Ofgem Consultation

Switching Incentive Regime (SIR)

DCC Response

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1. Do you support the establishment of the Switching Incentive Regime (SIR) in the Licence as the mechanism for assuring the Switching element of DCC's Price Control?

We support the establishment of the Switching Incentive Regime (SIR) within the Licence. This provides an appropriate level of regulatory certainty and clarity for all parties. We also look forward to working with Ofgem on the Direction and guidance that will be required under the Licence and to seeing Ofgem's proposals at the earliest possible opportunity. This will allow a suitable amount of time to embed the operation of the scheme in Data Communications Company's (DCC) business areas and processes.

We support the roles that Ofgem wants to give the Retail Energy Code (REC) Code Manager and the REC Performance Assurance Board in implementing and administering the scheme. As agreed with RECCo, for the SIR to operate as intended, further work will be needed on the proposed Service Level Agreements (SLAs). More granular detail will also need to be developed to support the reporting of the SLAs, including measurement methodologies, exclusions and target levels. Among other things, we will also want to ensure that factors that are not within DCC's control (such as behaviours of other parties that affect the performance of systems and processes) do not lead to financial penalties for DCC.

We are working collaboratively with RECCo on these changes and welcome Ofgem's support to reach a swift conclusion to this work. We recognise that it may not be completed in time for 1 April 2023. We therefore welcome Ofgem's steer that the work to finalise the design of the SIR under the REC can realistically come into force from any date with any margin earned from 1 April 2023 onwards subjected to potential reductions after this point. We will be happy to collaborate further with all parties involved to ensure the regime is fit for purpose. Our proposal would be for the regime to be implemented once all SLAs, supporting material and guidance is drafted, consulted on and agreed.

2. Do you agree in principle with the revocation and replacement of the May 2019 Direction, in the event that we establish the SIR?

We agree with the revocation and replacement of the May 2019 Direction should the SIR be established within the Smart Meter Communication Licence.

3. Do you agree with the definition of the four categories of measure identified that will constitute the SIR?

We agree in principle with the creation of the new terms and with the proposal to keep them consistent with OPR.

We suggest that the terms are renamed so that they are distinct from those used in Operational Performance Regime (OPR). This will support regulatory clarity under the licence. As currently drafted, it is not clear which terms should be applied in the $BMOPA_t$[1] formula in licence condition 38.8 and which should be applied to the $CRSPA_t$[2] formula in licence condition 36.10A.

Examples of alternative terms would be SIRSUM, SIRSDM, SIRDIM, SIRVMM.

[1] BMOPA - Baseline Margin Operational Performance Adjustment (see LC36.14)
[2] CRSPA - Centralised Registration Service Performance Adjustment (see LC36.9)

4. Do you agree with our proposal that DCC should be able to earn a margin somewhere in the range of 6 – 9% of its economically and efficiently incurred internal costs under the enduring Switching arrangements (equating to a range of 6.4% - 9.9% in terms of return on costs)?

We are very concerned with Ofgem's proposals in this area. The margin must be set at a level that aligns with the risks associated with running the service. It is disappointing that there was no earlier engagement on this topic - particularly given the large shift in Ofgem's position. Proposals of this nature could impact DCC's decision-making and appetite for undertaking future projects. We are keen to work with Ofgem to reach an agreement on a reasonable level of margin.

There is compelling independent evidence to support 15% as an appropriate margin for the enduring switching service. In Autumn 2022, we commissioned an independent report to assess the risk profile and appropriate margin for DCC's Enduring Switching Service. This was a balanced and evidence-based assessment of the switching activities and associated residual risks. The report then compared this assessment with both internal and external benchmarks to derive market parallels for the appropriate margin.

The study found that the overall risk profile for switching appears higher than both the transitional and Design, Build and Test (DBT) phases (where margin was set at 12%). It found the profile to be more in line with DCC's smart metering services (where margin is set at 15%). The internal comparators are an important element having been set by a competitive process in the bidding process for the licence.

The external comparators reinforce the appropriateness of the 12% to 15% range, with the study finding that the average maximum Earnings Before Tax for asset-light comparators is 13%.

It is important that both internal and external comparators are considered collectively as there are limitations to using external comparators only given the uniqueness of the type of services DCC provides from both a nationwide and global perspective. We do believe, however, that they should form part of the overall evidence base to ensure a balanced and rounded assessment.

We note that Ofgem refers to an external benchmark of 1.9% which is the maximum margin that energy suppliers are currently permitted to earn on energy supplied to its customers. We understand that this rate is applied to energy suppliers' total costs whereas, for DCC, the margin rate is applied to internal costs only. If we were to translate that 1.9% to a rate which applies only to internal costs, the translated margin rate would be far greater than 1.9%.

5. Do you support either of the options we have identified for incentivising DCC's margin in the early post-go live period of Switching? Are there any other options you think should be considered?

In May 2019, Ofgem set out its decision on the margin and incentives for the DBT phase of switching. That decision was put into effect by a Direction issued on the same day which stated that the arrangements would be in place from 31 May 2019 until revoked or amended by Ofgem.[1] As of today,

[1] See paragraph 8 of Ofgem's direction: https://www.ofgem.gov.uk/sites/default/files/docs/2019/05/cws_dbt_direction_260419_0.pdf

that direction has not been revoked or amended, therefore our view is that neither option 1 nor 2 are appropriate.

Applying a new incentive regime to margin earned now (i.e. option 2) would be unfair. We are unable to respond to an incentive regime now which does not yet exist. Furthermore, it would be unreasonable to place margin at risk while the switching service is in the very early stages of operations. Applying option 2 would also require changes to separate the reporting for a single regulatory year. The costs incurred in making this change may not be commensurate to the amount of margin expected to be put at risk.

In summary, we challenge the validity of applying either option. Nonetheless, we consider option 2 to be unreasonable for the reasons set out above. If the choice is only between the two options proposed, the more acceptable option for us would be to roll over the existing DBT scheme outcome.

6. Do you agree that the proposed Licence drafting appropriately reflects the policy intent of our proposal to establish the Switching Incentive Regime?

There are a number of points where the Licence drafting is unclear and needs further work to ensure that it reflects the policy intent. Also, the proposed drafting at licence condition 36.10 seems to pre-empt consideration of responses to Question 5 of this consultation. We would welcome the opportunity to work with Ofgem to ensure that the Licence drafting is correct and would be happy to be consulted again once the policy intent has been finalised and the drafting revised.

Our observations and questions about the Licence drafting are as follows:

- In the Chapter 9 Particular Definitions at Condition 35.5, the definition for 'Centralised Registration Service External Contract Gain Share' is identical to that of 'Centralised Registration Service External Cost.' This does not seem correct.
- The definition 'Centralised Registration Service External Cost' includes obsolete terms 'Switching Network' and 'CSS Systems Integrator' and, we suspect, should be updated to refer to new terminology.
- We believe that the definition of 'Centralised Registration Service Margin' should reflect that this amount of revenue is determined in accordance with the provisions of Part D of Condition 36. We query if it is appropriate to define this term by reference to 'Centralised Registration Service Revenue', of which 'Centralised Registration Service Margin' is now proposed to be a component.
- Many of the Centralised Registration Service Revenue formula terms in Part D of Condition 36 refer to the SEC Panel and SEC Parties. However, with the introduction of the SIR and the finance flows through the REC, it is not clear why there should be a SEC governance role in the Switching Arrangements.
- There is a typographical error in paragraph (a) of the meaning of $CRSM_t$, where the semi-colon looks to be in an incorrect place.
- We would expect the latest date by which DCC will receive the direction that determines the Centralised Registration Service Margin to be included in paragraph (b) of the meaning of this term. We would also expect the latest date by which a Direction of the Authority will be issued to DCC for the purpose of Condition 36.10B to be established, so there is certainty as to when the CRSPA will be determined, similar to the window within which the Authority was required to give a Direction under Condition 38.9.
- There are numerous references to the 'REC Panel' in Parts D and D2 of Condition 36. There is no defined 'REC Panel' role in REC governance and we are unclear as to which part of REC governance Ofgem is intending to refer. We would welcome greater clarity on that question in order to understand the policy intent.