Decision

DCC Price Control: Regulatory Year 2020/21

Subject	**Decision**
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The Data Communications Company (DCC) is required to report Price Control Information by 31 July each year. It must report in accordance with the Regulatory Instructions and Guidance that we publish.

Each July, DCC can also propose an adjustment to its Baseline Margin (BM) and External Contract Gain Share values (ECGS). We assess these proposals and determine whether any adjustments are justified.

In October 2021, we consulted on our proposals following a review of the report and information submitted by DCC in July 2021 for the Regulatory Year from 1 April 2020 until 31 March 2021.

This document sets out our decisions and the reasons for them on the costs DCC reported under its price control for the Regulatory Year 2020/21 and its application to adjust the Baseline Margin and External Contract Gain Share values under the Licence.

Alongside this document we have published notices of our Price Control Decisions and Determinations and Directions relating to the calculation of Allowed Revenue set out in the Price Control Conditions in the Licence.

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Executive summary

DCC has an essential role to play in the energy market. It is important that DCC receives sufficient funds to perform its role, and it is equally important that we hold DCC to account for delivering value for money and high-quality services. Through the price control, Ofgem is seeking to ensure that DCC continues to be able to make the required investments to deliver a good quality of service, whilst also focusing the organisation on delivering an efficient operation.

These are our final determinations for the DCC price control for the regulatory year 2020/21 (RY20/21). Our decisions reflect our conclusions on the economic and efficient level of costs incurred in RY20/21 and in the cost forecasts; DCC's performance under the Operational Performance Regime (OPR); and adjustments to the Baseline Margin (BM) values set out in the licence and the External Contract Gain Share (ECGS) term. Our final determination follows from our assessment and October consultation on DCC's costs and performance; and takes into consideration stakeholder views we have received in response to the consultation.

Cost Assessment

Overall, DCC's total reported costs for RY20/21 are £628.4m. This is a 21% increase in total costs compared to last year's forecasts. Over the Licence term (RY13/14-RY25/26), total costs are now forecast to be £4.4bn, 10% greater than last year's forecast.

After considering all consultation responses, including from DCC, we have determined a total of £1.16m incurred Internal Costs in RY20/21 (including the associated shared service charge) as Unacceptable.[1] Our determination on Unacceptable Costs comprises expenditure on inefficiencies in contractor benchmarking; costs associated with recruitment of new roles in Commercial and Operations cost centres; application of Shared Service Charge; and growth of the strategy and product management team in DCC's corporate management cost centre.

In our decision, we have taken account of additional evidence provided by DCC as part of its consultation response to justify some of the costs associated with the recruitment of

[1] As per Licence Condition 37.8(a) of the *Smart Meter Communication Licence* (or 'DCC Licence'). https://epr.ofgem.gov.uk/Content/Documents/Smart%20DCC%20Limited%20-%20Smart%20Meter%20Communication%20Consolidated%20Licence%20Conditions%20-%20Current%20Version.pdf

executive roles and benchmarking of contractor roles and accordingly have partially reduced the disallowance amount from our consultation position.

In addition, we have determined a total of £45.74m (including the associated shared service charge) in forecast Internal Costs and £24.73m in forecast External Costs as Unacceptable for RY21/22 and RY22/23 due to the level of uncertainty and insufficient justification. We have also determined a total of £181.28m increase in forecast Internal Costs (RY23/24 onwards) and £65.47m increase in forecast External Costs (RY23/24 onwards) as Unacceptable. DCC has not justified these costs, and we consider these costs are not sufficiently certain to include in DCC's future Allowed Revenue.

We encourage DCC to take steps to improve its forecasting and provide clear and transparent cost forecasts for its customers and as part of the price control. As DCC matures, we would expect DCC to be in a position to forecast with more certainty, and to be able to justify costs further into the future.

Performance Incentives

All of DCC's BM (which includes adjustments) is at risk against one of DCC's performance regimes. This was the third year in which DCC's performance was assessed under the Operational Performance Regime (OPR) and Baseline Margin Project Performance Adjustment Scheme (BMPPAS).

We have considered the responses received and our consultation position remains unchanged. DCC will retain its full baseline margin as it met all targets under the OPR.

As there were no Projects to be assessed under the BMPPAS for RY20/21, there are no decisions to be made.

We also provide an update on the implementation of the revised OPR. Under the revised OPR, DCC's customer engagement and contract management will be financially incentivised. As part of the trial run in RY20/21, we received submissions from both DCC and SEC Panel on DCC's performance during RY20/21. Based on the submissions received we recommend a score of 1.17 for this trial period. We also proposed to implement the contract management incentive over RY21/22 with margin attached. Following consideration of the consultation responses our positions remain unchanged.

Switching

Separately to the BM, DCC receives margin on the Switching Programme, which is at risk under a separate performance regime. We have considered responses and our position remains unchanged. All forecast costs beyond RY22/23 to the end of the licence period will be disallowed due to a lack of justification for these costs.

The second and third of the delivery milestones under the Design, Build and Test Phase of the Switching Programme occurred this year in RY20/21. DCC will retain 100% of margin associated with these milestones as all targets were achieved. The final values these milestones represent in terms of margin retained will be finalised when the Design, Build and Test Phase concludes.

Baseline Margin

The BM adjustment mechanism was included in the Licence to recognise the uncertainty and risk of DCC's Mandatory Business over time. It is intended to ensure that DCC is compensated for material changes in certain aspects of its Mandatory Business under the Licence.

DCC applied for a £15.33m adjustment to its BM for RY20/21 to RY22/23 for increases in the volume and complexity of work caused by both new drivers and drivers previously identified by DCC. Following consideration of the consultation responses, we have decided to maintain our consultation position. We have, however, adjusted the BM to reflect changes to Internal Costs disallowances. We have directed a reduced adjustment of £7.29m to reflect:

- the price control decisions on Unacceptable Costs
- parts of DCC's application, where we have not seen sufficient evidence of a material change that could not have been foreseen, or for which the driver does not appear to meet the conditions in the Licence.

External Contract Gain Share

The DCC Allowed Revenue formula includes an ECGS term that allows for an upward adjustment to DCC's revenue in recognition of a reduction in External Costs that DCC helped achieve. Between RY15/16 and RY20/21, DCC secured cost reductions of around £155m in External Costs based on DCC's ECGS applications and brought benefits including this year's application of £83.48m (54% of total cost reductions) to DCC's customers through lower charges.

DCC applied to adjust this term for RY21/22 to RY25/26 reflecting a reduction in External Costs as a result of savings from refinancing and its in-house Test Labs service. Following consideration of consultation responses and the additional evidence provided by DCC, we have changed our position. We have decided not to fully reject the savings from DCC's in-house Test Labs Service. We have, however, recalculated these savings and awarded a partial ECGS Adjustment for Test Labs of £2.96m. The total awarded ECGS Adjustments amounts to £13.50m.

Allowed Revenue Decision

Our decisions on the various components outlined above results in a total Allowed Revenue over the entire licence period of £3.92bn (including pass-through costs). Please see Appendix 1 for Allowed Revenue as proposed by DCC and the impacts of this year's decision.

1. Introduction

Context

1.1. DCC is the central communications body licensed 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. Under the DCC regulatory framework,[2] we have a role in ensuring that DCC's costs are incurred economically and efficiently. We review DCC's costs and performance after the end of the Regulatory Year in which the costs were incurred, as well as forecast costs that DCC deem certain enough to include in its forecast Allowed Revenue. This approach is referred to as an 'ex-post' price control. DCC must submit price control information by 31 July following each Regulatory Year in line with the Regulatory Instructions and Guidance (RIGs).[3] Price control reporting covering the Regulatory Year from 1 April 2020 until 31 March 2021 was submitted on 31 July 2021.

1.3. Over the licence term the majority of DCC costs are incurred by its Fundamental Service Providers (FSPs), comprising of the Communication Service Providers (CSPs) and the Data Service Provider (DSP), who are responsible for delivering the data and communications services to support smart metering, and were appointed through a competitive tender process. 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. The costs incurred by the FSPs are referred to as External Costs within DCC's allowed revenue.

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[2] *Smart Meter Communication Licence.* https://epr.ofgem.gov.uk/Content/Documents/Smart%20DCC%20Limited%20-%20Smart%20Meter%20Communication%20Consolidated%20Licence%20Conditions%20-%20Current%20Version.pdf

[3] Ofgem (2021), *Data Communications Company (DCC): Regulatory Instructions and Guidance*. www.ofgem.gov.uk/publications/data-communications-company-dcc-regulatory-instructions-and-guidance-2021

1.4. All other costs incurred by DCC in relation to the provision of the service are either Internal Costs, Pass-Through Costs,[4] or costs associated with the Centralised Registration Service.[5]

1.5. In each Regulatory Year an amount of additional revenue, over and above the sum of the Internal Costs and External Costs is included in the Allowed Revenue – this is the BM. Each July, DCC can propose an adjustment to its BM values. We assess this proposal and determine whether to adjust the values agreed when the Licence was awarded. DCC's BM is at risk against its performance, previously under the Implementation Performance Regime (IPR), and now against the OPR and government directed Project Performance Regimes. We determine the outcome of this performance as part of our price control assessment.

1.6. Separately, DCC receives a percentage margin on the Switching Programme. This margin is subject to a separate performance regime.

1.7. DCC also submitted an application to amend the ECGS term of its Allowed Revenue following External Cost savings. The ECGS is a mechanism within the price control for DCC to apply to increase its Allowed Revenue recognising its instrumental role in reducing External Costs.

Our decision-making process

1.8. The DCC price control process can be viewed in the wider context of helping to achieve Ofgem's key priorities:[6]

- energy consumers receiving good value energy services
- to minimise costs, increasing levels of flexibility throughout the system, with energy consumers routinely using smart technology to shift demand

[4] Principally, the cost of the Alternative HAN Company and the Smart Energy Code administration secretariat.
[5] Centralised Registration Service refers to the Switching programme.
[6] For more details, see: *Our Strategy and Priorities*. www.ofgem.gov.uk/about-us/our-strategy-and-priorities

- a data-enabled energy sector, with ubiquitous smart metering and open access to data stimulating new services and markets whilst reducing costs.

1.9. As required by the DCC Licence,[7] our assessment of DCC costs is grounded in comparing DCC's incurred costs and revised forecast with DCC's Licence Application Business Plan (LABP) and the previous year's forecast. Our guidance document[8] sets out the approach in detail and the information we expect to be provided with to enable us to determine whether DCC's costs are economic and efficient.

1.10. We published a consultation in October 2021[9] with our detailed proposals concerning RY20/21, and conducted a stakeholder meeting on the consultation in December 2021. This document sets out our decisions on DCC's:

- incurred and forecast External Costs and Internal Costs for RY20/21 (Section 2 and Section 3)
- performance under the Operational Performance Regime (OPR) (Section 4)
- application for an adjustment to its Baseline Margin (Section 5)
- application for an adjustment to External Contract Gain Share (Section 5)
- performance under the Switching incentive regime (Section 6).

1.11. We received 12 responses in total, one of which was confidential. All non-confidential responses are published on our website.[10] We have fully considered all responses received to our consultation. We have summarised the key points received from the consultation and provide an explanation of the reasons for our decisions.

[7] Licence condition 37 of the *Smart Meter Communication Licence*
[8] Ofgem (2021), *DCC Price Control Guidance: Processes and Procedures*. www.ofgem.gov.uk/publications/dcc-price-control-guidance-processes-and-procedures-2021
[9] Ofgem (2021), *DCC Price Control Consultation: Regulatory Year 2020/21.* www.ofgem.gov.uk/publications/dcc-price-control-consultation-regulatory-year-202021
[10] Please refer to the subsidiary documents of the consultation. www.ofgem.gov.uk/publications/dcc-price-control-consultation-regulatory-year-202021

1.12. Please note that we may provide feedback to DCC directly on the detailed points it raised in its consultation response.

1.13. A Notice of our price control decision, determinations and directions accompanies this document. We also include a Notice providing DCC with a direction so that it can reflect our decisions in its next Charging Statement.

1.14. For further context to these decisions, please read this document alongside our October 2021 consultation on the RY20/21 Price Control. The consultation document describes how DCC's costs have changed since the previous year and outlines our view on whether we think DCC's explanation in its price control submission justifies the cost variances. It also summarises our proposals on whether to accept DCC's application to adjust the BM and ECGS terms.

Related Publications

1.15. The 2020/21 Price Control Consultation Document is at: www.ofgem.gov.uk/publications/dcc-price-control-consultation-regulatory-year-202021

1.16. The DCC Regulatory Instructions and Guidance 2021 is at: www.ofgem.gov.uk/publications/data-communications-company-dcc-regulatory-instructions-and-guidance-2021

1.17. The DCC Price Control Guidance: Processes and Procedures 2021 is at: www.ofgem.gov.uk/publications/dcc-price-control-guidance-processes-and-procedures-2021

1.18. The DCC Licence is at: https://epr.ofgem.gov.uk/Content/Documents/Smart%20DCC%20Limited%20-%20Smart%20Meter%20Communication%20Consolidated%20Licence%20Conditions%20-%20Current%20Version.pdf

Your feedback

1.19. We believe that consultation is at the heart of good policy development. We are keen to receive your comments about this report. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall quality of this document?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Are its conclusions balanced?
5. Did it make reasoned recommendations?
6. Any further comments?

Please send any general feedback comments to smartmetering@ofgem.gov.uk

2. External costs

Section summary

Respondents' views on our assessment of DCC's External Costs were mixed. Most stakeholders disagreed with our proposal to accept DCC's incurred external costs as economic and efficient. Concerns were raised over continued year-on-year increases in overall external costs, DCC's accountability for perceived inefficiencies in contract management, and the sub-optimal levels of service received by DCC customers, with a particular focus on ongoing issues in the North Communication Region.

We note the concerns raised; however, we consider that DCC has provided sufficient evidence to justify the incurred variance in external costs, including evidence of its approach to negotiate better deals, challenge its providers on the costs of individual change and project requests, and achieve acceptable commercial outcomes. We outline expectations on DCC to make improvements and to incentivise DCC's key capabilities, we are also introducing all three elements of the revised Operational Performance Regime (OPR) from 1st April 2022.

Our proposals to disallow DCC's forecast costs associated with DSP UIT and SMETS1 FOC service received broad support. Upon receiving additional evidence from DCC, we have decided to adjust the proposed forecast cost disallowance for RY21/22. We maintain our remaining forecast disallowance positions.

Questions posed at the consultation:

Question 1: What are your views on our proposal to accept DCC's External Costs incurred in RY20/21 as economic and efficient?

Question 2: What are your views on our proposal to disallow the variance in enduring forecast costs for S1SP_3b and a proportion of the UIT forecast costs for DSP?

Background

2.1. External costs form the largest part of DCC's costs at ~73% as of RY20/21. They are incurred by DCC's Fundamental Service Providers (FSPs) delivering the core SMETS2 programme and a range of service providers delivering the more recent SMETS1 and Switching programmes. We assess both incurred and forecasted external costs on the basis of DCC's annual submission and any further evidence provided by stakeholders at the consultation stage.

2.2. DCC's price control submission stated that DCC had incurred £458.02m over the course of RY20/21, with a variance on last year's forecast of £72.13m subject to ex-post justification.

2.3. Overall, we consider that DCC has provided sufficient justification and evidence for the costs incurred in RY20/21. However, our cost assessment has revealed some forecasts costs which we do not consider meet the thresholds for certainty and economy at this stage. We therefore determine that £6.400m of DCC's external cost forecasts for RY21/22, and £83.803m of DCC's forecast external costs from RY22/23 are Unacceptable.[11]

2.4. We also consider that there are significant areas for improvement, some of which we commented on in our consultation and which we address further in response to stakeholders' representation in this section.

[11] As defined in Licence Condition 37.8(a) of the DCC Licence. Unacceptable Costs are any External (or Internal) Costs that the Authority considers were not economically and efficiently incurred in the relevant Regulatory Year.

Q1. Incurred costs

Proposal at consultation: accept DCC's incurred External Costs, as reported in RY20/21, as 'economic and efficient'.

Decision: remains unchanged from consultation proposal.

Respondents' views[12]

2.5. Stakeholders' views were mixed with the majority of respondents disagreeing with our minded-to position. Those who considered that DCC's incurred external costs should not be deemed economic and efficient expressed a range of concerns in the following areas: continued year-on-year increases in the overall external costs, DCC's accountability and liability for costs, the quality of service enjoyed by DCC customers; and other general comments about the ex-post price control framework.

2.6. One respondent agreed with the key points highlighted in our consultation, welcoming assurance that DCC's costs are scrutinised. However, they echoed some of the concerns raised by other respondents.

2.7. One stakeholder noted they were unable to comment on our proposal on account of insufficient information available to them. This stakeholder called for a better transparency on DCC's costs, noting DCC's position as a regulated monopoly.

2.8. Two stakeholders did not state their views on this area.

2.9. DCC agreed with our proposals. DCC addressed our concerns around the Urgent Work Orders (UWOs), explaining that their use is limited to instances of technical or regulatory emergencies, allowing DCC to refine scope of work without interruption of service provided by the service provider. DCC reiterated the safeguards in place, including requiring UWOs to include Statement of Work (SOW) instruction, Terms & Conditions, and a Purchase Order (PO). DCC also restated the tools employed during its contract negotiations and performance management of service providers to achieve best outcomes.

[12] For clarity, we are using the terms 'stakeholders' and 'respondents' interchangeably throughout this document.

Key areas of concern among stakeholders

Main cost assessment: Increase in external costs

2.10. Six respondents voiced concerns over another year-on-year increase in DCC's external costs.

2.11. One stakeholder questioned DCC's justification of the increase in external costs driven by SEC Releases and other SEC modifications, noting their difficulty to reconcile those costs with DCC's reporting to the SEC Panel. This stakeholder also questioned what evidence was sought from DCC to justify the cost increases.

2.12. Two stakeholders questioned how lessons learnt are being applied to avoid cost increases in future years.

Accountability for costs and perceived contract management inefficiencies

2.13. Seven respondents highlighted their concerns in relation to DCC's accountability for incurred external costs. In particular, stakeholders expressed strong concerns over a perceived imbalance in the distribution of risk between DCC and its customers. One stakeholder felt that DCC customers are unable to effectively challenge the costs presented to them by DCC.

2.14. A number of stakeholders argued that some of the external costs incurred in RY20/21 arose due to inefficiencies on the part of DCC; specifically, 3 stakeholders pointed to the delays and associated cost increases in the SMETS1 programme. Of these, 2 stakeholders called for an additional disallowance of the variance in SMETS1 external costs on account of DCC's poor contract management, lack of contingency planning and requirements specification, which they saw as having led to additional costs.[13]

Service Quality

2.15. Six stakeholders highlighted issues with the level of service received from DCC's service providers. Some stakeholders asked that the continued sub-optimal levels of

[13] These additional costs were driven by the need for enduring support for Initial Operating Capability (IOC), Middle Operating Capability (MOC) testing and migration, Final Operating Capability (FOC) testing, extended Dual Control Organisation (DCO) support and redesign of the migration solution. For more details, see Section 2 and Appendix 1 of our consultation.

service be considered as evidence that DCC's external costs should not be accepted as economic and efficient. In particular, stakeholders reported ongoing issues in the North Communication Region, as evidenced by CSP-N failing to meet minimum service levels under Code Performance Measures 1 and 2 throughout RY20/21.[14]

2.16. Other service quality issues reported by stakeholders included: a high number of Major Incidents occurring throughout RY20/21,[15] defects on communication hub devices causing operational issues, DCC's failure to provide requested Impact Assessments on SEC modifications within the SEC-defined timescales, or planned maintenance exceeding SEC service level agreement, among others.[16]

2.17. In the context of these service quality and performance issues, several stakeholders raised concerns over the costs of implementing SEC modifications, where changes are required due to DCC's service falling short of SEC requirements. On behalf of other parties, one stakeholder asked for principles to be set out to determine where any 'costs of remediating service failures should be borne'.

2.18. Nevertheless, one stakeholder also noted a number of improvements, including: the establishment of the Common Issues Forum, incident management, improved approach to scheduling maintenance activities, and good examples of customer engagement in the remediation of Dual Control Organisation (DCO) service issues and mitigation of superfluous alerts on the system.

Other comments and observations

2.19. Two stakeholders called for better transparency of DCC's costs and their visibility to DCC customers.

2.20. Two stakeholders raised concerns over how multiannual issues (such as service failures, or perceived poor planning in programmes) are assessed under the current price control.

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[14] See *Smart Energy Code,* Section H13. Available at: https://smartenergycodecompany.co.uk/the-smart-energy-code-2/
[15] Total of 51 Major Incidents affecting DCC's service, resulting in approx. 198 hours of lost service time.
[16] We are making public all non-confidential responses, where more details can be found on these reported technical issues.

2.21. Five respondents suggested that an introduction of elements of, or a move towards, an ex-ante price control, whereby DCC would seek an advanced approval for its spend, had the potential to alleviate some of stakeholders' concerns.

Reasons for our decision

Main cost assessment

2.22. We have carefully considered stakeholder representations and we have decided to maintain our consultation position. We will not make a disallowance in DCC's incurred external costs in RY20/21.

2.23. While not all information can be made public due to commercial sensitivity, on balance, we are satisfied with the level of justification DCC provided to us for the cost variances in RY20/21. As outlined in paragraph 2.17 of our consultation, DCC submitted both qualitative and quantitative evidence, including copies of impact assessments or SOW authorisation, as relevant, outlining the drivers and scope of individual change and project requests. DCC also provided details of the negotiation strategy pursued in each case and the resulting commercial outcomes, which we deem acceptable. DCC responded to 56 clarification questions with supporting evidence, where requested.

2.24. We recognise stakeholders' concerns over the continued increases in the overall external costs. Upon stakeholder feedback questioning the drivers for cost variances referred to on p.32 of our consultation,[17] we have reviewed DCC's evidence for these costs. We consider that these variances have been sufficiently justified. We would refer stakeholders to *Appendix 1* of the consultation document,[18] where we provided more details on the drivers of new material changes and projects.

2.25. Nevertheless, we believe that DCC can and should do more to improve its transparency on costs to its customers, who must have clarity on how these costs contribute to expected outcomes. As DCC matures, its costs should become more certain and easier for DCC to explain to customers. We therefore expect evidence of

[17] Variance in external costs driven by growth in the costs of the DSP (£56.96m) and CSPs (£10.90m).

[18] Ofgem (2021), *DCC Price Control Consultation: Regulatory Year 2020/21,* p.118. www.ofgem.gov.uk/publications/dcc-price-control-consultation-regulatory-year-202021

customer engagement from DCC to accompany its justification of any material variance in external costs in future RYs.

2.26. Furthermore, we are introducing a customer engagement incentive under the revised OPR, which will place 15% of DCC Baseline Margin at risk from RY21/22.

Accountability for costs and perceived contract management inefficiencies

2.27. We note stakeholders' concerns over DCC's accountability for the impact of its perceived inefficiencies in contract management. As requested by 2 respondents, we have reviewed the cost variances in the SMETS1 programme in particular; however, we have decided to maintain our consultation position and not make a cost disallowance. This is for two main reasons.

2.28. First, we note that some of the factors leading to the programme delays may have laid outside DCC's direct control and there is evidence that DCC did take remedial action and worked with service providers to ensure that enrolment and adoption of SMETS1 meters could continue according to the agreed Joint Industry Plan.[19]

2.29. Secondly, some stakeholders proposed to disallow the variance of £4.264m in SMETS1 costs. We note that this amount is an aggregate of individual variances, both positive and negative, across the programme.[20] We haven't received evidence that would enable quantification of a direct detrimental impact of DCC's actions on the programme costs. However, we recognise that this is an area of significant concern among DCC customers. We are therefore taking the following actions:

- first, going forward, we will be considering how DCC has adopted important 'lessons learnt'. In this, as well as past price control determinations, we have highlighted several areas of DCC's contract management where improvements should be made. For example, one of the key areas of concern has been consistency in adherence to due diligence in change management.[21] This year,

[19] For more details, see *Joint Industry Plan Change Request on DCC's delivery plan for SMETS1 Services.* www.sms-plc.com/media/4427/dcc-smets1-delivery-plan-consultation-final.pdf
[20] For more details, please see Table 2.4 (p.35) in the consultation document. www.ofgem.gov.uk/publications/dcc-price-control-consultation-regulatory-year-202021
[21] For our previous comments on this area, please see Ofgem (2020) *DCC Price Control Consultation: Regulatory Year 2019/20,* paragraphs 2.32-2.34. www.ofgem.gov.uk/publications/dcc-price-control-consultation-regulatory-year-201920

we highlighted the need for better timeliness of negotiations to avoid potential overreliance on emergency mechanisms such as Urgent Work Orders (UWOs). We have also raised concerns over DCC's processes for the payment of Working Capital Charges. We also noted that DCC should seek to strengthen its contingency-planning and demonstrate more robust risk sharing. To date, DCC has provided assurances that lessons learnt are being incorporated in its contract management strategy. We expect that DCC will apply these lessons across all current and future programmes. We consider that failure to do so may constitute grounds for a potential future disallowance in external costs.

- secondly, to further incentivise DCC in this area, we have decided to introduce the contract management incentive under the revised OPR, which will put 15% of DCC's Baseline Margin at risk. This incentive will be implemented with margin attached over RY21/22. We believe that this incentive will drive efficiencies in external costs and ultimately result in savings for DCC's customers. In line with our March 2021 decision, SEC Parties will be provided with a non-commercially confidential copy of the auditor's report for increased transparency. We will also draw on the findings of the auditor in our cost assessment.[22] For further details, please see Section 4 of this decision.

2.30. There is some evidence that DCC has made improvements in its contract management strategy. For example, we note that DCC has moved away from the Letters of Instructions (LoI), which we commented on in our RY19/20 consultation.[23] DCC also demonstrated consistency in securing savings from its service providers on new contracts.

Service Quality

2.31. With regards to the service quality issues highlighted in the consultation responses, we note that this remains an area of high concern among stakeholders. In particular, we recognise the performance issues in the North Communication Region and

[22] Ofgem (2021), *OPR Guidance (Subsidiary Documents),* Section 5. www.ofgem.gov.uk/publications/decision-opr-guidance-march-2021
[23] Ofgem (2020), *DCC Price Control Consultation: Regulatory Year 2019/20,* paragraphs 2.29-2.31. www.ofgem.gov.uk/publications/dcc-price-control-consultation-regulatory-year-201920

stakeholders' evidence of important code performance measures not being met with expected consistency.

2.32. However, on balance, we do not consider it would be appropriate to make a disallowance in incurred external costs on the basis of service quality in RY20/21. Performance is subject to an incentive framework under the OPR. To ensure that the incentive is fit for purpose in delivering expected outcomes for DCC customers, we are introducing a revised system performance incentive from RY22/23, which will place 70% of DCC's Baseline Margin at risk. We believe that it will provide a proportionate and effective measure to drive improvements in DCC's service.

2.33. It is important to note that there are inherent technological differences between the communication regions which contribute to the regional disparities experienced by DCC customers. We expect DCC to be more proactive in managing these disparities and work with customers and appropriate industry groups to help mitigate these going forward. We will continue to monitor this area as part of our standard compliance oversight activities.

2.34. We acknowledge stakeholders' concerns in regard to the costs of remedial activities. We expect DCC to work closely with its customers in managing the costs of any necessary service improvements, including timely customer engagement and due consideration of available options. Where this cost results in a material variance, DCC is obligated to justify it through its price control submission. We encourage stakeholders to provide evidence where remedial activities were required due to DCC's service being inefficient or non-compliant with the SEC measures for us to consider as part of the price control assessment.

Other comments and observations

2.35. We note stakeholders' interest in exploring the introduction of elements of an 'ex-ante' regime. We discuss this feedback and our response in more detail in Section 3 ('Proxy measures for quantifying Unacceptable Costs'). However, we would note that all issues identified through our compliance and price control, including evidence received in response to this and other consultations, inform our thinking about the future regulatory framework for DCC ('DCC Review'), which will be in place following the expiry of the current licence.

Q2. Forecast costs

Proposal at consultation: disallow variance in DSP UIT forecast costs to the value of £5.600m in RY21/22 and £12.500m p/a from RY22/23 until the end of the Licence term; disallow variance in the forecast costs of S1SP_3b to the value of £33.803m from RY22/23.

Decision: adjust DSP UIT disallowance in RY20/21 to £6.400m; unchanged for the remaining positions.

Context

2.36. At consultation stage, we proposed to disallow forecast external costs for two service providers on account of insufficient justification for their certainty, and economy and efficiency:

- a partial disallowance of DSP costs associated with User Integration Testing (UIT) in RY21/22, and a full disallowance from RY22/23 until the end of the licence term
- a full disallowance of S1SP_3b operational costs following the expiry of this SMETS1 service provider's contract in RY22/23.

Respondents' views

2.37. We have received broad support for our proposal to disallow these forecast costs. Seven stakeholders explicitly agreed with our position, echoing our concerns over the certainty and lack of justification for these costs. One of these stakeholders noted that DCC should improve its contracting process by avoiding setting business requirements too early without further flexibility to account for device behaviours and other unknown factors.

2.38. Two other stakeholders commented without objection. One of these stakeholders observed that large year-on-year variances ought to call into question DCC's forecasting. This stakeholder also questioned why we did not propose disallowance of DSP forecast costs on the same grounds as those of S1SP_3b, ie contract expiry.

2.39. Three stakeholders did not have a view, of whom one respondent noted they were unable to comment on the proposals due to restricted information owing to commercial sensitivity.

2.40. DCC did not object to our proposal and provided limited further evidence and clarification.

2.41. With respect to DSP UIT costs, DCC clarified that the forecast costs had been overestimated due to a reporting error. DCC provided additional evidence for the forecast costs in RY21/22, inviting a correction of the forecast to £6.100m. DCC also committed to present a revised forecast for further years in its upcoming price control submission.

2.42. With regards to the disallowance of S1SP_3b costs, DCC likewise committed to resubmitting its forecasts in the July 2022 submission, following conclusion of contract negotiations with the service provider.

Reasons for our decision

2.43. Having reviewed additional evidence from DCC, we have decided to revise our position and adjust the acceptable forecast costs to £6.100m in RY20/21 in line with information provided by DCC. For clarity, as the forecast costs for RY21/22 had been submitted as £12.500m, this means that the corresponding partial disallowance in RY20/21 will be adjusted upwards from £5.600m to £6.400m.

2.44. In considering stakeholder feedback regarding applying a contract expiry date as a cut-off date for all forecasts, we have reviewed other DSP forecast costs and do not consider it appropriate to make further forecast disallowances. We would note that upon removing the disallowed UIT costs from the forecast, the total variance in DSP forecast costs becomes negative and only previously allowed fixed operational charges continue to apply.

2.45. We have not received any further evidence on the proposed S1SP_3b disallowance. We therefore maintain our minded-to consultation position. We note that DCC is currently engaged in negotiations with the service provider to extend the contract beyond its current expiry in RY22/23. We note stakeholder's feedback in this area and encourage DCC to apply lessons learnt to secure best outcomes for its customers through the renegotiations of this and other contracts.

2.46. In the upcoming price control submission, we invite DCC to provide a new forecast for DSP UIT costs beyond RY21/22 and for S1SP_3b costs beyond RY22/23. DCC should ensure that these forecasts are accompanied by justifications outlining how they meet the certainty and economy thresholds. We also recommend that DCC take steps to improve quality assurance of its forecasting to prevent reoccurrence of reporting errors. Reliable forecasting is a key competency of a mature commercial organisation to give its customers an accurate picture of the expected future expenditure.

3. Internal costs

Section summary

The majority of respondents agreed with our assessment of DCC’s internal costs. This section summarises respondents’ views and states our final decision.

We consider, based on the information provided by DCC and other respondents, a proportion of internal costs not to be economic and efficient. We have therefore determined these costs as Unacceptable Costs under the Licence. As such, we direct that £1.16m from DCC’s internal costs in 2020/21 are Unacceptable. This is due to inefficiencies in contractor benchmarking, shared service charges, recruitment costs, and activity relating to Electric Vehicles given that this is not part of DCC’s Authorised Business.

We also direct that £45.74m of DCC’s internal cost forecasts for RY21/22 and RY22/23; and £174.22m of DCC’s internal cost forecasts for RY23/24 onwards are Unacceptable.

In cases where quantifying incurred costs is not possible, we may take inefficiencies identified in the cost assessment into account when determining DCC’s score under the OPR’s contract management and customer engagement incentives.

Questions posed at the consultation:

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

Question 4: What are your views on our proposal to disallow the Shared Service Charge associated with external services procured for Additional Baseline activities such as NEP and ECOS?

Question 5: What are your views on our proposal to disallow non-resource recruitment costs in the Commercial and Operations cost centres?

Question 6: Do you have any views on potential proxy measures to calculate cost disallowances in areas where DCC may not have acted economically and efficiently, but the dependencies and scale of the impact are not clear?

Question 7: When it is determined that DCC may not have acted in an economic or efficient manner but an appropriate methodology cannot be applied to calculate the proportion of costs impacted, we propose to take these instances into account when deciding DCC's score under the Contract Management and Customer Engagement aspects of the OPR. What are your views on this proposed approach to be adopted from RY2021/22 price control, if an alternative measure is not determined?

Question 8: What are your views on our proposal to disallow forecast variances in Network Evolution, SMETS1, and ECoS programmes?

Question 9: What are your views on our proposal to disallow the costs associated with DCC's activity relating to EVs? Please provide any evidence if you have engaged with DCC in this area.

Question 10: What are your views on our proposals to disallow forecast cost variances in the Corporate Management, Commercial, Finance, Operations, and Programme (Service Delivery) Cost Centres in RY21/22 and RY22/23, and all baseline forecast costs for RY23/24 onwards?

Q3 Contractor and Permanent Benchmarking

Proposal at consultation: inconsistency in DCC's application of its benchmarking approach resulted in a significant number of contractors hired above reasonable market rates, as a result of which we proposed to disallow £0.430m of contractor costs in RY20/21. We also assessed the economic efficiency of DCC's permanent staff hiring applying the methodology we set out in RY19/20. We concluded that DCC significantly improved in this area and only incurred in a small inefficiency. As a result, we did not propose any disallowance for permanent staff costs in RY20/21. Finally, we assessed a high-level benchmarking exercise of the wider benefits package that DCC's permanent staff receive. We concluded that there was margin for improvement, notably around bonus payments. We did not propose a disallowance but encouraged DCC to improve in this area.

Decision: following further evidence from DCC on market rates for contractors, we have reduced the disallowance to £0.350m. Our position on the permanent costs benchmarking, including wider benefits package, remains unchanged.

Respondents' views

3.1. The majority of respondents supported our proposals on benchmarking, while also recognising DCC's improvement in the permanent-contractor staff ratio. Three respondents acknowledged and welcomed the level of scrutiny applied to these costs.

3.2. One respondent disagreed with our proposal on the basis that, in their view, the full benefits package should be included in the benchmark, not just the salary. Similarly, another respondent said that bonuses should also follow industry standards, not just rely on DCC's parent company's policy,[24] and would welcome some evidence of this being the case.

3.3. Three respondents raised concerns at the continued growth of headcount figures, and a perceived lack of transparency for what was driving this increase. One of these respondents had concerns that DCC was recruiting permanent employees to drive DCC's growth agenda (ie looking at the next licence period), which, they thought,

[24] Capita plc is DCC's parent company

should not be funded by the ring-fenced monopoly and could potentially be anti-competitive.

3.4. DCC provided some additional evidence to show that its contractor costs were within reasonable market rates and reiterated some of the arguments raised in its initial submission.

3.5. In terms of additional evidence, DCC carried out a re-benchmarking exercise by asking one of its benchmarking providers to review a sub-set (eleven) of the contractor roles. This exercise applied the same methodology as the original benchmark in terms of sample size and data points. Ten of these roles came back with a higher day rate. DCC explained that the main reason for this was that six of the eleven roles erroneously used a historical benchmark from 2018 instead of a more recent one.

3.6. DCC reiterated the argument that benchmarks should not be the only factor to consider when looking at payroll efficiencies. They said that flexibility was required to ensure that DCC attract the right skills for certain roles, especially for roles that demand skillsets that are often very technical in niche projects and/or programmes. DCC also said that they acutely felt the impact of the increasingly competitive nature of the job market, particularly over the last two years, with demand for technology jobs increasing significantly during the COVID-19 pandemic. DCC added that benchmarks would inevitably not be able to keep pace with such growth.

3.7. Finally, DCC welcomed the opportunity to provide further clarity around the car allowance benefit. However, DCC reiterated its view that the cost effectiveness of its remuneration levels should be looked at using a holistic approach and take account of all benefits.

Reasons for our decision

3.8. We have reviewed the responses we received, including the additional evidence provided by DCC. We maintain our position that DCC should consistently apply its approach to benchmarking contractors, however we have taken account of the new benchmarking values. Based on the additional evidence received, we have reduced the disallowance amount from our consultation proposal of £0.430m to £0.350m. We maintain our position on the permanent benchmarking and the wider benefits package.

3.9. In regard to the concerns raised by stakeholders around the increase in headcount figures and lack of transparency for the drivers behind it, we discuss this issue further in paragraphs 3.50 and 3.90 in this chapter.

3.10. In response to the re-benchmarking exercise for contractor roles, we were satisfied with the robustness of the methodology in terms of sample size and number of data points. However, we were disappointed to learn that for this exercise the benchmarking provider used data from November 2021. We do not think this is the right approach to benchmark costs that were incurred in the RY20/21 (ie from April 2020 to March 2021). For future benchmark exercises, we expect DCC to use data from the same period as the incurred costs that are being set against the benchmark. Nevertheless, we recognise that data from November 2021 is likely to be more accurate than data from 2018.

3.11. Taking the above into account, we have decided to only accept the new benchmark data for the six roles for which erroneous 2018 data was used in the initial submission, and reject the new data for the other five roles. Furthermore, we have adjusted the benchmark data we are accepting for inflation.

3.12. In response to DCC's argument that flexibility to hire above the benchmark was required to ensure that DCC attracts the right skills for certain roles, we would like to reiterate what we said in our consultation document on this issue.[25] In our consultation position we recognised the need for some level of flexibility when looking at payroll efficiencies and discussed two different ways in which this is taken into account.

3.13. Firstly, the benchmark methodology we expect DCC to follow already allows for some flexibility. This is because DCC's recruiting managers have the discretion to offer up to 10% above the median of the benchmark. Our position, in line with previous price control determinations, was that such a margin should give DCC enough flexibility in most cases.

[25] Ofgem (2021), *DCC Price Control Consultation: Regulatory Year 2020/21*, pp.58-60. www.ofgem.gov.uk/publications/dcc-price-control-consultation-regulatory-year-202021

3.14. Secondly, we recognised that in certain situations DCC might require to hire above this benchmark (including the 10% margin). In its submission, DCC explained that the approval of a business case was needed in these situations.

3.15. However, we were not satisfied with the evidence and justification presented to us as part of DCC's submission and subsequent engagement. Among other things, DCC failed to provide any business case, or similar document, for any of the roles hired above the benchmark. DCC did not provide any further evidence in this area as part of its response to the consultation.

3.16. As we said in our consultation, we expect to see DCC applying consistently its own approach to recruiting. We also expect DCC to be able to provide robust evidence of its internal approvals and decision-making, particularly when it deviates from the stated methodology on benchmarking.

3.17. We are also concerned that DCC carried out a re-benchmarking exercise and found errors. If DCC's benchmarking method is not robust enough, it can lead to devaluing or inflating the benchmarked rates. In future price control submissions, we would expect to see evidence from DCC on what steps have been taken to mitigate this risk.

Permanent staff benefits benchmarking

3.18. In regard to stakeholder comments on the benchmark methodology for permanent staff excluding non-base salary benefits, we would like to refer to our consultation position on this issue,[26] which remains unchanged. In our consultation, we discussed that in this year's submission DCC included the results from a high-level benchmarking exercise of the wider benefits package. This was in response to our feedback from previous years encouraging DCC to incorporate these benefits into its approach to benchmarking.

3.19. This benchmarking exercise included bonuses, pension arrangements and holiday entitlement using a sample of 50 key permanent roles. We noted that this was

[26] Ofgem (2021), *DCC Price Control Consultation: Regulatory Year 2020/21*, pp.62-63. www.ofgem.gov.uk/publications/dcc-price-control-consultation-regulatory-year-202021

presented as a one-off exercise, and that DCC expected to use the results to help it move to whole-remuneration benchmarking in future.

3.20. In our consultation, we welcomed that DCC was taking steps to ensure its permanent staff costs were more economic and efficient by improving the benchmark methodology. We acknowledged that the pensions and holiday entitlement seemed to be economic and efficient. However, we also expressed our view that the bonus paid by the DCC to its permanent staff may not have been completely economic and efficient, and encouraged DCC to review this going forward.

3.21. In regard to DCC's argument that the cost effectiveness of its remuneration levels should be looked at using a holistic approach and take account of all benefits, we reiterate what we said in our consultation.[27] Our view is that if the different benefits are benchmarked individually, then we need to consider the efficiency of each benefit on its own merits.

3.22. If DCC wishes us to consider the cost effectiveness of its remuneration package as a whole, it should provide us with appropriate data to do so. For example, a benchmark that compares the full benefits package with that of comparable organisations.

[27] Ofgem (2021), *DCC Price Control Consultation: Regulatory Year 2020/21*, paragraph 3.66. www.ofgem.gov.uk/publications/dcc-price-control-consultation-regulatory-year-202021

Q4 Shared Service Charge

Proposal at consultation: reject the Shared Service Charge associated with external services procured for Additional Baseline activities.[28] *This amounts to a disallowance of £0.212m in RY20/21. Accept the 9.5% Shared Service Charge associated with the baseline costs of DCC's core smart metering service. Adjust the Shared Service Charge in line with the proposed unacceptable Internal Costs. The total proposed disallowance amounted to £0.311m in RY20/21 and £17.409m in forecast costs to the end of the Licence term.*

Decision: reject the Shared Service Charge associated with external services procured for Additional Baseline activities and accept the 9.5% Shared Service Charge. Adjust the Shared Service Charge in line with the unacceptable Internal Costs. The revised total disallowance amounts to £0.294m in RY20/21 and £17.409m in forecast costs to the end of the Licence term.

Context

3.23. DCC pays a Shared Service Charge to its parent company, Capita, to cover support services such as HR tools, property services, payroll, IT and senior management input. Inclusion of the Shared Service Charge was part of the competitive bid during the Licence tender. It is calculated as a percentage of Internal Costs, as set out in the Licence Application Business Plan (LABP).

3.24. DCC is required by the Regulatory Instructions and Guidance (RIGs)[29] to report information on the Shared Service Charge, including how it has been calculated and how the Shared Service Charge provides value for money. DCC must also ensure there is no cross-subsidisation across affiliates or related undertakings.[30]

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[28] Additional Baseline activities are associated with requirements that the Licensee was expected to deliver at the time of Licence Award, but which had not been fully costed in the LABP. For example, SMETS1 enrolment and adoption costs are considered Additional Baseline.
[29] Ofgem (2021), *Data Communications Company (DCC): Regulatory Instructions and Guidance.* www.ofgem.gov.uk/publications/data-communications-company-dcc-regulatory-instructions-and-guidance-2021
[30] This is a requirement under Licence Condition 11 of the Smart Meter Communication Licence.

3.25. In the RY16/17 price control decision,[31] we decided that in future years we would not require further justification for the Shared Service Charge associated with Baseline Activity for price control purposes.

3.26. In its response to the RY17/18 consultation, DCC proposed to 'undertake an in-depth review of Capita Shared Services to provide greater assurance of their value for money. This would also ensure that there is no "double-counting" between services provided by DCC and those same equivalent services that should be provided under the Shared Service Charge'.[32]

3.27. For New Scope Activities,[33] DCC must provide full justification to demonstrate that any Shared Service Charge relating to these activities is economic and efficient.

Respondents' views

3.28. The majority of respondents supported our minded-to position.

3.29. Two respondents said that the DCC should achieve value for money when applying the Shared Service Charge costs and be required to robustly evidence this. On this basis, they suggested that the DCC should be required to undertake independent benchmarking of the services delivered and the associated costs.

3.30. One respondent thought that the Shared Service fee did not seem appropriate, and that it was unclear what Shared Services were needed for projects such as Network Evolution that were not part of its submitted costs elsewhere.

3.31. DCC opposed our consultation proposal to disallow the shared service charges associated with external services procured for Additional Baseline activities arguing

[31] Ofgem (2018), *DCC Price Control Decision: Regulatory Year 2016/17.* www.ofgem.gov.uk/publications/dcc-price-control-decision-regulatory-year-201617
[32] Ofgem (2019), *DCC Price Control Decision: Regulatory Year 2017/18*. www.ofgem.gov.uk/publications/dcc-price-control-decision-regulatory-year-201718
[33] New Scope Activities are activities associated with delivering requirements additional to those that the Licensee was expected to deliver at the time of Licence Award. The Switching Programme is considered New Scope.

that it was inconsistent with our previous decisions. In particular, DCC said that our minded-to position was inconsistent with:

- our RY19/20 decision to allow Shared Service Charges linked to external services expenditure on Network Evolution Programme (NEP)
- a past confirmation that, for Baseline activities (original and additional), DCC would not need to apply for the Shared Service Charge, nor prove justification for its economy and efficiency.

3.32. DCC sought to clarify its understanding of what should be considered Baseline activity. In particular, DCC argued that this was activity associated with delivering the requirements provided to the Licensee during the licensing competition. It added that this included both activities, which the Licensee was expected to fully cost in the LABP, and activities, which were known but not fully scoped at that time and so not fully costed.

Reasons for our decision

3.33. We have reviewed the responses we received. We do not believe DCC has offered enough evidence to support Shared Service Charges for external services procured for Additional Baseline activities. Therefore, we have decided to maintain our consultation position and reject these charges.

3.34. We disagree with DCC's claim that our consultation position was inconsistent with previous decisions. As DCC matured as an organisation and took on more activities, we engaged with DCC to agree on how to classify these new activities and report the associated costs in the RIGs. Activities now classified as 'Additional Baseline' activities (SMETS1, SMKI, Parsing and Correlation Service) were previously classified as 'New Scope' in the RIGs. We continuously engage with DCC to ensure RIGs reporting accurately reflects the nature of the activity, its costs and associated Shared Service Charges.

3.35. We would like to clarify that we have not taken any position on Shared Service Charges linked to external services expenditure in relation to the Network Evolution

Programme (NEP) in our RY19/20 Decision[34] because the cost was minimal, and we were still engaging with DCC to understand if NEP should be classified as a New Scope or Additional Baseline activity. We concluded in May 2021, through our engagement with DCC, that NEP and Enduring Change of Supplier (ECOS) should be classified as Additional Baseline activity.

3.36. Furthermore, we would like to point out that, historically, DCC has never applied for Shared Service Charges linked to external services of Additional Baseline activities (SMETS1, SMKI, Parsing and Correlation Service).

3.37. Our default position is that Shared Service Charges should not apply for external services procured for Additional Baseline activities, in line with DCC's usual practice in this area. If DCC wishes to depart from its historic practice, we would expect DCC to provide sufficient evidence as to why Shared Service Charge is applicable and delivers value for money for external services of Additional Baseline activities. In this year's submission, DCC did not provide any evidence on why NEP and ECOS, which it agreed were Additional Baseline activities, should be treated differently from SMETS1, SMKI, and Parsing and correlation service. As a result of this, we have decided to maintain our consultation position and reject these charges.

3.38. We agree with stakeholders' comments that DCC should ensure that the Shared Services Charges deliver value for money. We would like to point out that in its response to the RY17/18 Consultation DCC proposed to undertake an in-depth review of Capita Shared Services to provide greater assurance of their value for money, and that there is no 'double-counting' between services provided by DCC and equivalent services that should be provided under the Shared Service Charge. We will engage with DCC to ensure the Shared Service Charge delivers value for money.

[34] Ofgem (2021), *DCC Price Control Decision Regulatory Year 2019/20.* www.ofgem.gov.uk/publications/dcc-price-control-decision-regulatory-year-201920

Q5 Recruitment costs

Proposal at consultation: on the basis that 20% of the base salary is an appropriate recruitment agency fee to pay for hiring senior roles, disallow £0.150m of incurred non-resource recruitment costs in the Commercial cost centre and £0.129m of incurred non-resource recruitment costs in the Operations cost centre, totalling a disallowance of £0.279m in RY20/21.

Decision: upon reviewing additional evidence submitted by DCC and making corrections in our disallowance model, we are reducing the total disallowance to £0.243m in RY20/21. This disallowance is split between £0.059m of incurred non-resource recruitment costs in the Commercial cost centre, and £0.179m of incurred non-resource recruitment costs in the Operations cost centre.

Respondents' views

3.39. Our proposals received a broad support from stakeholders, with eight respondents agreeing with the minded-to position. Three stakeholders did not have a view but did not raise any concerns or objections.

3.40. Five stakeholders expressed concerns over the recruitment of new senior roles and questioned how these roles respond to the needs of DCC customers. Two stakeholders expressed concern over resource allocation to activities which they saw as 'protecting the interests of DCC and its parent as opposed to those of DCC's customers'. Two respondents specifically questioned resource requirements for activities related to influencing governmental and regulatory policy.

3.41. Two stakeholders called for greater transparency on DCC's internal structure to allow DCC customers to better understand resourcing of individual projects.

3.42. DCC disagreed with our view that recruitment fees equivalent to 20% of the base salary are reflective of the standard market rate for *executive search companies.* DCC suggested an average level of recruitment fees for senior roles to be between 25% and 35% of the first-year salary, when recruited using these companies. DCC stated that its decisions to use more specialised *executive search companies* with higher fees are informed by considerations of 'whole life' recruitment costs, for example by limiting the risk of a potential bad hire for a specialised role and a subsequent need for a repeated recruitment exercise. Based on its own market research, DCC evidenced average hiring fees for executive level appointments in the range of 30%-33% of the base salary.

3.43. DCC argued that the total recruitment costs were higher in RY20/21 owing to a high turnover of executive staff due to COVID-19. However, DCC further stated that a new resourcing model was introduced in 2021 which should reduce hiring costs in future years.

Reasons for our decision

3.44. Of the thirteen new roles driving the non-resource variance across the Commercial and Operations cost centres, three roles were at the executive level.[35] We accept DCC's justification for using *executive search companies* for the recruitment of these roles. DCC provided evidence that executive roles recruited through these agencies attract typical recruitment fees of 30% of the base salary. We did not receive any evidence to the contrary. We are therefore changing our position and consider that only recruitment fees above 30% of the base salaries of these roles are Unacceptable and shall be disallowed.

3.45. The remaining ten roles across the two cost centres represented a range of senior non-executive roles. We do not consider that DCC provided sufficient justification for the application of executive-level fees to all of these roles. We haven't received any other evidence contrary to our consultation position in relation to senior non-executive roles. We are therefore maintaining our proposal and consider that recruitment fees above 20% of the base salaries of these roles are Unacceptable and shall be disallowed.

3.46. For transparency, we note that we have also made certain corrections in the inputs for our disallowance model used at the consultation stage. These corrections focused on improving estimates of salary data in cases of absence of data. At the consultation stage, where we lacked role-specific data, we made an estimate on the basis of average staff cost of corresponding seniority as reported in DCC's main RIGs submission. We have now revised our approach and decided to update our estimates by using actual equivalent salary data provided by DCC in its permanent

[35] One of these executive roles was hired twice, therefore the recruitment fee was paid twice and we assume total costs of hiring 4 executive-level roles for our calculations.

benchmarking sheet. These corrections have made our analysis more robust and the final calculations more accurate.

3.47. Upon correcting our inputs and applying recruitment fees of 30% to the executive roles, we have recalculated the disallowance in each cost centre as follows:

- £0.059m in non-resource recruitment costs in the Commercial cost centre
- £0.174m in non-resource recruitment costs in the Operations cost centre.[36]

3.48. We therefore determine that £0.234m of internal costs in RY20/21 are Unacceptable.

3.49. We welcome DCC's decision to introduce a new resourcing model. We invite DCC to provide further details on the newly adopted processes, and the cost savings and efficiencies achieved, in its next price control. We also acknowledge DCC's effort to recruit best candidates and avoid repeated recruitments. However, where DCC continues to rely on specialist recruitment agencies, we expect DCC to ensure that recruitment fees do not unreasonably deviate from the market rates typical for the types of roles recruited. DCC should justify those cases, where a specialist hire at a higher fee is deemed appropriate.

3.50. We also note stakeholder's concerns with regards to a perceived lack of transparency in DCC's recruitment and internal structure. We encourage DCC to improve the visibility of its internal resource allocation across programmes to its customers and we expect DCC to better communicate to its customers how its resourcing policy meets their needs and what customer outcomes are achieved.

[36] For clarity, while the overall disallowance has been reduced, the corrections in our disallowance model result in the disallowance in the Operations cost centre increasing by c.35% compared to our consultation position.

Q6-7 Proxy measures for quantifying Unacceptable Costs[37]

Proposal at consultation: due to being unable to quantify uneconomic and inefficient costs in the SMETS1 and Network Evolution programmes, we asked for stakeholder's views on potential proxy measures to calculate cost disallowances in areas, where DCC may not have acted economically and efficiently but the dependencies and scale of the impact are not clear.

We also proposed that if we do not identify an alternative method, we may consider using the OPR as a proxy. We proposed to take inefficiencies identified in the cost assessment into account when determining DCC's score under the contract management and customer engagement incentives and sought views on adopting this approach from the RY2021/22 Price Control.

Decision: remains unchanged from consultation position. We may consider using the OPR in exceptional cases as part of our controls to ensure costs are economic and efficient. If we were to use this method, we would consult on our proposals as part of our price control process for the relevant Regulatory Year.

Respondents' views

Stakeholder views on proxy measures

3.51. The majority of respondents were broadly supportive of using a proxy measure to quantify inefficient DCC costs, in cases where we had been unable to determine the proportion of uneconomic and inefficient costs.

3.52. Several respondents suggested means to determine whether DCC's costs had been economic and efficient. For example, by monitoring the outputs of DCC contracts, assessing the volume of change requests (which may indicate poor planning), or reviewing unexpected actions and results from projects which have led to negative impacts or outcomes.

[37] Unacceptable Costs are defined in Licence Condition 37.8(a) of the DCC Licence. Unacceptable Costs are any External Costs or Internal Costs that the Authority considers were not economically and efficiently incurred in the relevant Regulatory Year.

3.53. Five respondents suggested using an ex-ante approach to scrutinise DCC costs in advance of them being incurred. One respondent noted that this may allow the ex-post stage of the price control to focus on the actual outcomes and results achieved by DCC. Two respondents suggested that this potential ex-ante element could be delivered through the SEC governance structure, with one respondent stating they did not believe the Quarterly Finance Forums[38] were appropriate for this assessment.

3.54. Three respondents commented that additional proxy measures may result in DCC skewing its behaviour or adopting a highly risk-averse approach to its business, resulting in worse outcomes rather than improvements.

3.55. Three respondents raised concerns over DCC being unable to provide necessary cost information for Ofgem's assessment, including information on headcounts across different projects. One of these respondents stated that, if DCC is unable to provide sufficiently accurate data to enable Ofgem to properly assess the efficiency of DCC's costs, then they questioned whether any cost allowance can be justified.

3.56. DCC did not agree with our consultation positions. DCC stated that the ex-post price control reflects the uncertainty it is exposed to, and delays are often outside DCC's control. DCC stated the proposal to disallow costs based on delays does not acknowledge these features.

3.57. DCC noted Ofgem has a duty to evaluate DCC's costs in the Regulatory Year they are incurred, based on the information, which was available to DCC at the time, whereas a proxy could penalise DCC for decisions made in previous Regulatory Years or historical delays. DCC noted that Ofgem's price control guidance states DCC should not be penalised through hindsight when better outcomes are known.

3.58. DCC also stated that a proxy should not be applied as a general rule without considering case-specific elements, and could lead to either an under- or over-estimate of Unacceptable Costs.

3.59. DCC further explained that it was difficult to estimate the costs incurred in the Data Services Provider (DSP) and Communication hubs and networks (CH&N) sub-

[38] DCC provides additional transparency on costs directly to its customers through its quarterly finance forums under suitable confidentiality arrangements.

programmes which may have been uneconomic and inefficient. Therefore Ofgem should be looking at each case on the merits of the outturn costs.

Taking cost inefficiencies into account under the OPR

3.60. Respondents were generally supportive of using the OPR to take account of unquantified inefficient costs if an alternative option was not available, with seven respondents explicitly supporting our proposal. Three respondents (including DCC) did not support the use of the OPR.

3.61. One respondent stated that the criteria for cost assessment is different to the OPR and therefore should be considered separately.

3.62. One respondent noted that using the OPR was a blunt tool, and that using timesheets and additional information from DCC would be a more accurate measure.

3.63. At the stakeholder event held in December 2021, we discussed our consultation positions. Several stakeholders raised concerns that it was difficult to understand the headcounts on each programme and requested that DCC should provide this information.

3.64. DCC disagreed with our proposal to use the OPR, and stated that, should Ofgem determine DCC has not acted in an economic and efficient manner, the costs incurred should be disallowed under the cost assessment. Using the OPR would undermine the incentive.

3.65. DCC's response noted that it was unclear how using the OPR would work in practice, and if Ofgem wanted to use this route it should do so by amending the OPR Guidance.

Reasons for our decision

3.66. We consider that there must be appropriate controls in place to ensure DCC's costs are economic and efficient, and means to disallow Unacceptable Costs where necessary. We therefore consider having a range of tools to hold DCC to account, including proxy methods, is proportionate in exceptional circumstances where we have been unable to quantify uneconomic or inefficient costs.

3.67. After assessing consultation responses, we are maintaining our consultation position to use the OPR as an acceptable alternative in such cases. While we acknowledge cost assessment is different to the OPR, we noted that quantifying cost disallowances may not be possible when it is clear DCC could have done better in terms of customer engagement and contract management but the impact on costs is not directly quantifiable. When we note such instances, we consider it may be acceptable to use the OPR as customer engagement and contract management are incentivised under the OPR. Whether we follow this approach would depend on the circumstances of each individual case, and we would consult on our proposal as part of our price control assessment for the relevant Regulatory Year.

3.68. As discussed in our consultation, we were not able to determine the outturn costs given the level of information provided to us, and were not able to quantify a potential disallowance (for example, either total costs associated with DSP or CH&N, or the fraction of these costs which we determine were not incurred economically or efficiently).

3.69. We expect DCC to ensure it conducts its business economically and efficiently, and demonstrate this to us. The Licence puts the burden of proof on DCC to justify costs as economic and efficient. If DCC fails to do this adequately, we may determine that the costs were not incurred economically and efficiently and that they are therefore Unacceptable Costs.[39]

3.70. We intend to work with DCC to come to an understanding of the information we require, in order for DCC to provide sufficient evidence for our cost assessment, which will include the provision of clear breakdowns of costs on individual programmes, and related headcounts. We will update the RIGs and price control guidance accordingly if any changes are needed.

3.71. If DCC does not provide a sufficient breakdown of costs for us to make an assessment and quantify the Unacceptable Costs associated with a given activity, we may consider disallowing the total cost or variance associated with the activity. We

[39] As stated in our *Price Control Processes and Procedures Guidance.*
www.ofgem.gov.uk/publications/dcc-price-control-guidance-processes-and-procedures-2021

consider this is in line with previous price control decisions where we were unable to determine the proportion of unjustified costs so disallowed the full variance.[40]

3.72. Where there have been inefficiencies which we cannot quantify, we may also take this into account under the contract management and customer engagement aspects of the OPR by amending the overall score awarded to DCC, rather than proposing a total cost disallowance as detailed above. We consider this scenario would be highly dependent on the individual circumstances and must be assessed on a case-by-case basis.

3.73. As discussed in our consultation, if we identify an issue with DCC's customer engagement which has led to increased costs, after assessing the Customer Engagement submissions from DCC and the SEC Panel and awarding a score for DCC's performance, we may subsequently reduce this score – and therefore reduce the margin retained – as a case by case measure, in response to being unable to quantify the proportion of uneconomic and efficient costs under the cost assessment.

3.74. Similarly, if the issue identified is related to contract management, after assessing the auditor report for the Contract Management aspect of the OPR and awarding a score for DCC's performance, we may subsequently reduce the score – and margin retained – in response to being unable to quantify the proportion of uneconomic and efficient costs.

3.75. This OPR score reduction would take into account the wider context of the issue, including any mitigating action DCC has taken and would not unfairly penalise DCC for circumstances outside its control. We would consult on the modified OPR score as part of our price control consultation for the relevant Regulatory Year, including how we arrived at the score and our reasoning. This ensures DCC and other stakeholders can respond to our proposals and make representations.

3.76. We consider that the use of a proxy measure would not be using the benefit of hindsight to assess DCC's actions over the relevant Regulatory Year. As part of the

[40] In the RY19/20 price control, insufficient justification and cost breakdown was provided for the variance in forecast costs related to Network Evolution in the commercial operations and vendor management teams, and the full forecast cost associated with the teams was disallowed.
See Ofgem (2021), *DCC Price Control Decision Regulatory Year 2019/20.*
www.ofgem.gov.uk/publications/dcc-price-control-decision-regulatory-year-201920

ex-post price control, we assess all costs after they are incurred using the information which was available to DCC at the time.

3.77. Taking the CH&N procurement as an example, the licence stipulates that DCC should consider a competitive procurement unless DCC is satisfied that another means would be more economic and efficient or would be immaterial within the overall context of the mandatory business. We therefore expect DCC to follow due process and conduct necessary assessments at the start of its planning. DCC should be able to evidence all considerations it has made, including an assessment of why its preferred option would meet the required licence criteria. These fundamental requirements were known to DCC at the time of initial planning and are expected to be part of DCC's procurement strategy.

3.78. We note that many stakeholders suggested using an ex-ante approach. An ex-ante framework, while not viable in quantifying cost inefficiencies where we do not have sufficient information, may be helpful in providing additional scrutiny over DCC costs before they are incurred.

3.79. However, there are a number of questions which must be answered to understand how an ex-ante framework may work in practice. We have provided a non-exhaustive list of some potential issues, which may need to be considered, below:

- what happens to costs if DCC fails to deliver to specifications, or only delivers in part what was originally agreed?
- how should money be returned to customers in such instances and how should the proportion of costs be determined?
- what level of detail is DCC able to provide on its costs and business cases, and what level do its customers need?
- how early should DCC be sharing details of costs/projects with customers?
- how should the information be shared and evaluated?

3.80. As discussed in Section 4 ('OPR: Way Forward'), we are aware DCC is working with SEC Panel and SEC sub-committees to implement better ways of working and engagement plans with its customers, which may include methods to set out costs or business cases in advance so DCC customers can engage better. We would encourage DCC to continue this engagement. It may be useful to keep in mind that this work may feed into setting up a potential ex-ante framework.

3.81. It is important to note that any changes to the DCC price control are subject to the broader DCC licence review workstream, and we are not in a position to make any decisions on it at this time. We encourage stakeholders to engage with our work in this area and will engage on the next stage of the review in due course.

Q8 Forecast Programme Costs

Proposal at consultation: disallow all forecast variance in the SMETS1, Network Evolution and Enduring Change of Supplier (ECoS) programmes.

Decision: no change from consultation position.

Respondents' views

3.82. Eight respondents explicitly supported our proposal to disallow the forecast variance. Three did not address this question directly. DCC did not agree.

3.83. In their wider consultation responses, stakeholders raised general concerns over the increasing levels of resource which are being forecast without sufficient justification.

3.84. While supportive of our proposal, one respondent further highlighted this disallowance would not impact charges to DCC Users.

3.85. DCC provided additional evidence detailing the costs it has already incurred in RY21/22 against its forecasts from RY20/21, and noted it will be providing a more detailed justification in the RY21/22 price control submission. DCC requested we allow the forecasts as the additional evidence shows the forecasts are being borne out by the incurred cost.

3.86. DCC's consultation response further explained the key drivers for costs in the programmes – that the increase in costs in SMETS1 was largely due to operational, testing and programme resources, and the increase in Network Evolution and ECoS was linked to increased activity levels.

Reasons for our decision

3.87. After reviewing DCC's additional evidence and the responses received, we remain concerned with the increase in forecast costs and are not satisfied with the level of justification received. We are therefore maintaining our consultation position and are disallowing all forecast variance associated with the SMETS1, Network Evolution, and ECoS programmes, amounting to £17.844m over RY21/22 and £9.115m over RY22/23.

3.88. In part due to the challenge in determining what proportion of costs were not incurred economically and efficiently in RY20/21, at consultation, we considered that we didn’t have sufficient assurance that related forecast costs were justified as being economic and efficient. We also considered there was a lot of uncertainty in the programmes’ forecast costs.

3.89. DCC’s additional evidence demonstrates it is incurring costs in the programmes in the areas where it had forecast such costs. While this addresses the costs’ certainty, we have not had assurance that the costs are economic and efficient. We do not consider DCC has sufficiently justified these forecasts, nor provided clarity over the business requirements for additional roles.

3.90. We urge DCC to improve the description of activity in its submission when it provides justification for costs. For example, DCC’s price control submission set out numerous roles which were forecast due to expected increase in activity in the programmes. We expect greater detail describing the activity. Given that DCC expects to roll staff from one project to the next as requirements change, we expect DCC to provide further explanation of increases in headcount in its submission to better justify costs, including why this work cannot be carried out by the existing staff.

3.91. Where any disallowed forecast costs have subsequently been incurred, we expect clear rationale for these costs in the RY21/22 price control and will be giving them appropriate scrutiny. We welcome DCC’s assurance it will be providing a more detailed justification for these costs in its RY21/22 price control submission.

3.92. We note that we have concerns with the level of justification and inconsistent reporting this year and plan to engage with DCC in advance of next year’s submission to improve the reporting process.

3.93. We recognise this will mean there will be large variances for the RY21/22 price control. Stakeholders may wish to engage with DCC and refer to DCC’s charging statements to gain a better understanding of upcoming charges, as there is a much higher threshold for forecast costs to be accepted in the price control.

Q9 Activity relating to Electric Vehicles and reuse

Proposal at consultation: disallow 50% (£0.167m) of product management team costs incurred in RY20/21, and 100% of the forecasts (£0.982m) over RY21/22 and RY22/23. Disallow costs associated with an EV Engagement procurement amounting to £0.192m of costs incurred in RY20/21 and forecast costs of £0.280m.

Decision: reduction of the EV engagement procurement disallowance to £0.112m in RY20/21 due to the quoted costs of the procurement not being incurred in full in the Regulatory Year. The remainder of our proposals are unchanged.

Respondents' views

3.94. Nine respondents explicitly supported our proposal. Two did not address this point directly. DCC disagreed with our position.

3.95. Six respondents considered that DCC's focus should be the core business. One of these noted that EVs were not included within this business.

3.96. Two respondents raised concerns with DCC's existing service performance, one of whom felt it was unlikely DCC could successfully leverage its network for use with EVs until it had greatly improved its core service capabilities.

3.97. One respondent further commented that any work in this area should not be at the expense of the Mandatory Business and that DCC should first ensure that it is delivering its core services in a timely manner. The respondent noted that deviating from these requirements raises questions on DCC's priorities.

3.98. While two stakeholders recognised the potential of EVs and that this may be part of DCC's work in future, they stated formal review and sign-off are essential, especially where costs are funded by DCC Users. Two respondents explicitly noted they did not consider DCC had provided appropriate justification for this work.

3.99. Further to this, three stakeholders did not consider it appropriate that DCC incurred costs on non-mandated activity which is then charged to DCC users. One respondent suggested this aspect should be considered as part of the DCC licence review.

3.100. One respondent suggested DCC should break down costs incurred by staff on innovation-related activity to differentiate between advisory activity (eg working groups) and DCC's 'business development' activity.

3.101. One respondent further noted that they had not received sufficient engagement on DCC Boxed nor Elective Communication Services.

3.102. DCC confirmed its priority should remain the delivery of its core business. It stated the product management team is critical to the support of this core business, for both existing and new customers.

3.103. DCC did not agree with our consultation position. It explained that the driver for this work were requests from government with the expectation that DCC should carry out work in this area. DCC considered it was therefore disproportionate for Ofgem to disallow the costs associated with the product management team.

3.104. DCC noted that following engagement with government, it took part in further meetings with industry working groups to feed into a consultation on industry standards. DCC provided additional evidence detailing such engagement with industry. DCC also explained it had engaged with customers when preparing its Business and Development Plan, which set out expected activity exploring options for EV charging, and took part in follow-up engagements to explore potential collaborations, including supporting government-funded trials.

3.105. DCC pointed to the Second Enduring General Objective of its licence, stating it is obligated to enable and explore potential re-use of the DCC network, requiring DCC to seek out innovation in the design and operation of Energy Networks as well as the reduction of the charges for Mandatory Business Services by providing Value Added Services.

3.106. Regarding the EV Engagement procurement, DCC explained this was again as a result of government's requests. In the case that this area should become mandated work for DCC, DCC considered it needs to be able to explain how the system could support smart charging to stakeholders.

3.107. DCC also explained that the full quoted cost of the EV Engagement procurement (£0.192m) was not incurred in RY20/21. The incurred spend was £0.112m.

Reasons for our decision

3.108. After reviewing the responses received and DCC's additional evidence, we are maintaining our consultation position to disallow 50% (£0.167m) of product management team costs incurred in RY20/21, and 100% of the forecasts (£0.982m) over RY21/22 and RY22/23. However, we are reducing the disallowance on the EV engagement procurement from £0.192m to £0.112m in RY20/21, as DCC provided additional clarification which explained the full cost of the procurement was not incurred in RY20/21. We are maintaining our proposed disallowance of the forecasted £0.280m for the procurement in RY21/22.

3.109. We consider EVs will be a key step in transitioning to net zero and the adoption of increasingly cost competitive EVs will be the primary route to decarbonise road transport, offering new opportunities for existing and future energy consumers. The resulting electrification of transport will have significant benefits, not only for EV users, but wider society, including other electricity consumers, through reducing carbon emissions and improving air quality. However, while we are aware that EV policy requirements may become part of DCC's business in future, work in this area is not currently part of the Authorised Business. We must take this into account when considering our duty to ensure DCC is compliant with its licence obligations, and incurs all its costs economically and efficiently.

3.110. We are aware that government has been engaging with DCC in this area, and DCC's additional evidence demonstrates engagement from late November 2020 onwards. However, we do not consider DCC's resulting actions to be proportionate to the requests.

3.111. For example, we do not have assurance that procuring an external service for DCC's communications strategy was proportionate. We expect good communication to be part of DCC's existing business, and we do not consider the procurement to be an appropriate expenditure, particularly given recent expansions of DCC's headcount, including the customer engagement team. We consider DCC has resource capable of engaging with government and wider stakeholders, and responding to industry consultations, without requiring dedicated product staff. As stated in our decision last year, load-control trials involve sending messages over the DCC network, which it already has capability to do, and should not involve DCC's product management team to any material extent. As requests from government were agreed in December 2020, we do not consider it appropriate that any resulting engagement should take the described level of resource within the Regulatory Year.

3.112. We also do not consider the activity or resource has been sufficiently justified, particularly given the work is not part of DCC's Authorised Business. As DCC's incurred costs are recouped through charges to its Users, we do not consider it appropriate that DCC is engaging in exploratory work, which is being charged back to its customers, where there are not defined mandated requirements upon DCC. Should DCC conduct work relating to EVs or reuse, as a result of government request or otherwise, we expect the work to be proportionate with clarity around arrangements for review, sign-off and funding.

3.113. With regards to DCC's comments on its objectives, we note that DCC has a duty to carry on its Mandatory Business at all times in accordance with its General Objectives[41] and, in discharging that duty, DCC must have regard to the General Objectives in the round, weighing them as appropriate in each particular case.[42] We therefore consider DCC should not be shifting focus to offer additional services when there are still numerous concerns with DCC's core service performance.

3.114. The Licence requires DCC to prepare a Development Plan, identifying factors likely to affect the future development and performance of its business, and the opportunities likely to be available for developing the infrastructure, systems, and processes in place for the provision of Services. In this respect, we recognise that EVs and network reuse may be such activity which could affect the business. However, we do not consider this alone authorises DCC to carry out significant activity in this area and justifies dedicated resource and procurement in this area.

3.115. With regards to the concern raised about DCC's engagement on DCC boxed and the Elective Communications Services overhaul, we consider DCC must ensure it is engaging with customers effectively and incurring costs economically and efficiently. We recognise DCC is taking steps to improve its customer engagement, which we discuss further in Section 4 ('OPR: Way Forward').

[41] Conditions 5.4 and 5.5 in the Licence describe the Interim General Objective. Conditions 5.9 and 5.10 outline the First and Second Enduring General Objectives respectively.
[42] As stated in conditions 5.11 and 5.12 of the Licence.

3.116. We welcome that DCC clarified the cost of the EV engagement procurement which was incurred during RY20/21 as £0.112m rather than £0.192m, and have reduced the proposed disallowance on this basis.

Q10 Forecast Costs

Proposal at consultation: minded to disallow variances in the forecast costs across the Commercial, Corporate Management, Finance, Operations, and Service Delivery (Programmes) cost centres to the value of £5.069m in RY21/22 and £9.157m in RY22/23 on account of insufficient justification for their certainty and economy. On the same grounds, we were also minded to disallow all variance in DCC's baseline forecast from RY23/24 to the end of the Licence term to the value of £160.101m.

Decision: upon considering stakeholders' representation and additional evidence from DCC, we are maintaining our consultation position.

Context

3.117. When updating the forecast for a price control submission, DCC must ensure its forecast costs meet the threshold of being significantly more likely than not to occur (the "certainty threshold"). DCC is also expected to explain and provide sufficient evidence that it has made the most economic and efficient decisions. DCC typically provides justification for two years of forecasts and does not attempt to justify any costs it expects to incur after these two years. This is because costs may become more uncertain the further into the future they are. At the consultation stage, we considered that DCC had not provided sufficient evidence for the certainty and economy of the forecast costs.

3.118. DCC baseline forecast costs for RY23/24 onwards increase by an average of £53m each year. DCC however did not provide any justification for this increase in its price control submission. We have therefore consulted on removing these costs from the forecast.

Respondents' views

3.119. Our proposals received broad support from stakeholders. Seven respondents agreed with our minded-to position.

3.120. One stakeholder noted that forecast cost increases should be expected to be minimal as DCC's service becomes more stable. Another respondent noted that DCC customers rely on accurate forecasting in considering the impact of DCC charges on their own cash-flows.

3.121. Three stakeholders voiced concerns over the projected increase in internal resource requirements in the context of DCC's Disaggregation Strategy.[43] These stakeholders noted that increasing internal resource to manage growing complexity of contracts would be contrary to the aim of the Strategy to 'consolidate and simplify' DCC's contracts. One of these stakeholders raised concern that the increase in complexity and associated internal resources was a direct result of the Strategy, which has produced a greater number of contracts.

3.122. One stakeholder raised concerns over DCC's Business Accuracy Programme.[44] They observed that, as reported to DCC customers, the Programme would not generate net benefit for DCC customers until after the end of the current Licence, and questioned whether it could be seen as providing value for money.

3.123. Four respondents did not have a view on this question but did not object to our proposals. One of these respondents expressed concerns over a lack of forecasting post-RY21/22 and questioned what lessons are being learnt and applied to improve the accuracy of DCC's forecasting.

3.124. DCC disagreed with our proposal but submitted limited additional evidence for our consideration. DCC re-iterated its submission-stage arguments for the variances in the Commercial, Operations and Service Delivery cost centres. With respect to the commercial operations sub-team, DCC restated a need to 'upskill' the team due to the introduction of the NAO framework under the contract management incentive of the revised OPR.[45]

3.125. DCC also provided data on 'actual spend' in RY21/22, set against the forecast costs in Commercial, Corporate Management and Service Delivery (Programme) cost centres.

[43] The Disaggregation Strategy is a proposed contract management strategy under which DCC would seek to 'break up' some of its larger external contracts into smaller agreements.
[44] The Business Accuracy Programme is a proposed programme under which DCC would review its internal processes and systems and develop new integrated solutions.
[45] "National Audit Office" Framework. For more details on the use of the NAO assessment framework under the contract management incentive of the revised OPR, please see Ofgem (20210), *OPR Guidance*, Section 5. www.ofgem.gov.uk/publications/decision-opr-guidance-march-2021

Reasons for our decision

3.126. Having reviewed DCC's additional evidence, we have decided to maintain our position and disallow forecast cost variances in RY21/22 and RY22/23 across the cost centres in line with our consultation proposal. For clarity, detailed disallowances per cost centre and RY are set out in Table 3.1 below.

3.127. With regards to DCC's qualitative evidence, DCC has not provided any new substantial information beyond its original submission. We do not consider that the introduction of the NAO framework alone justifies the need to increase resource in the commercial operations sub-team. Whilst the contract management element of the revised OPR, using the NAO framework as its assessment tool, introduces a new incentive on DCC, DCC's contract management function should already be sufficiently mature to perform well against the framework.

3.128. DCC's quantitative evidence of actual spend in RY20/21 against forecast costs does not provide clear evidence in support of either certainty or economy of the forecast costs. DCC's data suggests that no or minimal costs (<6%) were incurred against the forecast costs in the cost centres where this evidence was provided.

3.129. DCC submitted no additional evidence for the variances in the baseline forecast costs from RY23/24 onwards. We are therefore maintaining our position and determine that these costs shall be disallowed.

3.130. We recognise stakeholder concerns over the quality of DCC's forecasting. We encourage DCC to work with its customers on sharing further information on its forecast costs outside the price control submission as appropriate – for example using Quarterly Finance Forums.

3.131. We note stakeholders' comments about DCC's Disaggregation Strategy and Business Accuracy Programme. DCC's Disaggregation Strategy forms part of DCC's contract management approach, which will be subject to an OPR incentive. With regards to the Business Accuracy Programme, we note that DCC will be required to justify any material costs it may incur under future price controls, where we will be able to carry out a full assessment, and we welcome stakeholder representation on this issue. We will also continue to monitor these areas as part of our ongoing compliance activities.

Table 3.1: Forecast disallowances per cost centre in RY21/22 and RY22/23

Cost Centre	RY21/22 disallowance (£m)	RY22/23 disallowance (£m)	Total Disallowance (£m)
Commercial	1.551	2.152	**3.703**
Corporate Management	0.870	0.407	**1.277**
Finance	0.209	0.722	**0.931**
Operations	1.700	5.534	**7.234**
Service Delivery (Programmes)	0.739	0.342	**1.081**
Total	**5.069**	**9.157**	**14.226**

4. Performance incentives

Section summary

This section covers DCC's submission of its performance under the Operational Performance Regime (OPR) and any relevant Baseline Margin Project Performance Adjustment Schemes (BMPPAS). There are no decisions to be made on the BMPPAS for RY20/21.

In our consultation, we proposed that DCC should retain its full margin as it met all the targets under the OPR.

We also provided an update on the implementation of the revised OPR. Under the revised OPR, DCC's customer engagement will be financially incentivised. As part of the trial run in RY20/21, we received submissions from both DCC and SEC Panel on DCC's performance during RY20/21. Based on the submissions received we recommend a score of 1.17 for this trial period.

Following consideration of the consultation responses our positions remain unchanged.

Questions posed at the consultation:

Question 11: What are your views on our proposed position on DCC's performance under OPR and trial run for customer engagement, and implementation of the contract management incentive?

Operational Performance

Proposal at consultation: allow DCC to retain all Baseline Margin under the OPR, as all targets were achieved.

Decision: remains unchanged from consultation proposal.

Context

4.1. All of DCC's BM (including adjustments) is at risk against one of DCC's performance regimes.[46]

4.2. The margin DCC recovered in RY16/17 and RY17/18 was not put at risk against a performance regime as the Implementation Performance Regime had concluded and the OPR was yet to begin. All the BM recovered in RY16/17 and RY17/18 is being put at risk across RY18/19, RY19/20, and RY20/21.

4.3. This is the third year in which DCC's performance is being assessed by the OPR. Separately to the BM, DCC receives margin on the Switching Programme. This switching margin is at risk under a separate performance regime, which is covered in Section 6 of this document.

4.4. As set out in Schedule 4 to the Licence, the current OPR was initially consulted on in March 2016 and the final decision and direction was published in September 2017.[47]

4.5. The current OPR consists of five equally weighted performance measures: two Service User Measures (SUM) and three Service Delivery Measures (SDM). Table 4.1 lists the five measures and subdivisions.

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[46] See Part C of LC 38 of the Smart Meter Communications Licence.
[47] For more detail please refer to Ofgem (2017), *Decision on DCC's Operational Performance Regime*. www.ofgem.gov.uk/publications-and-updates/decision-dcc-s-operational-performance-regime

Table 4.1: Operational Performance Measures

Measure	Area of reporting	Metric	Weighting
SUM1	DCC service desk	Percentage of incidents resolved within Target Resolution Time	20%
SUM2a	Communication Hubs	Percentage of Communications Hubs delivered on time	10%
SUM2b		Percentage of Communications Hubs accepted by customers	5%
SUM2c		Percentage of Communications Hubs not faulty at installation	5%
SDM1a	DCC WAN coverage	All CSP contractual milestone dates met	20%
SDM1b		Percentage of first time SMWAN connectivity at install	
SDM2	Core service requests	Percentage of service responses delivered within Target Response Time	20%
SDM3	Service/System Availability	Percentage availability of Data Service, User Gateway, Service Management System and Self Service Interface	20%

4.6. These OPR performance measures are composed of a combination of the performance measures reported to SEC and described in DCC's Performance Measurement Methodology.

4.7. The total BM at risk under the OPR this year is £8.911m. DCC proposed that it should retain its full margin as it achieved all targets under the OPR (and therefore the BMOPA term took the value of 0).

4.8. In its RY20/21 price control submission, DCC reported that they met all targets except for SDM1. Specifically, the SDM1a element was not met due to the inability of DCC to complete site installations to provide the targeted WAN coverage. Although SDM1b was achieved, both parts of the delivery milestones must be met for all targets to be achieved.

4.9. DCC applied to the SEC Panel for an 'OPR Exceptional Event' to acknowledge the impact of COVID-19 on the completion of the SDM1a milestone. This application was accepted which resulted in DCC achieving all OPR targets.

Respondents' Views

4.10. Most respondents who commented disagreed with our proposal and felt that DCC had not met all OPR targets, despite being awarded an 'OPR Exceptional Event' to acknowledge the impact of COVID-19 on the completion of the SDM1a milestone.

4.11. Five respondents disagreed with the proposal and highlighted issues with the methodological calculations implemented in the Performance Measurement Reports. These calculations feed into the overall OPR percentages and scores. Respondents believed this created a false narrative on the targets which were stated to have been achieved.

4.12. Further two respondents conveyed strong views about the SDM2 measure which detailed the core service request performance under the OPR. They acknowledged that this measure was above the minimum service level but had not reached the target service levels, therefore denoting overall targets should not have been achieved.

4.13. One respondent expressed there has been a consistent issue with the CPM1 measure not reaching the minimum service level and therefore did not support the proposal that DCC should retain all Baseline Margin under OPR.

4.14. Another respondent understood smart metering was transitioning between the two performance regimes but believed it remained important that DCC be held to account for what it failed to deliver during key rollout years.

4.15. Excluding DCC and Capita, one respondent agreed with the proposal that OPR targets were achieved in line with our requirements.

Reasons for our decision

4.16. We have reviewed all the responses received. Whilst we acknowledge all comments made in relation to the OPR scores provided by DCC, we believe that there is insufficient evidence for us to change our consultation position.

4.17. We understand respondents' views in relation to the missed milestone SDM1a; however, a successful application was granted from SEC which authorised DCC to achieve its targets. As a result, we are unable to move away from our consultation position as SEC followed standard procedures before reaching the final decision.

4.18. DCC completed its OPR scores in line with our Regulatory Instructions and Guidance (RIGs)[48] and associated guidance document[49] alongside our RIGs Annex 1.[50] DCC is required to populate its performance scores in relation to the various performance measures described in Annex 1. The performance measures are calculated as per the formulae defined in the RIGs guidance documents. The formulae in the guidance illustrate the calculations that should be used to determine the OPR scores. DCC has followed these calculations, and this has been correctly applied to the spreadsheets in Annex 1. This provided us with the relevant scores to interpret DCC's performance.

4.19. We acknowledge stakeholders' concerns regarding the calculations for the performance measures SDM2 and CPM1. Both performance measures have been correctly calculated as per Appendix 2 of our RIGs Annex 1 document.[51]

4.20. The current OPR framework was initially agreed through consultation with stakeholders in 2017.[52] However, in RY18/19 we noted this framework did not fully reflect customer experiences as the measures solely focused on a narrow range of DCC's technical outputs. There were also concerns that the current OPR did not effectively incentivise DCC. It is vital that DCC is incentivised appropriately to ensure it is operating effectively and delivering better outcomes for customers.[53]

4.21. As a result, we have revised the OPR measures and are implementing a new OPR framework which aims to better capture DCC's performance in future regulatory years.

4.22. To conclude, as there are no changes to our consultation position, the BMOPA term is calculated to be 0.

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[48] Ofgem (2021), *Data Communications Company (DCC): Regulatory Instructions and Guidance.* www.ofgem.gov.uk/publications/data-communications-company-dcc-regulatory-instructions-and-guidance-2021
[49] Ofgem (2021), *DCC Price Control Guidance: Processes and Procedures.* www.ofgem.gov.uk/publications/dcc-price-control-guidance-processes-and-procedures-2021
[50] Ofgem (2021), *Annex 1 Quality of Service Information.* (See subsidiary documents to *DCC Price Control Guidance: Processes and Procedures,* as above)
[51] Ofgem (2021), *Annex 1 Quality of Service Information,* Appendix 2.
[52] Ofgem (2017), *Decision on DCC's Operational Performance Regime.* www.ofgem.gov.uk/publications/decision-dccs-operational-performance-regime
[53] Ofgem (2020), *Operational Performance Regime Working Paper.* www.ofgem.gov.uk/publications/dcc-operational-performance-regime-working-paper

OPR: Way Forward

Proposal at consultation: we provided an update on the implementation of the revised OPR. Under the revised OPR, DCC's customer engagement will be financially incentivised. As part of the trial run in RY20/21, we received submissions from both DCC and SEC Panel on DCC's performance during RY20/21. Based on the submissions received we recommend a score of 1.17 for this trial period. We also proposed to implement the contract management incentive with margin attached over RY21/22.

Decision: remains unchanged from consultation proposal.

Context

4.23. We became concerned, following DCC's submission of its performance under the OPR for the RY18/19 Price Control, that the OPR metrics may not be providing the best incentives to DCC. We asked stakeholders in our DCC Price Control RY18/19 Consultation[54] for their views on how the OPR could be modified and improved. All respondents, including DCC, agreed with our concerns and supported a review of the current OPR framework.

4.24. Following consultation, in October 2020 we published our decision[55] to financially incentivise three areas under a revised OPR: system performance, customer engagement and contract management. As part of our decision, we also implemented a licence change to enable Ofgem to publish guidance, regarding the process, procedures and criteria of the OPR.

4.25. In March 2021, we published the OPR Guidance[56] to enable implementation. This included setting the performance levels and values for the system performance penalty mechanisms, and detailed processes for the customer engagement and contract management incentives. We proposed a trial run in RY20/21 for both Customer Engagement and Contract Management, without margin attached, for

[54] Ofgem (2019), *DCC Price Control Consultation: Regulatory Year 2018/19.* www.ofgem.gov.uk/publications/dcc-price-control-consultation-regulatory-year-201819
[55] Ofgem (2020), *DCC Operational Performance Regime Review: Decision.* www.ofgem.gov.uk/publications/dcc-operational-performance-regime-review-october-2020-decision
[56] Ofgem (2021), *Decision on OPR Guidance.* www.ofgem.gov.uk/publications/decision-opr-guidance-march-2021

these incentives to come into effect with margin attached in RY21/22. We decided to implement a twelve-month grace period for System Performance measures in RY21/22, for the new regime to come into effect in RY22/23.

Respondents' Views

Customer Engagement

4.26. Of the twelve responses we received to our consultation, five respondents explicitly commented on our score of 1.17 for the trial run of DCC's customer engagement under the revised OPR.

4.27. One respondent agreed with our position and three others said that they support the SEC Panels scoring and were concerned with the difference in assessments between DCC and the SEC. They pointed out that the divergence between SEC and DCC scores could be a result of different assessment methods, or may actually point to the serious underlying problem of aligning DCC's perception with the reality of issues SEC Parties face. Respondents stressed that this fundamental disagreement in performance between SEC and DCC needs to be investigated, analysed and ultimately addressed.

4.28. One respondent said that they did not agree with DCC's view that it proactively engaged with customers and undertook timely and frequent engagement with customers. The respondent pointed out that there is still not clarity around DCC's change process and that DCC's engagement taking place through workshops and webinars often lacks structured minutes and documented actions, which makes it hard to follow up on comments and questions raised. The respondent cited examples of projects such as DCC Boxed and DNO Transformation Programme, where they had to proactively engage and request information from DCC repeatedly. The respondent highlighted the importance of a decision-making forum and agreed governance structures.

4.29. One respondent noted that there have been some improvements in DCC's customer engagement but added that engagement is not always consistent and, therefore, there needs to be a continued improvement in this area.

4.30. Some respondents mentioned the Customer Portal which was intended to provide DCC Users an online platform for easy access to services and information. One respondent commented that the Customer Portal services, such as more transparency from DCC on its customers' consultation responses and wider engagement, could have been delivered via the SmartDCC website. Another respondent said that the portal is an example of DCC activity which incurred costs for DCC Users but failed to deliver any benefits as it was not built to requirements in the first place. Respondents also suggested that costs associated with the portal should be disallowed.

4.31. DCC responded saying that the trial year has been a useful exercise and further explanation of the scores assigned would help DCC to respond accordingly and allow the incentive to work effectively.

Contract Management

4.32. Five respondents gave views on this issue, including DCC. All respondents except DCC supported our position.

4.33. DCC explained that the adoption of the NAO framework is a significant change for DCC and there is the potential for different interpretations of DCC's performance. DCC stated a trial year would help manage this issue and improve the effectiveness of the incentive.

4.34. DCC also commented that not conducting a trial year would amount to 'moving the goalposts' of a regime that we previously consulted on.

4.35. DCC noted it is making improvements to its processes including mobilising programmes and projects sooner by planning further in advance for decisions to re-procure or extend, and improving knowledge transfer at contract handovers.

Reasons for our decision

Customer Engagement

4.36. We have reviewed all the responses received. We maintain our consultation position of assigning a score of 1.17 for this trial period.

4.37. We note stakeholders' concern on the difference in scores assigned by DCC and the SEC. We understand that DCC is engaging with SECAS and Sub-committee Chairs to review the process for engagement throughout the decision-making cycle and set a standard framework. We expect this work will help DCC and SEC to address the reasons behind difference is scoring.

4.38. In March 2021, we published the OPR Guidance[57] which explains the scoring methodology. The score assigned for the trial period is in line with the scoring methodology set out in our guidance. Based on the submissions from DCC and the SEC Panel, we note that engagement is inconsistent and there are material areas of concern around transparency, cost benefit information, timely engagement and closing the feedback loop.

4.39. A clear plan and timetable of engagement, which sets out what information will be shared and the role of customers at each decision point in the programme cycle, would benefit the process. We expect that DCC's joint project with SECAS and Sub-committee Chairs will lead to more effective engagement.

Contract Management

4.40. Our rationale for implementing the contract management incentive has not changed. Contract management is core to DCC's business model and as such we consider DCC should be demonstrating good contract management practices. Given DCC customers' and our longstanding concerns with DCC's contract management, we want to drive rapid improvements in this area to deliver real benefits to DCC's customers and end-consumers. We are therefore maintaining our consultation position to implement the incentive with margin attached over RY21/22.

4.41. We consider that good contract management should be evident regardless of what framework DCC is being assessed against. As discussed in our consultation, we are aware DCC has conducted its own benchmarking exercise for its activities against the NAO framework, and DCC explained in its RY20/21 price control submission and consultation response that it has already made changes to its contract management processes to drive improvements. We remain of the view that it is reasonable to expect that DCC's contract management function should already be sufficiently mature to perform well against the NAO framework. These requirements were set out clearly in the OPR Guidance, as decided on in consultation with DCC and other stakeholders, and we consider DCC has had sufficient time to review and adjust its

[57] Ofgem (2021), *Decision on OPR Guidance.* www.ofgem.gov.uk/publications/decision-opr-guidance-march-2021

processes where required. We therefore do not agree with DCC's argument that it needs more time to be assessed against the NAO framework.

4.42. In our October 2020 OPR Review decision,[58] we decided to implement the Contract Management incentive over RY21/22 with margin attached. We also proposed to implement a trial period, believing that a trial would be beneficial to give SEC, Ofgem and DCC a chance to become familiar with the assessment process and allow us to consider any improvements. We proposed to run the trial over RY20/21 to ensure the financial incentive will be implemented as originally envisaged for RY21/22. After consulting with stakeholders on the OPR Guidance, our March 2021 OPR Guidance decision[59] maintained the position that the OPR should come into effect with margin attached over RY21/22 after reviewing stakeholder responses.

4.43. Although we were not able to conduct the trial period, we consider upholding the decisions to implement the incentive in RY21/22 with margin attached provides the necessary certainty to DCC of our expectations, and to DCC customers for improvements in DCC's service. We consider delaying the implementation of the incentive would not achieve the policy intent of putting strong incentives in place for DCC to make rapid improvements as desired by stakeholders.

4.44. As part of our price control process, we will consult on our proposed position on DCC's contract management performance under the OPR. This will ensure DCC and other stakeholders will have the opportunity to respond to our consultation position and make any necessary representations to DCC's performance.

4.45. We are also exploring alternative approaches in absence of a full trial year and are currently engaging with DCC on next steps.

[58] Ofgem (2020), *DCC Operational Performance Regime Review: Decision.* www.ofgem.gov.uk/publications/dcc-operational-performance-regime-review-october-2020-decision
[59] Ofgem (2021), *Decision on OPR Guidance.* www.ofgem.gov.uk/publications/decision-opr-guidance-march-2021

Project Performance

Context

4.46. The Secretary of State may create a BMPPAS, defining a Project and an incentive regime, which determines the BM DCC retains based on its performance in the defined Project. BM adjustments which are awarded to DCC for work associated with such a Project are held at risk by the BMPPAS incentive regime.

4.47. Any reductions made due to a BMPPAS incentive regime are made through the BMPPA term given in the Licence.

4.48. The assessment of the R2.0 BMPPAS was finalised last year. As a result, in RY20/21 there were no Projects to be assessed under the BMPPAS regime.

Our view

4.49. There are no decisions to be made on BMPPAS for RY20/21.

5. Baseline Margin and External Contract Gain Share

Section summary

This section summarises DCC's application for adjustments to its Baseline Margin and External Contract Gain Share.

The BM will be adjusted to reflect changes to DCC's Mandatory Business. After consideration of consultation responses, our position remains unchanged in regard to BM drivers and activities. We have, however, adjusted the BM to reflect changes to Internal Costs disallowances. We have directed an adjustment of £7.29m.

The ECGS will be adjusted to reflect the cost savings DCC has achieved through refinancing and its in-house Test Labs Service. Following consideration of consultation responses and the additional evidence provided by DCC, we have changed our position, no longer fully rejecting the savings from DCC's in-house Test Labs Service. We have, however, recalculated these savings and awarded a partial ECGS Adjustment for Test Labs of £2.96m. The total awarded ECGS Adjustments amounts to £13.50m.

The total ECGS savings secured by DCC for customers between RY15/16 (DCC's first ECGS Adjustment application) and RY20/21 (including this year's application) is £83.48m which accounts for 54% of total cost reductions.

Questions posed at the consultation:

Question 12: What are your views on our assessment of DCC's application to adjust its Baseline Margin?

Question 13: What are your views on our assessment of DCC's application to adjust its ECGS?

Q12 Baseline Margin

Proposal at consultation: adjust DCC's Baseline Margin by £7.26m (in RY20/21 prices) for work being performed between RY20/21 and RY22/23. DCC provided insufficient evidence for activities related to three drivers and missed the application window for two other drivers. For one of these drivers, we were minded to reject the claim that there had been a material change in scope or volume. Based on these grounds, we proposed that DCC should not be awarded Baseline Margin for these activities and drivers. We were minded to accept that 15% is an acceptable margin for the core smart metering activities.

Decision: our position on Baseline Margin activities and drivers remains unchanged from the consultation proposal. We have adjusted the BM to reflect changes to Internal Costs disallowances and direct an adjustment to DCC's Baseline Margin of £7.29m (with RY20/21 price base) for work being performed between RY20/21 and RY22/23. We consider that 15% is an acceptable margin.

Context

5.1. The BM adjustment mechanism allows DCC to apply for a Relevant Adjustment to the Baseline Margin values specified in Appendix 1, Condition 36 of the Licence. The adjustment mechanism is detailed in Appendix 2, Condition 36 of the Licence.

5.2. The BM adjustment mechanism was included in the Licence in recognition of the uncertainty of the nature and risks of DCC's Mandatory Business over the Licence term. The adjustment mechanism is intended to ensure that DCC is compensated for material changes in certain aspects of its Mandatory Business – including the volume, characteristics, risks and timescales of these activities. Greater detail on the conditions and requirements for a BM Relevant Adjustment can be found in the RIGs[60] and the processes and procedures document.[61]

5.3. DCC's BM (including adjustments) is subject to DCC's performance regime under which its BM may be reduced for poor performance. 100% of the BM recovered this

[60] Ofgem (2021), *Data Communications Company (DCC): Regulatory Instructions and Guidance*. www.ofgem.gov.uk/publications/data-communications-company-dcc-regulatory-instructions-and-guidance-2021
[61] Ofgem (2021), *DCC Price Control Guidance: Processes and Procedures.* www.ofgem.gov.uk/publications/dcc-price-control-guidance-processes-and-procedures-2021

year is held to account by the OPR and by a Baseline Margin Project Performance Adjustment Scheme, as directed by the Secretary of State.

Respondents' views

5.4. The majority of respondents supported our consultation proposal for the BM adjustment.

5.5. One stakeholder partly disagreed with our proposal on the grounds that DCC should provide further justification for the area of Network Evolution Programme (NEP) and Data Service Provider/Trusted Service Provider re-procurement. The stakeholder said that it was not clear how these activities could not have been foreseen by DCC and therefore met the criteria of 'material changes to mandatory business'. This is because, in their view, enhancing and reprocuring these services must fall into a mandatory business requirement of contract management and continuous improvement.

5.6. Whilst DCC largely supported our proposals for BM adjustment, it contested our proposal to disallow the 'mandated Great Britain Companion Specification (GBCS) update' driver. DCC also noted that significant proportion of the proposed reductions were the direct result of disallowances of forecast costs.

5.7. In relation to mandated GBCS, DCC explained that, whilst the GBCS updates were supposed to be introduced in RY19/20, an earlier rollout was not possible due to the delays to the R2.0 programme. DCC argued that it had already been severely penalised for the delay in the programme through the removal of incentivised margin, and to deduct the Baseline Margin Adjustment would therefore effectively penalise DCC twice for the same issue. DCC added that this was contrary to the regulatory principles of the current regime.

5.8. Two respondents said that, whilst supportive of our position on the BM adjustment, they would like to see more openness and transparency from DCC regarding costs and processes related to all changes. One respondent added that this has been raised with DCC in numerous occasions and has been ignored so far.

5.9. Two respondents specifically supported our proposal to reject the adjustment for the DNO Transformation programme. They said that aligning current DCC performance with the SEC, alongside improving the engagement and service provided to DNOs, should not result in increased scope or cost. One respondent added that, if that was the case, at a minimum, DNOs should be consulted before committing to further costs.

Reasons for our decision

5.10. We have considered the responses we received, including DCC's additional explanation regarding GBCS, and stakeholder's concerns around whether the Network Evolution Programme met the criteria for BM adjustment.

5.11. In relation to GBCS, our view is that the Baseline Margin Project Performance Adjustment Scheme (for Release 2.0) by BEIS incentivised DCC on delivery of the project. The criteria considered under a project performance incentive are different from those considered for a BM adjustment. In particular, the criteria considered for a BM adjustment are defined in Licence Condition 36, Appendix 2, Part A.[62] Therefore, our position is that DCC is not being penalised twice for the same issue because the objectives, criteria and requirements for BM adjustment and project performance incentive are different.

5.12. Regarding the Network Evolution Programme (NEP) driver for BM adjustment submission and related activities, we accept DCC's argument that the changes introduced by the NEP represent a material change to the scope of DCC's work, as envisaged and set in the LABP. In relation to the Data Service Provider (DSP) and Trusted Service Provider (TSP) re-procurements activities, our position is that these constitute a material variation from the LABP, based on the uncertainty and difficulty in their costing, which was noted in the LABP itself. This is in line with our RY19/20 Decision.[63]

5.13. Finally, we note stakeholders' concerns around a general lack of transparency regarding costs and processes related to changes to DCC's activities. It is important that DCC engages with its stakeholders in a transparent manner about its planned activities and costs. We urge DCC to take steps to improve in this area.

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[62] *Smart Meter Communication Licence.* https://epr.ofgem.gov.uk/Content/Documents/Smart%20DCC%20Limited%20-%20Smart%20Meter%20Communication%20Consolidated%20Licence%20Conditions%20-%20Current%20Version.pdf
[63] Ofgem (2021), *DCC Price Control Decision Regulatory Year 2019/20.* www.ofgem.gov.uk/publications/dcc-price-control-decision-regulatory-year-201920

Q13 External Contract Gain Share

Proposal at consultation: direct an adjustment to DCC's External Contract Gain Share of £10.55m across RY22/23 to RY25/26 on the basis of £34.13m of savings from the continuation of refinancing arrangements for the CSPs, and financing of Tranche 1 and 2 of Communication Hubs (CHs). Reject £3.98m ECGS Adjustment relating to DCC's in-house Test Labs Service on the basis that the application did not meet all the relevant conditions.

Decision: direct an adjustment to DCC's External Contract Gain Share of £13.50m across RY22/23 to RY25/26. Partially accept ECGS Adjustment relating to DCC's in-house Test Labs Service. DCC provided additional evidence related to this service, which we have used to recalculate the incurred savings and associated ECGS Adjustment.

Context

5.14. The formula for DCC's Allowed Revenue includes an ECGS term, which allows for an upward adjustment to the Allowed Revenue where DCC has secured cost savings in the Fundamental Service Provider (FSP) contracts as detailed in Condition 39 of the Smart Meter Communication Licence.[64] This is so that DCC has an incentive to seek and achieve cost savings in the FSP contracts. This term is zero unless DCC applies for a Relevant Adjustment to this term.

Respondents' views

5.15. The majority of respondents were supportive or did not oppose our proposals.

5.16. DCC disagreed with our minded-to position to reject the ECGS adjustment relating to DCC's in-house test lab services. It argued that this service represented genuine cost savings found within DCC's Fundamental Service Providers (FSP) contracts and had directly resulted in lower costs passed to its customers. DCC also responded to our minded-to position that the ECGS adjustment application did not meet the required

[64] *Smart Meter Communication Licence.* https://epr.ofgem.gov.uk/Content/Documents/Smart%20DCC%20Limited%20-%20Smart%20Meter%20Communication%20Consolidated%20Licence%20Conditions%20-%20Current%20Version.pdf

eligibility criteria set in the Licence Conditions (LC), submitting additional evidence and arguments. In particular:

- in relation to Licence Condition 39.A4 (a), which states that DCC must 'set out how the costs associated with the activities that are the subject of the proposal were included in the original External Service Provider Contract (or Contracts)'. Our minded-to position was that DCC has not met this requirement as the services provided in the new test labs were not the same as to those provided under the original FSP contracts. DCC provided additional evidence to show that the service was now more enhanced, effectively providing more for less.

- in relation to Licence Condition 39.A5 (b), which states that in order for Ofgem to approve any ECGS adjustment, the Relevant Adjustment notice "must be served within the first Application Window after the date on which the grounds for proposing the Relevant Adjustment first arose". Our consultation position was that DCC missed the relevant Application Window, which was July 2019. DCC disagreed with our interpretation of the LC and argued that what determines the appropriate Application Window is the effective reduction of External Costs (ie achieving net savings). Therefore, in its view, the July 2021 was the first Application Window for the Test Labs ECGS application, because RY20/21 was the first year a net saving was realised. It also argued that it informed us about its intention to make an ECGS application when savings were achieved in previous price control submission, without us objecting or raising any concerns.

5.17. Two respondents welcomed the savings incurred by DCC through refinancing of service providers, however, they thought that DCC should now be in a position to actively explore and secure additional cost savings in other areas of its operations. A third respondent expressed their disappointment with the fact that all the savings to date appeared to rely on refinancing.

5.18. Two respondents specifically supported our proposed position to reject the ECGS adjustment application for DCC's in-house Test Labs service. One of them argued that, whilst the saving was welcome, there was no explanation of the impact or quality and effectiveness of the testing undertaken.

5.19. One respondent raised the lack of cost savings on the CPS-North contract, noting that, instead, the growth of the costs of CSP-North has been nearly double that of CSP – Central and South.

5.20. The same respondent also disagreed with the claim that DCC's proposed distribution of savings between its customers was consistent with previous years as the costs savings made in RY20/21 from Communication Hub financing were not distributed to all DCC users and only impacted suppliers. They argued that, as such, DNOs as DCC users have received no benefits from the DCC activity in this area.

Reasons for our decision

5.21. We have reviewed the responses we received, including the additional evidence submitted by DCC in relation to DCC's in-house Test labs service. We have decided there is now sufficient evidence to demonstrate that ECGS related to Test labs service meets the eligibility condition (Licence Condition 39.A4 (a)) for a Relevant Adjustment. We are now convinced that the User Integration Testing (UIT) service which was part of the original FSP contracts is being provided more efficiently through the DCC test labs.

5.22. In relation to the Application Window condition (Licence Condition 39.A5 (b)), we are still of the view that DCC missed the Application Window for the relevant ECGS Adjustment. However, we will make an exception in this case and accept DCC's Application. The main reasons for this are that we recognise that DCC's customers find the Test Labs useful, and we wish to incentivise similar innovative initiatives from DCC in future. Therefore, we are willing to be more flexible in this particular case.

5.23. We would like to be very clear that our acceptance of DCC's application in this particular case does not constitute any precedence for future applications.

5.24. Furthermore, we would like to take this opportunity to clarify what should be understood by Application Window in this context to avoid similar situations in the future. We may also update our Process and Procedure Guidance[65] to include this

[65] Ofgem (2021), *DCC Price Control Guidance: Processes and Procedures.* www.ofgem.gov.uk/publications/dcc-price-control-guidance-processes-and-procedures-2021

clarification for ECGS applications. We consider the grounds for proposing the Relevant Adjustment first arise when either of the below occurs:

a. when amendments to the FSP contract are agreed and the contract is signed with an aim to realise savings; or

b. when costs are incurred to deliver the same service previously delivered by the FSPs with an aim to realise savings. It is reasonable to assume that if costs have been incurred elsewhere to deliver the same service the FSP contract will be amended to realise the savings and the delay is just procedural.

5.25. Paragraph 5.9 in our Process and Procedure Guidance[66] states that if the values for future years are not certain at the time of the original application, DCC should apply for the specific values in the first application window after such values become certain. Thus, if DCC is not certain of the savings to be realised in the future, DCC should make the ECGS application with relevant information available and then apply for the specific values of the savings in the first application window after the values become certain (for example, when net savings are realised).

5.26. DCC first incurred costs to deliver the Test Labs service in-house in RY18/19, which was expected to eventually deliver significant savings according to a business case. Following the definition of Application Window described above, it was in that period when the grounds for proposing the Relevant Adjustment first arose. Therefore, the first Application Window was July 2019 instead of July 2021.

5.27. We would also like to clarify that our silence on a matter in previous price control submissions or other forms of engagement should not be considered as indication of our future approach once the matter comes to be formally assessed within the relevant price control. In particular, our silence on an issue should not be considered as tacit acceptance or approval. Therefore, we reject DCC's argument that we validated its approach to Test Labs Application for ECGS when we did not comment on some statements in previous price control submissions.

[66] Ofgem (2021), *DCC Price Control Guidance: Processes and Procedures.* www.ofgem.gov.uk/publications/dcc-price-control-guidance-processes-and-procedures-2021

5.28. In relation to the in-house Test Labs savings calculation methodology proposed by DCC, we have decided to adjust it. In particular, we have done the following adjustments, reducing the total savings figure by £1.15m:

- included Shared Charges in DCC's in-house Test Labs service costs to properly reflect the savings seen by DCC's customers

- excluded office costs from the counterfactual ('do nothing' scenario). Our position is that ECGS savings should be calculated by comparing the costs in the original Fundamental Service Provider contracts against the new total costs. DCC confirmed that the office costs were not set out in the original FSP contracts.

5.29. In relation to the proposed gainshare arrangements for the in-house Test Labs benefits between customers and DCC, we have decided to reject a 50%-50% split for the additional savings,[67] and apply a split of 62.5% (for customers) to 37.5% (for DCC) instead. We have taken this decision based on the following reasons:

- the proposed 50%-50% split deviates from DCC's default position on gainshare (as noted in its RY20/21 Relevant Adjustment Submission), which states that the largest share of the savings always ought to be returned to customers.

- the proposed 50%-50% split deviates from usual practice in this area, and in particular, from the original Test labs savings as forecasted in the baseline business case. It is worth noting that this would be the first time DCC is proposing to apply this new gainshare arrangement. Notably, DCC did not explain why the additional savings merit a different treatment from the originally forecasted Test Labs savings in the business case.

- the 62.5%-37.5% split we are applying is what DCC proposed for all other equivalent ECGS types included in this year's application. This includes DCC's gainshare proposal for the forecasted Test Labs savings in the original business case.

[67] Savings in excess of what was forecasted in the in the baseline business case.

5.30. Based on the above, we have changed our minded-to position. We are no longer fully rejecting the savings from DCC's in-house Test Labs Service, and partially accept DCC's application.

5.31. In regard to DCC's service and performance levels in the North, we acknowledge that this remains an area of particular concern.

5.32. The ECGS is calculated as £9.883m for RY22/23, £1.055m for RY23/24, £1.111m for RY24/25 and £1.456m for RY25/26. In total, the ECGS Adjustment is £13.50m. Between RY15/16 (DCC's first ECGS Adjustment application) and RY20/21 (including this year's application), DCC has secured cost reductions of £154.55m in the FSP contracts and CHs financing, and Test Labs service, and brought benefits of £83.48m (54% of total cost reductions) to DCC's customers through lower charges.

6. Switching

Section summary

This section covers our assessment of DCC's costs associated with the Switching Programme in RY20/21 and the forecasts to the end of the licence period.

This section also gives our decision on the second and third incentivised delivery milestones of the Design, Build and Test phase of the Switching Programme: Delivery Milestone 2 (DM2) and Delivery Milestone 3 (DM3).

We proposed to disallow DCC's forecast costs of £7.053m for RY23/24 onwards as DCC did not provide any justifications for these costs.

This year all associated milestones (DM2 and DM3) were achieved. We therefore proposed that DCC should retain all margin associated with these milestones.

Following consideration of consultation responses, which largely supported our proposal, our positions remain unchanged.

Questions posed at the consultation:

Question 14: What are your views on our proposed position on DCC's costs associated with the Switching Programme?

Question 15: What are your views on our assessment of Delivery Milestone 2 and Delivery Milestone 3 of the Switching Programme?

Q14 Switching Costs

Proposal at consultation: disallow all forecast costs beyond RY22/23 to the end of the Licence period, £7.053m. Disallow the corresponding margin (which is calculated as a percentage of internal costs), an additional £0.031m.

Decision: remains unchanged from the consultation proposal.

Context

6.1. The Switching Programme has been established to improve consumer’s experience of switching between energy suppliers. DCC plays a central role in delivering this programme.

6.2. The costs and performance of the Switching Programme are dealt with separately from the rest of DCC’s business.

Respondents’ views

6.3. All respondents who commented agreed with our proposal for DCC to lose all forecast costs related to the Switching Programme due to a lack of justification for these costs.

6.4. Two respondents stated that they are aware costs are increasing and that a further review of DCC’s costs in this area is likely to be warranted.

6.5. One respondent, who agreed with the disallowance, expressed that DCC should not be allowed to seek any Switching Programme costs for financial years beyond the end of this programme.

6.6. Another respondent restated that DCC and its service providers play a central role in delivering the Switching Programme and every cost should be justified as the Business Plan was not competitively tendered.

Reasons for our decision

6.7. We have reviewed the responses we received. We believe that there is insufficient evidence for us to change our consultation position.

Q15 Switching Performance

Proposal at consultation: allow DCC to retain 20% and 25% of margin associated with DM2 and DM3, respectively.

Decision: remains unchanged from the consultation proposal.

Context

6.8. We published our decision on an updated incentive regime for DCC's role in the Design, Build and Test (DBT) Phase of the programme in May 2019.[68] Please note, this is a separate regime from the Operational Performance Regime and Baseline Margin Project Performance Scheme (discussed in Section 4).

6.9. The first of the delivery milestones under the DBT Phase occurred in RY19/20. The second and third of the delivery milestone occurred this year in RY20/21. Delivery Milestone 2 (DM2) required DCC to successfully complete the initial pre-integration testing of the CSS (Centralised Switching Service). Delivery Milestone 3 (DM3) represented the successful completion of the planning and preparation activities for SIT (System Integration Testing).

6.10. All margin on internal costs relating to the successful delivery of the DBT phase is at risk against the DBT milestones, with 20% of the margin at risk against DM2 and 25% of the margin at risk against DM3. The final values that this represents in terms of margin retained will be finalised when all delivery milestones under the DBT phase have been assessed.

6.11. Note, the margin and incentives for the Switching programme are entirely separate from the BM and the BM adjustment process.

[68] Ofgem (2019), *Decision on margin and incentives for DCC's role within the Design, Build and Test Phase of the Switching Programme.* www.ofgem.gov.uk/publications-and-updates/decision-margin-and-incentives-dccs-role-within-design-build-and-test-phase-switching-programme

Respondents' views

6.12. Six respondents, including DCC, supported our proposal for DCC to retain all margin at risk against DM2 and DM3 as both milestones were achieved. Six respondents did not have a view on our proposal.

Reasons for our decision

6.13. We have reviewed the responses we received. We believe that there is insufficient evidence for us to change our consultation position.

7. Appendices

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Appendix 1 – Determination Allowed Revenue (AR)

Regulatory Year	RY20/21	RY21/22	RY22/23	RY23/24	RY24/25	RY25/26
LABP (20/21 prices)	240.269	244.796	241.416	248.234	256.303	108.404
Previous year (20/21 prices)	485.414	441.189	368.480	407.094	448.185	255.969
Submitted AR RY20/21	**595.499**	**454.315**	**453.073**	**479.893**	**511.365**	**269.582**
Cost Disallowances						
External costs						
S1SP_3b enduring costs	0.000	0.000	-5.831	-9.103	-9.332	-9.537
DSP UIT	0.000	-6.400	-12.500	-12.500	-12.500	-12.500
Total External costs Disallowances	**0.000**	**-6.400**	**-18.331**	**-21.603**	**-21.832**	**-22.037**
Internal costs (includes Switching costs)						
Baseline forecast internal costs	0.000	0.000	0.000	-66.123	-63.994	-29.984
CRS forecast internal costs (Switching costs)	0.000	0.000	0.000	-2.367	-2.367	-2.319
Benchmarking	-0.350	0.000	0.000	0.000	0.000	0.000
Recruitment Costs	-0.234	0.000	0.000	0.000	0.000	0.000
SMETS1 costs RY21/22 and RY22/23	0.000	-6.905	-2.888	0.000	0.000	0.000
Network Evolution costs RY21/22 and RY22/23	0.000	-8.891	-4.155	0.000	0.000	0.000
ECOS costs RY21/22 and RY22/23	0.000	-2.048	-2.072	0.000	0.000	0.000
Product Management team costs	-0.167	-0.491	-0.491	0.000	0.000	0.000
EV Engagement costs	-0.112	-0.280	0.000	0.000	0.000	0.000
Commercial costs	0.000	-1.551	-2.152	0.000	0.000	0.000
Corporate Management costs	0.000	-0.870	-0.407	0.000	0.000	0.000
Finance costs	0.000	-0.209	-0.722	0.000	0.000	0.000
Operations costs	0.000	-1.700	-5.534	0.000	0.000	0.000
Service Delivery (Programme) costs	0.000	-0.739	-0.342	0.000	0.000	0.000
Shared Service Charge	-0.294	-1.781	-1.508	-5.768	-5.660	-2.693
Total Internal cost disallowances	**-1.156**	**-25.465**	**-20.271**	**-74.258**	**-72.021**	**-34.996**
Total cost (internal and external) disallowances	**-1.156**	**-31.865**	**-38.602**	**-95.862**	**-93.853**	**-57.034**

Regulatory Year	**RY20/21**	**RY21/22**	**RY22/23**	**RY23/24**	**RY24/25**	**RY25/26**
Performance Adjustment Reductions						
OPR	0.000	0.000	0.000	0.000	0.000	0.000
CRS performance	0.000	0.000	0.000	-0.013	-0.013	-0.006
Consultation AR excluding BM and ECGS adjustments	594.343	422.450	414.471	384.019	417.500	212.542
Baseline Margin and ECGS adjustments						
BM adjustment (20/21 prices)	0.000	0.000	3.333	0.569	3.391	0.000
ECGS adjustment	0.000	0.000	9.883	1.055	1.111	1.456
Decision AR with BM and ECGS adjustments	**594.343**	**422.450**	**427.687**	**385.643**	**422.002**	**213.998**