

Terms of Reference for assessment of DCC's Contract Management and Procurement activities under the Operational Performance Regime

Overview

In October 2020 Ofgem published their decision¹ to incorporate a Contract Management incentive under the Operational Performance Regime (OPR), which is used to assess and incentivise the Data Communication Company's (DCC) performance. The Contract Management incentive aims to improve DCC's performance in contract management and procurement to drive efficiencies on DCC's external costs, and ultimately savings for DCC's customers.

The Contract Management incentive will operate as an annual independent audit of DCC's contract and commercial management and procurement activities, using the assessment criteria and scoring framework as set out in the National Audit Office (NAO) contractual relationships framework². In the first year of the audit (regulatory year 20/21), no DCC margin will be attached to the outcome of the assessment. In following years, 25% of DCC's margin will be at risk.

Following consultation, Ofgem decided that Smart Energy Code Administrator and Secretariat (SECAS) should undertake the procurement process for the auditor on behalf of Ofgem. DCC's customers remain concerned over DCC's performance, and this is particularly the case for contract management, where small improvements to DCC's processes in this area can drive significant cost savings over the lifecycle of DCC's contracts. SECAS running the procurement process ensures a higher level of transparency over an area that is critical to DCC customers. To ensure independence of

¹ Decision on the Operational Performance Regime Review October 2020: <https://www.ofgem.gov.uk/publications-and-updates/dcc-operational-performance-regime-review-october-2020-decision>

² NAO Contractual Relationships Framework: <https://www.nao.org.uk/wp-content/uploads/2016/11/Framework-for-publication.xlsx>

the process, Ofgem will approve the final contract award and take on the role of the contracting party.

The auditor will work with DCC on an annual basis to gather the necessary evidence for the assessment as set out in the NAO Framework. As part of the assessment, the auditor will engage with the Smart Energy Code (SEC) Panel to gather evidence on the SEC change process and assess how DCC obligations under this process are accounted for within their contractual arrangements. The auditor will share an interim report with DCC to give DCC an early opportunity to respond and provide further evidence. The auditor will then produce a final report to be shared with Ofgem, DCC and DESNZ; and a non-commercially confidential version of this report - including scoring - will be provided to SEC Panel and SEC parties as one of the outcomes of the assessment. DCC and industry will have the opportunity to respond to the auditor's report as part of Ofgem's annual consultation on the price control, where Ofgem will set out their position on DCC's retained margin under the incentive.

The audit will take place annually from 1 May to 31 July, with the auditor submitting its final report to Ofgem by 31 July.

Background

The Data Communications Company (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 energy suppliers, network operators and energy service companies. It is important that as a monopoly company DCC faces sufficient incentives to play its role well, delivering value for money and high quality services.

DCC was appointed using an outsourced service model, to manage contracted smart metering service providers. As such, external costs compose the largest proportion of DCC's costs, and it is critical that these contracts are entered into, managed and closed out effectively and efficiently. Given the size and volume of DCC's contract portfolio, and that several original service provider contracts will require extension, it is important that DCC increases focus on this area in the coming years.

Each year, Ofgem scrutinises DCC's incurred and forecast costs through the annual Price Control process to determine whether these costs are economic and efficient. Alongside the cost assessment, DCC also faces financial incentives under the Operational

Performance Regime (OPR). The majority of DCC's Baseline Margin is at risk against the OPR if DCC does not meet the performance levels set by the regime.

Given Ofgem's and industry's concerns around DCC's contract management and procurement processes, Ofgem consulted on whether it would be appropriate to financially incentivise DCC's contract management and procurement as part of the revised OPR regime in May 2020³. Stakeholders responded largely in favour of Ofgem's proposals, and in October 2020 Ofgem published their decision to implement a financial incentive based on an audit of DCC's contract management and procurement activity under the NAO contractual relationships framework.

This document sets out the terms of reference for the assurance review by the auditor being requested by Ofgem.

Timings and Process

We will contract the auditor initially for a three year period. Within that three year period, the audit will take place on an annual cycle between May to July each year, with the final report issued by 31 July. The auditor will also need to be available to Ofgem for further clarification on the auditor's report in January. The budget for the auditor contract was set by SECAS.

We would expect the auditor's contact with representatives from DCC and SECAS to take place remotely via video conferencing, phone etc. We expect all documents to be sent electronically via a secure platform. Physical inspection of contracts or office space would not be required under the scope of this audit.

We have set out the milestones of this process below:

- **Preparations/ confirming the Terms of Reference (March-April):** Ofgem will publish the updated TOR as agreed with the auditor. This period will also be used to prepare for the evaluation period, such as initial meetings between Ofgem, the auditor, and relevant DCC teams.
- **Evaluation (May-June):** The independent auditor will then evaluate DCC's contract management and procurement activity using the NAO framework and

³ DCC Operational Performance Regime Review: Consultation May 2020: <https://www.ofgem.gov.uk/publications-and-updates/dcc-operational-performance-regime-review-may-2020-consultation>

the agreed terms of reference. The auditor will work closely with DCC during this assessment to enable access to the required evidence as well as speaking to a number of DCC user representatives and service providers, and the SEC Panel, the latter in particular in regards to the SEC change process. The auditor will need to provide an interim report for DCC to comment on by **12 June**.

- **Reporting (June-July):** The independent auditor will submit a draft report to Ofgem by **26 June**, taking account of DCC's comments. This report will include the auditor's assessment on the level of attainment that DCC has reached for each supporting question and domain. Ofgem will review the report, and may request further iteration to ensure the report meets the requirements set out in the scope/terms of reference. The final report must be issued to Ofgem by **31 July**. Once the final report has been issued, Ofgem will confirm to SECAS that the work is complete. The full report will then be issued to Ofgem, DCC and BEIS, and Ofgem will issue a non-commercially confidential version of this report to be circulated to the SEC Parties and the Panel.
- **Consultation (Oct-Dec):** Ofgem will incorporate a summary of the auditor's report as part of the price control consultation, setting out the audit scores as part of Ofgem's minded-to position on DCC's performance under the OPR. Ofgem will then publish the price control consultation to provide an opportunity for all stakeholders to respond. In particular, this will provide an opportunity for DCC users, the SEC Panel and DCC to submit additional evidence to appeal the auditor's scoring.
- **Decision (Jan-Feb):** Ofgem will then consider responses and any additional evidence submitted by stakeholders. This may include further clarification with the auditor around the scores. Ofgem will then determine whether to make any adjustments and publish the final decision.

Note, in future years we may amend these timelines.

Assessment Framework

The auditor will assess the DCC's contract management and procurement activity using a modified version of the NAO Contractual Relationships Audit Framework. The modified version of the framework amends two of the supporting questions to be relevant to the assessment of the SEC change process, and adds an additional attainment level. The full

modified version of the framework has been published [here](#) – a high level summary of the framework is set out in annex 1.

The NAO Framework sets out seven 'domains' of assessment covering contract management, procurement and re-procurement. Each domain is broken down into three supporting questions, setting out the information that an auditor would need to collect, judgement questions, evidence to be gathered and indicators of good practice. The auditor is to give equal priority to each domain in its assessment.

The framework defines four levels of attainment for each supporting question. The auditor will collect evidence within the scope of the audit based on the information and judgement questions specified in the framework to determine DCC's level of attainment for each supporting question. The judgement questions are non-exhaustive and the auditor may draw on its own judgement to assess DCC.

Evidence sources given as non-exhaustive examples in the framework include business cases, commercial strategy, risk assessments, performance reports, financial models, board papers and minutes.

Required outputs

As stipulated under the milestone timeline, we would expect the auditor to submit their final report to Ofgem by 31 July.

We expect this report to state DCC's level of attainment for each supporting question under the NAO framework, providing a detailed rationale for this level of attainment based on the evidence assessed. We expect the report to highlight areas of good practice from DCC and areas where their performance could be improved as per the assessment. The auditor may also give their general reflections on the audit process as part of their report.

Ofgem will produce a non-commercially confidential version of the report that will be made available to SEC parties. Some or no redactions may be made to this version of the report compared to the final commercially confidential version. DCC will have a chance to comment on the non-commercially confidential version of the report to highlight any areas of commercial confidentiality, though it will be up to Ofgem to decide whether to make redactions. We expect this report to be redacted only in areas where there are strict commercial confidentiality concerns with the aim of as much transparency as possible. The report will then be shared with SEC Panel who will have

the opportunity to request further clarification or information in the report, but it will be up to Ofgem whether to act on these comments. The final report will then be shared with SEC parties.

Scope of the audit

The assessment criteria in the modified NAO Framework cover DCC's activities in contract management, procurement and re-procurement, and will cover DCC's activities over the course of a Regulatory Year. We have set out the scope for the audit below, which we may amend for future years.

The auditor will assess and gather evidence of DCC's contract management of DCC's Communication Service Providers - Arqiva and VMO2 (formerly Telefonica) – and Data Service Provider – CGI.

The auditor will also assess DCC's contract management of the three SMETS1 service providers that incurred the highest costs over the Regulatory Year.

The auditor will also assess DCC's contract management in terms of adherence to the SEC modification change process. The auditor will not assess individual Change Requests/Project Requests but may draw on evidence relating to a sample of these to assess DCC's overall delivery of SEC change.

The auditor will assess procurement and re-procurement activity under DCC's Network Evolution programme. This will cover the procurement of 4G Comms Hubs and Networks and re-procurement of the Data Services Provider (DSP), Smart Metering Key Infrastructure (SMKI) and Data Service Management Systems (DSMS).

Activity covered by Baseline Margin Project Performance Adjustment Schemes (BMPPAS) - or where DESNZ intend to put one in place for upcoming regulatory years - will be excluded from the assessment.

Note, we do not expect the auditor to produce a score for each activity in scope. Instead, we expect the auditor to draw on examples of these activities, where relevant, to produce a score for each supporting question.

The auditor can at any point of the auditing process (without seeking prior approval from Ofgem), request further information from DCC to assist the auditor in its assessment of DCC's contract management.

The auditor can, at its discretion, request face-to-face meetings with DCC staff and arrange on-site visits with suppliers to aid its assessment of DCC's contract management.

Under the revised NAO framework, the auditor is required to evaluate the effectiveness of DCC's management of the end of the contract, taking into account the potential for re-bidding or handover. As the License is due to expire in 2025 with a potential for a Business Handover period, the auditor will place particular emphasis on the preparation for a transfer of business. This focus is in the context of ensuring a seamless transition of contracts, Intellectual Property, and resources to the future Licensee. The auditor's assessment may include, but is not limited to, a review of novation clauses, contracts with the parent company, and Intellectual Property transfer agreements to verify that suitable transition plans are in place.

The auditor will provide its general recommendations on any areas of improvement found throughout the auditing process, which DCC can act upon.

The auditor, using its previous recommendations, will assess whether DCC has demonstrated any progress in the areas of improvement and adjust scores where consistent poor performance is noted.

The auditor may wish to provide a score for each 'audit pillar' (of contract management, procurement, re-procurement and SEC mod change), which informed the overall score given to each supporting question. Annex 2 sets out an example of how the auditor may wish to prepare the scoring in this way. We expect this will indicate how DCC is performing in each individual area, whilst still allowing an overall score to be calculated according to the methodology set out in the OPR Guidance. We do not expect to dictate how these individual scores should be blended to produce the overall score, and are open to other means of awarding the scores based on the auditor's judgement.

Annex 1

Table 1 - Summary of NAO Framework domains and supporting questions, incorporating modifications for DCC

| Domain | Key question | Supporting questions |
|---------------------------------------|--|---|
| 1. Commercial strategy | Is there an overarching commercial strategy, with a clear rationale for the approach being taken? | 1.1. Is there a clear and consistently held view of what the contract is producing, the type of commercial relationship desired, the basic contract structure and how it will be managed? |
| | | 1.2 Has there been an assessment of strategic drivers, including policy drivers, and the internal and external environment? |
| | | 1.3 Has the commercial strategy been based upon the assessment of strategic drivers and the internal and external environment? |
| 2. Capability & governance | Does DCC have the capability needed to manage the contract and is it developing capability for the future? | 2.1 Does DCC have the necessary capability, skills and systems? |
| | | 2.2 Does DCC understand its future needs and is it working towards meeting them? |
| | | 2.3 Has DCC deployed its capability in a balanced way across the lifecycle and is commercial capability effectively integrated with the business? |
| 3. Market | Has sourcing supported the | 3.1 Has market management driven long term value for money? |

| Domain | Key question | Supporting questions |
|----------------------------------|---|---|
| management & sourcing | commercial strategy and followed recognised good practice to optimise VFM? | 3.2 Was there a defensible process that resulted in the selection of a capable supplier? |
| | | 3.3 Was there optimum use of competitive pressure? |
| 4. Contract Approach | Does the balance of risk and reward encourage service improvement, minimise perverse incentives and promote good relationships? | 4.1. Is there an appropriate allocation of risk between DCC and the supplier? |
| | | 4.2. Are there incentives to encourage the supplier to act in the interest of DCC? |
| | | 4.3. Are suitable mechanisms established to drive the desired relationship? |
| 5. Contract management | Is the service being managed well, with costs and benefits being realised as expected? | 5.1 Do DCC and the supplier have comprehensive knowledge of service performance? |
| | | 5.2. Are the suppliers delivering in accordance with the contracts, and are they actively managed by DCC to meet or exceed requirements (including delivering accurate, timely Impact Assessments)? |
| | | 5.3 Is DCC meeting its obligations? |
| 6. Contract lifecycle | Will the service continue to demonstrate VfM through its lifecycle? | 6.1. Does the contract continue to support DCC's strategic intent? |
| | | 6.2. Are VFM mechanisms used to ensure the contract continues to deliver VFM over its life? |

| Domain | Key question | Supporting questions |
|--|---|---|
| | | 6.3. Is change controlled and well managed and does the contract remain current? |
| 7. Transition & termination | Is DCC ready for the end of the contract? | 7.1 Has market management been undertaken to support new contracts? |
| | | 7.2 Has the end of the contract been managed effectively to allow re-bid or handover? |
| | | 7.3 Are insights from the operation of the contract brought to bear in developing the new contract? |

Annex 2

The table below shows a potential method of presenting the scoring in the auditor’s report. Numbers used for the scores are for example purposes only. A hyphen (-) represents that the question is not applicable to that audit pillar in the particular Regulatory Year.

In the example below we have taken an average of the scores for each audit pillar, and rounded it to the closest integer to determine the overall score. We are open to the auditor using its own judgement when arriving at the overall score, and it may wish to use a different methodology.

Table 2 - Potential method of presenting the scoring

| Supporting Questions | Audit pillar | Auditor Score | Overall score (blended) |
|---|---------------------|----------------------|--------------------------------|
| 1.1. Is there a clear and consistently held view of what the contract is producing, the type of commercial relationship desired, the basic contract structure and how it will be managed? | Procurement | 1 | 2 |
| | Reprocurement | 2 | |
| | Contract management | 3 | |
| | SEC mods | - | |
| 1.2 Has there been an assessment of strategic drivers, including policy drivers, and the internal and external environment? | Procurement | 1 | 2 |
| | Reprocurement | 3 | |
| | Contract management | - | |
| | SEC mods | - | |
| 1.3 Has the commercial strategy been based upon the assessment of strategic drivers | Procurement | 1 | 1 |
| | Reprocurement | 1 | |

| Supporting Questions | Audit pillar | Auditor Score | Overall score (blended) |
|---|---------------------|----------------------|--------------------------------|
| and the internal and external environment? | Contract management | - | |
| | SEC mods | - | |
| 2.1 Does DCC have the necessary capability, skills and systems? | Procurement | - | 3 |
| | Reprocurement | - | |
| | Contract management | 3 | |
| | SEC mods | - | |
| 2.2 Does DCC understand its future needs and is it working towards meeting them? | Procurement | 2 | 1 |
| | Reprocurement | 0 | |
| | Contract management | - | |
| | SEC mods | - | |
| 2.3 Has DCC deployed its capability in a balanced way across the lifecycle and is commercial capability effectively integrated with the business? | Procurement | 3 | 2 |
| | Reprocurement | 0 | |
| | Contract management | 2 | |
| | SEC mods | - | |
| | Procurement | 1 | 1 |

| Supporting Questions | Audit pillar | Auditor Score | Overall score (blended) |
|--|---------------------|----------------------|--------------------------------|
| 3.1 Has market management driven long term value for money? | Reprocurement | 1 | |
| | Contract management | - | |
| | SEC mods | - | |
| 3.2 Was there a defensible process that resulted in the selection of a capable supplier? | Procurement | 0 | 0 |
| | Reprocurement | 0 | |
| | Contract management | - | |
| | SEC mods | - | |
| 3.3 Was there optimum use of competitive pressure? | Procurement | 0 | 1 |
| | Reprocurement | 1 | |
| | Contract management | - | |
| | SEC mods | - | |
| 4.1. Is there an appropriate allocation of risk between DCC and supplier? | Procurement | - | 1 |
| | Reprocurement | - | |
| | Contract management | 1 | |
| | SEC mods | - | |

| Supporting Questions | Audit pillar | Auditor Score | Overall score (blended) |
|--|---------------------|----------------------|--------------------------------|
| 4.2. Are there incentives to encourage the supplier to act in the interest of the DCC? | Procurement | - | 3 |
| | Reprocurement | - | |
| | Contract management | 3 | |
| | SEC mods | - | |
| 4.3. Are suitable mechanisms established to drive the desired relationship? | Procurement | - | 2 |
| | Reprocurement | - | |
| | Contract management | 2 | |
| | SEC mods | - | |
| 5.1 Do DCC and the supplier have comprehensive knowledge of service performance? | Procurement | - | 3 |
| | Reprocurement | - | |
| | Contract management | 3 | |
| | SEC mods | - | |
| 5.2. Are the suppliers delivering in accordance with the contracts and are they actively managed by DCC to meet or exceed requirements (including delivering accurate, timely Impact Assessments)? | Procurement | - | 1 |
| | Reprocurement | - | |
| | Contract management | 2 | |

| Supporting Questions | Audit pillar | Auditor Score | Overall score (blended) |
|---|---------------------|----------------------|--------------------------------|
| | SEC mods | 0 | |
| 5.3 Is DCC meeting its obligations? | Procurement | - | 1 |
| | Reprocurement | - | |
| | Contract management | 1 | |
| | SEC mods | 1 | |
| 6.1. Does the contract continue to support DCC's strategic intent? | Procurement | - | 2 |
| | Reprocurement | - | |
| | Contract management | 2 | |
| | SEC mods | - | |
| 6.2. Are VFM mechanisms used to ensure the contract continues to deliver VFM over its life? | Procurement | 3 | 2 |
| | Reprocurement | 1 | |
| | Contract management | 2 | |
| | SEC mods | - | |
| 6.3. Is change controlled and well managed and does the contract remain current? | Procurement | - | 2 |
| | Reprocurement | - | |

| Supporting Questions | Audit pillar | Auditor Score | Overall score (blended) |
|---|---------------------|----------------------|--------------------------------|
| | Contract management | 2 | |
| | SEC mods | - | |
| 7.1 Has market management been undertaken to support new contracts? | Procurement | 0 | 0 |
| | Reprocurement | - | |
| | Contract management | - | |
| | SEC mods | - | |
| 7.2 Has the end of the contract been managed effectively to allow re-bid or handover? | Procurement | 2 | 2 |
| | Reprocurement | 2 | |
| | Contract management | 3 | |
| | SEC mods | - | |
| 7.3 Are insights from the operation of the contract brought to bear in developing the new contract? | Procurement | 1 | 2 |
| | Reprocurement | 2 | |
| | Contract management | 3 | |
| | SEC mods | - | |