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21 December 2017

Dear Rob,

DCC Price Control consultation 2016/17

Thank you for providing the opportunity to respond to your consultation on the DCC Price Control for the regulatory year 2016/17. This letter represents the views of Smart DCC and addresses the specific points and questions in the Initial Proposals published in October 2017.

Key Points

In summary, we believe Ofgem has made a fair assessment of DCC's management of costs for regulatory year 2016/17 with only a few, but important exceptions.

This year's submission has seen a concerted effort by DCC to report and justify costs better. We have noted the feedback Ofgem has provided on previous submissions and have worked hard to improve in the areas suggested. DCC welcomes Ofgem's recognition of this effort and is working to continually improve the submission and simultaneously balance the challenge of reporting the right information, in the right amount, and at the right level of detail.

The attached document provides DCC's detailed response to Ofgem's Initial Proposals. We have primarily responded to the items for which we believe there is a strong case for an alternative decision and items where Ofgem signalled clearly that it was open to considering additional evidence. These pertain to

- **Concerns with the unintended consequences of a higher test for certainty in forecast costs**. It is our view that more forecast costs should be communicated to the Industry through the consultation.
- **Disallowance of specific Internal Costs** where DCC believes it has provided sufficient evidence of economic and efficient expenditure or Ofgem has arrived at a unreasonable conclusion, as follows:
    - Disallowance of external services costs related to Systems Integration, where we believe that Ofgem has misunderstood the nature of this service and not taken account of the offsetting cost savings made by DCC. We must be allowed to

challenge our existing supply chain through using other providers whilst ensuring that we don't pay twice.

- Disallowance of a portion of all Operations contractor costs. We propose a revised approach which is more proportionate in its impact.
- Disallowance of two years of forecast costs for the Preston Brook office on the grounds that insufficient quantitative evidence was provided. We reassert that the evidence was available to Ofgem, and therefore reiterate the key points of the process and provide the evidence alongside this response.

- **Ofgem's decision on the Baseline Margin Application**. We consider that Ofgem's proposals in respect of the treatment of Operations staff do not adequately reflect the degree of change in Operations requirements over time. In addition, it is our view that the application process is made unreasonably difficult due to a lack of information on the basis of previous decisions and when 'grounds' for an application arose.
- **Efficiency targets in the near term**. We are committed to demonstrating year on year efficiency gains, but ask Ofgem to consider the timing of when to commit to targets. This is especially the case for Operations, which leads us to believe that targets would be more effective if set after DCC is operating at scale. It should be noted that we have been focussing on cost reduction activities throughout 2016/17 and 2017/18 and we will continue this into 2018/19 with the introduction of voluntary cost reduction targets.

In addition, we have included some views on other issues that have emerged through this year's Price Control, such as the definition of baseline vs. new scope activities. We also discuss some of the ways which DCC is working towards effective contract management, as well as our commitment to returning costs to customers through the penalty interest rate.

If you wish to discuss any points in this letter, or indeed any other aspects of the Price Control, please do not hesitate to contact me.

Yours Sincerely,

Helen Fleming
Director of Corporate Affairs

DCC Price Control Response

Regulatory Year 2016/17

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Contents

1 Introduction

This document provides Smart DCC's detailed feedback to Ofgem's Initial Proposals for the 2016/17 DCC Price Control.

It is constructed largely around the consultation questions, and where DCC has not offered a dedicated response then Ofgem can assume that DCC is accepting of Ofgem's position.

In addition, this response covers a number of other issues which we believe are pertinent to the Price Control assessment process and thus might merit further consideration ahead of next year's Price Control.

GENERAL POINTS TO CONSIDER

2 Unintended consequences of a new definition of certainty

This topic does not relate to a specific question in the consultation document, however it is relevant to the later section on Ofgem's proposals relating to the Baseline Margin application and hence DCC has decided to present it first within this detailed response.

One outcome of the 2015/16 DCC Price Control, was a revision to the definition of cost certainty in the RIGs guidance and the establishment of a threshold of "significantly more likely than not to occur" for a forecast to be allowed. This was intended to encourage DCC to prepare more robust forecasts and also to align cost forecasts in the RIGs with the criteria required for a Baseline Margin Application.

As a result of this change and the desire to ensure that there was clear alignment between the margin and allowed costs, all forecasts for internal payroll and accommodation costs were disallowed by Ofgem as part of its RY2015/16 decision.

DCC supported the decision to clarify the certainty test and has sought to comply with this in the forecasts presented in its RY2016/17 submission.

However, reflecting on this, the decision to apply such a demanding test of certainty has resulted in an unintended consequence, whereby costs are being disallowed even where it is plain that costs will occur. This has the potential to result in a view of future costs, which is clearly incorrect and hence unhelpful to customers or stakeholders.

It could also obscure which costs are being disallowed on the grounds of a lack of justification, or through being deemed inappropriate, as against those which simply do not meet the certainty threshold. Again, this makes it difficult for customers to make an objective judgment of DCC's performance.

2.1 Costs as certain vs. a 'best view'

The LABP provides a baseline of costs established following a competitively tendered procurement. Each year, DCC reports actual costs against this baseline and updates the forecast costs, for the remainder of the licence, based on any new information.

The purpose of incorporating forecast costs is to encourage DCC to think ahead, and as a result seek efficiency gains, but to also provide customers with an indication of what costs to expect. However, the revised certainty test has a significant impact on the latter.

As the bar for inclusion within the forecast has been set at a high level, a forecast increase in costs will routinely be disallowed in full, even where it is manifest that material costs can be expected. Hence the allowed forecast is almost certain to be an under-estimate of the probable costs.

Whilst Ofgem is correctly following the licence and guidance, DCC believes that it would be more transparent and helpful to our customers if Ofgem could formally record either DCC's previous forecast submissions year by year, or publish some alternative "best view" of future costs as part of its price control decision. This would:

1. **Give a more accurate picture to customers of likely future costs.** Although the forecast may ultimately prove to be inaccurate, it is surely better than a value of zero being inserted. A prime example of this is in the treatment of SMETS1 costs for 2018/19, where the forecast has been disallowed on certainty grounds. However, it is clear that there will be substantial costs and DCC provided its forecast based on current understanding. DCC believes that making that forecast available to customers would be of value of them.
2. **Provide a clearer signal to DCC in relation to forecasts which have not been shown to be economic and efficient.** Much of DCC's future costs will be dependent on the eventual pipeline of work, for example, the introduction of new programmes or volume of SEC modifications. In terms of justifying its costs, it is beneficial to see which parts of the forecast have failed to persuade Ofgem, as opposed to those which have simply failed a certainty test.
3. **Recognise that most, if not all, DCC functions will exist through to the end of licence**. Every function will show a base level of cost through to the end of licence, irrespective of the precise nature and volume of activity. Some areas are largely independent of activity such as parts of Corporate Affairs or Finance. It is our view that the need and evidence in these areas have already been demonstrated and allowed, and therefore forecast costs should be allowed over a longer period than simply two years ahead.
4. **Avoid painting a misleading picture of the variances**. This is evident in Ofgem's Initial Proposals. Internal Baseline costs are presented as increasing 52%; however, due to the disallowance of forecast costs in 2015/16, this is in fact a comparison against the costs allowed in 2014/15. Had the disallowed forecast from 2015/16 been taken into account, the cost increase is actually only 7%.

   To demonstrate this, we have recreated Table 1.1 Internal costs with both Ofgem's original numbers and our proposed forecast values that were disallowed in 2015/16.

Total Licence Costs	RY2015/16 forecast	RY2016/17 forecast		
	(£m)	(£m)	Var (£)	Var (%)
Before disallowance in 2015/16				
Internal-Baseline	237	253	16	7%
Internal New Scope	34	60	26	76%
Shared Service	23	26	3	12%
Total Internal Costs	**294**	**338**	**44**	**15%**
Final allowed values				
Internal-Baseline	167	253	86	52%
Internal New Scope	31	60	29	94%
Shared Service	17	26	10	60%
Total Internal Costs	**214**	**338**	**124**	**58%**

Table 2-1: Comparison of variances against allowed vs. disallowed forecasts (any discrepancies are due to rounding, as these are in £m)

Similarly, for accommodation, the increase in costs when compared against the RY2015/16 forecast is actually 15% instead of the 190% presented in Ofgem's document.

This is a significant difference not only in terms of value, but equally it creates the serious risk of there being a widespread misunderstanding of DCC's costs by our customers and other stakeholders. This has the potential to create unnecessary confusion, as well as undermining DCC's reputation for management of its activities and its costs in a way that is not justified.

5. **Prevent a disincentive to forecast costs**. Forecasting is a time-consuming task, and this burden is increased significantly if DCC is forced to re-justify the overwhelming majority of roles on a regular basis, due to the short time horizon over which forecasts are deemed certain.

   It is clearly in the interests of customers – and indeed Ofgem – for DCC to produce as robust a forecast as it can, even if that forecast does not meet the certainty threshold. Hence, it would be unfortunate if the application of the certainty test, and the prospect of forecasts being disallowed, created a disincentive on DCC to invest time and effort in forecasting.

2.2 Proposed way forward

We would welcome discussions with Ofgem on the use of the certainty test. Our view is that a greater amount of forecast costs beyond two years should be allowed on the grounds that it provides a better view of future costs to customer, and ensures that DCC remains focussed on presenting forecast costs which are as robust as possible given the information available at the time.

In addition, we ask Ofgem to consider the idea of publishing a “best view” forecast alongside the allowed forecast. We already do this in the indicative charging statements shared with our customers, so this would provide some consistency.

There may be potential implications for the baseline margin application, which we recognise would need to be thought through.

Finally, we would welcome the opportunity to agree with Ofgem a more realistic baseline than LABP, such that DCC can focus its justifications on true variations between actuals and forecasts, and Ofgem can similarly focus its scrutiny. This would give a clearer picture to our customers, in line with the points made above and would ensure greater consistency with the costs which our customers are seeing through the charging statements.

3 Definition of Baseline Costs

There has been discussion in the past as to what constitutes baseline scope as against what is regarded as new scope. We believed we had agreed on a definition of baseline scope in discussions with Ofgem after the RY2015/16 price control decision. However, our understanding of this definition now appears to be different given footnote 8 on page 10 of the consultation document.

Ofgem defines baseline as activity which was “fully costed” during the Licencing Competition. In our view, this is not correct as, for example, SMETS1 and DBCH were both activities which DCC was always expected to deliver, and Ofgem has already accepted them as being baseline activity for the purposes of overhead and margin calculations, despite them not being fully costed.

We acknowledge that there has been some confusion in reporting baseline vs. new scope in previous RIGs. Historically, baseline activity which was not costed at licence award was typically reported under “new scope”, for reasons of transparency. We wanted to make it clear where cost increases were being driven by projects which were previously un-costed. However, these projects were often to deliver baseline scope, i.e. SMETS2 functionality.

We believe there is a benefit to being more explicit over what is new and what is not, and the implications for costs. The LABP is becoming less and less useful as a baseline against which to measure cost variance due to the evolution of the resulting solution.

In our view it would be sensible to differentiate between those activities which were fully costed in the LABP, as against those activities which were known to be a requirement but where there was not enough information available for these to be costed.

We would welcome an opportunity to discuss with Ofgem the best approach to ensuring transparency for new scope activities vs. baseline scope activities. One obvious option would be a modification of the RIGs to create a third category of costs, namely, “Baseline Scope – Un-costed in LABP”. As in section 2, this would contribute to a better understanding of DCC’s costs for the benefit of our customers and stakeholders. However, regardless of how Ofgem chooses to address this, we do not agree with the current definition as it is written in the submission and would ask Ofgem to rectify this in the Final Proposals.

4 Realising cost efficiencies through a target

In the Initial Proposals, Ofgem has stated, *"…. we consider DCC should publish and commit to efficiency targets in order to demonstrate to customers that cost efficiency is central to their business planning strategy."*

DCC understands and supports this initiative. It is reasonable to expect a modern business to deliver efficiency improvements in a systematic way, year-on-year.

We are committed to delivering against the Licence obligations and providing support and services to customers that meet their expectations at the most efficient cost. However, organisational cost reduction programmes are most successful when a degree of maturity has been reached and operational and customer delivery is fully embedded.

DCC is an organisation which is heavily focussed on delivery of functionality to our customers, and will face many challenges over the next couple of years with the implementation of R2.0, SMETS1 and then the move to a routine Release Management model. In addition, during this period, our Operational services will be ramping up alongside the SMETS2 rollout and preparing to support SMETS1 and DBCHs.

The key point to make is that DCC is a business which is growing rapidly, and hence many processes are yet to be proven at scale, such that they can be optimised to drive cost efficiency.

The manner in which efficiencies and cost savings can be delivered will evolve over time. By way of example, DCC has been effective in delivering savings to its customers over the last two years through the application of refinancing to the main External Services contracts. This has delivered many millions of pounds of cost savings and DCC will continue to explore the potential that exists for future savings.

In business planning for the 2018/19 year, cost efficiency targets are being required of each of the DCC's operational units, totalling a £5m challenge on our Internal Costs. In the 2017/18 Price Control submission, it is reasonable to assume that DCC's forecasts for 2018/19 and beyond will show how efficiencies will be captured, particularly given the greater clarity that will have been obtained on what is required to deliver SMETS1 and R2.0, as well as DCC's future release model.

In respect of day-to-day efficiency, DCC is still climbing the maturity curve. In Operations in particular, many of the processes and systems have yet to be proven even at a relatively modest scale. Arguably the focus in these areas should not be on efficiency at this point, but actually on the effectiveness of the processes, as this will have far and away the greatest impact on our customers.

Over time, the attention will switch to delivering greater volumes of activity without a corresponding increase in headcount and then eventually, to ongoing reductions in absolute costs.

We are open to discussing realistic cost reduction targets for inclusion in the forecasts presented in the RY2017/18 submission as well, which could be committed to after DCC is operating at scale. This would be effective for RY2019/20.

Ofgem can be assured that DCC is committed to demonstrating efficiency and we look forward to spelling this out through both our business plan and next Price Control submission and in discussions with our customers.

CONSULTATION QUESTIONS

5 Question 2: *Do you have any views on DCC's contract management performance?*

Ofgem commented on DCC's Contract management performance suggesting that additional costs were incurred on activity that should have been delivered by the fundamental service providers. These concerns centred on the delays to the delivery of Release 1.2 and 1.3, the inability of stakeholders to use the service effectively and the decision making processes to enable work to continue at pace to achieve the planned timelines.

The reasons behind the delays in delivery are varied and have been discussed and debated in previous Price Control submissions. However, we would argue that Contract Management performance cannot be considered to be at the root of these issues.

Having said that, there have been challenges inherent within the contracts that DCC inherited, when it was awarded the Licence, and the pressure "to deliver" has created a context in which DCC had to work within the limitations of the contracts, when a pause for re-negotiation might have been the ideal. In this environment, DCC is pleased with the cost savings it has been able to negotiate with the FSPs despite limited commercial leverage.

We would like to reassure Ofgem that DCC is not complacent about the way in which the Supply Chain is managed. As has been discussed previously, and described in Part 5, pages 47-50 in the submission, this year has seen additional investment in the Commercial teams both in respect of numbers of resources, but also the experience being brought to bear.

Also DCC is now in a position where it is able to create significant new contracts for itself and hence apply lessons from the experience of the FSP contracts. For example, DCC is currently in the midst of negotiating a large suite of contracts with multiple providers which will underpin enrolment and adoption of SMETS1 meters.

As a matter of policy, these will all contain "cost of failure" clauses such that the new service providers are appropriately incentivised to deliver and also that any penalties or rewards are fully aligned with those which DCC will experience.

Likewise, in respect of the FSPs, we are now reaching a point where the scope of work extends beyond that which was covered by the original contracts, for example, the routine future release model which will govern delivery of maintenance and modification releases. This provides the opportunity to build in additional contractual levers given our experience of the performance of the contracts to date.

Finally, there is also the opportunity to bring new providers into the DCC ecosystem. Some contracts are approaching formal breakpoints and DCC will be evaluating what is the appropriate way forward in respect of re-tendering etc. In addition, this year, we have sought to increase the competitive pressure on our service providers by seeking quotations from alternative providers so as to obtain better benchmarks and thus increase our commercial leverage with incumbents.

Ofgem is aware of many of these initiatives already and we look forward to providing much greater information through our 2017/18 Price Control submission and in our ongoing discussions with customers.

6 Question 3: *Disallowance of certain Internal Costs and forecasts*

6.1 Internal Costs: payroll disallowance

DCC is pleased with Ofgem's decision to allow all costs for permanent staff. We have endeavoured to reduce our dependency on contractors and build a balanced workforce appropriate to the activities which DCC needs to deliver. In addition, particular emphasis has been placed on value-for-money being obtained in our recruitment decisions. Ofgem's conclusion is an important recognition of this transition.

However, contractors are likely to remain part of our resource mix, as we believe this is important in delivering a responsive, flexible and economic and efficient outcome for consumers. There are situations which require either additional staff for a time-limited period to deliver specific deliverables, or delivery where there is no permanent requirement for those skills within DCC. In addition, the ability to release contractors allows us to reduce the headcount more readily, which could be a more important consideration in future years.

One area which DCC has found challenging is in arriving at an enduring method for benchmarking contractor rates. To date, we have sought to validate these decisions through the use of a modified version of the benchmarking method used for permanent staff, based on information from the Hay PayNet database. We have also attempted to supplement the benchmarks with any relevant evidence from the recruitment process.

DCC accepts that it is reasonable for Ofgem to apply pressure on DCC to evidence that consumers are not paying overly expensive rates for contractors. However, DCC relies on a market-based approach to the sourcing of contractors with professional recruitment staff, in effect, testing the market with each recruitment of a contractor that occurs.

In many ways, this is little different from a procurement where Ofgem is correct in expecting DCC to rely on a robust process of interaction with the market so as to obtain good value for our customers. We would argue that a benchmark model can inform, but ultimately should be regarded as inferior to this regular market testing.

Nonetheless, and given Ofgem's interest in benchmarking, we have commented further on the methodology for disallowances below:

As part of Ofgem's decision in RY2015/16, they developed a methodology for disallowing contractor costs which were deemed not to be economic and efficient. After the decision was published, in February 2017, this methodology was shared with DCC. As such, neither DCC nor the rest of industry was able to comment on Ofgem's designated approach.

It is our view that, bearing in mind that we purchase contractor resource in the market, following robust processes, Ofgem's method is unreasonably punitive on DCC. We therefore propose that if Ofgem is to make disallowances based on benchmarking data, then any contractors for whom supplementary evidence was provided should be excluded from these calculations.

We have provided additional information in appendix A which draws a clearer link between the evidence presented in the original submission and hence identifies specifically where roles were able to be benchmarked against external sources and those which did not have this evidence. Table 6-1 shows the resulting calculations from Appendix A.

Total Evidenced FTE	9.9
Total as a percentage	**51.4%**
Total Not Evidenced FTE	9.4
Total as a percentage	**48.6%**

Table 6-1: Operations contractors both with and without benchmarking evidence

The total FTE for which additional evidence was not presented represents 49% of the contractor cost base in Operations. We therefore propose that Ofgem apply their existing methodology against this percentage rather than the full contractor cost.

Furthermore, we have concluded that the current approach of using the Hay's database is not a satisfactory approach for benchmarking contractors. We would welcome working together with Ofgem on a way forward for the assessment of contractor costs which ideally recognises the procurement-like nature of these expenditure decisions, or alternatively in establishing a more appropriate method of benchmarking.

6.2 External Services: Disallowance of SI support

In their RY2015/16 decision, Ofgem made a clear statement to DCC about customers not paying twice for services. For the avoidance of doubt, we understand and agree wholeheartedly with Ofgem's stance.

We also accept that a key part of DCC's mandate is to hold the FSPs accountable for their contractual obligations.

In Part 2 of the submission, we laid out a chronological case of the situation and the decisions which DCC made in achieving completion of Systems Integration activities to enable release 1.3. Ofgem have concluded incorrectly that these activities were, in essence, ones which the DSP was contracted to provide. DCC must emphasise that the work carried out was in fact additional and complementary, and was informed by our experience at R1.2.

Our belief is that the DSP has delivered under the terms of their existing contract and the following explains how the contracted work in question differs from those obligations:

On 18 December 2015, DCC was directed by the Secretary of State onto the redesigned delivery plan DCC had developed in consultation with all Service Providers to incorporate changes to the GBCS to deliver the SMETS2 service. The plan included a multiple release strategy to achieve full functionality and therefore required a more complex integration and testing approach as a result of multiple releases being developed in parallel, as opposed to one single release.

The DSP originally believed this could be managed through only one additional role, which would simultaneously be independent[1]. As stated in the submission, when SI testing issues began to surface, DCC asked all Service Providers to increase the resources dedicated to working in SI testing in order to identify and resolve the issues quickly. The CSPs carried this out as well as the DSP, but with DCC providing the oversight to the DSP to ensure performance. This was deemed as economic and efficient by Ofgem.

For R1.3, and learning the lessons from R1.2, DCC decided to bring in additional interim SI leadership resources through an external consultancy, rather than using DCC resource. The proposal was to bring in a new team to assist in the *management* of the SI resources in place at the DSP. As a by-product, this would eliminate the need for certain roles, both within the SI and DCC's teams.

The intended outcome was that DCC would retain the skills and experience of the majority of the DSP SI team while improving the quality of oversight, leadership, tools and processes. In addition, other internal costs were able to be reduced in response to the introduction of the external consultants, by releasing resource that had previously been deployed to support the SI, such that the costs of the consultant were materially offset. As DCC states in the submission, savings of £952k were realised as follows:

- **£438k -** Removal of the DCC delivery assurance team (peak 9 FTE);
- **£364k** - Removal of Baringa resources from the DCC programme team (5 FTE);
- **£150k** – Contribution received from the DSP in relation to the removal of their SI senior management team.

These costs represent internal costs which we would have spent, had we not brought in this external support, and could in addition have had overhead and margin applied

To consider the alternatives that were open to DCC, there was the option to execute a change to the SI elements within the DSP contract; however this would almost certainly have been a lengthy and potentially expensive process with no guarantee of success. It was our view that the introduction of a third party to support the DSP was more time-efficient and cost effective than a Change Request, and hence gave DCC a much better chance of achieving its delivery objectives.

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[1] There was a perceived conflict of interest of CGI being both the DSP and the SI, as incentives were built into the CR160 contracts to determine at fault costs in the case of delays. This is explained in a supporting document provided to Ofgem on CR160.

For the reasons described in our submission and above, we would argue that use of the external consultancy was the economic and efficient choice and by virtue of the difference in scope, does not constitute paying twice. It is our view that Ofgem should allow the full costs particularly given the compensating cost savings which do not seem to have been taken account of in the assessment to date.

6.3 Forecast of Accommodation costs

Ofgem states that the reason behind their disallowance of forecast costs for the DCC location at Preston Brook is due to the failure of DCC to provide "quantitative evidence of the Cost Benefit analysis, rates achieved, or any updated space occupancy study for the new space." We wish to reiterate several points around this reasoning which we believe demonstrates that sufficient evidence was available that more than justifies the decision to select the new office location.

Specifically, DCC did carry out a detailed and thorough process prior to committing to the new location, including a Cost Benefit Analysis (CBA). The decision making process was subject to appropriate governance at both Executive and Board level to ensure the most economic and efficient outcome.

DCC stated that a CBA was carried out as part of our approach (see p.167 of Part 5). However, Ofgem did not request this evidence.

DCC recognises that the burden of justification lies with us and hence additional evidence could have been provided upfront; however it is important to note that DCC provided over 350 pieces of evidence in the initial submission and then over 80 additional pieces in response to further questioning. We have always maintained our willingness to provide additional evidence should Ofgem request it and it is unreasonable for Ofgem to make a judgment of this importance without requesting any relevant evidence.

Ofgem did request further information for accommodation as part of the Clarification Questions, but in respect of future submissions only:

"Can you confirm that we will see relevant cost-benefit evidence for Preston Brook as part of the submission next year?"

In summary, Ofgem did not request our CBA for Preston Brook this year, but instead requested it for next year.

We would assume that there is some confusion on both of our parts concerning this piece of evidence, so DCC is providing all relevant materials to Ofgem, as part of this response.

In addition, we would like to re-emphasise the comprehensive process which was followed in identifying the new site at Preston Brook and was described in our submission:

- DCC carried out a country-wide assessment to identify those localities where pools of staff with relevant experience would be found and to gather local salary data.
- A property search was conducted which when combined with the regional research allowed DCC to narrow this down to a long list of offices in different locations around the UK.
- DCC considered a range of criteria, including cost, in our scoring of the different offices.
- DCC then narrowed down the options to a short list of three locations based on quantitative data in our CBA.
- Site visits were carried out at each of the three sites.
- The top three went through internal governance for discussion of the different trade-offs and advantages of each site, finally concluding on Preston Brook which came out top in the cost benefit analysis.
- The DCC executive committee were fully involved in this process including the shortlisting and final decision-making which was then approved in advance by the DCC board.

As a result of this process, we consider the decision to choose Preston Brook was robust and carried out with a high degree of due diligence. We are extremely pleased with the quality of talent and skills we have been able to recruit in Preston Brook which is providing additional capability and support to our customers without incurring London-weighting of costs for these new roles.

As a final point, DCC welcomes Ofgem's decision to allow London-based Ibex accommodation forecast costs which are in line with allowed forecasts of resources. This is in line with the reasoning for disallowance of accommodation costs last year and provides DCC with consistency. [2] DCC believes the same line of reasoning should be applied to Preston Brook.

6.4 Shared Services for Switching

As part of the 2015/16 Final Proposals, it was proposed that DCC should not need to re-justify its overhead/shared services cost every year for baseline scope, but would need to do so for new scope activities. Switching is considered to be a new scope activity.

In light of this decision, we accept Ofgem's decision to disallow shared services costs in respect of the team preparing the Switching business case. Ofgem can be reassured that we are currently building a case justifying a shared services rate for the Switching programme team, in line with Ofgem's policy, and this will be presented in our RY2017/18 submission.

7 Question 5: *Baseline Margin application*

7.1 Provision of information

Firstly, we wish to acknowledge the progress which has been made on the application of the Baseline Margin Application (BMA) framework, by Ofgem and DCC. We consider that the updated DCC Price Control Guidance, published in June 2017, provided additional clarity of Ofgem's approach and expectations of the BMA.

However, we consider that further work could be done to clarify and enhance the process such as through the publication of Ofgem's models in relation to past and current decisions – something which is routine in other regulated sectors.

We consider that the lack of this detailed information could impair DCC's ability to make a successful application by, for example, making it difficult for us to track which costs included in a BMA application from a previous year were allowed or disallowed and therefore whether or not we can make a new case under certainty grounds.

It is noteworthy that during the course of this consultation period, following our request, Ofgem provided part of the information we think is required. This data pertained to the current year's application and as a result has mitigated the amount of challenge in our response. We still request Ofgem provide the same level of data for historical years.

7.2 Areas of agreement

We welcome Ofgem's assessment of the BMA on the following:

- **15% margin rate for all current DCC activity (except Switching)** – To date all the activity DCC has undertaken relates to scope which was envisaged at the time the winning bid was submitted by Capita. Hence, we consider that Ofgem has made the appropriate decision in accepting the 15% for these activities until the end of the Licence in 2025.
- **Acknowledgment that appropriate External Services can accrue margin -** In order for DCC to deliver its obligations in the most economic and efficient manner, it is crucial that the regulatory framework doesn't incentivise us to resource our activity through the hire of

[2] https://www.ofgem.gov.uk/system/files/docs/2016/11/dcc_1516_price_control_consultation_2.pdf, pg. 15.

additional personnel. This assessment will ensure we continue to take the most economic and efficient decision as to how to deliver, or resource, a DCC activity.

We believe that these decisions are helpful in bringing greater clarity to the application process and how DCC should focus on choosing the most economic and efficient approaches.

7.3 Ensuring further clarity

Whilst acknowledging the progress made in improving the BM application process, there are still a number of aspects that we believe merit further examination:

Disallowance of R2.0 and SMETS1 RY2018/19 margin

This point relates not just to the margin application but also to the disallowance of the underlying forecast costs.

We have worked very closely with BEIS to plan the delivery of the R2.0 and SMETS1 programmes. In addition, these plans have been subject to considerable engagement with our customers and gone through various formal consultation processes. In light of this, DCC would argue that the basis of these forecasts is economic and efficient, and as DCC will be held accountable for delivering to these plans, they should be considered to pass the test of sufficient certainty. In the case of SMETS1 this should extend into RY2019/20.

Continuing with SMETS1, Ofgem cites the uncertainty as to which delivery Option BEIS will select, and the uncertainty this brings to the 2018/19 forecast costs. Whilst we appreciate Ofgem's logic, this was taken account of in our forecast for 2018/19, which was based on the baseline resource required irrespective of the chosen delivery option. Hence we believe that Ofgem should allow the forecast and the associated margin.

We anticipate that there will be specific increments of resource which will be influenced by BEIS' choice of delivery mechanisms. We will only be able to apply for the margin associated with those increments, through a BMA following BEIS' decisions.

Disallowance of all additional operational resources

Since the Licence award, there have been a significant number of changes to the DCC system specifications, associated regulatory requirements and practical expectations which could not have been foreseen at the LABP. These changes have not only taken place over this price control period, but have been covered in detail through all our Price Control and BMA submissions to Ofgem to-date.

Ofgem's assessment raises two key issues:

When did 'grounds' for an application based on Operational resources arise? In our BM applications to-date, we have highlighted grounds that have arisen which had a significant impact on the DCC system requirements, in the context of the certainty threshold that was applied at that time.

The previous applications have typically been driven by impacts associated with the Design Build and Test phases of the Programmes. Whilst a limited number of Operations roles have been impacted, it is only with the completion of the build phase in 2016/17 that DCC has been able to fully and effectively consider the impacts on Operations driven by all the changes in the scope and requirements of the solution.

Page 25 of Part 2 of the submission, and subsequently section 6.6, states that the operational requirement, above and beyond the scope of the LABP, was not significantly certain up until the specifications of the live solution.

In our view, this threshold of certainty was only achieved in time for the July 2017 application window, as the Target Operational Model (TOM) was not fully understood until the period up to the delivery of R1.2, which delivered the live DCC service.

In addition, we agree that a number of the discreet changes relate to grounds included in previous applications, but we do not consider that the certainty threshold for cost was met until 2016/17. Moreover, it would not have been economic and efficient to assess each single change in isolation, and hence DCC adopted the rational and proportionate approach by assessing and implementing the TOM only when all the information regarding the changes to the original DCC system specification and SEC requirements met the certainty test.

Increase in DCC's operations from LABP - We consider that the increase in resources was due to the additional requirements and complexity which have increased over the four years since the LABP was finalised. The majority of these changes could not have been anticipated at the bid stage and hence could not have been included. For example, we could not have anticipated multiple revisions to GBCS with all the consequential changes that this brought.

In Part 2, section 6.4 and 6.6 we provided rationale for the increase in Operational requirements above and beyond the bid documents, both transitional and permanent. Without wanting to cover information already provided, we flagged the following drivers:

Significant gaps in the Operational Service Requirements at bid stage - It should be well understand that there were significant gaps or explicit uncertainties in the OSRs. This applies both to requirements directly related to Operations, but also in respect of the requirements for the solution which then have a knock-on effect on the Operations service.

In previous years, Ofgem has allowed variations in the allowed costs and margin covering, for example, Design and Assurance resource resulting from these changes. Hence, it appears inconsistent that Ofgem is now describing changes to Operations as "under-bidding", instead of recognising that increases in resource are merely the consequence of change to the solution.

Evolution of technical standards - Two key changes since the LABP were the GBCS rebasing and inclusion of Smart Metering Key Infrastructure (SMKI). These impact directly on operational and service management within DCC, as well as the service desk requirements.

Multi-release strategy - The GBCS rebase had a consequential impact as a multi-release strategy was required for its implementation. This created new requirements on Operations by requiring a phased approach to the introduction of operational capability

Additional SEC provisions – Since the first version of the SEC a large number of changes have been made, which have had impacts on the current and enduring operations of DCC. While the changes in preceding years to 2016/17 were taking place, the focus was on incorporating this into the DCC solution, in the knowledge that where operational impacts existed this would need to be fully accounted for ahead of go-live.

Significant increase in the number of DCC's customers – During DCC's lifetime there has been a welcome but unforeseen increase in the number of customers, particularly in the supply community. The increased numbers of customers has an impact in itself, but also it should be argued that many of these new customers are small and have more limited ability to engage with DCC through on-boarding and ongoing live operation.

The consequence is that DCC has had to increase resources so as to interact effectively with this number of market participants, but also to help mitigate the capability gap that may exist such that they have an equal opportunity to on-board and engage with DCC.

In light of these drivers, we do not consider that Ofgem's disallowance of BM in respect of DCC's additional operational costs is reasonable. The factors described contribute to a significant volume of additional work for DCC, and a more complex environment and set of requirements. These increases in volume and complexity could not have been predicted and the Operations function has no option but to seek to cater for them. Hence, in our view, our application meets the qualification criteria required for a valid BMA and is consistent with the licence and the guidance.

This argument is further underpinned by Ofgem's assessment that the large majority of these costs were economic and efficient, and hence in our view should have margin applied.

8 Question 7: *What are your views on DCC's reporting which explains its reasons for over recovery of revenue in RY16/17?*

Historically, costs have risen with increases in the requirements and complexity of the solution. This upward track has always presented the risk that DCC might need to re-open the charging statement to obtain additional funds from our customers. We do not believe that this would be a desirable outcome and hence we have tended towards a prudent assessment of our needs for funding.

As our ability to forecast our costs is maturing, we are improving our ability to manage this risk; however we continue to be risk averse when it comes to unexpected charging increases. Nonetheless, DCC is committed to returning money to customers in a prompt fashion and have been proactively seeking ways to accomplish this.

In the charging statement for RY2016/17, we recognised that we were in the position of over-recovery. This led us to reduce the charging amount by just under £5m, which was distributed throughout the year.

However, we have gone on to under-spend by a significant amount in RY2016/17, primarily driven by our success in refinancing of DSP costs at a much lower rate. Whilst the correction factor provides an existing mechanism to return the over-recovered amount, it spreads the refund across the charging year, meaning that customers would not receive this in full until March of 2019. As such, we have been in discussions with Ofgem to reopen the charging statement in RY2017/18 so as to allow this reduction to be passed on to our customers in a timelier manner.

We are planning, subject to Ofgem and DCC Board Approval, to return around £25m of savings to customers.

The revised Charging Statement for RY2017/18 (issue 1.1) was issued for consultation on 12 December 2017[3]. Subject to there being no objections to this approach, we propose that the revised version takes effect in January 2018. This proposal reduces charges levied February, March and April 2018[4].

[3] Notice letter: https://www.smartdcc.co.uk/media/446170/notice_letter_to_ofgem_to_reduce_charges_in_cs_1718_vfinal.pdf and draft revised Charging Statement: https://www.smartdcc.co.uk/media/446180/charging_statement_ry1718_-_issue_1.1__revised_draft_for_consultation_.pdf

[4] Charges are levied in arrears.

Appendix A – Contractor role IDs which had benchmarking evidence

Role ID	Role Title	2016-17 FTE	Evidence Provided	Part 5 Appendix Location
02.497.02.01	HR Change Person	0.79	No	
02.506.02.01	Ops Transformation Lead	0.26	Yes	Page 122
02.506.04.02	Operational Design Analyst	0.16	Yes	Page 122
10.065.02.02	Head of Service Management	0.95	Yes	Page 144
10.068.04.01	Service Performance Analyst / BI Reporting	0.72	Yes	Page 156
10.072.03.03	Ops Readiness Workstream Lead	1.00	Yes	Page 127
10.212.03.01	Operational Readiness Programme Manager	0.13	Yes	Page 132
10.212.03.02	Operational Readiness Programme Manager	0.82	Yes	Page 132
10.214.03.02	BCDR Specialist	0.76	Yes	Page 151
10.228.04.02	Business Analyst	0.64	Yes	Page 135
10.229.03.01	Comms Hubs BA	1.00	No	
10.375.03.01	User Service Manager - Large Supplier	0.02	No	
10.397.03.01	Service Readiness Programme Manager	0.21	Yes	Page 137
10.397.03.02	Comms Hub Project Manager	0.75	Yes	Page 142
10.412.03.01	Transition Manager	1.00	Yes	Page 139
10.413.03.01	Programme Delivery - Ops Readiness PM	0.28	No	
10.414.03.01	Project Manager	0.44	No	
10.416.03.01	Ops Readiness Process Analyst	0.3	No	
10.416.03.02	Ops Readiness Process Analyst	0.58	No	
10.418.03.01	Ops Readiness Process Analyst	0.81	No	
10.477.04.01	SEC Requirements Traceability Consultant	0.65	No	
10.487.02.01	Programme Delivery Manager	0.98	No	
10.499.04.01	Learning Consultant Team PM	0.44	No	
10.500.04.01	Learning Consultant	0.56	Yes	Page 126
10.501.04.01	Learning Consultant	0.64	Yes	Page 126
10.502.04.01	Learning Consultant	0.39	Yes	Page 126
10.503.04.01	Learning Consultant	0.47	Yes	Page 126
10.504.04.01	Learning Consultant	0.37	Yes	Page 126
10.505.02.01	Transition and Defect Manager	0.09	No	
10.505.02.02	Transition and Defect Manager	0.32	No	
10.509.03.01	Forecasting & Planning Manager	0.41	No	
10.521.04.01	Operational Readiness & Transformation PSO	0.77	No	
10.564.03.01	ITIL Expert	0.07	Yes	Page 162
10.570.04.01	Business Analyst	0.30	No	
10.571.04.01	Business Analyst	0.24	No	
10.573.03.01	Ops Readiness Project Manager	0.57	No	
10.575.04.01	Project Manager (Planning)	0.34	No	
10.754.03.02	Operational Performance Associate	0.04	No	
	Total	**19.27**		

Total Evidenced FTE	9.9
Total as a percentage	**51.4%**
Total Not Evidenced FTE	9.4
Total as a percentage	**48.6%**