3rd Floor North
200 Aldersgate Street
London EC1A 4HD
Tel: 03000 231 231

citizensadvice.org.uk

4th January 2017

Dear Natasha,

Citizens Advice is pleased to respond to Ofgem's consultation on the draft direction on margin and incentives for the Data and Communications Company's (DCC) role within the Transitional Phase of the Switching Programme. Detailed comments follow, but our principal comments are:

- We welcome Ofgem's interrogation of the DCC's initial suggestion of a 15% margin (or 17.65% return on costs) for the Switching Programme, but remain sceptical that a range of 8-12% margin (or 8.7%-13.6% return on costs) is appropriate.
- We query the proposed options for the incentive curve design, expecting that (given its past difficulties in meeting critical milestones) the DCC should face more immediate incentives to meet agreed implementation milestones.
- We question whether the reputational consequences of failing to score well on the stakeholder engagement incentive will be sufficient and suggest margin is placed at risk, given the criticality of stakeholder input to the success of the Programme.

Consumers will ultimately bear the cost of the Switching Programme. While we believe there are likely to be significant benefits to be achieved from faster, more reliable switching, it must be done in a cost-effective manner which minimises uncompetitive profits.

The DCC's case for 17.65% return on costs

While the overall margin is a relatively small amount of money in the context of the Transitional Phase of the Switching Programme (£2.2m-£3.5m, assuming a margin of between 8-12%, on the basis of the DCC's cost estimates), it is important to establish it at an efficient level, given this contract is being awarded to the DCC in a non-competitive manner and because Ofgem's decisions regarding margin seem to condition Capita's future commercial expectation. We therefore welcome that Ofgem has undertaken a comparative analysis that goes beyond the DCC's own commercially driven efforts.

It is welcome that Ofgem are not persuaded by the analysis presented by the DCC in its business case justifying a 17.65% return on costs. The DCC offers three points in favour of this. Firstly, it draws a comparison with the Smart Metering Implementation Programme. This comparison is, as Ofgem notes, invalid given the complexity and risk of these activities is orders of magnitude greater than those associated with the

3rd Floor North
200 Aldersgate Street
London EC1A 4HD
Tel: 03000 231 231

citizensadvice.org.uk

Switching Programme. Further, this represents a single data point from a competitive process three years ago. Both costs and the competitive climate will have changed significantly since this point.

Secondly, the DCC compares its suggested margin with the return achieved by the division within Capita that it sits in, at a 25% return rate. The return that Capita receives from client should not be relevant to this contract decision. Finally, the DCC offer analysis from Europe Economics to provide a benchmark for their suggested margin. Unfortunately, the DCC's Business Case only includes a thin summary of this analysis, rather than taking the more transparent step to include the report itself. It is therefore difficult to offer a view on whether it is sufficiently persuasive to justify such an extraordinary return. We therefore agree with Ofgem that the DCC has not made the case for a 17.65% return on costs.

Ofgem's justification for 8.7%-13.6% return on costs

We agree that with Ofgem that it would be inappropriate to use the Weighted Average Cost of Capital approach to calculating returns, given the asset-light nature of the the Switching Programme, and that a return on sales approach is more reflective of the activities under consideration.

We also agree with Ofgem that the DCC faces minimal risks in undertaking its role within the Transitional Phase of the Switching Programme, as it will operate as a monopoly provider, face none of the risks associated with an ex ante price control regime and there are few risks of not being paid. We agree that all economic, regulatory and reputational risks are almost entirely within the DCC's control.

However, this makes us question the sector based approach Ofgem takes in determining the appropriate range of values for the DCC's return. These companies will disproportionately perform in more competitive markets than the un-competitive context the DCC is in for this contract. They will face real risks which will be priced into their profit margins, which Ofgem rightly acknowledges the DCC will not face. Using these sectors' average net profit to determine the appropriate range and the weighted average cost of capital to determine the lower bound of return is therefore a judgement reached based on an invalid comparison. If profit margin is determined in part by risk, and Ofgem accepts that the DCC faces no significant risks (and low risk overall), then the acceptable margin range for the DCC must necessarily be lower than the range for companies that do face real market risks. We would therefore suggest Ofgem revisits its reasoning in this area and downwardly adjusts the DCC's margin range accordingly.

3rd Floor North
200 Aldersgate Street
London EC1A 4HD
Tel: 03000 231 231

citizensadvice.org.uk

In general, we worry that the assumption that the DCC will undertake this work has gone largely unchallenged through the development of the Switching Programme so far. While we appreciate that Ofgem are under tight project management constraints for the delivery of the project, this assumption puts Ofgem in a more difficult negotiating position. However, we would still expect Ofgem to direct a margin, as it has indicated in prior decision documents, that is '*commensurate with the degree of associated risk*'[1], which Ofgem recognise is low.

Comments on incentives

We agree with Ofgem's plan to apply incentives based on timely delivery of key milestones to a specified quality and on stakeholder satisfaction. We also agree there should be no upside reward to early delivery and that it is appropriate to not set out the specific milestones in Ofgem's direction, given the complexities of this early stage of the Programme. The suggested description of delivery milestones also strike us as sensible.

We empathise with Ofgem's rationale concerning trade-offs between time and quality and understand why this has led it to a preferred incentive curve design that does not overly penalise late delivery. However, the reasoning for Ofgem's position here is - in our view - based too greatly on first principles rather than on the evidence of the DCC's performance thus far. In particular, we note the Smart Metering Implementation Programme (SMIP) has encountered significant delays to the go-live milestones that the DCC is responsible for.

We would recommend that Ofgem comes to a view in light of this evidence, rather than treating the Switching Programme as an entirely independent project. Our view is that consideration of such evidence should lead Ofgem to the view that a sharper penalty for missing the initial implementation date, followed by a gentle sloping towards losing 100% of margin at risk, would be a more appropriate shape for the incentive curve. However, we agree that there should be a recovery mechanism in place to allow the DCC to reclaim this lost margin if they make sufficient progress against subsequent milestones (subject to a consideration of any extra costs that earlier delays have caused for industry).

We welcome the inclusion of a stakeholder satisfaction incentive, but disagree that margin should not be placed at risk. Ofgem argues that reputational impact is likely to be a greater motivator to a commercial organisation such as the DCC. This may well be the case, but this does little to undermine the case for *additionally* placing some of the DCC's margin at risk. We recognise the complexities in incentive design at play here, but

[1] Decision: DCC's role in developing a Centralised Registration Service, Ofgem 2016.

3rd Floor North
200 Aldersgate Street
London EC1A 4HD
Tel: 03000 231 231

citizensadvice.org.uk

given that stakeholder input and collaboration will be crucial to the success of the Switching Programme, we suggest that this position is reconsidered. As with the design of the incentive curve, Ofgem should also consider DCC's past performance in relation to stakeholder satisfaction. Stakeholder engagement by DCC during SMIP has not been optimal, despite improvements over time.

If you would like to discuss any of the points raised in this response, please do not hesitate to contact me.

Yours sincerely,

Morgan Wild
Senior Policy Researcher
Citizens Advice