Rachel Clarke
Switching Programme Director
Ofgem
9 Millbank
London SW1P 3GE

29 December 2016

By email to: switchingprogramme@ofgem.gov.uk

Dear Rachel

Consultation on draft DCC business case for DCC activities during the Transitional Phase of the Switching Programme

Thank you for the chance to comment on the draft DCC business case for DCC activities during the Transitional Phase of the Switching Programme (**DCC Business Case**). This letter sets out our responses to certain of the questions in your letter of 23 November 2016 on the DCC Business Case and our views overall on the various issues raised by the DCC Business Case.

By way of general points:

- We do not see DCC's commercial expectations as relevant in the setting of any approach to risk and reward, and certainly not more relevant or to be more heavily weighted than the need for benchmarked and competitive rates for carrying out the specific core tasks allocated to them within this Programme.

- Ideally, this role would itself have been subject to competitive tender, potentially through a contract rather than a licence, where direct performance incentives, and specific penalties, could have been provided for.

- We do not agree with DCC's proposed margin calculated as a fixed rate of return of 15% of revenue on *all* DCC costs and further work is needed to consider on which costs should form part of the margin calculation, e.g. it should not cover the cost to DCC of managing its own compliance with its licence or the charge control reporting process,[1] and it should not cover the cost to DCC of validating milestone achievement.[2] It certainly should not include Capita's corporate overhead charge

[1] The cost(s) to DCC of interacting with Ofgem and the industry for forecasting and planning purposes vis the programme itself and as part of the governance process should be included as a cost for margin purposes. Likewise, we assume that DCC's costs for managing its own position and putting forward its views on the DBT and Live Operations phase during the Transitional Phase should *not* be a cost for margin purposes. We do not think that this should be recoverable at all via charge controls, whether within the capita overhead or as a separate activity.
[2] Cost referred to in paragraph 39, DCC Business Plan (p. 13).

nor any pass-through costs from external support (all of which should be disclosed to Ofgem and industry participants, whose customers are paying for it).[3]

- We do not agree with the application of the Capita overhead charge levied at 9.5% of DCC's internal costs: should any percentage for overhead be included, this cannot be a cost for margin calculation purposes.

- We do not agree with the level of contingency being proposed, nor with the inclusion of an additional management reserve proposed by DCC.

- We do not consider that these proposals reflect the current approaches in the market for professional services, nor do we see that other than the structural advantages of DCC assuming this role, that DCC has, more than other professional bodies in the market, any greater knowledge or skill-base to undertake the tasks (which latter point could in principle have justified a market-defying margin).

- We consider that the level and impact of uncertainty is overestimated in DCC's proposals, particularly given the overall scope (albeit with some questions around the boundaries) of the work within this phase and that margin is applied to the costs incurred in managing this uncertainty. In the current climate, suppliers are competing by fixing their contract rates, trading off their experience in the area against the risks of scope creep and uncertainty. We do not think DCC is taking any risk that is not within their control.

- Views on DCC's role and potential performance in the Switching Programme are inevitably coloured by experiences from the Smart Programme, noting there the series of delays to go-live and the progressive loss of contingency. This is relevant to constructing an appropriate regime for managing costs as effectively as possible, and to ensuring value for money for suppliers and more importantly, their customers. It may also make DCC's "non-financial, reputational incentive" difficult to operate, although it is not clear what this is and how it would work in subsequent phases of the programme.[4]

- That said, we acknowledge that the DCC is profit-making and it is appropriate that they be rewarded for delivering well and to time and against defined standards, or be penalised for not doing so.

[3] A non-exclusive list of DCC's costs is included at paragraph 65 of the DCC Business Case, which costs include this overhead.
[4] Set out in paragraph 41 of the DCC Business Plan, p. 14.

In response to specific questions:

Question 1: Is DCC's approach, as outlined in the business case, clear enough about how DCC will account for activities it is asked to undertake and how delivery can be assessed? If not how could this be improved?

The scope which DCC has prepared is extremely broad, perhaps necessarily so at this stage given the need to estimate for charge control purposes, internal approvals and consultations, but this will not continue to be the case as Ofgem finalises its own business case. Retaining the broad scope does in our view make it harder to track performance against the business case. We would look to see DCC mitigate any *remaining* Programme uncertainties during transition following Ofgem's conclusion of its business case and these consultations by applying their organisational experience (the cost of which is covered based on their proposals) to make some educated guesses, e.g. being clear on the number of iterations of documents which they are required to review, produce etc.

By working continuously to define the scope more clearly it should be possible to narrow down the error bars and the contingency amount (please see comments below on this point). Using this example, should there be a requirement for more iterations than had been scoped for, the forecasting and change control processes should be able to accommodate an adjustment of scope (and any knock-on impacts). Given the work that has gone into forecast, change control and accountability, these processes should be used to manage a widening of scope, rather than the combined contingency and management reserve.

Reducing the contingency (and including here the matters covered in principle by the management reserve) to a more reasonable level goes someway to mitigating the risk arising from the incentive to overspend due to the margin arrangements coupled with the ability to overspend due the significant contingency reserves. We would also suggest the inclusion of a 'carrot and stick' approach (i.e. in addition to the margin incentive on offer as a result of meeting milestones, there should be certain penalties for serious deficiencies). This would need to reflect a causal link between delay or failure to meet the requirements due to DCC action or inaction as against any extension of timeframe due e.g. as the result of issues raised during a consultation.

There may also be a perception that with whilst 25% of margin is at risk of failure on milestones, it may be advantageous for DCC to drag out the remaining 75% of costs over as long a period as possible to recoup any losses. The forecast, planning and ongoing stakeholder participation process and the accountability this brings may address this. Experience indicates that there is a risk the resources for and efficacy of wider industry review and input can decline over time, which places a continuing burden on Ofgem (effectively as the commissioning party) to hold DCC to account in a proxy of a contractual supply relationship. This raises the need to re-consider potential penalties, which we will consider in our response to Ofgem's consultation on margin and incentives.

First Utility Limited: PO Box 4360 : Warwick : CV34 9DB
Registered in England and Wales : Registered Number 05070887 : Registered Office Point 3 : Opus 40 Business Park : Haywood Road : Warwick : CV34 5AH

Question 3: For those activities that Ofgem is proposing to should be carried out by DCC but could be carried out by other parties (i.e non-core activities not relating to procurement and development of the technical specification) have the correct activities been assigned to DCC or would other industry partners be better placed to take these on? If so, which activities, which industry partners and why would they be better placed?

As noted above, whilst DCC's involvement with central switching is to an extent locked in, it does not follow that the organisation has the expertise to provide all the services which are included. Ideally, the core CRS services would have been subject to a procurement exercise, where the benefits (and risks) of a fixed price service could have been considered.

We have some doubts as to DCC's inclusion in the development of the switching regulatory and industry framework. Here, DCC is not obviously expert in these areas and inclusion is not necessary for their activities in relation to the technical specification. Programme and project management is important but there is always a risk where this could expand or already envisages overall management by a body whose own output and delivery is vital to that programme. This is not to say these disciplines are not needed within DCC for the core activities: for the programme as a whole, we do not think that DCC is best placed to provide this service.

We are concerned by the considerations around expanding DCC's role, in part to take up the perceived slack resulting from industry participants being focused on other substantial projects and Ofgem itself subject to budget constraints. Any such expansion cannot cover assurance activities, nor easily encompass overall programme management, of which DCC's role is a central part, but a part nonetheless. We appreciate the challenges in terms of funding mechanisms but this should not drive inefficient and inappropriate arrangements for delivery of key elements of this programme.

Question 4: Should the management reserve and contingency (Section 11.4) be included within the upfront charges on industry and what is the justification for this? Does the level of management reserve feel appropriate for the Switching Programme, taking into account the type, scale and actuality of potential unknowns?

We do not think that the management reserve should be included in the upfront charges on industry. Inclusion provides the wrong incentives for tight management of scope and delivery, with the accountability (notwithstanding the forecast and reconciliation process) taking place afterwards.

We are also concerned that the up-front inclusion of such a substantial amount will not act as a contingency but as an incentive on DCC to work up to the amount of that contingency, rendering void the purpose of including it and leaving industry with little choice should a subsequent call on contingency properly defined be needed.

In practice, industry participants do not have the equivalent time to devote to assessment, management and accountability as they do to their own key contracts. This justifies the level of accountability and transparency already worked up for the Programme and business case planning, which is needed on an ongoing basis (and for which industry itself is paying). Plus, as Ofgem has recognised, the lack of direct contractual accountability to industry participants requires that Ofgem itself act as the informed customer, working through the charge control mechanism in particular, as well as the scope and planning processes described by DCC and Ofgem. Inclusion of a management reserve as well as a substantial contingency seems to us to place a significant burden on Ofgem to track this element as well as the efficiency of the costs incurred overall. This seems disproportionate to the benefits of including some flexibility upfront.

We also note that whilst some uncertainty exists at present as to the scope of certain of the activities, this will decrease significantly as Ofgem's own business plan is worked up and tested. To that extent, too great a level of uncertainty cover is being provided to reflect a temporary level of scope uncertainty. Added to this is the fact that ex post charge controls and the reconciliation process can raise no credit risks or concerns for DCC: it will be paid and any adjustments will be where costs are not incurred reasonably, a matter within their hands.

In principle, it is reasonable to include an element of contingency as an upfront cost to industry, notwithstanding that this is the transitional phase of the Programme and not implementation and delivery of the actual system and services. Overall, we consider the level of contingency (even without the management reserve) to be included up-front as too high. This is particularly so transition is not about actual delivery of the system itself and given the charge control is on an *ex post plus* basis. We consider that 10% of total costs (noting the points made above regarding costs that should fairly be included and those that cannot fairly be included and focusing on costs for core activities) is reasonable to manage uncertainty.

For completeness, we think that the change management process is workable for considering a change in scope (widening or decreasing) based on a materiality threshold *in advance of the incurring of any costs*, to be considered in the reforecast process to ensure continuity of support from DCC for core activities.

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

Yours sincerely

Natasha Hobday

Natasha Hobday
Group Policy and Regulation Director