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DCC Price Control Consultation: Regulatory Year 2015/16

Consultation

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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.

In this document we review the costs DCC reported for regulatory year 2015/16. We set out our proposals. We also explain our assessment of DCC's application to amend its baseline margin and external contract gain share values. We also assess DCC's performance against a set of implementation milestones. We would like to hear your thoughts on our proposals.

The DCC, service 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 it 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. We have also published a guidance document that sets out the processes and procedures we will follow when assessing costs and changes to the baseline margin values. DCC must report the relevant data and submit any proposals to adjust its baseline margin values no later than 31 July following each regulatory year.

DCC submitted its price control reporting templates for 1 April 2015 to 31 March 2016 on 31 July 2016. On the same day it submitted a proposal for an adjustment to its baseline margin and External Contract Gain Share values.

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

Associated documents

- Data Communications Company (DCC): Regulatory Instructions and Guidance
  https://www.ofgem.gov.uk/publications-and-updates/data-communications-company-dcc-regulatory-instructions-and-guidance-2015

- Data Communications Company – Regulatory reporting template
  https://www.ofgem.gov.uk/sites/default/files/docs/2015/05/dccrigs2015.pdf

- Guidance Document: Processes and Procedures
  https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-guidance-processes-and-procedures

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

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

Significant changes in 2015/16 have led to increased DCC costs compared to last year's forecast, with a £6.1m or 6% increase for 2015/16 and a £189.7m 10% increase over the licence period. The key cost drivers included:

- Changes in the Great Britain Companion Specification (GBCS) which describes the detailed requirements for communications between smart metering Devices in consumers' premises and industry and the associated deferral of the go-live date and the resulting move to a multi-release strategy[3].
- Systems Integration Testing (SIT)
- Greater than anticipated activity in preparing operational services for go live
- Preparatory work for new service development not costed in DCC's Licence Application Business Plan (LABP) including Enrolment and Adoption of SMETS1, Dual Band Communications Hub (DBCH) and the Central Registration Service (CRS)

As part of its Price control submission, DCC must explain any variation between costs incurred or forecast in 2015/16 and costs forecast as part of its LABP and in the previous year's price control submission. DCC must demonstrate through its reporting that it has incurred costs as efficiently and economically as possible, doing everything it reasonably can to ensure value for money.

Cost assessment

For the significant majority of costs, DCC has provided reasonable justification and evidence for the costs incurred in 2015/16. However, our cost assessment has revealed some incurred costs which we do not consider to be economic and efficient. We also consider that there is not sufficient certainty in some of DCC's forecast costs post go-live. **We therefore propose that £0.696 million from DCC's total costs in 2015/16 are unacceptable costs, and propose not to allow a £59.170m increase in their forecasts over the remaining term of the licence.**

Any costs that we consider were not economically and efficiently incurred will either be excluded from the future calculation of allowed revenue or be subject to an undertaking about their future management.

Baseline margin

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

[3] Note that the substantive portion of external costs associated with this change isn't reported in the 2015/16 price control. We expect to see the full impact of these cost reported in next year's price control.

For RY15/16 DCC has applied for a £1.604m adjustment to their baseline margin due to an increase of volumes of activity as a result of re-planning to a multi-release strategy during RY15/16 and additional new scope activities. We propose to amend their application, which leads to a reduction in the value of the adjustment. We consider the DCC's application was not consistent with the relevant licence conditions. Those conditions stipulate that cost variations underpinning the application must only reflect changes in the previous regulatory year, i.e. between 14/15 and 15/16 rather than LABP and 2015/16 (the latter being the basis of DCC's application). We consider it is appropriate for DCC to have applied a 15% margin. **We therefore propose an adjustment to DCC's Baseline Margin of £0.647m.**

External Contract Gain Share

The DCC Allowed Revenue formula includes an External Contract Gain Share term. The effect of the application of External Contract Gain Share is to provide for an upward adjustment to the amount of Allowed Revenue that reflects some part of the reduction in External Costs that DCC helped achieve. This term is zero unless DCC applies to vary the relevant term within Allowed Revenue.

DCC has applied to adjust this term by for RY2017/18-2019/20 reflecting a reduction in external costs as a result of a refinancing agreement for an FSP's set-up charges. **We propose to accept DCC's application to adjust the ECGS term by a total of £2.911m.**

Performance

We have assessed DCC's performance against IM8. This is an implementation milestone which incentivises DCC to be ready for Systems Integration Testing in the North (IM8a) and the Central and South (IM8b) regions by the due date directed by BEIS. We consider DCC to have met IM8b. We consider DCC delivered against IM8a in the North region later than the due date. **We therefore propose to disallow £53,462 from the Baseline Margin Implementation Total (BMIT).**

We welcome the improvements DCC has made to its procurement and risk management strategy and processes in response to the issues identified as part of the 14/15 price control. We also note the improvements DCC has made to its external change control process.

While undertaking the cost assessment this year we identified a number of examples where DCC has incurred cost related to issues in managing the FSPs, notably on IT costs and CGI's role as System Integrator. As a contract management body we expect DCC to make sure that contract specifications are clear and that they have the right commercial levers in place to avoid additional cost and manage performance.

Next steps

We welcome your views, and will consider them when we take our decision. Please send responses to smartmetering@ofgem.gov.uk by 12 January 2017. We will publish our decision in February 2017.

1. Introduction

Data and Communications Company (DCC)

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

1.2. The Department for Business, Energy and Industrial Strategy ('BEIS'), formerly the Department for Energy and Climate Change ('DECC'), granted 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. BEIS also established price control arrangements that restrict DCC's revenues, to counter its monopoly position.

1.3. Over the licence term the majority of DCC costs are incurred by their Fundamental Service Providers (FSPs) who are responsible for delivering the data and communications services to support smart metering, and were appointed through a competitive tendering process. One of DCC's key responsibilities is to effectively manage these large external contracts and ensure value for money and good quality service for consumers.

Price control

1.4. We have a role in ensuring that DCC's costs are incurred economically and efficiently. We review DCC's costs after the end of the regulatory year in which the costs were incurred and forecast costs that DCC deem certain enough to include in their forecast allowed revenue. This approach is referred to as an 'ex post' price control. DCC must submit price control information by 31 July following each regulatory year in line with the Regulatory Instructions and Guidance (RIGs)[4]. Price control reporting covering the regulatory year from 1 April 2015 until 31 March 2016 was submitted in July 2016.

1.5. The level of baseline margin allowed each year is fixed in the licence. Each July, DCC can propose an adjustment be made to the value in the licence. The licence provides criteria related to actual, or likely, material changes to their business activities, risks and timescales or deadlines, which DCC must demonstrate in its proposal. It also makes clear that applications can only be made in the regulatory year immediately after the grounds for an adjustment first arose. DCC proposed an adjustment be made to the value of its baseline margin with their 15/16 price control submission.

[4] https://www.ofgem.gov.uk/publications-and-updates/data-communications-company-dcc-regulatory-instructions-and-guidance-2015

1.6. For the first time DCC also submitted an application to amend the External Contract Gain Share (ECGS) term of their allowed revenue following external cost savings. The ECGS is a mechanism within the price control for DCC to apply to increase their allowed revenue recognising their instrumental role in reducing external costs.

Our approach

1.7. As required by the licence, our assessment of DCC costs is grounded in comparing DCC's incurred costs and revised forecast with DCC's Licence Application Business Plan (LABP) and the previous year's forecast. Our guidance document published in 2015 sets out the approach in detail and the information we expect to be provided with to enable us to determine whether DCC's costs are economic and efficient.[5]

1.8. In this consultation we have set out our proposed positions on DCC's 2015/16 submission for industry to respond to. We are restricted as to the detail we can include due to the commercially sensitive nature of much of the analysis we undertake. Despite this we consider it important that this consultation is as accessible and helpful to industry as possible.

Purpose of consultation

1.9. Our proposals are based on a detailed cost assessment following the submission of DCC's price control reporting and accompanying baseline margin adjustment and ECGS proposals in July 2016. We are seeking your views on our proposals regarding:

- **Costs:** whether DCC incurred costs economically and efficiently during regulatory year 2015/16 and if it did not, how those costs should be treated. Also, whether we accept the updated forecasts for the licence term.
- **Baseline margin:** whether the baseline margin values in the licence should be adjusted based on DCC's application.
- **Implementation milestones:** whether DCC achieved the implementation milestone that fell due during regulatory year 2015/16 and what the implications are for DCC's allowed revenue.

[5] https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-guidance-processes-and-procedures

2. 2015/16 cost drivers

2.1. DCC incurred costs over the 2015/16 regulatory year and forecasts for the remainder of the licence have increased compared to last year's forecast. To avoid repetition throughout this document, the following provides a summary of the key reasons for these cost increases provided by DCC as part of their submission.

Changes to the baseline

2.2. DCC's solution design is dependent on the Great Britain Companion Specification (GBCS) which describes the detailed requirements for communications between smart metering Devices in consumers' premises, and between these Devices and users of the smart metering system (such as Energy Suppliers and Network Operators) via the DCC.

2.3. In 2014/15, DCC's price control submission described the evolution of the GBCS from versions v.0.8.0 to v0.8.1, the version that was published in November 2014. The costs associated with uplifting the overall design to meet the new specification are a significant proportion of the cost increases reported in this year's price control. DCC served a significant change request (CR091) on each of its External Service Providers (both Fundamental and other service providers) to bring the overall solution design up to v0.8.1 and the associated deferral of the go-live date from December 2015 to April 2016 with contingency. This is the date where DCC provides functionality that could support energy suppliers' smart meter commissioning and installation procedures.

2.4. At the beginning of 2015/16 a number of significant issue resolution proposals (IRPs) were raised identifying further requirements from the specification. This led to the development of a further new version of the GBCS (v0.8.2). After consideration of the extent of the IRPs and the scale of change required, DCC put forward a plan to implement the IRPs and DCC change requests via a multi- release strategy. Exploring how this would impact on delivery led to a request for both time and functional contingency and a new direction from the Secretary of State. The date of live operations shifted from April 2016 to July 2016. The first release available to industry in line with the then July 2016 go-live date is referred to as release 1.2.

2.5. DCC state that the move to uplift of the GBCS specification and the multi-release strategy led to the need for additional resource to manage the releases in parallel, a greater volume of testing associated with the new plan and contract variances for the Smart Meter Key Infrastructure (SMKI), Parse and Correlate software and Automatic Testing of GBCS (ATG).

2.6. We note that the discussions and negotiations for the change of plan with the Fundamental Service Providers (FSPs) were not concluded within 2015/16. Therefore the substantive portion of costs associated with this change request isn't reported in the 2015/16 price control. We expect to see the full impact of these cost reported in next year's price control.

Systems Integration Testing (SIT)

2.7. DCC state that the challenge of testing the integrated solution has been significant. It states that progress has often been slow with solutions needing to be found for many problems. DCC state that they have had to play a very active role in supporting CGI in its role as system integrator. This led to a strain on DCC resource and the need for an external review of system integration.

Preparing operational services for go-live

2.8. In 2015/16 DCC began to deliver some early services and finalised the requirements and contract for the Service Desk. DCC state that greater certainty on stakeholder and regulatory requirements for the service desk has led to the need for more resource to plan and support live operational services than anticipated at bid. For example, it was always envisaged that the Service Desk would be a 24/7 operation but DCC assumptions at bid were based on a business hours only service. DCC modelling on resource requirements for the Service Desk also revealed that a greater number of agents at a higher skill level were required to deliver the standard of service required by Users. Further governance, commercial management and IT related requirements to support Service Desk operations also led to additional costs.

New service development

2.9. In 2015/16 DCC became involved in new separate work streams which while envisaged they would carry out some of these roles at the point of licence award, they were not included in the Licence Application Business Plan (LABP) because the scope was not sufficiently certain. These have led to additional resource expenditure. These new areas include:

- Enrolment and Adoption of SMETS1 – in RY2015/16 the Secretary of State directed DCC to deliver a feasibility report on adopting these first generations meters in to the DCC system.
- Dual Band Communications Hub (DBCH) – in March 2015 the Secretary of State directed DCC to obtain an impact assessment on providing communications hubs that are capable of operation a Home Area Network (HAN) radio at more than one frequency range. This will enable smart meter communications links in a greater number of premises.
- Central Registration Service (CRS) – Ofgem made the decision earlier this year that DCC should be responsible for procuring, delivering and operating a new CRS to facilitate faster, more reliable switching between energy suppliers[6].

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[6] https://www.ofgem.gov.uk/system/files/docs/2016/05/dcc_statcon_decision_publication_final.pdf

3. Cost assessment

Chapter Summary

Total costs over the licence are £294m higher than at the time of contract award and £190m higher than last year's forecast over the licence term.

Based on the evidence reported by DCC we consider that the majority of the costs reported were economically and efficiently incurred. We do consider that a small proportion incurred and forecast costs not to be economic and efficient and are therefore unacceptable costs.

Question 1: What are your views on our cost proposals?

Overview of DCC's total cost base

Total Cost forecast

3.1. Over the licence period DCC's latest total cost forecast for the price control is £2.172 billion, which is broken down into the components in Table 3.1 below. Please see appendix 2 for allowed revenue and cost definitions.

Table 3.1 DCC total cost forecast

Cost category	Total (£m)
External costs	1,824
Internal costs	294
Pass-Through costs	53
Total	**2,172**

Changes in incurred costs for RY 2015/16

3.2. Table 3.2 below shows the costs incurred in RY 2015/16 relative to last year's forecast costs and to the costs agreed as part of the licence competition via DCC's Licence Application Business Plan (LABP). Reported costs in RY 2015/16 are around 6% higher than last year's forecast, mainly due to the increase in internal costs for reasons outlined in the previous chapter.

Table 3.2 Changes in DCC incurred costs in RY 2015/16 compared to RY 2014/15 forecast and LABP

Cost category	Change from RY 2014/15 forecast		Change from LABP	
	Total (£m)	%	Total (£m)	%
External costs	0.7	1%	10.7	17%
Internal costs[7]	9.1	36%	19.0	123%
Pass-Through costs	-3.7	-77%	-3.7	-77%
Total	**6.1**	**6%**	**26.0**	**31%**

Changes in costs over the licence period

3.3. Over the licence term, DCC is forecasting a total of £190 million increase in costs relative to RY 2014/15 forecasts (around 10% increases). This leads to a £294 million (16%) costs increase from LABP. Table 3.3 shows the breakdown of these changes in various cost categories.

Table 3.3 Changes in DCC costs over the licence period compared to RY 2014/15 forecast costs and LABP

Cost category	Change from RY 2014/15 forecast		Change from LABP	
	Total (£m)	%	Total (£m)	%
External costs	89.4	5%	155.8	9%
Internal costs	103.7	54%	142.1	93%
Pass-Through costs	-3.4	-6%	-3.7	-7%
Total	**189.7**	**10%**	**294.2**	**16%**

Cost assessment proposals

3.4. At the bid stage, DCC faced a degree of uncertainty about future costs when they submitted the Licence Application business Plan (LABP). DCC did not know which service providers would be selected; what the service provider solutions entailed; and what its obligations to service users would be under the SEC. Details about these requirements have emerged and developed further as DCC designs, builds and tests the smart metering solution.

[7] Internal costs include SMKI, Parse and Correlate and shared service costs in Table 3.2 and Table 3.3.

3.5. Nevertheless LABP remains an important benchmark for DCC costs. DCC is required in its price control submission to compare its costs incurred against those estimated in LABP and also updated expenditure forecasts. We will therefore hold DCC to account for its competitive bid position. As time since LABP increases, we will however place a greater weight on comparison to the previous year's forecasts to inform our cost assessment.

3.6. For the significant majority of costs, DCC has provided reasonable justification and evidence for the costs incurred in 2015/16. However, our cost assessment has revealed some incurred and forecast costs which we do not consider to be economic and efficient. We also consider that there is not sufficient certainty in some of DCC's forecast costs post go-live.

3.7. We therefore propose that £0.696 million from DCC's total costs in 2015/16 are unacceptable costs, and propose not to allow a £59.170m increase in their forecasts over the remaining term of licence. Table 3.4 below shows the breakdown of these unacceptable costs.

Table 3.4 Overview of our proposed position on costs that are not economic and efficient

Cost Category	Total 2015/16 (£m)	Remaining years of licence (£m)
Internal Costs *(including shared service charge)*	**0.696**	**59.170**
Resource costs	0.633	52.336
Accommodation costs	0.00	6.298
External Services	0.013	0.038
IT Services	0.050	0.498
External Costs	**0**	**0**
Total	**0.696**	**59.170**

3.8. Any costs that we consider were not economically and efficiently incurred will either be excluded from the future calculation of allowed revenue or be subject to an undertaking about their future management. The remainder of this chapter explains our findings from the cost assessment and the reasons for our proposals.

Internal Cost assessment

3.9. This section explains our price control proposals for internal costs. Further details and a breakdown of costs are included in Appendix 3.

3.10. We have included the applied shared service charge on the costs proposed below and throughout this document. Details of shared services are included later on in this chapter.

Resourcing and accommodation

Resource benchmarking

Proposal: £0.633m of costs not economically and efficiently incurred (RY15/16)

3.11. Under the price control we expect DCC to employ staff at economic and efficient levels. For the previous price control DCC provided evidence of this through a benchmarking exercise that compared salaries to equivalent roles in the wider employment market using Hay Group's salary database.[8] We determined a portion of these costs were not economic and efficient under the RY14/15 price control. DCC have updated this analysis for RY15/16.

3.12. DCC undertook this comparative exercise for both employees and contractors (by applying a % premium to make the permanent costs more comparable). DCC's justification includes that they continue to benchmark staffing at either the 75th or 50th percentile, dependent on the areas of the business and levels of skills that staff are required to demonstrate. DCC consider that the nature of their work in some cases necessitates a highly skilled workforce. They also say they sometimes experience difficulty in recruiting these skills. These factors can lead to advertising roles at higher salaries.

3.13. We have analysed these costs on a cost centre basis to recognise the difference in functions, and therefore potential skill levels. We have intentionally avoided assessing these costs on a role by role basis. We consider it should be DCC's responsibility to manage their salary costs within cost centres effectively, the outcome of which should be economic and efficient resource costs within each cost centre. The approach we have taken provides flexibility to the DCC to manage its resourcing costs, recognising for certain key and/or specialist roles they may need to pay more, offset by savings elsewhere in the cost centre.

3.14. Overall there is a broad range in which different cost centres fall compared to the benchmark, however these tend to often be over the 50th and in some cases over the 75th percentile. In many cases there has also been an increase in the difference above the benchmark compared to DCC's RY14/15 evidence. This suggests salaries are increasingly above the benchmarked levels.

3.15. Considering DCC's evidence and justification we propose that where permanent employee costs within each cost centre are benchmarked above the appropriate level, the difference is not economic and efficient. In general we are of the same view as last year that we do not consider that DCC has provided sufficient justification for why remuneration in some cases has been above the 50th percentile.

[8] Please see chapter 4 and appendix 3 in the 14/15 consultation for more detail on DCC's approach and our view: https://www.ofgem.gov.uk/sites/default/files/docs/dcc_price_control_consultation_regulatory_year_201415.pdf

We do recognise there are some exceptional cases where remuneration above the 50th percentile could be justified where DCC provides sufficient evidence.

3.16. As DCC have benchmarked staff using a 'snapshot' of cost at one point in time, some of DCC's 2015/16 resource costs have not been benchmarked. DCC has also in some cases had to pro-rata costs to obtain an appropriate benchmark. We have therefore used DCC's analysis as a representative sample and taken an equivalent percentage off DCC's incurred resource costs, where the costs are above the benchmark for the cost centre as a whole. We propose that £0.429m of permanent employee costs in RY15/16 are not economic and efficient. Please see appendix 3 for the individual cost centre assessment.

3.17. We appreciate there are challenges in benchmarking contractors, however the DCC has provided some limited additional evidence to support a benchmark for contractors at a higher cost than permanent staff. In addition, for certain cost centres where their workload is closely linked to go-live activities, we recognise DCC may require highly skilled contractors in the short term, meaning paying above the benchmark could be justified. However we did not consider this justification should extend to all areas of contractor use by DCC. We therefore propose to determine £0.204m of contractor cost in RY15/16 is not economic and efficient. This represents the costs which are above the DCC's benchmark, applied at a cost centre level.

3.18. We do not intend to remove the unacceptable benchmark costs from forecasts for future years. This is because we can only accurately assess incurred resource costs against benchmarks with any certainty. We will therefore only conduct this assessment on a year-by-year basis when we receive full information from DCC.

Forecast resource costs

Proposal: £52.336m of baseline forecast costs not economic and efficient

3.19. DCC forecast resource costs for 2016/17 onwards increased by 95% compared to their previous forecast. The overall trend for these increases is a peak in RY16/17 (primarily associated with the move from start up to operational phase) with forecast costs having also significantly increased to the end of the licence. DCC's reasons for these increases are further set out by cost centre in Appendix 3.

3.20. In RY16/17, costs have increased significantly due to the changes in RY15/16 explained in chapter 2 of this document. This increase in the scope and volume of activity to be undertaken in the RY16/17 accounts for 20% of the increase forecast. We have considered the variation for RY 16/17 in the context of these changes, as explained by DCC in their submission, and consider the majority of them to be acceptable. For the avoidance of doubt this does not prejudge the outcome of our assessment of the benchmarking that will be provided in next year's price control. We have also removed a relatively small proportion of corporate management increases as explained in Appendix 3.

3.21. From 17/18 onwards, the biggest driver for this increase was that in RY15/16 it became apparent that DCC may be required in future to take on additional activity beyond what was included in DCC's previous forecast. For example the likelihood of an increased volume of SEC modifications, which arguably could have been anticipated earlier, and the move to an ongoing release strategy. DCC's reasons for the increases are set out by cost centre in Appendix 3. In most cost centres there is not sufficient evidence that the volumes of activity and subsequent costs are certain enough to be included in forecasts. We do however recognise that it is probable that at least some of these costs will be included in future price controls, once there is evidence the associated costs are sufficiently likely.

Accommodation

Proposal: £6.298m of forecast costs not economic and efficient

3.22. DCC accommodation costs increased by 98% compared to the previous forecast. Last year we took out increased forecast costs for accommodation on the grounds that they were not sufficiently certain. We propose to do the same this year for similar reasons.

3.23. The DCC has the flexibility to lease office space back to Capita in future years, if they identify that they procured more space than necessary. DCC currently forecasts costs of the full office space for the remainder of the licence term. The amount of space DCC requires will vary depending on the volumes of people working for or visiting DCC. Given DCC forecast a decrease in FTE volumes in the future, we do not consider that it would be economic and efficient to allow these forecast cost increases.

External services

Proposal: £0.013m incurred costs and £0.038m forecast costs not economically and efficiently incurred.

3.24. DCC uses external services to provide support such as short term technical expertise and assistance in fulfilling regulatory requirements. In the majority of cases this has been justified and explained by DCC. Where such services are likely to be required on a regular basis, we expect DCC to consider recruiting the necessary skills to be able to take on these activities in house. Where DCC consider it not possible to do these tasks in house, there needs to be clear justification as to why external services were necessary.

3.25. We do however propose that a small portion of external services is not economic and efficient. Although these costs are below the materiality threshold in terms of value, we consider there to be an important principle to uphold. These costs relate to DCC's use of external services to evidence their proposal for an adjustment to their Baseline Margin. We do not consider it acceptable for DCC incur external service costs, which get passed on to consumers, to justify their commercial position in relation to their parent company.

IT Services

Proposal: £0.050m incurred costs and £0.498m forecast costs not economic and efficient.

3.26. We propose the majority of DCC's IT service costs as economic and efficient. The exception is £0.548m of the cost variation over the course of the licence term for the FTP server[9] due to the change in timescales and change in requirements as explained in Chapter 2. We have split this cost disallowance across 15/16 and each remaining year of the licence term.

3.27. The £0.548m was incurred as a result of the DSP deviating from the design specifications agreed with the DCC. This effectively resulted in DCC paying for the delays and complications due to the mismatch in the design specification rather than the DSP bearing the cost, which ought to have been the case, given they had not delivered in line with their contract.

3.28. This is an important principle to uphold: consumers should not have to pay twice for the DCC's services. Therefore we propose that this is not an acceptable cost. Further detail concerning DCC's performance in manging the FSP contracts is outlined in chapter 5.

Shared Service charge

Proposal: DCC has demonstrated value for money associated with the incurred and forecast shared service costs in its 2015/16 price control submission, conditional on the impact of our decision on uneconomic and inefficient costs. We propose to cap costs associated with the shared service charge based on DCC's approach to estimate costs to DCC if they could not draw on support from Capita.

3.29. DCC pays a shared service charge to cover support services.[10] It is an amount paid by the DCC for shared services sourced from DCC's parent company, Capita. DCC have explained that the shared service charge is a corporate overhead charge that it pays to its parent. Inclusion of the shared services charge was part of the competitive bid during the licence competition. It was calculated as a percentage of internal costs set out in the LABP.[11]

3.30. DCC is required by the RIGs to report information on the shared service charge, including how it has been calculated and how the shared service charge provides value for money. DCC have committed as part of their procurement strategy to review these costs on a regular basis and ensure and demonstrate they

[9] File Transfer Protocol server. This provides an interface between numerous DCC systems enabling the transfer of data.
[10] 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.
[11] A cost related to the communications hubs was excluded from the charge in the LABP.

remain competitive. They must also ensure there is no cross-subsidisation across affiliates and/or related undertakings[12]. Given the significant increase in DCC costs since licence award and the fact that it is now performing additional activities which were explicitly excluded from the LABP, it is important that DCC continues to monitor its shared services costs to ensure they are economic and efficient. For example, these activities may not draw upon the shared services from Capita in the same proportions.

3.31. In previous years DCC has provided limited information of the calculation and value for money on shared services. DCC have now provided us with more evidence of the value of shared services.

3.32. DCC have costed the quantifiable benefits they receive from Capita as a well as identifying less tangible benefits. DCC provided limited evidence to quantify or record where it had made use of more intangible support from Capita (for example, advice and support for commercial negotiations). They have also created a counter-factual scenario as to what equivalent services would cost if they could not draw these from Capita. DCC's analysis providers lower, base and upper scenarios based on a number of variables.

3.33. We consider that the base counterfactual scenario provided in DCC's analysis creates an upper limit as to when we would no longer consider that the shared service charge provides value for money. We are therefore proposing that a cap set for shared services at £18.512m over the licence term, above which we would not consider costs to be economic and efficient without further justification.

3.34. This year, taking into account our proposed uneconomic and inefficient costs, shared service costs come slightly below a counterfactual cost limit. We therefore propose that shared service costs across the licence are value for money, conditional on the impact of our decision on uneconomic and inefficient costs.

Materiality and Real Price Effects (RPEs) – Internal costs

3.35. RPI is the Retail Price Index and is a common tool used in models of price regulation to adjust for economy wide inflation between regulatory reviews. RPE is the real price effect which captures changes to a firm's specific input costs due to price inflation above (or below) the RPI. Real Price Effects (RPEs) are the assumption used in DCC reporting to take account for the impact of inflation over time. The purpose of this is to ensure that costs reported for the relevant regulatory year are reported in nominal terms.

3.36. DCC indexes internal costs (payroll increases) using RPI and they have increased some resource costs for 38 roles between RY14/15 and RY15/16 due to price effects amounting to a £0.064m cost variation.

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[12] This is a requirement under Licence condition 11 of the Smart Meter Communication Licence.

3.37. We still do not consider that DCC's methodology is applying the most appropriate approach to RPEs. DCC need to provide more convincing evidence justifying why their cost increases deviate from economy wide inflation (RPI) over the equivalent period. Despite this, we propose not to find these costs unacceptable. Our reasons for this are the low materiality of the RPE costs this year and the potential of double counting unacceptable costs when considered alongside our other resource cost proposals. We consider that DCC should improve its understanding of the concept of RPEs and we will provide feedback to DCC with clarifications.

3.38. The materiality threshold for internal costs is set at 1% of total costs, or at an absolute value of £0.15m, whichever one is lower. We accept DCC's approach for this year.

External Cost assessment

Proposal: Incurred external costs are economic and efficient for the regulatory year 2015/16.

3.39. The review of external costs reporting is limited to the FSPs (Fundamental Service Providers) as defined under the licence. CGI is contracted as the Data Service Provider (DSP). The Communication Service Providers (CSPs) are Telefonica and Arqiva for Central and South and the North region respectively. This means that costs associated with other externally procured services, such as SMKI or Parse and Correlate contracts, are reported under internal costs.

3.40. A large number of contractual charges were paid (or became payable) by the FSPs in RY15/16 for the achievement of payment milestones.

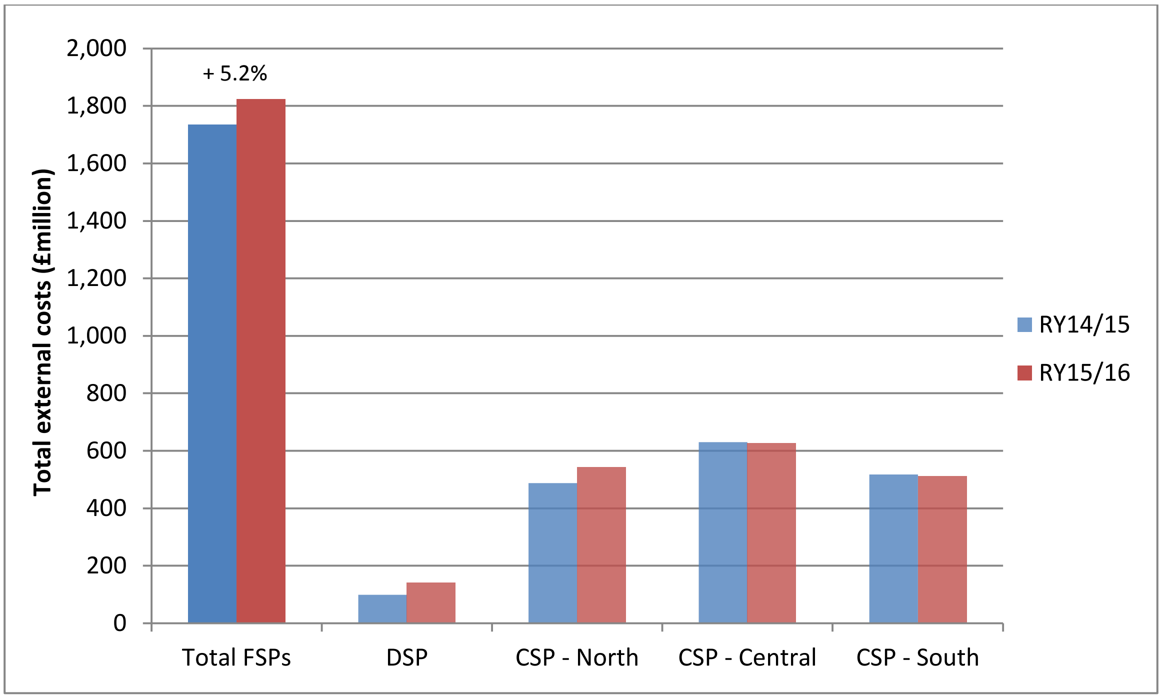
3.41. Table 1 below shows the variation in external costs in absolute terms and as a share of forecasted costs, relative to RY14/15 and LABP forecasts for both the full licence and for RY15/16.

Table 1: Variation in external costs

	Cost increase for RY 15/16		Total cost increase over the full licence term[13]	
	£m	%	£m	%
From 14/15 forecasts	*0.7*	*1.0%*	*89.4*	*5.2%*
From LABP	*10.7*	*17.1%*	*155.8*	*9.3%*

3.42. The total cost difference to 14/15 forecasts is an increase of £89.4 million over the licence period for all FSPs, which is a 5.2% external cost increase. Figure 1 below presents the total external costs for the service providers over the full licence term for 14/15 and RY15/16 forecasts.

Figure 1: Forecast total external costs over the licence period in RY14/15 and RY15/16 by FSP[14]



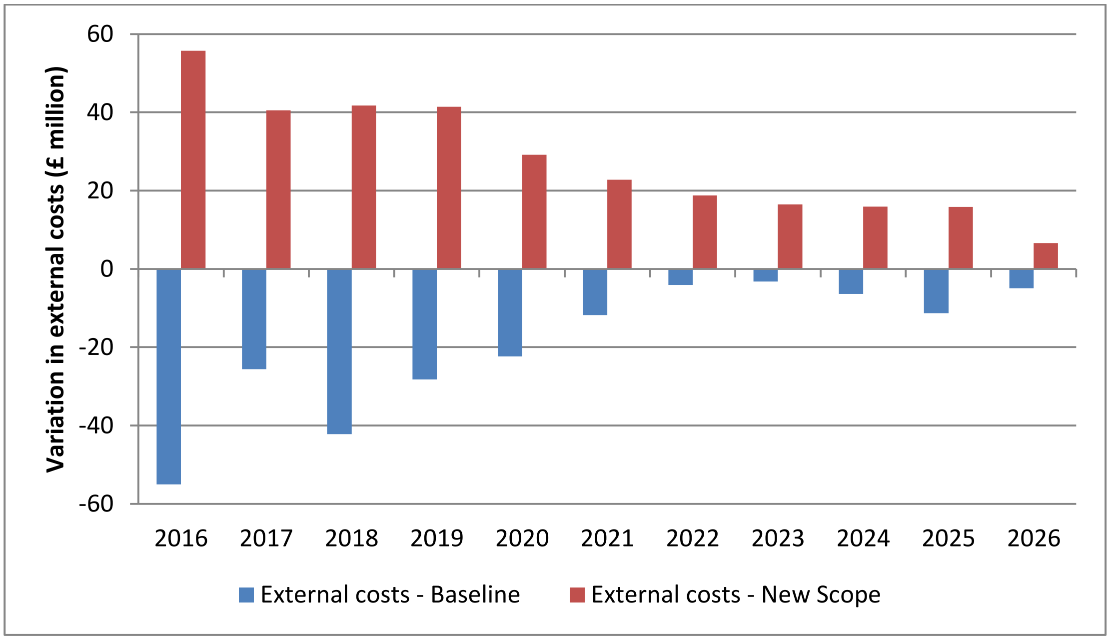
3.43. DCC has reported that this external cost increase of 5.2% is due to DSP and CSP North increases. The CSP responsible for Central and South shows reduced total external costs over the licence term in RY15/16 as compared to the previous year's

[13] Note that the licence term is different to the length of the service provider contracts (e.g. the CSP contracts are longer than the licence term)
[14] Note that the CSP for Central and South is the same provider (Telefonica) and that the large majority of external costs associated with CR160 are not included in this analysis.

forecast in 14/15. This is due to the re-profiling of costs due to the delay in the go-live date.

3.44. Figure 2 below shows the yearly variation of incurred and forecast external cost in RY15/16 relative to the previous year, presented separately for baseline and new scope costs over the licence term.

Figure 2: External cost variation from 14/15 forecasts over time, by cost category



3.45. DCC has reported that this total external cost increase is due to new scope costs, as baseline costs have decreased in 15/16 as compared to 14/15 forecasts which is shown in the figure above[15]. The primary driver of reduced baseline costs is the reclassification of Fixed Operational Charges to Network Availability Charges (NACs) for CSP North. This is included as part of CR091 within new scope costs and was part of the negotiation process for this new change request.

3.46. Baseline costs variations are explained in full by DCC as they are primarily due to the impact of major programme changes (due to timing changes and delay of go-live, reclassification of costs as described above and amendments in the financing arrangements).

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'baseline' costs include costs associated with delivering the requirements associated with the original contract award to the FSP. 'New scope' costs should include any requirements that are considered by the licensee to be additional to the requirements associated with the original contract award.

3.47. The key material driver of the new scope cost increase for RY15/16 is CR091. This high-value change request represents an instruction to the FSPs to re-set the baseline plan from GBCS V0.8 to GBCS V0.8.1.

3.48. The evidence provided for CR091 is satisfactory and in our view the variation in external costs has been made on reasonable grounds.

- DCC provides evidence on scope and drivers for change, consideration of alternative options, compliance with change process and they have undertaken appropriate due diligence. DCC further demonstrates value for the customer from the negotiation process and provides a list of measures to evidence value for money & efficiency.

- CR035/CAN015 was the previously agreed major change request that covered changes to the GBCS specification and a reset of planned go-live date. It therefore formed the revised baseline against which the impact of CR091 was assessed and DCC investigated whether additional resources were incremental to the contracted resource base and this baseline.

- We sought independent assurance that DCC board approved change costs related to CR091 were reflected in the FSP's contracts. We also sought assurance that DCC correctly followed the External Change process. DCC largely followed its own process and achieved savings of approximately 18% reduction in total cost compared to the FSPs initial positions. However we do note the concerns following evidence highlighting some failures to maintain a secure record of appropriate approvals and occasions where contractual timelines were not met.

3.49. We expect DCC to demonstrate through its reporting that it has incurred contract costs as efficiently and economically as possible, doing everything it reasonably can to ensure value for money. DCC needs to provide clearer evidence of benchmarking wherever possible to demonstrate that alternative options including the counterfactual have been considered.

Materiality and Real Price Effects (RPEs) – External costs

3.50. CPI is the Consumer Price Index and is a common tool to adjust for economy wide inflation and is included within the FSP contracts. The purpose of this is to ensure that costs reported for the relevant regulatory year are reported in nominal terms. We propose that incurred external costs due to real price effects (RPEs) are economic and efficient (RY15/16).

3.51. The materiality threshold for external costs is set at 1% of the total costs. We accept the materiality threshold defined by DCC for this year.

4. Baseline Margin and ECGS applications

Chapter Summary

In RY15/16 DCC submitted applications for a £1.604m adjustment to their Baseline Margin (BM) and a £2.911m adjustment to allowed revenue reflecting an External Contract Gain Share (ECGS). We propose to amend DCC's BM application and allow a £0.647m adjustment. We propose to accept DCC's ECGS application.

Question 2: What are your views on our assessment of DCC's application to adjust their baseline margin?

Baseline Margin adjustment

Proposal: Direct an adjustment to DCC's Baseline Margin of £0.647m. We consider it is appropriate for DCC to have applied a 15% margin rate to the variation.

Background

4.1. The baseline margin adjustment mechanism was included in the Licence to recognise the uncertainty when the Licence was granted over the nature and risk of DCC's Mandatory Business over time. It is intended to ensure that DCC is compensated for material changes in certain aspects of its Mandatory Business under the Licence including the activities it carries out, the risk it faces or the timescales and deadlines that it must meet. We set out further detail as to the conditions and requirements for a Baseline Margin Adjustment in the last year's price control consultation[16], the RIGs and the process and guidance document.

4.2. Last year DCC submitted a notice which proposed a baseline margin adjustment along with their RY14/15 price control. This equated to £3.114m, made up of two separate justifications. One related to volume and timescales of activity, and the other relating to the risk DCC was exposed to as a result of taking on the SMKI and Parse and Correlate contracts. They also proposed a margin of 15% on the variation. The volume based application was based on volumes in 14/15 only.

4.3. We considered their application duly made, but reduced the value of the adjustment to £0.483m. We consulted on whether to apply a 10% or 15% margin, and decided that we considered 15% as appropriate in that particular case.

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16 https://www.ofgem.gov.uk/sites/default/files/docs/dcc_price_control_consultation_regulatory_year_201415.pdf

DCC's application of a Baseline Adjustment for RY15/16

4.4. For RY15/16, DCC has applied for a £1.604m adjustment to their baseline margin. Their notice explains this is down to two drivers. The first is a significant increase of volumes of activity they have been required to undertake as a result of re-planning to a multi-release strategy during RY15/16. The second is the additional new scope activities they have undertaken including: feasibility assessments for Enrolment and Adoption and Dual Band Comms Hubs; additional requirements under the SEC and preparatory work for their role in the Centralised Registration Service[17].

4.5. DCC has calculated this proposed adjustment by quantifying the change in volume of activities as the number of FTE that have been involved in the above changes. This has then been compared to the initial FTE anticipated at LABP. DCC have applied for the cost difference between these values. They have then proposed a margin rate of 15% on this cost.

Reasons for our proposal

4.6. Considering DCC's proposal is similar in nature to the first variation of their previous application, there is scope and precedent for an adjustment to be made to their Baseline Margin. However we propose to amend their application, which leads to a reduction in the value of the adjustment.

4.7. Reflecting the licence obligation to apply for an adjustment in the price control immediately after the grounds arise, DCC's justification for this year's adjustment relates to change in volume of activities related to drivers that solely occurred in RY15/16. However, DCC's methodology is to quantify the FTE variation (as a proxy for volumes of activity) by comparing FTE and associated costs to those anticipated at LABP. DCC's 14/15 forecasts for RY15/16 already included a material and significant variation in FTE compared to LABP. These previous increases in forecasted RY15/16 activity between LABP and RY14/15 forecasts were explained and justified by DCC in previous price control submissions, and were considered sufficiently certain to be included in the forecast following our price control determination. We therefore consider that the impact of the drivers for this year's margin adjustment application is properly calculated as the variation between 14/15 forecast FTE and incurred FTE for RY15/16.

4.8. We consider this approach consistent with licence requirements for a Baseline Margin Adjustment. Under the Smart Meter Communications Licence, applications for an adjustment must be made in the first window after the grounds for proposing that adjustment first arose[18]. The principle behind the inclusion of this criteria is to ensure that Baseline Margin Adjustments are applied for at the first opportunity they can be justified.

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[17] Please note that for 16/17 onwards CRS costs will be subject to the CRS specific price control, incentive and margin arrangements. Inclusion in 15/16 under the smart price control does not set any precedent for these arrangements.
[18] Condition 36, Appendix 2 A6 (b)

4.9. Applications should be made once a material change has or is likely to take place, which would include changes DCC consider certain enough to appear in their forecasts. Applications should not include adjustments for changes eligible for application in previous years. If DCC consider they have grounds to propose a margin adjustment, they should apply for the impact of those grounds for all relevant years of the licence term assuming the forecasts as presented in the price control are sufficiently certain and economic and efficient. This is an important distinction between this mechanism and a 'cost-plus' arrangement, where DCC would apply for an adjustment on an incurred cost variation from LABP each year. If this were the arrangement DCC would have little incentive to accurately forecast costs and maintain cost control.

4.10. We consider DCC is justified in applying for an adjustment as a result of the explained drivers that occurred in RY15/16, where this varied from previously forecast volumes of activity. If DCC considered their FTE variation (as a proxy for volumes of activity) from LABP that was justified in previous price controls was eligible for a Baseline Margin Adjustment, then they should have applied in the window the grounds first arose, i.e. when they were first considered sufficiently likely to take place[19].

4.11. We have also amended the application to account for any costs we propose were not economically and efficiently incurred under the price control.

Margin rate

4.12. When determining any Relevant Adjustments to DCC's baseline margin the licence requires us to have regard to the DCC's expected rate of return on its activities over time. As part of last year's price control we considered the unique nature of DCC's ex-post regulatory framework, and its limited fixed and intangible assets. We also considered the definition of baseline margin in the licence as an amount above the licensee's costs, and the influence of this on DCC's expected return in bidding for the role. We proposed that the sales margin (or its earnings as a proportion of revenue) to be the most appropriate measure of DCC's return.

4.13. We previously consulted on two margin options, 10% or 15%. We determined that the margin established as part of the competitive tender process remained a reasonable estimate of the return that the market would have determined for those costs. This was considered in the context that DCC was still not an established company and therefore were limited comparisons.

4.14. This year DCC have evidenced that they consider a 15% margin to still be appropriate. We have considered DCC's evidence and propose that our arguments set out last year still apply. We therefore still regard 15% as a reasonable estimate in this particular case. However we still intend to consider rate of return on any future Baseline Margin Adjustment applications, and would expect DCC to be able to

[19] We stated in our RIGs process and guidance document that 'grounds' arise once there is sufficient certainty (paragraph 4.12)

justify the rate of return it proposes. As DCC moves away from LABP and into an established business we do not necessarily consider that 15% is an appropriate margin on variations eligible for a Baseline Margin Adjustment on an ongoing basis.

External Contract Gain Share

Proposal: We propose to confirm DCC's application to adjust the ECGS term by a total of £2.911m between 2017/18 and 2019/20.

Background

4.15. The DCC Allowed Revenue formula includes an External Contract Gain Share term. The effect of the application of External Contract Gain Share is to provide for an upward adjustment to the amount of Allowed Revenue that reflects some part of the reduction in External Costs that DCC helped achieve.[20].

4.16. This term is zero unless DCC applies to vary the relevant term within Allowed Revenue.

DCC's application of an External Contract Gain Share Adjustment

4.17. DCC has applied to adjust this term for RY2017/18-2019/20 reflecting a reduction in external costs as a result of a refinancing agreement for an FSP's set-up charges. DCC described in its application how it was involved in the refinancing arrangement namely to help the finance provider understood the regulatory environment that the DCC operates in and working to ensure that all three parties (DCC, the FSP and the finance provider) were content to enter the new agreement.

Reasons for our proposal

4.18. We consider that DCC's application is duly made and that DCC has provided sufficient evidence that it was instrumental in the arrangement. DCC's application gave sufficient evidence that the overall saving from the refinancing agreement would not have been achieved without DCC's involvement.

4.19. We also consider that DCC's application for a gain share of 44% (which includes the FSP's share as set out in the contract) as a proportion of the overall saving is appropriate based on comparisons to regulatory precedent in the industry[21].

4.20. DCC should note that this would not set any precedent for different activities that may be the subject of any future proposal.

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[20] Condition 39, 39.3

[21] For example the proportion of savings retained by offshore transmission owners and distribution companies are around 50%.

5. Performance

Chapter Summary

We consider DCC to have delivered against IM8 in the North region later than the due date as directed by BEIS. We therefore propose to disallow £53,462 from BMIT. We welcome the improvements DCC has made to its procurement and risk management strategy and processes. We note the improvements DCC has made to its external change control process but have identified some issues relating to DCC's contract management activity.

Question 3: What are your views on our assessment of DCC's performance against IM8?

Performance against implementation milestones

5.1. Our main measure of DCC's current performance is against the implementation performance regime. This lists a series of implementation milestones (IMs) that DCC must achieve in the lead-up to live operations. The regime is designed to encourage performance by putting some of DCC's margin at risk. If DCC fails to meet an IM by the date specified in the licence then it could lose part or all of margin attached to that IM. If DCC loses some of its margin it has the opportunity to gain some or all of it back by meeting a subsequent milestone.

5.2. We have based our assessment of DCC's performance against the IM criteria directed by BEIS on 19 October 2016. This means that during RY15/16 IM8a (Licensee is ready for Systems Integration Testing in the North Region) and IM8b (Licensee is ready for Systems Integration Testing in the Central and South Regions) which forms IM8 (Licensee Ready for Systems Integration Testing with Licensee) was due.

5.3. We consider DCC to have met IM8b by the due date set out in the IM criteria directed by BEIS. However, DCC provided evidence from the performance auditor which confirms that IM8a was met on 28 September 2015. The due date as directed by BEIS was 1 September 2015. In line with the direction, this means DCC sacrifices a proportion of the baseline margin implementation total (BMIT) which this milestone put at risk.[22] **We therefore propose to disallow £53,462 from BMIT.**

[22] IM8at = BMIT x 7.5% x TF8a Where TF8a is 0.09 as per the direction and BMIT is £7.920m as defined in the condition 35.6 in the Licence. BMIT consists of DCC's margin for 2013/14 to 2015/16 multiplied by the price index adjuster.

Procurement and risk management

5.4. Both procurement and risk management processes are key contributors to ensuring DCC costs are economic and efficient. In last year's price control we raised a number of concerns with DCC's procurement and risk management processes following an independent forensic review[23]. We are pleased to note that DCC has taken clear steps to improve their internal processes following feedback from last year's price control and forensic review.

5.5. We may carry out further extensive forensic reviews in the future to assess ongoing adherence to DCC's own policies and see if further improvements can be made once DCC is operational.

Procurement

5.6. DCC procures specific goods and services in order to deliver the Mandatory Business Services during the Licence period[24]. DCC's procurement strategy sets out how DCC plans to procure Relevant Service Capability and how it will meet the obligations as set out under the licence.[25] We require DCC to provide us with any assessments and evidence of how it has met the terms of its procurement strategy and how value for money has been secured as part of the price control.

5.7. DCC state that they have taken the following steps to improve their procurement process, including:

- Sourcing strategies are now clearly documented
- The rationale for the procurement is challenged and checked for consistency with DCC's procurement strategy and policy
- Evaluation criteria is made transparent to providers and assessment against the criteria is documented and verified
- Any changes in requirements or outcomes throughout the procurement process as a result of due diligence are clearly documented
- Involvement by DCC's parent company Capita in any procurement (as a provider or advisor) is subject to board and Managing director approval.

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[23] https://www.ofgem.gov.uk/sites/default/files/docs/forensic_accounting_review_redacted_version.pdf

[24] Mandatory Business Services are those services the DCC must provide. Licence Condition 6, Part B.

[25] Licence condition 16: Procurement of Relevant Service Capability.

5.8. DCC procured various Relevant Service Capability requirements from External Service Providers in 2015/16 including operational reporting solution, the DCC Service Desk and various testing and technical advice providers. DCC has provided sufficient justification for its procurement activity in 2015/16.

Service Desk and operational reporting provider contracts

5.9. We sought independent assurance on a sample of the larger contracts signed in the regulatory year. These included the operational reporting solution (Business information and Management information or 'BI/MI') and the service desk.

5.10. DCC identified the need for Service Desk services and BI/MI services to support the roll-out of the Programme in its Best and Final Offer (BAFO) submitted to the Department of Energy and Climate Change (DECC) in June 2013. It was also specified in that document that these services would be provided by Capita subsidiaries.

5.11. An independent review provided us with assurance that the bid, internal evaluation documents and contract values were in agreement. The review also confirmed evidence of DCC's due diligence process to hold discussions with the service providers about pricing and scope inclusions following the identification of additional service requirements since the BAFO at licence award.

5.12. We also asked for assurance on whether the process to agree these contracts was consistent in principle with DCC's own procurement policies. The independent review suggested that there were some instances where documentation of the contract handling was not consistent with DCC's procurement strategy. We do recognise that these are not new procurements given the providers were agreed at licence award and not subject to competitive procurement process. Nevertheless DCC must ensure that they continue to subject all contracts/ providers to regular review to ensure that the principles to procurement activities outlined in the licence are upheld.

Risk Management

5.13. DCC is required by its licence to manage and mitigate its risks to ensure that the service it provides is, and will remain, fit for purpose.[26]

5.14. DCC states that it has implemented the following improvements to their risk management procedure following the findings from last year's forensic review:

- DCC has a new risk management tool in place which is specifically designed for risk management allowing risks to be properly monitored, traced through

[26] Licence condition 7

the business and automatically escalated between work stream and programme risk management.

- DCC has amended their risk management approach to better define the impact/ consequences and monetary value of risks (including identifying those risks linked to any baseline margin application).

- DCC has also made efforts to reduce the complexity of their risk management approach by using common evaluation criteria for all risk types.

Fundamental Service provider contract management

5.15. DCC's contract management responsibilities are crucial to delivering the DCC service. The Fundamental Service Provider (FSP) contracts (the DSP and CSPs) contain a number of provisions that should enable DCC to efficiently manage these providers. These provisions include the following and evidence from DCC on whether they exercised them or not:

- Benchmarking reviews: These cannot be undertaken until 3 years after the effective dates of the contracts. Next year will be the first year when benchmarking reviews are possible.

- Gainsharing: There were no gain share opportunities identified by DCC or service providers in 2015/16.

- Refinancing gainsharing: The CSPs have set up the finance arrangements for the first tranche of communication hubs. Financing for future financing arrangements will be provided in 2016/17. Following a review of its set up charges, one FSP put in place a new refinancing arrangement resulting in a refinancing gain. See the section in Chapter 4 on the external contract gain share application for more information and how DCC was involved.

- Non-mandatory activities: During 2015/16 no requests were made for DCC approval of the use of relevant assets for providing non-mandatory activities.

- Financial audit: DCC carried out financial audits for each FSP in 2015/16. Opportunities to realise cost savings or verification of the FSPs compliance with continuous improvements were not part of this year's audits. They will apply once the delivery period begins.

- Efficiency gains: There were no efficiency gains to report in 2015/16.

5.16. We recognise that these provisions are more designed to manage ongoing operations rather than implementation. In the implementation phase the change management process forms a key part of DCC's contract management activities. DCC stated in its submission that they have made further improvements to their external change control approval process which include the introduction of a change working group to triage proposed changes, improved documentation and audit trail and steps to improve visibility and decision making at a higher management level.

5.17. DCC also commissioned an external review of the change process which has led to the development of new detailed processes and new governance arrangements which it has agreed with the FSPs. We are pleased that DCC has continued to make improvements and address concerns raised by last years' forensic review regarding external change management. Notwithstanding the issues identified relating to CR091 explained in chapter 4.

5.18. DCC state that efforts required to ensure that FSPs have met their timescales and performance standards has had a direct impact on DCC's resource requirement. There are examples of where DCC has incurred cost due challenges in managing the DSP as both the DSP and System Integrator (SI). DCC state that their focus was furthering implementation rather than apportioning liabilities at the risk of creating further delays to live services. While we recognise the benefits in achieving go-live at the earliest possible date, we are concerned about the risk that consumers pay twice for services because of errors and challenges in managing the FSPs. This has led to us finding some associated costs as unacceptable where we consider the outcome could have been avoided by DCC (see chapter 3).

5.19. While we do recognise the challenge DCC faces in inheriting the FSP contracts, as a contract management body we expect DCC to make sure that contract specifications are clear and that they have the right commercial levers in place to avoid additional cost and manage performance.

6. Revenue reporting

Chapter Summary

This Chapter firstly explains the link between DCC's Allowed Revenue, Regulated Revenue and its Charging Statement. In addition, we outline the impact of our proposals on DCC's Allowed Revenue.

Secondly, in this year's Price Control, we invited DCC to submit voluntary reporting on its reasons for over-recovery of revenue in RY15/16. This is in advance of the introduction of a penalty interest rate in RY16/17 which is designed to incentivise DCC to improve the accuracy of its charges and deter it from over-recovering revenue.

Question 4: What are your views on DCC's voluntary reporting which explains its reasons for over recovery of revenue in RY15/16?

Context

6.1. Allowed Revenue is the total revenue DCC is entitled to recover from Services Users. It is defined in Licence Condition 35 and calculated in accordance with the Principal Formula set out in Licence Condition 36. Under the Price Control arrangements, DCC incurs costs and passes these onto users by way of service charges. An explanation of how it is calculated is provided in *Appendix 5* in the 2014/15 consultation[27].

6.2. DCC's Regulated Revenue[28] is defined in Licence Condition 35 and is the actual revenue, measured on an accruals basis in relation to each Regulatory Year received by DCC through Service Charges. These are set out in DCC's Charging Statement which enables SEC Parties to estimate their annual Service Charges for the effective Regulatory Year.

6.3. The estimated correction factor[29] is defined in Licence Condition 36 and provides a mechanism for DCC to return the difference between Allowed Revenue and Regulated Revenue to SEC Parties with respect to the prior Regulatory Year.

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[27] https://www.ofgem.gov.uk/sites/default/files/docs/dcc_price_control_consultation_regulatory_year_201415.pdf

[28] The definition of 'Regulated Revenue' in Condition 35.5 now explicitly includes any interest accrued on over-recovered service charges and this takes effect formally in next year's price control.

[29] The amendments in the formula for the correction factor takes effect from 21 July 2016, and they are in Licence Conditions 36.15 and 36.16.

6.4. DCC's charges to Service Users are based on a prudent estimate of Allowed Revenue that is sufficient to cover their anticipated costs for the year so that charges will not need to be changed within the Regulatory Year.

6.5. 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).

Link between Allowed Revenue, Regulated Revenue and Charging Statement

6.6. Table 6.1 compares the costs and revenue estimated in the Charging Statement[30] to Allowed Revenue and costs actually incurred in RY 2015/16.

Table 6.1 Charing Statement compared to costs actually incurred, RY 2015/16

RY 2015/16	Charging Statement (£m)[31]	Reported (£m)
Internal cost (IC)	34.0	34.4
Baseline margin (BM)	2.9	2.9
External cost (EC)	72.3	73.3
Pass through costs (PTC)	4.5	1.1
Correction factor (K)	-8.5	-11.3
Total	105.2	**100.4**
Prudent estimate	9.5	n/a
Estimated Fixed Revenue	**114.7**	n/a

6.7. In 2015/16 DCC reported its Allowed Revenue to be £100.4 million, around £14.3 million less than the Estimated Fixed Revenue[32] in its Charging Statement for RY 2015/16. This difference can be explained by:

- **Pass-Through Costs (£3.4m):** A £3.4 million lower Pass-Through Cost compared to the estimate included in the Charging Statement because the estimate of £4.5 million was based on the value provided in the SECCo Ltd budget. However, SECCo Ltd had over recovered funds from the prior year and their expenditure in RY 2015/16 was less than budgeted.

[30] https://www.smartdcc.co.uk/media/300703/draft_charging_statement.pdf
[31] DCC charging statement, ending 31 March 2016; RIGs Price Control submission. Costs and Revenue in the Charging statement are estimated.
[32] Estimated Fixed Revenue is calculated based on the charges set out in the Charging Statement. DCC also estimated the Explicit Charges Revenue which is not included in our Price Control purpose. The Explicit Charges is applicable where a party procures a specific DCC service.

- **Prudent estimate (£8.3m):** Of the £9.5 million prudent estimate in the Charging Statement, £1.2 million was used to cover the overspend on Internal cost, External Costs and a small underspend against Baseline Margin, leaving a net balance of £8.3 million unused.

- **Correction factor lag (£2.8m)**[33]: There are £2.8 million of the correction factor for RY 2014/15 is not given back to Service Users in the Charging Statement due to the time lag[34]. This remainder was returned to users in the 16/17 charging statement.

6.8. The correction factor reflects DCC's over-recovery, and this should be returned to users in the form of lower charges in subsequent years. It is important that charges are returned to users as soon as possible. However, given the correction factor is only finalised after the end of the Regulatory Year, and part way through the following Regulatory Year, we recognise there will always be a lag in returning some of the over-payments. This lag can be offset to some extent by DCC's forecasts of the correction factor which it factors into its charges.

Voluntary reporting with respect to the penalty interest regime

6.9. In April 2016, we published our decision to modify the Licence held by the DCC to amend the definition of Regulated Revenue and to introduce a penalty interest rate regime for over-recovery of revenue. The penalty interest rate[35] will apply from regulatory year 2016/17.

6.10. The effect of the modification is to introduce a 'Report and Direct' penalty interest rate regime. If DCC over-recovers revenue from users that breaches 110 % of Allowed Revenue a penalty interest of 3% above the Bank of England base rate may be directed on any proportion of over recovery that DCC has not justified to the Authority's satisfaction[36].

6.11. We invited DCC to submit voluntary reporting on their reasons for over-recovery of revenue as part of the 15/16 price control. This would not be subject to a penalty interest rate in RY 2015/16.

[33] The numbers may not add up due to rounding.
[34] See figure 5.1 and the accompanying explanation to this issue in last year's decision: https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-decision-regulatory-year-201415
[35] https://www.ofgem.gov.uk/publications-and-updates/decision-modify-licence-introduce-dcc-penalty-interest-rate
[36] https://www.ofgem.gov.uk/system/files/docs/2016/05/decision_to_modify_smart_meter_communication_licence_for_dcc_penalty_interest_rate_web_version.pdf

DCC's explanation

6.12. For RY 2015/16 the proportion of Regulated Revenue to Allowed Revenue is 115 % and so it breaches the 110 % threshold. DCC gave the following reasons for the variation:

- Uncontrollable variation in costs incurred and Regulated Revenue in RY 2015/16. For example additional revenue due to increase in actual meter numbers compared to estimate; interest received on cash balances; lower Pass-Through Costs than estimated.

- Proportion of the correction factor as at the end of RY 2015/16 which is being returned to customers in RY 2016/17 charges. This timing delay results in a mismatch (£2.8 million) between Allowed Revenue and Regulated Revenue.

Our view

6.13. We consider that the uncontrollable cost variation would be acceptable in principle and would not attract the penalty interest rate. Although we feel that DCC's explanation on these factors should be explained in more detail as part of their submission.

6.14. We do have concerns about the gap (and time delay) between actual correction factor and the correction factor outlined in the Charging statement. Returning the over-recovered service charges sooner would benefit service users, especially small suppliers. In the future, DCC would need to provide a clearer explanation on why this was not avoidable in order for the variation not to attract the penalty interest rate.

7. Next Steps

Views on our proposals

7.1. We welcome views on the proposals in this document. We will consider any views provided when we take our decision. Please send responses to smartmetering@ofgem.gov.uk by 12 January 2017. We intend to publish our decision on DCC's price control in February 2017.

Changes to the Regulatory Instructions and Guidance (RIGs)

7.2. We may decide that the changes to the RIGs for price control purposes are required in advance of next year's price control. Potential changes include:

- Amendments to reflect the changes to the Implementation Milestones
- Amendments to reflect the Operational Performance Regime.
- Any amendments to make the price control consistent with the plan for reporting on the Centralised Registration Service.

7.3. If these changes are required we will consult on them to ensure they remain consistent with the licence.

Future of the DCC price control

7.4. We are committed to moving to more ex ante controls once DCC reaches a steady state. This would give the industry and DCC certainty about costs. We will start thinking about this next year as DCC moves to the delivery phase. Any changes to the price control regime will involve extensive consultation to help ensure any new regime delivers the right outcomes for DCC, industry and consumers.

Appendices

Index

Appendix 1 - Consultation Response and Questions

We'd like to hear your views on any of the issues in this document. We would particularly like to hear from SEC users. We would especially welcome responses to the questions at the beginning of each chapter. These are replicated below.

Please make sure we have your response by 12 January 2017. Send them to:

Robyn Daniell
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Ofgem
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020 7901 3132
smartmetering@ofgem.gov.uk

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

If you'd like your response to be confidential, mark it clearly to that effect and include your reasons. Please restrict any confidential material to an appendix. Once we've considered the responses to this consultation, we plan to publish our final decision in February 2016.

CHAPTER: Three

Question 1: What are your views on our cost proposals?

CHAPTER: Four

Question 2: What are your views on our assessment of DCC's application to adjust their baseline margin?

CHAPTER: Five

Question 3: What are your views on our assessment of DCC's performance against IM8?

CHAPTER: six

Question 4: What are your views on DCC's voluntary reporting which explains its reasons for over recovery of revenue in RY15/16?

Appendix 2 – Allowed Revenue

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

1.2 Allowed revenue is defined in licence condition 36[37] and is the total revenue DCC is entitled to. It is calculated using the following formula:

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

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

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

1.4. DCC's costs are made up of:

- **External costs** – costs economically and efficiently incurred in procuring fundamental service capability from external service provides, i.e. infrastructure costs.[38]

[37] Allowed revenue is defined in the RIGS in part 4 and the categories of costs are defined in Licence condition 35.

[38] As defined in licence condition 35 of the Licence. The fundamental service capability is defined in Licence condition 16 .40 and predominately comprises capability provided by 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.

- **Internal costs** – costs (excluding external costs and pass-through costs) economically and efficiently incurred for the purposes of the provision of Mandatory Business Services[39] under or pursuant to the SEC, and also include any shared service charge. [40]
- **Pass through costs** – defined[41] under the licence as the sum of the total annual fee paid by the licensee to the Authority and the payments made by the licensee to SECCo Ltd for purposes associated with the governance and administration of the SEC.

[39] As defined in licence condition 1 of the Licence, this means the services comprising the mandatory business of the Licensee, namely (i) the Core Communication Services, (ii) the Elective Communication Services, and (iii) the Enabling Services in each case as operated or provided by the Licensee in accordance with the requirements of the Licence.
[40] Internal Costs may include governance and administration costs of the SEC that are not included in pass-through costs. The shared service charge is a percentage of eligible internal costs paid to the parent company for use of shared services
[41] Defined in licence conditions 35 and 36.8

Appendix 3 – Internal Cost assessment

➔ This Appendix summarises DCC's total internal costs. It also sets out DCC's reported material cost variations and their justifications, with our subsequent proposed positions.

1.2. For the benefit of stakeholder understanding, DCC's internal Baseline costs are reported by cost centre. DCC report separately on New Scope costs. This is an overview the types of costs associated with each cost centre:

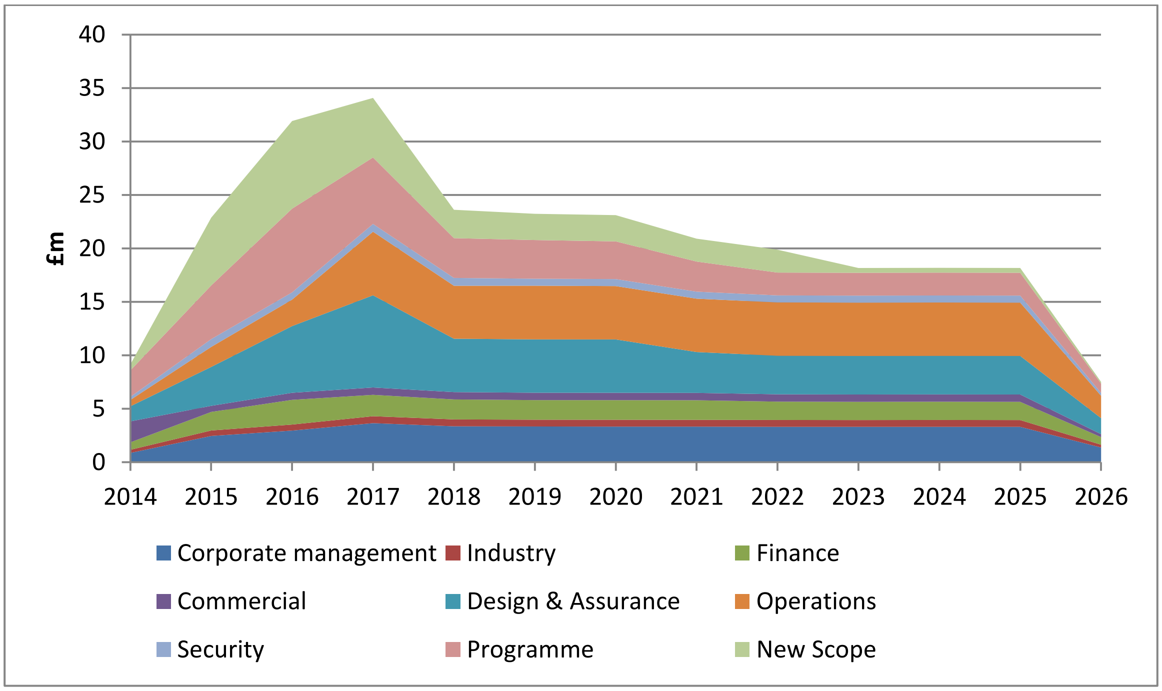
Cost Centre	Function costs include
Corporate Management	• Costs for the managing director, the senior management team, and the DCC board • Regulation, policy and legal services • Accommodation costs
Industry	• Leads engagement with service users, the SEC panel and other industry bodies
Finance	• Commercial finance activities including supporting change management, producing budgets and developing and applying the charging methodology • Operational finance activities including managing the billing and credit cover aspects of DCC • Regulatory finance activities including the price control and other regulatory and statutory reporting
Commercial	• Leads the contract and commercial management of the fundamental service providers • Evaluating services procured from Capita and additional contracts which require management, such as SMKI, Parse and Correlate. • Oversees DCC's procurement strategy
Design and Assurance	• Leads the development and maintenance of DCC technical architecture and service design • Works closely with the FSPs • Responsible for technically assuring DCC services and overseeing the delivery and implementation of the test strategy and test approach
Operations	• Ensuring that DCC services meet the needs of all service users • Designing and providing the day-to-day operational interface for service users including a first line service desk. Responsible for operational reporting and the provision of any transitional services ahead of go-live, early life support and enduring operations
Programme	• Coordinating delivery across the whole DCC ecosystem during the implementation phase • Ensuring that the services, systems, resources and assets are all in place in accordance with the programme plan • Allow DCC to appropriately design and build activities to be completed to facilitate integration and user integration testing
Security	• Assuring the security of all DCC systems • Establishing an information security policy, including security

	assurance standards, processes, procedures and implementation timescales • Maintains information security standards and certification throughout the licence

Internal cost variations

1.1. Figure A2.1 below shows DCC's forecast of the evolution of its internal costs over time across cost centres. The internal costs are forecasted to peak in RY 2016/17 due to DCC go-live.

Figure A3.1 Internal costs by cost centre (excluding shared service charge)



1.2. Table A2.1 below shows FTE employed by DCC for RY 2015/16 as reported by DCC in this Price Control. It also provides the forecast for RY 2016/17 in the table.

Table A3.1 Regulatory Year FTEs by cost centre.

cost centre	2015/16	2016/17 forecast
Corporate management	12.9	17.5
Industry	6.2	7.0
Finance	21.6	22.7
Commercial	4.6	5.0
Design & Assurance	52.4	76.8
Operations	12.0	36.5

Security	5.3	7.9
Programme	27.8	32.2
New Scope	16.9	15.9
IT Resources	6.8	4.1
Service Desk	12.9	30.5
Total	**179.4**	**256.1**

Summary of material baseline cost variations and our proposals

Variation from previous forecast (%)	DCC's justifications for material variations	Our proposed position considering DCC's evidence and justifications *any benchmarking disallowances follow the methodology set out in chapter 3*
Corporate Management DCC's submission: / *Our proposed position:* Incurred costs: 54.6% increase / *Incurred costs: 52.0% increase* Over the licence: 91.5% increase / *Over the licence: 36.6% increase*	**Resource costs** • Activity relating to additional SEC requirements and increased numbers of modifications. • DCC had not anticipated the volume of resource that would be required for them to meet their regulatory requirements. **Accommodation** • DCC have included previously removed forecast costs. • DCC no longer anticipate giving excess space back to Capita. **External services** • DCC used consultancy for price control, due to the extensive change in scope over the year. They are currently resourcing an internal price control team for future years. • DCC procured legal consultancy for contractual negotiations relating to the move to a multi-stage release strategy.	**Resource costs** • 3% of incurred resource costs not economic and efficient due to benchmarking evidence and justification. • The volume of resource required for SEC and some other regulatory requirements is not yet certain over the licence term. Propose a proportion of the increase beyond 16/17 is too uncertain to be included in forecasts. This uncertainty also applies to DCC internal legal services. **Accommodation** • Propose £6.298m be removed from forecasts. As explained in chapter 3. **External services** • We consider these external services to be economic and efficient. As explained in chapter 3 we do not expect DCC to continue to use these specific external services on an ongoing basis, they should endeavour to recruit these skills in house in future.
Industry DCC's submission: / *Our proposed position:* Incurred costs: 13.0% decrease / *Incurred costs: 13.0% decrease* Over the licence: 8.6% increase / *Over the licence: 8.6% increase*	**Resource costs** • DCC have recruited two new roles over the year, which we had previously taken out the forecast due to uncertainty. This is due to increased volumes of industry engagement required by DCC. • They have also merged their function with communications, which has changed the mix of roles and responsibilities of the team.	**Resource costs** • We consider variations as economic and efficient
Finance *Our proposed*	**Resource costs** • There continues to be a number of underlying	**Resource costs** • 5% of incurred resource costs not economic and efficient

DCC's submission: <u>Incurred costs</u> 25.7% increase <u>Over the licence</u> 9.4% increase	*position:* *<u>Incurred costs</u>* *19.9% increase* *<u>Over the licence</u>* *4.1% decrease*	processes, such as the charging and billing for Communications Hubs that are still evolving. This needs extra resourcing in the commercial finance team. • An increase in contractors due to the volume and complexity of changes. Contractors particularly helped with their financial reporting processes. • DCC consider that as they are establishing a new finance operation there is a necessity to hire specialist roles.	due to benchmarking evidence and justification. • Remove some roles from forecast where DCC have not demonstrated the activities they are undertaking are necessary.
Commercial DCC's submission: <u>Incurred costs</u> 9.4% decrease <u>Over the licence</u> 1.0% decrease	*Our proposed position:* *<u>Incurred costs</u>* *9.4% decrease* *<u>Over the licence</u>* *1.0% decrease*	**Resource costs** • No longer using Capita procurement as they now have internal resource to manage procurement. This has reduced costs.	**Resource costs** • We consider variations as economic and efficient
Design and Assurance DCC's submission: <u>Incurred costs</u> 15.2% increase <u>Over the licence</u> 131.7% increase	*Our proposed position:* *<u>Incurred costs</u>* *13.2% increase* *<u>Over the licence</u>* *30.2% increase*	**Resource costs** • The need for specialised skills means that the pool of resources suitably qualified and experienced to carry out certain roles is limited. This scarcity leads to higher costs. • Due to the changes that occurred in RY15/16 they have recruited temporary staff on contracts and extend contracts for existing staff where required. This is to mitigate delivery risk and reduce work backlogs. • Across the licence DCC consider they need increased resource to support system fixes and the ongoing release strategy.	**Resource costs** • 2% of incurred resource costs not economic and efficient due to benchmarking evidence and justification. • Remove variation in previous forecast from 17/18 onwards. This is due to a current lack of certainty as to the volume of activity that will be required over the licence term.
Operations DCC's submission: <u>Incurred costs</u> 28.5% increase	*Our proposed position:* *<u>Incurred costs</u>* *19.8% increase*	**Resource costs** • Significant increase in work as a result of re-planning and multistage release strategy. DCC have employed business analysts, service specialists and programme managers. Had to extend number of industry forums.	**Resource costs** • We consider 10% of incurred resource costs not economic and efficient due to benchmarking evidence and justification. • Some of DCC's justifications for ongoing costs relate to projects that we still consider uncertain in terms of

Over the licence 93.2% increase *Over the licence* *58.0% increase*	• DCC has described the increase in costs across the licence term for reasons such as ongoing demand for training, enrolment and adoption, half hourly settlement and Centralised Registration Service. **Service Desk** • Costs have increased significantly due to an initial under-scoping of what was required.	volume and scope. We therefore propose to remove much of the associated cost out of forecasts. **Service Desk** • We are minded to accept the forecast service desk costs as economic and efficient. DCC are delivering to support to industry that will ultimately benefit consumers. DCC also clearly set out and justified these costs.
Programme DCC's submission: Incurred costs 29.9% increase Over the licence 87.8% increase *Our proposed position:* *Incurred costs* *26.6% increase* *Over the licence* *36.2% increase*	**Resource costs** • Re-planning and move to multi-stage release has increased complexity and costs in the short term. • DCC explained it would need to manage a further ongoing release strategy past go live, for which they will need programme management. This has led to an extension of some costs until the end of the licence. **External Services** • External review of system integration (SI). This was to produce recommendations on improvements to the SI process with service providers. **IT Services** FTP[42] cost increases mostly due to increased levels of service management and support and changes to timescales and requirements.	**Resource costs** • 2% of incurred resource costs not economic and efficient due to benchmarking evidence and justification. • DCC have forecast prospective costs associated with an ongoing release strategy. We consider the scope and volumes of work involved too uncertain to currently include in forecasts. **External Services** • The review has led to improvement to processes and prevented further delays to delivery. Therefore we consider the associated costs were economic and efficient. **IT Services** • Propose £0.548m of variation is not economic and efficient (as explained in chapter 3)
Security DCC's submission: Incurred costs *Our proposed position:* *Incurred costs*	**Resource costs** • Increased complexity of the security solution is driving an increase in resource requirements. **Internal Services**	**Resource costs** • We consider variations as economic and efficient **Internal Services** • We consider variations economic and efficient

[42] File Transfer Protocol server. This provides an interface between numerous DCC systems enabling the transfer of data.

46.2% decrease Over the licence 27.5% decrease	*46.2% decrease* *Over the licence* *27.5% decrease*	• DCC have delayed their procurement of a security system due to the re-plan. This results in an additional 12 months' worth of cost savings by the end of the licence term.	

New Scope material cost increases and our proposals

New Scope: material variations from forecast		DCC's main justifications for variations	Our proposed position considering DCC's evidence and justifications.
New projects for RY15/16 New costs not previously forecast		• Feasibility study for Enrolment and Adoption including additional resource. • Resource associated with an Impact Assessment on DBCH. • Initial project start-up work supporting the Switching Programme[43].	• We consider variations economic and efficient • DCC has included short term resource to initially scope this work. DCC assured us they intend to move towards a permanent employee resourcing strategy if/when they are able to proceed with these projects.
External Services *(excluding new projects)* DCC's submission: Incurred costs 155.6% increase Licence term 49.8% increase	 *Our proposed position:* *Incurred costs* 155.6% *increase* *Over the licence* 49.8% *increase*	Change requests associated with the changes in GBCS specifications and implementation of a two stage release has led to cost increases to SMKI and P&C. Other substantial change requests include: ***SMKI*** (Smart Meter Key Infrastructure) • Changes to facilitate SMKI services over the internet for relevant industry parties • SMKI repository reconciliation between the DSP and TSP. ***P&C*** (Parse and Correlation Service) • Reference test data set for industry testing ***ATG*** (Automated Testing of GBCS) • Increase in set up charges for ATG as formal agreement not signed until RY15/16	• We consider variations economic and efficient • DCC has been required to make changes to their programme as a result of regulatory requirements. DCC has demonstrated that they have taken steps to scrutinise the costs associated with change requests.

[43] Although these initial costs have been included in this price control, DCC will report any further costs under the Switching Programme price control arrangements.

	CIO (Competent Independent Organisation) • Additional modifications required as a result of a number of change requests	
Other Resource costs *(excluding new projects)* DCC's submission: *Our proposed position:* Incurred costs: 5.7% decrease *Incurred costs: 5.7% decrease* Licence term: 175.2% increase *Over the licence: 73.8% increase*	**Testing** • New scope testing requirements as part of design and assurance **Delivery consultancy** • Additional consultancy support to coordinate leadership delivery to go live between Service Providers and DCC.	**Testing** • Propose to remove forecasts after 16/17 consistent with Design and Assurance removed forecasts **Delivery consultancy** • Propose as economic and efficient. This additional cost has supported DCC coordination with Service Providers in RY15/16 in the lead up to go live.

Appendix 4 - 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 (if any) and any other taxes based directly on the amount concerned.

Authority
The Gas and Electricity Markets Authority

B

Baseline Margin
In each Regulatory Year an amount of additional revenue, over and above the sum of the Licensee's Internal Costs and External Costs, that the Secretary of State has agreed shall be included (subject to the performance of the Baseline Margin Performance Adjustment) 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 (if any) of reduction in the Baseline Margin determined in accordance with the provisions of Part B of Condition 38 so as to secure, with respect to the applicable period, the effect set out in Part A of that condition.

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 2015/16.

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 currently 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. Smart DCC Ltd was granted the Licence by the Secretary of State with effect from 23 September 2013.

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

In relation to each Regulatory Year the sum of the 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 pursuant to the SEC (and may include costs incurred in respect of the governance and administration of the SEC that are not included in the pass-through costs).

L

Licence Application Business Plan

The plan of that name that was submitted by the Licensee in the course of or as a consequence of the licence application process. It contains the Licensee's estimates (which may be estimates that have been modified by the Licensee as a consequence of the Licence Application Process) of its revenues, costs, capital investments and cashflows 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 and to which the Licensee committed itself as a condition of that grant.

R

Regulatory Instructions and Guidance (RIGs)

The document of that name issued by the Authority under Licence Condition 33 for purposes relating to the obligations of the Licensee under Licence Condition 31 (Reporting of Quality of Service Information) and Licence Condition 32 (Reporting of Price Control Information). Provide the basis on which the licensee must report price control information as required under the 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 Licence Conditions 18 and 19 or otherwise received by the Licensee in relation to the carrying on of the Mandatory Business, after the deduction of value added tax (if any) and any other taxes based directly on the amount concerned.

Relevant Services Capability

Capability procured (or provided from within the Licensee's own resources) in accordance with Licence Condition 16 for the purposes of securing the provision of Mandatory Business Services under or pursuant to the Smart Energy Code. 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 an industry code which is a multiparty agreement which will define the rights and obligations between the 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 Ltd
The joint venture company established under the SEC for the purpose of acting as a corporate vehicle to assist the SEC Panel in exercising its powers, duties, and functions, including by entering into contracts for that purpose, owned by SEC Parties.

SEC Panel
Panel established under the SEC 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 (and such charges may reflect, among other things, expenditure incurred for the purpose of investigating or securing the future operation or provision of such services as well as expenditure incurred in connection with the governance and administration of the Smart Energy Code).

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 Gas Act 1986 and Sections 6(1A) and (1C) of the Electricity Act 1989.

M

Mandatory Business Costs
Costs associated with the provision 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
In relation to each Regulatory Year the amount equal to the total annual fee paid by the licensee to the Authority during that Regulatory Year and the payments made by the Licensee to SECCo Ltd for purposes associated with the governance and administration of the SEC.

Appendix 5 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

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

1.2. Please send your comments to:

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