Switching Programme Delivery Group – Meeting 5 (additional meeting)

1. **Welcome and introductions**
   - Rachel Clark (RC) welcomed all attendees to this additional meeting of the Switching Programme Delivery Group (SPDG).
   - This additional meeting was convened to discuss two consultations published by Ofgem on 24 November: the consultation on DCC's Draft Switching Business Case and the consultation on margins and incentives for DCC's role within the Transitional Phase of the Switching Programme. The purpose of the meeting was to present SPDG members with an opportunity to specifically ask questions and provide comments to Ofgem and DCC in relation to the two consultations.
   - Standing agenda items, including a wider programme update and review of the action log, will be picked up at the next meeting on 20 December 2016.

2. **Consultation on DCC's Draft Switching Business Case** (closes 23 December 2016)
   - RC introduced the consultation published by Ofgem on DCC's Draft Switching Business Case and thanked members who had submitted comments and questions in advance of the meeting. There was particular focus on the following topics within DCC's Business Case:

Materiality threshold

- Members queried the logic behind the calculation of the management reserve and the benchmark used to validate its magnitude. DCC responded by how its experience in running programmes informed planning for unknown unknowns; it also welcomed feedback on this point through the consultation.
- Further, members suggested that the full materiality threshold costed at 35% of the base cost (20% contingency and 15% management reserve) seems high given that it does not seem clear why procurement activity is risky. DCC pointed to the uncertainty around its role and the risks of the plan driving the contingency and noted that the ex post plus reporting arrangements mean it will face cost disallowance for costs not incurred 'economically and efficiently'.
- There was also a concern over the language around the contingency implying that it would be spent. DCC believe that it has prudently planned for eventualities given the current uncertainty around its role.
- Questions were raised over whether stakeholders would only be re-consulted on DCC's Business Case if the baseline changed by the amount of the materiality threshold (35%). Although exceeding the materiality threshold would trigger a re-baselining, Ofgem plans to go back to stakeholders if the baselined business case reflects significantly higher costs, with smaller changes throughout the programme approved at a programme level. Ofgem will also engage stakeholders for any significant changes in scope even if the cost difference is within the Materiality Threshold.

- A question was also raised relating to the logic behind the proposed materiality threshold for RY16/17 as set out in the business case. It was suggested that this does not seem appropriate given that this period is almost over and the costs to the end of this period should have a higher level of certainty and a lower materiality threshold. DCC agree, and will re-evaluate this for the baseline, with Ofgem hoping that DCC would include actual year to date costs within the figure presented for 2016/17.

Action: *Stakeholders to respond to consultation with views on DCC's proposed materiality threshold mechanism as well as its appropriate level (for both contingency and management reserve).*

Action: *DCC to update the business case for re-evaluated contingency and management reserve figures for RY16/17.*

Difference between Ofgem's and DCC's plans

- A query was raised over the reasons for the difference between the Ofgem and DCC plans. Ofgem stated that the difference was around timing, with Ofgem's plan indicating contract signature by the end of 2018 and the DCC plan showing October 2019. Ofgem's date is driven by Ofgem's ambition to deliver customer benefits from the programme by 2019, and has included aggressive parallel running. Alternatively, the DCC plan was created in a bottom-up, left to right approach.
- Ofgem updated the group that the detailed and robust joint planning was taking place (approx. 75 products are being planned) and will be incorporated as fully as possible into DCC's Business Case, intended to be baselined in March 2017, as more clarity on scale and scope is determined. At that point Ofgem and DCC will be working to an aligned plan.
- This planning will result in more detailed work packages including what Ofgem and DCC will each be leading on and develop a shared understanding that will help drive the plan forward from both sides. The planning assumption adopted is that reform package 2 is going to be delivered – this is the assumption in advance of the preferred solution being decided on in December 2017.
- Ofgem were asked about the resource spike in DCC's plan. Ofgem's response was that it is not prescribing DCC's resourcing, but once there is clarity as to what is involved in each package it hopes that the resource spike encountered for overlapping activities will be manageable.
- Ofgem were also asked who was challenging its plan. Ofgem responded that its timescales are based on an understanding of the regulatory process and although dates may appear tight they consider them to be realistic for delivery.
- There will be a Major Project Authority (MPA) review of the programme in February 2017 to look at planning assumptions, explaining whether they are robust and credible, and ensuring that risks are properly recognised and accounted for. DCC noted that its planning allowed for a time contingency, with plans looking at possibilities of delays (contingency affects scope and time impact). Stakeholders asked if the business plan could highlight that this is accounted for.
- One member raised a potential comparator for a switching project in the telecoms sector, as the delivery of Ofcom's project in telecoms appears to be possible within a shorter time

frame and a lower cost. RC confirmed that Ofgem will consider this comparator project in more detail and will speak to Ofcom about the comparability of its experience.

Action: *DCC to highlight that that its business plan accounts for time contingency*.

Action: *Ofgem to consider Ofcom comparator in more detail and arrange meeting with Ofcom to discuss learnings from its switching project*.

Action: *Ofgem to engage with industry (and SPDG) as the new plan is finalised.*

External assurance

- A question was raised around whether DCC's Business Case was assured before going out for consultation. Ofgem confirmed that this had not happened but had sought expert advice on aspects of the business case. Ofgem intends to procure external assurance of the plan once the programme had identified a preferred solution. It was noted that the published consultation was meant to focus on the methodology rather than focus on the actual numbers, which will be reviewed once the planning of the resource for each task is completed.

March baseline

- DCC noted that in advance of its baselined Business Case in March 2017 there will be more certainty, and it is hoped that this increased certainty in DCC's role will reduce the number of risks which form the basis of the contingency. Although there will still be uncertainty around the reform packages, Ofgem hopes that the baselined business case can draw out the cost difference between the reform options.
- It was a concern for stakeholders that the March baseline will not be consulted on again. Ofgem noted that the stakeholders have an opportunity to comment now and it would not expect to consult again unless costs were materially higher than anticipated. Although no formal consultation on the baselined DCC plan is anticipated, it would be bought back to SPDG in the future for further review.
- It was noted that it would be helpful for Ofgem to publish its assumptions underpinning its plan, which Ofgem can do after the detailed planning work. It was pointed out that the assumptions in DCC's RAIDO were missing from Appendix E of its Business Case.

Action: *DCC to do a variance report with headline changes between the Business Case being consulted on and the baselined version.*

Action: *DCC to draw out cost difference between the reform options in its baselined business case.*

Action: *Ofgem to update published consultation once provided with complete RAIDO Appendix from DCC. Circulated and published December 12th 2016.*

DCC's non-core activities

- There was a discussion around what non-core activities DCC would be taking on. Ofgem responded that from a programme perspective it felt DCC were well-positioned to do some

of the additional work (relating to security and design proving) although this is not specified in the licence requirements.
- DCC is additionally involved in detailed design work and delivery strategy as these work areas will help ensure DCC can manage the programme risks of disjointed handovers.
- A question was raised about support in proving the MIS. Ofgem clarified that this would only be done if reform package 3, which includes a MIS, is chosen. Ofgem do not expect that effort will be invested in MIS work unless reform package 3 emerged as the preferred solution.

Charging arrangements

- A question was raised over how charges and costs were going to be managed. It was clarified that this will be done through an extra line(s) in the charging statements, as the transitional phase of Switching is currently under Smart and costs for both are recovered through the same mechanism.
- There was also a question around how Ofgem costs would be forecast. Ofgem responded that all costs will be accounted for in the cost-benefit analysis to be included in the economic case in August's business case with January's strategic outline case including the current economic case as Ofgem understand it.
- Further, there was a question over how overall costs would be allocated between different parties when fed to suppliers. Ofgem confirmed that it is tracking, and will report to SPDG on, cost incurred in the programme, whether by Ofgem, DCC or industry code bodies.

Action: *Stakeholders to comment on the extent to which the contingency and management reserve are included in upfront charging mechanism.*

Overhead charges

- A question was presented as to why the corporate overhead charge is included in the margin calculation if it is just a pass-through percentage of the total direct costs for the DCC. DCC responded that these costs are incurred as they face demand on the services that are linked to the corporate overhead and it leverages benefit from Capita's shared services. Ofgem noted that it is interrogating the overhead as part of the wider DCC price control to ensure value for money. The current DCC price control consultation is considering a fixed overhead over the duration of DCC's licence.
- Stakeholders noted that DCC do not appear to be incentivised to manage risk as its contingency and management reserve have both overhead and margin applied to them. DCC replied by pointing to prudent programme budgeting and that it is subject to ex post plus price control (the details of which are currently being worked up). The management reserve has to go through a change control process approved by Ofgem so there is visibility and traceability of how DCC spends money. For access to contingency DCC would have to evidence that it had gone through the correct Ofgem / DCC change control procedures and could provide reason for accessing these funds.

Incentivising cost reduction

- A query was raised as to what opportunities had been identified to reduce costs and whether there were incentives for keeping spend down. DCC responded by explaining that it was incentivised by the fact that costs can be disallowed (and Ofgem have an explicit duty to keep costs down). Ofgem noted the need to balance the fact that it's in the consumers' interest to run the programme, but also in their interest to keep costs down.

Changes from DCC's previous plan

- DCC were asked how it had managed to decrease costs between its previous business case and the version out for consultation. DCC responded that there were various contributing factors, but the decrease was mainly driven by changes to the resource profile increasing the number of permanent staff. DCC noted that recruitment depends on scope and if timelines were tighter, experience shows that there would be a recruitment challenge in matching the resource profile.
- There was a query on the classification of internal costs and the ability of DCC to easily switch between permanent staff and consultants at no negative risk to DCC, but at a cost to industry. DCC responded that the price control mechanism protects industry from this risk as it would be subject to price control scrutiny which would be able to disallow costs if they were not economically and efficiently incurred. DCC will produce an industry update report (currently being workshopped) on the dimensions of time, cost and quality.

3. **Consultation on margins and incentives for DCC's role within the Transitional Phase of the Switching Programme** (closes 12 January 2017)

- RC introduced the consultation published by Ofgem on margins and incentives for DCC's role within the Transitional Phase of the Switching Programme. Discussion was focused on the following areas within the consultation:

Context for setting margin

- In considering what margin DCC should be able to earn, stakeholders noted that DCC is a new monopoly with no competition. It faces limited risk and its risk of not delivering is also minimal given its scope will be clearly defined, though it was noted that there could be a possible regulatory risk if Ofgem do not believe DCC completed its task correctly.
- Ofgem were asked to clarify how it had determined the 8-12% range it consulted on. Ofgem responded that this had been done in the absence of a mechanism for setting a rate through competitive process. The range of comparators covers professional organisations and other regulated bodies, though it is difficult to find a comparator that sits in the same environment and plays a similar role to DCC. Ofgem encouraged stakeholders to provide views as to the other suitable comparators.
- DCC feel that professional services organisations are the most appropriate comparators as professional services firms could do similar work and would best emulate a competitive environment. DCC also noted that it faced a competitive environment when bidding for the licence. Stakeholders noted that professional services companies are pricing differently

under the current economic climate, though DCC believe this is dealt with through using the historical performance of a range of comparators in establishing its benchmark.

Action: *Stakeholders to respond to consultation with appropriate comparators.*

Possible approaches to determining margin

- Stakeholders focussed on the fact that the margin DCC earn should link to its risk. They felt that 8-12% reflects a highly risky commercial arrangement, especially under the current economic climate.
- Various suggestions were made as to how the margin could be determined, these include:
  - determining how much would you need to attract someone to bid for the system in 2025 when DCC's licence ends;
  - starting at 1% and working up;
  - comparing DCC's margin to the CMA's recommendation for suppliers and Ofgem's decisions on networks' margins;
  - creating a matrix for levels of risk (accounting for how much risk is in DCC's control);
  - learning from fixed price contracts (stakeholders to bring experience from outsourcing arrangements);
  - considering which companies are earning 8-12% and comparing their risks with those faced by DCC;
  - taking into regard any decisions from the NAO on achieving value for money in due course;
  - comparing to other switching programmes (telecoms and banking); and
  - considering whether the margin should reflect the margin that is acceptable for suppliers to charge their customers.
- One suggestion was to benchmark the Switching margin against the SMIP margin where DCC sought 15% and the Switching Programme's lower perceived risk should suggest a lower margin. DCC responded to this by saying that SMIP turned out to be riskier than anticipated and risk had been underestimated before.
- Ofgem also invited stakeholders to provide views on the most appropriate measure to use for the margin (i.e. net profit, earnings before interest and tax (EBIT) or earnings before interest, tax, depreciation and amortisation (EBITDA)).

Action: *Stakeholders to respond to consultation with comments on best measure to use for calculating DCC's margin.*

Stakeholders' consultation responses

- In relation to responding to the consultation, stakeholders noted that there were resource constraints and they were struggling with the timelines to provide the best possible consultation responses. Specifically for Switching, the two consultations and upcoming Request for Information (RFI) in January were placing pressure on resources. Ofgem noted that they will be working on responses as they come through and that the closing dates for the consultation were not expected to change. Although it was acknowledged that the 4 weeks allocated for responding to the RFI would be tight, work is being done to familiarise industry with RFI content before it is published and it is being tested to get a sense of how long it will take to complete.

4. **Next meeting**

- The next SPDG is scheduled for 20 December 2016. At this meeting, PWC will provide out of industry challenge and insight, and experts from financial services and telecoms sector will talk through lessons learned.

Attendees

Rachel Clark (Chair)	Ofgem
Jonathan Ainley	BEIS
Andy Wiggans	Npower
Natasha Hobday	First Utility
Alex Travell	E.ON
Douglas McLaren	Scottish Power
Alison Russell	Utilita
Bryn Coles	DCC
Paul Saker	EDF Energy
Rochelle Harrison	British Gas
Anthony Lewis	DCC
Kasmira Smarzo	DCC
Alan Raper	Gas Distribution Network
Andrew Amato	Ofgem
Natasha Sheel	Ofgem
Alex Belsham-Harris	Citizens Advice
Ralph Baxter	Octopus Energy
Liz Furmedge	SSE
Mark Anderson	SSE
Sarah Pennington	Ofgem
Hilary Chapman (telecon)	SGN
Simon Brooke (telecon)	Electricity North West
Graeme Barton (telecon)	Ofgem