British Gas
Looking after your world

12th January 2017

Rachel Clark
Ofgem
9 Millbank
LONDON
SW1P 3GE

Dear Rachel,

Margin and incentives for DCC's role in the transitional phase of the Switching Programme

British Gas' response to Ofgem's draft direction for DCC's margin and incentives of the switching programme is non-confidential and may be shared on your website.

British Gas broadly agrees with Ofgem's draft direction, although we feel it is generous in part and we offer the following observations in terms of support:

- We agree that the external costs should be excluded from DCC's margin calculation. We feel including external costs in the margin calculation would cause DCC a conflict of interest in their procurement activities and is in opposition to their SMIP price control formula.
- Given the low risk from DCC's monopoly position we believe an 8% margin is generous, however we agree with Ofgem's analysis finding suitable comparators challenging.
- Within the DCC's business case on page 10, the DCC states that approximately 50% of their costs are linked to technical specification and procurement activities, with the other 50% supporting Ofgem's programme.
    - The 50% is at odds with the 25% stated as at risk in the DCC margin proposal, without any justification from the DCC. We therefore believe at least 50% of the DCC margin should be at risk within the incentive arrangements.
    - For the avoidance of doubt, we strongly believe the DCC's programme management resource costs for the Switching programme should be included in the margin at risk, as these resources have a direct influence over the success of the DCC meeting their milestones.
- The proportion of time over which the DCC loses their milestone payment should be at most 10% of the time period to deliver. With a 15-25% range the DCC can deliver between 11 to 17 weeks late and still receive a small reward. This is counterintuitive to the collaborative approach Ofgem and DCC are using to decide the programme timescales.
- Learning from the SMIP, we believe principles should be in place for assessing re-plans, including the DCC additional costs and the affect on the DCC's margin. We feel that this potential element of the programme has not been discussed and warrants principles being established ahead of milestones. We have often felt during the SMIP re-plans that the DCC's milestones and incentives have simply lifted and shifted with the delays, regardless of fault, passing increasing cost and risk onto suppliers.

We have answered the your consultation questions in the appendix. Please do not hesitate to contact me on the number below, if you want to talk through in detail.

Yours sincerely,

Sharon Johnson
Head of Industry Development
British Gas
07789 570250

Appendix: Answers to consultation questions

Chapter 3

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.

   Yes we agree that earnings before tax is a reasonable comparison to similar organisations to the DCC.

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

   We agree that the DCC and the faster switching programme have low risk. Given the DCC is a monopoly organisation with the Smart Energy Code protecting invoice payments and the control and collaboration the DCC have with Ofgem in the Faster Switching programme. The DCC has also completed 3 regulatory years of ex post price control reviews to understand whether their costs are economic and efficient.

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.

   No, we have already offered Xoserve, Gemserv, Elexon and the energy networks.

Chapter 5

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.

   We agree that a simple 2 point line is the best shape for the margin at risk curve. A straight line between 100% and 0% incentive payment is simple to understand and administer. However the gradient of line will be key to setting the incentive correctly.

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.

   We agree that the length of time between full incentive and zero should be in proportion to timescales on the plan as the milestones are subsequent to each other. We feel that between 15%-25% additional time before losing the whole incentive is too high and 10% is the correct level. At 25% the DCC will have 17 weeks or 4 months longer to deliver the transitional phase before losing 100% of their incentive, likewise with 15% the DCC have 11 weeks, close to 3 months.

   For a programme where the DCC are in collaboration with Ofgem and jointly agree the timescales, generous, though diminishing incentives, should not be required.

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

Yes.

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.

   We have no preference on the recovery mechanism.

   However, learning from the SMIP, we believe principles should be in place for assessing re-plans, including the DCC additional costs and the affect on the DCC's margin. We feel that this potential element of the programme has not been discussed and warrants principles being established ahead of milestones. We have often felt during the SMIP re-plans that the DCC's milestones and incentives have simply lifted and shifted with the delays, regardless of fault, passing increasing cost and risk onto suppliers.