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DCC Price Control Consultation: Regulatory Year 2017/18

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, storage, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including residential and business users.

- **We welcome the opportunity to comment on the DCC Price Control Consultation, and are supportive of most of the conclusions drawn by Ofgem; however our sensitivity to rising charges and the future sustainability of DCC has risen substantially since the 2016/17 review.**

We remain committed to the principle of a National DCC, and the benefits that it should bring by providing a common, interoperable, secure and affordable interface between suppliers and other users, and enrolled smart meters. However, we must make every effort to ensure that the DCC is delivered economically and efficiently, in order to minimise the impact on the customer's bill.

EDF Energy agrees with the National Audit Office (NAO) findings on the understatement of DCC costs of the Smart programme. The NAO noted that DCC is currently forecasting that its' costs to 2025 will be £0.3 billion higher than the Department expected. They also suggested that Ofgem should consider improving the transparency of DCC costs, both for price control and for public and parliamentary scrutiny.

Overall Perspective

In respect to the above paragraphs, the following issues raised by this consultation are of particular concern to EDF Energy:

- **The continual increase in the DCC's costs; we propose a 'Financial Controls Framework' and 'SEC Oversight Group' to assist DCC with identifying potential cost savings and to provide guidance over justifying future expenditure and delivery of 'cost effective' change**

- In respect to the proposal to increase the Baseline Margin by 2% to 17 %, we do not believe that this increase has been justified.
- The External Contract Gain Share (ECGS) proposals; it is not acceptable in today's market conditions that Users fund DCC, (a regulated monopoly), to find cost savings on which DCC then receives a substantial proportion of the saving, thereby reducing the benefit to consumers.
- No external costs have been disallowed despite the delays to delivery of key DCC functionality in accordance with the agreed milestones. Evidence that DCC has made every effort to recover/reduce costs from its' Service Providers' where they are accountable for the delay or issue, should be sought by Ofgem.
- DCC should have a clear plan for reducing costs as each respective "release delivery period" comes to an end. . It should not be allowed any future cost increase until such a plan is in place.

DCC Cost Escalation

We recognise that, in assessing the DCC's costs, Ofgem will need to have access to more detailed and granular data than can be shared with industry. We are therefore reliant on Ofgem to undertake the detailed assessment of DCC's costs and to conclude whether they have been efficiently incurred or not. At the same time, we remain concerned at:

- **The continuing escalation in DCC costs, and the lack of transparency/governance and advanced notice that has been afforded to industry regarding 'default/embedded' charges. Examples being: Ready to Scale, Production Proving, Centralised Test Lab, Cloud services, and others.**

EDF Energy agrees DCC should be able to make the allowed and required investments, in accordance with "Condition 5. General Objectives of the Licensee" within that allowed as part of its 'release programme' to deliver an efficient and good quality of service to Users, whilst also focusing their organisation on delivering an effective ongoing operation. We continue to remain extremely concerned at the significant increase in the level of DCC's costs since contract award; particularly as DCC Users are expecting to see cost reductions through continuous improvement (as set out in Schedule 2.4 of the DSP/CSPs contracts), and greater involvement in key decisions.

In RY17/18 total DCC costs (excluding pass-through costs) were £257m, £41.2m (19%) higher than forecast in RY16/17. Over the Licence term, total costs (excluding pass-through costs) are now forecast to be £471m (£89.49m) or 19% higher than last year's forecast.

- These levels of progressive increase are unsustainable. In previous responses to Price Control consultations we suggested setting up a 'Financial Oversight Group' to assist DCC with identifying potential cost savings and assisting with guidance over future expenditure. We continue to believe such a group is required.

- EDF Energy suggests that a 'financial controls framework' be developed to help DCC structure its applications for additional or variance in its funding, and to provide confidence to DCC Users, stakeholders and consumers, that a clear business case has been constructed with achievable benefits that drive value.

- To achieve this, it is recommended that the Authority considers establishing a SEC sub-committee to act 'in confidence' on behalf of SEC Parties to engage with and assist DCC in progressing the governance associated with the 'financial controls framework'.

- In addition, it is vital that any investment (Releases, Changes and Improvements) made in DCC and its SP's is subject to traceability and benefits realisation, to confirm the positive outcome funded by Users and Energy Consumers is achieved.

External Costs

As presented in our responses to previous DCC Price Control consultations, it is difficult to assess whether the DCC External Costs are economic and efficient. The original contracts were redacted and subsequent contract amendments are not visible to Users.

- We are surprised to see in the consultation that Ofgem is not proposing to disallow any External Costs for RY17/18, bearing in mind the industry have had to absorb costs associated with delays both within their own rollout programmes, as well as DCC. We would like to know how DCC has mitigated the cost of delays and defects within both its own organisation, and its service providers..

- Ofgem may wish to re-investigate this area to see if external costs could be reduced in a similar manner to our suggestions on internal DCC resources. We would hope that DCC could demonstrate that they have sought reductions in rising external charges due to delays and defects.

- We accept justifiable variations will be necessary from time-to-time. However, before DCC carries out any additional work activities, full liaison with stakeholders must be carried out, with a fully costed business case signed off by Users. In order to ensure economic and efficient costs are achieved, this business case must include robust justification, reporting, and formal benefits realisation.

- We would also observe that in undertaking additional work, DCC and its SP's have provided cost estimates to which BEIS have added a risk factor (optimism bias – in accordance with the cabinet green book), however it is not clear to us whether the charges for external costs have been adjusted to reflect the removal of optimism bias, or the bias converted into an 'increase' and if so how this has been applied/governed.

Ofgem Draft Findings

We note from Ofgem's draft findings that DCC should focus more on:

- Understanding Customer needs. This should include the resolution of issues associated with the DCC solution that have been raised via the Technical Specification Issues Resolution Sub-group (TSIRS).
- Resource Efficiency – The Licence Application Business Plan (LABP) estimated the maximum resource level to be 109, compared to the forecast of 388 in RY18/19 (excluding service desk staff). We would ask Ofgem to seek clarification from DCC to explain the rationale for such a significant increase in internal staffing, considering that the bulk of any work undertaken to deliver changes sits with the external providers.
- Justification of payroll costs for contractors.
- Shared Services - Further explanation is required as to what is covered by DCC Shared Service Charges, and specifically what is not included.

EDF Energy supports Ofgems' proposal to remove £2.345m from DCC's Allowed Revenue in RY 17/18. We also support Ofgems' minded position not to allow £134.603m of increases (covering Resource, Benchmarking, External and Shared Service), over the remaining Licence period, on the basis that there is insufficient justification for these costs, and to allow them would make DCC increasingly unsustainable at a point in time when costs must reduce.

- The combination of lack of traceability over 'Release (Major and Minor) Costs' and unjustified 'forecast of future costs' leads to the worrying conclusion that the benefits that DCC were targeted to deliver on behalf of its users, have been abandoned.

Baseline Margin

Whilst we accept Baseline Margin is at risk, we would like to see confirmation that DCC's margin, including any adjustment, are truly 100% at risk, bearing in mind some of the activities lack the definition of how success can measured e.g. SMETS1 preparatory work. In addition, we seek clarification on where Optimism Bias starts and where Baseline Margin finishes.

- **Without further evidence we do not accept that the additional DCC activities and added responsibilities warrant an increase in Baseline Margin from 15% to 17% over the Licence Term. We cannot agree with Ofgem's proposal to increase Baseline Margin by £5.948m (17%), which would increase it in total to £40.888m. We do, however, agree with Ofgem's decision to withhold £0.106m for lack of evidence relating to a set of financial roles.**

Whilst we accept DCC should be compensated for agreed material changes to its Mandatory Business under the Licence, there are a number of items within RY17/18 which EDF Energy believes must have been included at the time of Licence/Contract award and included in the LABP and in the subsequent R1.2/1.3 award. These areas are fundamental to the successful delivery of the DCC service, and in particular, the DCC/SP bidders were well aware on the number of properties requiring smart metering, and the scale and criticality of the activities needed to achieve a successful implementation. These activities include Robust Testing, Production Proving and Cost to Scale.

External Contract Gain Share

We are concerned that DCC continue to receive a substantial proportion of savings from External Service Provider arrangements via the External Contract Gain Share (ECGS), and question if this is appropriate going forward. It is the responsibility of the Authority, DCC and SEC Parties to minimise costs, which are ultimately recovered from consumers.

- **It is not acceptable that suppliers are paying DCC to find cost savings on which they not only receive a baseline margin, but also a substantial proportion of the benefit. Ofgem should consider revisiting the principle of External Contract Gain Share, on this basis.**

We require confirmation that DCC Users should not being charged for the costs involved in achieving these savings. Until such confirmation is received, we are unable at this time to agree with Ofgem's proposal to adjust DCC's ECGS by a total of £13.204m between RY19/20 and RY24/25.

EDF Energy asks that Ofgem's draft findings should be further reviewed before being finalised.

Our detailed responses are set out in the attachment to this letter. Should you wish to discuss any of the issues raised in our response or have any queries, please contact Ashley Pocock on 07875 112854, or myself.

I confirm that this letter and its attachment may be published on Ofgem's website.

Yours sincerely,

Paul Delamare

Paul Delamare
Head of Customers Policy and Regulation

Attachment

DCC Price Control Consultation: Regulatory Year 2017/18

EDF Energy's response to your questions

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

As presented in our previous responses to DCC Price control, it is difficult to assess whether the DCC external costs are economic and efficient. The original contracts were redacted, and subsequent contract amendments are not visible to Users. The basis for demonstrating that external costs represent good value for money in a situation of escalating costs needs careful consideration. A new financial controls framework should be established which can determine against set criteria whether DCC has secured its external charges in accordance with operating an economic and efficient monopoly.

DCC has undertaken a number of ad-hoc initiatives, funded by Users, throughout the lifecycle of the activity, whether this is likely to result in a positive outcome or not. Many of these initiatives feature both internal and external costs, are poorly presented to Users, unsupported by clear and compelling business cases and are not subject to formal governance both in terms of costs or benefit realisation. This needs to be addressed urgently.

We appreciate it is challenging for the DCC to manage their Fundamental Service Providers (FSP) to ensure value for money and good quality of service to customers. However, we remain extremely concerned at the rate at which External Charges continue to increase and, in particular, the variation over the Licence term since LABP.

We fully support Ofgem's observations regarding the room for further improvement by DCC, particularly in the areas of commercial negotiations, customer engagement and risk management. We therefore find it difficult to support DCC's justification of a £13.7m (7.9%) variation in costs for RY 2017/18 and £78.3m (72.5%) from LABP.

Whilst we accept there have been changes as a result of changes to the GBCS and SEC, the cost increases of £262m (12%) over the variation of the licence and £778.8m (46.7%) appear to be excessive. This is especially the case given that the DSP (CGI) and the two CSPs (Arqiva and Telefonica) were fully aware of the number of properties requiring smart metering at the time they applied for the CSP/DSP roles. It is not clear how the LABP costings can have been so far out. A number of changes being submitted by DCC should have been taken into account at the time the LABP was put together, for example Production Proving and Demand Management.

With regard to RY 2017/18, an increase of 15% for the DSP (33% over Licence period) again appears excessive. In addition, a number of drivers for the variation in External Costs across the Licence term, compared to the RY 2016/17 forecast, require closer examination to see if costs could have been reduced. In particular, CR184 (DBCH) which accounts for £105m (40%) of the £262m total variation costs. Further investigation should also be carried out on CR160 with a cost of £47m (18%) as a result to delays in testing, primarily resulting from the DCC.

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

DCC's internal costs have progressively increased over the initial period of its licence. Some of these costs are legitimately related to the management overhead associated with Service Provider contracts, planning and administration, user engagement, technical specifications and consultations. In comparison with the LABP, the DCC resourcing and associated costs have increased dramatically, and this needs deeper investigation. The lack of a clear senior management focus on retaining the lean and agile intent of the licence is of concern.

It is also of concern that DCC are assuming responsibility for work activities contracted to Service Providers.

Internal Costs have continued to increase year on year since the publication of the LABP on 30 April 2014. While we accept there are genuine requirements for changes since LABP, we are concerned by the size of some the increases. For example, in RY17/18 Internal Costs increased by £61.5m which is £22.12m (56%) higher than forecast in RY16/17 and is £51m higher than the LABP forecast. Over the remainder of the Licence period, Internal Costs are forecast to increase by a further £165.7m relative to the RY16/17 forecast and by £219m compared to LABP. Increases of this magnitude cannot be allowed to continue, and require investigation.

With regard to the level of Resources, numbers have continued to increase at an alarming rate. The number of FTEs was estimated in the LABP to be 109; these are now due to increase to 388 in RY18/19 (excluding service desk staff). Although we recognise savings have been made by DCC regarding Contractor numbers, we believe greater savings could be made by further reducing number of contractors DCC are still employing. A number of these contractors have been there for many years and should have passed on their expertise to an FTE by now.

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

We agree with Ofgem's comments requiring DCC to employ staff at economic and efficient remuneration levels. The salaries currently offered by DCC appear to be much higher than equivalent roles in industry. We would not expect DCC to offer any FTE or Contractor position with a salary greater than 10% above the 50th percentile.

We challenge the payment of bonuses paid to FTEs and Contractors in February 2017 and May 2018 when there have been so many delays to DCC's delivery of a number of "Releases and Functionality" over the Regulatory Year. Bonuses should be linked to effective delivery. Every time DCC is late with delivery, it results in significant additional charges to DCC Users.

For these reasons we are unable to support DCC being rewarded for non or late delivery and with the proposed calculated contractor premium of £2.233m in RY17/18 and £0.423m in RY18/19. In addition, we also oppose the proposed 20% contractor premium which totals £0.757m in RY17/18 and £0.136m in RY18/19. For these reasons, we support Ofgem's proposal to disallow £1.476m of contractor cost in RY17/18 and £0.286m in RY18/19 as not being economic and efficient.

In EDF Energy's view, it would be worthwhile exercise to benchmark the number of staff needed to operate as a 'lean and agile' Licence holder of similar stature and responsibility.

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

It would have been useful if there was an explanation in the consultation as to what is covered by DCC Shared Service Charges, and in particular details of what is not included.

Provided it remains cheaper for DCC to carry out Shared services in-house we are in agreement that provided baseline charges are calculated in line with the LABP formula that Ofgem should not require further justification.

We further agree any new scope activities DCC have been asked to carry out where a business case has been signed off by Users should also be paid where adequate justification has been made.

We understand Ofgem's concerns surrounding the switching programme and support their decision to withhold £0.091m as a result of inadequate evidence being provided by DCC.

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

EDF Energy agrees with Ofgem that DCC should be required to undertake formal engagement and where appropriate consult and seek User support for expenditure beyond that previously agreed. We believe that a formal 'Financial Controls Framework' is needed to provide visibility, presentation of business case, risk management, and benefits realisation, in order to gain agreement to proceed on any investment where Users charges will increase, or there are financial risks that may impact Users.

We support Ofgem's proposal to expect more robust evidence from DCC on how it has taken customers views in to account in future Price Control submissions. As a minimum we would expect DCC to listen to the views expressed at DCC Sub Group meetings and forums. However, these meetings should not be taken as agreement to move forward and implement new work or changes. The representatives at these meetings quite often do not have the necessary financial authority to agree the level of expenditure being requested. Under no circumstances should DCC be able to commit to any expenditure without the explicit financial agreement of Users. In addition, just because an activity is contained within DCC Business Plan it does not give DCC permission to proceed without agreement from stakeholders. DCC must demonstrate good business practice has been followed.

Project accounting must apply to past as well as future projects, such that the residual (non-R1.0, R1.2/1.3, R1.4, R2.0, R3.0 project accounted) spend is relatively small. DCC accounting by resource type/cost centre is insufficient when each of its activities are subject to consultation and IA.

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

The principle as established in the DCC Licence of 'Development and Business Planning' is insufficient to satisfy the needs of users, and a stronger 'Financial Controls Framework' is necessary to structure the information and preparatory work needed to legitimise and gain support from funding Users. It is understood that there is sensitivity from DCC to sharing detailed financial information, but Users must be regarded as effective investors in DCC, to be able to assess legitimacy of the DCC business case and associated risks.

EDF Energy would suggest that a 'financial controls framework' be developed to help DCC structure its applications for additional or variance in its funding, and to provide confidence to DCC Users and stakeholders that a clear business case has been constructed with achievable benefits that drive value. To achieve this, it is recommended that the Authority considers establishing a SEC sub-committee (Financial Oversight Group) to act 'in confidence' on behalf of SEC Parties to engage with and assist DCC in progressing the governance associated with the 'financial controls framework'. In addition, it is vital that any investment (Releases, Changes and Improvements) made in DCC and its SP's is subject to traceability and benefits realisation, to confirm the positive outcome funded by Energy Consumers is achieved.

Any governance process whereby DCC communicate potential decisions to Users must include a fully costed business case, setting out the advantages and disadvantages of the proposal. Under no circumstances should DCC be allowed to proceed without the proposal being signed-off by Users. This process should also apply where savings could be made from External Service Providers. As mentioned above attendees at forums and sub-groups do not always have the financial authority to agree modifications or new scope of work to be carried out by DCC or External Service Providers.

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

We acknowledge the Operational Performance Regime will commence in RY18/19 which will assist Ofgem with their Price Control decisions., EDF Energy, however, continues to have a number of concerns relating to DCC's application to adjust their baseline margin between RY17/18 to RY 19/20 as part of the Allowed Revenue by 22% increasing it over the Licence term from £34,939m to £42.7m.

- Whilst we accept Baseline Margin is at risk, we would like to see confirmation that DCC's margin, including any adjustment, are truly 100% at risk, bearing in mind some of the activities lack areas where success can be measured e.g. SMETS1 work. While we accept that the DCC should be able to earn a margin on increased scope, it should not be able to profit from increased costs resulting from its own poor decisions, inefficiency or other factors of its own making. Currently, the accounting/governance framework applied to the DCC does not adequately distinguish between the two. Each material change/project should have clearly defined 'margin at risk', elements.

Without further evidence we do not accept that the additional DCC activities and added responsibilities warrant an increase in Baseline Margin from 15% to 17% over the Licence Term. Without further evidence to the contrary, we cannot agree with Ofgem's proposal to increase it by £5.948m (17%) which would increase it to £40.888m.

We do, however, agree with Ofgem's decision to withhold £0.106m for lack of evidence relating to lack of evidence relating to a set of financial roles.

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?

Where DCC has responded to specific and approved requests direct from the Authority or from the SEC change process, for change to the service it provides, then it is appropriate to accept application of the baseline margin to these activities. However, it is not clear that this applies to all of the work undertaken by DCC, and where there is a lack of 'formal' approval, the baseline margin, and in some cases the activity itself should not be allowed. There is a case to consider that where DCC has failed to provide an acceptable service in accordance with 'good industry practice', (which may be the basis for DCC's claim that Customer expectations have changed), that any adjustment to the baseline margin to reflect this recovery work should is inappropriate.

We agree with the concept that DCC's Baseline Margin should be increased in recognition of the uncertainty of the nature and risks of DCC's Mandatory Business over the Licence term and that it is also closely linked to their performance regime which commences in RY18/19. However, on this occasion we are opposed to the proposed current increase. In addition, we would seek reassurance that all additional core smart responsibilities could not have been foreseen at the time of the LABP and that all new activities have followed the correct governance e.g. business case produced and financial charges correctly signed off by Users.

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

It is entirely appropriate for DCC to expect a share of 'external contract' savings, where it has funded the risk associated with seeking the saving, at the level determined in their licence. Funding of both the risk investment and a substantial portion of the reward by Users and their customers is inappropriate, especially as there are no controls in place to limit DCC exploration of savings or provide visibility of the costs of the investment needed to achieve the savings. In addition, there is currently no process established for consideration of the wider business impact on SEC parties through consultation or engagement. External gain share projects should be subject to identification and joint assessment with Users/Authority/SEC panel before any investment is made at User cost, before proceeding.

Whilst we agree with Ofgem's assessment of DCC's application for ECGS, which incentivises the DCC to achieve cost savings from external service providers, we seek confirmation that DCC Users are not also being charged for the costs involved in achieving these savings. Until such confirmation is received we are unable to agree with Ofgem's proposal to adjust DCC's ECGS by a total of £13.204m between RY19/20 and RY24/25.

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

We agree with Ofgem's view that DCC has over-recovered in the areas identified. Also of concern is the substantial increase in DCC resources in comparison to the LABP. This needs further examination, particularly in respect to activities associated with the management and oversight of Service providers and End-to-End system and service assurance.

The Licence requires DCC to make all reasonable steps to secure that its regulated revenue does not exceed a prudent estimate of Allowed Revenue, regulated Revenue and Charging Statement. A clear penalty regime was put in place to stop this from happening.

We are concerned to see DCC have exceeded the 110% threshold by 6% to £257.9m. EDF Energy accepts there is nothing DCC could have done regarding Pass-Through Costs for which they have no control over, or changes to the BMPIA term (which reduced Allowed Revenue). Further explanation is, however, required on the remaining two items.

For these reasons we do not agree with Ofgem's view that DCC has provided sufficient explanation why regulated Revenue exceeds Allowed Revenue in RY16/17. DCC have clearly exceeded the 110% threshold, therefore, the penalty regime should be applied

DCC cost traceability

EDF Energy would also draw Ofgems attention to the lack of traceability of both costs and benefits associated with each the packages of work being undertaken by DCC, namely the series of incremental releases (R1.0, R1.2/R1.3, R1.4, R2.0) which are the only structured and costed increases above the LABP and which were subject to consultation and impact assessment. The inability to perform an audit trail on how each of these packages has progressed against their baseline cost, approval of any cost increases, and the erosion of projected benefits, is poor governance and accountability. The lack of sensitivity to how these costs are changing and the inability for key stakeholders to review and address escalating costs is disturbing.

Both the Industry and SEC Panel would expect DCC to improve the accuracy of its charges and to consult as appropriate with its stakeholders on a regular basis.

EDF Energy
December 2018