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By email to: switchingprogramme@ofgem.gov.uk

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Dear Natasha

Switching Programme: Draft direction on margin and incentives for Transitional Phase

Thank you for providing the opportunity to respond to your consultation on the draft direction on margin and incentives for DCC's role within the transitional phase of the Switching programme (herein 'programme').

This letter, along with the accompanying annex, constitutes the response of Smart DCC Ltd, as licensee. I can confirm that we are content for this response to be treated as non-confidential and suitable for publication.

Through the Commercial workstream, DCC has been in discussion with Ofgem, for some months, on the return that should be available to DCC in recognition of our contribution to the programme to design and procure a solution which delivers faster and more reliable switching.

Our case, both for a specific margin level and for an appropriate incentive framework, is laid out in our proposal which Ofgem has published alongside this consultation.

We see limited value in repeating the detail of our proposal in this letter; however we have reframed our position against the consultation questions in the accompanying annex. In addition, there are a number of key points which we wish to emphasise:

Ofgem's proposal

The central decision which needs to be made concerns the level of margin which DCC will be able to earn through a successful contribution to this programme. In our business case, we have argued for 15%, whereas Ofgem argues for a range of 8-12%. However there are many other factors that can impact upon the likelihood

of achieving the allowed margin, which we go on to describe in subsequent sections.

Ofgem should be mindful that it is the combination of what is available by way of a return, and our view as to the extent to which this might be reduced, which will ultimately shape our decision as to whether we are able to participate or not.

There are significant decisions yet to be made around the scope, programme timescales/plan and others, which can all materially impact upon our assessment of our probable return, and hence it is reasonable for DCC to propose a level of margin which makes an allowance for this uncertainty.

Inherent risk

Ofgem seeks to place considerable emphasis on risk as a determinant of the return and argues that our participation is inherently low risk. Contrary to Ofgem's view, we see considerable uncertainty and risk in this programme.

Ofgem admits that there is uncertainty over the scope of the Transitional Phase. DCC has prepared a business case, after several months of joint working with Ofgem, however Ofgem does not feel able to sign-off on this plan.

Whilst we welcome Ofgem's commitment to work with us to produce a revised plan, addressing any points raised by stakeholders in response to this consultation, we are still left with uncertainty and hence risk. Questions of scope and how these are resolved, the acceptability of further cost or effort if we believe either to be required, how we reconcile differences in the overall programme plan with our own business case - all could impact on the ultimate form of the plan and the amount of risk we are taking on, in committing to deliver against it.

We are pleased with Ofgem's proposal that our margin should be based on a percentage of costs incurred, rather than a fixed value. This should bring a welcome simplicity to establishing the precise value of margin to be claimed. However, it does also emphasise the importance of agreeing a robust change management process. Change is inevitable and it is important that it does not become a distraction from the main task of delivering the programme.

We perceive significant risk that pressure will be applied to reduce our plan timescales to align with externally-imposed deadlines. This could place our milestone-linked margin at risk due to shorter timelines, whilst introducing a risk of disallowance if our response is to increase the resource on the programme in an effort to compensate.

In addition, we are dependent on Ofgem, and potentially other industry parties, to not impact upon our ability to deliver our obligations.

Ultimately, however, we are dependent on Ofgem, in its role as programme lead, to recognise where such occurrences arise. As indicated previously, this will require a robust but responsive change mechanism to be put in place, such that we are not unfairly penalised. We stand ready to work with Ofgem to define such a process.

Price Control risk

DCC had envisaged that the Price Control process would be relatively straightforward to operate. The business case, created through joint working between DCC and Ofgem, would provide a clear baseline against which our contribution could be judged, and any variations would be subject to formal change control.

Unfortunately, as the business case is not being formally approved, and Ofgem reserves its position in relation to the ex post review, we are effectively faced with a price control against a zero baseline, i.e. potentially having to justify all expenditure regardless of its value.

We recognise that the process of consulting on the business case ahead of baselining is intended to respond to that concern but the real test will be the stance that Ofgem takes when it comes to carry out its actual ex-post assessment.

We remain concerned that, in practice, this remains much more like our experience under Smart Metering than was envisaged when the proposition of an ex-post plus regime was being discussed. We look to Ofgem to provide assurance that it will only disallow costs that fall within the baselined business case in very exceptional circumstances.

In light of the above, it is unsurprising that our experience of being regulated on an ex-post basis serves to shape our commercial expectations. We perceive ex-post as being a much more penal regime than an ex-ante arrangement. It gives us limited reassurance that we will be able to recover our costs, and where we are penalised in this way, we have to bear 100% of the disallowance. There is no scope to earn upside such that we can trade-off losses in other areas. This leads us to feel there is an inevitability that our margin will be reduced below the allowed level, unlike many ex-ante regulated sectors where outperformance is routine and accepted by the regulator.

The proposal to base the margin on a fixed percentage of costs, rather than the use of a fixed value is a positive decision. It is preferable as firstly, it recognises the level of uncertainty over the scope of the programme, and it is responsive to changes in the cost base and thus avoids the need for a margin adjustment mechanism.

Our current discussions with Ofgem over the baseline margin adjustment process in the Smart Metering programme only emphasises the difficulty in operating such an adjustment process. We have no wish to see this carried over to the Switching programme.

Comparative return

We agree with Ofgem that a comparative approach is the appropriate way to establish a suitable return for an asset-light regulated business. This is in line with recent regulatory practice, as evidenced by the CMA, Ofwat, etc. However, the real challenge is in defining appropriate comparators.

We would seriously question a number of the choices assessed by Ofgem, such as international comparisons, which are notoriously difficult to make, and certain of the other less well-defined comparator sets, such as contract management companies, or staffing/outsourcing services. These companies are essentially providers of commodity services, and we do not consider that they have the kinds of capabilities which would allow them to play the pivotal role that DCC will play in the delivery of this one-off programme.

Ofgem also seeks to make the case that margin should be set in line with net profit rather than EBIT. This perhaps demonstrates a misunderstanding of the tax position faced by DCC. Whilst DCC is considered to be a not-for-profit entity, this does not mean it has no tax liability, which is borne on our behalf by Capita in respect of the margin we pass to them, as our shareholder. For that reason, tax is a material consideration and hence the only meaningful measure of profitability that should be considered is one stated before tax is deducted, i.e. EBIT.

We commissioned independent research from Europe Economics, which was shared with Ofgem, and demonstrated that a return of around 15% was appropriate when DCC was compared with other network and technology enabled businesses providing an operational service.

Thinking about the specifics of the transition phase, our role is to provide specialist programme services in the context of a complex transformation programme.

If Ofgem were to consider other options for delivery of the Transitional Phase, then we would suggest that Ofgem would need to contract with a professional services organisation and, in light of that, we consider that the margin which we have proposed is very competitive and offers good value.

Whether the level of margin is considered at a macro level, as in the Europe Economics research, or based on the specifics of the task at hand, DCC is confident that 15% represents a fair and reasonable commercial return.

Use of Incentives

DCC questions the appropriateness of Ofgem's proposals for a time-based incentive scheme, during the Transitional Phase. However, we agree that if such a scheme is to be applied, it should only relate to those items where DCC has a large degree of ownership and control.

Ofgem rightly recognises that there is the potential for timeliness and quality to conflict. We are concerned that a time-based incentive scheme has the potential to disincentivise additional quality in this phase of the programme, which might then deliver material time and/or cost savings in subsequent phases of the programme. We share the belief that close working within the programme can help to mitigate the risk of this occurring.

We are disappointed that the time-based scheme offers no potential for upside, but see the prospect of a 100% recovery of any lost margin at the final milestone, as being a helpful initiative.

For the Transitional Phase, we support the principle of keeping the incentive and recovery mechanisms relatively simple – this feels proportionate to the value of this

phase. However we feel that the delivery time percentages proposed (i.e. the time past the milestone at which 100% of margin is lost) are too low.

It does not feel right that DCC might see substantial reductions in margin, as a result of only being a matter of days late in meeting a milestone, simply as a consequence of the time periods between milestones being short. In addition, it could result in the change management process being a real source of contention, if a day's effort denied, linked to change, has a material impact on margin retained.

If you have any questions about our response, please do not hesitate to contact me.

Yours Sincerely

Helen Fleming
Director of Policy