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Dear Jacqui

### **DCC Price Control Consultation: Regulatory Year 2015/16**

Thank you for providing the opportunity to respond to your consultation on the 2015/16 DCC Price Control. This constitutes the response of Smart DCC Ltd, as licensee.

The full response is made up of this letter and two supporting annexes. I can confirm that we are content for the letter and first annex to be treated as non-confidential and suitable for publication.

The second annex contains confidential information and we request that it is not published.

#### *Summary*

We are pleased that Ofgem has concluded that the external costs incurred with our fundamental service providers were assessed as being economic and efficient in 2015/16.

This was a year of considerable change, almost exclusively driven from outside DCC, and we are proud of the progress that was made towards delivering the DCC infrastructure and service.

We are disappointed that Ofgem has sought to disallow certain of our internal costs. This appears inconsistent with Ofgem's conclusions in respect of our external costs and presents a challenge to DCC which we will say more about later in this letter and in the annex.

More positively, we had our first opportunity to reduce the overall cost of the programme to consumers, by working with one of our service providers to restructure certain of their activities. We are pleased that Ofgem has recognised

this through their acceptance of our gainshare application and we will continue to seek other opportunities to further reduce costs.

As a general point, DCC is increasingly concerned by Ofgem's apparent attempts to modify the commercial terms under which the licence was awarded through a competitive tender process. Yet again, there have been explicit references to reopening the question of what is the appropriate margin for DCC, when this was fixed for the full term of the licence.

Likewise, having previously restricted the applicability of the overhead charge, Ofgem has now proposed to introduce an arbitrary cap on the absolute value of the overhead over the full term of the licence. This removes the link to internal costs which again was an explicit term of the agreement under which DCC was established, and hence further reduces the inherent certainty of the regulatory framework

If Ofgem persists with this proposal, we may have to consider alternative approaches to justifying or procuring these services, which will almost certainly result in higher costs and hence poorer value for consumers. Ofgem should be mindful of the perverse incentives that might be created.

Our greatest issue with Ofgem's proposals concerns our application for a baseline margin adjustment, where Ofgem has, in our view, changed completely since last year, the terms under which margin adjustment is assessed. This change has the immediate consequence of denying DCC c.£1m in margin this year and an unspecified amount in future years.

We are strongly of the view that Ofgem's proposals are unfair and potentially unlawful. In particular, we consider that Ofgem's interpretation of the relevant licence provisions and Price Control guidance is incorrect. Moreover, we note that DCC made clear the approach that it intended to adopt to margin adjustment in its 2014/15 notification, that is, not to apply for it until it was sufficiently certain of the underlying costs to which it related. Unsurprisingly, Ofgem accepted that approach.

We feel obliged to put on the record that we feel unclear about the future under what feels like an uncertain and at times negative regulatory environment which fails to reflect the scale of challenge and risk that we have faced in delivering the DCC Smart Meter infrastructure.

In developing this response, we have followed the broad structure of the consultation document, addressing the specific questions which Ofgem has raised, and these can be found in the attached annex. However there are a number of key arguments which DCC wishes to make through this letter and would ask Ofgem to consider before finalising its proposals.

#### *Ofgem approach to ex-post regulation*

Ex-post cost assessment can have negative consequences, especially where there is no upside for performance delivery. If the company is concerned about costs being disallowed it may "play safe" and avoid taking risks or seeking to innovate in a manner which could be of benefit to consumers.

This is a particular risk in the context of an organisation like DCC that is facing significant unknowns and delivery challenges. During 2016, DCC pulled out all the stops to keep on track to deliver a live service, which we subsequently did – a decision which we believe was supported by both Government and Industry. For Ofgem to then disallow certain costs on the grounds of inefficiency sends completely the wrong signals about our focus on delivery.

A focus on the consumer benefit would lead Ofgem to prioritise innovation in delivery and effective management of the external service providers who account for around 80% of DCC's total costs – not on chipping away at DCC's internal costs which are a small part of the total.

Ofgem has considerable flexibility in the standard of proof that it applies to price control assessment. In our view, Ofgem should be giving greater consideration to the particular context of the DCC and the reasonable mitigations that Ofgem might take to address the known risks of an ex post regime.

Pointers from previous Ofgem decisions involving ex post cost assessment highlight that, in most (if not all) other cases where Ofgem uses ex post assessment it is as part of a broader ex ante control. Hence, even where costs are judged to be inefficient they are subject to the sharing mechanism that applies, e.g. the company only bears perhaps 25-45% of the inefficient costs.

In the absence of a formal sharing factor, DCC bears 100% of any disallowances and hence there is a stronger argument for taking a more cautious approach to disallowing costs.

Other “ex-post within ex-ante” arrangements also offer inherent trade-offs, as the company has the potential for outperformance in respect of incentives etc., which helps address what could otherwise be significant implications for the certainty of financeability. However, DCC does not benefit from such upside opportunities, with the exception of the external contract gainshare, which by definition is linked to specific opportunities rather than a reward for systemic improvement.

Again, this should make Ofgem cautious in disallowing costs and be more aware of the potential impacts on financeability.

In network price controls, Ofgem has previously indicated that to completely disallow costs they would need to be “manifestly inefficient”, and that it is important not to judge costs with the benefit of hindsight. It is important for there to be clarity as to what the appropriate standard is against which efficiency will be judged in the DCC context.

Given the inherent difficulties with an ex post regime we welcome Ofgem's commitment to move to an ex-ante regime for DCC in due course and would encourage thinking to start on that as soon as possible

#### *Cost disallowances - resources*

Virtually all of the disallowances relate to permanent or contract resource costs. The consultation document is unclear as to the method that has been applied in arriving at these conclusions, being a mixture of analysis and judgement, and thus

far we have been unable to obtain sufficient detail from Ofgem to enable us to replicate their conclusions.

We have asked Ofgem to provide further insight into its workings, such that we can critique the appropriateness of their proposals or seek to modify our processes in future years. Ofgem have agreed to do so but have only agreed to do so after this consultation is finalised and its final proposals are published.

We do not understand the logic of such an approach; the obvious reason that DCC needs the information is in order to respond effectively to this consultation. Ofgem's approach is disappointing, unfair and inconsistent with the greater commitment to transparency of decision-making shown in other sectors regulated by Ofgem, such as the energy networks where cost models are developed jointly and shared.

However what we do know is that some cost centres have been judged efficient whilst others not. We would argue that a more balanced assessment would have looked at our resource costs in the round, rather than on a cost centre basis. This allows management to make choices about where it is appropriate to make investments in resourcing, in the interests of delivering the overall objectives of the programme.

In its conduct of the energy network price controls, Ofgem is careful to avoid 'cherry picking' of this sort by focussing on overall costs. We believe that Ofgem should be adopting a similar approach in its assessment of DCC costs, thus enabling management to give priority where appropriate to considerations of timeliness or quality, rather than be purely driven by cost.

As a further point, if Ofgem insists on scrutinising costs at a cost centre level, Ofgem should apply a suitable materiality test. In both Finance and Corporate Management, Ofgem has disallowed resource costs which are lower than the cost of 1FTE. We would argue that this is not good regulatory practice and suggests micromanagement, which is disproportionate to the sums at stake. Ofgem should also consider the impact on morale within DCC, when managers are subject to scrutiny of this sort.

We understand that Ofgem has a general concern over the employment of staff above a median salary cost; although Ofgem has acknowledged also that, in some roles, the complexity of the programme we are delivering demands a level of expertise above the norm.

Hence we are disappointed to find that the majority of disallowances are associated with roles in those areas where expertise might be expected to deliver the greatest value, namely Programme Management, Design and Assurance and Operations. It is surely not to the benefit of consumers or industry if DCC is incentivised to seek out lower cost resource in areas such as these, or indeed others, such as Commercial Management – lower cost will generally equate to lower expertise. Ofgem is not in a position to judge the calibre of the staff and hence whether this genuinely represents inefficiency.

By their very nature, salary levels are set in the market and reflect the costs in the market at a point in time. As Ofgem notes, we have had a number of instances during the year of staff walking away from accepted offers of employment, having

received a better financial offer elsewhere. Ofgem should give proper weight to such evidence rather than simply relying on statistical evidence of wage rates.

#### *Cost disallowances - services*

In respect of external services, Ofgem states that it does not consider it acceptable for DCC to incur external service costs to justify its commercial position in relation to its parent company. However, we believe that there is an important matter of principle here.

Ofgem has consistently chosen to challenge the margin which DCC can earn, both in respect of the cost base it applies to and the actual level of margin itself, irrespective of the fact that these commercial arrangements were arrived at through an open and competitive procurement process and were intended to cover the whole period of the licence.

It would appear that Ofgem sees the margin as being only of interest to our shareholder, but in an ex-post environment where Ofgem feels able to disallow costs as a matter of routine, the margin provides the only mechanism open to DCC through which we can absorb losses, such as disallowances. This goes to the heart of a regulated entity being able to finance its activities.

In light of this, we believe that it is completely reasonable to commission external advice to inform and support our position and is a clear example of where it would not be efficient for DCC to maintain such specialist expertise internally.

It should also be said that in other sectors, regulated by Ofgem, regulatory costs such as these would be treated as normal business expenses, subject to them being obtained economically and efficiently. In the worst case, such expenses would be subject to the sharing factor, but could be traded off against savings elsewhere or incentive rewards. Again, it seems unreasonable for Ofgem to disallow costs under ex-post which would be allowable under ex-ante.

Furthermore, the notion of 'a point of principle' does not give Ofgem the right to ignore normal regulatory practice which would indicate that these costs should be considered immaterial for disallowance.

To conclude, for Ofgem to disallow these costs is wholly unfair and unreasonable, particularly as the need for such expenditure is essentially a consequence of Ofgem's continued and unjustified challenges to our rate of return.

If Ofgem continues to pursue the argument around the rate of return, it has the potential to damage significantly the relationship with DCC. We would ask Ofgem to respect the terms under which the licence was awarded.

#### *Overhead charge*

The commercial bid that Capita made to win the DCC licence included an overhead charge, based on a percentage of our internal costs. As in many "group organisations", this overhead charge is intended to support the corporate centre, as well as fund services provided on a collective basis which group companies can access, thus benefiting from economies of scale.

In the case of DCC, this use of overhead provides us with services such as Accounts Payable/Receivable, Treasury, Legal advice, HR services etc. at no transactional cost. It also contributes to more intangible services which we can draw on, such as executive oversight/support, health and safety management or specialist commercial advice. Finally, it provides our contribution to Capita's corporate costs, such as the executive management, head office organisation, R&D etc.

In an effort to reassure Ofgem of the significant value being obtained through the overhead, DCC provided evidence of indicative costs that we might face if we were forced to contract directly for some of these centrally provided services. In response, Ofgem now proposes to cap the overhead charge for the full-term, based on the sample of those services which were able to be readily valued, ignoring the fact that this was clearly presented as a subset of the shared services available to DCC, and makes no allowance for either the more intangible services or any contribution to the group overhead.

Furthermore, Ofgem has sought to apply this retrospectively.

We regard Ofgem's proposals as arbitrary and unacceptable, and it is hard to know how to move forward on this issue.

Surely it can not be to the benefit of DCC's customers if DCC were forced to devote time and money, on an ongoing basis, to potentially difficult and expensive cost-justification exercises, so as to prove the value obtained from the overhead.

Likewise, we could consider wholesale insourcing of activity, but it is hard to imagine that this would prove more economic and efficient.

We would strongly argue that both courses of action would result in greater expense overall and hence poorer value for consumers. Also, it would be counter to the Government's intent when the licence was awarded, namely that DCC should draw upon the Capita organisation as a means to deliver on its objectives.

Regrettably, we can only interpret Ofgem's actions as a further attempt to amend the commercial basis under which DCC was formed. Ofgem should be mindful of the impact on commercial and regulatory certainty that will result from unjustified and unexpected proposals, such as this.

#### *Baseline Margin application*

Our greatest concern lies in Ofgem's treatment of our application for an adjustment to the Baseline Margin.

There were extensive discussions prior to the 2014/15 submission on the way in which the application process is intended to work, ultimately leading to the issuing of a set of Ofgem guidance in July 2015. This enabled us to make a successful application in 2014/15, based on volume, and gave us some confidence as to how to approach future applications.

In that application we indicated that we would be seeking a Baseline Margin adjustment for 2015/16 and that this would be made for the first time in the 2015/16 Price Control submission when the underlying costs in respect of which margin was

claimed were sufficiently certain. At no point did Ofgem indicate, let alone advise that we should apply before we had such certainty and that our failure to do so would preclude Ofgem granting margin for costs that Ofgem accepted had been incurred economically and efficiently.

We are, therefore, most concerned and indeed, dismayed that Ofgem has apparently re-interpreted the licence and guidance this year, with no notification of this re-think to DCC, and in the process disallowed around £1m of legitimate margin, as well as effectively limiting claims which we would have expected to make in the coming years.

The nub of Ofgem's argument seems to be that we should have made our application for a proportion of the adjustment in 2014/15 and thus, under the terms of the licence, Ofgem cannot grant that margin adjustment now. Our position, (which we also understood was Ofgem's, until Ofgem's consultation response to this notification), is that under the licence we should only apply when additional costs, which might attract margin, were sufficiently certain. This is what we did in the 2015 notification and have done in this notification. Indeed, our intention to adopt that approach was stated in our submission to Ofgem in 2014/15 (2015 notification), and the subsequent response to the request for further information. As we have said, Ofgem never indicated that this might be incorrect.

Ofgem's position would logically push DCC towards making an application for margin on all forecast costs for the rest of the term of the licence, irrespective of the certainty of the forecasts. This is perverse because (i) such costs may not be quantifiable, particularly the further out you forecast, (ii) it introduces inherent unreliability in the application; (iii) it is likely to inflate the size of the adjustment; and (iv) it increases the regulatory burden in terms of cost and admin in debating whether the adjustment is justifiable or not (v) the fixed sums in Appendix 1 to Condition 36 would likely subsequently need to be changed up or down. The previous approach (DCC's current approach) is more certain, quantifiable and sensible in light of how the allowable revenue is calculated under Condition 36 of the licence.

We consider Ofgem's position is an irrational one for an economic regulator to take and one which is unlikely to be to the benefit of consumers.

In response to this unexpected outcome, DCC sought advice from Leading Counsel, including as to Ofgem's interpretation of the licence and guidance, which is reflected in the views set out in the confidential Annex to this letter.

### *Conclusion*

All in all, DCC is both disappointed and deeply troubled by Ofgem's proposals and in particular two aspects. Firstly, the apparent desire by Ofgem to unpick the commercial agreement under which the licence was awarded to DCC. Secondly, the lack of balance which we believe the application of the ex-post regime is providing.

We are increasingly concerned that Ofgem's actions could undermine the financial viability and confidence of DCC, as well as limiting its ability to deliver value to consumers and Industry.

If you have any questions regarding the contents of this letter and annex, please do not hesitate to contact me.

Yours Sincerely

A handwritten signature in blue ink, appearing to read 'H Fleming'.

**Helen Fleming**  
Director of Policy

Cc: Robyn Daniell, Ofgem