Natasha Sheel
Switching Programme
9 Millbank
London
SW1P 3GE

12 January 2017

Dear Natasha,

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

SSE welcomes Ofgem's consultation on the Draft direction on DCC margin and incentives, and the opportunity to provide in depth feedback from our experienced subject matter experts.

We have set out in this letter a summary of key observations by question area below. In addition, please find our further response to the questions in Chapter 3 and 5 contained within the attached annex.

Key Observations

SSE strongly supports Ofgem's desire to continually provide value for money from all suppliers which in turn will deliver greater stability in pricing to customers. Ultimately we will all share in this objective. In both of the parallel consultations, the arrangements under review are for provision of a new service provision, affecting the cost of energy for all consumers and so clearly our drive in seeking the best value on their behalf is both relevant and extremely important.

However, we note the main thrust of this draft is to provide a margin and incentive to DCC for achieving deliverables defined for a procurement exercise. Our considered opinion is that in this instance a more effective and focused approach would be to investigate a performance credit system for failure to deliver to committed timescales. In view of the low risks identified by Ofgem for the DCC's proposals, with which we agree, we feel focusing DCC on success rather than margin would be the correct approach.

In conjunction with our responses detailed below, we would draw your attention to our other responses recently submitted for the related draft business case consultation. As such, we recommend a joined up approach in consideration of all material submitted for both of the related consultations.

In our previous response, we drew attention to Ofcom's recent cross platform switching proposals which appear to have much in common with those envisaged for the DCC. We accept the challenges with external benchmark comparison, touched upon within this consultation and recognise there is often a need to apply some flexibility when reviewing comparators with similar characteristics, against those for the DCC. The UK telecoms services provision sector would therefore appear to offer further scope for useful comparison. However we also accept the need for a carefully measured and proportionate approach in candidate selection, to avoid any risk of similarities appearing superficial. Suitable candidates should demonstrate a similarity across a sufficiently representative span of domains. An instance where we did not feel this aspect worked so well was in the DCC's draft business case submission, where their analysis sought to compare the DCC's characteristics with organisations with seemingly different business models, for example in seeking to compare margin aspirations with those for either Talk Talk Group PLC or for WorldPay PLC.

Please note further summary observations by each question as follows:

<u>Chapter 3</u>

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.

We do not agree with the proposed methodology for assessing and setting DCC's margin as a fixed percentage for the duration of the Transitional Phase of the programme[1]. To set margin for this activity is, in our view, completely unnecessary. As a result of the charges DCC already have included, for example a 9.5% overhead charge, in their Draft Business Case[2]. If the time period covered in Transition Phase only includes the period up until a signature is obtained after procurement phase, we are not sure why is it necessary to have a margin associated with this activity? It is rather unusual to expect any risk or margin to be associated with this activity due to its nature as a procurement exercise. In our opinion the continuous reference to, 'cost and programme uncertainties'[3], without articulating them, is not in itself an acceptable reason for allowing a fixed percentage margin.

We would suggest that a much more appropriate way of enforcing agreed timescales and consistent, high quality activity by DCC, would be to develop a performance credit system by which DCC would pay credits according to an agreed value in relation to the procurement activities not completed to an acceptable standard or to the agreed budget and schedule. When considering the effort and costs that will be incurred by each industry participant during the transitional phase, it would be a simple matter for the costs around these activities to be captured. Once available to Ofgem these could be utilised on a day-to-day basis to charge for any late delivery. By adopting this approach, DCC will understand and be called to account for any delays that they incur in delivering the three proposed documents.

Question 2: Do you agree with our proposed methodology for assessing DCC's risk? If there are further aspects to this which you feel have not been covered, please specify.

We support Ofgem's view that there is little risk faced by DCC other than reputational risk. However, we would argue that the reputational risk to DCC is so minimal it is inconsequential, and therefore not worthy of assessment as risk that would encourage DCC to commit and keep to agreed deadlines. We have seen, through the several deadlines DCC

---

[1] Ofgem, Consultation Paper Draft direction on margin and incentives for DCC's role within the Transitional Phase of the Switching Programme, 24/11/16, Overview, pp 1.

[2] DCC, Draft DCC Business Case for DCC activities during the Transitional Phase of the Switching Programme, v2.1, 23/11/16, section1.5.3, item 25., pp 11.

[3] Ofgem, Consultation Paper Draft direction on margin and incentives for DCC's role within the Transitional Phase of the Switching Programme, 24/11/16, Ofgem's proposal, Item 2.13, pp 16.

have missed throughout the SMART programme, that reputational damage as a result of missing these deadlines appears to have little impact on DCC, but rather impacts Ofgem and suppliers instead.

As mentioned above, we suggest an alternative method of reinforcing DCC's understanding of the need to keep to agreed budget, standards and schedule via a performance credit system, with charges which need to be further reflective by including the total costs incurred by industry, where planned implementations do not take effect either to time and/or to an acceptable standard.

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.

As previously mentioned, we perceive that there is no acceptable justification for margin to be set for this activity by DCC within the DCC Draft Business Case. We would request that the DCC rates tables should be exposed by Ofgem to Industry for a fuller assessment, which will allow a value for money assessment to be achieved. Without disclosure of these rates it is difficult to fully complete any reasonably objective assessment.

<u>Chapter 5</u>

Question 1: Do you agree with our minded 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?

If a margin setting exercise is decided upon as the means by which DCC will be encouraged to attain their procurement activity goals, in principle we are in agreement with Ofgem's minded position for the shape of the margin at risk curve.

However, as already stated our view is that a margin setting exercise is not appropriate for a procurement exercise, and that instead a system of financial performance credits on DCC would be more suitable. Industry could work with Ofgem in designing an appropriate way of allocating and penalising failure to hit designated and agreed targets.

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"?) Please provide justification for any alternative suggestions.

Our judgement is simple in that we perceive that once a milestone has been missed no margin should be offered. There should be no timeline allowing decreasing levels of margin dependent on the degree of lateness of delivery. We would reference again here the significant financial and reputational costs to Ofgem and Industry, rather than DCC, of any delays that would ensue from the procurement activity being delayed, going over budget or not being adequately completed. These are not difficult deliverables to achieve, in our opinion, especially over the length of the delivery period. DCC have complete control over the delivery and failure will solely be based on their inability to complete the process contracted for.

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?

We consider that 100% of the previously lost margin is entirely inappropriate for the recovery mechanism as it would reward DCC fully even if some or all prior milestones were missed and severe delays were experienced. If anything, this could do the opposite of incentivising DCC to work with full commitment to all milestones if the last one is the only one that would really 'matter' to them financially. As stated above, we believe that a simple and effective approach is to offer zero margin recovery. If an agreed milestone is not adequately fulfilled to the agreed budget, quality and timescales, no margin should be offered as this would be a reward for failure, without compensation for customers, Ofgem or Industry.

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 would suggest that recovery should be based on absolute delay, as this would encourage DCC to meet every milestone rather than just focus on meeting the last one. As long as each deadline is met, they will receive the margin in return for completing the work as agreed. Should they miss any deadline, they would lose the margin associated with meeting that deadline. This would seem the fairest option and most likely to fully incentivise the DCC. We would re-iterate our preference at this stage to replace margin with performance credit drivers to ensure that the correct focus is placed on achieving the deliverables within the committed timescales.

As previously mentioned, please note our full response to all questions in the attached annex. We also welcome considerations on the next steps for both of the related consultations to achieve the most appropriate solution for Ofgem, Suppliers and our customers. If you have any questions on any aspect of this response, could you please direct this to both Martyn Edwards on martyn.edwards@sse.com and Mark Anderson on mark.anderson@sse.com In particular, Mark's relevant specialist expertise and experience on all aspects covered in these consultations, is ideally placed to provide helpful assistance and insight to you in your dealings with service providers.

Yours sincerely

Adam Carden
Head of Industry Codes, Regulation

Annex: SSE further response to specific consultation questions

Chapter 3

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.

We would like to understand why margin is being used as the main incentive toward DCC delivery? In addition here we would like to reiterate a point we raised in our previous letter in response to the Draft DCC business case (dated 23 December 2016), in which we also referenced Ofgem's draft direction on DCC margin and incentives. In proposing to monitor stakeholder satisfaction with DCC activity via a six monthly survey, Ofgem 'do not intend to place margin at risk based on stakeholder feedback at this stage in the programme' as they believe 'reputational risk to be a sufficient driver'[4]. We would suggest that this is not an adequate level of measurement of stakeholder satisfaction on DCC's activities. We would also suggest that the reputational risk mentioned is not enough of a significant driver. If it is to be held up as a significant driver, then in fact stakeholder feedback should be included in that measurement of reputational quality and therefore associated risk. We would argue that instead, financial performance credits would better focus and motivate DCC toward effective and timely delivery.

Question 2: Do you agree with our proposed methodology for assessing DCC's risk? If there are further aspects to this which you feel have not been covered, please specify.

Our summary of the key desired outcomes from applying incentives are to help ensure delivery of:

- quality procurement and support to the Switching Programme
- timely procurement and support to the Switching Programme
- economic and efficient procurement and support to the Switching Programme. [5]

We agree with Ofgem's assessment that reputational risk is the only concern for DCC within this process. However, in our opinion if the above are the required outcomes then we do not feel this risk alone will have any material impact on how DCC perform during this process.

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 acknowledge and agree with Ofgem's assessment that delivery of the switching programme is less risky than SMIP and also that, 'It is also likely to be less technically challenging'. In light of this acknowledgement and also our previous comments we do not feel margin is justified to complete what is essentially a procurement exercise.

---

[4] Ibid, pp 8. Also repeated in 2.6, pp 14.

[5] Ibid, 1.15, pp 12.

Chapter 5

Question 1: Do you agree with our minded 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?

As previously stated we are in agreement in principle with Ofgem's shaping of the margin at risk curve if a margin setting exercise is decided upon. However, to reaffirm our view we do not believe that a margin setting exercise is appropriate in this case. Our view of creating a system of financial performance credits on DCC would be more suitable. We would like to repeat our offer of assistance to help design appropriate methods for calculating and allocating performance credits which would be commensurate with Industry costs being incurred. These credits would be more appropriate in our opinion for failure to hit the documentation deliverables.

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"?) Please provide justification for any alternative suggestions.

It is in our opinion important to re-iterate or position regarding the level of difficulty in achieving the deliverables defined. A set of documented outcomes over which DCC have complete control to complete a procurement exercise should be simple to execute. Confirmation from our perspective that once a milestone has been missed, no margin should be offered and no timeline should be allowed for decreasing levels of margin for lateness of delivery. We would reference again here the significant financial and reputational cost to Ofgem and Industry, rather than DCC, of any delays that would ensue from the procurement activity being delayed, going over budget or not being adequately completed.

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?

Our view that providing a method by which lost revenue could be recovered as a result of failure to hit deliverable deadlines, would negate the reason for having the initial incentives. Our view of providing zero incentive and replacing this with performance credits for failure to deliver to committed dates would be much more appropriate in this case.

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 have nothing further to add to this other than those already stated regarding removal of margin and replacement with performance credits to ensure that the correct focus is placed on achieving the deliverables within the committed timescales.