Data Communications Company (DCC): Price control decision 2013/14

Final decision

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Overview:

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

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

In November 2014 we consulted on our proposals following a review of the report and information submitted by DCC. This document sets out the decisions and reasons for them on the costs DCC reported under its first price control for the regulatory year 2013/14 and its application to adjust the baseline margin values under the licence.

We publish alongside this document our Notices of our Price Control Decisions, Determinations and Directions relating to the calculation of Allowed Revenue set out in the Price Control Conditions in the DCC's Licence.

The DCC, services users and other interested parties should read this document.

Context

Smart DCC Limited is referred to as the Data and Communications Company (DCC). It is a central communications body appointed to manage communications and data transfer for smart metering and which holds the Smart Meter Communication Licences[1]. Price control arrangements restrict DCC's revenues, to counter its monopoly position.

Under its licence DCC has to submit cost, revenue, and incentive reporting to the Gas and Electricity Markets Authority (the Authority)[2]. DCC must report on the basis of Regulatory Instructions and Guidance (RIGs) that we publish. DCC must report by 31 July following each regulatory year. DCC submitted its completed price control reporting templates for the first partial regulatory year from 23 September 2013 to 31 March 2014 on 31 July 2014. On the same day it submitted an application for an adjustment to its baseline margin values.

We have assessed and consulted on DCC's costs, revenue and performance against incentives. We have also assessed DCC's proposal for an increase in its baseline margin values. In November 2014 we consulted on our proposed decisions in respect of DCC's price control, its performance against its implementation milestones, and its application to change the baseline margin values. We have duly taken into account all responses received to our consultation. This document sets out our final decisions in respect of DCC's price control and proposal to adjust the baseline margin values. It also summarises the key points received from the consultation and an explanation of the reasons for our decisions.

Associated documents

- Data Communications Company (DCC): Price Control Consultation
  https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-consultation

- Data Communications Company (DCC): Regulatory Instructions and Guidance
  https://www.ofgem.gov.uk/ofgem-publications/88046/dccrigs2014.pdf

- Data Communications Company – Regulatory reporting template
  https://www.ofgem.gov.uk/ofgem-publications/86000/dccregreportingfinal.xls

- Smart Meter Communication Licence
  https://epr.ofgem.gov.uk/Document

[1] The Smart Meter Communication Licences granted pursuant to Sections 7AB(2) and (4) of the Electricity Act 1989 and Sections 6(1A) and (1C) of the Gas Act 1986 (such licences together referred to as 'the licence' throughout).
[2] The Office of the Gas and Electricity Markets Authority (Ofgem) supports the Gas and Electricity Markets Authority ('the Authority') in its day to day work. In this document, 'us/we', 'Ofgem' and 'Authority' are often used interchangeably.

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Executive Summary

DCC has an essential role to play in the energy market. Its performance is critical to making the smart meter rollout a success and enabling suppliers to provide a good service to their customers thereafter.

It is important that DCC receives sufficient funds to play its role well. And it is equally important that we hold DCC to account for delivering high quality services. DCC must ensure these services are provided economically and efficiently as required by the price control mechanism under its Licence.

These are our final determinations for the DCC price control for the regulatory year 2013/14. Our decisions reflect our conclusions on the economic and efficient level of costs incurred in 2013/14 and in the cost forecasts, DCC's performance against agreed milestones, and whether DCC met the criteria for an adjustment to its baseline margin values. It follows our assessment and consultation on DCC's costs, revenues, and activities during its first six months of operation.

Our decision: during 2013/14 DCC did not provide enough justification for some internal costs therefore £0.100 million are 'unacceptable costs' under the price control conditions of the licence. We do not accept £4.036 million of costs in DCC's forecasts. DCC failed to meet one of its implementation milestones, and there will be no adjustment to the current baseline margin values.

DCC and its service providers have had to manage additional complexity and incur further costs during 2013/14. This is because of new activity that either wasn't expected or activity that was not sufficiently clear[3] when DCC put forward its business plan in 2013. Some costs have had to increase because of this.

Over the licence term, DCC has projected that it will incur a further £71 million costs (including the cost of its external service providers), which is 3.8% higher relative to the business plan. In most cases we consider that the additional costs DCC predicts or has incurred for its new activity were economic and efficient, and so acceptable under the licence.

However, we still think that in some cases DCC has not fully explained or provided sufficient evidence and we have concluded that certain costs have not been

[3] Some elements needed to deliver the smart meter rollout programme were explicitly excluded from the bid as part of the tender process. This includes the cost of external security and software service that have been procured and the arrangements for financial security and stability which are required under the licence.

economically and efficiently incurred[4]. These costs have not yet been justified sufficiently and therefore should not appear in DCC's forecasts. In future price controls as costs become more predictable, DCC may be able to justify these costs. If these costs are incurred then DCC must explain these as variations from the forecasts and justify them as being economic and efficient in the appropriate regulatory year.

We have decided that some of the costs DCC has reported are unacceptable costs. In summary, we have determined:

Table 1: Determination summary

Cost area	2013/14	Remaining years of licence (Forecasts)
Internal costs	• £0.100 million of costs were unacceptable in 2013/14.	• £1.393 million of further salary costs for future years have not been justified and should not be reported in the forecasts over the licence term. • £0.857 million associated with the long term use of contractors in future years and should not be reported in the forecasts over the licence term. • The shared service charge on new costs, £1.786 million, has not been justified as economic and efficient. These should not be reported in the forecasts over the licence term.
External costs	• Cost variations are economic and efficient, and acceptable costs.	
Milestones	• DCC failed to meet a key delivery milestone (IM5) and so should lose £0.315 million of revenue.	• If IM12 (Commencement of Initial Operational Services) is achieved on time and to the required standard DCC can earn IM5 back.
Adjustment to Baseline Margin values	• DCC's application for a baseline margin values adjustment failed to meet the criteria, so there will be no adjustment to the current margin values.	• DCC can propose an adjustment to the baseline margin values each July. For the grounds to have arisen DCC needs to be able to prove that the licence criteria are met, including demonstrating materiality and likelihood.

[4] We have therefore concluded that some of the Internal Costs are Unacceptable Costs, as is defined under Licence condition 37.8. We have taken into consideration the issues listed in licence Condition 37.9.

What our decision means

We have determined that DCC has incurred some unacceptable costs in 2013/14, so these will need to be excluded from the future calculation of allowed revenue, and correspondingly in DCC's charges. For the forecast costs that we have decided are unacceptable, DCC will not be able to recover these from customers unless it can provide better evidence of value for money in future price controls.

Where we have decided that DCC has not met a key delivery milestone (IM5)[5], the calculation of 2014/15 allowed revenue will be reduced and money will be returned to customers via reduced charges. DCC can earn this IM payment back if IM12 (Commencement of Initial Operational Services) is achieved on time and to the required standard.[27]

The baseline margin adjustment mechanism was included in the licence in recognition of the uncertainty over the nature and risk of DCC's business over time. It allows DCC to apply to us to make a case for changes to the margin, so it is appropriately rewarded for the value it brings to energy customers. We have decided that DCC is not entitled to an adjustment to its baseline margin values this year, based on the evidence submitted. However, DCC may be able to put forward a case in future if grounds for an adjustment to baseline margin values and other licence criteria have been met. For example, where the materiality or certainty of existing activities, risks, or timescales have changed, or new activities or risks have arisen.

We have provided DCC with consent so that it can reflect our decisions on unacceptable costs and the missed implementation milestone in its 2015/16 charges.

Future years

As this is the first price control determination for DCC, it is important that we set out some clear future priorities so that DCC can factor these into its decisions. These priorities have been informed by the views of consultation respondents:

- DCC should establish processes that will ensure its spending is economic and efficient. For example, salary benchmarks that will help us assess whether DCC's recruitment decisions are value for money and a contractor strategy to ensure DCC uses contractors in an economic and efficient manner.

[5] Under its licence DCC had six implementation milestones (IMs) due in 2013/14. It achieved five of these key delivery milestones but it did not achieve IM5.

- Placing additional reporting requirements on DCC in relation to the procurement of shared services from Capita that are not included in the Licence Application Business Plan. DCC must assure us that it is procuring the shared services in a way which is consistent with the procurement principles, and the principles of business separation required by its licence and that it is economic and efficient.

- Improving the level and quality of evidence that DCC provides. DCC's evidence case must be improved in future years to demonstrate value for money. Otherwise DCC risks having costs determined to be unacceptable on the grounds of insufficient evidence that they have been economically and efficiently incurred.

We will continue to develop our price control assessment procedure drawing upon on our knowledge and approaches used elsewhere. DCC has raised a number of questions about process in response to our consultation. We address many of these but to create more clarity for future price control reporting we will issue guidance[6] to ensure the principles and criteria we will apply in conducting our assessment are clear.

In the long term, as DCC matures and its operating environment becomes more stable, we intend to bring in ex ante controls on DCC's costs. This will give DCC more certainty and a sharper focus on efficiency and was generally supported by respondents. We will fully consider and consult on options before deciding to change the structure of DCC's price control.

[6] Licence Condition 37.11, Part C.

1. Introduction

Background

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

1.2 Due to DCC's unique nature[8] and the new regime it will be operating, we have a role in ensuring that costs are incurred economically and efficiently. DCC incurs costs and passes these onto users. We review these costs after the end of the regulatory year in which the costs were incurred, this approach we call 'ex post'. One of DCC's key responsibilities is to effectively manage its external contracts and ensure value for money and good quality service for consumers. DCC must submit price control information by 31 July after the end each regulatory year[9].

1.3 The licence contains an implementation performance regime. This consists of a series of implementation milestones (IMs) that DCC must achieve by specified dates. Failure to meet an IM by its due date results in DCC sacrificing a pre-agreed amount of its margin. We assess DCC's performance against the implementation performance regime.

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

1.4 The first price control report covering the regulatory year from 23 September 2013 until 31 March 2014, was submitted in July 2014. DCC also applied for an adjustment in the value of its margin at the same time. During this regulatory year DCC had six IMs to achieve. In November 2014 we consulted on our proposals.

1.5 We have fully considered all the responses to our consultation. We will provide feedback to DCC on the detailed points it raised in its consultation response.

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

[8] DCC is asset-light compared to other regulated entities.

[9] The regulatory year is a period of 12 months beginning on 1 April in any calendar year and ending on 31 March of the next calendar year. The licensee's first regulatory year is deemed to have begun on 1 April 2013.

Principles and approach for future

1.6 In this first year it is important to establish principles that will apply to our assessment of DCC's costs, not least as we anticipate costs to increase in future years. Our consultation[10] and decision clearly set out our expectations and approach to assessing changes, and are doing this because it is likely DCC's activities will change in nature and scope.

1.7 We expect DCC to demonstrate through its reporting that it has incurred contract costs and its own internal costs as efficiently and economically as possible, doing everything it reasonably can to ensure value for money. The data we collect, together with information from other sources, will allow us to monitor and assess whether this was the case.

1.8 We recognise there have been changes since DCC put forward the Licence Application Business Plan (LABP). The requirements of the Smart Energy Code (SEC) and the longer lead-time and changes to the Great Britain Companion Specification (GBCS)[11] have required DCC to re-profile and re-assess the costs. But it must give strong justifications for variations above the competitive costs agreed as part of the competition. We also expect DCC to have a strategy in place for ensuring that costs are economic and efficient over the duration of the licence.

1.9 DCC has consulted[12] on options to re-plan the programme timeline. In future reviews, we will need to consider any associated changes in costs of the re-plan and DCC will need to sufficiently justify these costs as being economic and efficient.

1.10 This was our first review and was based on only six months of cost data. We are considering how we can build on the analysis we carried out this year. Based on our experience this year we will look at how we draw on and adapt tools and approaches used elsewhere. This is particularly important given the changes in cost that might result from the re-plan. We set out possible options in chapter 7.

1.11 We see some benefits in the evolution of the DCC price control over time to include some more ex-ante controls and incentives, drawing upon the approach taken for networks, and to introduce up front incentives on DCC to manage the costs of running the data and communications network for smart meters. This could be introduced when there is more stability in DCC's operations. We would engage and consult with DCC and stakeholders before making any changes.

[10] DCC price control consultation. Available here: https://www.ofgem.gov.uk/ofgem-publications/91527/dccpricecontrolconsultation.pdf
[11] Both of which have been developed after the licence was granted.
[12] http://www.smartdcc.co.uk/media/14108/141117_dcc_plan_and_im_consultation.pdf

2. Approach and general issues

Chapter summary

Most respondents supported our approach to assessing DCC's costs and performance. In this chapter we respond to general issues that stakeholders raised in the consultation.

Overview of our approach

2.1 In our November 2014 consultation we explained how we assessed DCC's costs. In accordance with licence condition 37 we assess whether DCC's costs have been incurred economically and efficiently. We compared the costs in the Licence Application Business Plan (LABP) with those DCC submitted in its price control reporting. To inform our assessment we conducted a cost visit[13] and carried out some initial benchmarking.

2.2 Our review for this first regulatory period has focused understanding:

- DCC's cost base
- what DCC does
- the causes of differences in costs incurred from those in the LABP.

2.3 As required by the licence, our assessment is grounded in comparing DCC's actual costs and revised forecasts with the costs DCC submitted in the LABP. We accept that the scope of DCC's activity might differ from what it expected, and this could affect how economic and efficient its costs are.

2.4 DCC must justify and demonstrate that the variation between its LABP costs and actual costs is economic and efficient. If we conclude that it hasn't then we may determine these costs are unacceptable and will need to consider whether to exclude them from any future calculation of the DCC's allowed revenue or to accept an undertaking from DCC on the future management of those costs.

2.5 DCC's costs in 2013/14 are mostly internal, and so it is these costs that have been our primary focus. However, we have still scrutinised the changes in external costs and expect them to be a more significant part of our analysis in future years. If there are significant changes in external cost in future years DCC must demonstrate

[13] During this visit we questioned DCC on various cost changes in order to help us understand the drivers behind the changes.

they are economic and efficient, this could be through providing evidence of benchmarking or the use of the value for money levers under the contracts.

Consultation responses

2.6 Most respondents supported, agreed with, or thought that our approach to assessing DCC's costs is reasonable. One commented that close management of expenditure is essential to obtain value for money (VfM). Another stated that DCC must fully explain and justify all areas of potential additional expenditure in addition to providing evidence to demonstrate VfM.

2.7 Some respondents also commented on areas where they thought the approach could be improved. A respondent recommended that costs need to be more transparent and include more detailed breakdowns. Two respondents suggested more regular or interim reporting requirements be imposed on DCC.

Our response

2.8 We have closely scrutinised all DCCs costs, both internal and external. We are satisfied that the cost increases that have been accepted are economic and efficient. Our decisions to find some costs unacceptable reflect that DCC needs to improve its justifications and rationale for cost changes relative to LABP. If DCC continues to provide a weak rational, DCC is more likely to have costs excluded. DCC has already made positive moves towards providing better quality evidence in its responses to our consultation.

2.9 Transparency of DCC in general seems to be an issue for stakeholders. There is a limit to what we can publish due to commercial sensitivity of data. But we will continue to ensure as much transparency as possible in future price controls. We also encourage DCC to publish more information, for example redacted versions of its reports or cost assessments.

2.10 It might be appropriate in the future to have more regular reporting of some aspects of the price control information and we will keep this under review. When considering this we need to take into account the regulatory reporting burden on DCC. However, where we have concerns, for example in the case of the shared service costs, we will introduce additional reporting. In chapter 7 we set out how we are strengthening and improving our approach.

General issues raised in responses

2.11 There were a number of general issues raised by respondents. These included:

- how much risk DCC faces and the impact on DCC's incentives to deliver the programme.

- whether our initial proposals represented a direction to disallow costs or accept an undertaking.
- the impact of this decision on future price controls.
- the quality of DCC reporting.
- the lack of transparency and issues with DCC's communication.
- commitments under the Licence Application Business Plan.

2.12 We address each of the issues in turn:

The level of risk DCC faces, and the impact on DCC's incentives to deliver the programme

2.13 DCC said our proposals would raise regulatory risk to an unacceptable level and that the proposals would substantially increase its financial and operational risk. DCC has argued that the proposals would give rise to a perverse incentive to operate in a way which reduces its regulatory and commercial risk, and may affect its ability to make the right decisions for the programme.

2.14 DCC was concerned it would not be able to make adjustments to minimise the risk of disallowance for the same cost areas that are already incurred in 2014/15. DCC suggested we should only consider excluding costs that are outstandingly bad, which DCC has been given prior notice are potentially unacceptable.

2.15 A few respondents commented that DCC faces very little risk under its framework. One commented that the baseline margin provided for in DCC's contract is inappropriate given that it is a regulated monopoly service provider with minimal risk. Another respondent thought risk should have been factored into the bids of DCC and its service providers. It was concerned that users would effectively be paying twice for change which is already factored into risk premiums, or that service providers are being rewarded for not adequately assessing risk in the first place.

Our response

2.16 Our decisions do not increase in the regulatory risk the DCC faces. We consider that they reflect the exercise of our statutory duties as expected and agreed by DCC. We consider that our proposals represent no increase in financial or operational risk. We have carefully considered the evidence, and concluded that some costs are unacceptable[14] under the definitions in the licence.

2.17 In response to the comments relating to risk being factored into the bids, we are unable to comment on elements of the framework that were agreed as part of the competition between DECC and those tendering for the licence or contracts.

[14] DCC did not provide justification that these costs were economic and efficient.

2.18 Licence condition 37 of DCC's licence sets out how we assess DCC's costs associated with the provision of its mandatory business. Our duties and powers relate to assessing whether or not DCC's costs in the relevant regulatory year were economically and efficiently incurred. If we determine any costs to be unacceptable, it is within our power to direct that those unacceptable costs be excluded from any future calculation of DCC's allowed revenue.

2.19 The licence makes clear that DCC is operating in an ex post regulatory framework in which we are required to review costs after they have been incurred. We apply ex post assessment in our regulation of OFTOs[15], and it is widely used in other regulatory jurisdictions. There have been no changes to these arrangements since the licence was bid for.

2.20 DCC has obligations and objectives under its licence in relation to its role in the roll out of smart meters. If it made decisions and/or acted in a way that contravened or failed to fulfil these obligations there could be wider compliance issues. A regime also exists in the licence to incentivise the DCC to meet its key delivery dates for its systems[16]. In the future, an operational incentive mechanism will also be introduced[17].

2.21 Economic regulation seeks to proxy or mimic competitive outcomes in monopolistic markets or businesses. Our role as economic regulator is therefore to introduce a proportionate degree of risk, in order to provide disciplining incentives on DCC to manage its costs appropriately

Whether our initial proposals represented a direction to disallow costs or accept an undertaking.

2.22 DCC said that our proposals did not indicate any resulting direction on DCC or whether it would be required to propose an undertaking. DCC asked us to clarify our position and the direction we would make.

Our response

2.23 The executive summary in our consultation contained proposals covering:

(i) costs that will be disallowed;
(ii) costs we have requested be removed from the forecasts ; and
(iii) costs that we require further reporting on in the future.

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[15] Offshore Transmission Operators
[16] This is through the implementation milestones
[17] Licence condition 36 Part E

2.24 The licence states the Authority will direct a decision on any cost that it finds to be unacceptable.[18] We only issue the legal direction as part of the final decision. We publish our legal directions alongside this document.

2.25 The licence allows us to accept an undertaking on the future management of unacceptable costs we have proposed are not economic and efficient. For such a situation, DCC in responding to our proposals can suggest this as an alternative to having unacceptable costs excluded. We appreciate DCC had not realised this was the process and will clarify this in guidance for future price controls. DCC did propose an undertaking for the unacceptable salary costs separately from their consultation response. We considered the undertaking but decided it was not sufficient to ensure the DCC will be able to avoid, prevent, or mitigate a further occurrence of the same or any similar costs. It was therefore not sufficient to protect consumers from bearing costs that we concluded were unacceptable.

The impact of this decision on future price controls

2.26 DCC asked whether our decision on costs in future years will be superseded by the relevant price control review undertaken in that year.

Our response

2.27 Each year we will compare actual cost to the costs in the LABP, and the latest cost forecast from the previous price control review. This is why it is important for us to review DCC's actual costs and its latest forecast costs. The updated forecasts should only contain economic and efficient costs, so that they represent a reasonable baseline against which to compare costs at the next price control.

2.28 If new evidence comes to light we might determine that certain forecast costs in the updated forecast are also not economic and efficient. Where DCC has not provided justification that future spending is economic and efficient, if it incurs these costs, it could seek to justify these costs as part of its price control reporting in future regulatory years. In doing so, it must explain these as changes from the forecasts and provide evidence to support them being economic and efficient.

Quality of DCC reporting

2.29 In our proposals we noted that we had been concerned generally with the quality of reporting by DCC. DCC commented that the Regulatory Instructions and Guidance (RIGs) did not have any guidance about how much detail to include with evidence to support cost variations to LABP. Another respondent also commented

[18] Licence condition 37 and licence condition 36.

that the RIGs might need to be amended if DCC is not submitting sufficient information.

Our response

2.30 We consider that this first price review process will have helped DCC to understand the standard of justification that it is required to produce. The qualitative questions in the RIGs were open-ended to allow DCC to provide as much justification as it thought reasonable. It could have provided evidence to support its statements that changes in salaries were competitive with market rates, for example, through external benchmarking. DCC failed to comply with the RIGs as it failed to answer all the qualitative questions.[19]

2.31 We recognise the benefits of updating the RIGs following the first time they have been applied. We will consult on adding further description and clarity in the RIGs. However the RIGs will never prescribe exactly how and to what level DCC should justify every cost variation. It is DCC's responsibility to prove costs incurred are economic and efficient and failing to justify them in future will mean it is likely that DCC's cost will be determined to be unacceptable.

Transparency of DCC

2.32 Some respondents raised concerns around transparency. In particular there were concerns over the transparency of:

- costs;
- how changes to costs were managed; and
- DCC's procurement of services from its parent and affiliates.

Our response

2.33 We appreciate the concerns raised by stakeholders and encourage DCC to listen to users concerns and be more transparent where there is scope for this. This could be an area of focus for the operational incentives.

The commitments under the Licence Application Business Plan

2.34 The licence requires DCC to have a LABP. This document contains estimates of revenues, costs, and cash flows for each regulatory year over the 12-year licence term. It is what DCC submitted in the course or as a consequence of the licence

[19] DCC not did provide the prudent estimate information for 2014/15 until September.

application process, and was taken into account by the Secretary of State in determining the grant of the licence.

2.35 DCC committed itself to the LABP as a condition of being granted the licence. This is explicitly stated in the definition of the LABP under licence condition 37. The framework for the DCC licence does allow costs set out in the LABP to change and for DCC to depart from the competitive bid position as stated in the LABP. In that case however, DCC must explain and provide sufficient evidence it has made the most economic and efficient decision. This reflects the level of uncertainty DCC is exposed to and the range of issues not known, or still to be clarified when the licence and contracts were awarded.

3. Performance

Chapter summary

DCC achieved five of the six implementation milestones (IMs) due in 2013/14. It did not achieve IM5. This is reflected in DCC's allowed revenue calculation in 2014/15 through the Baseline Margin Performance Adjustment ($BMPA_t$) factor in the price control calculation.[20] This will result in a £0.315 million reduction.

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

DCC's performance

3.1 DCC plays a vital role in the smart meter rollout. Soon after it was awarded the licence, it went through a rapid start up and had to quickly begin meeting obligations. During 2013/14 it undertook a number of key activities while facing some uncertainty and challenges not anticipated at licence award.

Performance against implementation milestones

Our decision

3.2 In our consultation we assessed DCC's performance against its implementation milestones (IMs). Of the 13 responses we received, 11 agreed with our assessment, two disagreed. Having considered these responses alongside our own analysis, our position remains unchanged. We consider DCC to have met five of the six IMs it had to meet in 2013/14. We do not consider it has met IM5 (Submission of DSP Interface Specifications). This is summarised in table 2, below.

Table 2: DCCs implementation milestones, 2014

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

[20] Licence Condition 36.7

Responses to our consultation – assessment of IMs

3.3 Most stakeholders agreed with our assessment of DCC's performance against the six IMs due in 2013/14. Several commented on our approach to assessing the IMs, including stating that it was laid out clearly, was reasonable and was rigorous.

3.4 DCC and one confidential respondent disagreed with our view that IM5 had not been achieved. DCC argues that IM5 relied on a number of external dependencies which made it impossible for it to complete the DSP Interface Specifications by the deadline. As such it disagreed that outstanding issues could have been resolved before the date the documents were submitted. DCC also said that the deadline for IM5 was not suitable and that under the circumstances issuing conditionally approved documents was the most appropriate action to take.

3.5 DCC also note that there are no quality criteria in the licence or requirement to submit a draft before the due date. Therefore it does not think that these are appropriate arguments against it achieving IM5.

3.6 DCC considers our position on IM5 as imposing a penalty on it for carrying out activity that benefits the programme. It suggests that this may give rise to perverse incentives as DCC may begin to operate in a way that reduces regulatory risk which would cause inefficiency that would transfer to SEC parties and consumers.

Reasons for our decision

3.7 DCC has provided evidence for having achieved IMs1-4 and IM6 that clearly demonstrated that it had met its obligations under the licence. The evidence we received on IM5 was insufficient to demonstrate that it met IM5. During our consultation we did not receive any further evidence to change our assessment.

3.8 We have to make our decision within the parameters set out in the licence. We therefore assessed DCC's evidence of achieving IM5 against the criteria outlined in the licence, which included the requirement on DCC to approve the documentation. We found that DCC's performance did not meet the criteria.

3.9 The licence gives DCC the opportunity to apply for changes to the IM due dates and criteria. DCC could have used this provision to request an extension to the IM5 due date if it did not consider it suitable. DCC could also use this provision to have the criteria changed if it considered it was impossible to complete the DSP Interface Specifications due to dependencies. DCC did request that the criteria relating to the DCC User Gateway Interface Specification (DUGIS) be amended to recognise its dependency on GBCS. However DCC did not apply to amend the due date for IM5 or to amend the criteria to recognise any other dependencies.

3.10 We accept that there was no explicit requirement in IM5 itself to submit a draft of the documents before the IM5 due date in the licence. However, schedule 5 requires DCC to submit a draft as soon as is practicable. It also requires DCC to comply with any remediation plans. Since DCC did not submit the documents until the day of the IM5 deadline this left no time to comply with any remediation plans before the deadline.

3.11 Further to this, only some of the IM5 documentation was subject to schedule 5 and so could be in draft form.[21] Documents that were not subject to schedule 5 should have been complete by the IM5 due date but there were not.[22]

3.12 We also accept that there are no explicit quality criteria in the licence. We note that it may be helpful in future if we focus our comments on whether deliverables are complete rather than their quality. IM5 required DCC to deliver various DSP Interface Specifications. DCC did not conclude these deliverables by the due date. This is evident by the Secretary of States direction to DCC that requires it to follow remediation plans 'in order to conclude these deliverables'.[23]

3.13 The licence is clear that some of DCC's revenue is at risk if an IM is not achieved. DCC agreed to this incentive regime. This is not a penalty, rather the execution of an incentive scheme that DCC agreed to.

3.14 We disagree that our decision on IM5 may give rise to perverse incentives and cause inefficiency that would transfer to the consumer. DCC is subject to an ongoing incentive mechanism, which includes the possibility of recovering the margin lost through IM5 on successful completion of IM12. We will also put in place an operational incentives scheme in place in due course.

3.15 Further to this, DCC has a duty to carry on the mandatory business in accordance with the general objectives of the licence.[24] This includes carrying on the mandatory business in the manner that is most likely to ensure the development, operation and maintenance of an efficient, economical and coordinated system for the provision of mandatory business services.[25]

3.16 The adjustment for not achieving IM5 is calculated by applying the formula in Schedule 3, Part A of the licence. The specific criteria was not achieved within six weeks of the IM5 due date. This means DCC sacrifices 4% of the baseline margin implementation total (BMIT) that this milestone put at risk. This therefore means that £0.315 million will be removed from the calculation of allowed revenue for regulatory year 2014/15.

3.17 We are providing DCC with consent to return this to SEC users through a reduction in the 2015/16 charges. DCC can earn this IM payment back if IM12 (Commencement of Initial Operational Services) is achieved on time and to the required standard.[27]

Response to wider IM issues

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[21] The Self-Service Interface Specification, the Registration Interface Specification and the User Gateway Interface Specification.
[22] The Enterprise Systems (Billing / Reporting) Interface Specification and the SMWAN Gateway Interface Specification.
[23] DCC – Decision on M5 and direction to re-submit in accordance with remediation plan, available here: https://epr.ofgem.gov.uk/Document
[24] Paragraph 5.5, Licence Condition 5, Part C.
[25] Paragraph 5.3, Licence Condition 5, Part B.

3.18 Some respondents questioned the effectiveness of the IM incentives regime and made suggestions for the IM review. This included views on the IM criteria, the IM due dates and the impact of changes on other stakeholders.

3.19 The implementation performance regime was agreed as part of the competitive tender. DCC is reviewing the IMs as part of the wider replanning exercise. We are keen to ensure that the review results in clear and unambiguous criteria for the remaining IMs. This should include reference to the quality of outputs where this is an important factor. DCC is required to consult with the SEC panel and parties as part of the IM review.[26]

3.20 One respondent also highlighted that there was an error in the formula included in licence condition 38.5 which resulted in IM8 being included twice. This will be corrected through a modification to the licence.

Assessing procurement

3.21 DCC published its procurement strategy in August 2014.[27] We're pleased that the strategy recognises full and open competitive tender as the most efficient form of procurement. We also welcome DCC's commitment to demonstrating value for money when drawing upon internal services or shared services from its parent company.[28] We will assess DCC's new procurement activities against this and the licence obligations.

3.22 We expect DCC's procurement strategy to make sure it is always follows best practice. DCC now has some procurement experience. This should put it in a better position to develop more defined criteria[29] for the different procurement processes and approaches defined in its strategy. This would provide transparency to users that DCC is procuring in the most efficient way possible. In its strategy DCC committed to providing us with any assessments and evidence of how it has met the terms of its procurement strategy. We intend to amend the RIGs to require DCC to give us its assessments, particularly if a full open competitive tender is not done.

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

[27] DCC procurement strategy and statement of service exemptions. Available here: https://www.gov.uk/government/consultations/dcc-procurement-strategy-and-statement-of-service-exemptions

[28] In the procurement strategy DCC commit ton "review[ing] all of the goods and services it purchases (including Capita shared services) on a regular basis; and develop[ing] a strategy to both ensure and demonstrate that they remain competitive". Smart DCC Ltd Procurement Strategy for Condition 16: Procurement of Relevant Service Capability Regulatory Year 2014/15, page 6. Available here: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/357052/SMIP_REG_Response_to_consultation_on_approval_of_procurement_strategy_and_statement_of_service_exemptions_ANNEX1.pdf

[29] For example specifying monetary and materiality thresholds.

4. Cost assessment

Chapter Summary

Respondents to our consultation broadly agreed with our proposals. DCC provided evidence that satisfied us that most costs were economic and efficient. A small proportion of DCC's costs were considered to not be economic and efficient and we have therefore determined these costs as unacceptable costs under the licence.

We direct that £0.100 million from DCC's internal costs in 2013/14 are unacceptable costs. We will require DCC to provide additional reporting to ensure that it is compliant with its licence conditions with respect to shared services.

Our decisions

4.1 Over the licence period, DCC's total cost forecast was £1.949 billion. This represented a total increase in costs of £71 million relative to LABP over the licence term, a 3.8% increase.

4.2 In 2013/14 DCC's costs were lower than DCC had forecast in its LABP. We understand that the primary cause of this lower cost was a re-profiling of costs into future years resulting from delays to the DCC work programme.

4.3 At the bid stage, DCC faced a lot of uncertainty about its future costs. Some specific cost items were also excluded from the bid process. Despite this, the LABP remains a key benchmark for DCC costs in terms of assessing their allowed revenue, as required under the licence. Each year DCC needs to provide us with evidence that costs have been efficiently and economically incurred, and explain any material changes relative to LABP. DCC must also provide a statement of any material revisions arising from such divergence that the DCC thinks is appropriate or necessary to make to any financial or operational matter included in the remaining years of the LABP.

4.4 In response to our consultation, the majority of stakeholders agreed with our approach and our proposals. A few questioned whether we had sufficiently challenged the costs. DCC and a confidential respondent disagreed with our approach and any costs being disallowed.

4.5 Having analysed the new evidence and responses to our consultation we maintain our initial view about those costs we identified as being not economically and efficiently incurred in our proposals.

4.6 Under Licence Condition 37, costs that we find were not economically and efficiently incurred by DCC are described as "unacceptable costs". In respect of such costs we are required to direct whether unacceptable costs are to be excluded from any future calculation of DCC's allowed revenues, or to accept an undertaking from DCC on how it will manage unacceptable costs and future procurement of relevant service capability. Our determinations are shown in Table 3.

Table 3: Unacceptable costs

Cost Category	Undertaking or excluded	Excluded Costs 2013/14 (£m)	Total over licence period (£m)
Internal Costs - Salaries - Long-term contractors	Excluded Not to be reported in forecasts	**0.100** **0**	**1.393** **0.857**
Shared service charge - New scope not related to shared service activity	Not to be reported in forecasts	**0**	**1.786**
Total		**0.100**	**4.036**

4.7 In the remainder of this section we set out our reasoning and decisions on:

- internal costs
- shared service costs
- external costs

Internal costs

4.8 DCC reported a £38 million change in internal costs over the licence term, representing a 25% difference from costs forecast in the LABP. New scope costs make up £28 million of this change, and staff costs account for a large proportion of the remaining £10 million.

4.9 It is important to recognise that a large proportion of this difference is attributed to activities that were explicitly excluded from the LABP as agreed with DECC during the tender process, because the requirements were not fully developed at that time. It was always expected DCC would incur costs associated with these activities.

Our decision on internal cost

4.10 We found these cost changes to be economic and efficient:

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

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

4.11 For these changes, DCC has provided enough evidence to satisfy us that the incremental costs were economically and efficiently incurred, and are acceptable.

4.12 We have determined and are directing that the following costs are not economic and efficient, and are unacceptable costs:

- costs where DCC has reported an increase in specific salary costs relative to LABP, but has not given enough justification;[30]and

- the premium cost for contractors which DCC has forecast will be employed over longer time periods, but where alternative non-contractor options are likely to be both viable and more efficient.[31]

Consultation responses

4.13 Most respondents to the consultation agreed with our initial proposals and supported our approach to scrutinising DCC's costs. However two respondents (DCC and one confidential respondent) disagreed with our proposals that some costs were not economically and efficiently incurred. Some respondents raised issues which they considered should be addressed in our final decision.

4.14 DCC that no costs should be found to be unacceptable. It gave a number of reasons including that: our proposals were an inappropriate penalty; disallowances were proposed from areas where costs are lower than LABP; costs were assessed in such detail that it creates a disproportionate regulatory burden, and does not meet DCC expectations or what they considered to be the standards of good regulation. DCC also raised other points, and provided benchmarking[32] evidence which it said supported its position that its costs were economic and efficient.

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[30] £1.393 million over the licence period, £0.100 million in 2014.
[31] £0.857 million from next year onward.
[32] Benchmarking involves evaluating costs by comparing them with an established external standard

Reasons for our decision

4.15 We have carefully considered all of the responses to our consultation proposals, and have further tested our analysis and conclusions in light of this evidence. The consultation responses broadly support our proposals, and the evidence and issues raised do not to lead us to conclude any approach different from that set out our consultation.

4.16 Overall, there are several indicators of inefficiency in the DCC cost base, which have informed or supported our proposals. These are:

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

4.17 In light of this evidence, we focused on changes relative to the LABP to assess the extent of unacceptable costs. For the majority of the internal cost increases relative to LABP, we have found these increases to be economic and efficient. However some staff costs and day rates have increased relative to the LABP assumption without sufficient justification. In light of the overall evidence of inefficiency above, we do not think these changes are economic and efficient, and have therefore determined they are unacceptable.

4.18 We note that DCC provided either weak or no justification for these cost changes from the LABP. DCC's decisions were not informed or supported by any external benchmarking. The licence puts the burden of proof on DCC for justifying costs as economic and efficient. We expect DCC to improve this aspect of its regulatory submissions in future.

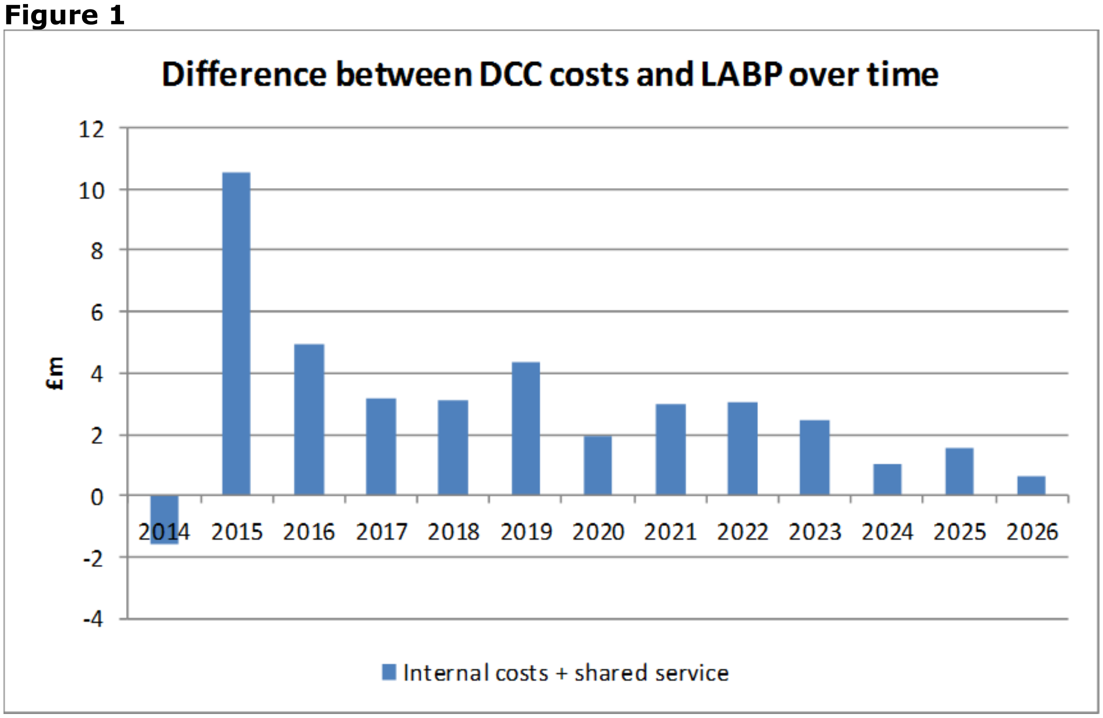
4.19 Our proposal to disallow costs that were not economic and efficient is not a penalty. There is a substantial volume of regulatory precedent for disallowing costs that are found to be inefficient in a price control process. The unacceptable costs in 2013/14 are a small proportion of DCC's actual costs in its first year. The uneconomic and inefficient costs in future years reflect that DCC needs to manage its costs and provide better justification in future.

4.20 We felt closer and more disaggregated scrutiny was also appropriate in light of the lack of robust or sufficient evidence and analysis provided by DCC in its price control report. Our initial review of DCC's supporting commentary highlighted significant concerns with DCC's procedures for controlling its costs, which necessarily prompted closer investigation. For example, DCC stated the increase in payroll costs was justified as salaries were comparable to market rates but it was unable to provide any evidence from an independent source to substantiate this claim. This is a similar principle as established in the RIIO model – well-justified business plans generally attract proportionately less detailed or disaggregated scrutiny.

4.21 Our determination on costs is based on unjustified increases in unit costs per Full Time Employee (FTE) relative to LABP. The aggregate reduction in costs in 2013/14 relative to LABP masks underlying movements in both FTEs and unit costs. The fact that aggregate costs are lower than LABP does not address the issue of underlying unit cost increases. We accept that DCC faces difficulties recruiting the right skill set and our proposed allowances reflect this – we have allowed the significant majority of the cost increases as acceptable due to being economic and efficient. Our cost disallowances reflect a sub-set of increases in staff costs relative to LABP that we have not been satisfied are economic and efficient.

4.22 Figure 1 below shows that although internal costs (including shared service charge) were below LABP in 2013/14, costs are significantly above LABP in 2014/15, and are expected to remain above LABP in all subsequent years.

Figure 1



4.23 We also consider that DCC's forecasts for future years contained assumptions about retaining contractor staff over the long term. DCC explained that it tends to only use contractors for staff required short-term for efficiency reasons. We therefore do not consider it economic and efficient to forecast certain contracted staff long-term where they represent an increase relative to LABP. DCC provided evidence that contractor costs were acceptable in 2013/14. However, should DCC continue to use contractors for longer periods of time, then it will need to provide appropriate justification in future price controls

4.24 We considered DCC's proposal for an undertaking for the unacceptable salary costs but decided it was not sufficient to ensure DCC will be able to avoid, prevent, or mitigate a further occurrence of the same or any similar costs. It did not contain a commitment to manage the unacceptable costs back over time through identifying efficiency savings. It was therefore not sufficient to protect consumers from bearing costs that we concluded were unacceptable. We think the proposals for benchmarking were sensible suggestions and DCC should implement these.

4.25 We welcome DCC's move towards providing external benchmarking evidence as part of their response to our consultation. This is a positive step towards justifying and managing its costs, and demonstrates that benchmarking can and should be used for assessing DCC costs. However, we consider the new benchmarking analysis put forward by DCC is not strong enough to alter our proposals. In fact we consider that the data provided by DCC in fact supports our proposals. We will work with the DCC in the future on developing an appropriate set of benchmarks that they should use going forward.

4.26 We recognised that benchmarking DCC using ASHE data was challenging, and we ran a number of scenarios and sense tests to check our results. We consider that we have placed a reasonable, conservative weighting on this evidence in our decision.

4.27 We do not consider that our application of the ex post review entails an excessive burden. There is no change in the burden on DCC. The test as defined in the licence continues to be to demonstrate the costs it incurs are economic and efficient. We are not requiring DCC to justify every salary or role at future reviews. Instead we are keen to encourage DCC to ensure that a general process is in place before staff are hired and costs are incurred – for example by making it routine to check salary offers with an independent market source. This would strengthen DCC's evidence base at future reviews.

4.28 Some respondents queried whether it was right to assume that the costs in LABP are economic and efficient. The LABP was a competitive position at the time, and it is important that our price control does not undermine the competitive process.

4.29 Our acceptance of some of the cost forecasts as economic and efficient at this review does not preclude the possibility that we could disallow some of these costs at future reviews in light of new evidence. DCC is still able to incur it but will need to explain the variation as part of its price control reporting in the appropriate regulatory year.

4.30 As part of our price control review we carefully considered whether DCC can continue to perform its core functions as a result of our determinations. Our view is that our cost disallowance represents a reasonable funding outcome that will ensure DCC can continue to meet its licence obligations and protect consumers

Shared service charge

4.31 A shared services charge was agreed as part of the LABP to cover support services.[33] It is an amount paid by the DCC for shared services sourced from DCC's parent company, Capita. It was calculated as a percentage of internal costs set out in the LABP, as part of the licence competition.

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

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

Our decision on shared services

4.33 We recognise that as a result of the competitive licence award process, costs within the LABP (including the shared service charge) should be considered economic and efficient. However, we are concerned that DCC has not provided evidence that it has a process to ensure that the shared service charge provides value for money in relation to activity that is not within the LABP**.** We will monitor and request additional reporting from DCC regarding its compliance with its licence requirements, in particular relating to the procurement strategy, relevant cross subsidy, price control, and procurement conditions.

4.34 We have not received strong enough justification and evidence that applying the shared service charge to new scope projects delivered by third parties where there no associated activity from their parent is economic and efficient. We therefore consider that the shared service charge associated with the SMKI, Parse and Correlate, and the ongoing financial stability and security costs are unacceptable costs. We consider that £1.786 million of uneconomic and inefficient costs should not be reported in DCC's forecasts over the licence term.

Consultation responses

4.35 Some respondents were concerned about the arrangements DCC has for taking services from its parent. They raised issues about requiring greater scrutiny and transparency in procuring services from DCC's parent company and affiliates. One respondent specifically asked for further detail and confirmation whether margin is

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

applied to services taken from Capita. A respondent said that DCC needs to demonstrate the shared service charge is the most economical option.

4.36 DCC and one confidential respondent disagreed that DCC should be required to develop a process to demonstrate VfM. They also disagreed with the proposal that the shared service charge on the new scope contracts was not economic and efficient. DCC argue that establishing a link between activity and the shared service would undermine the bid commitment, and finding costs are unacceptable on this basis would be unreasonable. DCC also said it would be inappropriate to require them to develop a process to demonstrate VfM, as it considered that doing so could be an inefficient use of time and money.

Reasons for our decision

4.37 We thoroughly reviewed and considered our position in light of the issues raised in response to the consultation and lessons learned from regulating other licensed monopolies in the energy sector.

4.38 We have considered the concerns of the wider stakeholders, reviewed the licence commitments, and the reasons DCC has put forward in justification for the approach to the shared service charge.

4.39 We appreciate the benefits for the shared services charge and note that the shared service charge was considered by DECC to be competitive at licence award. DCC must, however, demonstrate that these costs are economic and efficient and gives ongoing value for money. This is particularly important given the magnitude of the changes to the LABP since the bid was agreed. We expect DCC to assess and give evidence on how applying the charge to new scope projects that were not included as part of the bid is economic and efficient. It is important there is scrutiny and transparency of services taken from the DCC's parent.

4.40 When making our decision we must operate within the rules and criteria that are reflected in the licence. If commitments made at bid were not reflected in the licence we are unable to comment on these. Our view is that the services provided under the shared services charge are part of the relevant service capability[34] as they are used for the purposes of securing the provision of mandatory business services. These costs are therefore subject to our assessment of costs associated with the provision of mandatory business services, and DCC is required to provide evidence they are economic and efficient. The expectation that DCC does not need to provide any evidence that the shared service charge is economic and efficient, and that it should apply the charge on all internal costs is inconsistent with the licence obligations.

[34] This is defined under licence condition 16, and is the capability that used for the purposes of securing the provision of the Mandatory Business Services.

4.41 We are concerned that DCC appears to have no process for checking that the ongoing cost it is charged from Capita is economic and efficient. It raises serious questions about whether DCC is compliant with:

- Licence condition 11: cross subsidy provisions
- Licence condition 16: procuring of relevant service capability provisions and compliance with its procurement strategy
- Licence condition 32: price control reporting

4.42 We will issue a request for further information to investigate further whether DCC is complying with its licence conditions. We expect DCC to discuss with us the development of a process to ensure its shared services charge remains economic and efficient. However, if DCC does not develop a process and we still have concerns we may impose more regular and prescriptive reporting for the shared service costs. If DCC is found to be in breach of its licence we may take enforcement action.

4.43 We accept the level of shared services on the baseline costs as economic and efficient because they were set under the competitive pressures as part of the bid. However, in the absence of any evidence that a new scope activity has drawn on the shared services, we consider that the charge should not apply in respect of that activity. We do not consider that it is economic or efficient for DCC to pay a service charge for a service that they have not used. This is an important principle to establish given we expect to see economies of scale and efficiencies over time.

4.44 We proposed that the service charge should not apply to the procurement of two new contracts: SMKI and Parse and Correlate. DCC incurred additional direct costs for procuring and managing these contracts, and DCC has not provided sufficient evidence it is economic and efficient to apply the charge to these contracts.

4.45 We encourage DCC to thoroughly review its procurement strategy[35] and provide more detail on how it approaches and decides to take capability from its parent or related affiliates, as well as its approach to competitive tenders.

4.46 DCC has not provided sufficient justification for applying the charge to the ongoing costs related to the financial stability and security. It appears these are standing charges with little additional activity from Capita related to them.

External costs

4.47 External costs comprise the costs of the communication service providers (CSP) and the data service providers (DSP), which are defined under the licence as fundamental service providers. This means that costs associated with other

[35] Under licence condition 16

externally procured services, for example the Smart Metering Key Infrastructure (SMKI) contract are reported under internal costs.

4.48 Around £34 million of the total cost increase reflects changes in external costs. Most of this change is related to the cost of extended coverage and the re-baselining required due to the changes and longer lead-time for the GB Companion Specification (GBCS).

Our decision on external costs

4.49 DCC has provided evidence that the 2% variation in external cost is economic and efficient.

Consultation responses

4.50 DCC welcomed our proposal on external costs being economic and efficient. Some other respondents were concerned we had not sufficiently scrutinised the external cost. There were general concerns about the transparency of cost increases and the lack of industry oversight and governance.

Reasons for our decisions

4.51 DCC has provided evidence of how its change control process challenged and scrutinised the associated costs. In some cases this has reduced proposed cost changes from service providers.

4.52 We expect significant changes in external costs reported next year, as a result of the current re-planning exercise. We expect detailed justification for significant cost changes in future, for example this could include how DCC has checked the costs agreed are competitive, how it has considered different options, and evidence of how it assessed and scrutinised costs. We will be interested in how DCC uses the levers under the contracts to ensure value for money.

4.53 We encourage DCC to provide industry with more detail of costs in its documents. We appreciate that DCC needs to be mindful of commercial sensitivities, but we see benefits in allowing industry to scrutinise the costs before they are incurred.

5. Revenue reporting

Chapter Summary

DCC calculated its allowed revenue as being £13.494 million in 2013/14. As a condition to our direction on the unacceptable costs, we are also requiring DCC to restate its calculation of the 2013/14 allowed revenue to reflect our determinations on unacceptable costs by 31 July 2015. The failure to meet IM5 should be reflected in DCC's allowed revenue that is reported in 2014/15 as part of the calculation of BMPAt, which refers to IM values from the previous regulatory year.

We propose to amend the RIGs for the avoidance of any doubt that the updated forecasts should reflect economic and efficient costs. We will continue to monitor the use of the prudent estimate provision and DCC's cash flow position.

5.1 Allowed revenue is defined in licence condition 35 and calculated in accordance with the Principal Formula set out in licence condition 36.[36] It is the total revenue DCC is entitled to recover from users. Under the price control arrangements DCC incurs costs and passes these onto users by way of service charges. DCC's regulated revenue is the actual revenue, measured on an accruals basis, received through service charges.

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

Allowed revenue

5.3 DCC calculated uts allowed revenue in 2013/14 of £13.494 million. Our determinations mean that £0.415 million should be reflected in lower charges in future years, this will be reflected through the calculation of the correction factor. This reflects our decision to exclude £0.100 million internal costs we found not to be economically and efficiently incurred in 2013/14, and a £0.315 million reduction in BM due to failure to meet IM5 in 2013/14.

Allowed revenue in forecasts

5.4 Each year DCC must update its forecasts for the remaining years of its licence term. Under its licence DCC must also explain any material variances or changes to the any financial or operational matters in its LABP.

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

5.5 The changes reported in 2013/14 had increased costs over the licence term by £71m. We do consider that £4.036 million of costs in its forecasted allowed revenue calculations over the remaining licence term are not economic and efficient.

Prudent cost forecasts

5.6 DCC has argued in its response that its cost forecasts (and revenue forecasts) at each price control should be reported on a prudent basis[37]. DCC argued that this would reflect the most transparent methodology and provide up to date information to SEC Parties that was consistent with its charging statements.

Our decision

5.7 We accept that there is a difference between charging statements, which can be calculated on a prudent basis because costs have not yet been incurred, and forecasts in price control information, which is not reported on a prudent basis because it is provided for a different purpose. We also note that for the purposes of future price controls, we will be comparing DCC's costs against both LABP and against its cost forecasts at the previous price control (as modified by Ofgem's price control determinations). Allowing prudent forecasts could be detrimental to our visibility to assess costs as our comparisons against the LABP becomes less relevant. We need to ensure we secure a robust comparison basis for future reviews

5.8 We do not consider it would be appropriate to allow DCC to report its cost forecasts on a prudent basis. We believe this is consistent with DCC's licence obligations. We consider that allowing prudent forecasts in the price control information will make it significantly more difficult at future reviews for us and DCC to determine whether costs are economic and efficient.

5.9 We propose to amend the RIGs to clarify for the avoidance of any doubt that the updated forecasts should be of economic and efficient costs. We will consult on our changes to the RIGs in spring 2015.

When charges will be returned

Our decision

5.10 We are providing DCC with consent to allow it to adjust its 2015/16 charges with less than 3 months' notice, so that it can reflect the decisions on the unacceptable costs and IM5. This will slightly reduce the proposed charges that will take effect from 1 April 2015.[38] As a condition of our direction on the unacceptable costs, we are also requiring DCC to restate its calculation of the 2013/14 allowed

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[37] See DCC response para 9 and 97

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

revenue to reflect our determination on unacceptable costs by 31 July 2015. The failure to meet IM5 will be reflected in the calculation of DCC's allowed revenue for regulatory year 2014/15.

Consultation responses

5.11 Most respondents wanted our final determinations to be reflected in decisions as soon as possible. Many supported the reduction in charges being reflected in the 2015/16 charges. Some raised concerns that this was a two-year lag and would prefer the price control determination to be aligned with DCC's charging statement.

Reasons for our decision

5.12 It is important charges are returned to users as soon as possible. However, given the scale of the changes we do not think they would justify an in year change to the 2014/15 charging statement. Our proposals were published in November before DCC's charging statement so users would be aware of the potential impact on the charges DCC has published for 2015/16.

5.13 In future we may publish our consultation and final determinations earlier, however this is an annual price control review and it is important we have sufficient time to adequately scrutinise the evidence DCC provides. DCC must reports by 31st July each year and it is essential we leave enough time for proper consultation with stakeholders and sufficient time for us to fully consider their responses and any new evidence. For these reasons we are not able to commit to publishing our final determinations before DCC gives notice of its charges in December.

Prudent estimate

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

Our decision

5.15 We will continue to monitor the use of the prudent estimate provision and DCC's cash flow position. We will consider whether the prudent estimate provision places the right incentives on DCC. We may consider future on potential changes to DCC's licence to ensure the incentives to estimate allowed revenue are right. This could be through introducing a similar regime to the penal interest rates faced by networks for over-charging.

Consultation responses

5.16 A number of respondents raised concerns with DCC's approach to the prudent estimate provision. Some appreciated and supported the reasons for its introduction, but felt that on an ongoing basis it should not be needed. Some respondents strongly urged us to look to remove the prudent estimate provision One respondent argued it has a disproportionate impact on smaller suppliers.

5.17 DCC explained that its prudent estimate was based on 4 weeks operating liquidity to ensure they remain cash positive and able to meet financial commitments. They state that their budget and cash flow forecast includes their best estimates and contains no contingency.

Reasons for our decision

5.18 The prudent estimate provision is designed to ensure that service charges do not need to be amended in the course of the year except in response to a reasonably unlikely contingency. However, looking at the DCC's charging statements the prudent estimate is a significant proportion of the charges[39].

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

5.20 Over time we would expect the size of the prudent estimate to reduce. But we do share respondents concerns regarding whether DCC has the right incentives on it to manage the prudent estimate. Other regulated monopolies have incentives to meet Allowed Revenue through facing penal interest rates for over-charging. We will do further work on this issue and may consider what type of additional control it might be appropriate to place on DCC at this stage.

[39] Under LC36.6 regulated revenue should not significantly diverge from a prudent estimate of allowed revenue.

6. Baseline Margin Adjustment

Chapter Summary

DCC proposed an adjustment to the value of its baseline margin values for each year of the licence term. We assessed its proposal against the criteria in the licence. We do not consider the proposal to have met the criteria and have determined that the value of the baseline margin will not be adjusted.

6.1 The level of additional revenue over and above internal and external costs that DCC is allowed in each regulatory year is referred to as the baseline margin (BM). The value of the BM is fixed for each regulatory year and is included in the licence.[40]

6.2 Under certain circumstances[41] DCC can apply for an adjustment to the BM values in the licence. In 2013/14 DCC proposed an adjustment to the value of its BM for each year of the licence term.

6.3 We assessed a proposed BM adjustment of £3.4 million[42] over the course of the licence. DCC's application for a margin adjustment focussed on these areas, :

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

Our decision

6.4 In our November 2014 consultation we assessed DCC's application to adjust the BM values against the criteria in the licence. We did not consider it to have met the criteria and proposed that the BM values remained unchanged.[43]

6.5 Having considered the responses alongside our own analysis, our position remains unchanged. DCC's proposal for a BM adjustment did not meet the licence

[40] Licence condition 36 appendix 1.
[41] Detailed in licence condition 36, appendix 2.
[42] DCC originally applied for a £12.7 million adjustment, following a request for further information this was reduced by £9.2 million.
[43] DCC applied for an adjustment to its BM values based on the Smart Meter Key Infrastructure (SMKI) contract, the Parse and Correlate (P&C) contract, the Competent Independent Organisation (CIO) contract and Financial security, stability and financing activities. Further detail on DCC's application for a margin adjustment can be found in our November 2014 consultation, available here: https://www.ofgem.gov.uk/ofgem-publications/91527/dccpricecontrolconsultation.pdf.

criteria therefore the values of the BM for each regulatory year will remain unchanged.

Consultation responses

6.6 Of the 12 responses to our consultation, 10 agreed with our assessment. Only the licensee and one confidential respondent disagreed with our assessment against the criteria in the licence.

6.7 DCC disagrees with our interpretation of the licence criteria. It argues that mandatory business consists of operating mandatory business services whether or not provided by external suppliers. DCC considers that its risk and characteristics have changed and their proposed adjustment was not made only on the basis of volume alone as suggested by our consultation.

Reasons for our decision

Mandatory business

6.8 The licence sets out the criteria that a proposed relevant adjustment must relate to.[44] It refers to variations that have taken place or are likely to take place in certain named aspects of the mandatory business of the licensee. We interpret these aspects as relating to variations to the volume, characteristics, mixture of activities, risk, and timescales or deadlines that DCC itself incurs. The baseline margin adjustment mechanism was included in the licence in recognition of the uncertainty over the nature and risk of DCC's business over time. It allows DCC to apply to us to make a case for changes to the margin, so it is appropriately rewarded for the value it brings to energy customers.

6.9 DCC did not provide sufficient evidence in its baseline margin application of how the variations to mandatory business compared with the LABP met the criteria for a baseline margin adjustment.

6.10 This view is supported by the criteria we must consider in determining any adjustment to the BM values.[45] The licence requires us to have particular regard to the purpose the BM term is intended to serve and the basis on which BM values were agreed at licence grant. The margin is intended to ensure that DCC is rewarded for the work it does and risks it bears, not those of a third party. For example, the DCC does not earn margin on the Fundamental Service Provider contracts.

Risk

6.11 DCC did not make a case for SMKI or P&C on the basis of risk in its notice for an adjustment. Its original case for both contracts was based on changes to the volume of activities, changes to the characteristics of activities and changes in

[44] Licence condition 36, appendix 2.
[45] Licence condition 36, appendix 2, part A10.

resources volumes. In response to our request for additional information, DCC stated that the variations in its proposal for an adjustment should only be considered in the context of changes in volume of activities – in terms of the value of the contracts.

6.12 When justifying its case DCC argued that operational and financial risks have increased. It also argues that SMKI and P&C increase the level of work to be completed, increasing their risk of not meeting the IMs. However it does not adequately demonstrate this change in its risk, or quantify it.

6.13 DCC has not followed the licence criteria. It has not adequately demonstrated a change in its risk, or new information that has come to light to cause this change in risk. We expect DCC to quantify its risk in future when applying for an adjustment to the BM values based on material changes to its risk.

Characteristics

6.14 DCC makes no case in its notice for an adjustment for the CIO contract to be considered on the basis of changes to characteristics, only as changes to volume. It also stated that we should only consider variations to account for changes in volume of activities as part of its proposal for an adjustment in response to our direction for further information.

6.15 When justifying proposed variations in supplementary information provided, DCC argued that the CIO contract varied the characteristics of the Mandatory Business. We disagree with DCCs view that procuring and managing the CIO contract materially changed the characteristics of DCC’s business. We are not satisfied that DCC provided robust justification to demonstrate this. Further to this, the CIO’s role is to check and provide assurance that DCC is compliant with its security obligations. Arguably this reduces the risk DCC faces complying with its security obligations.

Future applications for adjustment to BM values

6.16 In future, if grounds arise or become more certain or material, DCC may be able to put forward a case for a BM adjustment on these items. We will consider each application on its merit, assessing it against the criteria in the licence.

6.17 As allowed by the licence, we intend on publishing guidance on the procedure that we will follow and the matters we will take into account when determining a proposal for an adjustment. This may include principles, methods of assessment, and types of criteria that are likely to be applied when determining a proposed adjustment.

7. Next steps and future price controls

In this chapter we set out some intended next steps and some longer term thoughts on the future development of our analysis and price control

Changes to the RIGs

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

7.2. We consider the RIGs to be appropriate for 2013/14. However given the number of queries and additional information we had to request from DCC after they had submitted their price control report, we consider that it may be beneficial to look at revising some aspects of the RIGs to avoid a repeat of this in future. We therefore intend to consult on changes to the RIGs to provide further description and clarity, as well as make some amendments to the reporting templates. We will consider including references to DCC's assessments of changes to external costs and procurement, which DCC may want to include to justify variations from LABP, where it is appropriate. However the RIGs will never prescribe exactly how and to what level DCC should justify every cost variation. We also state for the avoidance of any doubt our interpretation that the forecasts should be economic and efficient.

7.3. Proving costs incurred are economic and efficient is DCC's responsibility under its licence and failure to provide detailed justification in future will mean it is likely that DCC's cost will be unacceptable.

Future price controls

7.4. This year's reporting and cost assessment has given us a useful understanding of DCC's costs and the nature of their business. The views from the consultation responses have helped us set out some clear priorities for future price controls. In particular, our assessment in future years will focus on:

- how DCC obtains value for money from the shared service charge that it pays to Capita for support services. We may place additional reporting requirements on DCC in relation to the procurement of shared services from Capita which are not included in the Licence Application Business Plan.

- DCC should establish processes that will ensure its spending is economic and efficient. For example, salary benchmarks that will help us assess whether DCC's recruitment decisions are value for money and a contractor strategy to ensure DCC uses contractors in an economic and efficient manner.

- the level and quality of evidence that DCC provides. DCC's evidence case must be improved in future years to demonstrate value for money. Otherwise DCC risks having costs determined to be unacceptable due to lack of sufficient evidence to demonstrate that they were economically and efficiently incurred.

- The approach DCC takes to the prudent estimate and whether the current incentives are appropriate.

7.5. We will continue to develop our assessment drawing upon on knowledge and approaches used elsewhere. In the future we may consider:

- developing our benchmarking of internal and external costs
- whether a forensic accounting audit might be appropriate
- whether a technical audit would be appropriate
- the approaches that are used for other regulated entities to ensure there is not an over-recovery of cost
- undertaking work to support future considerations on rates of return.

Developing operational incentives

7.6. DCC must engage and consult with SEC parties on the design of the operational incentives. In future we will be looking to develop quality of service reporting and we expect the ex post review to look at the outputs DCC provides.

Consultation responses

7.7. A number of respondents commented on the incentives on DCC under the current framework. There was a mix of views on whether these were appropriate. A few respondents suggested the types of methodologies from RIIO[46] that could be applied to DCC.

Our view

7.8 Once the re-planning exercise[47] is finalised we expect DCC to start engaging early on developing the operational incentives framework. In light of the concerns raised in the responses we are keen to be involved in initial proposals and we expect SEC users to be fully engaged, consulted, and their views taken into consideration. We are interested in the suggestions from respondents on the benefits of adopting elements of the RIIO framework and we will consider these further in the development of the operational incentives.

[46] RIIO is the performance based regulatory framework used to set price controls for energy networks. Further information on RIIO can be found here: https://www.ofgem.gov.uk/ofgem-publications/64031/re-wiringbritainfs.pdf
[47] DCC has consulted on changing the programme timeline. The consultation is available here: http://www.smartdcc.co.uk/media/14108/141117_dcc_plan_and_im_consultation.pdf

Movement to ex ante controls

Consultation responses

7.9 There was also a range of views on our proposal to move to more ex ante controls in the future. One respondent was strongly against introducing a RIIO-based regime, and another was concerned about the incentives to control cost and thought ex ante controls should be introduced as soon as possible. Most respondents held a variation on a similar view that ex ante controls could be appropriate after the implementation phase is completed.

Our view

7.10 We see benefits in moving to more ex ante controls once DCC reaches a steady state. This would give the industry and DCC certainty about costs. We agree that there would need to be more stability in the activity of the DCC's operations before such an ex ante regime can be introduced. We will fully consider and consult on options before deciding to change the structure of DCC's price control.

Appendices

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Appendix 1 – List of responses

1.1 We received 13 responses to our consultation, one of the responses is confidential and another respondent has provided some additional analysis that is confidential.

1.2 We have published the non-confidential responses on our website.

The non-confidential respondents to our consultation were:
British Gas
Consumer Advice Bureau (CAB)
Data Communications Company (DCC)
Co-operative Energy
EDF Energy
ENWL
EON
RWE-Npower
Scottish Power
Secure Meters Group
SSE
Spark Energy

Appendix 2 - Glossary

A

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

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

Authority
The Gas and Electricity Markets Authority

B

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

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

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

C

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

Communications Service Provider (CSP)

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

D

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

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

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

E

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

F

FTE
Full Time Equivalent

G

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

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

H

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

I

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

L

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

R

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

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

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

S

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

SECCo

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

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

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

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

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

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

M

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

O

Ofgem
Office of Gas and Electricity Markets

ONS
Office for National Statistics

P

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