DCC Price Control Consultation

DCC response

21st January 2015

CONTENTS

1 EXECUTIVE SUMMARY

1. We would like to thank Ofgem for the opportunity to review and respond to its consultation in relation to our first Price Control for RY[1] 2013/14. This document sets out our response to that draft determination.

2. RY 2013/14 was an eventful and successful year for DCC (Smart DCC Ltd), in its consultation Ofgem recognised that we "have done a good job to establish the resources and processes required to deliver the smart meter roll-out and manage costs during 2013/14". Within a short space of time we have established our core business capabilities and implemented governance and management systems. We have tested, aligned and integrated our plans with the JIP[2] and have assured and approved the initial ISDP[3] and applied these disciplines to assess the impacts, and re-plan, in light of the delay to the delivery of a complete and stable GBCS[4] by DECC[5].

3. We have been successful in establishing design governance, management and assurance processes, engaging our prospective users and other key stakeholders through forums and consultation. We assured design documentation from External Service Providers and ensured alignment with relevant Government-produced specifications and the emerging SEC[6].

1.1 Our view on Ofgem's proposals

4. We welcome Ofgem's proposal to accept the changes in External Costs as being economic and efficient. We consider that Ofgem's proposal to disallow certain Internal Costs is disproportionate given that we underspent in RY 2013/14 by 9% (£1.3m) against our forecast set out in the Licence Application Business Plan. Ofgem's approach also undermines the principles established during the competitive procurement of the Licence by DECC.

5. We are concerned about the level of uncertainty over Ofgem's proposals in respect of disallowed costs. There is no indication as to any resulting direction on DCC or, for example, whether an undertaking will be required.

6. We consider that Ofgem's proposal regarding our performance is unreasonable and does not give due regard to the circumstances of the case and the fact that we made decisions in the best interests of the programme, ensuring that we continue to meet

[1] RY – Regulatory Year

[2] JIP – Joint Industry Plan

[3] ISDP – Integrated Solution Delivery Plan

[4] GBSC – Great Britain Companion Specification

[5] DECC – Department of Energy and Climate Change

[6] SEC – Smart Energy Code

our Interim General Objective to "…contribute to the achievement of a full, timely, efficient, economical and secure Completion of Implementation…".

1.1.1 *Ofgem's cost assessment*

7. We do not agree that the proposed disallowed cost of £0.1m in RY 2013/14 and future disallowances (referred to in this document as "ex ante disallowances") of £4m are uneconomic or inefficient. We consider that this potentially represents a penalty to DCC. In regulated environments, a penalty is imposed in egregious circumstances only; where some form of wrongdoing has occurred. This is not the case in our Price Control assessment.

8. The reasons we disagree with Ofgem's proposals are because:

   - costs have been assessed at a granular level, which has resulted in disallowances in areas where, overall, savings have been made;
   - the effect of disallowances is unclear, but it appears to be an extreme measure in the context of this being the first submission and assessment within a new regulatory framework, and where an alternative option is available under with Licence Condition 37; and
   - the benchmarks used in Ofgem's cost assessment are not comparable and therefore we do not consider them to be appropriate for use.

9. It is our view that Ofgem should reconsider its proposal to disallow costs incurred RY 2013/14.

10. It is our view that, going forward, Ofgem should consider ex post disallowances only where we have been previously notified that they are considered to be potentially at risk of disallowance.

11. In addition, it is our view that Ofgem should clarify to DCC:

   - what direction Ofgem would issue under Licence Condition 37 with respect to the Internal Costs we have incurred in RY 2013/14, that it has considered were not economic and efficient, and how it proposes that the amount spent in RY 2013/14 would be recovered;
   - the specific cost items to which the proposed disallowance relates ;
   - whether proposed disallowances are based on principles or whether they are in relation to insufficient justification and evidence (we require more clarity on these issues to help us understand and therefore enable us to resolve financial commitments (and forecasts) for the future); and
   - whether Ofgem's determination in relation to our future Price Control submissions would supersede any previous determinations where ex ante disallowances have been made.

1.1.2 Implementation Milestone 5

12. We disagree with Ofgem's draft determination that IM5[7] was not met. The reasons we disagree are because:

- we produced, approved and submitted documents by the IM5 Implementation Due Date in accordance with Schedule 5 of our Licence;
- we produced, approved and submitted documents that we considered fit for purpose given the status of external dependencies at the time, which has subsequently proven to have been the correct assessment;
- we wanted to provide documents that SEC Parties were able to fully rely on, however we were unable to do this due to the delay of external dependencies being available in a stable and/or final format. We instead provided documents containing as much information as possible to SEC Parties so that they may begin early design work, but were treated with sufficient caution so as not to cause them to begin detailed solution developments which will have incurred significant sunk costs; and
- we consider this approach was the best option to minimise the risk of delay and additional cost to the programme and ultimately the consumer.

13. It is our view that Ofgem should carefully consider the balance of dependencies within the programme during this critical transitional period in light of our General Objectives. In the circumstances, it should accept that conditional approval was the most efficient and practical way of dealing with the reliance on, and the delays to, external dependencies which were not within our control.

14. Acceptance that we met IM5, or at least for Ofgem to recognise that conditional approval is merely a technicality would signal that Ofgem understands that we are charged with making difficult decisions in a highly complex programme. It would further signal that we should not be penalised financially for making pragmatic and justified decisions for the benefit of the programme, SEC Parties and ultimately consumers.

1.1.3 Corporate overhead charge

15. We disagree with Ofgem's draft determination in relation to the corporate overhead charge (referred to as the "shared service charge" in Ofgem's consultation document). The reasons we disagree are because:

- it undermines the principles established during the Licence Application process; and

[7] IM5 – Implementation Milestone 5

- Ofgem has misunderstood the standard methodology used in allocating corporate overhead.

16. It is our view that Ofgem should reconsider its proposal to disallow the corporate overhead charge associated with the SMKI[8], Parse and Correlate and financial stability and security costs.

1.1.4 Baseline Margin

17. We disagree with Ofgem's draft determination in relation to our Baseline Margin application, because:

- it undermines the principles established during the Licence Application process; and
- we consider that we met the criteria as set out in Licence Condition 36 (Appendix 1, Part A).

18. It is our view that Ofgem should allow a relevant adjustment to the Baseline Margin values in light of our application.

1.2 Potential consequences of Ofgem's draft determination

We consider that the draft determination in its current form will:

- introduce perverse incentives by impeding our ability to do the right thing for the programme;
- increase our regulatory risk to an unacceptable level because of uncertainty relating to cost disallowances;
- make resourcing decisions difficult in light of the likelihood of arbitrary and disproportionate ex post cost disallowances; and
- lead to a suboptimal position of managing to the lowest point of cost[9] rather than to the overall efficiency of the programme.

19. We are working within a new and unique regulatory framework, where we must continue to monitor any unintended consequences of the regulatory and incentive framework. If Ofgem penalise us for carrying out activity which serves to benefit the programme in accordance with our General Objectives this would give rise to perverse incentives for us to operate in a way which reduces our regulatory and commercial risk. This may only be to the detriment to the success of the programme

[8] SMKI – Smart Metering Key Infrastructure

[9] For example, by not taking into account intangible costs such as the opportunity cost of delaying recruitment to pay a lower salary, against the quality difference of recruiting more experienced staff who will be able to drive the programme.

and ultimately consumers. We consider that this is an important issue which must be kept at the forefront of the regulatory agenda.

2 SUMMARY OF RESPONSES TO CONSULTATION QUESTIONS

Consultation question	Summary of DCC response	Further discussion
Question 1: What are your views on our approach to assessing DCC's costs? And do you have any suggestions on where we can improve our approach?	We do not agree with Ofgem's approach to cost assessment. We consider that its assessment has been carried out at an overly granular level and therefore is disproportionate and misleading. It does not give regard to the efficiency savings in RY 2013/14.	Please see Section 3 - Ofgem's Cost Assessment
Question 2: What are your views on our assessment of DCC's performance against the IMs?	We do not agree with Ofgem's approach to assessment of DCC's performance against the IMs. We consider that conditional approval of the documents was the most efficient and practical way of dealing with a delay to external dependencies that were not within our control.	Please see Section 4 – Implementation Milestone 5
Question 3: Do you have any observations from the current incentive framework which can inform early thinking on developing an enduring framework?	We welcome Ofgem's approach to gather early thoughts on the incentives framework. We look forward to engaging with users to develop performance measures from RY 2016/17 onwards and to work with Ofgem, in the near future, to develop an incentive framework for the enduring phase which is robust and fit for purpose.	N/A
Question 4: What are your views on our proposal?	We disagree with the proposals outlined in Ofgem's consultation.	Please see Section 3 - Ofgem's Cost Assessment
Question 5: Do you have any views on how the RIIO	We can see merit in considering how aspects	N/A

Price Control approach could be applied to DCC in future?	of the RIIO Price Control approach may apply to DCC, although we consider that this may be more appropriate in the enduring phase. We are keen to work closely with Ofgem to achieve this.	
Question 6: We are looking for ways to benchmark DCC costs. What other sources of data or potential comparators can you recommend for subsets of DCC costs?	We can see the merits of benchmarking costs; however DCC is a very specialist organisation which makes it very difficult to find appropriate comparators.	Please see Section 3.7 - Benchmarking
Question 7: What are your views on DCC's approach to the prudent estimate?	The prudent estimate is set to ensure that the risk of in-year changes to service charges is minimised to the lowest possible level. We consider this approach to be in SEC Parties' best interests as it allows them to plan their internal cash flow with a high level of confidence.	Please see Section 7.1 - Prudent estimate
Question 8: Do you agree that our proposals should take affect from April 2015/16?	We agree that any proposals can only take effect from 1st April 2015.	Please see Section 7.2 – Effective date Ofgem's determination
Question 9: Do you agree with our assessment against the criteria in the Licence?	We do not agree with Ofgem's assessment for the reasons given in this response.	Please see Section 6 - Baseline Margin
Question 10: What are your views on our longer term strategy of moving towards a more ex ante Price Control? How might this be achieved?	We support the evolution of the Price Control regime to include a greater ex ante approach and look forward to working closely with Ofgem to achieve this.	N/A

Table 1 - Summary of responses to consultation questions

3 OFGEM'S COST ASSESSMENT

34. This section sets out our response to Ofgem's cost assessment, and is structured as follows:

- 3.1 Overview
- 3.2 Efficiency savings made in RY 2013/14
- 3.3 Our Price Control submission
- 3.4 Use of granular approach
- 3.5 Disallowed costs
- 3.6 Our view on disallowed costs
- 3.7 Benchmarking
- 3.8 – 3.10 Development of the LABP, Quality of reporting and Updated forecasts
- 3.11 Potential consequences of Ofgem's draft determination on costs
- 3.12 DCC's concluding views

3.1 Overview

35. Ofgem's draft determination is to disallow £0.1m from our Internal Costs in RY 2013/14 and £4.0m of our forecast Internal Costs over the remaining term of the Licence. These disallowances are made in relation to staff costs and our corporate overhead charge. The corporate overhead charge is discussed in Section 5 of this document.

36. Ofgem's proposal is to allow the changes in External Costs as being economic and efficient.

37. We welcome Ofgem's draft determination on External Costs. We consider that its proposed decision in relation to Internal Costs is disproportionate, and it does not take into account the savings that were made in RY 2013/14. We have outlined the efficiency savings we have made, in the section below.

3.2 Efficiency savings made in RY 2013/14

38. A breakdown of our incurred costs compared to the costs forecast in the LABP (Licence Application Business Plan) is provided in Table 2 below. 73% of our incurred costs were Internal Costs, which is consistent with the expectation in our LABP.

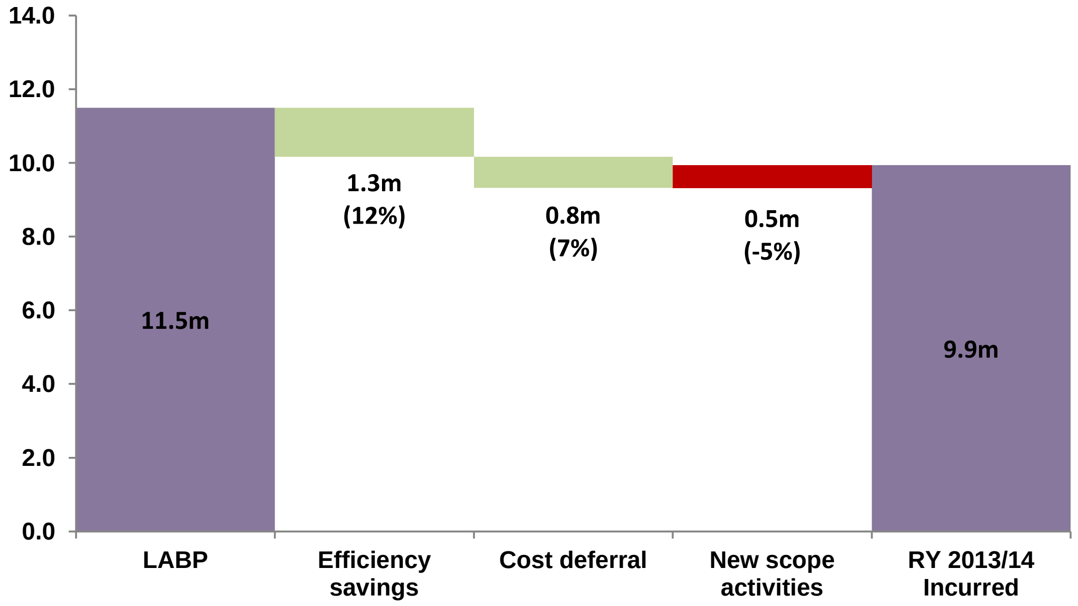
Cost category	RY 2013/14 Incurred £m	RY 2013/14 LABP £m	Variance £m	Variance %
Internal Costs	9.9	11.5	(1.6)	(14%)
External Costs	0.6	-	0.6	-
Baseline Margin	1.8	1.8	-	-
Pass-Through Costs	1.2	1.5	(0.3)	(20%)
Total	**13.5**	**14.8**	**(1.3)**	**(9%)**

Table 2 - RY 2013/14 incurred costs compared to the LABP

39. The reduction in Internal Costs incurred is shown in Figure 3.1.A and is composed of:

1. a reduction against the LABP due to efficiency savings we generated (£1.3m);
2. a reduction against the LABP due to deferral of IT spend to RY 2014/15 (£0.8m); and
3. an increase due to costs for activity that has arisen due to additional scope or a change in the scope of our work – referred to as 'New Scope' (£0.5m).

Fig 3.1.A Variation in Internal Costs incurred in RY 2013/14 to LABP



40. The New Scope costs incurred in RY 2013/14 were accepted by Ofgem as economic and efficient[10]. They also determined that the competitive procurements for the SMKI service and Parse and Correlate service resulted in contracts of economic and efficient values[11].

41. The efficiency savings of **£1.3m** were made in the following areas:

- Staff costs (£0.6m)

Overall staff costs were 9% lower than forecast staff costs in the LABP and average FTE[12] in RY 2013/14 was 12% lower at 49 compared to 55 forecast in the LABP.

Savings have been made due to staff being recruited later than anticipated based on availability of appropriately skilled resources in line with our requirements and without any detrimental impact to the programme. These are true savings to the programme as future costs in relation to these staff are not forecast to increase as a result of a delay in their recruitment.

- Cost of recruitment and accommodation (£0.2m)

Overall, these costs were 21% lower than the forecast recruitment and accommodation costs in the LABP.

Savings in recruitment have been made due to the reduction in FTE in RY 2013/14 and negotiation of recruitment fees to lower levels than that forecast in LABP.

- Other costs (£0.6m)

We made efficiency savings of 18% compared to LABP by implementing the following measures:

- 50% reduction in the number of industry events held per annum. This is based on SEC Party feedback and use of alternative engagement methods;
- obtaining the credit rating facility through our parent company at a fixed cost for unlimited use compared to an external provider charging per credit check;
- assessing the level of certain services required, such as a behaviour performance analyst, knowledge management tool, and press and communications support; and
- reducing the use of external services during transition phase by using in-house resources.

[10] Appendix 3 paragraphs 1.109 – 1.111 of Ofgem's Price Control consultation

[11] Paragraph 4.19 of Ofgem's Price Control consultation

[12] Full Time Equivalent

3.3 Our Price Control submission

42. In our Price Control submission we presented costs incurred and forecast as specified in the RIGs[13], broken down by cost centre for each function. Variances to LABP above a materiality level (set by DCC[14]) were explained in the commentary. In most cases, and particularly in relation to staff costs, aggregate material variances were composed of smaller, non-material variances.

43. With respect to staff costs we provided analysis based on the driver of a variance, principally if it related to a salary package change, an FTE change, or a transfer of FTE into the function from another function.

3.4 Use of granular approach

44. We note that Ofgem has assessed costs at a detailed level which, in our view, has led to a disproportionate draft determination and indicates it is using a methodology that will significantly increase our regulatory burden. We also note that the RIGs, which were not available at Licence Application and only finalised in June 2014, do not make reference to the level of detail on which costs will be assessed and the materiality level to be applied.

45. We were of the view, given the RIGs are unclear in relation to the level of scrutiny Ofgem would apply, that Ofgem would take a proportionate approach to assessment. We expected this to be a high-level assessment of how we incur costs and the cost itself at a more aggregated level. This assumption was made in the absence of comparable price control submissions which use an ex-post approach to price control. It is our view that this high-level assessment approach is more consistent with the principles of good regulation[15].

46. We also assumed that only material costs would be assessed. This is in line with the approach taken in RIIO where it is explicit in the RIGs that an understanding of material variances is required[16]. In some instances materiality thresholds are clearly defined, such as £0.1m for completion of operating expenditure worksheets in the RIIO-T1 Gas Transmission Price Control V1.5.[17]

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[13] RIGs – Regulatory Instructions and Guidance

[14] The materiality threshold was set out in our Price Control submission (July 2014), Section 2.1.

[15] The principles of good regulation (established by the Better Regulation Task Force in 1997) state that regulation should be transparent, accountable, proportionate, consistent and targeted only at case where action is required

[16] Section 1.15(3) and 11.2 of RIIO-T1 Gas Transmission Price Control – Regulatory Instructions and Guidance; Version 1.5 www.ofgem.gov.uk/ofgem-publications/87322/riio-t1gastransmissionrigsversion1.5.pdf

[17] Section 5.4 of RIIO-T1 Gas Transmission Price Control – Regulatory Instructions and Guidance; Version 1.5 www.ofgem.gov.uk/ofgem-publications/87322/riio-t1gastransmissionrigsversion1.5.pdf

47. The areas that Ofgem have highlighted where disallowances have been made were not material in each of the functional areas in which they occurred. This is shown in Section 3.6 of this document.

48. We did not apply for any additional Baseline Margin in respect of these variances due to their immateriality. We were, therefore, not incentivised to incur additional costs in any of these areas.

49. It is important to note that the LABP was no more than a best estimate cost model at Licence Application, and not a committed model in which this programme could be delivered (refer to Section 3.8 of this document for detail on the development of the LABP). Therefore it is inevitable that variances will arise.

50. We did not provide specific justification and evidence for each variance in each functional area as part of our Price Control submission. Providing justification and evidence at this overly granular level would have resulted in an unnecessarily onerous and burdensome regime. An increased process and reporting requirement may divert focus from the material aspects of programme delivery and therefore result in delays to programme implementation. It may also drive an increase in resource costs to allow us to carry out this activity.

3.5 Disallowed costs

51. We note that, under the Price Control regime in accordance with Licence 37 Part B Ofgem may:

(a) direct that any External Costs or Internal Costs that it considers were not economically and efficiently incurred in the Relevant Regulatory Year ("Unacceptable Costs") are to be excluded from any future calculation of the Licensee's Allowed Revenue under Condition 36; or

(b) accept an undertaking given by the Licensee with respect to the Unacceptable Costs on terms that relate to either or both of:

i. the Licensee's future management of these costs, and

ii. the Licensee's future procurement of Relevant Service Capability.

52. Ofgem has disallowed both incurred and forecast costs, stating that we are not allowed to fully recover the costs submitted as part of the Price Control in future years. It is not clear from the consultation what direction Ofgem proposes to issue under Licence Condition 37 with respect to the disallowed Internal Costs we have incurred in RY 2013/14, and how it will address future forecast costs yet to be incurred.

53. We request that clarity be provided on these issues by Ofgem.

3.5.1 Ex post disallowances

54. In the absence of any direction on disallowed costs, we consider that an ex post disallowance of costs could be tantamount to a penalty or fine on our business. In regulated environments, a penalty or a fine is imposed in egregious circumstances only; where some form of wrongdoing has occurred. For example, one would expect any penalty to be considered in line with the seriousness of the breach [18]. In this case, disallowances have been made to on the basis of not providing sufficient justification and evidence for cost variances that, in the round, are immaterial. This seems to be an extreme measure in these circumstances and in the context of this being the first submission and assessment within a new regulatory framework.

55. We consider that costs we have incurred in RY 2014/15 prior to the final determination being issued (up to 12 months of costs) are also at risk. Where a disallowance has been made on the grounds of principle and/or process we have had no opportunity to make adjustments to minimise the risk of a disallowance in the same areas of costs incurred in RY 2014/15.

56. Ofgem describes the disallowance of £0.1m during RY 2013/14 as “small”[19] we fundamentally disagree. We consider that the principle of disallowing costs that have been incurred in the preceding Regulatory Year in these circumstances is significant. The figure of £0.1m is material in comparison to the expected return for RY 2013/14.

57. It is unclear from the consultation how the amounts disallowed have been calculated and to which resources they relate to. We are unable to reconcile the disallowances to the information we submitted under Price Control. Without this information it is not possible to exclude the disallowed costs from any future calculations of our Allowed Revenue under Licence Condition 37.

58. The disallowances are primarily focussed on our staff costs, which are a significant proportion of our Internal Costs (55% in RY 2013/14). Our quality of staff is critical for successful delivery of this programme and we require highly specialised roles across our organisation, such as service management specialists, specialist architects in integration, network, and security, and test specialists. To minimise delays and reduce inherent risk in this first year of the programme we had to obtain significantly experienced resource within a relatively short time-frame presenting challenges in terms of both availability and costs.

[18] See paragraph 5.11 – 5.14 of ‘The Gas and Electricity Markets Authority’s statement of policy with respect to Financial Penalties and Consumer Redress under the Gas Act 1986 and the Electricity Act 1989’, accessible here: https://www.ofgem.gov.uk/ofgem-publications/86949/penaltiesandredresspolicystatement31march2014.pdf

[19] Page 6 of Ofgem’s Price Control consultation

3.5.2 Ex ante disallowances

59. It is unclear from the determination how ex ante disallowances are to be treated in practical terms, for example, if a disallowance relates to a cost that does not arise in a future year. Some costs are future forecasts and therefore are not guaranteed to be incurred; others will be committed costs (including the costs already incurred during RY 2014/15).

60. We are keen to understand how Ofgem calculated the disallowances and the specific cost items to which the disallowances relate.

61. For disallowances relating to costs yet to be incurred we expect that any resulting variance to LABP will be assessed under Price Control for the Regulatory Year in which the variance arises. We expect that Ofgem's determination in relation to that Regulatory Year's submission would supersede any previous ex ante disallowances.

3.6 Our view on disallowed costs by function

62. We disagree with Ofgem's proposals to disallow costs in relation to salaries and contractors, and with the approach it has taken in making its assessment for each function.

63. Ofgem has focussed on three functions where disallowances have been made; Corporate Management, Finance and Security. Table 3 summarises the following:

a. % variance of total expenditure vs the LABP. In all but one of the functions our total expenditure was less than forecast in the LABP.

b. % variance of total expenditure vs the LABP excluding the impact of costs transferred between functions. Cost transfers are not real variances but a reallocation of a cost between functions. Excluding this impact we underspent against the LABP in all three functions by an average of 25%.

c. % variance of staff costs incurred vs the LABP excluding the impact of costs transferred between functions. In all but one of the functions we underspent in staff costs.

d. Cost areas where Ofgem have disallowed costs in each of these functions, and whether the total variance in these cost areas fell below the materiality threshold. In all but one area the total variance where disallowances have been made fell below the materiality threshold.

Cost category	Corporate Management	Finance	Security
% increase/(decrease) in total expenditure vs LABP	**(18%)**	26%	**(32%)**
% increase/(decrease) in total expenditure excluding transfers vs LABP	**(21%)**	**(21%)**	**(32%)**
% increase/(decrease) in staff costs excluding transfers vs LABP	26%	**(11%)**	**(13%)**
Reason for disallowance per determination	Change in FTEs and in particular differences in salary have not been sufficiently well justified. While we appreciate that the nature of DCC's task is challenging and evolving, DCC has failed to provide evidence to support all the differences in salary above LABP.[20]	We consider there are roles where salaries and the benefits packages have increased relative to the LABP without justification. We have found these staff costs not to be economic and efficient and will disallow the additional cost.[21]	We propose to disallow increases relative to LABP where DCC has not provided sufficient evidence. We also propose to remove the difference in cost from the LABP associated with incorporating long-term contractors in the forecasts.[22]
Change in FTE below materiality threshold	**Yes**	N/A	N/A
Change in salary package below materiality threshold	No	**Yes**	**Yes**

Table 3 - RY 2013/14 incurred costs compared to the LABP

65. We are surprised that disallowances have been made in areas where, overall, we have underspent against our forecast in the LABP.

66. We also consider that disallowing variances that fell below the materiality threshold is disproportionate and not consistent with Ofgem's approach applied in other Price Controls and, therefore, not the approach we had expected them to apply.

67. Providing additional justification beyond that provided for immaterial variances would have required an onerous level of reporting that in our opinion would have been disproportionate and not an efficient or economic use of time and resources.

[20] Appendix 3, paragraph 1.39 of Ofgem's Price Control consultation

[21] Appendix 3, paragraph 1.59 of Ofgem's Price Control consultation

[22] Appendix 3, paragraph 1.97 of Ofgem's Price Control consultation

68. In some instances, for example salary package variance for the Finance function, the variance was a **saving** of 10% rather than an additional cost. We would not have expected a disallowance to be made with respect to cost savings.

69. In the Security function Ofgem have noted that they will disallow future forecasts associated with long-term contractors. This role which was forecast as a contractor has since been filled with a permanent employee.

70. In its views on cost changes in the Finance function, Ofgem state that DCC had sufficient information when preparing its bid to form reasonable expectations of the challenges and deliverables that the Finance team would have to manage. They state that many of the issues are similar to other regulated entities and, therefore, to a certain extent could have been anticipated when the bid was being prepared.[23]

71. We strongly disagree with these views. There are no other comparable regulated entities operating in the initial years of their Licence with similar Price Control conditions and a similar financial model. Therefore, it would not have been possible to anticipate with any degree of certainty the complexity and level of work carried out by the Finance function.

3.7 Benchmarking

72. We recognise that benchmarking can be a useful tool for assessing costs where appropriate comparators are available. We understand that Ofgem is keen for us to demonstrate that we have carried out external benchmarking of costs and welcome the opportunity for further discussion with them in this regard.

73. We do not, however, consider that the benchmarking exercise on salaries and benefits carried out by Ofgem uses appropriate comparators. Our reasons are explained in Section 3.7.1 below. On this basis we would be concerned if the benchmarking data continued to be used as an indicator of whether staff expenditure is economic and efficient.

3.7.1 Concept

74. After reviewing the ASHE data we do not agree that the benchmarking carried out by Ofgem uses relevant comparator for our business. Our concerns are set out below.

- There is not enough definition between roles in the ASHE data set to allow for accurate mapping of our roles. For example, the data set contains role descriptions at the 4 digit SOC code such as ‘Finance managers and directors’ (SOC 1131) and ‘Chartered and certified accountants’. A potential issue is that one role could fall into both of these categories. Depending on which category the role is mapped to can lead to varying results. A second issue is that multiple roles can be mapped to one category with a risk that

[23] Appendix 3, paragraph 1.56 and 1.57 of Ofgem’s Price Control consultation

roles at either end of the scale generate material variances compared to the median/mean. An example of this would be a newly qualified accountant and a 5+ years post qualified accountant. Both roles could map to 'Chartered and certified accountants' but there is a 58% variance in their typical salaries.[24]

- The data set does not reflect the high level of specialism in the roles we have in the business. 42% of our average FTE in RY 2013/14 was composed of technical staff in the design, architecture, operations and security functions. This is a direct representation of the niche, complex and unique nature of our business. Ofgem recognises this in their determination[25] and we consider this to be a key issue in trying to rely on external benchmarking to support its assessment.

- The data set does not take into account the size or type of organisation. The salary surveys we have used to carry out our ex-post analysis, in Section 3.7.2 of this document, compare data across different types of organisations, with salaries for finance professionals in Greater London being £5-30k on average higher for corporates than for small and medium entities. We would classify ourselves as corporate as we belong to a group with turnover of over £100m.[26]

75. We consider that it is important that we ensure that we have the correct level of talent and resource to run our business. This is ultimately in the wider interests of the consumer as it will ensure the right governance and internal control structure is implanted and will also provide the right level of commercial insight and management when dealing with our Service Providers, ultimately driving better value for money.

3.7.2 Alternative benchmarking sources - salaries and benefits

76. We are committed to paying the economic and efficient rate for the level of qualification and experience that we deem necessary for each role. Industry surveys may be one option that provide more relevant comparators and therefore support our economic and efficient recruiting decisions. This is because they are industry specific and tend to provide data for specific roles by regions and by organisation types.

77. We carried out an ex post benchmarking exercise for both our Finance team and the Security team, comparing basic salary to data from surveys conducted by third parties[27]. A summary of the results are shown in Table 4. We found that the salary levels were within the expected range of the survey for the level of role, with one exception in each team. Also the total annual basic salary for each team was lower

[24] Hays Accountancy and Finance Market Overview and Salary Guide 2014 (Hays Guide), Qualified Accountancy in Greater London

[25] Appendix 4, paragraph 1.15

[26] This is methodology applied in the Hays Guide

[27] Hays Guide 2014 for Finance and Barclay Simpson Market Report 2014 for Security

than the comparable benchmark. Full results of our exercise have been provided alongside this response.

Team	No. roles compared	No. roles within benchmark salary range	No. roles below typical/median benchmark salary	Overall % saving in annual basis salary compared to typical/median benchmark
Finance	11	10	10	7%
Security	8	7	7	9%

Table 4 - RY 2013/14 incurred costs compared to the LABP

3.7.3 Alternative benchmarking sources - scale of DCC operations

78. We have no comments on how these should be benchmarked with external entities. The relative costs of different functions could however be benchmarked over time to determine movements.

3.8 Development of the LABP

79. Our Price Control submission contains a comparison between incurred and forecast costs and the LABP. The LABP is a document derived from the cost model that was submitted as part of the Licence Application process. It does **not** reflect a committed business plan against which the programme can be realistically delivered, but a model constructed against a set of information provided for a competitive procurement process.

80. As a result there were significant risks and uncertainties that were not provided for in the cost model. Those known at the time were detailed in Section 8 of the LABP. We also outline some of the Internal Costs that were explicitly excluded from the LABP in Section 3.3.8 [28].

81. As part of the Licence Application process managed by DECC, all bidders had access to a set of information. This included draft versions of:

- The Smart Meter Communication Licence;
- the SEC;
- Operational Service Requirements; and

[28] Licence Application Business Plan, accessible here: www.smartdcc.co.uk/media/7417/redacted_licence_application_business_plan_-_30_april_2014_2_.pdf

- contracts for the DSP[29] and CSPs[30].

82. Against this set of information a Best and Final Offer was submitted, which included the best estimate cost model produced against a set of specified, and in some cases ambiguous, requirements that were available at the time. This model was produced with a Licence Award date in August 2013.

83. This model did not include External Costs, Pass-Through costs, and certain Internal Costs that were excluded at the time due to lack of information and/or requirements. It also did not include a cash flow or revenue profile.

84. The LABP is a published reflection of this cost model with additional information included. This includes the External Costs, Pass-Through costs, and a one month adjustment to reflect the delay in the Licence Award to September 2013.

85. The LABP also included a hypothetical cash flow and revenue profile. This did not form part of the Licensing Competition response.

3.9 Quality of reporting

86. Ofgem considers that we had not provided a sufficient level of detail and evidence in our reporting under Price Control, and therefore did not fully comply with the RIGs reporting requirements[31].

87. However, the RIGs for RY 2013/14 did not provide any guidance regarding the level of detail required with respect to justification or evidence to support material cost variations compared to the LABP.

88. Whilst this first assessment has provided us with a better understanding of Ofgem's reporting expectations, we would propose that these requirements be clearly defined in the RIGs for RY 2014/15[32].

3.10 Updated forecasts

89. Ofgem proposes that DCC should remove future costs from our updated forecasts that are uncertain and where it is not possible to make accurate estimates[33].

90. We question this proposal as, by definition, a forecast is an estimate and hence is inherently uncertain. Our forecasts are the best estimate of costs that are likely to

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[29] DSP - Data Service Provider

[30] CSPs – Communications Service Providers

[31] Chapter 2 paragraph 2.17 of Ofgem's Price Control consultation

[32] We note that that data assurance trials have been carried out elsewhere in the industry in an effort to improve data submissions

[33] Chapter 2 paragraph 2.14 of Ofgem's Price Control consultation

arise over the Licence term, but at this early stage in the programme there is a high level of uncertainty associated with both the value and profile of some future costs.

91. It should also be noted that we are comparing both incurred and updated forecasts to the LABP, which itself was a forecast with a high level of uncertainty.

92. Our Price Control submission was completed based on information as at 31 March 2014. This includes the forecast costs estimated based on information available at the time.

93. These forecast costs were consistent with the forecasts used in the production of indicative Charging Statements and Indicative Budgets published in January 2014, updated for costs incurred between January and March 2014.

94. Following our submission in July 2014 Ofgem requested additional information. Through this process some future forecast costs were removed, as it was not possible to justify and evidence how they were economic and efficient, by the very nature of them being estimates.

95. An example of a cost removed is the estimated audit cost of our DSP and CSPs. We had forecast a cost over several years but a procurement process was still to be carried out to contract an audit supplier. As a result it was not possible to justify and evidence how the estimated cost was economic and efficient.

96. As a result of removing certain future costs, the forecast presented in Price Control is not aligned with the forecast used to produce the indicative Charging Statements and Indicative Budgets. Our view is that this does not provide consistent and up to date information to SEC Parties, and increases the complexity of work to be carried out if preparing different version of our forecasts for different reporting purposes.

97. We propose to include estimates in our forecasts on a prudent basis in Price Control in line with the forecasts used to produce Indicative Charging Statements and Budgets. We can provide justification and evidence of how these costs are economic and efficient once incurred in subsequent Price Control submissions.

98. If this proposal is accepted we would propose an amendment be made to the RIGs to include this definition.

3.11 Potential consequences of Ofgem's draft determination on costs

99. We consider that Ofgem's draft determination substantially increases both our financial and operational risk, caused by having costs retrospectively disallowed and uncertainty about any proposed direction. Ultimately we will be unable to recruit the required resource and make procurement decisions with confidence if there is an unmanageable risk of retrospective disallowance.

100. Ofgem's draft determination places a strong emphasis on carrying out substantial onerous and detailed reporting to justify value for money for costs at a very granular level. We consider that this will lead to an excessively bureaucratic organisation with

significant focus on evidence and documentation for individual costs that do not meet any sensible materiality threshold for fear of cost disallowances.

101. This significantly increases the regulatory burden placed on us and would be an inefficient use of the time and resources that would eventually be transferred to SEC Parties and therefore the consumer. Focus on these areas would divert attention from the most important aspects of this programme in this initial period; preparing for go-live and beginning the mass roll-out of smart meters. This was a key concern highlighted in DECC's consultation on the draft DCC Licence in April 2012 when Price Control conditions were being drafted. In that consultation, DECC made the following statements[34]:

> "From the award of the licence, until DCC go-live, the DCC will need to concentrate on setting up, testing and trialling the services;"
>
> "During this time, it is important that it concentrates on key milestones rather than having its attention diverted onto making small improvements in it cost base;"
>
> "The DCC should be concerned with the overall costs of its data and communication service for smart meters and not focussed solely on its internal costs. Consumers will be affected by the combination of DCC and service provider costs, so the price control framework must give incentives on the DCC to drive for efficiencies in the service provider contracts as well as internal efficiencies."

3.12 DCC's concluding views

102. We do not agree that the proposed disallowed cost of £0.1m in RY 2013/14 is uneconomic or inefficient. The consultation does not appear to recognise the value of DCC carrying out its activity in an autonomous way in order to do the right thing. It is our view that Ofgem should reconsider its proposed decision to disallow costs incurred.

103. It is our view that, going forward, Ofgem should consider ex post disallowances only for egregious costs or where we have been previously notified that they are considered as potentially unacceptable costs. We would welcome early discussion on how an expedient and selective ex ante approval process could work to ensure that high value changes, necessary for the success of the programme, are agreed.

104. It is our view that Ofgem should clarify, to DCC, the following:

[34] Section 4.225 of DECC's consultation on the draft DCC Licence and Licence Application Regulations, accessible here: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/42892/4937-cons-draft-dcc-licence-smart-meters.pdf

- what direction Ofgem would issue under Licence Condition 37 with respect to Internal Costs we have incurred in RY 2013/14 that it has considered were not economic and efficient, and how it proposes that the amounts spent in RY 2013/14 will be recovered;
- whether references in the Price Control consultation to “disallowances” are the same as “Unacceptable Costs” as defined in Licence Condition 37;
- the specific cost items to which the proposed disallowance relates across the term of the Licence; and
- whether Ofgem’s determination in relation to future Price Control submissions would supersede any ex ante disallowances made in previous Regulatory Years (with the RIGs being updated accordingly).

4 IMPLEMENTATION MILESTONE 5

4.1 Overview

105. IM5 required us to produce, approve and submit to the Secretary of State, in accordance with Schedule 5 of the Licence, several draft documents by 28th February 2014. They were the: Self-Service Interface Specification (SSI), the Registration Interface Specification, the User Gateway Interface Specification (UGIS) and the Codes of Connection[35].

106. Completion of these documents was dependent on several external deliverables, including a complete and stable version of GBCS[36] and the SMKI Certificate Policy in the SEC3B conclusions[37]. Completion of the SSI was dependent in part on the completion of the service management design which was subject to a later milestone in June 2014. The completion of the Codes of Connection were dependent both on further demand modelling with service users to estimate the pattern of message flows within each day and on concluding the nature of the anomaly detection service. The version of the SEC at that time (SEC3) did not accommodate this and could only be resolved though DECC's acceptance of our proposal in response to the SEC4[38] consultation.

107. At Licence Award a complete and stable version of GBCS had been expected by DCC and the DSP in December 2013. GBCS v0.7 rev 6 was published by the Secretary of State on 7th February 2014, only three weeks prior to the submission date for IM5 and this was still not a complete and stable version on which the draft documents could be produced with full specifications. Recognising this, and following application by DCC, the Secretary of State directed a modification to redefine IM5 as follows:

> "The following documents have been produced and approved by the Licensee and been submitted to the Secretary of State in accordance with Schedule 5 to this Licence: the Self-Service Interface Specification, the Registration Interface Specification and the User Gateway Interface Specification in so far as it may be completed according to version 0.7 of the GB Companion Specification."

108. Prior to our application for this modification we consulted[39] SEC Parties on our proposal to caveat the acceptance criteria of IM5. Out of seven responses received

[35] Collectively the 'DSP Interface Specifications'

[36] Great Britain Companion Specification

[37] Published by DECC on 12th June 2014, accessible here: https://www.gov.uk/government/consultations/new-smart-energy-code-content-stage-3

[38] We understand that DECC will be concluding on this as part of its upcoming further conclusions on SEC4.

[39] Consultation ran from 20th January to 7th February 2014

four supported our proposal, two proposed that it would be more appropriate to amend the due date rather than redefine the criteria, and one shared concerns about the overall progress of the Smart Meter Implementation Programme and recommended that we escalate the impact of GBCS slippage on our programme to DECC.

109. Following Design Forums with SEC Parties and a two-week consultation on DSP Interface Specification[40] we submitted draft documents to the Secretary of State on 28th February 2014, which met the required deadline. There is no requirement in the Licence for us to submit draft versions prior to this date.

110. We produced the documents so that they were fit for purpose for SEC Parties given the information available at the time. The documents were developed to a sufficient level of detail to enable SEC Parties to begin their planning and design, and so minimise the risk of delay and additional cost in this area. The Secretary of State agreed with this assessment.

111. However, we knew that there would be further changes that would impact the finalisation of these documents, such as the release of GBCS v0.8 in July 2014. Therefore, it was not possible to produce documents that were complete on which SEC Parties could begin developing a full solution.

112. We outlined the outstanding issues in a mitigation plan that we submitted to the Secretary of State with the draft documents. Working with DECC we further refined this mitigation plan and submitted an updated version on 26th March 2014 (now called the remediation plan).

113. On 3rd April 2014 the Secretary of State concluded that the documents submitted did:

> "not have conspicuous technical flaws in the significant areas already completed, have been consulted upon adequately and engage sufficiently with the wider regulatory regime at this stage of their development. Several elements remain incomplete due to wider dependencies or because further work recognised by DCC in its own reviews. However, the Secretary of State agrees with DCC's assessment that these are sufficiently well developed to allow service users to begin, although not necessarily complete, their own design work."

114. To deal with these outstanding issues the Secretary of State directed us to follow our remediation plan submitted on 26th March 2014 (and any subsequent revisions to it proposed by us and agreed by the Secretary of State), to report on progress against this plan no less than on a monthly basis, and to resubmit the documents once judged complete.

[40] Consultation ran from 8th January to 22nd January 2014

115. As there were outstanding issues that needed to be resolved, and the documents could not be developed to a complete level, we approved these documents on a conditional basis. Providing conditional approval was the most suitable option available to maintain the integrity of the programme and minimise the risk of unnecessary additional cost to SEC Parties. It also ensured that we remained aligned with our Interim General Objective to contribute "to the achievement of a full, timely, efficient, economical, and secure Completion of Implementation".

116. Ofgem's proposed decision is that we did not achieve IM5 – submission of DSP Interface Specification, and is therefore proposing to disallow £0.3m (18%) of our Baseline Margin which was linked to achieving IM5.

117. In its consultation, Ofgem considers that we did not meet IM5 because:

- we conditionally approved documents;
- the level of quality of some of the documents was not as expected; and
- the Secretary of State issued a direction to follow a remediation plan.

118. Our response to this draft determination is set out below.

4.2 Conditional approval of documents

119. In considering the status of these documents as we approached the milestone due date, we were faced with three options to consider, they were:

- Option 1 - to issue fully approved documents (with the knowledge that they were incomplete).
- Option 2 - to issue documents which had been conditionally approved.
- Option 3 - to issue no documents at all.

120. These options are discussed below.

4.2.1 Issuing fully approved documents

121. Option 1 was to issue fully approved documents. Doing this would have enabled us to claim the milestone complete without any question. However, this would have signalled to SEC Parties that, unambiguously, the documents were full and complete and were reliable. We were faced with considerable risk that development by SEC Parties would have begun based on incomplete specifications. This would have resulted in a solution that would have been, at best, dysfunctional, and required subsequent re-work, which would have likely incurred significant delay and additional cost to the entire programme and therefore consumers. This would not have been credible, and would have seriously damaged the reputation of DCC, the DSP and the programme. The contractual consequence would be that the DSP would have had to amend the solution again which would have been at an additional cost.

Two large energy suppliers were also concerned regarding the risk of developing systems that would require subsequent amendments[41]:

> "We would also be cautious about building IT systems to interface with the DUGIS, if the interface requirements could change in such a way that required us to re-visit tasks or rework system functionality that we had considered completed. This would increase costs that will ultimately be passed on to consumers."

> "Failure to assure key aspects of the design will increase the risk of failure and the consequential redesign, build and test will ultimately increase costs and lead to further delays."

122. Further to this we were made aware via transitional governance, that SEC Parties had raised concerns about fully approved documents being submitted solely in order to meet IM5 and mitigate financial loss via the Price Control process. This view was also received in one consultation response from a large energy supplier with respect to amendment of the IM5 criteria;

> "The DCC is clearly more strongly incentivised to deliver against milestones to which it is contractually bound than those to which it has no formal obligation."

123. The view was that the structure of incentive payments should not prevent any party from doing what was best for the programme. We agreed with this view in light of the overarching General Objectives in the Licence.

4.2.2 Issuing documents which had been conditionally approved

124. Option 2 was to issue documents which had been conditionally approved which would provide as much information as possible to SEC Parties, so that they may begin early design work, but was treated with sufficient caution so as not to cause SEC Parties to begin detailed solution developments which will have incurred significant sunk costs. One large energy supplier agreed with our proposal to caveat the acceptance criteria for IM5 on this basis:

> "…this is on the basis that the version of the DUGIS made available at the end of February 2014 is sufficient to determine the core capability of the interface, such that our internal design work can be progressed."

125. Under this option a supporting mitigation plan would be issued which would make reference to the gaps and/or errors within GBCS and policy decisions which were yet

[41] Quotes from responses on our consultation on amendment of IM5 criteria

to be defined or approved via transitional governance (most notably TBDG[42] and TSEG[43]).

4.2.3 Issuing no documents at all

126. Option 3 was to issue no documents at all, given that GBCS and SEC were unstable and subject to significant updates and/or change. Under this option, we could have waited for stability and then issued fully approved documents. This would have introduced an unacceptable amount of delay, uncertainty and additional cost into the programme.

127. We concluded that option 2 was the most appropriate option to prevent delay, uncertainty and additional cost and provide transparency of the issues to be resolved.

4.2.4 Further detail on chosen option

128. GBCS and SEC were, and continue to be, fundamental dependencies for DCC and for the DSP Interface Specifications required for IM5. Without a complete and stable version of GBCS, the SMKI Certificate Policy in the SEC3B conclusions and completion of the service management design, it was impossible to complete the DSP Interface Specifications, therefore we disagree with Ofgem's view that outstanding issues could have been feasibly resolved prior to the date of the submission.

129. To maintain the integrity of the programme, we took the following decisions:

- to conditionally approve the DSP Interface Specifications, subject to the issues raised in the mitigation plan; and
- to conditionally approve the DSP milestones, subject to the issues raised in the mitigation plan.

130. We concluded that conditionally approving these specifications would enable us to better incentivise the DSP to focus on driving both GBCS and the DSP Specifications toward completion. The submission and resulting publication of DSP Interface Specifications (although incomplete) enabled SEC Parties to begin their detailed planning and systems design, whilst minimising impact on these parts of the programme delivery. We consider that our decision to conditionally approve the DSP Interface Specifications was aligned with the Interim General Objective to achieve "full, timely, efficient, economical, and secure Completion of Implementation"[44].

[42] Technical and Business Design Group

[43] Transitional Security Expert Group

[44] Licence Condition 5.4

4.3 Time management

131. By way of background, given the significant shortfall in the input requirements to put these documents together with the late delivery of GBCS, we consider that the deadline for IM5 was not suitable based on the work that needed to be completed to achieve it.

132. This view is supported by two of the responses by large energy suppliers to our consultation on amending IM5 criteria, where they considered that amending the due date would be a prudent option.

4.4 Quality of documents

133. Ofgem states that some of the documents provided were not at the level of quality expected. For example, it considers that we did not include gas use cases which DECC had indicated that they expected us to include.

134. We do not consider this to be a valid reason for determining that we did not meet IM5, as there is no quality criterion set out in the Licence. However, the section below responds to the points raised by Ofgem.

135. Additional gas use cases were published by DECC as part of version 0.7 rev 6 of GBCS, on 7th February 2014 (just three weeks prior to the IM5 due date). It was our understanding that DECC had provided these with a view for us to incorporate them in UGIS and considered them to be sufficiently developed.

136. We were of the view that the gas use cases were neither well developed, nor stable. We made the assessment that inclusion of these gas use cases would have required extra design resources from both the DSP and DCC to include them within the UGIS. DCC also held the opinion that the immaturity of the gas use cases meant that they were likely to change substantially as future versions of GBCS were released, resulting in additional cost for future re-work. This proved to be a correct judgement.

137. Were we to have included them in the documentation, it would have significantly impacted the quality of UGIS and would have caused SEC Parties, who are reliant on a stable UGIS, to perform significant nugatory effort.

138. We consider that we were further justified in this course of action based on a proving exercise we undertook of all GBCS use cases upon receipt of version 0.7 rev 7 of GBCS on 14th May 2014.

139. This exercise identified 445 issues, of which 235 required updates to GBCS.

140. More than half of the identified issues related to gas use cases[45] including 10 critical issues which required immediate resolution, for example:

- Installation Process – there was misalignment between the GBCS, CHTS (Communications Hub Technical Specification), and ZigBee Blackwall specifications on how gas meters should join to the Communications Hub and ambiguity relating to interdependencies. Without this resolution the gas meter could not connect to the HAN; and

- Section 10 of GBCS for ZSE (ZigBee) Implementation was completely rewritten as a result of multiple proving comments relating to inconsistencies, errors and ambiguities.

141. We made the decision that incurring additional costs to include gas use cases within UGIS was inefficient and uneconomic given the future re-work which would be an inevitable consequence of the GBCS proving exercise and subsequent updates to GBCS by DECC.

4.5 Potential consequences of Ofgem's draft determination

142. If Ofgem penalise us for carrying out activity which serves to benefit the programme, this may give rise to perverse incentives for us to operate in a way which reduces our regulatory risk, to the detriment of the programme. This inefficiency would transfer to SEC Parties and therefore the consumer.

143. Under Ofgem's proposal, we will effectively be fined £0.3m (or 18% of the Baseline Margin for RY 2013/14) for doing the right thing by ensuring that SEC Parties were not provided with documents that ultimately they were not able to rely upon due to changes that had to be made that were outside of our control. We consider that we managed delays outside of our control in a professional manner so as to ensure the risk of delay to the programme was minimised, that money and resources were not wasted by stakeholders, and that DECC, SEC Parties and Ofgem were kept informed.

4.6 DCC's concluding views

144. We strongly disagree with Ofgem's draft determination that IM5 was not met.

145. It is our view that Ofgem should carefully consider the balance of dependencies within the programme during this critical transitional period in light of General Objectives. In the circumstances, it should accept that conditional approval was the most efficient and practical way of dealing with a delay to GBCS that was not within DCC's control. Acceptance that DCC met IM5 or at least for Ofgem to use its discretion and accept conditional approval would signal Ofgem's understanding that

[45] Gas use case represented 30% of total use cases

we are charged with making difficult decisions in a highly complex programme. It would further signal that we would not be penalised financially for making pragmatic decisions for the benefit of the programme and ultimately consumers.

146. It is our view that Ofgem should recognise that we did meet IM5 albeit we gave conditional approval to the documents. Alternatively it should recognise that IM5 was not met based on a technicality and so it would be unreasonable and inappropriate, in the circumstances, for us to be penalised for limiting factors which were outside of our control, and therefore allows the Baseline Margin to recognise this.

5 CORPORATE OVERHEAD CHARGE

5.1 Background

147. The corporate overhead charge (referred to as the "shared service charge" in Ofgem's consultation document) is paid by DCC to our parent company Capita Plc (Capita). The charge was set by our parent company and included as part of its Licence Application, and recovers an allocation of group overhead. This is a standard approach that is applied by many companies, with a common methodology being to allocate group overhead on a proportionate basis, in our case the relevant driver is Internal Costs. We note that Ofgem has applied this methodology to recover overheads it has incurred in relation to tender exercises[46].

148. The provision of these central functions is integral to the stability and financial integrity of DCC; they enable us to operate in a way that provides flexibility, service assurance and resilience. The flexibility allows us to access a variety of central functions and advice as required. An example of this would be DCC's access to the central procurement function for resources and ad hoc advice. This minimises delays in procurement and we benefit from dedicated consultancy at times when it is necessary at internal rates which are lower than external consultancy rates.

149. In RY 2013/14 our expenditure on Internal Costs was less than we forecast, resulting in a 16% lower corporate overhead charge than the value contained within the LABP (but derived as a percentage of the forecast Internal Costs). This is a real saving which will benefit SEC Parties and therefore consumers. As the corporate overhead charge is a percentage of Internal Costs this reduction in the actual charge does not impact on our ability to benefit from the parent company's central functions as and when required.

5.2 Disallowance of part of the corporate overhead charge

150. Ofgem is proposing to disallow the corporate service charge associated with SMKI and Parse and Correlate in RY 2013/14 onwards, and our financial stability and security costs from RY 2014/15 onwards. We disagree with Ofgem's proposed decision.

151. The percentage rate is levied on all Internal Costs as defined in the Licence and includes all costs economically and efficiently incurred by us for the purposes of the provision of Mandatory Business Services (less External and Pass-Through Costs). Such Internal Costs include third party contracts such as SMKI and Parse and Correlate and any other contracts which may be procured externally (with the exception of the DSP and the CSPs).

[46] See paragraph 1.14 of the "Offshore Electricity Transmission: Cost Recovery Methodology for Tender Round 3 (provided alongside this document)

5.3 Ofgem proposal for a process to ensure value for money

152. Ofgem's proposal[47] that we should develop a process to ensure value for money from the corporate overhead charge is not appropriate. We will, of course, through the Price Control submission, make a full assessment of the Internal Costs, which is the basis of the calculation of the corporate overhead charge. Where we make economic and efficient expenditure on Internal Costs, then by default it should result in a corporate overhead charge which is economic and efficient as was agreed during the competitive procurement of DCC. We anticipate that the extent to which this is satisfactory would be determined through Ofgem's determination on future Price Controls.

5.4 Application of corporate overhead charge to new scope activity

153. Ofgem is keen to establish a principle where if a new scope activity has not 'used' a service provided in exchange for the corporate overhead charge, the charge should not apply. We consider that this statement demonstrates a misunderstanding of a corporate overhead in respect of any business.

154. Whilst we recognise that there is a link between the corporate overhead charge and some of the central function services we benefit from and use, we do not consider this relationship to be linear.

155. In the Licence Application process the corporate overhead charge was not applied based on the use of corporate overhead services, it was applied as a percentage on all forecast Internal Costs. This rate does not vary with use of services[48]. Therefore, to establish a principle that links activity and the corporate overhead service would contravene the principles established through the competitive Licence Application process. We consider that any disallowance on this basis is unreasonable.

5.5 Use of corporate overhead for Relevant Service Capability

156. Ofgem's view is that services provided under the corporate overhead charge are part of Relevant Service Capability and that we should provide evidence that we have met the obligation to procure Relevant Service Capability on a competitive basis[49]. We disagree, this is explained below.

157. The parent company's central functions for which the corporate overhead charge is levied do not constitute Relevant Service Capability under our Licence, as there is no intention for these functions or services to be transferred to a successor Licensee should DCC no longer hold the Licence. The corporate overhead charge was included within the LABP and consequently the percentage rate which was applied

[47] Paragraph 4.39 of Ofgem's Price Control consultation

[48] For example, the charge does not vary as our headcount changes.

[49] Paragraph 4.37 of Ofgem's Price Control consultation

was tested for both value for money and appropriateness through the Licence competition. The central functions and services are not something that DCC decides to procure, post Licence Award, albeit we (and ultimately consumers) clearly benefit from the functions and the services that the corporate overhead charge covers.

158. We have discussed our views on what constitutes Relevant Service Capability under the Licence with Ofgem and DECC and sought confirmation that these services would not be subject to the transfer or novation provisions within the Licence. At the time of this response, we have not received the clarification we sought.

5.6 Potential consequences of Ofgem's draft determination

159. Ofgem's draft determination places a strong emphasis on carrying out substantial reporting to justify value for money of use of central resources which are not measured. To do this is infeasible without significant additional resources and support from our parent company, which would increase costs. An example of the impracticality of it would be the parent company's CEO having to time record every meeting attended where DCC was discussed and a process established for then charging this to DCC. We consider this would be an inefficient use of time and resource. This inefficiency would eventually be transferred to SEC Parties and therefore the consumer.

160. If a principle is established whereby the use of central functions is linked to the corporate overhead charge, the charge will not vary with a change in the value of Internal Costs. Therefore, we may not benefit from potential savings that would arise from incurring lower Internal Costs, and therefore pass these back to consumers via SEC Parties.

5.7 DCC's concluding views

161. It is our view that Ofgem should reconsider its proposal to disallow the corporate overhead charge associated with the SMKI, Parse and Correlate and financial stability and security costs.

162. It is our view that Ofgem should revisit its understanding of the corporate overhead charge, and should accept that this was a competitively agreed rate and not something that is appropriate to be justified on the basis of use.

6 BASELINE MARGIN

6.1 Background

163. The Baseline Margin is the amount of additional revenue over and above the sum of Internal and External Costs that is included in the Allowed Revenue. Under Lice Condition 36 Appendix 2, DCC proposed an adjustment to the Baseline Margin values to reflect changes that had taken place during RY 2013/14.

164. Ofgem's proposal is that additional Baseline Margin cannot be applied to the value of external contracts (not to be confused with External Costs), because the activity is carried out by a third party. It also considers that the contracts do not increase DCC's volume of activities and thus do not meet the Licence criteria. We disagree with this proposed decision.

6.2 Application of Baseline Margin to value of external contracts

165. Licence Condition 36(A3) states that we may propose a Relevant Adjustment which relates to any variation that has taken place, or is likely to take place, in any one or more of the aspects set out in Licence Condition 36(A3) (a-e) of the Mandatory Business of the Licensee, which are:

(a) the total volume of the activities comprising that business;

(b) the characteristics of the activities comprising that business;

(c) the mixture (whether by category or volume) of the activities comprising that business;

(d) the risks (whether financial or operational) to which the Licensee is exposed in the carrying on of that business; and

(e) the timescales or deadlines that the Licensee is required to meet (whether under this Licence or otherwise) in the carrying on of that business.

It appears that Ofgem's interpretation of this Licence Condition is that the variation may only apply to the activities carried out by DCC staff/resources themselves. However, Mandatory Business consists of the operation and provision of Mandatory Business Services whether or not provided by external suppliers, for example the billing system which was anticipated to be provided by Oracle. For this reason the inclusion of the SMKI and Parse and Correlate services, which were explicitly excluded at Licence Application at the request of DECC, does represent a variation in the volume of Mandatory Business. It has also increased the risk we are exposed to in carrying out Mandatory Business, for the following reasons:

- our corporate risk has increased as we are now responsible for the procurement, design, development and provision of SMKI and Parse and Correlate Services. SMKI is one of the largest and most complex PKI (Public Key Infrastructure) implementations in the world;

- as per the informal version of the SMKI service definitions provided to DCC by DECC on 1st October 2013, we are now required to establish and operate the SMKI Registration Authority, which means that we assume the risk of verifying SEC Parties and their representatives;

- the Recovery Procedures (which are still being developed in conjunction with DECC, CESG[50] and SEC Parties) require us to act unilaterally, based on procedures agreed through consultation, in the event of a serious compromise of a SEC Party's SMKI credentials. This carries a significant risk, with large cost implications of invoking the Recovery Procedures and associated liabilities; and

- the provision of the Parse and Correlate Services has increased our exposure to the stability and robustness of the GBCS protocol, in that we have become responsible for the implementation of GBCS, as defined by DECC. The amendments to GBCS (such as GBCS v0.8.1) have introduced risk to the DCC's plan and solution.

166. In our opinion, the addition of these material contracts clearly represents a change in volume of activity. The level of risk we are exposed to, in managing and being responsible for provision of services under those contracts, has increased. As highlighted above, much of this risk is subjective and therefore not quantifiable.

167. Ofgem's proposal suggests that our application was made on the basis of volume variations only, which is not the case. We provided robust justification for the procurement of the CIO (Competent Independent Organisation) contract explaining why it should be defined as a variation in the characteristic of activities comprising Mandatory Business[51]. This explanation was supported by reference to the Operational Service Requirements[52] in the Invitation to Submit the Best and Final Offer which set out the original information on which DCC assumptions were based[53]. We note that this was not referenced by Ofgem in paragraph 6.17 of its Price Control consultation document.

168. We agreed not to include the costs associated with SMKI Services and Parse and Correlate software, or any contingency, in the LABP with the understanding that we would be able to use the Baseline Margin adjustment mechanism to retrospectively correct for the lost Baseline Margin.

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[50] Communications-Electronic Security Group

[51] In accordance with Licence Condition 36, Appendix 2, A3(b)

[52] This is the set of requirements against which the parent company was required to bid against.

[53] New information was made available during finalisation which amended these assumptions.

6.3 Potential consequences of Ofgem's draft determination

169. If Ofgem penalise DCC for carrying out mandatory activity which serves to benefit the programme this may give rise to perverse incentives for us to operate in a way which reduces our regulatory risk, to the detriment of the programme and ultimately consumers. An example would be that DCC may be less inclined to carrying out New Scope activities, or seek to delay their implementation until after Ofgem has reached a decision on an application.

6.4 DCC's concluding views

170. It is our view that Ofgem should reconsider its proposal to reject a Relevant Adjustment to the Baseline Margin values in light of our application.

7 RESPONSES TO OTHER CONSULTATION QUESTIONS

7.1 Prudent estimate

171. As mentioned in Ofgem's consultation[54] the prudent estimate is designed to ensure that service charges do not need to be amended in the course of the year, except in response to a reasonable unlikely contingency[55].

172. In the Charging Statement, the prudent estimate is set to ensure that the risk of in-year changes to service charges is minimised to the lowest possible level. We consider this approach to be in SEC Parties' best interests as it allows them to plan their internal cash flow with a high level of confidence. Any over recovery of charges is ring fenced and returned to SEC Parties through the correction factor.

173. Ofgem state the correction factor reported in RY 2013/14 of £6m is very high[56]. Although this amount is material we do not consider it to be 'high' considering the level of uncertainty to which the programme is exposed. It is impossible in this implementation phase to set service charges in advance with precise values and payment profile. Once we are in an operational phase with a longer term stable cost model we expect to be able to forecast service charges with more certainty and aim to minimise the correction factor value as so far as is possible.

174. The prudent estimate is set considering the level of operating liquidity required by DCC and accounts for uncertainties during this implementation phase. In accordance with the Charging Methodology, we must divide Estimated Fixed Revenue by the number of months in the Regulatory Year and invoice accordingly i.e. we have a fixed monthly income profile. Whilst this approach provides certainty of service charges to SEC Parties it does not provide us with sufficient operating liquidity to ensure we can meet our financial commitments in months where cash outflows exceed cash inflows.

175. During the implementation phase our cost profile is not uniformly spread and, therefore, we require a prudent estimate to set the level of service charges to enable liabilities to be settled as and when they are presented for payment.

7.1.1 Operating liquidity

176. The prudent estimate is based on four weeks' operating liquidity to ensure we remain cash positive and are able to meet financial commitments as they become due. In

[54] Paragraph 5.13 of Ofgem's Price Control consultation

[55] Licence Condition 36.5

[56] Paragraph 5.7, chapter 5 of Ofgem's Price Control consultation

general four weeks is the minimum required to adequately cover standard payment terms for any invoices becoming due at the end of the prior month.

7.1.2 Main drivers of uncertainties

177. The main drivers of uncertainty are:

- programme re-planning as a result of delay in release of external dependencies;
- development of requirements that were immature, undefined, or unknown at Licence application;
- changes to the SEC;
- volumes; and
- results from testing.

178. In our budget and cash flow forecasts we include our best estimate of an accurate value and timing of future costs. This is based on the information available to us at the time, and contains no contingency. The prudent estimate provides a level of contingency in relation to uncertainties, which is vital for us to operate in a fluid manner and, therefore, minimise unnecessary delays to the programme.

179. The proportion of prudent estimate in relation to total service charges has varied in the Charging Statements published to date (see Table 5, below). This variation arises based on our expectation of cash outflow in the immediate period following the end of the charging period, and the level of uncertainty associated with activities occurring. We expect it to stabilise and then reduce as requirements become more established and the programme moves into a more steady state.

Regulatory Year	2013/14	2014/15	2015/16
Prudent estimate	6.74%	17.35%	8.25%

Table 5 - Movement in prudent estimate

7.2 Effective date of Ofgem's determination

180. Ofgem proposes that the reduction in service charges (i.e. the disallowed costs) should take effect from the Charging Statement for RY 2015/16. We agree that any costs disallowed for RY 2013/14 should take effect from 1st April 2015, and would be reflected in the Charging Statement for RY ending 31st March 2016 published in April 2015.

181. It is not clear from the draft determination if the disallowance of forecasted allowed revenue for RY 2014/15 should also take effect from RY 2015/16 charges. We would disagree with this approach as the disallowance is based on a forecast and not on incurred costs that have been assessed through Price Control. Our expectation is

that any amendments to service charges would be made in the Regulatory Year following the final determination of Price Control.

182. We submitted the draft Charging Statement, for RY ending 31st March 2016, to Ofgem on 31 December 2014[57]. That draft Charging Statement did not reflect Ofgem's proposed disallowance for RY 2013/14.

[57] This is accessible on the DCC website: http://www.smartdcc.co.uk/media/19072/2015-01-06-lc19-draft_charging_statement_for_ry_1516.pdf