

# Consultation on Margin and Incentives for Switching Programme

## Annex to Letter Response



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## 1 Introduction

This document forms part of Smart DCC's response to Ofgem's consultation on the draft direction on margin and incentives for DCC's role within the Transitional Phase of the Switching programme (herein 'programme').

DCC submitted its position to Ofgem ahead of the draft consultation and this was included within the consultation document.

As stated in the letter, we see limited value in repeating the detail of our proposal; however we are restating our position against the consultation questions in this annex.

## 2 Consultation Questions

### 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.*

Following some months of discussion with Ofgem, we can agree with a number of aspects of Ofgem's proposals concerning margin:

#### **Fixed percentage vs. fixed value for margin**

We agree that a fixed percentage is preferable to a fixed value for margin as firstly, it recognises the current level of uncertainty over the scope of DCC's role in the Transitional Phase, and secondly it is responsive to potential resulting changes to the cost base. As a result it avoids the need for an adjustment mechanism, such as exists in the Smart Metering programme.

We agree that the margin percentage will be applied to internal costs and welcome Ofgem's confirmation that this includes both internal resources and consultants/contractors operating in lieu of permanent staff, as well as potential procurement of external services.<sup>1</sup>

#### **Approach to setting the margin level**

We are content with the steps that are described by Ofgem in section 3 of its consultation document, but inevitably it is within the detail and the subsequent conclusions that we differ.

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<sup>1</sup> Note that external services are procurements for services such as consultants. It is distinct from external costs, which are costs associated with DCC's Fundamental Service Providers (FSPs).

### Step 2

We are pleased that Ofgem has adopted a comparative approach as the appropriate methodology to use in trying to establish a range for margin. This aligns with the professional advice that we have received, and is also consistent with recent regulatory precedents, such as in Ofwat's review of retail arrangements in Water and Ofcom's review of the regulatory framework for the Post Office.

### Step 3

We have considered Ofgem's question as to the choice of EBIT or Net Profit as a benchmark in Step 3. There are a number of observations that we wish to make.

When commercial businesses talk about margin, they are typically referring to operating margins (i.e. EBIT or EBITDA), rather than Net Profit. As both of these measures are widely published, availability should not impact upon the choice of EBIT or Net Profit, as a comparator.

However, we believe that there is a compelling reason why EBIT should be used rather than Net Profit, and this stems from what appears to be a misreading of DCC's wider tax position.

DCC does not operate on a not for profit basis. In Smart DCC Ltd, Capita has created a vehicle to match pass through revenues with its associated costs within its corporate structure. Any profits/losses from DCC are passed to Capita, where they are consolidated, and any tax payments are made.

Any profit/loss on DCC's activities generally, or on the Switching Programme specifically, will be subject to corporation taxes irrespective as to whether the profit resides in DCC or is passed back to Capita. Hence, the liability for tax must be a consideration in arriving at an appropriate margin.

In respect of financing, any interest on the keep-well deed is a pass through cost, and hence has no impact on the choice of Net Profit or EBIT.

This indicates that the use of a pre-tax comparator such as EBIT is required. To do otherwise would ignore taxation as a material component within DCC finances.

### Step 4

In addressing Ofgem's comparative analysis (paras 3.36 onwards), DCC acknowledges that there is an element of subjectivity to this process, however we make the following points.

Ofgem discusses the returns achieved by Xoserve and Electralink. Both of these businesses have relative certainty in the scope of the activities and their operations are much more mature and well-established. It could be argued that Xoserve has less financial risk in that it is non-regulated and not subject to ex-post price controls. Hence it is interesting to note that they are achieving a return of between 9 and 20%. As Ofgem itself believes these two businesses are "potential close comparators," a DCC margin of 15% falls well within this range, and hence, in our view, is reasonable.

Ofgem then seeks to extend its analysis to cover an extensively varied selection of industries and market sectors. In a number of cases, we would question the applicability of these comparators, e.g. diversified communications services, staffing and outsourcing services, telecom services etc. These are poor comparators because the services provided by these companies are well established within their respective markets and arguably are commoditised services as a result.

These companies might be expected to compete on very thin margins to reflect a highly competitive and saturated market. This occurs in mature markets, where the majority of risk in developing a fit-for-purpose solution to meet customer needs has largely worked its way through market forces.

The Switching Programme in comparison constitutes a major transformation, delivered on a national scale, and is inherently novel and a one-off service. These factors are all associated with higher risk.

In the remaining cases, Ofgem's analysis of comparators does not clearly define what services the companies are providing. For example, it is not clear to us what "Processing systems and products" refers to, nor is it clear what the distinction is between "Information services" and "Information Technology Services". The links provided at Yahoo Finance point to a list of companies within the Industry and does not describe the service provided. This prevents DCC from providing objective comments and limits their value as comparators accordingly.

Finally, we would agree with Ofgem's decision to assess the return achieved by professional services firms. In our view, these are the sorts of companies that Ofgem would need to contract with, in the absence of DCC, to deliver DCC's currently defined role in the Programme.

Professional services firms are generally comprised of highly experienced professionals who are called upon to deliver highly complex, one-off projects. These services are generally bespoke to the challenges as required and are specifically not commoditised services or products. The Switching Programme could be said to be precisely the kind of activity that such a firm would deliver.

However, where we differ from Ofgem is in the conclusion we draw.

Ofgem asserts that a 12% margin is a reasonable reflection of the return being achieved by such firms. It rightly identifies that that this is an average return, and hence will be made up of projects contributing high returns and others contributing low returns. However, where we would disagree with this analysis is that Ofgem states that the Switching Programme is low risk.

We have indicated, both in the covering letter and this annex, why we don't agree with this assessment of risk. From our perspective, we believe that the 15% return we have requested is consistent with the risk we perceive and also with an industry where 12% constitutes an average return.

In our proposal to Ofgem, we have outlined our approach to identifying an appropriate margin for what we consider to be high-value professional services activity. We stand behind the rationale presented in that document.

**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.*

We agree with Ofgem's identification of key areas of risk, however, again we disagree with certain specifics of the details.

By way of example, Ofgem has taken the clear stance that it will not approve our plan and corresponding budget, as articulated in the business case. This leads to inherent uncertainty over whether what is in essence a jointly developed plan could ultimately be deemed uneconomic and inefficient, but with DCC bearing the entire risk of disallowance.

This has become a more relevant issue in light of our concern over a number of aspects of Ofgem's assessment of our 2015/16 Smart Metering price control. For example, we have witnessed a number of cost disallowances, relating to expenditure which we believe to be both reasonable and rational. Likewise, and even more worrying, we have serious concerns over Ofgem's approach to the assessment of our baseline margin application, and whether it has behaved fairly and reasonably in its treatment of DCC.

Experiences of this sort suggest that regulatory certainty is not something we can rely upon, thus increasing the perceived risks that we face through unexpected actions by Ofgem. This erodes confidence in our ability to justify expenditures as economic and efficient, and could ultimately lead to a risk-averse approach, which is likely to be to the detriment of consumers.

There is also a fundamental point that risk is not the sole determinant of a return and that market dynamics have a role. It was always intended that the DCC would provide a potential vehicle for delivering industry wide change, such as this. Our shareholder has the right to make a commercial return commensurate with its expectations when it successfully sought the licence to establish DCC as part of a competitive procurement

The proposed regime is downside only and hence is it possible that the real margin obtained will be lower than the figure confirmed eventually by Ofgem. Again, this is reinforced by our experience in the smart metering programme where we have experienced continual dilution of our margin.

**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.*

This programme is a complex undertaking in that it is national in scope, has a large number of affected stakeholders, and still has technical uncertainty surrounding what the final solution will look like. Effective delivery of the transitional programme will have a very public and tangible impact on the experience of energy users and therefore the degree to which benefits are realised. As such it requires skills commensurate with the scale, difficulty and criticality associated with it.

The contribution Ofgem is seeking from DCC to deliver the programme is high-value and consistent with services it would need to source from a sophisticated professional services organisation. As such, DCC believes it should obtain a return consistent with this.

DCC has invested considerable time in discussion with Ofgem on an appropriate margin for this activity. We stand by the analysis provided in our proposal for margin and incentives.

## Chapter Five

In this section we attempt to provide our view for each of the four questions. However, in our analysis we have realised that the duration of the milestone, the duration of the margin recovery period (15%, 20%, 25%), the potential delay per milestone, and the recovery mechanism are dynamically related. Therefore it is important to note that we have looked at each question in isolation, but refer inherently to the other questions in our answers.

In order to answer questions in this section, it is necessary to remind ourselves of the objectives of the incentive scheme.

The primary objective of the incentive scheme is to deliver the Transition Phase on time i.e. milestone three (DM3). Ofgem clearly states that the recovery mechanism is meant to support delivery of the overall programme, implying that DM3 has a greater priority than milestone 1 (DM1) or milestone 2 (DM2) because DM3 sits on the critical path for the subsequent phases. It was recognised that there are two additional points on the critical path within the Transition Phase itself, namely DM1 and DM2. As such, the purpose of these two intermediary milestones is to reduce the risk of not meeting DM3.

A secondary purpose of DM1 and DM2 is to encourage DCC to make up any slippage along the way to DM3. This is because:

- If DM1 and DM2 are on time, but DM3 slips, the margin recovered is the same regardless of the scenario, the amount of actual delay, the margin recovery period, or recovery mechanism.
- If DM1 and DM2 are late, but DM3 is on time, the margin is 100% regardless of the scenario, the amount of actual delay, the margin recovery period, or recovery mechanism.
- DCC is always incentivised to meet DM3 because that yields a 100% margin regardless of the scenario, the amount of actual delay, the margin recovery period, or recovery mechanism.

Therefore, in reality, we are actually only concerned for scenarios where DM1 and/or DM2 are delayed. The arguments within all of the responses in this section therefore assume these facets and therefore look at how the different proposed approaches and assumptions would drive behaviours that would achieve these objectives.

**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.

DCC agrees with Ofgem’s analysis of the pros and cons of both the 2- and 3-point margin loss curves. We endorse Ofgem’s proposal to opt for the 2-point (straight line) loss curve, due to the relative simplicity that will result.

It is doubtful that the use of the more complex 3-point curve would enhance the incentive properties in a significant way. In addition, the planned activities do not lead to a clear point in the plan upon which to determine the place in the margin recovery period where the kink would sit.

**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”?)

In light of these objectives, it is critical to consider two aspects of the margin recovery period. The margin recovery periods are actually very short and could be overly punitive under certain conditions.

### Short Milestone Durations

One of the challenges associated with the plan is the relatively short periods between milestones, and in particular DM1 and DM2, which is a mere four months. As these periods are short, the opportunity to recover any slippage is by definition limited, i.e. it is much easier to recover a week over one year than over four months. This is critical to keep in mind because the three milestones are sequential and therefore a delay to one milestone will have a like-for-like impact on subsequent milestones unless DCC can think of a creative way to recover the slippage by DM3.

However, a further consideration is the ability to make up that delay so that the incentive scheme is effective in meeting its objectives. The short duration of the milestones coupled with the sequential nature of the activities associated with each means we have only days to simultaneously recover slippage from DM1 and also mitigate any issues that come up for DM2, depending on the period for margin to drop. This is reiterated in Table 1 below.

**Table 1: Values for X - period for margin to drop to 0%**

	Scenario 1: 15%	Scenario 2: 20%	Scenario 3: 25%
<b>DM1 (weeks)</b>	28	28	28
<b>DM2 (weeks)</b>	16	16	16
<b>DM3 (weeks)</b>	24	24	24
<b>%LM</b>	15%	20%	25%
<b>X1</b>	4.2 <sup>2</sup> (21 days)	5.6 (28 days)	7 (35 days)
<b>X2</b>	2.4 (12 days)	3.2 (16 days)	4 (20 days)
<b>X3</b>	3.6 (18 days)	4.8 (24 days)	6 (30 days)

<sup>2</sup> Note that in the consultation document, these figures are rounded to 4, 3, and 4.

Therefore, the shorter the margin recovery period, the less time there is to make up any slippage and the greater the likelihood that DCC is punished twice for a delay in DM1. This results in two negative aspects. First, it erodes the incentive to recover slippage in DM2 and second pushes DCC into a high risk scenario of focusing solely on delivering DM3 on time. This is elaborated more in the section on Relative Recovery below.

We recognise that Ofgem must balance the incentive to deliver on time with an incentive to recover slippage in the event that a milestone is actually delayed. In light of the fact that the recovery amount is a matter of days, we believe 25% will provide enough time to incentivise the recovery of slippage at DM1 when working towards DM2 and therefore drive the behaviour that increases the likelihood of meeting DM3 on time.

### Overly Punitive

A second point to consider is the amount of the earned margin in relation to the amount of delay. As is laid out in Ofgem's example under the relative recovery mechanism, 28% loss of margin could be seen as overly punitive. We agree with this for two reasons.

First, it fails to take into account the amount of slippage recovered. If DCC missed DM1 by four weeks, but is able to recover three weeks of that by DM3, resulting in only a one week delay, a 28% loss of margin fails to reward the hard work and creative thinking which would have been required to overcome that lost time. The longer recovery period of 25% feels more reflective of the amount of work that would be required at a loss of margin around 17%. See Table 2 below:

**Table 2: Total margin earned based on DM3 delivery**

Milestone Delay	Relative Recovery			Absolute Recovery		
TA1, TA2, TA3	15%	20%	25%	15%	20%	25%
4,4,3	25%	40%	50%	25%	46%	57%
4,4,2	50%	60%	67%	50%	64%	71%
4,4,1	72%	79%	83%	7%	82%	86%

A margin which can be eroded in a matter of days, coupled with the risk of price control disallowance, is unlikely to drive DCC to find potential innovative approaches to overcome slippage, thus encouraging a short-sighted, minimum risk approach.

Lastly, it is important to consider the incentive scheme in light of the larger delivery picture. A 28% loss of margin, for a one week delay in DM3, again is clearly punitive when considered in the context of the entire incentive period and the three year Transition Phase as a whole.

For that reason, we would propose that the period for margin to fall to 0% should be set at no less than 25% of the delivery time.



**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?*

DCC would argue that providing a 100% recovery mechanism at the final milestone gives a powerful incentive for us to strive continually to meet the preferred timescales of the programme, even when earlier difficulties have been encountered. This in effect aligns DCC's objectives with Ofgem's and government's policy intent.

We also endorse Ofgem's intention to apply an equal weighting to each milestone in terms of the slope of margin loss curve (15%, 20%, or 25%) to encourage DCC to equally value the three milestones. We believe this provides a suitable incentive on DCC to stay on track for their activities, and hence secure margin as the project progresses.

**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.*

We agree with Ofgem's assessment relating to the pros and cons of a relative vs. absolute recovery mechanism, but would distinguish the behavioural considerations between the two.

Keeping in mind the dual purpose for DM1 and DM2 referenced at the beginning of this section, it is worth looking at the behaviours that relative vs. absolute might drive. We see the ability to recover previously lost margin at the final milestone as being a key consideration for driving behaviours that match Ofgem objectives, namely to deliver DM3 as close to the delivery date as possible and do this in a way that recovers any slippage from DM1.

### Relative Recovery

Relative recovery effectively equalises the total margin earned based on the delivery of DM3, as shown in Table 3 below. Note this is based on total margin of £376k per milestone.

**Table 3: Values under Relative Recovery under Ofgem scenario**

	DM1		DM2		DM3	
	Value	%	Value	%	Value	%
<b>Initial Earned Margin</b>	£0	0%	£126	34%	£188	50%
<b>Recovered Margin</b>	£188	50%	£62	17%	-	-
<b>Total Earned</b>	£188	50%	£188	50%	£188	50%

Ultimately, this equalisation means that the first and second milestones can be missed provided that the slippage is made up by the third milestone. We believe this inadvertently creates an incentive to put all of our emphasis on DM3, which brings into question the inherent value of the intermediary milestones. Under the relative approach, there is less of a financial incentive to deliver DM1 and DM2 on time because the ultimate delivery of DM3 will recover the difference.

## Absolute Recovery

The Absolute Recovery approach is DCC's preference for several reasons.

Firstly, it provides an overall stronger financial incentive compared to Relative Recovery (see Table 4). As the three milestones are sequential, a delay to one milestone will have a like-for-like impact on subsequent milestones unless DCC can think of a creative way to recover the slippage by DM3. Therefore, there need to be strong financial incentives to recover any slippage as soon as DCC realises it will occur.

Secondly, Absolute Recovery creates a stronger incentive if an early milestone is missed, i.e. it increases the total amount of margin we can recover to make up slippage incrementally from DM1 at both DM2 and DM3, whereas relative recovery creates a stronger incentive to make up slippage only at DM3. This is demonstrated in Table 4 below.

Under Relative Recovery, the recovered margin is the same regardless of whether one makes up zero, one, or two weeks in DM2. The final margin rates are all equal. Under Absolute Recovery, however, there are incremental changes amongst the different scenarios. These incremental changes are highlighted in purple in table 4.

**Table 4: Comparison of Relative vs. Absolute Recovery under different delivery scenarios**

Milestone Delay	Relative			Absolute		
TA1, TA2, TA3	15%	20%	25%	15%	20%	25%
4,4,2	50%	60%	67%	50%	64%	71%
4,3,2	50%	60%	67%	50%	64%	74%
4,2,2	50%	60%	67%	50%	68%	77%
4,4,1	72%	80%	83%	75%	82%	86%
4,3,1	72%	80%	83%	75%	82%	87%
4,2,1	72%	80%	83%	75%	84%	88%
4,1,1	72%	80%	83%	79%	86%	90%

There is another factor that becomes apparent when considering where the purple shaded areas are. The incremental incentives do not exist under the 15% margin recovery period. The table above shows that the incentive to make up slippage in DM2 exists only when there is adequate time to do so, i.e. when the recovery period is 25% or greater.

This makes sense from a practical point of view. A longer time period between DM1 and DM2 provides DCC with greater scope to find ways to minimise the slippage.

The case for Absolute Recovery is tied intrinsically to the duration of the margin recovery period. The ability to recover any slippage along the way reduces the risk of not meeting DM3 at the end, but only when the recovery period is 25% under Ofgem's scenario of DM1 being initially four weeks late.

The Absolute Recovery approach actually creates a clearer financial incentive for us to deliver DM1 and DM2 on time.

For these reasons, DCC supports an absolute recovery mechanism at a 25% margin slippage rate. This demonstrably creates the strongest incentive to drive behaviours that meet the objectives of the incentive scheme and ultimately deliver the entire Transition Phase on time.