Data Communications Company

DCC 2015/16 Price Control Consultation

Annex to Letter Response

Version:	V1.0
Date:	12 January 2017
Author:	Smart DCC
Classification:	DCC Confidential

1 Introduction

This annex forms part of Smart DCC's response to Ofgem's consultation on its draft proposals for the 2015/16 DCC Price Control.

It should be read, alongside the covering letter and supplementary confidential document, and can be regarded as non-confidential and suitable for publication.

2 Consultation Questions

Question 1: What are your views on our cost proposals?

Our submission put considerable focus on the management of our external service provider costs which equate to around 80% of our overall cost base and have been subject to major change this year. We are very pleased that Ofgem has allowed the full cost of the fundamental service providers, whilst remaining not complacent about the continuing need to bear down on these costs.

We were disappointed by the extent of disallowance of our internal costs, especially as these are subject largely to the same drivers that our external costs are. We will deal with each of these in subsequent sections.

We would also like to make an important point about ex-post regulation and the distinct differences with ex-ante regulation. DCC has very much less room for manoeuvre than an ex-ante business, for example:

- An ex-ante business can trade off an over-spend against an under-spend within its allowed expenditure. An ex-post business has the over-spend disallowed but is unable to make use of the under-spend in the same way.
- In judging the efficiency of an ex-ante business it is acknowledged that no business is perfect and the hurdle for expenditure being deemed efficient is usually set at an upper-quartile, an upper-third, or even at average. An ex-post business, from our experience, is expected to be 100% efficient in all respects which seems wholly unrealistic of any business, whether regulated or not.
- Where cost is disallowed, an ex-ante business can share that with consumers, so the business may only need to absorb half, or less, of the cost deemed "inefficient". In an ex-post arrangement, the business is liable for 100% of that cost.
- Ex-ante businesses have opportunities to earn additional revenue through outperformance against incentive arrangements. According to Ofgem, such rewards are not permissible in an ex-post environment.

One can only conclude that the ex-post regime is inherently substantially more penal than an ex-ante regime. We firmly believe that Ofgem needs to recognise these points and calibrate its assessment accordingly, if the DCC model established by Government is to be sustainable.

Resource disallowances (incurred)

As indicated in our covering letter, we are frustrated by the resource disallowances.

We have asked Ofgem to provide further detail of its analysis so that we can understand and revalidate the conclusions, but thus far Ofgem is only prepared to do so, following publication of its final decision. This impairs DCC's ability to challenge these findings, and also will limit the time available to us to address any issues identified, ahead of our 2016/17 price control submission.

Our strategy in justifying our resource costs has been to offer a combination of salary benchmarking, based on Hay Group's salary database, and written justification of the role of a team and the requirement for each new role within this. However, making judgments on the merits of specific recruitment decisions is, in our view, difficult.

Salary benchmarking is an inexact process and at best provides a lagging indicator. We find routinely that many of our roles are difficult to assess precisely using the more generic and role definitions and concepts of hierarchy, in something like the Hay database. Equally, we also encounter issues around sample size, where it is questionable as to whether the benchmarks being obtained are statistically robust. Ultimately benchmarking can only take you so far in guiding the salary level at which a role should be advertised.

All roles, prior to advertisement, come to DCC's Internal Change Board (ICB) where the requirement for the role, as well as the proposed salary and benefits are subject to challenge. The benchmark obtained from the Hay database is an important element in this discussion, but we also recognise other factors, such as recent experience of recruiting similar roles, as well as the wider context of resourcing within a team or cost centre, which might influence seniority/experience requirements.

Whilst salary is rarely the primary reason why people choose to join a company, such as DCC, it can be a major disincentive to join. Hence, each role which is advertised is in effect a test of the market rate at that point in time. As noted by Ofgem, DCC have had a number of incidents in recent months of people accepting offers, but then withdrawing ahead of their arrival, having received a "better offer".

Recruiting managers need to have the flexibility to be able to recruit the right person for the role, and can only do so from the pool of candidates available to them. As such, we allow managers to vary any offer by up to 10% from the figure approved at the ICB. Beyond this, the proposed salary package must return to the ICB for re-approval, prior to offer.

The key point we wish to make is that recruitment is a human process and not a mechanistic one – recruitment decisions are inherently impacted by factors outside the DCC's control, most obviously the availability of suitably qualified individuals and market conditions at that point in time. Managers also need the flexibility to recognise someone who might benefit the organisation in the longer term, or add skills/experience over and above the immediate requirements of the role. However, there do need to be controls around recruitment, and DCC has these in place both pre-advertisement and pre-offer.

We would also like to draw Ofgem's attention to the point made earlier re the risk of DCC being subject to a more penal approach, as a result of our ex-post regulation. Resourcing decisions can be very clearly impacted by this treatment. Ofgem would not see it as its role to decide the mix of staff that an ex-ante regulated company should employ, leaving such decisions to the discretion of management, but judging the quality of those decisions through the outputs delivered and the company's performance against its allowed expenditure. We do feel strongly that Ofgem should apply similar standards to DCC, and embrace this more holistic approach; otherwise the risk is that management is driven to manage cost, at the expense of timeliness, quality or innovation. This would not be of benefit to service users, and by extension, end-consumers.

Resource disallowances (forecast)

At first glance, the level of disallowance of forecast is concerning. Whilst we recognise that the future costs of the organisation are to some degree uncertain, our forecasts are made with careful consideration.

However we are aware that this disallowance does not preclude us from bringing forward such costs as they are incurred, which is what we will do.

External Services

DCC feels very strongly that this is an unfair proposal.

Almost since the inception of the DCC, Ofgem has sought to question the margin that DCC is able to collect – a figure that was set through an open and competitive procurement process.

It is clear that the level of margin was fixed for the period of the licence, irrespective of the different phases of activity and without any suggestion that it might be reopened almost immediately.

When subject to these continual challenges for DCC to justify its margin levels, it is reasonable for DCC to obtain external advice to assist in responding to this. In fact, it would arguably be inefficient for us to retain such specialist expertise internally.

This expenditure would have been completely unnecessary but for Ofgem's repeated attempts to re-open the margin level and hence it is unreasonable for Ofgem then to seek to disallow costs incurred by DCC, as a result.

Furthermore, Ofgem is incorrect to suggest that Capita should pay for any such defence. The margin is an integral and essential part of the financial arrangements which underpin DCC, and provides the only vehicle through which resource disallowances can be absorbed.

Ofgem should reflect on the treatment of such expenses in other sectors it regulates. Such regulatory costs are regarded as normal business expenses. To our knowledge there is no record of Ofgem disallowing such costs and insisting that the shareholders of energy networks should fund their regulatory submissions as part of their price controls.

Finally, the costs incurred are clearly de minimis, and Ofgem citing "principle" does not change this.

In our view, this disallowance is wrong on a number of bases and the proposal for both incurred and forecast costs should be withdrawn.

IT Services

We note Ofgem's comments re the proposed disallowance of costs in respect of the FTP project. Ofgem raised this issue with DCC during the assessment process and it is worth re-stating our position on this.

DCC takes its responsibilities to manage our service providers very seriously and strives constantly to obtain value for money for consumers.

Unfortunately, in a programme of the scale and complexity of this one, it can be very difficult and, from a commercial perspective, potentially counter-productive to attempt to isolate specific contractual events. The difficulties caused by aspects of CGI's delivery in respect of FTP have to be viewed in the context of the very large CR160 change request that was being negotiated with them at the same time, in connection with their main DSP contract, and the necessity of CGI remaining fully committed to development and delivery while this change was being discussed.

DCC is obliged to consider the big picture, and this inevitably means that compromises need to be made when reconciling the various and sometimes inconsistent commercial pressures at any one time.

If this proposal is confirmed, it would be an example of DCC obtaining no credit for the work that was demonstrated, through the Price Control submission, in optimising the costs of the programme, valued in the hundreds of millions, but being penalised for a single decision, valued in the hundreds of thousands. We believe our decision to prioritise the negotiation valued in the hundreds of millions was the rational choice.

DCC will have little option but to pursue CGI for the value disallowed, irrespective of the impact on the relationship with CGI and the knock-on impact on programme delivery, otherwise DCC will bear the full cost with no means of mitigating this. However in our view this would not be in consumers' interests for the reasons set out above.

We would wish to reassure Ofgem that DCC will continue to bear down on the costs of its service providers, but proposals such as this will only contribute to creating a more commercially risk-averse and adversarial approach, which is likely to result in longer timescales and higher costs for our customers.

Overhead charge/Shared Services

In our covering letter, we have registered our dissatisfaction with this proposal.

The terms under which DCC was established are clear – DCC is entitled to levy an overhead charge of 9.5% on its internal costs. However, Ofgem persists in seeking to modify this agreement.

The concept of an overhead charge is very common within groups of companies, such as Capita. The overhead charge serves to fund a variety of centrally provided services, which by definition can be more efficiently delivered on a collective basis – examples in Capita include Accounts Payable/Receivable, HR services, and legal services. In addition, it provides access to non-transactional or specialist services, such as commercial advice, audit, health and safety etc. Finally, there is the contribution that DCC, as a Capita company, makes to the corporate functions, e.g. executive management, head office.

DCC understands Ofgem’s desire for greater transparency in respect of the overhead charge. We have provided additional information, as far as is practicable, to the costs and benefits that accrue, in an attempt to provide reassurance that there is substantial value attached to this overhead contribution.

This was not portrayed as a formal and complete cost-benefit analysis, but simply sought to provide greater insight to Ofgem. The figures presented reflected an analysis of the most tangible of services, in particular, the transactional ones, the value of which could be readily quantified.

Our report to Ofgem makes it clear that there are the other non-transactional services provided over and above these, which are inherently harder to quantify, and also does not attempt to value the contribution to the corporate overhead which comes from being the member of a group of companies.

Hence we are very disappointed that Ofgem has knowingly disregarded the caveats and sought to use the base value to set a cap on the overhead charge for the duration of the licence. We also object to the way this is being applied retrospectively which we do not believe to be good regulatory practice.

Ofgem is attributing no value to the more specialist services, such as commercial advice and audit, whilst at the same time in other discussions, raising questions about our management of the service providers or issues of compliance, where such corporate services can help.

The fact that DCC is part of a group of companies was well understood at the time of the licence award. Capita was clear about the inherent costs that result from this, but also the wider pool of expertise and services that DCC could access. Consistent with that, Government has consistently reminded us that Capita’s capability was an important consideration in its decision and encouraged us to draw on this, wherever we think it might advantageous.

Ofgem cannot now seek to regulate as if that is not the case and as if some other “ideal” commercial model could be assumed without the evidence that such a model is either practical or in consumers wider interests.

In our view, Ofgem’s overall treatment of the Overhead charge is disappointing and we would ask Ofgem to think again, and if appropriate, bring forward alternative proposals that DCC could seriously engage with.

RPEs

DCC notes Ofgem’s comments on RPEs and would welcome the opportunity to engage with Ofgem further on this topic, so as to arrive at a sustainable methodology going forward.

External cost assessment

We are pleased that Ofgem has concluded that we have been economic and efficient in our management of the fundamental service provider costs. This equates to around 80% of the programme’s cost base, and we firmly believe that it is in this area where we can deliver the greatest value for consumers.

As Ofgem's proposals are in the public domain, and can be read by other parties, we wish to make two points about paragraph 3.48, and specifically the third bullet re the independent assurance which was undertaken on DCC's management of the CR091 change request.

Firstly, we would like to point out that the external assurance was markedly more positive in its outcomes than the exercise in the previous year, thus demonstrating that we have taken on board the previous observations of the auditor.

Secondly, it makes reference to "contractual timelines were not met". For the benefit of other readers, the DCC change management process does include certain timelines which process steps should be delivered within, e.g. a timeframe for the service provider to submit an impact assessment.

The CR091 change request was many times bigger than a typical change request, and frankly it would be nigh impossible for the standard timelines to be met without seriously impacting on the quality of those products or processes. We took the view then that getting those impact assessments right was key, and the fact that this took longer than the process definition allows for, is of second order importance.

The fact that savings of around 18% were achieved when compared with the initial position is testament to this.

Question 2: What are your views on our assessment of DCC's application to adjust their baseline margin?

Ofgem's assessment of our Baseline Margin (BM) application is a matter of considerable concern to DCC. We believe Ofgem has taken a position which is unfair, unreasonable and in breach of our legitimate expectations.

This is described further in the confidential annex.

Question 3: What are your views on our assessment of DCC's performance against IM8?

As Ofgem has described, the implementation performance regime provides the necessary incentivisation for the delivery phase of the programme.

We were pleased with progress achieved during the year and the successful delivery against the IM8b milestone. However we recognise that IM8a was indeed late, and having signed up to placing our margin at risk, Ofgem is correct in disallowing the sum of £53,462 from BMIT.

Question 4: What are your views on DCC's voluntary reporting which explains its reasons for over recovery of revenue in RY15/16?

In 2015/16, DCC did encounter a number of factors which introduced difficulties into the management of regulated revenue, which Ofgem has summarised at para 6.12.

We are pleased with Ofgem's conclusion that the over recovery of revenue was outside of DCC's control, and would not attract the penalty interest rate. However, we also note Ofgem's comments about providing more detail as part of the submission and will factor this into future submissions.

We note also Ofgem's concern that over-recovered service charges be returned to suppliers as soon as is practicable. DCC did in fact take steps to do this following last year's price control decision and will do so again this year, hence the 2017/18 charging statement does include a correction factor based on an anticipated value of over-recovery in 2016/17.

Like Ofgem, we believe it is preferable to pass some money back to suppliers promptly, even if this is based on an estimate, followed by a smaller, final adjustment later, rather than wait some months until the precise values are known.

We recognise that it is important that we get the balance right between the raising of revenue required by DCC, and not over-recovering charges or subjecting suppliers to unreasonable volatility.

We would be happy to discuss charging arrangements more broadly with Ofgem and Industry so as to identify further improvements that can be made.