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DCC Price Control Consultation

Consultation

Publication date: 26 November 2014

Response deadline: 21 January 2014

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Overview:

The Data and Communications Company (DCC) is required to report price control information by 31 July, following each regulatory year. It must report in accordance with the Regulatory Instructions and Guidance that we publish. We assess the information submitted and determine whether to allow changes in costs.

Each July DCC can also propose an adjustment to its baseline margin values. We assess this proposal and determine whether or not to change the level of margin values agreed when the licence was awarded.

In this document we review the costs DCC reported under its first price control. We set out our proposals and would like to hear your thoughts on these. We also explain our assessment of DCC's application to change its baseline margin values. We're interested in your comments on this as well.

Context

Smart DCC Limited is referred to as the Data and Communications Company (DCC). It is a central communications body appointed to manage communications and data transfer for smart metering. It is responsible for linking smart meters in homes and small businesses with the systems of energy suppliers, network operators and other companies. DCC will develop and provide data and communications services for smart meters through its external service providers. DECC granted Smart DCC Limited the Smart Meter Communication Licence[1] on 23 September 2013.

Under its licence DCC has to submit cost, revenue, and incentive reporting to the Gas and Electricity Markets Authority (the Authority). DCC must report on the basis of Regulatory Instructions and Guidance (RIGs) that we publish.[2] DCC must report by 31 July following each regulatory year.[3]

DCC submitted its price control reporting templates for the first partial regulatory year from 23 September 2013 to 31 March 2014 on 31 July 2014. On the same day it submitted an application for an adjustment to its baseline margin values.

We have assessed DCC's costs, revenue and performance against incentives. We have also assessed DCC's proposal for an increase in its baseline margin values. We are now consulting on our proposed decisions in respect of DCC's price control and baseline margin values adjustment.

Associated documents

- Data Communications Company (DCC): Regulatory Instructions and Guidance
  https://www.ofgem.gov.uk/ofgem-publications/88046/dccrigs2014.pdf
- Data Communications Company – Regulatory reporting template
  https://www.ofgem.gov.uk/ofgem-publications/86000/dccregreportingfinal.xls
- Smart Meter Communication Licence
  https://epr.ofgem.gov.uk/Document

[1]The Smart Meter Communication Licences granted pursuant to Sections 7AB(2) and (4) of the Electricity Act 1989 and Sections 6(1A) and (1C) of the Gas Act 1986. This consultation is being conducted in respect of both of those licences. Together, those licences are referred to as 'the licence' throughout this document.
[2] Data Communications Company (DCC): Regulatory Instructions and Guidance. Available here: https://www.ofgem.gov.uk/publications-and-updates/data-communications-company-dcc-regulatory-instructions-and-guidance
[3] A regulatory year runs from 1 April in any calendar year to 31 March in the following calendar year. DCC's first regulatory year is deemed to have begun on 1 April 2013 (Licence Condition 1.4).

Contents

Executive Summary

DCC has an essential role to play in the energy market. Its performance is critical to the success of the smart meter rollout and enabling suppliers to provide a good service to their customers thereafter. The quality of DCC's service is of paramount importance to the smart metering programme. However it is important that we ensure these services are provided in an economic and efficient manner.

This is the first review of DCC's price control. DCC's price control allows it to fund its economic and efficient costs during a period of uncertainty as it gears up to support the smart meter rollout. DCC is a monopoly provider of smart metering data and communications services to suppliers and networks. It is funded by gas and electricity consumers. We closely scrutinise DCC's costs and revenues to ensure value for money.

This document sets out our proposals for DCC's costs and revenues. Our proposals reflect a fair but challenging assessment of DCC's costs, revenues and related activities during its first six months of operation. It also establishes some important principles about how we expect DCC to manage its costs in future.

DCC's price control

DCC was licensed following a competitive licence application process run by DECC. This concluded in September 2013, when the licence was granted to DCC by the Secretary of State. The application process applied competitive pressure to DCC's business plan and the costs it predicted. We assess DCC's costs each year to make sure consumers continue to receive value for money. DCC's business plan provides an important benchmark to help us judge the efficiency over time.

The price control we run for DCC is different to that of other companies that we regulate. DCC incurs costs and passes these on to users. We review these costs after the end of the regulatory year in which they were incurred – an approach we call 'ex post'. If DCC's costs differ materially from those predicted in its business plan, it must explain and justify the differences to show that it incurred the extra costs economically and efficiently. Our decisions can affect money that DCC has already spent and money that it intends to spend.

DECC chose this approach so that DCC would be funded to deliver its objectives in an uncertain period as the regulatory framework develops and DCC prepares to support the smart meter rollout. For other companies, such as the networks, allowances are agreed up front.

As DCC matures and its operating environment becomes more stable, we intend to move closer to the networks approach. This will give DCC more certainty and a stronger focus on efficiency.

DCC has an incentive to achieve key delivery milestones because it put a margin at risk to meeting these milestones as part of the licence competition. In each regulatory year, we will assess whether DCC has met the delivery milestones that were due in that period.

The risks and complexity of DCC's work may vary over the course of the licence period. DCC can apply to us to adjust the margin values specified in the licence so that its margin will not be reduced by changes to its circumstances or the scope of its work. We will assess whether there are grounds for adjusting the baseline margin values in the licence.

Our approach

Our proposals are based on a detailed cost assessment following the submission of DCC's price control reporting in July 2014.[4]

Our assessment considered the differences in DCC's actual costs and forecast costs relative to its business plan. Where costs have not been fully justified, we may decide to disallow or, if they are predicted costs, we may decide to adjust the revised projections downwards.

As this is the first review, it is important that we establish some principles that will contain future escalations in costs. We know that the cost position reported by DCC in July does not reflect its current view of costs, given a number of developments in the technical specifications since the licence was awarded. There are likely to be further costs as a result of the revised delivery plan which DCC is currently consulting on.[5]

Our objective is to take an appropriate view of the costs DCC incurred in 2013/14 in accordance with the terms of the licence and in doing so set clear boundaries for the future management of its costs.

Our proposals

DCC and its service providers have had to manage additional complexity and incur further costs during this review period. This is because of new activity that either wasn't expected or activity that was not sufficiently clear[6] when DCC put forward its business plan in 2013.

[4] The reporting reflects the information available up to March 2014
[5] http://www.smartdcc.co.uk/media/14108/141117_dcc_plan_and_im_consultation.pdf
[6] Some elements needed to deliver the smart meter rollout programme were explicitly excluded from the bid as part of the tender process. This includes the cost of external security and software service that have been procured and the arrangements for financial security and stability which are required under the licence.

We accept that some costs have had to increase because of this.

Over the licence term, DCC has projected a further £71 million costs (including the cost of their external service providers). This is mainly because of these changes and represents a 3.8% cost variance relative to the business plan.

In most cases DCC has put forward reasonable grounds and evidence for the additional costs it predicts for its new activity. There is also evidence that it has some controls in place to put downward pressure on costs.

However, we do not think DCC has fully explained or justified all of these additional costs or provided sufficient evidence to demonstrate value for money in every case. In particular we think that:

- The level of detail in DCC's evidence case must be improved in future years to demonstrate value for money.
- The shared service charge that DCC pays to Capita for support services should not increase directly in proportion to DCC's internal costs for new scope activities.
- There is no direct link between changes in DCC's cost and its entitlement to additional margin.

We propose to disallow a small amount of costs (£0.1 million) during 2014 where we do not think DCC has made a strong enough case for costs incurred.

Also, we will not be allowing DCC to fully recover the costs submitted as part of the price control in future years, because they did not provide sufficient justification for these future increases. We propose that £4 million should be removed from future cost projections. We also require DCC establish more processes to demonstrate value for money on certain cost items.

In summary, we propose:

Table 1: Summary of our proposals

Cost area	Assessment
Internal costs	• **£1.5 million** of further salary costs have not been justified and should be excluded from the forecasts over the licence term. • **£0.9 million** associated with the long term use of contractors has been removed from the forecasts over the licence term. • The shared service charge on new costs that do not use the service are not economic and efficient;

	£1.8 million should be removed from the forecasts over the licence term.
External costs	• Costs are economic and efficient.
Milestones	• DCC failed to meet a key delivery milestone (IM5) and so should lose £0.3 million of revenue in 2013/14.
Margin adjustment	• DCC's application for a margin adjustment failed to meet the criteria, so it is not entitled an increase in the margin values in 2013/14.

Next steps

We welcome your views, and will consider them when we take our decision. Please send responses to Tricia Quinn (tricia.quinn@ofgem.gov.uk) by 21 January 2015. We will publish our decision on DCC's price control in February 2015.

1. Introduction

1.1. DCC is a central communications body licenced to provide the communications, data transfer and management required to support smart metering. It is responsible for linking smart meters in homes and small businesses with the systems of energy suppliers, network operators and other companies.

1.2. DECC granted the smart meter communication licence[7] ("the licence") to DCC on 23 September 2013 following a licence competition. The Licence is for 12 years and will remain in place until 22 September 2025, unless it is extended or revoked. DECC also established price control arrangements that restrict DCC's revenues, to counter its monopoly position.

1.3. Due to DCC's unique nature[8] and the new regime it will be operating we have a role in ensuring that costs are incurred economically and efficiently. We will assess this through an annual review. DCC incurs costs and passes these onto users. Over the licence term the large majority of these costs are incurred by their external service providers, who were appointed through a competitive tendering process. We review these costs after the end of the regulatory year in which the costs were incurred, this approach we call 'ex post'. One of DCC's key responsibilities is to effectively manage these large external contracts and ensure value for money and good quality service for consumers. DCC must submit price control information by 31 July following each regulatory year.

1.4. The level of baseline margin allowed each year is fixed in the licence. Each July, DCC can apply to us for an adjustment to the value in the licence. The licence provides criteria related to likely and material changes to their business activities, risks and timescales or deadlines, which DCC must demonstrate in its application.

1.5. We published the Regulatory Instructions and Guidance (RIGs) in May 2014. The RIGs provide the basis on which the licensee must report price control information, and provide a framework that enables us to collect data from DCC in a consistent format.

1.6. The first price control report covering the regulatory year from 23 September 2013 until 31 March 2014, was submitted in July 2014. DCC also applied for an adjustment in the value of its margin at the same time.

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[7]The Smart Meter Communication Licences granted pursuant to Sections 7AB(2) and (4) of the Electricity Act 1989 and Sections 6(1A) and (1C) of the Gas Act 1986. This consultation is being conducted in respect of both of those licences. Together, those licences are referred to as 'the licence' throughout this document.
[8] DCC is asset-light compared to other regulated entities.

1.7. In this first year it is important to establish principles that will apply to our assessment of DCC's costs, not least as we anticipate costs to increase in future years. We clearly set out our expectations and approach to assessing changes, and are doing this due to the likelihood of future changes and the scope for changes to DCC's activities.

Purpose of consultation

1.8. This consultation describes our proposals in relation to DCC's first:

- ex post review of DCC's price control
- application for a baseline margin (BM) adjustment.

1.9. Our proposals are based on a detailed cost assessment following the submission of DCC's price control reporting and BM adjustment application in July 2014. We are seeking your views on our proposals regarding:

- **Costs:** whether DCC incurred costs economically and efficiently during regulatory year 2013/14 and if it did not, how those costs should be treated. Also, whether we accept the updated forecasts for the licence term.
- **Implementation milestones:** whether DCC achieved the five implementation milestones that fell due during regulatory year 2013/14 and what the implications are for DCC's allowed revenue.
- **Baseline margin:** whether the baseline margin values in the licence should be adjusted.

DCC ex post review

1.10. This is the first ex post review of DCC's price control. This price control regime is different from that of other companies we regulate.[9] DCC has inherited a set of competitively procured contracts from government. We expect the competitive procurement process to have delivered value for money in the pricing of those contracts.

1.11. The competitive application process for the DCC licence should have ensured the efficiency of the initial costs stated in the licence application business plan (LABP). This review will look at how DCC's actual internal costs and external service provider costs differ from those in the LABP.

1.12. We expect DCC to demonstrate through its reporting that it has incurred contract costs and its own internal costs as efficiently and economically as possible, doing everything it reasonably can to ensure value for money. The data we collect,

[9] Under RIIO, the networks are subject to an ex ante price control where the costs are agreed in advance (ie before they are incurred).

together with information from other sources, will allow us to monitor and assess whether costs were economically and efficiently incurred.

1.13. We recognise there have been changes since DCC put forward the LABP. The requirements of the Smart Energy Code (SEC) and the longer lead time and changes to the Great Britain Companion Specification (GBCS)[10] have required DCC to re-profile and re-assess the costs. However it must provide robust justifications for variations above the competitive costs agreed as part of the competition. We also expect DCC to have a strategy in place for ensuring that costs are economic and efficient over the duration of the licence.

1.14. DCC is consulting[11] on options to re-plan the programme timeline. In future reviews we will need to consider any associated changes in costs of the re-plan and DCC will need to sufficiently justify these are economic and efficient.

1.15. Our ambition for the DCC price control over time is to move to a more ex-ante model, similar to the approach taken for networks, and to introduce up front incentives on DCC to manage the costs of running the data and communications network for smart meters. This is likely to need more stability in the activity of the DCC's operations before it can be introduced.

[10] Both of which have been developed after the licence was granted.
[11] http://www.smartdcc.co.uk/media/14108/141117_dcc_plan_and_im_consultation.pdf

2. Our approach

Chapter summary
We compared the costs in the LABP with those DCC submitted in its price control reporting. To inform our assessment we conducted a cost visit and carried out some initial benchmarking.

We also scrutinised updated forecasts. We propose DCC remove costs from forecasts that are unlikely, or where we have found that they are not economic and efficient.

Question 1: What are your views on our approach to assessing DCC's costs? And do you have any suggestions on where we can improve our approach?

2.1. The licence requires DCC to send us price control information each year. This must provide comparisons between the LABP and:

- the internal (Smart DCC) and external costs (fundamental service provider[12]) actually incurred.
- any updated forecasts.

2.2. DCC also must explain:

- any material divergence revealed by the comparisons.
- any material revisions to any financial or operational matters arising from that divergence.
- any significant deviations from the forecast costs in the business plan or any updated forecast.

2.3. The RIGs inform DCC about the information and level of detail we require. They were designed to allow us to compare actual costs with forecasts. They should also guide DCC on creating systems to collect the data we require. The information provided under the RIGs is the basis for our determination on whether costs are economic and efficient.[13]

2.4. DCC submitted its first price control report to us, together with an application for a BM adjustment, on 31 July 2014. This is DCC's first year of price control reporting. Since it has only been in operation for part of the regulatory year, we have only six months of incurred cost data to assess.

[12] External services that are not provided by the fundamental service providers are included in internal costs.
[13] We used additional sources of information to supplement the RIGs where appropriate.

2.5. We requested additional information and evidence where appropriate. We have also conducted a cost visit to gain a better understanding of DCC's processes for managing its costs.

2.6. To inform our assessment we carried out some initial benchmarking of salaries. Our primary comparator for salaries and bonuses was the Annual Survey of House and Earnings (ASHE) data provided by the Office for National Statistics (ONS). More detail on our methodology is set out in chapter 4 and appendix 4.

2.7. Licence Condition 37 requires us to assess whether DCC's costs have been incurred economically and efficiently. DCC's costs in 2013/14 are mostly internal, and therefore have been our primary focus. However, we have still scrutinised the changes in external costs and expect them to be a more significant part of our analysis in future years.

2.8. As required by the licence, our assessment is grounded in comparing DCC's outturn costs and revised forecasts with the costs DCC submitted in the LABP. We accept that the scope of DCC's activity might differ from what it expected, and this could increase or decrease the economic and efficient level of costs.

2.9. Our review for this first regulatory period has focused on obtaining a detailed understanding of:

- DCC's cost base
- the activities DCC undertakes
- the causes of differences from DCC's licence bid submission.

2.10. We use the LABP as our reference for DCC's bid position. DCC bears the burden of justifying any variations in cost. DCC must provide sufficient justification to demonstrate that the variation in costs is economic and efficient. If we conclude that the costs are not economic and efficiently incurred we will need to consider whether to disallow or accept an undertaking on the future management of those costs.

The Licence Application Business Plan

2.11. The licence requires DCC to have a LABP.[14] This document contains estimates of revenues, costs, and cash flows for each regulatory year over the 12-year licence term. It is based on the bid DCC submitted, which was taken into account as part of the application process. It therefore reflects DCCs bid position in terms of the scope, outputs, requirements, tasks, assumptions and solutions as anticipated at the time. When DCC was granted the licence it also committed itself to the LABP.

[14] The definition of the LABP is provided in Licence Condition 37.

2.12. DCC submitted the LABP on 24 December 2013,[15] and published a redacted version on its website in April 2014.[16] As these costs were secured through the competition we assume they are economic and efficient. So we can monitor and assess its costs each year, DCC compare the internal and external costs to those in the LABP. DCC must also provide updated forecasts for the remaining regulatory years.

Updated forecasts

2.13. In future years we will continue to compare cost variations to the LABP. We will also compare variations to the updated forecasts provided by DCC. As part of this year's analysis we have scrutinised the updated forecasts.

2.14. We propose that DCC should remove future costs which are uncertain and it is not possible to make accurate estimates. If we question whether a cost is economic and efficient, DCC is still able to incur it but will need to explain the variation as part of its price control reporting in the appropriate regulatory year.

2.15. This will mean the price control forecasts provided are likely to be lower than the charges in the indicative budgets and charging statements, where DCC is allowed to make a prudent estimate of its allowed revenue.

2.16. To provide transparency we encourage DCC to publish an update to the redacted LABP. Appendix 5 provides the updated forecasts based on our proposals.

Quality of reporting

2.17. DCC largely complied with the RIGs reporting requirements. However there were initial issues with the level of detail and evidence in its supporting commentary and justifications for the actual cost changes.

2.18. DCC is a new regulated entity and is reporting under a new price control framework. During the assessment, we asked a series of questions to seek more information and evidence to support the cost variations reported. As a result DCC provided enough detail for us to conduct our review and develop proposals.

2.19. DCC should now have an understanding of our expectations about the level of evidence it needs to provide, when it completes its returns under the RIGs. In future

[15] Under Licence condition 37.4 (a) the LABP can be submitted as a consequence of the licence application process but it must reflect the agreement and position at licence grant.
[16] DCC's redacted LABP is available from: http://www.smartdcc.co.uk/media/7417/redacted_licence_application_business_plan_-_30_april_2014_2_.pdf

we expect that DCC reporting will contain sufficient detail so that we do not have to ask subsequent questions to the same extent. Under the licence DCC has to explain the material divergences. If it fails to demonstrate that costs are economically and efficiently incurred it is likely that we will find they have not been. Any costs that we consider were not economically and efficiently incurred will either be excluded from the future calculation of allowed revenue or be subject to an undertaking about their future management.

2.20. If the quality of DCC's reporting continues to be an issue we may need to consider further obligations to improve it. We may look at the reporting obligations on other entities we regulate and assess whether these can be applied to DCC.

3. Performance

Chapter summary

DCC achieved five of the six implementation milestones (IMs) due in 2013/14. It did not achieve IM5 - Submission of DSP Interface Specifications. We will disallow £0.3m of DCC's margin, which was linked to meeting IM5.

During its review of the IM's DCC should seek to remove any ambiguity from the criteria of the remaining IM's.

DCC now has a procurement strategy in place. We intend on amending the RIGs to make DCC give us its procurement assessments.

Question 2: What are your views on our assessment of DCC's performance against the IMs?
Question 3: Do you have any observations from the current incentive framework which can inform early thinking on developing an enduring framework?

DCC's performance

3.1. DCC has a vital role in the implementation, operation, management, and ongoing improvement of the smart metering infrastructure. After it was awarded the licence, DCC went through a rapid start up. It had to quickly establish itself and begin meeting obligations.

3.2. It has undertaken a number of key activities in 2013/14 including mobilisation and design development. During this time it faced some uncertainty and challenges that were not anticipated at licence award. Some elements needed to deliver the smart meter rollout programme were explicitly excluded from the bid as part of the tender process, for example the cost of external security and software service. It is likely there will be further challenges in 2014/15. We are aware that there is further programme rephasing, and expansion of scope anticipated.

3.3. DCC had six implementation milestones (IMs) to meet in 2013/14. It met five of these. We do not consider DCC to have met IM5 (Submission of DSP Interface Specifications).

Performance against implementation milestones

3.4. Our main measure of DCC’s performance in its first six months of operation is against the implementation performance regime.[17] This lists a series of implementation milestones (IMs) that DCC must achieve in the lead-up to initial live operations. The regime is designed to encourage performance by putting some of DCC’s margin at risk. If DCC fails to meet an IM by the date specified in the licence then it could lose part or all of margin attached to that IM.[18]

3.5. As shown in table 2.1, below, during its first year DCC had six IMs to meet. We consider DCC to have met five of them.[19] In our view DCC did not meet IM5.

Table 2.1: DCCs implementation milestones, 2014

Implementation milestone	Due by	Achieved
1. Completion of Licensee Mobilisation	31/10/2013	✓
2. Submission of Integrated Solution Delivery Plan	29/11/2013	✓
3. Establishment of Service Design Authority	29/11/2013	✓
4. Submission of the Test Strategy	28/02/2014	✓
5. Submission of DSP Interface Specifications	28/02/2014	×
6. Submission of the ICHIS	28/02/2014	✓

Our assessment of the implementation milestones

3.6. DCC provided evidence to demonstrate compliance with each IM. We verified this evidence and assessed it against the criteria in the licence. The evidence provided for IMs1-4 and IM6 clearly demonstrated that DCC had met its obligations under the licence. The evidence provided for IM5 indicated that DCC had only partially met the obligations in the licence, therefore in our view had not achieved IM5.

3.7. IM5 required DCC (by 28 February 2014) to produce, review, approve and submit to the Secretary of State (as appropriate) several technical documents.[20] Some of these documents[21] were to be submitted in accordance with schedule 5 of the licence, which sets out the procedure for document development.[22]

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[17] Licence Condition 38 and the implementation milestones are listed in Schedule 3.
[18] Some of the IMs let DCC to recover any revenue lost if a future IM is achieved.
[19] Appendix 2 provides additional detail on what was expected under each IM.
[20] See table A2 in appendix 2 for more detail.
[21] The Self-Service Interface Specification; the Registration Interface Specification; and the User Gateway Interface Specification.
[22] This includes the need to consult appropriately; submit the document in draft as soon as is practicable; and comply with the requirements with respect to process and timeframe of any direction to resubmit the document.

3.8. DCC faced challenges to meeting IM5 as a result of the longer lead times involved in completing GBCS. To account for this DCC successfully applied to the Secretary of State for the criteria of IM5 to be altered to include reference to the dependency on GBCS.[23]

3.9. Despite this, we do not consider DCC to have met IM5. This is because:

- **Conditional approval:** DCC only conditionally approved the documents[24].

- **Quality of the documents:** some of the documents were not at the level of quality expected[25]

- **Remediation plans**: The Secretary of State had to direct DCC to follow remediation plans so the documents could 'reach the required level of quality'.[26] The remediation plans extended long beyond the deadline in IM5 and have subsequently slipped. Some remain incomplete.

3.10. DCC did not appear to allow itself sufficient time to complete processes in the licence. For example:

- **Schedule 5:** DCC did not submit drafts of documents until the final day of the IM5 deadline. This made it impossible to comply with any requirements to resubmit the document before the IM5 deadline.

- **Conditional approval:** DCC did not approve the documents until the day before IM5 was due. This left little time to address any issues faced getting approval of the documents.

3.11. There is scope for DCC to improve its process for producing documents of the required quality, by the required deadlines. For the remaining IMs, we expect DCC to allow time for:

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[23] The Secretary of State amended the criteria so that the self-service interface specification, the registration interface specification and the user gateway interface specification documents only had to be complete in so far as they could be according to the 0.7 version of GBCS. The direction (DCC – Amendment to IM5 criteria relating to GBCS) is available here: https://epr.ofgem.gov.uk/Document

[24] DCC was required to approve the documents. Conditions were attached to the documents because there were issues these should have been resolved before DCC the date IM5 was due.

[25] For example, DECC had given DCC some gas use cases expecting them to be included but they weren't.

[26] DCC – Decision on M5 and direction to re-submit in accordance with remediation plan, available here: https://epr.ofgem.gov.uk/Document

- any consultations required
- reviewing documents to ensure they meet quality standards.

Margin adjustment for IM5

3.12. The adjustment for not achieving IM5 is calculated by applying the formula in Schedule 3, Part A of the licence. The specified criteria was not achieved within six weeks of the IM5 due date. This means DCC sacrifices 4% of the baseline margin implementation total (BMIT) which this milestone put at risk. **We therefore propose to disallow £0.315 million.**

3.13. This will be returned to SEC users through a reduction in the 2015/16 charges. DCC can earn this IM payment back if IM12 (Commencement of Initial Operational Services) is achieved on time and to the required standard.[27]

IM review

3.14. The licence places a duty on DCC to review the remaining milestones.[28] DCC must consult the SEC panel and SEC parties about proposals to change the dates or criteria. It must then apply to the Secretary of State based on its proposals. DCC's re-planning consultation also includes how it proposes to approach the IM review.[29]

3.15. It is important that DCC use the IM review to ensure the criteria for each IM are clear, removing any ambiguity about DCC's performance. Where appropriate, DCC should consider using an independent assessor to verify that it has met the criteria.

Assessment of procurement

3.16. DCC published its procurement strategy in August 2014.[30] We're pleased that the strategy recognises full and open competitive tender as the most efficient form of procurement. We also welcome DCC's commitment to demonstrating value for money when drawing upon internal services or shared services from its parent company. We will assess DCC's new procurement activities against this and the relevant licence obligations.

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[27] IM12 is currently due on 30 September 2015, however this may be subject to change.
[28] This obligation is placed on DCC under schedule 3, part F of the licence.
[29] DCC propose undertaking the review in two stages, the first included within the re-planning consultation considers dates for next three IMs (IM7, IM8, IM9).
[30] DCC procurement strategy and statement of service exemptions. Available here: https://www.gov.uk/government/consultations/dcc-procurement-strategy-and-statement-of-service-exemptions

3.17. We expect DCC's procurement strategy to make sure it is always follows best practice. DCC now has some procurement experience. This should put it in a better position to develop more defined criteria[31] for the different procurement processes and approaches defined in its strategy. This would provide transparency to users that DCC is undertaking procurement in the most efficient way possible.

3.18. In its strategy DCC committed to providing us with any assessments and evidence of how it has met the terms of its procurement strategy. We intend to amend the RIGs to make DCC give us its assessments, particularly if a full open competitive tender is not undertaken.

Next steps

3.19. In future years we expect this chapter to expand as we begin to report on DCC's performance and results in delivering smart metering services. As DCC is still in the implementation phase of its licence term we are yet to develop quality of service reporting. We expect to add this to the RIGs in the future, and DCC will be required to report in line with it.

3.20. We haven't yet developed operational incentives. The licence requires DCC's operational performance regime to be in place not before March 2016 and no later than 31 October 2018.[32] The structure and contents cannot substantially differ from the illustrative provisions in schedule 4 of the licence. The performance measures will contain metrics on measures for service users, service delivery, development and improvement, and value for money. We encourage DCC to engage with users early on developing these measures.

[31] For example specifying monetary and materiality thresholds.
[32] Licence condition 38, paragraph 38.10.

4. Cost Assessment

Chapter Summary

We assess changes in DCC's costs in comparison to the LABP. Total costs are £71 million higher than at the time of contract award and we consider the majority are economically and efficiently incurred, including most costs associated with activities excluded from the licence application business plan (these include the SMKI and Parse and Correlate contracts[33], and financial security and stability which together account for £20 million of the cost increase).

In our view a small proportion of DCC's costs have not been justified as economic and efficient. We propose to disallow £0.1 million from DCC's total costs in 2013/14, and not allow a £4 million increase in their forecasts over the remaining term of the licence. This relates to unjustified changes in staff costs, assumed use of contractors in forecasts and the shared service charge.

Question 4: What are your views on our proposal?
Question 5: Do you have any views on how the RIIO price control approach could be applied to DCC in future?
Question 6: We are looking for ways to benchmark DCC costs. What other sources of data or potential comparators can you recommend for subsets of DCC costs?

Our proposals

4.1. At the bid stage, DCC faced a significant degree of uncertainty about future costs. DCC did not know which service providers would be selected; what the service provider solutions entailed; and what its obligations to service users would be under the SEC.

4.2. Some elements needed to deliver the smart meter rollout programme were explicitly excluded from the bid as part of the tender process. These account for over £20 million of the increase in internal costs. This includes the cost of external security and software service that have been procured and the arrangements for financial security and stability which are required under the licence.

4.3. A large proportion of the cost deviations from LABP relate to external change faced by DCC. In its price control forecasts and outturn 2013/14 costs, several factors have caused DCC's costs to change relative to the LABP:

[33] There are external services for external security and software.

- changing requirements of the Smart Energy Code (SEC)
- longer lead time and changes to the Great Britain Companion Specification (GBCS)

4.4. In this context, we consider that overall the DCC has done a good job to establish the resources and processes required to deliver the smart meter roll-out, and manage costs during 2013/14. However, the LABP remains an important benchmark for DCC costs, and we will hold DCC to account for its competitive bid position.

4.5. Despite this, there are a number of areas where in our view costs have not been justified as economic and efficient. **We propose to disallow £0.1 million from DCC's total costs in 2013/14, and not allow a £4 million increase in their forecasts over the remaining term of the licence.** Table 3.1 below, shows the breakdown of these disallowances.

Table 3.1: Overview of our proposals

Cost Category	Total 2013/14 (£m)	Total over licence period (£m)
Internal Costs		
- Salary disallowance	**0.1**	**1.4**
- Removal from forecasts of long-term contractors	**0**	**0.9**
External Costs	**0**	**0**
New Scope Shared Services	**0**	**1.8**
Total	**0.1**	**4.1**

4.6. Our view on DCC costs is based on the following areas where some of DCC's internal costs are not economic and efficient.

- **Increased staff costs:** There has been some inflation in staff costs for specific roles within DCC relative to LABP for which DCC has not provided sufficient justification. These changes would not be expected given that staff were employed reasonably soon after DCC submitted its bid.

- **Assumed use of contractors in forecasts:** DCC's forecasts include some staff who are remunerated as contractors throughout the duration of the licence period. DCC need to provide evidence it has considered alternatives and justify the use of long-term contractors as the most economic and efficient option.

- **Shared service charges:** We have concerns with DCC's arrangement for its shared service costs, which are charged from DCC's parent company. We accept there are benefits to DCC in obtaining shared services from its parent, and recognise the shared service charge was competitive at licence award. However DCC has an obligation to demonstrate the efficiency of the charge on an ongoing basis. It has failed to provide evidence of this, and we propose to require DCC to establish a process to demonstrate the economic and efficiency of this charge in future. We also consider that there are some new scope costs that will not result in an increase in the volume of services provided, and these costs should not be subject to the shared service charge.

4.7. Over the licence period DCC's latest total cost forecast is £1.949 billion. DCC forecast a total increase in costs of £71 million relative to LABP over the licence term, a 3.8% increase. A comparison of DCC submitted costs for the 2014 price control to LABP is provided in appendix 3.

4.8. In the remainder of this section we set out the following:

- Review of internal costs and justifications
- Review of shared service costs and justifications
- Review of external costs and justifications
- Summary of our views on DCC's costs and our proposals

Internal Costs

4.9. In this section we set out our assessment of whether DCC's internal costs are economic and efficient. We provide in turn:

- a summary of movements in costs relative to LABP
- a summary of the initial benchmarking analysis we have undertaken
- conclusions and our position on cost disallowances

Changes to internal costs relative to LABP

4.10. DCC reported a £38 million change in internal costs over the licence term, representing a 25% difference from costs forecast in the LABP. The main drivers of this change are new scope costs of £28 million, and changes in staff costs which account for a large proportion of the remaining £10 million.

4.11. This appears to be a large change in internal costs. However, it is important to recognise that a large proportion of this difference is attributed to activity that was not sufficiently defined at the time of the LABP. These activities were explicitly excluded from the LABP as agreed with DECC during the tender process, because the requirements were not fully developed at that time. It was always expected DCC would incur costs associated with these activities. Our review of new scope costs and baseline changes is explained in detail in appendix 3.

Summary of our initial benchmarking analysis of internal costs

4.12. DCC's licence places an obligation on DCC to demonstrate, at each price control, that its costs are economic and efficient. We consider that an essential part of this would be the use of external comparators against which DCC costs can be benchmarked.

4.13. DCC provided very little evidence of this in its submissions to us. DCC stated that its salaries were comparable with market rates and its recruitment strategy ensures that salaries are competitive, though did not provide evidence to support these arguments. DCC explained that it was confident its salaries were economic and efficient because:

- external agencies input into the process;
- DCC directors have experience of setting salaries and a feel for what salary and benefits package should be offered; and
- any staff recruited above a certain level must be signed off by the DCC's parent company board.

4.14. We accept that benchmarking analysis, particularly during the early start-up phase of the DCC is challenging. Nevertheless, the initial external benchmarking we have undertaken supports our views and the proposals we are making on the economic and efficient level of costs.

4.15. Our primary source of information for comparing salaries and bonuses was the ASHE data provided by the ONS. We undertook a detailed mapping exercise to derive salaries from the ASHE database which could be compared to DCC's staff costs. The results of this comparison supported our views on DCC's cost changes from the LABP.

4.16. We appreciate that benchmarking salaries using ASHE data in this way has limitations, and must be treated with caution. For these reasons, we have not used our analysis as a basis for calculating cost disallowances. However, the assessment does indicate that changes above the LABP need to be justified with supporting evidence.

4.17. Further information on our approach and conclusions is provided in appendix 4. We invite views and suggestions on other ways we might seek to benchmark these costs.

Our decision on internal cost disallowances

4.18. The complexity and evolving requirements of the smart meter rollout has already changed the scope of DCC's activity relative to what was expected at the time of the licence competition and further change is likely. This could drive increases or decreases in the economic and efficient level of costs.

4.19. DCC's internal costs have increased by £38 million relative to LABP. As described above we are proposing to accept some of these cost changes as economic and efficient. In particular we will allow:

- costs related to activities which were explicitly excluded from the bid but which have been competitively procured, or were licence obligations and

- costs where DCC has provided clear evidence that the complexity or scope of its activities has increased.

4.20. There are a number of cost centres where DCC appears to have underestimated the scope of activity at the bid stage – most notably in the finance and corporate management functions.

4.21. For some of these changes DCC has provided sufficient evidence that the incremental costs were economically and efficiently incurred, and we will therefore allow these costs. However, we would expect these types of risk to have been accounted for by DCC in formulating its baseline margin at the bid stage. As we explain in chapter 6, DCC is therefore unlikely to be entitled to a margin adjustment in relation to these costs.

4.22. In addition, as a result of comparing costs to LABP, we view some costs are not economic and efficient. This includes:

- costs where DCC has reported an increase in salary costs for specific roles relative to LABP, but has not provided sufficient justification[34]; and

- the premium cost for contractors which DCC has forecast will be employed over longer time periods, but where alternative non-contractor options are likely to be both viable and more efficient[35].

4.23. Staff costs and day rates have been compared to those included in the LABP. However, for these changes we have not seen sufficient justification from DCC to consider the changes to be economic and efficient. DCC has also explained that it tends to only use contractors for staff required within a short-term timeframe for efficiency reasons. We therefore do not consider it economic and efficient to forecast certain contracted staff long-term.

4.24. **We are proposing to disallow these costs, as well as any associated shared service charge.** The allocation of these disallowances to each cost centre is shown in appendix 3.

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[34] £1.5 million over the licence period, £0.1 million in 2014.
[35] £0.9 million from next year onward.

4.25. Our decision to disallow these costs is supported by our external benchmarking analysis. This analysis gives us particular confidence that further differences above the competitive bid needed robust justification.

4.26. We note that DCC provided either weak or no justification for these cost changes from the LABP. It did not undertake any robust external benchmarking of its own in support of the efficiency of its costs. The licence places the burden of proof for the justification of costs as economic and efficient on DCC. We will expect DCC to improve this aspect of its regulatory submissions in future.

4.27. Overall, there are several indicators of at least some inefficiency in the DCC cost base, which have informed or provided support for our proposals. These are:

- the lack of benchmarking evidence put forward by DCC;
- the direction of travel indicated by our initial benchmarking;
- the cost changes from the LABP; and
- the quality of reporting and justification, for some costs.

4.28. We remain open to further developments on robust external benchmarking models. Given the evolving nature of the drivers of DCC costs, cost reporting developments, and improved understanding of the DCC cost base we will evolve our approach to assessing DCC's costs over time. However, there are principles and expectations that we will use to ensure cost changes are economic and efficient.

4.29. Our acceptance of some of the cost forecasts as economic and efficient at this review does not preclude the possibility that we could disallow some of these costs at future reviews in light of new evidence.

4.30. There are a number of issues we will be considering in future reviews:

- productivity and real price effects
- improvements to benchmarking analysis
- output metrics

4.31. We discuss these in appendix 3.

Shared service charge

4.32. A shared services charge was agreed as part of the LABP to cover support services[36]. It is an amount paid by the DCC for shared services sourced from DCC's parent company, Capita. It was calculated as a percentage of internal costs set out in the LABP, as part of the licence competition. A cost related to the communications hubs was excluded from the charge in the LABP.

4.33. We set out our approach to the shared service charge in the RIGs. DCC is required to report on:

- the shared services charge;
- how the charge has been calculated; and
- the value for money of the charge.

Description of cost changes

4.34. DCC has calculated the shared service charge by applying the percentage agreed at competition to all internal costs, including to changes in costs from baseline and all new scope work. Apart from the cost that was excluded in the LABP. As a result the shared service charge increases in proportion with the increase in the internal cost reported over the licence term.

Justification for cost changes

4.35. DCC have used the same level of charge and methodology as was included in the LABP. This means that the shared service charge has been applied to all internal costs. DCC argue that this is economic and efficient since it formed part of the bid during the competitive tender process. The exclusion of the communication hub related costs DCC state was a special case but provided little explanation to support this.

4.36. DCC have also explained the shared services provide a number of benefits, including:

- **Enabling DCC to mobilise** within tight timescales, avoiding programme delays and supporting the ongoing operations through drawing on the parents established teams and systems;

[36] The support services covered by the charge are listed in section 3.3.1 of the redacted LABP and examples given in paragraph 5.19 of the RIGs.

- **Effective management of the DCC** through drawing on the parents group functions on internal audit and advice;
- **Attracting and retention of the high calibre resource** through Capita group benefits.

Our position on cost changes shared services

4.37. DCC has an obligation to procure relevant service capability[37] on a competitive basis. The services provided under the shared services charge are part of the relevant service capability. The licence allows it to procure services from an affiliate or a related undertaking where it is satisfied that it is the most economical and efficient option or the amount is immaterial.[38] DCC should have evidence that it has met this obligation. It is also required to provide evidence of the value for money of the shared services in the RIGs.

4.38. We appreciate the benefits for the shared services charge and recognise the shared service charge was competitive at licence award. But DCC must demonstrate that these costs are economic and efficient[39] and the ongoing value for money of this charge.[40] In our view, simply referring to the percentage agreed being competitive at bid is not sufficient justification. Particularly given the magnitude of the changes to the LABP since then.

4.39. DCC has failed to provide evidence that the shared service charge is economic and efficient. **We propose requiring DCC to commit to developing a process to ensure that the shared service charge provides value for money to DCC.** We propose the process be completed to our satisfaction within 6 months.

4.40. The RIGs include reporting lines for costs that are excluded from the service charge. This reflects that a cost related to communications hubs did not attract the charge at bid. DCC has not reported any new costs as being excluded from the charge.

4.41. We accept the level of shared services on the baseline costs as economic and efficient given the competitive pressures as part of the bid. However, if a new scope activity has not drawn upon the shared services the charge should not apply. This is an important principle to establish given we expect to see economies of scale and efficiencies over time.

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[37] Relevant service capability is capability procured for the purposes of securing the provision of Mandatory Business Services.
[38] This criteria is set out in Licence Condition 16.
[39] Under Licence Condition 16 if DCC does not undertake a competitive procurement to obtain services it must be satisfied that procurement of capability from its own resources, an affiliate or from elsewhere is the most economic and efficient option.
[40] This is specified in the qualitative questions in the RIGs.

4.42. In our view the charge should not apply to the procurement of two new contracts: SMKI and Parse and Correlate. DCC incurred additional direct costs for procurement and management of these contracts and DCC has not provided any evidence these costs have increased the volume of activity associated with the shared services.

4.43. We also propose to disallow the ongoing costs related to the financial stability and security as these standing charges involve limited additional activity for DCC.

4.44. We propose to disallow the shared service charge associated with the SMKI, Parse and Correlate, and financial stability and security costs. This would be a £1.8m reduction to the forecasts over the licence term.

External costs

4.45. External costs comprise the costs of the communication service providers (CSP) and the data service providers (DSP), which are defined under the licence as fundamental service providers. This means that costs associated with other externally procured services, for example the Smart Metering Key Infrastructure (SMKI) contract are reported under internal costs

4.46. Around £34 million of the total cost increase reflects changes in external costs. The main drivers of this change are the cost of extended coverage and the re-baselining required due to the changes and longer lead-time for the GB Companion Specification (GBCS). This is a relatively small percentage increase in external cost of 2%, when compared with the LABP external costs.

4.47. The external costs mostly reflect the contracts that were competitively-procured contracts by government. We expect the procurement process conducted to have delivered value for money in the pricing of those contracts. However, we expect DCC to demonstrate through its reporting that it has incurred contract costs as efficiently and economically as possible, doing everything it reasonably can to ensure value for money.

Our position on cost changes in external costs

4.48. In our view the 2% variation in external cost has been made on reasonable grounds. DCC has provided evidence of how its change control process challenged and scrutinised the associated costs. In some cases this has reduced proposed cost changes from service providers. **We propose to allow the changes in external costs as being economic and efficient.** Further detail on our review of external costs is provided in appendix 3.

4.49. It is likely there will be further changes in external costs reported in future years. We expect detailed justification for cost variations and will be interested in how DCC uses the levers under the contracts to ensure value for money. We intend to consult on amending the RIGs to specify that DCC must provide the assessments and analysis that it undertakes as part of the change control process.

4.50. We encourage DCC to be more transparent when consulting on changes to costs. We recommend that DCC provides industry with more detail of costs in its documents. We appreciate that DCC needs to be mindful of commercial sensitivities, but we see benefits in allowing industry to scrutinise the costs before they are incurred. This could strengthen DCC's case that costs it is incurring have been robustly tested and reviewed. DCC will be required to provide this type of analysis once the enduring SEC modification process is in effect. This will provide a level of ex ante control in the future.

5. Revenue reporting

Chapter Summary

Provides an overview of DCC's Allowed Revenue and the impact of our proposals.

Question 7: What are your views on DCC's approach to the prudent estimate?
Question 8: Do you agree that our proposals should take affect from April 2015/16?

5.1. Allowed revenue is defined in licence condition 36[41] and is the total revenue DCC is entitled to. An explanation of how it is calculated is provided in appendix 5.

5.2 Under the price control arrangements DCC incurs costs and passes these onto users. DCC's regulated revenue is the actual revenue, measured on an accruals basis, received through service charges.

5.3 We have no role in approving DCC's service charges in advance; these are set in the DCC's charging statement. Indicative charging statements and budgets are available on DCC's website (www.smartdcc.co.uk).

Allowed revenue reported

5.4 In 2013/14 DCC reported it's allowed revenue to be £13.5 million. Over 70% of this was internal costs. External costs were a small proportion of the allowed revenue: just over 4%. The BM was 13%, and pass-through costs just under 9%.[42]

5.5. DCC did not deliver any minimal or value added services in 2013/14. It is not expected to deliver any value added services in 2014/15.

5.6 DCC published its charging statement for 2013/14 in November 2013. Its prudent estimate of estimated allowed revenue for 2013/14 was £19.3 million. Appendix 6 provides a breakdown of the charging statement breakdown and compares it to the costs reported in 2013/14.

5.7 The correction factor[43] reported in 2013/14 was £6 million. This mechanism is designed to correct variances between allowed and regulated revenue. A breakdown of the correction factor is provided in appendix 6. The correction factor is very high, however we consider this first year is an exception. The components of the correction factor are related to the uncertainties of set up, re-alignment, and

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[41] Allowed revenue is defined in the RIGS in part 4.
[42] The pass through costs are SECCo Ltd costs as the Authority has not charged a fee.
[43] The correction factor is defined in licence condition 36.

re-phasing. In future years we do not expect a correction factor of this size. We will be monitoring DCC's use of its prudent estimate.

Allowed revenue in forecasts

5.8 DCC forecasts it's allowed revenue for the licence term in its reporting. Changes reported in 2013/14 have increased DCC's forecast costs over the total licence term. This will lead to higher allowed revenue in subsequent years in proportion to the costs. DCC will need to prove that its costs are economic and efficient each year as part of our review.

5.9 The indicative charging statements and budgets indicate that not all cost changes are reported under the price control. This is because under the price control DCC reports in July 2014 the information it had for the previous regulatory year. We do not approve DCC's charges but will assess the costs once they have been incurred.

Adjusted allowed revenue and forecasts

5.10 As a result of our proposals there is a £0.4 million reduction in the allowed revenue in 2013/14. This brings it down to £13.1 million. We've also not allowed £4 million of the forecasted allowed revenue over the remaining licence term. See table A5.1 in appendix 5 for a breakdown of our proposals and the changes to allowed revenue.

5.11 We propose that the reductions in charges should take effect from the 2015/16 charges. DCC will be providing three months' notice of these charges in December 2014. If we publish our final decisions in February 2015, this will slightly reduce the proposed charges that will take affect from 1 April 2015.[44]

Prudent estimate

5.12 DCC must take all reasonable steps to secure that regulated revenue does not exceed a prudent estimate of allowed revenue for each regulatory year. The concept of a prudent estimate is unique to DCC. Other companies we regulate have an obligation to take reasonable steps to ensure regulated revenue does not exceed their allowed revenue.

5.13 The prudent estimate is designed to ensure that service charges do not need to be amended in the course of the year except in response to a reasonably unlikely contingency. However, looking at the DCC's charging statements the prudent estimate is a significant proportion of the charges.

[44] Under Licence Condition 19 our price control decision can be an exception to the requirement for three months notice.

5.14 As 2013/14 was a part year we only six months of cash flows to assess, but these indicate DCC is in a very liquid position. We appreciate the level of uncertainty during implementation, which was reflected in the high value of the correction factor, and that the prudent estimate gives users certainty in charging.

5.15 We will continue to monitor the use the prudent estimate and DCC's cash flow position. We will consider whether the prudent estimate places the right incentives on DCC. Over time we would expect the size of the prudent estimate to reduce. If this continues to be high we may introduce an incentive to meet allowed revenue, similar to the penal interest rates faced by networks for over-charging.

5.16 DCC only trades with credit worthy parties, and as charges can be adjusted in year if there is an unforeseen event, in future there may be a case to remove the prudent estimate entirely.

6. Baseline Margin Adjustment

Chapter Summary

DCC proposed an adjustment to the value of its baseline margin for each year of the licence term. We assessed its proposal against the criteria in the licence. We do not consider the proposal to have met the criteria therefore propose that the value of the margin remains unchanged.

Question 9: Do you agree with our assessment against the criteria in the licence?

Our decision

6.1. We are proposing that the BM values remain unchanged. We do not consider DCC's proposal to have met the criteria outlined in the licence to justify adjusting the BM values in the licence at this stage.[45]

Background

6.2 The BM is the amount of additional revenue over and above the sum of internal and external costs that is included in allowed revenue. The level of BM allowed in each regulatory year is fixed in value and set out in the licence.[46]

6.3 Each July, under certain circumstances,[47] DCC may apply for an adjustment to BM values in the licence. Any adjustment proposed by DCC must relate to a material variation[48] in one of more of the following aspects the mandatory business[49] of DCC:

- the total volume of the activities comprising that business;
- the characteristics of the activities comprising that business;

[45] Licence condition 36, appendix 2
[46] Licence condition 36, appendix 1.
[47] Detailed in Licence condition 36, appendix 2.
[48] This may be due to a discrete but material change, or aggregation of incremental but non-material changes.
[49] The mandatory business means the part of DCC's activities that consists of the operation or provision, on behalf of or to SEC parties, of mandatory business services under or in accordance with the SEC.

- the mixture (whether by category or volume) of the activities comprising that business;
- the risks (whether financial or operational) to which the Licensee is exposed in the carrying on of that business; and
- the timescales or deadlines that the Licensee is required to meet (whether under this Licence or otherwise) in the carrying on of that business.

6.4. The licence also details the process that DCC must follow when proposing an adjustment.

6.5. The BM adjustment process was included in the licence to protect DCC against margin dilution due to a material change in the activities DCC carries out, the risk DCC faces, or the timescales or deadlines that DCC must meet.

6.6 It is not a cost plus arrangement and it is not intended to be an annual review of the margin level agreed at bid, or to protect against increases in costs that do not correspond to a material change in one of the five categories outlined above.

Our assessment of DCC proposal

6.6. The licence specifies that DCC must apply for an adjustment during the first application window[50] after which the grounds for proposing the adjustment arose. DCC submitted their proposal on 31 July 2014, the final day of the first application window. DCC proposed an adjustment for each year of the licence term, the total value of which was £12.7 million.

6.7. We assessed this proposal against the criteria in the licence[51] however, in order to be able to make a determination we requested further information.[52]

6.9 This was the first year that DCC had gone through the process we agreed to consider their proposal, issuing a direction to obtain the additional information required. We also issued a counter-notice to extend the determination period by three months.

[50] The application window is the month of July during any regulatory year (other than regulatory year 2013/14).
[51] Licence condition 36, appendix 2, part A.
[52] Using our powers under licence condition 36, appendix 2, part B, paragraph A.

6.10 DCC reviewed its approach to the BM adjustment. Due to the level of uncertainty around future costs DCC recommended that, at this time, we no longer consider many of the variations proposed.

6.11 This reduced the proposed total adjustment by £9.2 million.[53] Since these variations were removed due to current uncertainty, we consider it likely that DCC with apply for an adjustment based on them in future as they become more certain.

6.12 As a result of this additional information, we assessed a proposed a BM adjustment of £3.4 million over the course of the licence. This was all in relation to variations to account for scope anticipated at licence award but excluded from LABP. In particular it related to:

- SMKI contract
- Parse and Correlate contract
- Competent Independent Organisation (CIO) contract
- Financial security, stability and financing.

6.13 We assessed each of these and concluded that none fit the criteria in the licence, therefore we will not be adjusting the BM values this year. Below we outline our reasoning for this.

SMKI, Parse and Correlate and CIO contracts

6.14 DCC have proposed a margin adjustment on the total value[54] of the SMKI, Parse and Correlate and CIO contracts. DCC argues that since these costs were excluded from internal costs in the LABP, it represents an increase in the volume of activities. They also stated the procurement of the contracts increased the risk to which it is exposed.

6.15. We do not consider that margin can be applied to the value of these external contracts. The activity in these contracts is carried out by a third party. This does not increase DCC's volume of activities thus does not meet the licence criteria for a BM adjustment.

6.17 DCC have not adequately demonstrated or quantified the operational and financial risk associated with the procurement of the SMKI and Parse and Correlate

[53] DCC also removed a small amount (£0.037 million) from their proposal in relation to changes in volume of activities in regulatory year 2013/14 as the deemed that the change was not material enough.
[54] Including the optional one year extension period of the SMKI contract and the optional two year extension period of the Parse and Correlate contract

contracts. We also question what new information has come to light between licence award and the application window that materially increases any risk.

Financial security, stability and financing.

6.18 This includes:

- Financial security: parent company deed of guarantee and indemnity
- Financial stability: keepwell deed[55]
- Working capital charge

6.19 DCC have asked for a margin adjustment based on the cost of these items. DCC's view is that since these costs were excluded from the LABP this represents an increase in the volume of activities.

6.20 We do not hold the same view. DCC is asking for an adjustment based on cost without any corresponding burden or requirements to carry out additional activities. Furthermore DCC was aware that it had to put these arrangements in place, therefore this is not new information.

[55] A revolving credit facility to ensure DCC has access to additional operational resource and support if it requires it.

7. Next Steps

Question 10: What are your views on our longer term strategy of moving towards a more ex ante price control? How might this be achieved?

Views on our proposals

7.1. We welcome views on the proposals in this document. Please get in touch with us early if you'd like to:

- discuss or provide feedback on our proposals, or
- provide any additional information that will help us assess DCC's costs.

7.2. We will consider any views provided when we take our decision. Please send responses to tricia.quinn@ofgem.gov.uk by 20 January 2014. We intend to publish our decision on DCC's price control in February 2015.

Changes to the RIGs

7.3. We will consult on changes to the RIGs to improve the price control reporting in early 2015. This will include minor corrections due to errors in the template and clarifications in the RIGs themselves. We will also add references to the assessments for external costs and procurement to ensure DCC provides this as part of its evidence under the price control reporting.

Developing operational incentives

7.4. DCC must engage and consult with SEC parties on the design of the operational incentives.[56] Once the re-planning exercise is finalised we expect DCC to start early engagement on the development of the operational incentives framework. In future we will be looking to develop quality of service reporting and we expect the ex post review to look at the outputs DCC provides. We are interested in your thoughts on how to best present this so you can assess it easily.

Future of the DCC price control

7.5. We see benefits in moving to more ex ante controls once DCC reaches a steady state. This would give the industry and DCC certainty about costs. We will explore

[56] Licence Condition 36.

introducing more ex ante controls in the current regime, aiming to move to a full ex ante control in the longer term.

Appendix 1 - Consultation response and questions

1.1. We'd like to hear your views on any of the issues in this document. We would particularly like to hear from SEC users.

1.2. We would especially welcome responses to the questions at the beginning of each chapter. These are replicated below.

1.3. Please make sure we have your response by 20 January 2015. It would be helpful if you could submit your comments both electronically and in writing. Send them to:

Tricia Quinn
Smarter Metering
Ofgem
9 Millbank
London
SW1P 3GE
020 7901 3132
tricia.quinn@ofgem.gov.uk

1.4. Unless you mark your response as confidential, we'll publish it in our library and on our website (www.ofgem.gov.uk). If you ask us to keep your response confidential we'll respect this request unless a legal duty means we can't, for example under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. If you'd like your response to be confidential, mark it clearly to that effect and include your reasons. Please restrict any confidential material to an appendix.

1.6. Once we've considered the responses to this consultation, we plan to publish our final decision in February 2015. If you have any questions, please send them to:

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tricia.quinn@ofgem.gov.uk

CHAPTER: Two

Question 1: What are your views on our approach to assessing DCC's costs? And do you have any suggestions on where we can improve our approach?

CHAPTER: Three

Question 2: What are your views on our assessment of DCC's performance against the IMs?

Question 3: Do you have any observations from the current incentive framework which can inform early thinking on developing an enduring framework?

CHAPTER: Four

Question 4: What are your views on our proposal?

Question 5: Do you have any views on how the methodologies used for networks could be applied to DCC in future?

Question 6: We are looking for ways to benchmark DCC costs. What other sources of data or potential comparators can you recommend for subsets of DCC costs

CHAPTER: Five

Question 7: What are your views on DCC's approach to the prudent estimate?

Question 8: Do you agree that our proposals should take affect from April 2015/16?

CHAPTER: Six

Question 9: Do you agree with our assessment against the criteria in the licence?

CHAPTER: Seven

Question 10: What are your views on our longer term strategy of moving towards a more ex ante price control? How might this be achieved?

Appendix 2 – Implementation milestones

The table below outlines the criteria DCC had to meet when delivering the first six implementation milestones. DCC achieved IM1-IM4 and IM6. In our view DCC did not achieve IM5.

Implementation milestone	Achieved
1. Completion of Licensee Mobilisation • Registration of Licensee company, appointment of board of directors and installation of senior management and operational management teams at Licensee's offices. • Initial Licensee Website has been established and is operational, with adequate content being provided for the purpose. • All major corporate policy documents of the Licensee have been approved by its board of directors, submitted to the Authority, and published. • External Service Provider Governance Framework and Joint Partnership Charter have been approved by Partnership Management Board.	✓
2. Submission of Integrated Solution Delivery Plan • Licensee has received draft Implementation Plans and High Level Plans from External Service Providers. • Licensee has completed and issued to all relevant parties its Gap Analysis of the draft Implementation Plans, prior to submission. • Integrated Solution Delivery Plan (received from the Data Services Provider) has been authorised by the Licensee and submitted to Smart Metering Delivery Group.	✓
3. Establishment of Service Design Authority • Terms of Reference for the Service Design Authority have been agreed. • First meeting of the Service Design Authority has been held and appropriate meeting notes are published promptly on the Licensee's Website.	✓
4. Submission of the Test Strategy • Test Strategy Product Descriptions have been produced by the Data Services Provider and been approved by the Licensee. • Initial draft of the full Test Strategy has been produced by the Data Services Provider and been approved by the Licensee. • Final Test Strategy has been produced by the Data Services Provider, approved by the Licensee, and is published promptly	✓

on the Licensee's Website.	
5. Submission of DSP Interface Specifications • The following documents have been produced and approved by the Licensee and been submitted to the Secretary of State in accordance with Schedule 5 to the Licence: • The Self-Service Interface Specification, the Registration Interface Specification, and the User Gateway Interface Specification insofar as it may be completed according to version 0.7 of the GB companion specification. • The Enterprise Systems (Billing/Reporting) Interface Specification has been reviewed and approved by the Licensee. • The SMWAN Gateway Interface Specification has been reviewed and approved by the Licensee, in line with the Code of Connection and overall solution design.	✘
6. Submission of the ICHIS • Initial draft of the ICHIS (Intimate Communications Hub Interface Specification) has been approved by the Licensee. • Consultation with SEC Parties on that initial draft has been completed by the Licensee and the comments received are published. • ICHIS document has been finalised and an Authority to Proceed Notice has been issued by the Licensee to the Communication Service Providers. • ICHIS has been approved by the Licensee and has been submitted to the Secretary of State in accordance with Schedule 5 to this Licence.	✓

Appendix 3 – Detailed review of DCC costs and justification

1.1. This appendix contains our detailed review of the justifications DCC provided for the movements in its costs relative to LABP.

Overview of DCC's total cost base and movement from LABP

1.2. Figure A3.1, below, describes DCC's total cost base as reported in its first price control submission. DCC's costs[57] are made up of:

- **External costs** – costs economically and efficiently incurred in procuring fundamental service capability from external service provides, i.e. infrastructure costs.[58]
- **Internal costs** – costs (excluding external costs and pass-through costs) economically and efficiently incurred for the purposes of the provision of Mandatory Business Services under or pursuant to the SEC,[59]and also include any shared service charge. [60]
- **Pass through costs** – defined[61] under the licence as the sum of the total annual fee paid by the licensee to the Authority and the payments made by the licensee to SECCo Ltd for purposes associated with the governance and administration of the SEC.

1.3. DCC's external costs are expected to make up the significant majority of DCC's cost base in future. However, to date DCC has mostly only incurred internal costs.

[57] The categories of costs are defined in Licence condition 35

[58] As defined in licence condition 35 of the smart meter communication licence. The fundamental service capability predominately comprises of the communication service providers (CSP) and the data service providers (DSP). This definition means that costs associated with other externally procured contracts, for example the Smart Metering Key Infrastructure (SMKI) contract are reported under internal costs.

[59] As defined in the smart meter communication licence, this means the services comprising the mandatory business of the Licensee, namely (i) the Core Communication Services, (ii) the Elective Communication Services, and (iii) the Enabling Services.

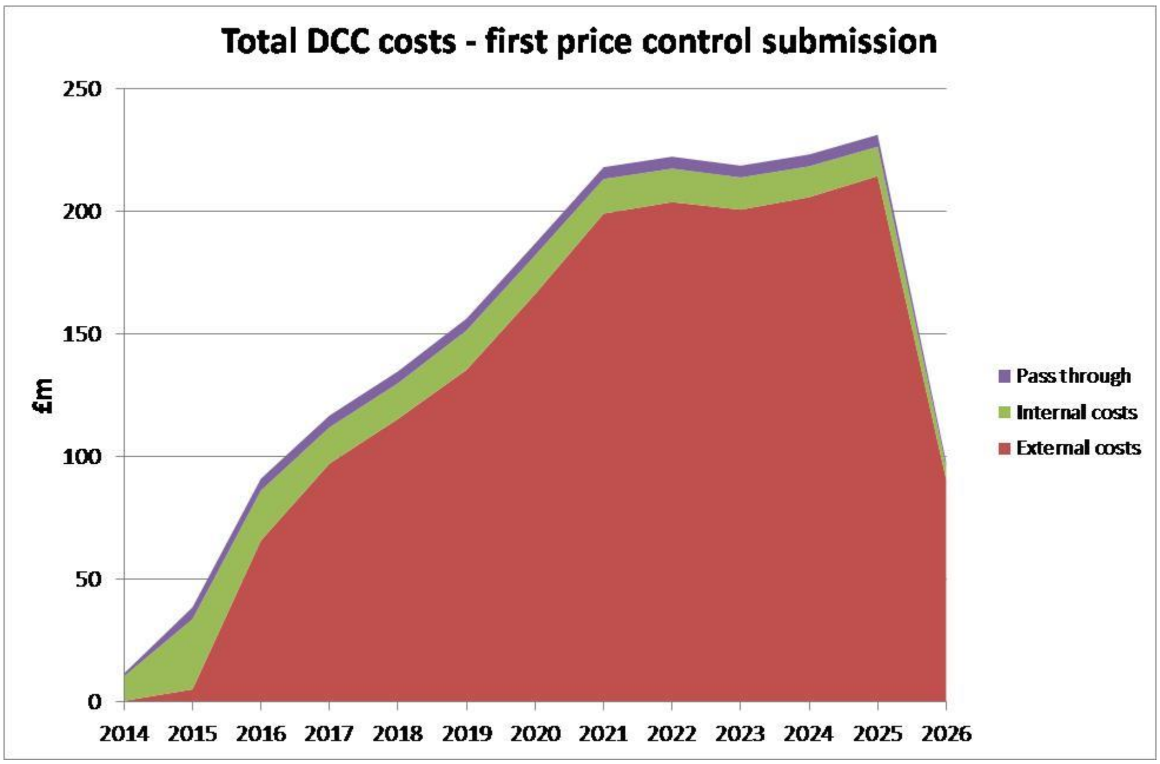
[60] Internal Costs may include governance and administration costs of the SEC that are not included in pass-through costs. The shared service charge is a percentage of eligible internal costs paid to the parent company for use of shared services

[61] Defined in licence conditions 35 and 36.8

Over the course of the licence DCC's internal activities will play a central role in managing external costs to an efficient and economic level.[62]

1.4. Our assessment for this first review has therefore focussed primarily on the starting position for internal costs. While we have also scrutinized movements in external costs relative to LABP, we expect this to form a more significant part of our analysis in future reviews.

Figure A3.1: DCC total cost base over the licence, 2014 submission



1.5. Over the licence period DCC's latest total cost forecast is £1.949 billion, which is broken down into the components in table A3.1 below.

[62] The definition of 'external costs' in the licence captures only costs economically and efficiently incurred in procuring the fundamental service capability during each Regulatory Year The nature of the contracts with fundamental service providers means that they are not paid until they achieve the testing milestones set out in their contracts.

Table A3.1: DCC total cost forecast

Cost category	Total (£m)
External costs	1,702
Internal costs	190
Pass through	57
Total	**1,949**

1.6. DCC total costs are forecast to increase steadily between 2014/15 and 2020/21. This corresponds with the current timetable for the smart meter roll out and the expected delivery of infrastructure projects by the external service providers. The costs of these projects flow through DCC from the fundamental service provider contracts.[63] Following the mass rollout period, DCC costs are expected to broadly flatten out, before tailing off as DCC winds down in 2025/26.

1.7. In the 2013/14 regulatory year DCC incurred a total cost of £11.7 million[64], reflecting 6 months of activity (DCC began its operations in September 2013). Some delays in DCC's delivery timetable and in the recruitment of staff have pushed costs from 2013/14 into 2014/15 relative to LABP.

1.8. Over the course of the licence external costs make up the large majority of DCC total costs. However, the structure of the DSP and CSP contracts means that these costs do not flow through until systems integration testing. This means that there is little in the way of external costs until 2014/15 (£0.6 million was incurred in 2013/14).

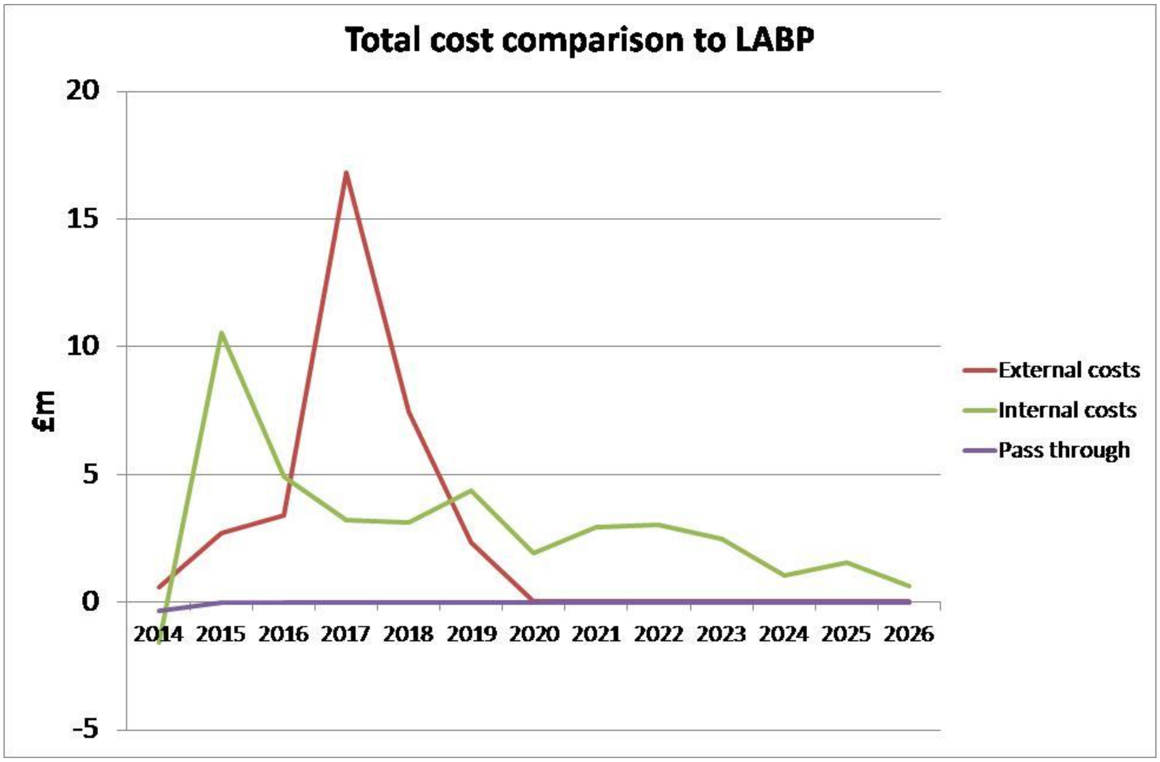
1.9. The significant majority of 2013/14 costs (£10 million) therefore relates to internal costs. One of the components of internal costs is DCC's shared service costs.

1.10. Pass through costs were £1.2 million in 2013/14 and relate the SECCo Ltd costs.[65] No Authority fee was charged. We do not scrutinise the pass through costs as DCC has no control over these.

1.11. Figure A3.2, below, shows the changes in costs DCC reported in price control compared to those forecast in the LABP.

[63] These contracts were competitively procured by DECC during the tender stage.
[64] This does not include the BM value.
[65] SECCo Ltd is the Smart Energy Code Company which was established to enter into any contractual arrangements necessary to assist the SEC Panel in fulfilling its objectives and obligations.

Figure A3.2: Change in DCC costs compared to LABP over the licence



1.12. Table A3.2 below shows the costs incurred in 2013/14 relative to the costs agreed as part of the licence competition. Reported costs in 2013/14 are lower than the bid, mostly due to delays in licence award and some other costs being re-profiled into subsequent years.

Table A3.2: Changes in DCC costs compared to LABP in 2013/14

Cost category	Total (£m)	As a % of LABP
External costs	0.6	N/A[66]
Internal costs	-1.6	-13%
Pass through	-0.3	-21%
Total[67]	**-£1.3**	**-10%**

[66] No external costs were forecast in the first year in the LABP
[67] Figures may not sum precisely due to rounding

1.13. Over the course of the licence DCC is forecasting a total change of £71 million in costs relative to LABP, a 3.8% change. The breakdown of the changes in the various cost categories shown in table A3.3, below.

Table A3.3: Changes in DCC costs compared to LABP over the licence period

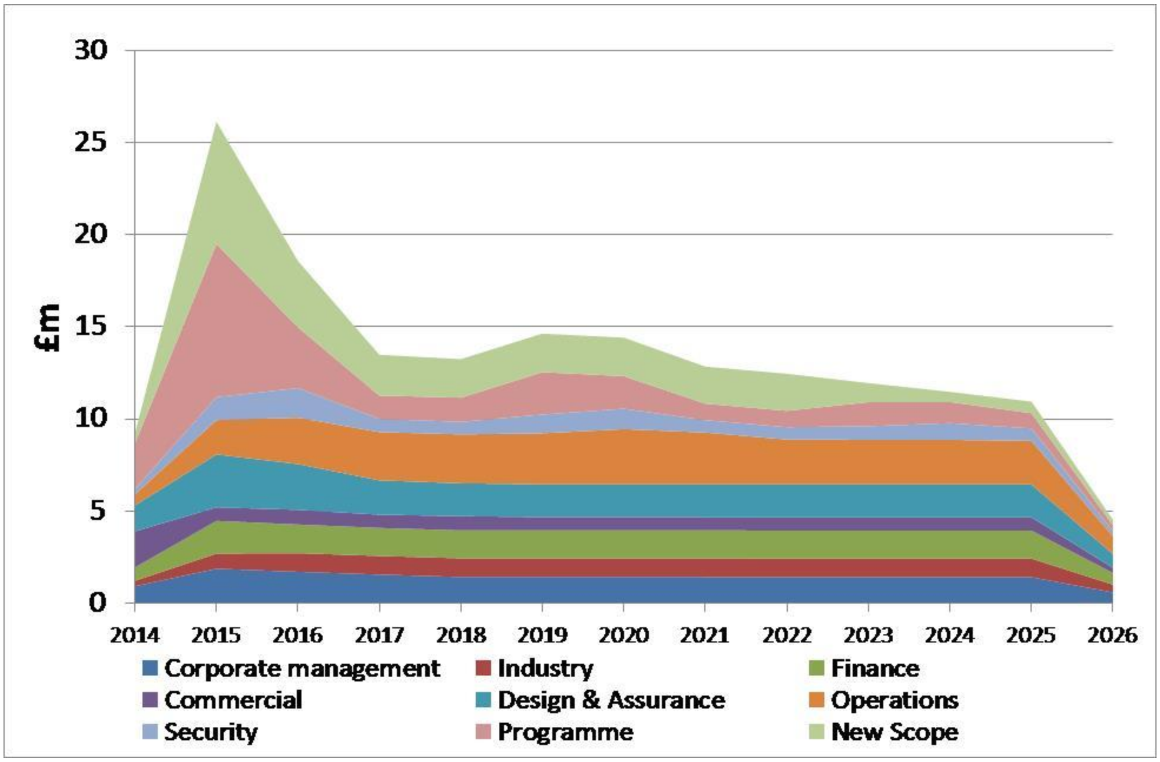
Cost Category	Total (£m)	As a % of LABP
External costs	**33.5**	**2.0%**
Internal costs (including shared service costs)	**38.2**	**25.1%**
Pass through	**-0.3**	**-0.6%**
Total[68]	**71.4**	**3.8%**

Internal Costs Detailed Review

1.14. DCC reports its internal costs to us both by cost centre and expense type. Figure A3.3, below shows the DCC's forecast of the evolution of its internal costs over time by cost centre. An increase in costs is forecast for the year 2014/15, driven by increases in the Programme cost centre. Costs for most other centres remain relatively stable over the licence period.

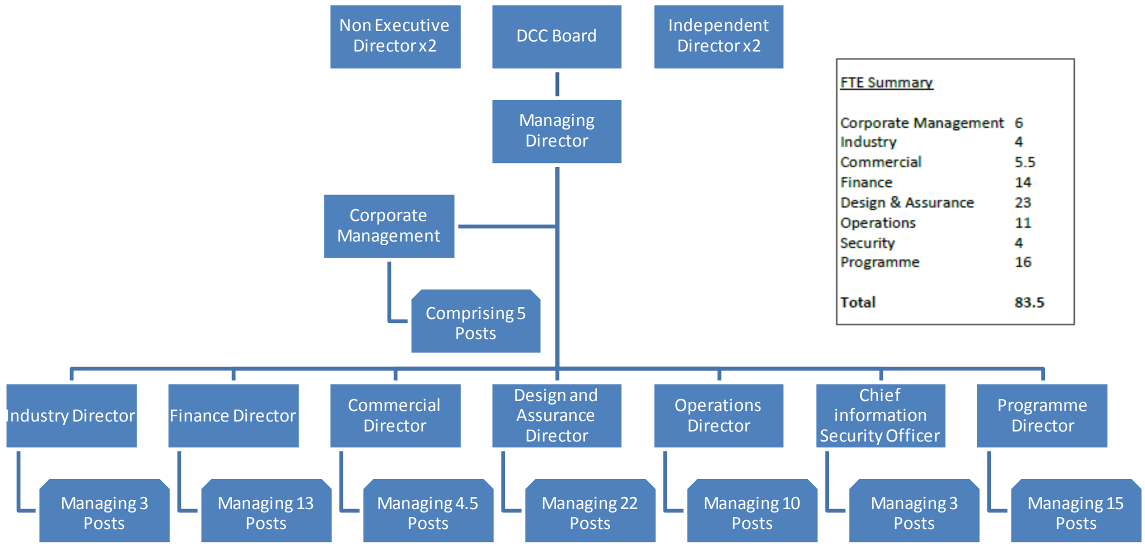
Figure A3.3: Internal costs by cost centre

[68] Figures may not sum precisely due to rounding



1.15. Figure A3.4 below provides an organisational chart showing the cost centre structure DCC employed as of September 2014 in each cost centre, and a summary of total full time equivalents (FTEs) within each cost centre at that date. In total there were 83.5 FTEs employed by DCC as of September 2014.

Figure A3.4: Roles and FTEs by cost centre



1.16. Table A3.5 below shows average FTEs by cost centre in 2013/14 and forecast for 2014/15 as reported by DCC in its price control reporting.

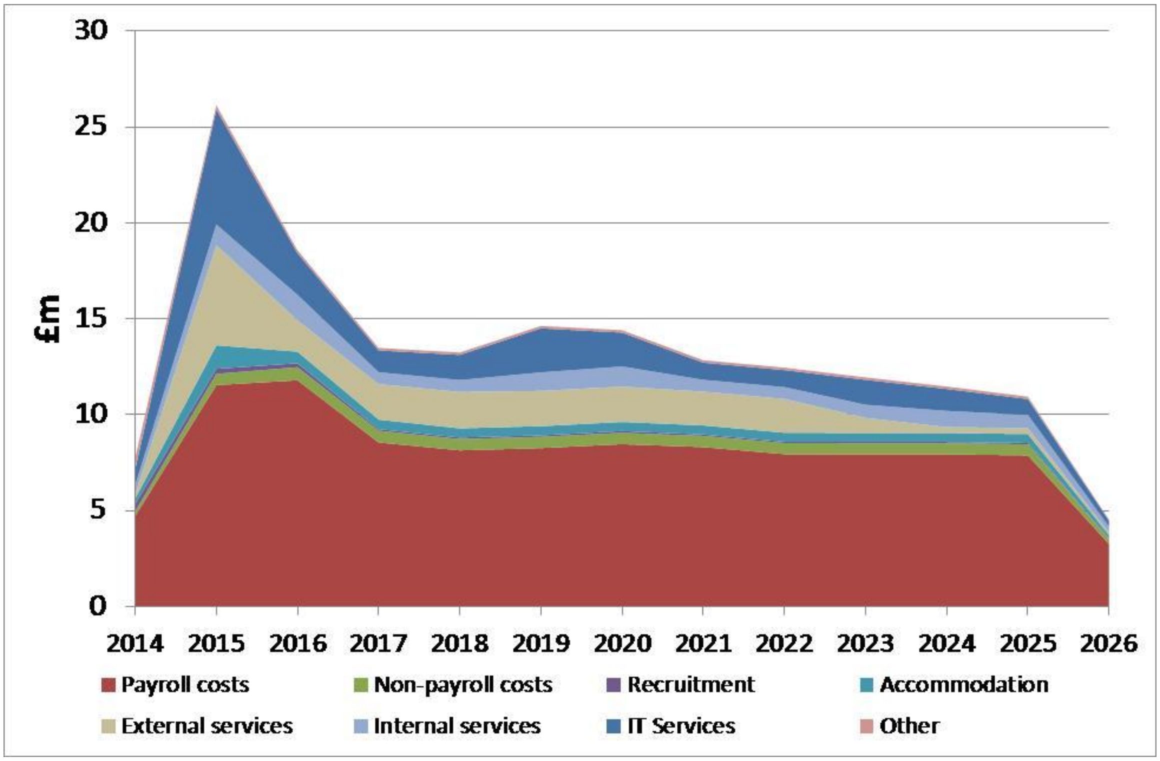
Table A3.5: Regulatory year average FTEs by cost centre

Cost centre	2013/14 outturn	2014/15 forecast
Corporate management	2.6	8.0
Industry	3.0	5.1
Finance	7.8	15.9
Commercial	3.9	4.5
Design & Assurance	13.1	22.3
Operations	4.5	21.6
Security	3.2	6.0
Programme	9.8	11.6
New Scope	1.0	9.3
Total	**48.9**	**104.2**

1.17. We provide a detailed review of each cost centre later in this Appendix.

1.18. DCC's costs are predominantly payroll costs. Total internal costs are therefore driven primarily by salaries and headcount. There is no significant capex programme. Figure A3.4, below demonstrates this.

Figure A3.4: Internal costs by expenditure type



1.19. DCC has explained that the spike of costs in 2014/15 is driven by the following factors:

- IT services
- External services
- Accommodation.

IT services

1.20. DCC forecasts a spike in IT services costs of £6 million in 2014/15, relative to steady-state expenditure of £1-2 million. Some of this increase is due to a delay in procuring DCC's billing system, and is therefore a transfer of costs from 2013/14.

1.21. DCC has also changed its chosen billing system solution. At LABP, DCC anticipated using Oracle, however it has now decided to adopt a SAP[69] solution. DCC

[69] SAP (Systems, Applications, and Products) is a provider of enterprise software and software-related

expects this to drive cost savings in future, however, the savings will not be reflected in forecasts until the level of savings becomes clearer.

1.22. We intend to thoroughly scrutinise the efficiency of the peak in these costs next year. We expect DCC to demonstrate to us that the switch to a different billing system will deliver net benefits over the licence period relative to LABP. We expect to see cost reductions in future.

External services

1.23. The external services category includes the cost of procuring services such as auditors, compliance officers and credit rating agency fees. This is distinct from External Costs i.e. external services is a cost category within internal costs.

1.24. There is a peak of over £5m in this category expected in 2014/15, relative to ongoing costs of £1-2 million per annum. The majority of this peak is driven by the procurement of the SMKI contract. We have scrutinised the cost of this contract and consider these forecasts to be economic and efficient since the contract was competitively procured.

1.25. DCC has also found some savings in other external services costs relative to LABP. These include savings related to:

- knowledge management documentation process.[70];
- reduced use of a behaviour performance analyst;
- fewer industry events than had been anticipated; and
- lower achieved credit rating agency fees.

1.26. In total DCC forecasts these reductions will amount to £1.7 million over the licence.

Accommodation

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services.

1.27. DCC forecasts a spike in accommodation costs in 2014/15 to £1.3 million, relative to steady state of £0.5 million per annum. The cost increase in 2014/15 is due to relocation of DCC's office from its current temporary accommodation.

1.28. The cost of accommodation in 2013/14 was below that forecast in LABP. However the cost forecast in 2014/15 is above LABP. DCC attribute this to its requirement for additional space given the greater number of staff that have been employed. This is also reflected in higher ongoing costs after 2014/15.

1.29. DCC have stressed that accommodation cost per FTE is lower than forecast at LABP. We intend to closely scrutinise future increases in accommodation costs. We will expect DCC to provide analysis of options it has considered for controlling accommodation costs in future.

Corporate Management

1.30. The corporate management cost centre includes costs for the managing director, the senior management team, and the DCC board, as well as any direct support provided to these roles in discharging their licence obligations.

Description of cost changes

1.31. In 2013/14 there was an 18% reduction in corporate management costs relative to LABP. This was largely due to delays in recruiting some positions.

1.32. However, over the licence term, costs are forecast to increase by 24%, driven by increased resource requirements. Resource changes can be grouped into three categories, outlined below:

- **FTE Transfers**: FTEs transferred in from industry and commercial. One role was transferred out to the finance centre in 2013/14. Further transfers are expected next year.
- **FTE increases:** There were a number of increases and extensions of required roles to retain experience within DCC in light of the emerging complexity in DCC scope.
- **Payroll changes:** Salaries or the benefits packages for a number of roles have increased. Some of the cost increases have been offset by reductions in costs and savings elsewhere (eg DCC's knowledge management tool, and a reduction in spend on the behavioural performance analyst).

DCC justification for cost changes

1.33. DCC explained that it had not anticipated the scale and complexity of the regulatory requirements it would face. This drove re-structuring of the regulatory team to report directly to the managing director.

1.34. Similarly at LABP DCC anticipated that the majority of its legal needs would be commercial. However, following set-up it became apparent that most legal resource would be required on regulatory issues. The drivers of this have been interpretation of the licence, and the scale and volume of DCCs involvement in the SEC. DCC transferred legal roles into the corporate management cost centre.

1.35. These changes resulted in some transfer of FTEs into the corporate management cost centre. However, there have also been increases in FTEs and staff costs over the licence period.

1.36. The main justification given for these increases is that the complexity and scale of DCC's operations have increased relative to what it had forecast in LABP. Complexities cited by DCC included:

- the volume of changes to the SEC
- the emerging nature of the SEC subsidiary documents
- the need to engage with new industry change initiatives[71] earlier and with greater intensity than expected.

1.37. Given its expectation at LABP on where legal resource would be needed, DCC had expected to draw on Capita shared services and external legal resource. When the legal requirements of regulation became apparent, DCC recruited dedicated legal resource instead of using Capita resource. While this reduced the cost of external legal resource required, it has increased costs overall.

Our view on cost changes in the corporate management cost centre

1.38. Increases in costs that have been driven by role transfers without any associated increase in total costs are acceptable. We also consider that the complexity and changes to the SEC might mean that additional legal resource was required.

1.39. However, DCC could have recognised it would require dedicated regulatory resource at bid stage. Changes in FTEs and in particular differences in salary packages for this cost centre - have not been sufficiently well justified. While we appreciate that the nature of DCC's task is challenging and evolving, DCC has failed to provide evidence to support all the differences in salary above the LABP.

Industry

[71] This includes next day switching and electricity expert group.

1.40. The industry team leads engagement with service users, the SEC panel and other industry bodies. As such it is the primary external 'face' of DCC. This includes leading the DCC relationship with the SEC panel, and ensuring that DCC services are compliant with the licence and SEC obligations.

Description of cost changes

1.41. Over the course of the licence DCC is forecasting a 26% decrease in the costs of the Industry cost centre relative to LABP. In 2013/14 DCC's costs were £0.23 million lower than forecast in the LABP.

DCC justification for cost changes

1.42. The primary cause of these savings is FTE transfers into the corporate management cost centre. For 2013/14 there have also been some delays in recruiting, although these have not impacted DCC's ability to carry out required activities. These changes therefore do not amount to overall cost savings.

1.43. DCC has also explained that it has made some savings with respect to external and internal services. In particular DCC has reduced its forecast of the number of industry events it expects to host. It has also reduced its forecast of the use of capita communications support to manage communication and media requirements.

Our view on cost changes in the industry cost centre

1.44. Headcount transfers to other cost centres are for DCC to manage internally within the overall costs set out in the LABP.

1.45. We accept that DCC has responded to changing requirements in this area eg changing its engagement strategy with smaller customers. We also understand there has been positive feedback from users around DCC's level of external engagement. We recognise the benefits of the bilateral engagement with small suppliers, although in our view, DCC could have anticipated this at bid stage. We note that new scope costs for these bilateral activities have been offset by a decrease in the number of industry events.

1.46. Since the costs remaining in this cost centre are broadly in line with LABP we consider them to be economic and efficient. However, it is unlikely DCC would be entitled to any additional margin on the new scope costs in this cost centre, given the criteria in the licence with regards to new information becoming available.

Finance

1.47. The finance cost centre includes costs associated with:

- developing and applying the charging methodology; and

- managing the budget, forecast and billing aspects of DCC.

1.48. This function is also responsible for preparing the price control and annual performance reporting.

Description of cost changes

1.49. Over the course of the licence DCC is forecasting a 39% increase in the costs of the finance centre relative to LABP. In 2013/14 DCC's costs were £0.16 million higher than forecast in the LABP.

1.50. Since licence award the number of FTEs in the finance cost centre has increased markedly. There has therefore been a corresponding increase in payroll cost over the period of the licence. Over the term of the licence the finance payroll (and associated non-payroll and recruitment) costs are forecast to be £6.3 million higher than the LABP values. This is offset partially by a decrease in external services costs, as a result of using the credit rating service that is available to Capita rather than procuring external credit rating agency services.

1.51. DCC anticipates that staff numbers in this cost centre will double in 2014/15 compared to the position in 2013/14. Some of the change in FTE is driven by headcount transfer from other cost centres into finance. The remaining increase relates to underlying cost increases relative to LABP.

DCC justification for cost changes

1.52. DCC reports that the key driver of the increase in this cost centre has been the complexity and volume of the work involved. This included:

- More work than anticipated developing and publishing the charging statements and budgets

- Greater reporting and transparency requirements with regards to DCC costs and finance processes

- Development of the scope and processes of the RIGs

- Development of the charging methodology (for example the communications hub charging methodology is only being consulted on in SEC 4).

- Increased scope of the risk and internal control framework

- Effort required to define requirements for an appropriate billing system

- Greater than anticipated requirement for finance and billing team to engage with SEC parties.

1.53. To manage the additional challenges, DCC has recruited more staff and a higher calibre of staff with more experience than anticipated in the LABP. This process seems to have been driven by a review of the size and skill set required by the finance team. This has resulted in changes in both FTEs and salary packages.

1.54. In 2013/14, DCC also needed to recruit contractors on an interim basis in order to meet licence deliverables due within 3-6 months of awarding the licence. This was necessary due to delays in recruitment resulting from an extended recruitment process for more permanent staff.

1.55. In 2014/15, further new roles are being recruited to manage an effective risk and internal control framework, and to oversee the pricing strategy.

Our view on cost changes in the finance cost centre

1.56. We appreciate the complexity of the tasks carried out by the finance function and the increased level of engagement involved with industry. However, many of the issues described as new and unexpected challenges (for example, the development of charging statements, RIGs submissions and charging methodology) are similar to other regulated entities. Therefore to a certain extent these could have been anticipated by DCC when preparing its bid.

1.57. We consider DCC therefore had sufficient information to form reasonable expectations. There has not been any new information that has come to light between LABP and the price control that would justify the level of changes we have seen in this cost centre. We therefore consider there is a strong indication that DCC under estimated the amount of work required.

1.58. DCC’s assessment of the market value for posts in this function appears to be rather informal. We challenged DCC to explain how it ensures the finance function is both sized and paid at an efficient level. DCC informed us that it exercises its experience and knowledge and there is an internal sign-off process. However, any benchmarking undertaken by DCC is internally facing and DCC did not provide any evidence of its analysis.

1.59. We accept that DCC has had to create and fill additional posts in the finance team in order to fulfil its duties. Where these salaries are in line with salaries in the bid we consider the cost of these posts to be economic and efficient. However, we consider there are roles where salaries and the benefits packages have increased relative to LABP without justification. We have found these staff costs not to be economic and efficient and will disallow the additional cost.

1.60. It is reasonable that additional posts may be required during the start-up phase. However it is not clear that the same level of resource would be required once

DCC is operating in a steady state. We expect to consider this more closely at future reviews.

1.61. There is a strong indication that DCC underestimated the amount of work required. The risk of this type of cost inflation should have been reflected in DCC's bid margin. It is unlikely DCC would be entitled to any additional margin on the new scope costs in this cost centre, given the criteria in the licence with regards to new information becoming available.

Commercial

1.62. The commercial function leads the contract and commercial management of the fundamental service providers, evaluating services procured from Capita and additional contracts which require management, such as SMKI, Parse and Correlate. Commercial also oversees DCC's procurement strategy.

Description of cost changes

1.63. Over the course of the licence DCC is forecasting a 1.2% decrease in the costs of the commercial cost centre relative to LABP. In 2013/14 DCC's costs were £0.15 million lower than forecast in the LABP.

DCC justification for cost changes

1.64. Lower costs are primarily driven by transfer of the legal resource to corporate management. DCC also explained it had recruited an additional FTE in 2013/14 relative LABP which offset a small amount of other cost reductions.

1.65. Within the DCC forecasts from 2014/15 onwards there is a change in salary costs. This is due to longer lead times for the development of GBCS because of unforeseen complexity.

1.66. DCC has notified us that it is possible the number of staff in this cost centre will need to grow in future due to managing new contracts and to manage contract re-alignments, as well as changing definitions of DCC's relevant service capability. These will need to be justified if DCC incurs them.

Our view on cost changes in commercial cost centre

1.67. Overall DCC's cost forecasts remain below LABP. We consider costs at present to be economic and efficient, but we will closely scrutinise any further differences in salary and new FTEs.

Design and assurance

1.68. The design and assurance function leads the development and maintenance of DCC technical architecture and service design. It works closely with the FSPs. This function is responsible for technically assuring DCC services and overseeing the delivery and implementation of the test strategy and test approach.

1.69. DCC confirmed during the cost visit that its design and assurance role is primarily quality control. Each system is developed for the DCC by external developers and vendors (eg DSP, CSPs, SMKI, Parse and Correlate). These systems vendors have their own quality control, design and assurance functions. It is not DCCs role to duplicate these functions, but to ensure that external parties carry out their roles properly.

Description of cost changes

1.70. Over the course of the licence DCC is forecasting an 11.6% increase in the costs of the Design and Assurance function relative to LABP. In 2013/14 DCC's costs were £0.54 million lower than forecast in the LABP.

DCC justification for cost changes

1.71. DCC explained that changes are driven by the need for additional expert resource relative to LABP. As with other cost centres this has been due to changes to GBCS and new requirements from DECC.

1.72. DCC will also be required to manage simultaneous user integration testing for multiple users, rather than just two users as envisaged at licence bid stage. DCC has forecast additional roles on a contractor basis to support this increase in 2015/16.

1.73. DCC explained there has been some delay in the recruitment of permanent staff. This has resulted in some increases in staff costs due to hiring contractors on a short term basis.

1.74. Longer term, DCC has forecast additional FTEs over the licence term from 2016/17 onwards to increase the architect and testing resource. DCC has stated that this is assumption will be reviewed in subsequent forecasts.

Our view on cost changes in the design and assurance cost centre

1.75. There are numerous causes of changes in scope for this cost centre which are largely beyond the control of DCC. This is likely to cause changes in the cost base and until the requirements settle down it will be difficult to pin down the appropriate long term costs. Many of the roles required in the design and assurance function are technical and specialist in nature.

1.76. There are a number of roles where DCC has included forecasts for contractors over the longer term. Contractor rates are likely to be more expensive than securing these staff as permanent employees. DCC may have had to recruit by recommendation and use contractors to save time in the early stages. However this recruitment approach may not be best practice over longer horizons.

1.77. We will expect DCC to demonstrate more clearly in future that:

- there is no overlap in the costs and activities undertaken by DCC and the FSPs; and
- that the costs incurred by the FSPs and DCC are efficient overall.

1.78. If there is an increase in internal costs associated with testing and quality assurance, we might expect to see some demonstration of avoided external costs associated with these roles, or an improved ability to negotiate those costs downwards. Clearly this will also depend on DCC's ability to maximise value from its contractual arrangements with the FSPs.

1.79. Given the challenging context DCC has provided sufficient evidence to justify its costs this year. However we will continue to carefully assess any new additional costs that flow through as a result of re-planning, and this is likely to be a key area we focus on in 2014/15.

1.80. In future years we will expect DCC to provide evidence that changes in salary or benefits packages are competitive. We do not consider that recruitment by recommendation without external benchmarks is sufficient evidence of value for money.

Operations

1.81. The operations cost centre includes the cost of ensuring that DCC services meet the needs of all service users. This includes:

- designing and providing the day-to-day operational interface for service users;

- supporting the delivery of DCC services, including the consolidation of demand forecasting from service users;

- managing change processes and authorisations; and

- providing a first line service desk.

Description of cost changes

1.82. Over the course of the licence DCC is forecasting a 4.5% increase in the costs of the operations cost centre relative to LABP. In 2013/14 DCC's costs were £0.11 million lower than forecast in the LABP.

1.83. The cost reductions in 2013/14 were primarily due to the transfer of FTEs from the operations function into the finance function. Savings have been made due to a delay in roles starting. However, this saving was mostly offset by a change in the cost of overall salary packages due to the short-term use of contractors to fill the roles where permanent recruitment has been delayed.

1.84. Over the remaining years costs are forecast to increase relative to LABP. The biggest driver of this increase relates to increases in office equipment costs and WIFI capabilities.

1.85. Costs relating to the salary package of service desk agents have also changed relative to the LABP.

DCC justification for cost changes

1.86. DCC explained that forecasts of salary packages for the service desk have changed from the LABP because the roles will be more technical and skilled relative to LABP. This requirement became apparent after the bid stage, once DCC had greater interaction with and knowledge of service providers. Prior to this, DCC explained it had been difficult to fully define the service management solution.

1.87. Higher costs were incurred in 2013/14 as contractors were required due to the need to quickly get the function up and running. Additional consultants are also being hired next year to build the operating model for the service desk.

1.88. In terms of costs associated with office equipment and WIFI, DCC explained that it had experienced a larger number of external attendees at forums than it anticipated. DCC had to increase the WIFI capacity as the original WIFI capability couldn't handle the increased demand during these events.

Our position on cost changes in operations cost centre

1.89. We note that it is challenging to identify whether the additional levels of FTE and costs are efficient given the ongoing changes to the programme. The changes to service desk requirements have partially been driven through engagement with users. Getting this right is crucial for the roll out of smart meters.

1.90. At bid, DCC made a number of assumptions about the level of service desk capability and technical capability required. It may have underestimated the scope of these activities.

1.91. The FTE changes in 2014/15 are for temporary consultants and we therefore do not expect these higher costs to be included into the forecasts over the licence term, without evidence demonstrating this is the most economic and efficient option.

Security

1.92. The security team assures the security of all DCC systems. This involves establishing an information security policy, including security assurance standards, processes, procedures and implementation timescales. The team also maintains information security standards and certification throughout the licence.

Description of cost changes

1.93. Over the course of the licence DCC is forecasting a 6.5% increase in the costs of the Security cost centre relative to LABP. In 2013/14 DCC's costs were £0.15 million lower than forecast in the LABP.

1.94. DCC has informed us that it expects efficiencies in this cost centre in future due to an improved system for logging security incidents.

DCC justification for cost changes

1.95. DCC has explained that some roles will start earlier than anticipated to provide additional support to the team and service providers. DCC explained that salary packages have changed from the LABP for some roles in order to attract the right calibre of resource with the appropriate technical ability.

Our position on cost changes in security cost centre

1.96. DCC appears to be taking a prudent approach to choosing specific security solutions until the requirements for the security function becomes clear. This seems to be a sensible and efficient approach.

1.97. DCC state that salary packages are in line with market rates, but has provided no quantified evidence to support this. We propose to disallow increases relative to LABP where DCC has not provided sufficient evidence. We also propose to remove the difference in cost from the LABP associated with incorporating long-term contractors in the forecasts, as DCC needs to demonstrate their use is the most economic and efficient option.

Programme

1.98. The programme cost centre includes costs for coordinating delivery across the whole DCC ecosystem during the implementation phase. It will ensure that the services, systems, resources and assets are all in place in accordance with the programme plan. This will allow DCC to appropriately design and build activities to be completed to facilitate integration and subsequent user integration testing.

Description of cost changes

1.99. Over the course of the licence DCC is forecasting a 1.1% increase in the costs of the programme function relative to LABP. In 2013/14 DCC's costs were £0.92 million lower than forecast in the LABP. The majority of the costs in this cost centre relate to IT services costs.

1.100. We understand that in future some significant new scope costs (see below) will be allocated to the programme cost centre.

DCC justification for cost changes

1.101. DCC explained that it has faced new requirements, changes in scope and new timescales which have driven some changes in this cost centre. This has resulted in a re-phasing of IT costs across the licence term and some increases in FTEs and salaries.

1.102. DCC has had to recruit short-term contractors at higher rates to fill key roles until permanent employees can be recruited.

1.103. IT services includes a new billing system which DCC is now developing in-house. This has particularly been driven by the emerging charging methodology.

1.104. DCC anticipates making efficiency savings from this switch, compared to the original solution, although these savings are not yet incorporated in the regulatory cost forecasts. We expect to see further evidence of net benefits of the change in the billing system at the next review.

Our position on cost changes in programme cost centre

1.105. There are a number of differences in salary relative to LABP, some of which have not been sufficiently justified. In these instances we are disallowing the additional cost over the licence term.

1.106. There have been a number of developments that would have impacted this cost centre. This includes:

- changes to GBCS;
- clarification on the scope of SMKI; and
- changes to SEC requirements and SEC documentation.

1.107. There are also a number of areas where the level of activity will be known with greater certainty in the next reporting year – in particular the billing system changes. DCC must be transparent and must provide the total cost of the new billing system as soon as possible, so savings can be reflected in forecasts.

New Scope Internal Costs

1.108. DCC has forecast £28 million of new scope internal costs over the licence period. Review of new scope work

1.109. The main driver of new scope costs has been the procurement of several external service provider contracts, and in particular the SMKI contract. These were explicitly excluded from LABP, but have been procured competitively. We have scrutinised these costs and, since the contracts were competitively procured, we are allowing these costs as economic and efficient.

1.110. The costs for financial security and stability relate to requirements under the licence.[72] DCC must provide assurance that it will have sufficient financial stability to enable it to access sources of liquidity and capital on reasonable terms. We consented to arrangements put in place by DCC with Capita for these costs, [73] and looked at the costs as part of the review. We are allowing them as economic and efficient as part of this price control. However we will keep these arrangements under review in future, and look for efficiency savings with the costs associated with them.

1.111. We have also accepted DCC's justifications for other cost increases for:

- testing;
- architect;
- service management;
- industry;
- security; and
- procurement.

1.112. These increases have almost entirely been driven by the requirement for additional resource due to changes to the scope of DCC requirements that are outside its control.

1.113. We have also assessed salaries and staff costs for these additional FTEs and we have not found any which appear to be unreasonably high compared to similar

[72] Licence Condition 26
[73] We consented to these arrangements in December 2013.

existing roles in the LABP. We are therefore accepting the increased resource to meet the new scope of work as economic and efficient

1.114. We note that DCC incurred a financing charge in 2014. This was associated with the cost of obtaining working capital to cover start-up costs. The working capital was obtained from Capita and charged at a fixed rate. DCC informed us that the rate was the standard charge for Capita Group companies.

1.115. DCC required the working capital at short notice. As an organisation without a trading history, it might have been difficult to obtain a more competitive interest rate. We do not expect DCC to need to obtain working capital in the future. If it does we would expect DCC to explore a range of competitive rates.

Issues for future consideration

Productivity and real price effects

1.116. We intend to consider whether there is scope for introducing a productivity improvement factor into DCC's cost forecasts in future, similar to that used in the RIIO price controls. This may not be appropriate in the start-up years, however once DCC has settled into more of a steady state we expect to consider this issue further.

1.117. In principle we do not see any reason why DCC should not in future be expected to deliver productivity improvements over time. The network price controls have typically estimated productivity improvements of the order of 1% year-on-year. Productivity improvements may also need to be offset by estimates of future real price effects (RPEs). [74] We welcome initial views on how the methodologies that have been used for networks may be applied to DCC in future.

Improvements to benchmarking analysis

1.118. We want to understand further ways in which we might enhance our ability benchmark DCC. We would welcome views on:

- relevant comparators
- available data
- appropriate methodologies to undertake robust benchmarking of salaries, benefits packages and the scale of the DCC operation.

[74] Real price effects are allowances for the networks for above-inflation input cost increases, which would not be captured by the indexation of their price controls to the Retail Price Index. We would need to assess whether such allowances were also appropriate for DCC.

Output metrics

1.119. A central objective for the DCC's internal cost activities is to manage and reduce external costs borne by customers as far as possible. Therefore we may in future develop a metric to monitor this. Outputs may also be measured in terms of the volume of data flows processed by DCC. The development of the operational performance incentive regime will also inform our considerations of these metrics

External Costs Detailed Review

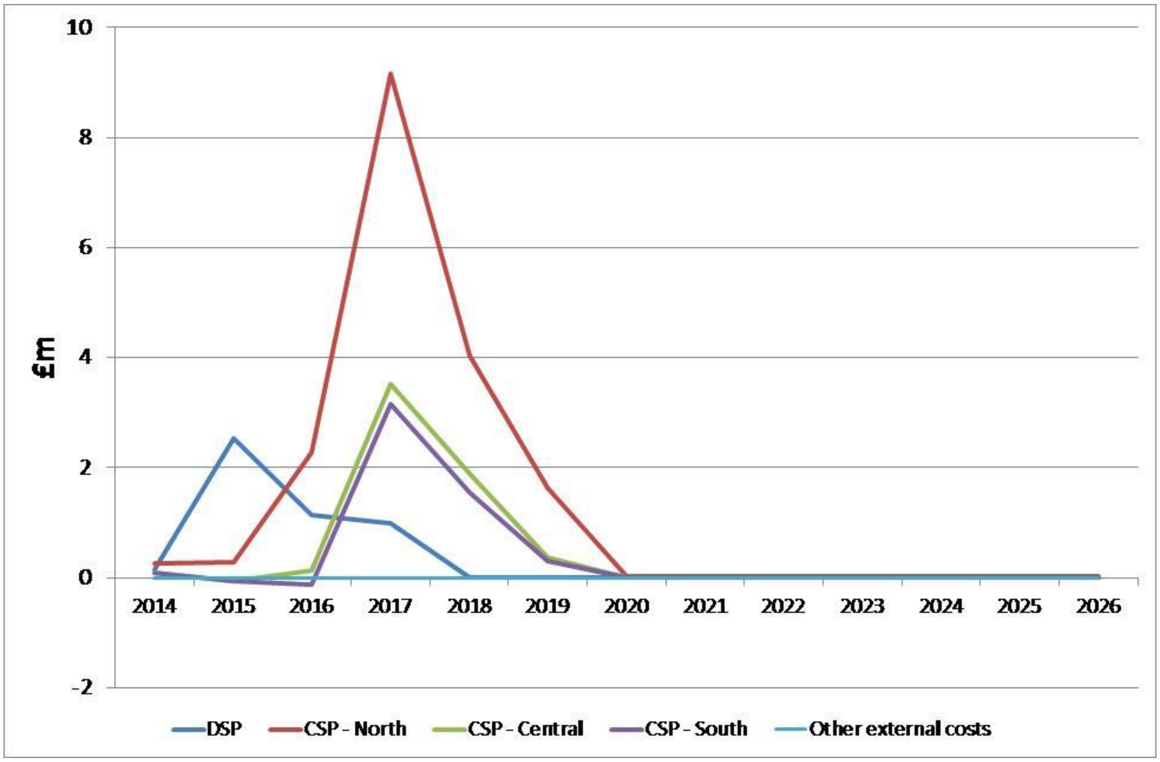
1.120. Table A3.6 below shows the increases in external costs relative to LABP over the full licence.

Table A3.6: External cost changes to LABP

Cost centre	Total increase relative to LABP £m	As a % of LABP
DSP	**4.8**	**6.4%**
CSP - North	**17.8**	**3.8%**
CSP - Central	**6.0**	**1.0%**
CSP - South	**4.9**	**1.0%**
Other	**0.0**	**-**
Total	**33.5**	**2.0%**

1.121. Figure A3.5 below shows the profile of these increases over time.

Figure A3.5: External costs relative to LABP over time



1.122. The total cost difference to LABP is an increase of £33.5 million over the licence period, which is a 2% external cost increase. DCC has reported these are entirely due to new scope costs, and there have been no changes to the baseline.

1.123. The main drivers for the change in cost were the longer lead times for GBCS; the changes that resulted from the version of GBCS 0.7; and the extension of coverage. These accounted for 97% of the changes. There were also additional costs related to impact assessments and other small items.

General Management of External Contracts

1.124. DCC reported it has undertaken its contract management role in respect to the fundamental service providers through establishing the governance and change control process. There has been no dispute resolution or audits undertaken of the contracts. DCC will report next year on the exit plans, updated business continuity and disaster recovery plans of the fundamental service providers.

1.125. The contracts contain a number of "value for money provisions" that should enable DCC to efficiently manage the fundamental service providers.[75] In 2013/14 these provisions were not exercised for the following reasons:

- **Benchmarking reviews:** These cannot be undertaken until 3 years after the effective dates of the contracts.
- **Gainsharing:**[76] There were no gainshare opportunities identified by DCC or service providers in 2013/14.
- **Refinancing gainsharing:** The CSPs have set up the finance arrangements for the first tranche of communication hubs. They have not yet investigated any new refinancing arrangements.
- **Non-mandatory activities:** During 2013/14 there were no requests for DCC approval of the use of relevant assets for providing non-mandatory activities.
- **Financial audit:** DCC did not conduct financial audits during 2013/14 as the service provider contracts only been running for three to four months. DCC expects to carry out audits in 2014/15.

DCC justification for the changes in external costs

1.126. The additional costs for the impact assessments and for project work were compiled in accordance with the terms of the service provider contracts.[77] DCC analysed each quotation, assessing:

- technical viability;
- whether the estimated days were efficient; and
- whether the correct day rates from the rate cards[78] were applied.

1.127. Where roles were needed that were not covered by rate cards DCC agreed additional rates and benchmarked these with other external consultants.

[75] Schedule 7.3 in contracts sets out the main value for money levers these are benchmark reviews, gainsharing mechanism, refinancing mechanism, non-mandatory activities, financial audit.
[76] Gainsharing is where service providers are able to implement efficiency improvements or through implementation of other changes costs of delivering services is reduced. The cost savings would be shared.
[77] Schedule 8.2 in each contract sets out the change management process.
[78] The rate cards detailed agreed day rates under the service provider contracts.

1.128. A complete version of the GBCS was expected in December 2013, but it was not available until July 2014. This had consequences for the date set for initial live operations, which was expected in Q3 2015. DCC undertook a re-planning exercise, assessing options of delay and cost with Service Providers. DCC consulted SEC parties in April 2014 and concluded that the preferred option was to mitigate the delay to Q4 2015. DCC's change control process reduced the cost of the delay by 29% through revising assumptions relating to testing, resource, risk, and operational charges.

1.129. GBCS version 0.7 contained changes that impacted the service providers. It changed the message formats and structures for the DSP, and had implications for the communications hubs for the CSPs. DCC concluded the changes were required to comply with SEC documents. DCC scrutinised and challenged the cost models, and the day rates were in line with the rate cards. Through this process DCC secured a reduction in the costs proposed by one of the CSPs.

1.130. During contract finalisation a change request was raised to extend the coverage for one of the CSP's. DCC reviewed the cost model and assessed the cost benefit analysis concluding benefits outweighed costs.

Appendix 4 – Further information on our initial benchmarking analysis

1.1. This appendix provides more detail of the initial external benchmarking we have undertaken. Since this is DCC's first price control review, a substantial part of our assessment has been to obtain a detailed understanding of DCC's costs and activities. As required by the licence we have also reviewed DCC's outturn costs and revised forecasts in comparison with the LABP. This has been our primary tool for comparative assessment.

1.2. We identified some increases in salaries and staff costs relative to LABP. DCC's justification of these tended to not include quantified comparisons with external benchmarks. We are interested in developing a robust external benchmarking methodology that is suitable for DCC to inform our decisions for future price control reviews. In particular, where salaries increase above the LABP in future, DCC will need to provide evidence that these increases are competitive.

1.3. We accept that it is difficult to obtain like-for-like comparators for the more specialist activities DCC undertakes, and the more technical roles and skills it requires. Given the challenges, and the fact that this is an early stage assessment, we have not used this external benchmarking analysis to mechanistically determine cost disallowances. However, the analysis has informed our proposals.

1.4. We invite DCC and other stakeholders to consider other ways we might seek to benchmark the DCC, both at this review and in future.

1.5. We discuss in turn:

- Benchmarking salaries and benefits packages; and
- Assessing the scale of DCC operations.

We have investigated two possible avenues of external benchmarking of DCC's payroll costs:

- Comparison of DCC salaries with similar job roles using ONS ASHE data
- High-level tests of the scale of operation, focusing on finance and corporate management functions.

We have been unable to use more sophisticated benchmarking techniques (eg econometric approaches) at this stage since we do not have sufficient data available yet. We have used our benchmarking as a sense-check for our conclusions drawn on the basis of comparing DCC's costs with LABP.

Salaries and benefits

1.6. Our primary comparator for salaries and bonuses was the Annual Survey of House and Earnings (ASHE) data provided by the Office for National Statistics (ONS).

1.7. ASHE is based on a 1% sample of employee jobs which is drawn from HM Revenue and Customs Pay as you Earn (PAYE) records. It collects information on the levels, distribution and make-up of earnings and hours paid. Results are produced for various industrial, occupational and geographic breakdowns, as well as by public and private sectors and age groups.

1.8. At the time we undertook our assessment, the available ASHE data for the year 2013 was provisional data, meaning the latest confirmed data was for the year 2012. The ONS has recently published finalised figures for 2013 and provisional figures for 2014. We will update our assessment using this new data for the Final Determination.

1.9. The salaries published in ASHE are in nominal terms ie in the price base of the year. We have therefore made inflation adjustments to the wage data to bring it in line with the DCC reported price base, using the Retail Price Index (RPI).

1.10. We use ASHE data to inform benchmarking in the RIIO price control reviews. For the energy networks the data is used to understand regional variations in wages for the purposes of comparing the networks on a like-for-like basis. In the context of DCC, we have used the absolute levels of earnings in the ASHE database to compare with the salaries DCC is paying to its staff. We are therefore using this data for a different purpose and in a different way than the RIIO controls.

1.11. To assess like-for-like salaries we undertook a detailed mapping exercise to align standard occupational classification (SOC) codes[79] in the ASHE data to DCC data on roles and salaries. DCC provided us with a breakdown of its salary costs into director, senior manager, manager base grade and assistant. We used our understanding of the nature of the roles within these grades to align them to SOC codes.

1.12. We compared DCC salaries to the ASHE data across a number of dimensions:

- We compared DCC costs to the mean, median and percentiles of the ASHE data;

[79] The Standard Occupational Classification (SOC) is a common classification of occupational information for the United Kingdom. It is used to classify workers into occupational “categories” which are differentiated in terms of their skill level and skill content.

- We looked at London and national wages; and

- We used both the confirmed ONS 2012 data and the provisional 2013 data.

1.13. We also assessed ONS SOC codes at the 1-digit, 2-digit and 4-digit level. The more disaggregated approach potentially allowed for closer alignment of roles.

1.14. In general, DCC's salaries appeared to be higher than our generated benchmark at the higher staff grades within DCC. At the lower grades DCC salaries appeared to be at or below the ASHE data. We tested this analysis across a range of different assumptions and using different cuts of the data and the conclusions were broadly consistent.

1.15. The fact that there are a number of specialist activities and technical roles is likely to explain at least some of the performance of DCC against these benchmarks. We recognise that it is difficult to calculate a completely like-for-like comparator set.

1.16. For these reasons, we have not used this analysis as a basis for mechanistically calculating cost disallowances. However, the assessment does indicate that there are reasonable grounds to require DCC to provide robust evidence for increases in the level of salaries. The analysis therefore supported our decision to disallow some costs on the basis of our comparison to LABP. The external benchmarking did not alert us to the possibility that we should not disallow costs.

1.17. In future, DCC needs to provide evidence that changes in salary costs above the LABP baseline are competitive and comparable to external benchmarks. We expect DCC to provide us with more justification of the value for money of changes to its salary benefits package, and we expect to scrutinise these costs closely in future.

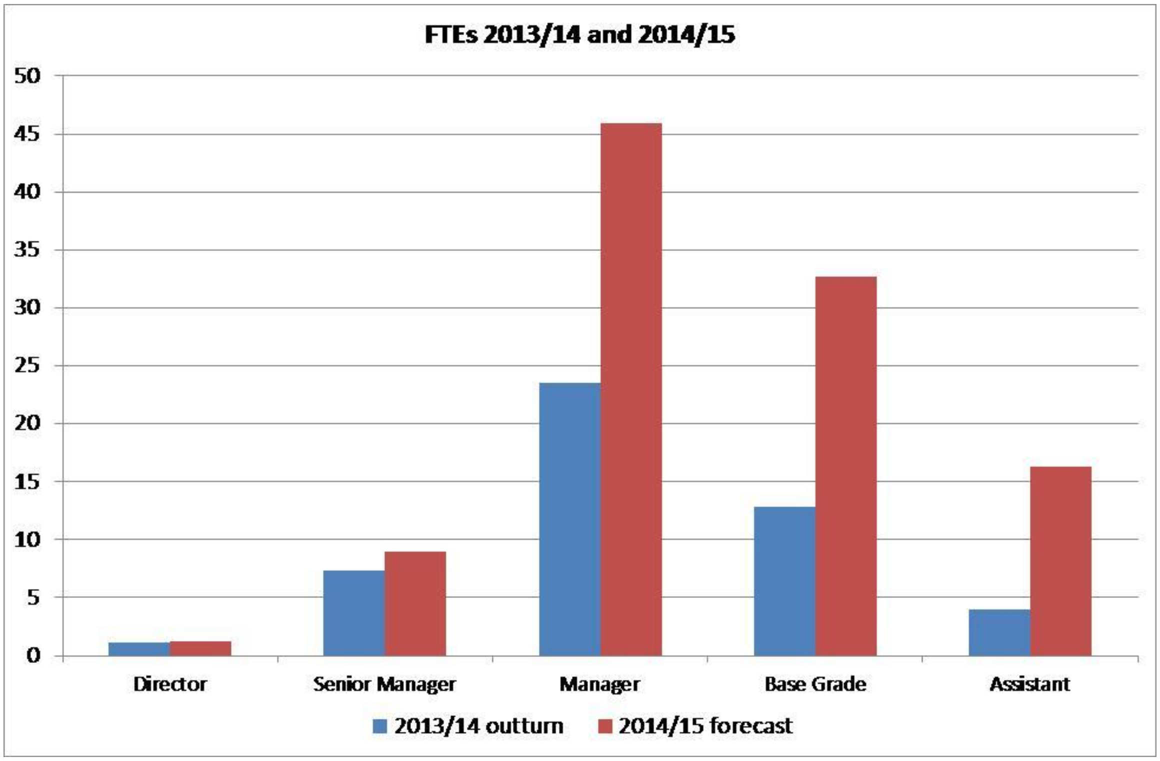
Assessing the scale of DCC operations

1.18. One of the themes running through DCC's regulatory submissions is that FTE increases have been required to meet the additional demands and complexities of DCC's scope of operation.

1.19. It is important DCC does not increase the scale of its operation beyond what is necessary and efficient. While we accept that the changing operating environment will drive some changes, DCC needs to demonstrate that the scale of operation is appropriate.

1.20. Figure A4.1 below shows outturn FTEs for DCC in 2013/14, and DCC's forecast for FTEs next year, by staff grade.

Figure A4.1: DCC FTEs by grade



1.21. While DCC has a number of unique costs and activities, there are some fairly standard activities which could be suitable for benchmarking. These include:

- Overheads including HR, IT support etc
- CEO and corporate management costs
- Finance, billing and procurement-type activities.

1.22. We would welcome views from respondents as to sources of data and potential comparators for these sub-sets of DCC costs.

Appendix 5 – DCC updated forecasts

The table below compares the LABP forecasted cost, with those reported under the price control, and the forecasts adjusted for our proposals.

£m	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	Total
LABP (AR)	14.8	28.7	85.6	99.0	126.3	151.8	187.5	217.1	221.2	218.2	224.3	231.6	98.0	1904.0
AR reported in 2013/14	13.5	35.9	93.9	119.0	136.9	158.5	189.5	220.1	224.3	220.7	225.4	233.2	98.6	1969.5
Reductions														
Salaries	0.101	0.147	0.147	0.122	0.120	0.120	0.120	0.120	0.114	0.112	0.112	0.112	0.047	1.5
Contractors	0.000	0.089	0.089	0.080	0.071	0.071	0.071	0.071	0.071	0.071	0.071	0.071	0.030	0.9
Shared services		0.358	0.199	0.179	0.179	0.179	0.179	0.171	0.171	0.079	0.033	0.040	0.020	1.8
IM5	0.315													
Total Reduction	0.416	0.633	0.435	0.382	0.370	0.370	0.370	0.362	0.356	0.262	0.216	0.223	0.096	4.5
Adjusted forecast AR	**13.1**	**35.3**	**93.5**	**118.6**	**136.6**	**158.1**	**189.1**	**219.8**	**223.9**	**220.4**	**225.2**	**233.0**	**98.5**	**1965.0**

Appendix 6 – Allowed Revenue

1.1 This appendix provides an explanation of DCC's allowed revenue.

1.2 Allowed revenue is defined in licence condition 36[80] and is the total revenue DCC is entitled to. It is calculated using the following formula:

$$ARt = ECt + ICt + PTCt + BMt + BMPAt + ECGSt - VASCt + Kt$$

1.3 Where for the regulatory year being reported (t):

Term	Definition
AR	Allowed revenue
EC	External cost
IC	Internal cost
PTC	Pass through cost
BM	Baseline margin
BMPA	Baseline margin adjustment
ECGS	External gain share
VASC	Value added services contribution
K	Correction factor

1.4 Table A6.1 provides a breakdown of the charging statement and compares it to the costs reported in 2013/14.

Table A6.1: Charging statement compared to costs actually incurred, 2014

Estimated fixed revenue by category RY2013/14		**Charges (£m)**	**Reported (£m)**
Internal	Baseline Costs	12.8	12.8

[80] Allowed revenue is defined in the RIGS in part 4.

Cost	Changes baseline	-0.2	-1.5
	Changes new scope		0.6
	Re-phasing	1.9	-1.9
Baseline margin		2	1.8
External cost	Baseline	0	0
	Changes	0	0.6
Pass through costs (SECCo costs)		1.5	1.2
Prudent Estimate		1.3	-
Revenue		19.3	13.5

1.5 The following components were listed by DCC in its reporting as contributing to the DCC's correction factor:

- **Changes in internal cost (-£1.5 million):** as a result of the delays explained in the cost assessment (chapter 4).
- **Re-phasing of internal cost from 2014/15 (-£1.9 million):** DCC anticipated costs of the billing system would materialise in 2013/14 rather than in 2014/15 as set in the LABP. However, it decided to look at other options for the billing system and this was not finalised in 2013/14.
- **Changes to the baseline margin (-£0.2 million):** DCC realigned the values in the licence for the BM[81] to reflect the later licence award date.
- **External costs (+£0.6 million):** No external costs were anticipated in 2013/14. However these costs were incurred as a consequence of the changes to GBCS and re-planning.
- **Pass-through costs (-£0.3 million):** The SECCo Ltd[82] budget was finalised after DCC set its charges. The SECCo costs were lower than anticipated and a credit note was received in April 2014.
- **Prudent Estimate (-£1.3 million):** This reflects the prudent estimate DCC includes in its charging statement.
- **Increase in the number of mandated smart metering systems (-£0.2 million):** The estimated number of meters in the charging statement was 100,498 million, but the average number invoiced was 100,866 million.

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[81] https://www.gov.uk/government/publications/modifications-to-the-smart-energy-code-and-the-smart-meter-communication-licences-smart-meters-no-2-of-2014

- **Changes to internal costs in LABP (-1.1million):** This reflects the re-alignment of the internal costs to reflect the later licence award date.[83]

[83] The charges set in the statement were based on a licence award in August 2013 however the licence was not awarded until September 2013.

Appendix 7 - Glossary

A

Allowed Revenue
Total amount of revenue determined on an accruals basis in relation to each regulatory year in accordance with the Principal Formula set out in Part C of Condition 36 after the deduction of value added tax and any other taxes.

Annual Survey of House and Earnings (ASHE)
Annual survey that provides fata on levels, distribution and make-up of earnings and hours worked for UK employees by sex and full-time/part-time status in all industries and occupations

Authority
The Gas and Electricity Markets Authority

B

Baseline Margin
In each Regulatory Year an amount of additional revenue, over and above the sum fi the Licensee's Internal Costs and External Costs, that the Secretary of State has agreed shall be included in the Licensee's Allowed Revenue, and is determined in accordance with the provisions of Part C of Condition 36.

Baseline Margin Implementation Performance Adjustment
The amount of reduction in the Baseline Margin determined in accordance with the provisions of Part B of Condition 38.

Baseline Margin Implementation Total
The Licensee's Baseline Margin, in total, for the period running from 23 September 2013 until the end of the Regulatory Year in which completion of implementation occurs.

C

Communications hub
A Device which complies with the requirements of CHTS and which contains two, logically separate Devices; the Communications Hub Function and the Gas Proxy Function.

Communications Service Provider (CSP)
Bodies awarded a contract to be a service provider of the DCC's communications services. Arqiva Limited and Telefónica UK Limited have been appointed to provide these services.

D

Data and Communications Company (DCC)
This is a company that manages the data and communications to and from domestic consumers' smart meters

Data Services Provider (DSP)
Body awarded the contract to deliver systems integration, application management and IT hosting services to the DCC. CGI IT UK Limited has been appointed to provide these services

Department for Energy and Climate Change (DECC)
The UK government department responsible for energy and climate change policy

E

External Costs
As defined in licence condition 35 of the smart meter communication licence. The fundamental service capability predominately comprises of the communication service providers (CSP) and the data service providers (DSP). This definition means that costs associated with other externally procured contracts, for example the Smart Metering Key Infrastructure (SMKI) contract are reported under internal costs.

F

FTE
Full Time Equivalent

G

Gainsharing
Gainsharing is where Service Providers are able to implement efficiency improvements or through implementation of other changes costs of delivering services is reduced. The cost savings would be shared.

Great Britain Companion Specification (GBCS)
The GBCS describes the detailed requirements for communications between Devices in consumers' premises, and between Devices and the Data and Communications Company (DCC).

H

HMRC
Her Majesty's Revenue and Customs - the tax authorities in the UK.

I

Internal Cost
Costs (excluding external costs and pass-through costs) that were economically and efficiently incurred by the Licensee for the purposes of the provision of Mandatory Business Services under or pursuan to the SEC

L

Licence Application Business Plan
The plan submitted in the course or as a consequence of the licence application process. It contains estimates of revenues, costs, capital investments and cash flows for each regulatory year of the Licence Term, and was taken into account by the Secretary of State in determining the grant of the Licence.

R

Regulatory Instructions and Guidance (RIGs)
Provide the basis on which the licensee must report price control information as required under the Smart Meter Communication Licence.

Regulated Revenue
The actual revenue in a regulatory year, measured on an accruals basis received by the Licensee through Service Charges that are levied in accordance with the provisions of Condition 18.

Relevant Services Capability
The internal and external resources which the DCC relies upon in order to provide services to DCC Users

S

Smart Energy Code (SEC)
The SEC is a new industry code which is a multiparty agreement which will define the rights and obligations between the Data and Communications Company (DCC) and the users of its services Suppliers, network operators and other users of the DCC's services who will all need to comply with the Code

SECCo
A company established under the SEC, owned by SEC Parties and which acts as a contracting body for the SEC Panel.

SEC Panel
Panel established to oversee the Smart Energy Code with powers and duties as set out in Section C of the SEC.

Service Charges
The charges levied by and payable to DCC in connection with the operation or provision of Mandatory Business Services under or pursuant to the SEC

Shared services
Support services sourced from the licensee's parent company and covered by the Shared services charge under Section 3.3.1 of the Business Plan. The terminology used in the RIGs is shared services but this charge covers corporate overheads.

Smart Meter
Smart meter is a meter which, in addition to traditional metering functionality (measuring and registering the amount of energy which passes through it) is capable of providing additional functionality, for example two way communication allowing it to transmit meter reads and receive data remotely. It must also comply with the technical specification set out by the Smart Metering Programme.

Smart Meter Communication Licence
The Smart Meter Communication Licences granted pursuant to Sections 7AB(2) and (4) of the Electricity Act 1989 and Sections 6(1A) and (1C) of the Gas Act 1986.

M

Mandatory Business Costs
Costs associated with the Authorised business of that consists of the operation or provision, on behalf of or to SEC parties, of Mandatory Business Services under pursuant to the SEC.

O

Ofgem
Office of Gas and Electricity Markets

ONS
Office for National Statistics

P

Pass-Through Costs
The amount equal to the total amount fee paid by the licensee to the Authority and the payments to SECCo Ltd for purposes associated with the governance and administration of the SEC.

Appendix 8 - feedback questionnaire

1.23. Consultation is at the heart of good policy development. We're keen to consider any comments or complaints about the way we've conducted this consultation. We'd particularly value your answers to these questions:

1. Do you have any comments about the overall process for this consultation?
2. Do you have any comments about the tone and content of the report?
3. Was the report easy to read and understand? Could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?

1.24. Please add any further comments and send your response to:

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