t</sub> shall be as set out in the schedule to this direction.
6. This direction shall take effect on [date of decision document- to be confirmed] and shall continue until revoked or amended by the Authority following a period of consultation with the licensee for not less than 28 days, beginning on the date of notice of the revocation or amendment, or such other period as may be agreed in writing by the Authority and the licensee, during which representations with respect to the proposed revocation or amendment may be made.
7. The following documents constitute notice pursuant to section 38A (Reasons for decisions) of the Gas Act 1986 and section 49A (Reasons for decisions) of the Electricity Act 1989:
  - a. This direction;
  - b. Ofgem. [date to be confirmed] "Decision on margin and incentives for DCC's role within the Transitional Phase of the Switching Programme";
  - c. Ofgem. (November 2016) "Minded to position on margin and incentives for DCC's role within the Transitional Phase of the Switching Programme"; and
  - d. Ofgem. (May 2016) "Decision: DCC's role in developing a Central Registration Service"

These documents are available on the Ofgem website: [www.ofgem.gov.uk](http://www.ofgem.gov.uk)

Dated:



Draft direction on margin and incentives for DCC's role within the Transitional Phase of the Switching Programme

**Signed on behalf of the Authority by Rob Salter-Church  
Duly authorised for that purpose by the Authority**

**SCHEDULE**

**Value of CRSPA<sub>t</sub>**

1. The value CRSPA<sub>t</sub> shall be calculated according to the following formula:

$$\text{CRSPA}_t = [\text{percentage subject to consultation}] * (\text{CRSIC}_t - \text{DM1}_t - \text{DM2}_t - \text{DM3}_t + R_t)]$$

**Interpretation**

2. Unless a contrary intention appears, any reference to terms in this direction is to be read to have the same meaning given in the licence.
3. In this direction:

CRSCB <sub>t</sub>	means the total cost base over the lifetime of the Transitional Phase of Switching Programme associated with the delivery of the identified milestones. The value of this term will be assessed through DCC's annual price control submission, having regard to the forecast within the document [DCC Business Case for DCC activities during the Transitional Phase of the Switching Programme]
CRSIC	has the definition provided for at condition 36 of the licence
DM1 <sub>t</sub>	means Delivery Milestone 1, which has the value of: <ul style="list-style-type: none"> <li>• 0 if the DM1<sub>t</sub> Specified Criteria are achieved by T1;</li> <li>• 1/3 CRSCB<sub>t</sub> x TA1 x [25%] if the DM1 Specified Criteria are achieved after T1 but before T1 + [4] weeks;</li> <li>• 1/3 CRSCB if the DM1<sub>t</sub> Specified Criteria are not achieved before T1 + [4] weeks</li> </ul>
DM2 <sub>t</sub>	means Delivery Milestone 2, which has the value of: <ul style="list-style-type: none"> <li>• 0 if the DM2<sub>t</sub> Specified Criteria are achieved by T2;</li> <li>• 1/3 CRSCB<sub>t</sub> x TA2 x [33%] if the DM2 Specified Criteria are achieved after T2 but before T2 + [3] weeks;</li> <li>• 1/3 CRSCB<sub>t</sub> if the DM2 Specified Criteria are not achieved before T2 + [3]weeks</li> </ul>
DM3 <sub>t</sub>	means Delivery Milestone 3, which has the value of:

Draft direction on margin and incentives for DCC's role within the Transitional Phase of the Switching Programme

	<ul style="list-style-type: none"> <li>• 0 if the DM3 Specified Criteria are achieved by T3;</li> <li>• <math>\frac{1}{3} \text{CRSCB}_t \times \text{TA3} \times [25\%]</math> if the DM3 Specified Criteria are achieved after T3 but before T3 + [4] weeks;</li> <li>• <math>\frac{1}{3} \text{CRSCB}_t</math> if the DM3 Specified Criteria are not achieved before date T3 + [4] weeks</li> </ul>
DM1 Specified Criteria	<p>means completion of the CRS technical specification</p> <p>The criteria for completion has the meaning given in [CRS technical specification product description document], as may be amended from time to time</p>
DM2 Specified Criteria	<p>means completion of the CRS tender packs for the final major procurement project</p> <p>The criteria for completion has the meaning given in [CRS tender pack product description document], as may be amended from time to time</p>
DM3 Specified Criteria	<p>means approval of the contract award recommendation report for the final major procurement project</p> <p>The criteria for approval has the meaning given in [contract award recommendation product description document], as may be amended from time to time</p>
$R_t$	Means the recovery mechanism which has the value of [to be confirmed subject to consultation]
T1	is a date to be set by the [Switching Programme Plan document], as may be amended from time to time
T2	is a date to be set by the [Switching Programme Plan document], as may be amended from time to time
T3	is a date to be set by the [Switching Programme Plan document], as may be amended from time to time
TA1	<p>Means the actual time in weeks after T1 that the DM1 Specified Criteria are met</p> <p>Where TA1 is greater than [4] weeks</p>

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	TA1 will be taken to equal [4] weeks
TA2	Means the actual time in weeks after T2 that the DM2 Specified Criteria are met  Where TA2 is greater than [3] weeks TA2 will be taken to equal [3] weeks
TA3	Means the actual time in weeks after T3 that the DM3 Specified Criteria are met  Where TA3 is greater than [4] weeks TA3 will be taken to equal [4] weeks

## Appendix 3 – DCC's Proposal on Margin & Incentives and DCC's Assessment of Potential Incentives

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**DCC's proposal for margin and incentives and DCC's assessment of potential incentives are included within this appendix. These sections are respectively the same as section 13 and Appendix G in the consultation on the draft DCC Business Case and are included as a supporting document to this consultation for completeness. This appendix has been written by DCC and does not reflect Ofgem opinion.**

## Appendix 4 - Glossary

---

### A

#### Allowed Revenue

Total amount of revenue determined on an accruals basis in relation to each regulatory year in accordance with the Principal Formula set out in Part C of Condition 36 of the licence after the deduction of value added tax (if any) and any other taxes based directly on the amount concerned.

#### Authority

The Gas and Electricity Markets Authority

### B

#### BEIS

Department for Business, Energy and Industrial Strategy. UK Government department responsible for energy and climate change policy.

### C

#### Centralised registration service (CRS)

This refers to the intended future service to facilitate faster switching at gas and electricity premises.

### D

#### Data and Communications Company (DCC)

This is a company that manages the data and communications to and from domestic consumers' smart meters. Smart DCC Ltd was granted the licence by the Secretary of State with effect from 23 September 2013.

### E

#### EBITDA margin

This measures profitability as a proportion of total revenue, where profit as determined by earnings before interest, tax, depreciation and amortisation (EBITDA) is divided by total revenue.

#### EBIT margin

Earnings before interest and tax (EBIT) can be used as a margin when taken as a proportion of total revenue. It provides a measure of earnings ability.

#### EBT margin

The ratio of earnings before tax (EBT) to total revenue is the EBT margin measuring profitability.

#### External Costs

As defined in licence condition 35 of the licence. Costs economically and efficiently incurred in procuring fundamental service capability from external service providers,



i.e. infrastructure costs. It is not anticipated for there to be a requirement for fundamental service capability and therefore External Costs within the Transitional Phase.

## **I**

### **Internal Cost**

As defined in Condition 35 of the licence. Costs (excluding external costs and pass-through costs) that were economically and efficiently incurred by the Licensee for the purposes of the provision of Mandatory Business Services under or pursuant to the SEC

## **M**

### **Mandatory Business Costs**

Costs associated with the Authorised business of that consists of the operation or provision, on behalf of or to SEC parties, of Mandatory Business Services under pursuant to the SEC.

### **Mandatory Business Services**

As defined in Condition 1 of the licence, means the services comprising of the Mandatory Business of the Licensee. These are the Core Communication Services and the Enabling Services.

## **N**

### **Net profit margin**

This measure of earnings potential takes net profit (what is remaining after deducting all expenses, interest, depreciation, amortisation and tax) as a proportion of total revenue.

## **O**

### **Ofgem**

Office of Gas and Electricity Markets

## **P**

### **Pass-Through Costs**

In relation to each Regulatory Year the amount equal to the total annual fee paid by the licensee to the Authority during that Regulatory Year and the payments made by the licensee to SECCo Ltd for purposes associated with the governance and administration of the SEC.

## **R**

### **Regulated Revenue**

The actual revenue in a regulatory year, measured on an accruals basis received by the Licensee through Service Charges that are levied in accordance with the provisions of Condition 18 of the licence.

### Regulatory Year

As defined in Condition 1 of the licence, means a period of 12 months beginning on the 1 April each calendar year and ending on 31 March of the next calendar year.

### Relevant Services Capability

As defined in Condition 1 of the licence, means the capability procured (or provided from within the Licensee's own resources) in accordance with Condition 16 (procurement of Relevant Service Capability) of the licence for the purposes of securing the provision of Mandatory Business Services under or pursuant to the Smart Energy Code. This means the internal and external resources which the DCC relies upon in order to provide services to DCC Users.

## S

### Smart Energy Code (SEC)

The SEC is a new industry code which is a multiparty agreement which will define the rights and obligations between the DCC and the users of its services Suppliers, network operators and other users of the DCC's services who will all need to comply with the Code

### SECCo Ltd

The joint venture company established under the SEC for the purpose of acting as a corporate vehicle to assist the SEC Panel in exercising its powers, duties, and functions, including by entering into contracts for that purpose, owned by SEC Parties.

### SEC Panel

Panel established under the SEC to oversee the Smart Energy Code with powers and duties as set out in Section C of the SEC.

### Smart Meter Communication Licence ("the licence")

The Smart Meter Communication Licences granted pursuant to Sections 7AB (2) and (4) of the Gas Act 1986 and Sections 6(1A) and (1C) of the Electricity Act 1989.

### Switching programme

This programme concerns the process used by industry to transfer a consumer from one supplier to another. Smart metering presents an opportunity to improve this process. Ofgem's ambition is for a fast, reliable and cost-effective process that facilitates competition and builds consumer confidence.

### Switching arrangements

The process by which a consumer switches from one supplier to another.

## Appendix 5 - Feedback Questionnaire

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1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

**Andrew MacFaul**  
Consultation Co-ordinator  
Ofgem  
9 Millbank  
London  
SW1P 3GE  
andrew.macfaul@ofgem.gov.uk