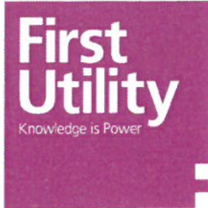

Natasha Sheel
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Ofgem
9 Millbank
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12 January 2017

By email to: switchingprogramme@ofgem.gov.uk

Dear Natasha

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

Thank you for the chance to comment on the draft direction on margin and incentives for DCC's role the Transitional Phase of the Switching Programme ("**Draft Direction**"). We also commented on the draft DCC business case for DCC activities during the Transitional Phase of the Switching Programme (**DCC Business Case**), which we may refer to in this letter. This letter sets out our responses to certain of the questions in the Draft Direction where we have views or particular preferences.

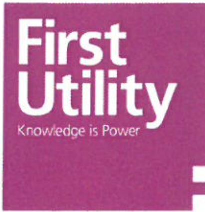
In response to specific questions:

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.

As we noted in our response to the DCC Business Case, ideally the services encompassed would have been competitively tendered to elicit fixed price offers, noting some uplift or mechanism upfront for the adverse cost impacts on DCC of uncertainty to address the risk of too high a bid uplift. Thus, the optimal pricing structure would have been a fixed price arrangement, with the risks of cost overruns borne by DCC however we appreciate that this is not feasible given the difficulty in defining a scope for the project and the uncertainties in programme costs.

We agree that it would make little sense to calculate DCC's returns based on a return on capital metric given the operations will be asset-light with minimal working capital requirements. As a consequence, we agree with Ofgem's conclusion that a return on sales approach is the most appropriate.

Although DCC will not incur any cost in respect of corporation tax, it is our understanding that the profit earned by DCC will be remitted to Capita plc where it will be subject to UK corporation tax. As a consequence, we believe that EBT is the most appropriate metric for establishing an appropriate margin for DCC (rather than net profit).



Chapter three, 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 believe that the risk to DCC in respect of the proposal outlined in Ofgem's consultation is minimal. We note that the only financial risks which DCC is exposed to are in relation to (i) the loss of a portion of the agreed margin as a consequence of failure to meet agreed milestones; and (ii) disallowance of certain costs by Ofgem as a consequence of inefficiencies on the part of DCC.

Taking these financial risks in turn:

i) While the likelihood of DCC failing to meet the agreed milestones is real, the current structure of the incentive arrangements means that DCC would sacrifice a portion of its margin but never incur any penalties which could make the contract loss-making; therefore the impact of this risk is low. Should Ofgem choose to include certain financial penalties in the contract, this would create additional risk which would need to be reflected in DCC's agreed margin. We would support the inclusion of such penalties to ensure the contract is run to time.

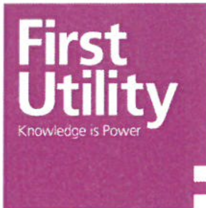
ii) In practice we expect that it will be challenging and time consuming for Ofgem to identify inefficiency which arises over the term of the contract. While this clause mitigates the risk of material inefficiency we believe that it would still be possible for DCC to operate sub-optimally without penalty. As a consequence we again consider this to be a low risk for DCC.

Regarding the reputational risk which has been identified, and noting that the challenges of the Smart programme have themselves had an impact on DCC's reputation, it is possible that a well-managed and efficient set of professional services provided to this programme could in fact improve DCC's reputation, that is, so far as we can see, the potential upside of DCC taking on this project outweighs any downside. We would also suggest that the 9.5% internal cost recharge, part of which relates to PR and executive steering, should go some way to mitigate the risk to DCC's and Capita plc's reputations (i.e. the impact which this risk has on the margin should be limited).

Overall therefore, in its current form the proposals represent a very low risk project for DCC.

Chapter 3, 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.

We agree with Ofgem's initial approach in determining an appropriate margin by reference to similar industries which are exposed to similarly low levels of risk. However, we are not convinced that the final margin proposal of 8% to 12% truly reflects the very low levels of project risk which DCC will be exposed to.



We believe that these project-specific risks need to be considered because while we accept that by allocating resource to this project, Capita and/or DCC may suffer a degree of opportunity cost, the lower project risk means that a lower margin should still be attractive.

We feel that Ofgem has identified sensible comparators in paragraph 3.41 of the Draft Direction and we would support the application of a margin more aligned to these. While we acknowledge Ofgem's comment that many of these comparators are more established and therefore more efficient than DCC, we would also point out that several of these comparators generate negative margins reflecting the greater financial risk which they are burdened with relative to DCC.

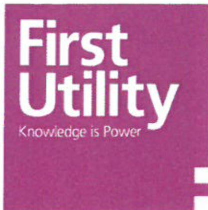
As a specific comparator (and consistent with Ofgem's first comparator, train operating companies) we note that during the period from 9 December 2012 to 8 November 2014, Virgin Rail Holdings Limited (**VRHL**) operated the West Coast railway under an interim franchise agreement on behalf of the DFT. As part of this agreement, the Virgin brand was used by the franchise (presenting reputational risk, consistent in principle with DCC although please note our comments above). All risks in respect of costs and revenues were borne by the DFT (again, consistent with the arrangement being considered here). During this period, VRHL earned a margin of just 1% of revenue to manage the operations, significantly less than is being proposed by DCC.

As noted in Ofgem's analysis, train operating companies do incur certain pass-through costs which artificially deflate the margin percentage. We still consider that provides some insight into margins typically applied on low risk service contracts in regulated industries.

As identified in paragraph 3.42 of the Draft Direction, DCC's operations are closely aligned to those of an IT provider to the energy sector. On the basis of Ofgem's analysis we understand that margins in this industry typically range from 6% to 10%. Given the low levels of project risk as outlined above, paragraphs 3.22 to 3.35 of the Draft Direction and covered in the reference to VRHL, we would expect DCC's margin to be at the bottom of this range (i.e. 6%).

Chapter five, 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.

We agree that the incentive curve as proposed by DCC essentially dulls the effect of any milestone being missed in the short-term. We feel that this sends the wrong signal to DCC and as a consequence, agree with Ofgem's proposal to modify this to a straight line chart, as shown in figure three of the relevant section of the Draft Direction. We do not believe that the chart shown in Figure 4 would be of merit provided a recovery mechanism (referred to below) is put in place.



Chapter five, 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?

Overall, this would be appropriate. We do think that specific penalties for delay and missed milestones could usefully be reconsidered, in particular given this recovery mechanism.

If you have any queries or would like to discuss any elements of this response, do let me know.

Yours sincerely

Natasha Hobday
Group Policy and Regulation Director

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