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

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including residential and business users.

We believe that consumers should be able to switch supplier quickly and reliably, and we support reform that will improve the consumer experience of the switching process. Any reform must deliver a good customer experience at a reasonable cost – consumers must benefit from the investment that is being made on their behalf as part of the Switching Programme.

DCC should expect to be able to achieve a reasonable margin in return for their involvement in the Transitional Phase of Switching Programme. However, at the same time any such margin needs to be justified based on the achievement of outcomes that can be clearly demonstrated to benefit consumers. An appropriate incentives regime that drives the right behaviours, and which places margin at risk, is essential. This will be even more important when the Switching Programme moves into its delivery and operational phases.

We do not believe that DCC have provided sufficient evidence to justify the margin level that they have proposed. All of the evidence provided in the consultation indicates that a margin of 8-12% would seem to be more appropriate, and more easily justified to the consumers that are ultimately footing the bill. A margin equivalent to that which DCC receives for smart metering communication services is not justified for a Transitional Phase which is low risk, and which is facilitative rather than delivering tangible consumer facing outcomes.

We are supportive of the approach to incentives detailed in the consultation. An incentive regime should ensure quality deliverables without creating perverse incentives which compromise some outcomes at the expense of others. The DCC should be incentivised to deliver as soon as possible even if a milestone is missed, and we agree the proposed 2 point margin loss gradient is an appropriate mechanism for this.

We do not agree with the proposal for a 100% recovery mechanism. The DCC should be encouraged to get things 'back on track' when a delivery milestone is not achieved. However, such a delay may result in impacts on other parties, who could incur additional costs as a result of the failure of DCC. Enabling DCC to fully recover any loss while other parties are not in the same position is not fair and equitable. Allowing the DCC to recover no more than 80% of their previously lost margin would be more appropriate.

We recognise the difficulty in identifying appropriate delivery milestones in this Transitional Phase and agree that those identified are the most appropriate in the circumstances. The subjective nature of those milestones means that independent assurance will be critical in providing confidence to stakeholders that they have been achieved. Future phases of the programme, especially delivery and operation of any new Centralised Registration Service will need to have an incentives regime that can be objectively measured, and which is focused on consumer facing outcomes.

The activities that DCC will undertake during the Transitional Phase could create the foundation for a new set of switching arrangements that deliver a good customer experience at a reasonable cost. This will only happen if:

- the detail of the new switching arrangements is agreed by industry,
- the plan to implement those arrangements is clear and is accepted by all industry parties, and
- the costs incurred are transparent, reasonable and deliver real value for money.

Our detailed responses are set out in the attachment to this letter. Should you wish to discuss any of the issues raised in our response or have any queries, please contact Ashley Pocock on 07875112854, or myself.

I confirm that this letter and its attachment may be published on Ofgem's website.
Yours sincerely,

Paul Delamare

Paul Delamare
Head of Customers Policy and Regulation

Attachment

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EDF Energy's response to your questions

CHAPTER: Three

Q1. 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.

We agree with the proposed methodology for assessing DCC's margin. The approach detailed in the consultation, based on an assessment of DCC's risk and a comparison with similar organisations, will result in a robust determination of the appropriate margin. We certainly feel that this assessment is more robust that than made by DCC, and that the range of 8-12% proposed is more appropriate than the 15% proposed by DCC.

Our view is that Earnings before Tax (EBT) is the most appropriate basis for measuring DCC's margin. While Earnings before Interest and Tax (EBIT) and Net Profit are more often used as standard measures, EBT more closely reflects the financial circumstances of DCC.

Q2. 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 that DCC's risks associated with the Transitional Phase are relatively low, and that this should be reflected into the final determination of the margin.

We note that a key mitigation for the level of risk faced by DCC is the agreement of a Programme Plan with agreed roles, responsibilities and delivery dates. As yet, we have not had visibility of that Programme Plan, or how and when this agreed plan will be achieved. This plan needs to be agreed and published as soon as possible to provide the required certainty to DCC, as well as to other industry parties who will need to contribute to activities and deliverables on this plan. The lack of clarity on what will be done, when and by who in the Transitional Phase and beyond remains a significant concern.

Q3. 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.

Within the time given for this consultation and limited visibility of companies outside of the energy sector, we have not been able to identify further comparators. We would note that Gemserv, who operate in a similar space to Electralink, declared operating profits of

£1.6million in 2016, against revenues of £15million. This profit margin of 10.7% is more closely aligned with the range of 8-12% proposed by Ofgem than the 15% proposed by DCC.

While it is important to use appropriate comparators as a basis for determining DCC's margin, it also needs to be born in mind that any costs that DCC incurs in the Transitional Phase will ultimately be recovered from consumers. While DCC should expect a return for their involvement in this phase of the Switching Programme, it is not clear how a margin of 15% would be justified to consumers at a time when the cost of electricity and gas remains an area of concern. This is especially the case in a Transitional Phase where the direct benefits to consumers arising from these costs are not quantifiable.

A margin of 15% may be more appropriate for the implementation phases of the Switching Programme, where there is a clearer link between performance and direct consumer benefit. However, any margin needs to demonstrate value for money, and be contingent on the delivery of performance that delivers tangible benefits to consumers.

CHAPTER: Five

Q1. 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 with the proposed use of a 2 point straight line gradient for the margin at risk. DCC should be penalised for not meeting a delivery milestone, but be incentivised to deliver as soon as possible after the original delivery date. The 3 point curve approach would not seem to apply a sufficient penalty for late delivery, and would allow DCC to retain the majority of its margin for a short delay. This is not appropriate for milestones over which DCC has a significant degree of control.

The 2 point straight line gradient approach is appropriate as it has a simple design that still encourages timely delivery.

Q2. 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.

In setting the value of 'X' a balance needs to be struck between incentivising timely delivery, and overly penalising such delays. Making this period too long could reduce the incentive on DCC to deliver as close as possible to their original date as they will still achieve the majority of their margin. Making it too short has the risk of creating perverse incentives, and might result in higher costs being incurred in an effort to achieve the more challenging timescales.

There is a need to identify and account for the consequential impact of any delay on other parties, as well as the Switching Programme as a whole. Delays in achieving milestones may cause other parties to incur additional costs, for example through provision of additional resource to support extended engagement activities. These need to be accounted when assessing the impact of any delay to delivery.

We do not have sufficient visibility of the detail of the delivery milestones or the impact of any delay to be able to undertake any in-depth analysis. However, a value of 20% of delivery 'X' would seem to strike an appropriate balance.

Q3. 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?

We are concerned that enabling 100% of the lost margin to be recovered where the final milestone is met on time could encourage DCC to place undue focus on this milestone at the expense of the intermediate milestones. We note that it is Ofgem's view that the sequential nature of the milestones and the tight timings between them makes the recovery of any delay unlikely, but this risk still exists.

It may also be the case that any delay to the delivery of the intermediate milestones might have consequential impacts for other parties who may incur additional costs as a result. It would not be appropriate for DCC to be able to recover the costs of any delay when other parties may not be in the same position.

We agree that some form of recovery mechanism is required to incentivise DCC to get things 'back on track', but we believe that 80% of the previously lost margin would be a more appropriate percentage.

Q4. 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.

Our preference would be for a recovery mechanism that is based on absolute delay. We recognise that both of the models detailed in the consultation have their drawbacks, and that there is no ideal solution. As noted in the consultation, basing recovery on relative delay could result in DCC being disproportionately penalised for delays which do not have a material impact on the overall programme. A recovery mechanism that is based on absolute delay may mean that interim milestones could be subject to recovery despite additional delays being created. We believe, however, that this risk would be to some extent mitigated by limiting recovery to 80% of the previously lost margin.

EDF Energy
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