Issued via email

OfGem
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28th December 2018

Dear Sir/Madam,

DCC Price Control Consultation RY2017 – 18

Thankyou for circulating the consultation material relating to the aforementioned consultation and for hosting the stakeholder workshop on the 5th December which we supported via representation on the day.

npower welcomes the opportunity to consider and respond to the proposals set out, our responses to the consultation questions can be found with annexe A below, but by way of summary ;

1. DCC needs to improve its arrangements for involving and engaging with its stakeholders, communicating more effectively at an early stage
2. DCC needs to be more transparent about [its] costs when consulting on (and justifying) new spend proposals
3. DCC needs to significantly improve its control and accuracy of forecast spend against actual delivered. The continued escalation of costs without apparent justification or the necessary transparency remains unacceptable and a concern to suppliers
4. DCC to communicate the base level service provision Supplier should reasonably expect, so an assessment of the "service vs cost trade off" can be made against the min service threshold
5. DCC to provide greater transparency on shared service arrangements now and into the future
6. DCC to evidence and justify its application for an adjustment to its baseline margin
7. Ofgem to reduce the over recovery revenue allowed to a more realistic and sustainable level and to explain why it believes a 15% margin on a monopoly activity is appropriate when it imposed a much lower margin on the Standard Variable Tariff Price Cap which operates in a highly competitive market.

I trust this response meets your approval and I am available to discuss any relevant matters at your convenience if needed via the details shown.

Yours Faithfully,

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Annexe A Response to Consultation questions

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

It is difficult to make a judgement as to whether these costs are economic and efficient as we do not have sight of all the evidence presented by DCC to Ofgem regarding their management of the sub-contracts with the Fundamental Service Providers (FSPs).

We are prepared to take at face value the assurances that Ofgem have expressed regarding the evidence that DCC have provided around their actions to ensure that the changes required of the FSPs are "economic and efficient". This suggests that DCC are carrying out their obligations with respect to managing the FSPs in a satisfactory manner. However, it is a concern that DCC have not been able to demonstrate and provide evidence around their assessment of risk, or that they have failed to take account of overhead costs in their cost benefit analysis. Hopefully the reassurances that DCC provided at the consultation meeting on 5th December, particularly around the latter, will mean that this is not repeated next or subsequent year/s.

Finally, we note that we cannot comment on whether the External Costs are actually economic and efficient in the broadest sense of these words. This is because the costs base is to a large extent defined by the FSP sub-contracts, and whilst there is some element for negotiation in the cost of new scope, the question that is really being asked in this consultation is whether the DCC contract management process has been sufficiently rigorous and robust.

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

It is disappointing to see that DCC's Internal Costs were 56% higher for the Regulatory Year 2017/18 (RY18) than forecast a year previously. The prior year forecasts would have been submitted in the summer of 2017, when the regulatory year in question was already in progress, and whilst it is clear that some of the variation was due to the Switching programme, there should nonetheless be a greater level of forecasting accuracy.

There is a significant growth in internal costs that appear to be driven by growing "customer demand", and we are concerned that this is a somewhat vague umbrella under which to seemingly justify cost increases. In particular:

- What are the increased customer numbers that could not have been reasonably forecast in the previous year, or at the time of the license award? The ongoing industry issues meant that the number of SMETS 2 installations in RY18 was significantly lower than expected, so we are unclear what increase in customer numbers DCC are experiencing.
- What are the increased customer expectations over and above those that could have been reasonably expected at the time of the license award? We need a much higher degree of clarity on this issue, as clearly DCC cannot justify a cost increase required to meet a basic level of service.

It would seem that Ofgem share our concern on the second point, as limited evidence has been presented that customer views have been sought around the trade-off between service and cost. We need to have absolute clarity as to what is the basic level of service expected of DCC is, and that any service level increases above that are based on agreement with customers as a result of appropriate discussion and consultation around the service and cost trade-off.

Consequently, we support the proposal to disallow the forecast costs associated with the Technical Operations Team, and would request that Ofgem seek further evidence from the DCC around the two points that we raise above before agreeing to allow the remaining cost increases.

On the question of the Technical Operations Team this has been presented as an additional service that DCC have set up to proactively manage the end-to-end system operation of the DCC solution. Again, it is not clear whether this is a service that DCC should be providing under their license obligation, or an additional service. The words that DCC use in paragraph 3.13 of the consultation appears to us to be activities they should be doing in order to fulfil their basic service obligation. It would be particularly disappointing if activities that should be part of DCC's basic service offering were being repackaged as additional services in order to justify extra cost allowances, and we look to Ofgem for assurances that this is not the case now and in the future.

Finally, we support the observation made in the consultation that DCC have made no specific mention of cost efficiencies going forward. It is essential that DCC activities are not simply seen as a "cost plus" exercise, and it is disappointing that long term payroll increases were submitted beyond RY21 without reference to efficiencies. We support the proposal to disallow such costs from RY21.

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

We rely on Ofgem's review of permanent staff costs to determine whether they are economic, efficient and justifiable. It is difficult for us to take a view on this, but we note that the realignment of bonus payments has meant that the percentile number for RY18 is of limited value. At the very least DCC should have provided an estimate of what the percentile figure would have been had bonuses been paid at a level consistent with previous years.

We are encouraged that DCC has reduced their reliance on contractors during the year, but agree with the concerns around the contractor premiums. It is not clear in the consultation as to whether the 50% premium is a comparison of contractor costs against the fully costed employee costs (i.e. after allowing for employer NI and pension contributions, sickness and holiday allowance etc.), although the DCC confirmed that was the case at the consultation meeting on 5th December. That being the case, a 50% premium compared to a fully costed employee seems to be excessive, and we agree with Ofgem's view that 20% is more appropriate.

Consequently, we support the proposal to disallow £1.476m of contractor costs in RY18 and £0.286m in RY19 as not economic, efficient or justifiable.

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

We share Ofgem's concern about the lack of clarity over the defined range of DCC Share Services provided by Capita. In particular there are two significant statements in the consultation:

- DCC statement that Capita offers only basic services under the Share Service Charge (paragraph 4.13); and
- Ofgem's acceptance that the 9.5% Shared Service Charge last year (paragraph 4.6).

We would like confirmation from Ofgem as to whether the analysis which accepted the 9.5% Service Charge last year was based on the assumption that this was for a "basic service", or whether a more enhanced service was envisaged when accepting the 9.5% charge. We would also like confirmation that DCC are not adding 9.5% service charge cost to the self-provided "value added" services that have been identified, as this would be an unacceptable double counting of costs.

One of the problems with the service charge formula is that it assumes the charge is fully variable, when in effect some of the charges do to not move in line with changes in internal DCC costs. Consequently, it is not always apparent when there are additional internal costs due to a scope change whether a 9.5% on-cost is appropriate. The fact that DCC proposed a 7.22% Service Charge for Switching costs indicates that they accept this point of principal.

We are also concerned that DCC has started to bring costs which were intended to be External into their own Internal Costs (via the external services category) and thereby apply a 9.5% additional Service Charge. It is very disappointing that DCC were not able to provide evidence that the Service Charge was taken into account in their decision making process, but on a wider point it is not clear to us what the difference is between External Costs and external services, and why one should attract what is effectively a 9.5% on-cost and the other does not. We believe that Ofgem should look closely at the whole area of how additional scope and costs attracts a Service Charge.

We support the decision to disallow the Shared Service Charge on the emulator contracts.

We note the additional material circulated by Ofgem on behalf of DCC on 19th December following the stakeholder event on the 5th December.

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?

Overall we support the proposals in section 5 to expect more robust evidence from DCC on how it has taken customer views into account. Whilst the engagement and dialogue with DCC has improved over the last year, in particular with the quarterly finance briefings, these are based on standard financial and regulatory cycles, and not necessarily connected to key DCC decision points. Consequently, whilst the quarterly updates are useful, they are not always timed to enable customers to input into key decisions with the necessary insight and information.

The expectations around customer input outlined in paragraph 5.8 are appropriate arrangements that would enable customers to have a meaningful input around DCC decisions. Whilst it is going to be the case that the majority of scope changes are driven by mandatory requirements, there is still a place for customer input to help decide how and when a change is implemented, in addition to which there will always be input required around non –mandatory scope.

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

The proposals outlined in paragraph 5.8 would seem to be the basis for the process that DCC should establish to enable meaningful customer input to decision-making. We believe that it would be helpful for a process of customer engagement, based on these criteria, to be formalised with DCC such that there is a standard engagement process they undertake whenever they consider any changes to scope or service that has an impact on their cost base. Such a process could vary based on the materiality of any change, with impacts being defined (i.e. high, medium, low etc.) based on agreed thresholds.

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

The Baseline Margin adjustment was included in the DCC license to compensate DCC for material changes in certain aspects of its Mandatory Business. It seems that a considerable number of adjustments have been requested this year, covering eight drivers and 22 sub-drivers. Clearly Ofgem has scrutinised these applications in detail, and to a large extent we have to rely and trust such scrutiny as without having sight of the detail behind each one it is difficult to make an informed judgement on the merits of each application. However, there does seem to be a lot of applications, and whilst a number of these have been rejected, our main concern is that this is seen as a negotiating process whereby many applications are made in the hope of some being approved. We rely very much on Ofgem's scrutiny to gain comfort that this is not the case.

We understand that this process operates under the terms of the DCC License, and therefore if the criteria for a margin adjustment is met then this has to be approved, but as with previous years we are concerned that the DCC is able to increase its margin at a time when industry costs continue to rise.

Finally, we would like Ofgem to explain why it believes a 15% margin on a monopoly activity is appropriate when it imposed a much lower margin on the Standard Variable Tariff Price Cap which operates in a highly competitive market.

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?

In simple terms, we would like DCC to articulate, evidence and demonstrate exactly what these changes in customer expectations and demands are, and why they are over and above what it would have been reasonable to expect at the time of the License award. We are concerned that such vague statements could be used to justify all manner of cost increases without cause.

We believe that what is required is a clear benchmark of the level of customer service that as a customer we can reasonably expect, and that such a level of service should be covered by the costs that DCC made in their License Application Business Plan (LABP). The instinctive reaction to some of these changes is “they should be doing this anyway”, and it is difficult to understand how the business drivers “Increases in Customers” and “Supporting a Changing Business” are material changes to the DCC’s Mandatory Business. These are business drivers that to a large extent seem predictable to us and should have been accounted for.

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

It would appear from the consultation that DCC have met the criteria for External Contract Gain Share, and provided that Ofgem are satisfied that DCC have played a key role in securing £44.161m of savings then it is appropriate for DCC to have a share of the benefits. We therefore support the assessment of the DCC application subject to it meeting Ofgem scrutiny and oversight.

It would be helpful if Ofgem or DCC were able to publish the cost of capital for the relevant set-up payments both before and after the refinancing arrangements.

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

Once again there appears to be a level of prudence in the setting of DCC charges, and we believe that a 16% over-recovery is unacceptable. Suppliers have enough cash flow challenges of their own, and should not be treated a de-facto financier of DCC working capital.

We consider that there are some contradictions in this section about which we believe Ofgem should provide greater clarity. The Section Summary states that the reasons DCC provided for the over-recovery are acceptable. However, paragraph 7.5 details how at least two of the four reasons provided by DCC in paragraph 7.4 could have been reasonably foreseen.

In addition, the final reason in paragraph 7.4 (relating to BMPIA being determined in February 2018 after the charging statement was set) appears to us to be invalid as the final charging statement was not finalised until March 2018.

Going forward it is essential that the final decision on this consultation is published in time for DCC to incorporate into the final charging statement for the new regulatory year.

Consequently, we do not agree with the proposal not to impose penalty interest on the over-recovered revenues. We believe that unless such a penalty is imposed there will be no incentive for DCC to improve its forecasting arrangements.

END