Andrew Roberts
Metering and Market Operations
Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

27 December 2018

Dear Andrew,

Consultation on DCC Price Control: Regulatory Year 2017/18

Thank you for the opportunity to respond to this consultation. We provide general comments on transparency in this cover letter and list our responses to questions from the consultation in the annex.

Transparency

We appreciate that Ofgem may be restricted as to the detail that can be included in this consultation. Therefore, we are relying on Ofgem's judgement that the lack of information underpinning its views in this consultation is due to the commercially sensitive nature of much of the analysis undertaken. The consequence of this restriction is that we cannot properly assess the views Ofgem has reached. This lack of transparency undermines the consultation. We call on Ofgem to challenge whether the restrictions it has placed on the information included in this consultation go beyond what can reasonably be expected on the grounds of commercial sensitivity.

Effectiveness of the price control framework

We supported the use of ex-post price control arrangements for the DCC as a starting point because an absence of suitable benchmarking data made it challenging to forecast, with a high degree of certainty, the costs of establishing the DCC's services. However, the role of the DCC has expanded to encompass a wider scope of activities than were ever anticipated and ex-post price control arrangements do not appear to be completely effective in driving DCC performance and keeping costs down.

The DCC's management of change requests (CRs) is one example. In our response to last year's Price Control consultation, we supported the DCC's proposals to amalgamate the delivery of change proposals. During the course of 2018, however, it has become clear that the implementation of this initiative has not delivered the intended reduction in costs. For instance, it seems there is now an additional £47m to deliver the bundled changes in a single upcoming release.

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Five years have now elapsed since the DCC licence was issued[1] and it would be reasonable to expect both Ofgem and the DCC to possess sufficient benchmark data for costs and outputs. We believe this provides an ideal platform to transition to ex-ante price control arrangements which, in a similar vein to RIIO-2, provides stakeholders with opportunities to shape, challenge and influence DCC plans before expenditure is incurred.

We urge Ofgem to expedite the transition to ex-ante price controls for the DCC. In the interim, we would welcome more transparency in the analysis of costs incurred by the DCC under ex-post price control settlements and a review of whether existing incentives are effectively driving performance and cost management by the DCC.

Should you wish to discuss any aspect of this response, please do not hesitate to contact me or James Nixon (james.nixon2@scottishpower.com).

Yours sincerely,

Andrew Ward
Director of Smart Metering

[1] The licence came into effect on 23 September 2013

Annex

Question 1: What are your views on our proposal to consider External Costs as economic and efficient?

External Costs comprise the costs incurred by the data service provider (DSP), CGI and the two communication service providers (CSPs) – collectively known as the DCC's fundamental service providers (FSPs).

For RY17/18, Ofgem note that External Costs are 7.9% higher and 12.0% higher for the total licence term. The total variation across the licence terms is £262m.

DSP costs have increased by 15% in RY17/18, the most out of all the FSPs. Ofgem states that refinancing arrangements have contributed to lower variations for communication service providers (CSPs).

Material drivers of variation in External Costs relate to contractual changes that DCC has negotiated with its service providers through Change Requests (CRs). Ofgem states that the DCC has provided evidence of maintaining commercial and contractual pressures in the negotiation and management of these CRs. Ofgem highlights extensive examination of alternatives to delivery by CSPs leading to positive value for money outcome. However, none of this evidence is shared in the consultation.

We are not afforded sufficient information to be able to assess whether the DCC has provided Ofgem with credible evidence of commercial rigour and tight cost control and whether Ofgem has reached the right conclusion in considering External Costs to be economic and efficient. Nor can we be fully confident that the DCC took steps to mitigate or avoid such costs in the first place; particularly around delays to R2/DBCH.

We also note the following points in Ofgem's assessment of the DCC's performance in contract management:

(a) the DCC is encouraged to conduct comprehensive risk assessments when seeking approval of change requests; and
(b) the DCC does not take a holistic view of total costs when carrying out cost benefit analyses of securing services through FSPs.

We would not expect such findings to be consistent with an organisation that incurs efficient and economic external costs. As such, we do not agree with Ofgem's view on External Costs incurred by the DCC.

Question 2: What are your views on our proposals on DCC's Internal Costs?

The DCC's Internal Costs are comprised of payroll costs, non-payroll costs, recruitment, accommodation, external services, internal services, service management, transition and IT services.

As the DCC's Internal Costs are dominated by payroll costs, it is disappointing not to see future projections of headcount past 2019/2020. Such projections might have provided

comfort that the current trend towards increasing staff numbers would soon be reversed, particularly as we would expect some large projects (e.g. Faster Switching and SMETS1 Enrolment & Adoption) will come to an end in that timeframe. We note that projections for most other cost categories extend to 2026. On that basis, we support Ofgem's view that £120.8m of forecast costs from RY20/21 to the end of the licence term should be disallowed due to a lack of justification provided by the DCC.

We note that the consultation suggests the DCC engaged stakeholders (through the Ready to Scale project) in its decision making with regard to the viability of a Technical Operations Centre; but we are not aware of any such engagement. We therefore support Ofgem's view that costs associated with the Technical Operations team should be disallowed for both RY17/18 and RY18/19. More generally, we call for a formalised process with an appropriate governance structure (which is not overly bureaucratic) where DCC users who ultimately fund any changes are given the decision making authority for additional spend.

We firmly opposed the use of emulators in testing; something we feel was later vindicated with the emergence of the RF noise issues that have plagued early SMETS2 deployments. To now discover that the emulator approach came at an additional cost, which was never explained beforehand, is hugely disappointing and can only damage confidence in the transparency of the DCC.

Question 3: What are your views on our proposals on DCC's approach to benchmarking of staff remuneration?

The DCC benchmarks the remuneration of permanent members of staff using the Hays database which defines the market average as the 50th percentile of a distribution of salaries for comparable roles. In a new approach to benchmarking contractors, the DCC has proposed using a 50% "contractor premium" as the benchmark against which its achievement of the economic and efficient employment of contractors is measured.

<u>Permanent staff</u>

Ofgem's finds that for most cost centres, permanent staff remuneration was under the 50th percentile because no bonuses were paid in RY17/18. This is because bonuses were paid in February 2017 and May 2018 due to an internal DCC decision to align objectives with the Regulatory Year. The remuneration level of permanent staff in RY17/18 is therefore not representative of what the DCC normally pays. We agree with Ofgem's view that the inclusion of bonus payments would result in a position where aggregate remuneration of permanent members of staff would be marginally above the 50th percentile. However, we support Ofgem's view that the permanent staff costs in RY17/18 are economic and efficient but call for scrutiny of these costs in RY18/19 when the inclusion of bonuses will give a more representative remuneration level.

<u>Contractors</u>

We note that Ofgem finds the evidence provided by the DCC to be insufficient to justify the choice of 50% as the level of the contractor premium benchmark. Ofgem proposes a contractor premium of 20% on the basis of evidence the DCC has provided in previous years.

In both RY15/16 and RY16/17, contractor payments were disallowed for being above the DCC's benchmark and not properly justified. This would be the third regulatory year in succession where contractor costs are disallowed.

We support Ofgem's decision to disallow £1.476m of contractor costs in RY17/18 but we think all contractor costs should be disallowed in RY18/19 until there is sufficient evidence from the DCC and a clear demonstration that the DCC is responding to Ofgem's findings on the remuneration of contractors over the last three regulatory years.

Question 4: What are your views on our proposals for Shared Services?

Shared services provided by Capita

We share Ofgem's concern that the DCC does not appear to have an understanding of the full range of services that should be provided under the Shared Service charge from Capita and whether those services are provided in full.

We think Ofgem should go further than encouraging the DCC to actively ensure and demonstrate that it is achieving value for money from the Shared Service charge. We think the DCC should be obliged to provide an independent audit of how it has accounted for the Shared Service charge in costs it has passed to customers.

Shared service charge on external services

As noted above, we have been critical of the DCC's procurement of emulators and we are disappointed to now find that the DCC has failed to properly consider the Shared Service charge associated with bringing the service in-house. We understand from the consultation that the DCC has established a Value-for-Money Board. We are unclear as to how the omission of a Shared Service charge from bringing emulators in-house could escape a proper review by this Board. The DCC should, in future, ensure that all impacts are considered when deciding to commit to in-house costs; particularly when this attracts a 9.5% Shared Service charge from Capita. We agree with Ofgem's view to disallow the Shared Service charge on the emulator contract.

Shared services on Centralised Registration Services (CRS) ie Switching Programme

We agree with Ofgem's minded to position of disallowing ~£0.3m of Shared Service costs for the CRS on the basis the DCC has not provided sufficient evidence/justification of the benefits received by Switching from Shared Services provided by Capita.

We note that in RY16/17, Ofgem disallowed the same costs and requested that the DCC provide full justification for any shared service costs relating to new scope activities such as the CRS for all future years.

It does not appear that the DCC has responded adequately to Ofgem's request and we think the DCC should be obliged to publish steps it will take to ensure it avoids repeating shortcomings from previous regulatory years.

Question 5: What are your views on our proposal to expect more robust evidence from DCC on how it has taken customer views into account in future price control submissions?

Ofgem's view is that meaningful input from customers is likely to be achieved by a combination of activities led by the DCC and the SEC Panel/sub-groups, and the DCC should work with the SEC Panel to develop and agree a clear set of defined activities and procedures.

We fully support this proposal. It seems clear to us that the DCC needs to be more transparent when engaging with customers; not only with regard to what information it shares, but whether it is actually seeking approval, or merely offering options for consideration. All too often, we believe the DCC has tabled items at, for example, the Implementation Managers Forum (IMF) or the Smart Metering Delivery Group (SMDG) and provided a high level overview of the costs and benefits, and then assumed approval despite an absence of any detail on the accuracy of those costs or benefits and any formal decision being taken by DCC users. A good example of this is the new test lab that the DCC is currently setting up. It seems that the DCC decided upon this unilaterally, and without any obvious governance around the expenditure incurred as a result, where it should have been subject to a detailed review and approvals process that involved the DCC Users.

Question 6: What are your views on the processes that DCC should establish to enable meaningful customer input to decision-making?

We agree that cost thresholds offer the most obvious trigger for wider engagement with customers. However, we also think the DCC needs to be very clear when asking for approval or input and what the next steps are in the decision making process. We would also like the DCC to be obligated to provide feedback to stakeholders on the ultimate decision taken; including the level of approved expenditure.

A suggested format could be for any proposals to be shared at the DCC Finance Stakeholders or at least targeted to the same audience with a formal provision of detailed models of costs and benefits for each initiative that ends with a formal submission of go/no go decisions from each supplier.

Question 7: What are your views on our assessment of DCC's application to adjust its Baseline Margin?

The Baseline Margin allows the DCC to earn a margin above its costs. This is a fixed amount but can be altered through the Baseline Margin adjustment mechanism. It currently sits at ~£35m in total, including adjustments made in previous years.

The adjustment mechanism is intended to ensure that the DCC is compensated for material changes in certain aspects of its Mandatory Business – including the volume, characteristics, risks and timescales of these activities. The DCC has applied to increase its Baseline Margin by 22%.

We do not regard the level of information provided by Ofgem in Section 6 in relation to new drivers and corresponding sub-drivers as identified in the DCC in its Baseline Margin

application to be adequate justification to allow such an increase. For instance, we question how 'PA Support' for 'Supporting a Changing Business' is a material change to the DCC's Mandatory Business.

We partially agree with Ofgem's view to reduce the DCC's application by £1.706m. But in the absence of a fuller disclosure of evidence around the impact of new drivers (and sub-drivers) of change, we think the full application should be disallowed.

For RY17/18, Ofgem continues to regard 15% to be an acceptable margin for core smart metering activities. We think this is inconsistent with other policy areas where Ofgem has placed downward pressure on returns e.g. RIIO2.

Question 8: In its submission, in support of its application for an adjustment to its Baseline Margin, DCC states that there has been a significant unanticipated change in customer expectations, and in customer and service provider demands. What are your views?

We do not think sufficient information has been provided here to allow us to properly arrive at a view. However, regardless of whether the CR's giving rise to the cost increases were instigated by the DCC's customers or the DCC itself - or, indeed, the government - the real question might be how many were absolute 'must haves' *versus* 'nice to haves'. The DCC's customers need to be given an opportunity to assess and determine whether the costs of any change are reasonable before it that cost is incurred, rather than after the fact.

Question 9: What are your views on our assessment of DCC's application for External Contract Gain Share?

While we note Ofgem is satisfied that the DCC's application for External Contract Gain Share was duly justified, we do not have sufficient information to allow us to make our own determination as to how successful the DCC was in refinancing the FSP contracts. For example, we do not have visibility of whether the refinancing defers costs to a later point or what the total refinancing costs are. If the External Contract Gain Share allows the DCC to take advantage of a short-term reduction in costs through refinancing then we would not support the proposed adjustment of £13.204m between RY19/20 and RY24/25. We call on Ofgem to provide more details in support of this decision.

Question 10: What are your views on our proposal on DCC's over-recovery of revenue?

We were somewhat surprised to find the DCC identify the greater than expected number of meters being connected as among the factors leading it to over-recover revenues, and we agree with Ofgem's assessment that the DCC could have reasonably predicted that the number of meters would continue to increase over the year. We agree with Ofgem's view that the DCC could take further steps to improve the accuracy of its estimates for the Charging Statement and that, in future, the DCC should improve the accuracy of its charges to users and consult as appropriate with its customers.

ScottishPower
December 2018