Consultation

DCC Price Control: Regulatory Year 2017/18

Publication date:	31 October 2018	**Contact:**	Andrew Roberts
		Team:	Metering and Market Operations
Response deadline:	28 December 2018	**Tel:**	020 7901 7000
		Email:	smartmetering@ofgem.gov.uk

The Data Communications Company (DCC), or Smart DCC Limited, is a central communications body appointed to manage communications and data transfer for smart metering. It holds the Smart Meter Communication Licences[1]. Price control arrangements restrict DCC's revenues and provide incentives to counter its monopoly position to deliver more efficient, better performance and innovation. Price control arrangements also ensure that costs incurred are economic and efficient.

DCC submitted its price control information (based on the Regulatory Instructions and Guidance (RIGs) that we publish) for 1 April 2017 to 31 March 2018 on 31 July 2018. On the same day it submitted proposals for adjustments to its Baseline Margin and External Contract Gain Share values.

This document includes our review of the DCC's costs for the 2017/18 regulatory year and outlines the scope, purpose and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses. We want to be transparent in our consultations and will publish the non-confidential responses we receive alongside a decision on next steps on our website at ofgem.gov.uk/consultations. If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential and, if possible, put the confidential material in separate appendices to your response.

[1] 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. This consultation is in respect of both those Licences. Those Licences are together referred to as 'the Licence' throughout this document.

© Crown copyright 2018
The text of this document may be reproduced (excluding logos) under and in accordance with the terms of the **Open Government Licence**.

Without prejudice to the generality of the terms of the Open Government Licence the material that is reproduced must be acknowledged as Crown copyright and the document title of this document must be specified in that acknowledgement.
Any enquiries related to the text of this publication should be sent to Ofgem at:
10 South Colonnade, Canary Wharf, London, E14 4PU. Alternatively, please call Ofgem on 0207 901 7000.

This publication is available at **www.ofgem.gov.uk**. Any enquiries regarding the use and re-use of this information resource should be sent to: psi@nationalarchives.gsi.gov.uk

Contents

Executive summary

The DCC has a pivotal role in ensuring the successful rollout and ongoing operation of smart metering in the GB energy market. As a monopoly service provider, it is vital that appropriate controls are in place over its costs and that it is subject to an appropriate incentive regime that focuses it on providing a good quality of service to its customers, which include energy suppliers. Through the price control, Ofgem is seeking to ensure that DCC continues to be able to make the required investments to deliver a good quality of service, whilst also focusing the organisation on delivering an efficient operation.

In regulatory year 2017/18 (RY17/18), DCC's primary focus was on delivering the core smart metering infrastructure, working with customers to identify and resolve defects identified through end-to-end system testing, and investing in service operations to support the move from testing to mass rollout. In parallel, DCC has progressed with plans for the delivery of Dual Band Communications Hubs, which will extend eligibility for smart metering to more challenging premises; and the enrolment of SMETS1 meters into the DCC system, which will enable those meters to retain their smart functionality when consumers switch supplier.

There has been an increase in costs compared to last year's price control submission. This is partly because DCC had not previously been able to forecast the costs of the new projects with sufficient certainty for them to be allowed through the price control. In RY17/18 total costs (excluding pass-through costs) were £257m, £41.2m or 19% higher than forecast last year. Over the Licence term, total costs (excluding pass-through costs) are now forecast to be £471m, or 19%, greater than last year's forecast.

Cost assessment

DCC's submission for RY17/18 was largely clearly laid out and provided reasonable justification for the majority of costs incurred. However, the submission has revealed three main issues where we have concerns and where, as a result, we are minded to disallow some costs or to remove some costs from the forecasts:

- **Understanding customer needs.** We want to see DCC decisions strongly informed by an understanding of its customers' needs. As a monopoly provider, DCC's customers have no choice other than to use DCC, so it is important that they are providing services which customers want, at a price that offers value for money. We recognise that DCC has made improvements in how it seeks to engage its customers. However, informal feedback from DCC customers remains that they feel they are not always offered the right opportunities to inform DCC decisions, and the evidence provided to us on how customer needs have been understood and taken into account is inconsistent/limited.
- **Resource efficiency.** DCC's headcount grew significantly in RY17/18 and is set to increase further. DCC has invested in building capability this year but we saw little evidence that DCC has a longer term plan to realise efficiencies and reverse the headcount trend over time as it moves into more stable operations. We are minded to disallow all variation in payroll forecasts from RY20/21 onwards.
- **Justification of payroll costs for contractors.** DCC has reduced its reliance on contractors in RY17/18, which we welcome. We accept DCC's justification for why contractors remain the right approach for some roles, and that there are a number of reasons why contractors may be paid more than equivalent permanent members of staff. However, we have not yet seen sufficient justification from DCC for the contractor premium in RY17/18 and are minded to disallow some costs, which we will re-examine subject to additional evidence being provided through this consultation process.

In addition to the points mentioned above, we also consider that DCC did not provide sufficient justification: that it took the shared service charge into account in assessing the overall value for money of its decision to contract directly for emulators; for the shared service charge on the Centralised Registration Service; and for the remaining portion of the Hunter McDonald contract which was disallowed in RY16/17.

Overall, unless we receive further information, our position is that £2.345m from DCC's total cost in RY17/18 are unacceptable costs, and we are minded to disallow a £134.603m increase in its forecasts over the remaining term of the Licence (please see Appendix 4 for the detailed breakdown on the proposed unacceptable costs). Any costs that we ultimately decide were not economically and efficiently incurred will either be excluded from the future calculation of allowed revenue or be subject to an undertaking about DCC's 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.

For RY17/18 DCC has applied for a £7.761m adjustment to its Baseline Margin (BM) for RY17/18 to RY19/20 due to eight new drivers (with 22 sub-drivers) that, it submits, have led to an increase in the volume of its activities, an increase in the complexity of its activities, and a reduction in the timescales within which it is expected to carry out its activities.

We are minded to adjust DCC's application to reflect the price control decisions on unacceptable costs. We are also minded to reject several parts of DCC's application, where we have not seen sufficient evidence of a material change that could not have been foreseen, or for which the driver does not appear to meet the conditions in the Licence, unless we receive further information.

Taking all of these disallowances into account, we are minded to amend DCC's application to an adjustment of £5.948m between RY17/18 and RY19/20.

External Contract Gain Share

The formula for the DCC's Allowed Revenue includes an External Contract Gain Share (ECGS) term which allows for an upward adjustment where DCC has secured cost savings in its fundamental service provider (FSP) contracts. This is so that DCC has an incentive to seek and achieve cost savings. This term is zero unless DCC applies for an adjustment.

Similar to the last two years, DCC has applied to adjust this term for RY19/20-RY24/25, reflecting a reduction in External Costs as a result of a further refinancing agreement. We are minded to accept DCC's application to adjust the ECGS term by a total of £13.204m between RY19/20 and RY24/25.

Next steps

We welcome your views, and will consider them when we make our decision. Please send responses to smartmetering@ofgem.gov.uk by 28 December 2018. We will publish our decision in February 2019.

1. Introduction

What are we consulting on?

1.1. As required by the Licence, our assessment of DCC's costs is based on comparing DCC's incurred costs and revised forecast with the previous year's forecast and with DCC's Licence Application Business Plan (LABP). Our guidance document, published in June 2018, 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.[2]

1.2. We are restricted as to the detail we can include in this document due to the commercially sensitive nature of much of the analysis we undertake. We know that, in the past, some users have found it difficult to provide meaningful input to the price control process given limited detail of cost information.

1.3. As part of this consultation, DCC has agreed to share parts of their Price Control submission for RY17/18. This is intended to provide further background as to the layout and key messages contained, and to give insight through the additional detail which should be helpful to stakeholders in responding to this consultation. This can be found on the DCC website.[3]

1.4. The content of each section of this document is summarised below, along with the questions to which we are seeking your response.

Section 1: Introduction

1.5. This section includes a short summary of the other sections in this document, a summary of DCC's activities during RY17/18, and an overview of DCC's costs during the year. It also sets out the stages in the Consultation process, specifies how you should respond, and explains how we will treat your response.

Section 2: External costs

1.6. This section summarises the costs incurred by DCC's Fundamental Service Providers (FSPs), or DCC's 'External Costs', for RY17/18, and the updated forecasts for the remainder of the Licence term. It sets out DCC's justification for any changes in those costs and our response. This section also provides an assessment of DCC's performance in contract management.

Question 1: What are your views on our proposal to consider External Costs as economic and efficient?

[2] https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-guidance-processes-and-procedures-0
[3] https://www.smartdcc.co.uk/about/price-control/

Section 3: Internal costs

1.7. This section examines DCC's Internal Costs, namely the costs that are economically and efficiently incurred by DCC for the purposes of the provision of the DCC service (these exclude External Costs and pass-through costs). Internal Costs incurred in RY17/18 and the DCC's updated forecasts for the remainder of the Licence term are examined, focussing on changes in those costs compared with last year's forecast and the LABP. The DCC's justification for any changes in those costs and our response, specifically considering payroll and external services, are set out. This section also investigates the DCC's approach to and the results of the benchmarking of permanent staff and contractor remuneration.

Question 2: What are your views on our proposals on DCC's Internal Costs?

Question 3: What are your views on our proposals on DCC's approach to benchmarking of staff remuneration?

Section 4: Shared Services

1.8. Capita charges a constant percentage of internal costs for the provision of certain internal support functions and DCC is required to ensure that those costs are economic and efficient. This section considers whether Capita's services have kept up with DCC's needs as the company has expanded; it examines whether DCC's approach to procurement fully accounts for the Shared Service Charge; and it reviews DCC's approach to and the results of its assessment of the Shared Service Charge that should be applied to Switching.

Question 4: What are your views on our proposals for Shared Services?

Section 5: Understanding customer needs

1.9. Respondents to the RY16/17 price control consultation made it clear that they wanted more proactive engagement from the DCC with its customers on costs, either directly or via Smart Energy Code (SEC) processes. This section summarises the changes in DCC's approach to customer engagement during RY17/18 and sets out our views on the company's performance.

Question 5: What are your views on our proposal to expect more robust evidence from DCC on how it has taken customer views into account in future price control submissions?

Question 6: What are your views on the processes that DCC should establish to enable meaningful customer input to decision-making?

Section 6: Baseline Margin Adjustment and External Costs Contract Gainshare applications

1.10. This section summarises DCC's application for adjustments to its Baseline Margin and External Contract Gain Share, and sets out our response.

Question 7: What are your views on our assessment of DCC's application to adjust its Baseline Margin?

Question 8: In its submission, in support of its application for an adjustment to its Baseline Margin, DCC states that there has been a significant unanticipated change in customer expectations, and in customer and service provider demands. What are your views?

Question 9: What are your views on our assessment of DCC's application for External Contract Gain Share?

Section 7: Over-recovery of revenue

1.11. The penalty interest rate regime was introduced in RY16/17 to incentivise DCC to improve the accuracy of its charges to users and deter it from over-recovering. This section reports on the DCC's performance in RY17/18, examines the DCC's justifications for over-recovery, and sets out our view on those reasons.

Question 10: What are your views on our proposal on DCC's over-recovery of revenue?

Related publications

1.12. The DCC's Licence is at: https://epr.ofgem.gov.uk/Content/Documents/Smart%20DCC%20Limited%20-%20Smart%20Meter%20Communication%20Consolidated%20Licence%20Conditions%20-%20Current%20Version.pdf

1.13. The DCC Regulatory Instructions and Guidance 2017 is at: https://www.ofgem.gov.uk/publications-and-updates/data-communications-company-dcc-regulatory-instructions-and-guidance-2017

1.14. The DCC Price Control Guidance: Processes and Procedures is at: https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-guidance-processes-and-procedures-0

1.15. Last year's Consultation Document is at: https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-consultation-regulatory-year-201617

1.16. Last year's Decision Document is at: https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-decision-regulatory-year-201617

1.17. The Price Control element of the DCC's website is at: https://www.smartdcc.co.uk/about/price-control/

DCC's summary of RY17/18

1.18. In its submission, DCC provided an overview of its key activities during RY17/18 and the factors which drove the overall level of activity and spending across the organisation.

1.19. DCC considers its primary focus for RY17/18 to have been delivering the core SMETS2 infrastructure, establishing the supporting DCC service operation to handle scale and ensuring sufficient resilience within its infrastructure to meet customer obligations. DCC identified certain achievements during the year:

- All elements of the core nationwide smart metering communications infrastructure and accompanying services were put in place with the successful introduction of the final elements of functionality required in the Smart Energy Code (SEC) through Release 1.3 and subsequent releases.
- Extensive End-to-End testing was carried out by energy suppliers to test the smart meters they have procured and their back-office systems to ensure full integration with the DCC systems.
- Plans for delivery of the Dual Band Communications Hubs (DBCH) were confirmed by BEIS and DCC contracted with its Service Providers for the delivery of the programme supporting this.
- Considerable progress has been made towards the inclusion of first generation SMETS1 meters into the DCC system.
- DCC carried out a "Project to Business" programme to ensure that the business operates in a way that supports the running of the smart metering infrastructure. The programme focused on maturing several aspects of the business including governance and controls; skills and capabilities; technology; and critical relationships, in particular with service providers. It also considered DCC's "readiness to scale".

1.20. DCC identified a number of key themes in its submission that summarise its work through the year:

- **Working closely with customers:** DCC states that during the year its engagement with customers deepened and became more practically focused. For example, it set up a monthly workshop to share information about testing; it worked with larger suppliers to share lessons learned from SMETS2 deployment; it introduced customer satisfaction measures and mapped customer journeys in order to improve its services; and it used a variety of forums to more widely consult with customers.
- **Working with service providers to obtain value for money:** DCC states that it has been proactive in finding ways to generate competitive pressures on incumbent service providers in order to ensure value for money. It has strengthened its commercial team, continued to seek out cost savings in the financing charges associated with the main service provider contracts, and conducted a competition to reduce the cost of delivering the DBCH programme.
- **Establishing a predictable, transparent and reliable service:** With RY17/18 the first full year of operational service for the DCC, the company worked closely with its customers and service providers to test and assure the capability and resilience of the smart metering infrastructure. DCC also conducted a "Ready to Scale" project, the aim of which was to appraise critically the capabilities and functions that the DCC needed to deliver a high-quality service at the scale required to support the smart metering implementation programme (SMIP).
- **Creating mature systems and an expert workforce:** DCC states that it has recognised that, as it grows, it may need to change the way it operates – it must have the right skills and capabilities in the right numbers to provide a high-quality service for its customers. For example, it has improved its human resources function to ensure that it can recruit and retain a calibre of workforce consistent with its needs; enhanced its commercial and procurement team to ensure that it is obtaining value for money from its service providers; and enhanced its Programme Management function to ensure it has the capability to manage multiple programme delivery.

Summary of DCC costs

1.21. DCC's latest forecast for total costs over the Licence period (RY13/14-RY25/26), as contained in its submission, is £3.264bn. Excluding pass-through costs, its forecast for costs over the Licence period is £2.933bn.

1.22. This is a 26% increase in total costs compared to last year's forecasts (or a 19% increase with pass-through costs excluded). Table 1.1 below breaks this down by type of cost and shows how costs reported in the RY17/18 submission have changed compared to last year's forecast.

Table 1.1: RY17/18 forecast and variation compared to RY16/17 forecast over the Licence period (RY13/14-RY25/26)

	RY16/17 forecast (£m)	RY17/18 forecast (£m)	Variance (£m)	Variance (%)
External - Baseline	1,471	1,475	4	0%
External - New Scope	714	972	258	36%
Total External Costs	**2,185**	**2,447**	**262**	**12%**
Internal - Baseline	209	384	174	83%
Internal - New Scope	46	60	13	29%
Total Internal Costs	**256**	**444**	**188**	**73%**
CRS	0	4	4	N/A
Shared Services	21	38	17	81%
Total Costs excl. Pass-Through Costs	**2,462**	**2,933**	**471**	**19%**
Pass-Through Costs	128	330	202	158%
Total Costs	**2,590**	**3,264**	**673**	**26%**

1.23. External Costs over the Licence term have increased by 12% compared to the RY16/17 forecast, to £2.447bn. The single biggest driver of the increase in External Costs is the new scope changes. Section 2 summarises the External Cost variations, DCC's justifications and our response.

1.24. Internal Costs have increased by 73% over the Licence term compared to last year's forecast, from £256m to £444m. Increased payroll costs account for about 80% of this change, principally in the Design & Assurance, Operations and Programme cost centres. Section 3 summarises the Internal Cost variations, DCC's justifications and our response.

1.25. The greatest proportional increase in costs has been seen in Pass-Through costs, which is the route by which Alternative HAN Company and the Smart Energy Code administration secretariat costs are recovered. DCC has no control over these costs, and we do not scrutinise them as part of the price control. Over the Licence term these costs have increased by 158% compared to the RY16/17 forecast, to £330m. This is wholly attributed to higher payments to the Alternative HAN Company.

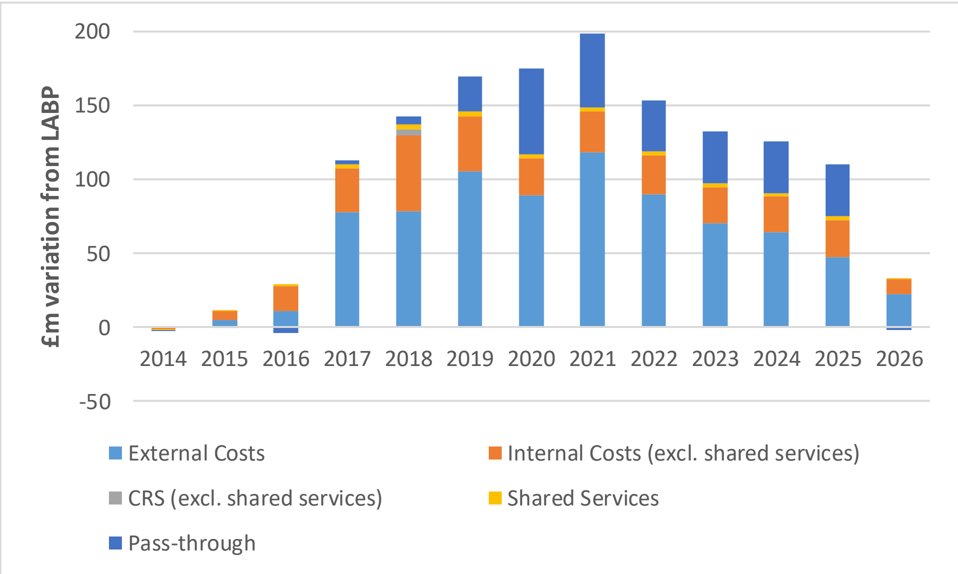
1.26.

Comparison to the Licence Award Business Plan (LABP)

1.27. As the length of time since the DCC Licence award increases, we will continue to place a greater weight on comparison to the previous year's forecasts to inform our cost assessment rather than DCC's Licence Award Business Plan (LABP). However, comparing costs back to the LABP remains an important benchmark for DCC costs and allows us to hold DCC to account for its competitive bid position.

1.28. Figure 1.1 below shows how the main cost categories in RY17/18 compare to the forecast at LABP. In aggregate, costs are £1,386m, or 73%, higher over the Licence term compared to DCC's forecast as part of the bid.

Figure 1.1: Comparison to LABP

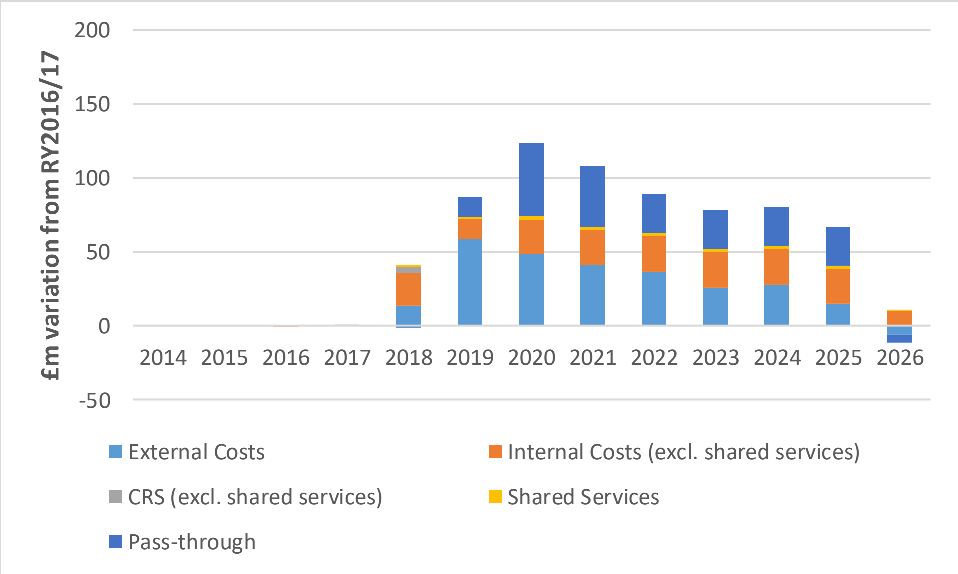


Comparison to last year's forecast

1.29. Figure 1.2 below shows how the main cost categories in RY17/18 compare to the forecast created as part of DCC's RY16/17 submission.

1.30. Overall, costs are £673m higher over the Licence term compared to the forecast established following DCC's RY16/17 submission.

Figure 1.2: Comparison to RY16/17 Forecast



Consultation stages

1.31. The key dates of the consultation process are set out in Figure 1.3 below.

Figure 1.3: Consultation stages

Consultation open	Consultation closes (awaiting decision). Deadline for responses	Responses reviewed and published	Consultation decision/policy statement
31/10/2018	**28/12/2018**	**February 2019**	**February 2019**

How to respond

1.32. We want to hear from anyone interested in this consultation. Please send your response to the person or team named on this document's front page.

1.33. We've asked for your feedback in each of the questions throughout. Please respond to each one as fully as you can.

1.34. We will publish non-confidential responses on our website at www.ofgem.gov.uk/consultations.

Your response, data and confidentiality

1.35. You can ask us to keep your response, or parts of your response, confidential. We'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.

1.36. If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you do wish to be kept confidential and those that you do not wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we'll get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

1.37. If the information you give in your response contains personal data under the General Data Protection Regulation 2016/379 (GDPR) and domestic legislation on data protection, the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 4.

1.38. If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

General feedback

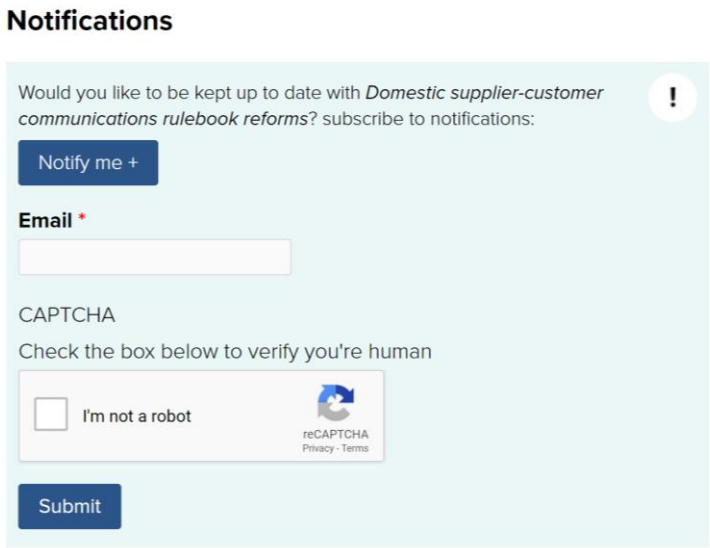
1.39. We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

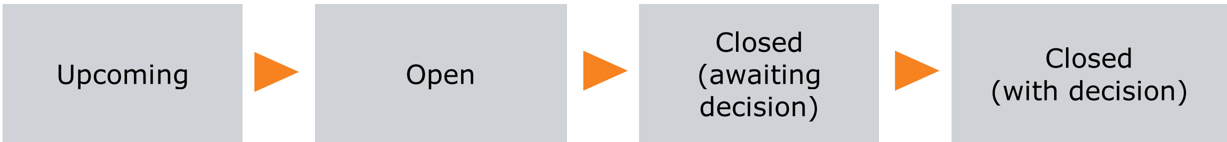
1.40. Please send any general feedback comments to stakeholders@ofgem.gov.uk

How to track the progress of the consultation

1.41. You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website. Ofgem.gov.uk/consultations.



Once subscribed to the notifications for a particular consultation, you will receive an email to notify you when it has changed status. Our consultation stages are:



2. External costs

Section summary

A key responsibility of the DCC is to manage the Fundamental Service Providers (FSPs) and ensure value for money and good quality service for customers. This section summarises the costs incurred by DCC's FSPs, or DCC's 'External Costs', for RY17/18, and the updated forecasts for the remainder of the Licence term. We are minded to find External Costs economic and efficient.

DCC has provided evidence of a strong focus on driving good commercial outcomes through comprehensive due diligence processes, and efforts to seek efficiencies through alternative delivery methods. However, there remains room for further improvement, particularly in commercial negotiations, customer engagement (detailed further in section 5) and risk management.

Question 1: What are your views on our proposal to consider External Costs as economic and efficient?

What are External Costs?

2.1. External Costs comprise a part of DCC's allowed revenue, and are the costs incurred by DCC's fundamental service providers (FSPs). The FSPs were appointed following a competitive tender process that was run by the government. They include the data service provider (DSP), CGI, and the two communication service providers (CSPs), Arqiva and Telefonica. Together, the FSPs are responsible for delivering the data and communications services to support smart metering.

2.2. External Costs are reported as a combination of baseline and new scope costs in the price control. Baseline costs refer to costs associated with delivering the requirements associated with the original contract award to the FSPs. New scope costs include any requirements that are considered by DCC to be additional to the requirements associated with the original contract award.

How have External Costs changed?

2.3. Table 2.1 below shows the variation in RY17/18 and Licence term External Costs relative to RY16/17 and LABP forecasts.

Table 2.1: External costs variation compared to last year's forecast and the LABP

	Variation for RY17/18		Total variation over the full Licence term	
	£m	%	£m	%
From RY16/17 forecasts	13.7	7.9	262.2	12.0
From LABP	78.3	72.5	778.8	46.7

2.4. Compared to last year's forecasts in the price control, total External Costs for RY17/18 are 7.9% higher for RY17/18 and 12.0% higher for the total Licence term. Compared to last year's forecasts, DSP costs have increased the most out of all the FSPs – at 15% for RY17/18, and by 33% over the Licence period. Refinancing arrangements at lower rates have contributed to relatively lower variations for the CSPs (discussed further in section 6). The percentage change in each FSP's costs from last year's forecast, and the aggregate annual variations, are shown below in Figure 2.1 and Figure 2.2 respectively.

Figure 2.1: Cost variations by FSP compared to RY16/17 forecast (%)

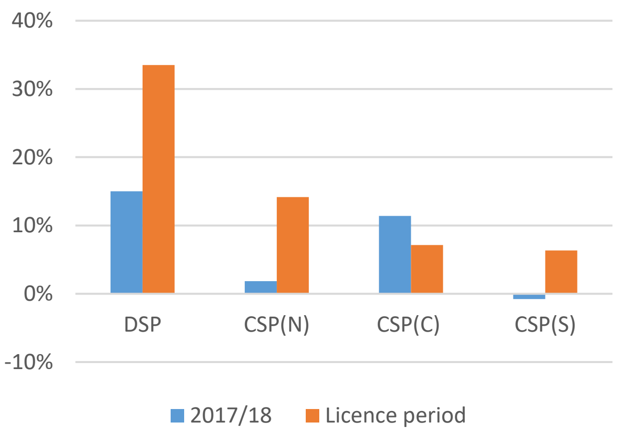
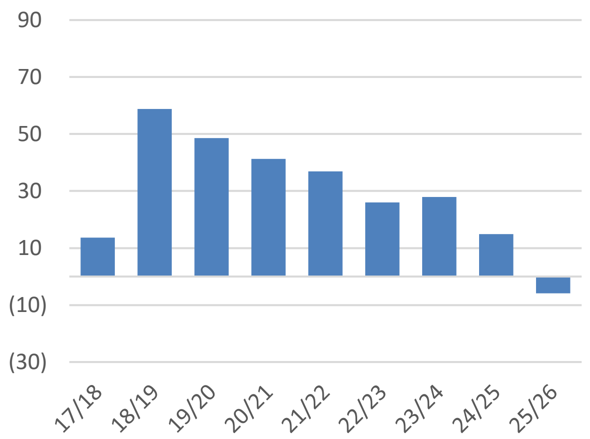


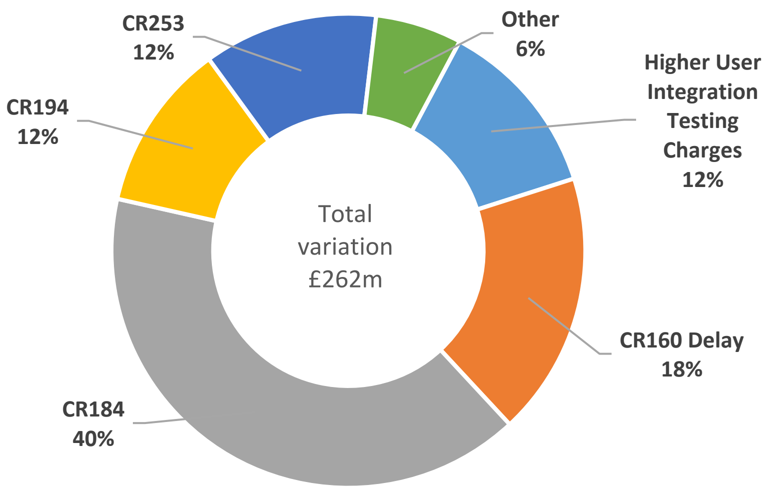
Figure 2.2: Annual cost variations compared to RY16/17 forecast (£m)



DCC's justification

2.5. Figure 2.3 below shows the material drivers of variation in External Costs over the Licence period, compared with last year's forecast. The drivers relate to contractual changes that DCC has negotiated with its service providers through Change Requests (CRs).

Figure 2.3: Drivers of the variation in External Costs across the Licence term, compared to the RY16/17 forecast



2.6. Change Requests raised for Release 2.0/DBCH account for over half of the variance. CR184 (40% of the variance) was raised to enable the CSPs to begin development of the DBCH; CR194 (12% of the variance) covers the technical changes that are required to meet the requirements of SEC; and CR253 (12% of the variance) relates to the provision of System Integration Testing and Device Integration Testing for Release 2.0. DCC has provided evidence of the work conducted to ensure that commercial and contractual pressures have been maintained in the negotiation and management of these Change Requests. In particular, there was extensive examination of alternatives to delivery by the CSPs which led to positive value for money outcomes. DCC has also provided evidence of comprehensive due diligence procedures which allowed DCC to drive down costs in its negotiations, and encouraged the CSPs to provide value for money.

2.7. CR160 Delay Costs (18% of the variance) relate to further amounts paid to the CSPs to compensate them for delays arising from the extension of testing beyond originally agreed dates for the CR160 contracts, in line with relevant compensation clauses contained in the contracts. As part of last year's submission, DCC provided narrative around the negotiation of this mechanism, and the principles of the agreement for compensating FSPs for economically and efficiently incurred costs due to external delays to the programme were agreed. The R1.2 delay costs for CSP(N) were also agreed last year. This year's submission covered payment of R1.3 delay costs for CSP(N) and of both R1.2 and R1.3 delay costs for CSP(S&C). Delay costs are not paid automatically to the FSPs and, in its submission, DCC provided evidence of the due diligence it performed on the claims.

2.8. DCC has provided an explanation of the need to extend the User Integration Phase and the concurrent testing required across multiple releases. Together, these have led to higher user integration testing charges (12% of the variance).

Our view

2.9. It is our view that the variation in External Costs was explained and evidenced as economic and efficient in DCC's RY17/18 submission and through subsequent communications.

2.10. It is our view that DCC provided sufficient narrative and evidence around the drivers of the various Change Requests raised during the regulatory year. DCC has detailed its efforts to explore all options available to it to ensure that costs remain economic and efficient to customers, and to ensure that commercial negotiations are centred on delivering value for money. There is also evidence that DCC has escalated issues as appropriate to the Department for Business, Energy and Industrial Strategy (BEIS). DCC has also provided evidence of forward planning, and has been proactive in putting in place ways to work around the capacity issues relating to testing environments and other resources.

DCC performance in contract management

2.11. The improvements DCC made to its contract management processes during RY16/17 have continued to be implemented in RY17/18. DCC has been able to provide evidence of extensive due diligence as well as clear, auditable records of decisions for contractual changes. We have been able to clearly trace DCC's thinking as the negotiations evolved, with evidence as to why certain decisions were made.

2.12. DCC has continued to make efforts to explore alternative contractual options. An example is the delivery of Dual Band Communications Hubs. DCC initially examined alternative procurement options to assess whether there were more competitive procurement models. It also conducted a strategic supply chain review to assess the potential impact on the CSPs of external factors (particularly relating to technology) and the commercial opportunities that could arise. Following the receipt of higher-than-expected quotes from the service providers, DCC conducted a competition for an alternative provider for the Dual Band Communications Hubs, the key objective of which was to test the costs submitted by the service providers. Following the receipt of bids, DCC was able to negotiate on price with the service providers, achieving material savings over the original quotes.

2.13. DCC provided a summary of its consideration of governance provisions and value for money tools defined in Schedule 7 and Schedule 8 of the FSP contracts. See Appendix 2 for further details.

2.14. DCC submitted evidence where it has been able to negotiate better value for money contracts in exchange for taking on risk. However, DCC did not provide evidence of how those risks were assessed nor of consideration of alternative options with varying risk profiles. For example:

- A decision was made during negotiations to take on foreign exchange risk in exchange for a lower unit price for the Dual Band Communications Hubs. While DCC identified that there were substantial savings to be made if DCC contracted in foreign currency – thereby assuming the risk of fluctuations in the exchange rate in the future – we have not seen evidence of a comprehensive assessment of the specific risk and the risk does not seem to have been incorporated into a company-wide risk-profile.

2.15. When seeking approvals for change requests that may give rise to future costs, we encourage DCC to conduct comprehensive risk assessments, and clearly present the risks and reasonable options to the Board.

2.16. We have also observed that DCC does not take a holistic view of total costs when carrying out cost benefit analyses of securing services through FSPs (which would be considered External Costs) or directly through providers (which would be classified as Internal Costs). In particular, in making its decision, the DCC fails to account for the overhead charge that would be applied to all Internal Costs, thereby underestimating the cost of delivering through Internal Costs. This is discussed further in section 4 specifically in relation to emulators.

3. Internal costs

Section summary

Payroll is a major component of Internal Costs: DCC's headcount is increasing as it transitions to a multi-release delivery structure and expands its operations cost centre to support customers. However, we would expect DCC to demonstrate greater focus on realising efficiencies and reversing the headcount trend as it moves into more stable operations.

DCC has justified the majority of these costs. However, DCC has provided limited evidence of customer demand for the Technical Operations team, the cost of which we are minded to disallow for both RY17/18 and RY18/19.

We welcome DCC's clear shift towards using more permanent staff rather than contractors. However, insufficient evidence has been provided to support the DCC's new approach to benchmarking contractor remuneration, as a result of which we are minded to disallow £1.476m of contractor cost in RY17/18 and £0.286m of contractor cost in RY18/19.

To facilitate its transition to a multi-release structure, DCC has sought external consultancy support, incurring significant one-off costs – it has implemented effective procurement procedures to ensure such costs are minimised. However, we are minded to disallow £0.326m associated with the System Integration consultancy support disallowed last year.

Finally, we are also minded to disallow £120.802m of forecast costs from RY20/21 to the end of the Licence term due to a lack of justification provided by DCC.

Question 2: What are your views on our proposals on DCC's Internal Costs?

Question 3: What are your views on our proposals on DCC's approach to benchmarking of staff remuneration?

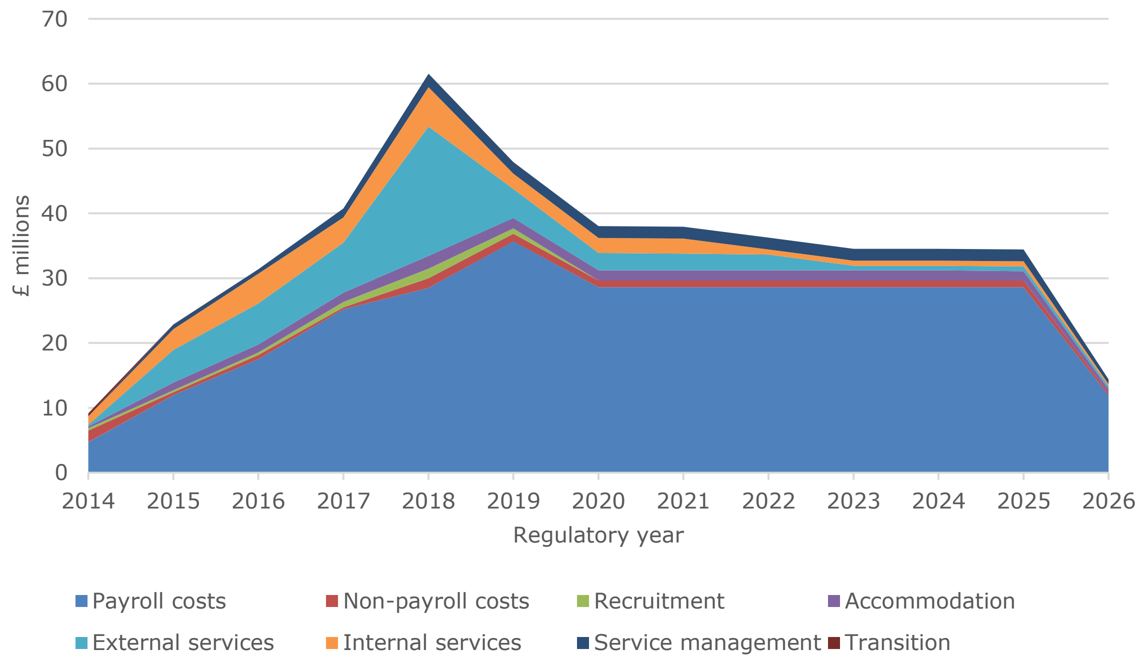
What are Internal Costs?

3.1. Internal Costs comprise the costs that are economically and efficiently incurred by DCC for the purposes of the provision of the DCC service (excluding External Costs and pass-through costs). These are defined by nine general ledger (GL) categories: payroll costs, non-payroll costs, recruitment, accommodation, external services, internal services, service management, transition, and IT services. Internal Costs are reported by 'cost centre' which cover the main activities where DCC incurs costs. Please see Appendix 3 for more detail.

How have Internal Costs changed?

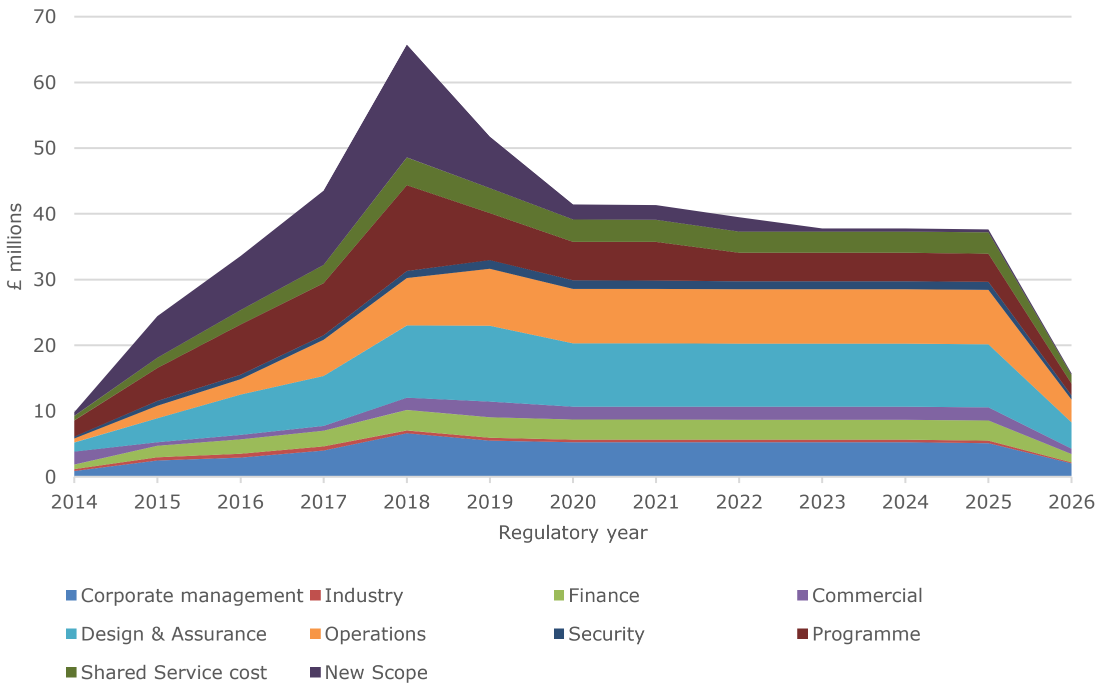
3.2. Figure 3.1 shows the distribution of costs by general ledger (GL) code over the Licence period, based on DCC's RY17/18 submission. Based on DCC's price control forecast, which includes only those costs that are significantly more likely to occur than not, internal costs peak in RY17/18, and fall in both RY18/19 and RY19/20. The GL codes are dominated by payroll costs – this reflects the fact that DCC is a relatively asset light company with a primary focus on contract management and programme delivery.

Figure 3.1: Forecast Internal Costs by cost type or GL code



3.3. Figure 3.2 shows forecast Internal Costs by cost centre. The costs associated with obligations not foreseen at LABP (New Scope) have become an increasingly significant driver of internal costs – in RY17/18 this is largely due to the SMETS1 programme. Programme, Design & Assurance, and Operations are the next three largest cost centres.

Figure 3.2: Forecast Internal Costs by cost centre

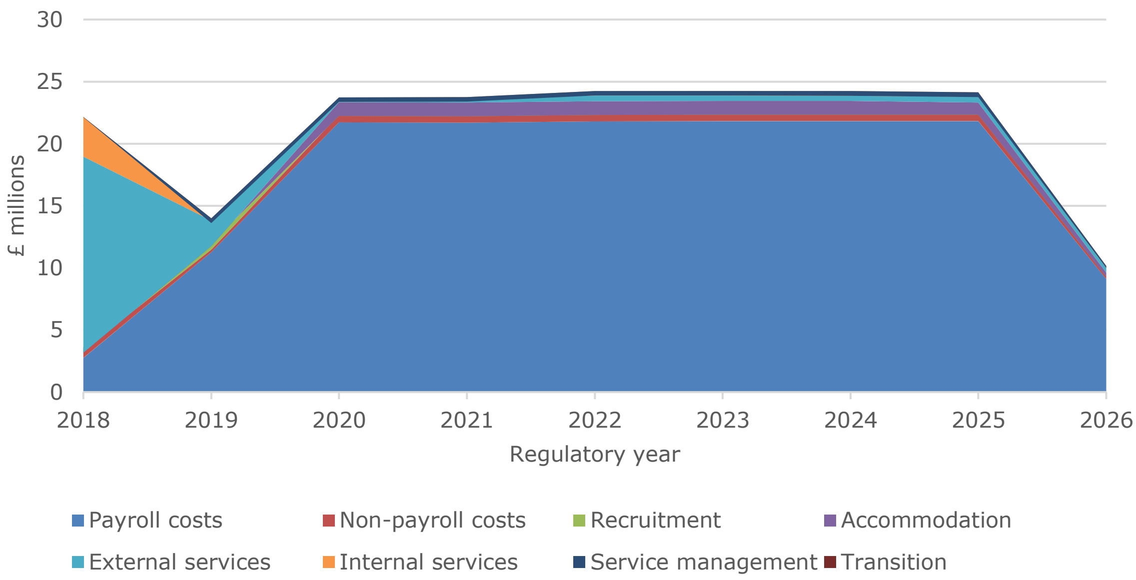


Variance on last year's forecast

3.4. In RY17/18 Internal Costs, excluding Shared Services, were £61.534m. This is £22.123m (56%) higher than forecast in RY16/17 and £51.145m higher than the LABP forecast. Over the remainder of the Licence period, Internal Costs are forecast to increase by a further £165.742m relative to the RY16/17 forecast, and by £219.4m compared to the LABP.

3.5. Figure 3.3 shows the variance in costs by GL code compared to the RY16/17 forecast. Payroll costs account for the greatest proportion of the variation in Internal Costs over all forecast years. However, in RY17/18, external services accounted for the vast majority of the variation (71%) – this was largely due to the SMETS1 programme and DCC's Project to Business programme.

Figure 3.3: Internal Cost variance by cost type or GL code relative to RY16/17 forecast (excluding Shared Services)



Payroll

3.6. DCC has applied for the payroll costs shown in Table 4.1. These show significant increases on last year's forecasts.

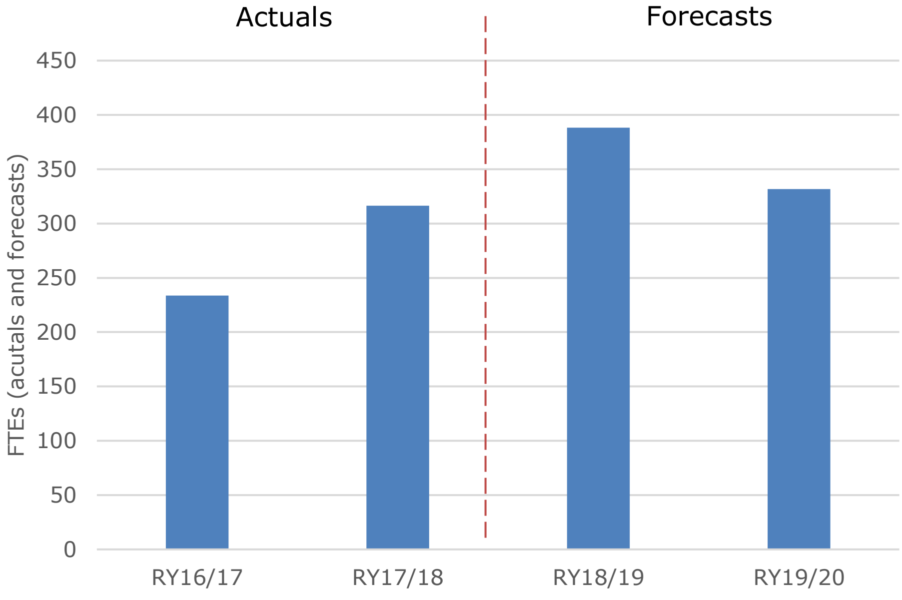
Table 4.1: Payroll costs compared to last year's forecast

Payroll (£m)	RY17/18	RY18/19	RY19/20	RY20/21	RY21/22	RY22/23	RY23/24	RY24/25	RY25/26
16/17 accepted forecast	25.770	24.420	6.903	6.903	6.788	6.777	6.777	6.777	2.818
Variation proposed in 17/18	2.752	11.265	21.720	21.689	21.804	21.815	21.815	21.815	9.092
Total	28.522	35.686	28.623	28.592	28.592	28.592	28.592	28.592	11.910

Headcount

3.7. Figure 3.4 shows that DCC's headcount is set to increase from 316 full time equivalents (FTEs) in RY17/18 to 388 FTEs in RY18/19. It is then expected to decrease to 332 FTEs in RY19/20 (these totals exclude service desk staffing). DCC did not provide forecasts for its headcount beyond RY19/20.

Figure 3.4: DCC headcount (FTEs, excluding service desk staff)



Permanent-contractor staff ratio

3.8. In the past a high proportion of DCC's staff have been contractors. In RY16/17 the ratio was around 40% contractor to 60% permanent staff. In RY17/18 there was a significant reduction in DCC's dependence on contractors. The ratio in RY17/18 was 22% contractor to 78% permanent staff.

DCC's justification

3.9. DCC provided an account of the activities and outputs for the majority of its internal resource requirement for RY17/18, RY18/19 and RY19/20. DCC explained activity at the team level and provided role profiles for every new role created during the year. DCC included one role that it subsequently clarified should not have been included as the position was not filled.

3.10. DCC explained that the increase in staff was largely driven by the transition towards a multi-release delivery model that has necessitated concurrent workstreams, as well as by a higher volume of support for End-to-End testing required, in part, as a result of higher than expected customer numbers. DCC has also undertaken several programmes to ensure that it is fully able to serve its customers in an operational capacity.

3.11. A significant amount of the variation in payroll in RY17/18 is attributed to the Centralised Registration Service (CRS/Switching) programme, which we had disallowed from previous forecasts because there was insufficient certainty.

3.12. DCC has forecast significant growth in the Operations cost centre – from 47 FTEs in RY17/18 to 80 FTEs in RY19/20. DCC explained that these members of staff are required to meet growing customer demand – arising from both increased customer numbers and increased customer expectations.

3.13. Part of this growth in the Operations cost centre is due to the creation of the new 'Technical Operations' team (11 FTEs). DCC describes this team as a single 'command centre' that will focus on the proactive monitoring of the end-to-end system operation of the DCC solution. DCC stated in its submission that this "proactive monitoring will alert DCC, and its customers, to potential problems with the systems prior to any customer impact, allowing DCC to maintain high availability and system response times in support of customer business processes".

3.14. DCC also stated that it had discussed the need for the new Technical Operations team with its customers via the "Ready to Scale" project during the year.

3.15. DCC made no specific mention of finding future efficiencies, and provided no justification for any variations in forecasted costs from RY20/21 to the end of the Licence term.

Our view

3.16. We welcome DCC's move away from its past reliance on contractor staff. DCC's move to a greater use of permanent staff is a sign that it is maturing as an organisation.

3.17. We recognise that DCC is currently in a period of increased workload, with several programmes running concurrently, alongside providing support for customers with End-to-End testing, and that this will lead to a temporary increase in headcount.

3.18. We expect to see clear and substantive evidence of customer engagement, and evidence that DCC has made the cost consequences associated with change requests and decisions clear to customers when seeking their views. The new Technical Operations team accounts for some of the headcount increase described above. DCC told us that this team was created to meet a customer need. However, we have so far seen limited evidence of how customer views were sought, including whether they had sight of cost information to enable them to assess value for money.

3.19. As a result, we are minded to disallow forecast costs associated with the Technical Operations team, unless we receive further information. This amounts to £0.808m in RY18/19 and £0.855m in RY19/20.

3.20. We are also minded to disallow forecast costs associated with the single role that DCC informed us was incorrect, which amounts to £0.067m in RY18/19 and £0.071m in RY19/20.

3.21. **In aggregate, we are minded to disallow £0.875m of forecast payroll costs in RY18/19, and £0.926m of forecast payroll costs in RY19/20.** We would welcome views from DCC's customers, and further evidence from DCC, on the need for the Technical Operations team and will take this into account in our final decision.

3.22. We are concerned that, in its submission, DCC has made no mention of finding future efficiencies. We expect that, as DCC becomes a more mature organisation, it should be able to find such efficiencies and be able to reduce its headcount. In particular, as current projects (such as SMETS1, DBCH and switching) draw to a close, we would expect to see increased efficiencies and forecasts for those efficiencies included in future submissions. We also consider that DCC should publish and commit to efficiency targets in order to demonstrate to customers that cost efficiency is central to its business planning strategy.

3.23. **We are minded to disallow all payroll and associated forecast cost variances from RY20/21 to the end of the Licence term, amounting to £120.802m.**

Benchmarking

Context

3.24. Under the price control we expect DCC to employ staff at economic and efficient remuneration levels. In the previous three price controls, DCC provided evidence of this through a benchmarking exercise that compared salaries to equivalent roles in the wider employment market, using the Hay Group's "PayHub" salary database.[4]

3.25. In this year's submission, DCC has used the same approach to benchmark the remuneration of permanent members of staff, but has developed a new approach for contractors.

3.26. DCC states that its default strategy when recruiting permanent candidates is to offer total remuneration packages that are in-line with market averages. For benchmarking purposes, using the Hays database, the "market average" would be defined as the 50th percentile of a distribution of salaries for comparable roles.

3.27. However, there are no similar, commercially-available benchmarking databases for contractors. DCC states that obtaining reliable and comparable benchmarks has always been difficult. As a result, DCC has benchmarked contractors based on calculating a "contractor premium" compared to permanent staff members' remuneration.

DCC's justification

Permanent staff

3.28. Although its objective is to offer market average remuneration for permanent members of staff, DCC recognises that in certain cases, it may have to offer higher than the 50th percentile of the benchmark to attract the right candidates (for example, when the role requires very specific technical skills which are in short supply, or when the role is crucial to ensure that DCC can meet agreed deadlines). Recruiting managers are given the discretion to offer a salary at up to 10% more than the benchmark. If a recruiting manager wishes to offer in excess of this, an internal business case is required to be presented to the Value-for-Money Board for approval.

3.29. DCC also states that it benchmarks at various stages during the recruitment process:

- Before the role is launched;
- Before DCC chooses to interview a candidate; and
- Before agreeing a remuneration package with a candidate.

[4] Please see chapter 4 and appendix 3 in the RY14/15 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

3.30. As part of its submission, and with the aim of demonstrating that the remuneration offered to permanent members of staff is economic and efficient, DCC compares the remuneration of permanent members of staff with the Hays 50th percentile. The comparison is presented at the level of the cost centre.

3.31. For most cost centres, permanent staff remuneration was under the 50th percentile. DCC states that the biggest driver for this was that no bonuses were paid between 1st April 2017 and 31st March 2018 – this was due to an internal decision to align corporate and personal objectives to the Regulatory Year (bonus payments were made in February 2017 and then in May 2018, with no payment during RY17/18).

Contractors

3.32. DCC states that, for contractors, its aim is to ensure that the day rate on offer is not higher than the equivalent of a 50% annual remuneration premium on top of permanent staff remuneration. This is determined by using its internal HR database where roles are compared and a contractor premium can be assigned to each role. As with permanent staff, DCC recognises that, in certain cases, it may need to offer day rates in excess of a 50% premium to attract the right candidates. As a result, an internal business case has to be submitted to the Value for Money Board for approval before agreeing day rates which are more than 10% higher than the benchmark.

3.33. As with permanent staff, DCC states that it benchmarks at various stages during the recruitment process:

- Before the role is launched;
- Before DCC chooses to interview a candidate; and
- Before agreeing a remuneration package with a candidate.

3.34. As part of its submission, DCC set out its approach to benchmarking contractors. To ensure that it is comparing like for like, DCC takes the annual remuneration package of a permanent member of staff and compares it to the annual remuneration equivalent of a contractor, where possible using exactly the same defined job roles. It is thus able to work out the contractor premium for each contractor employed in RY17/18.

3.35. DCC states that it further assures the level of the contractor premium, examining external data on contractor premiums. This data shows a premium of 45% for IT Management positions and of 39% for IT Non-Management positions.

Our view

Permanent staff

3.36. We note that the exclusion of bonus payments has had an impact on DCC's reported performance against the benchmark during RY17/18.

3.37. We believe that the inclusion of bonus payments at a level similar to that in previous years would result in a position where, for DCC as a whole, aggregate remuneration of permanent members of staff would be marginally above the 50th percentile.

3.38. DCC is expected to justify payments above the 50th percentile in its submission. DCC has identified instances in which remuneration above the 50th percentile is acceptable for permanent staff. These include exceptional relevant experience, the fact that there are only a few suitably qualified candidates, a lack of specialist skills, and the urgent need for input in order to meeting programme deadlines.

3.39. In DCC's submission, these justifications have tended to be provided at a company-wide, as opposed to cost centre-specific, level. In future years, we would encourage DCC to provide more detailed and focused justification for the higher rates of pay made to permanent staff in those cost centres which report remuneration above the 50th percentile.

3.40. Nevertheless, we consider that the permanent staff costs have been shown to be economic and efficient.

Contractors

3.41. We recognise that DCC has made considerable progress in reducing its dependence on contractors and acknowledge that contractors need to remain part of DCC's resource mix as they may be the most economic and efficient choice where there is not a permanent need for a specific skill. As in previous years, we accept that there are a number of reasons why contractors may be paid more that equivalent permanent members of staff.

3.42. DCC has provided detailed information on the actual remuneration of contractors and equivalent permanent staff members, and set out the way in which the contractor premium is calculated for individual roles.

3.43. In developing its new approach to benchmarking contractors, DCC has proposed using a 50% "contractor premium" as the benchmark against which its achievement of the economic and efficient employment of contractors is measured, using permanent staff member remuneration as the baseline. DCC states that the 50% premium is derived from an examination of its internal records and past practice and is broadly similar to data published by an IT recruitment agency. However, we consider that this evidence is neither sufficient nor robust enough to justify the choice of 50% as the level of the contractor premium benchmark. In addition, evidence submitted to us of the application of the benchmark during the recruitment process has been inconsistent.

3.44. We have previously accepted that contractors will be paid more than equivalent permanent members of staff. However, in both RY15/16 and RY16/17, we disallowed costs which were above DCC's benchmark where those costs were not properly justified by DCC.

3.45. We have calculated that the contractor premium totals £2.233m in RY17/18 and £0.423m in RY18/19. Based on the evidence that DCC has provided to us in previous years, we accept that a contractor premium of 20% is reasonable, which would total £0.757m in RY17/18 and £0.136m in RY18/19. We have not been provided with sufficient evidence in this year's submission to be able to assess further costs as acceptable.

3.46. **We are, therefore, minded to disallow £1.476m of contractor cost in RY17/18 and £0.286m of contractor cost in RY18/19 as not economic and efficient.**

3.47. As in previous years, we remain open to receiving additional evidence from DCC to justify its remuneration of contractors and would use such evidence to revisit the proposed disallowance.

3.48. We expect to see DCC applying a consistently robust approach to recruiting contractors, making an appropriate use of benchmarking to determine rates of remuneration for each appointment. We also expect DCC to be able to provide evidence of its decision-making. We remain open to exploring, with DCC, whether a new approach to benchmarking contractor remuneration could be based around the establishment of an auditable recruitment process.

External services

3.49. DCC has applied for the external services costs shown in Table 4.2. These show, in particular for RY17/18, a significant increase on last year's forecast.

Table 4.2: External Service costs compared to last year's forecast

Ex. Ser. (£m)	RY17/18	RY18/19	RY19/20	RY20/21	RY21/22	RY22/23	RY23/24	RY24/25	RY25/26
16/17 accepted forecast	4.150	2.433	2.419	2.309	1.979	0.279	0.293	0.280	0.081
Variation proposed in 17/18	15.808	2.055	0.220	0.253	0.451	0.441	0.427	0.441	0.391
Total	19.959	4.488	2.639	2.562	2.430	0.720	0.720	0.721	0.472

3.50. Where DCC is procuring services in lieu of carrying out the work in-house, it needs to prove that it was economic and efficient to do so.

DCC's justification

3.51. DCC provided us with an explanation of the need for each of the external services it procured. It also provided us with the range of options that it considered could meet that need, and set out why it chose the procurement of the external service over the alternative options. Finally, DCC provided us with evidence of the procurement process that it undertook when procuring these external services.

3.52. In RY17/18, as part of the SMETS1 enrolment and adoption project, DCC signed contracts with several key service providers who are currently managing the communications infrastructure for SMETS1 meters. A very large proportion of variation proposed by DCC is related to these contracts.

3.53. In RY17/18 DCC undertook a new programme of work called Project to Business which aimed to enhance DCC's ways of working. The programme was undertaken to ensure that the live service can operate at scale; that new services can be delivered to time, cost and quality; and that more robust processes are in place. Part of the programme involved procuring external services to audit and improve the DCC's internal processes and systems.

3.54. Other external services were procured for a range of services including Device Integration Testing (DIT) support, the SOC2 audit, and the provision of emulators (please see section 4 for detail on their procurement in relation to Shared Services).

3.55. In RY16/17 DCC contracted a consultancy to support the delivery of the Systems Integration function. The costs associated with this contract were disallowed in the RY16/17 price control decision. DCC applied for the costs related to this contract which fell in RY17/18 to be allowed in this year's price control.

Our view

3.56. The detailed and thorough explanation of the procurement process that DCC undertook when procuring external services has assured us that DCC has obtained the most economic and efficient contracts for the external services that it sought to procure.

3.57. DCC has prepared for its transition to a more mature organisation through a Project to Business initiative. We recognise that this has resulted in one-off costs this year, particularly in external services.

3.58. We note that the Project to Business initiative was specifically focused on capability-building and not on finding efficiencies, despite our calls in last year's price control decision to focus on business efficiencies.

3.59. With regards to the procurement of emulators, we are concerned that DCC did not take into account the Shared Services costs that are incurred in its overall assessment of value for money. This is discussed further in in section 4.

3.60. In line with our decision last year, we find that the costs associated with the consultancy contracted to support the delivery of the Systems Integration function are not economic and efficient. **We are therefore minded to disallow all costs associated with the System Integration consultancy work, which amount to £0.326m.**

4. Shared Services

DCC pays a Shared Service Charge to Capita for the provision of certain internal support functions and DCC is required to ensure that those costs are economic and efficient. This section examines the DCC's approach to Shared Services for RY17/18 across three key areas:

- Considering whether Capita's services have kept up with DCC's needs as the company has grown, particularly as the Shared Service Charge is determined as a fixed percentage of DCC's internal costs for baseline activity. This section also examines whether DCC may be starting to self-provide services that might be expected to be provided by Capita, resulting in increased costs to customers;
- Considering whether DCC's approach to procuring emulators took account of the Shared Service Charge associated with bringing the service in-house; and
- Considering whether DCC has provided sufficient evidence that Switching benefitted from £0.291m of Shared Services (a sum determined as a result of DCC's proposal that a 7.22% Shared Services charge should apply to Switching for RY17/18).

Question 4: What are your views on our proposals for Shared Services?

Context

4.1. DCC pays a Shared Service Charge to cover support services such as HR tools, property services, payroll, IT and senior management input. It is an amount paid by DCC for Shared Services sourced from DCC's parent company, Capita. 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.[5]

4.2. 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 has committed, as part of its procurement strategy, to review these costs on a regular basis and ensure and demonstrate that they remain competitive. DCC must also ensure there is no cross-subsidisation across affiliates or related undertakings.[6]

4.3. Given the significant increase in DCC costs since the Licence award and the fact that it is now performing additional activities which were not included in the LABP, it is important that DCC continues to monitor its Shared Services costs to ensure that they are economic and efficient. For example, these additional activities may not draw upon the Shared Services from Capita in the same proportions.

[5] A cost related to the communications hubs was excluded from the charge in the LABP.
[6] This is a requirement under Licence condition 11 of the Smart Meter Communication Licence.

4.4. In February 2017[7], we decided that in future years we would not require further justification for the Shared Service Charge associated with baseline activity for price control purposes. We accepted that a Shared Service Charge, as a proportion of Internal Costs for baseline activity, formed part of Capita's bid for the DCC Licence and, as such, was tested through competition as being economic and efficient. We also considered it justified as DCC demonstrated that Capita's Shared Services delivered value for money compared to the 'stand-alone' counterfactual scenario.

4.5. At that time, we also said that for new scope activities which were not included in the DCC's Licence bid, DCC must continue to provide justification to demonstrate that any shared service cost relating to these activities are economic and efficient. DCC must fully justify applying any Shared Service Charge on future new scope costs.

4.6. Last year, we accepted the 9.5% Shared Service Charge associated with the delivery of the baseline requirements of the DCC's core smart metering service, including SMETS2 systems, SMETS1 enrolment and provisions of DBCH.

4.7. However, we considered that DCC did not provide any evidence to show how switching activity benefitted from the Shared Services provided by Capita. As a result, the shared service costs associated with the switching programme were disallowed (a cost of £0.091m).

Shared Services provided by Capita

4.8. The support services covered by the Shared Service Charge are listed in section 3.3.1 of the redacted LABP and a non-exhaustive list of examples of Shared Services is included in Appendix 2 of the RIGs.

4.9. From the submission, we have some questions over whether DCC is starting to provide some services that might be expected to be provided by Capita under the Shared Service Charge. For example:

- DCC states that, within the Finance cost centre, the Finance Transformation Team has identified a number of enhancement projects for RY18/19, including "Move BPC to Cloud based system to reduce reliance on Capita infrastructure and improve performance of the system".
- DCC states that the Risk & Compliance function will "continue to be important to DCC and is likely to expand in future to manage a more complex regulatory environment… Although Capita provides audit within the existing Shared Services, it is currently only expected to carry out a single audit each year. This will reduce the burden on the team, but not fully meet our expected needs."
- DCC also states "Following review of the compliance and reporting requirements placed on DCC and the likelihood that these will grow as the REC develops, a decision was taken to set up an Internal Audit function to ensure that all compliance and business testing and assurance could be carried out."
- DCC states that "Whilst Capita continues to provide many of the transactional HR services required by DCC, it was recognised that there needed to be a local

[7] https://www.ofgem.gov.uk/system/files/docs/2017/03/2017.02_data_communications_company_dcc_price_control_decision_201511.pdf

capability to support the ongoing development of the workforce through performance management, training and development and succession planning. In addition, as DCC finds itself competing for expertise more akin to the high-tech sector, a key strand of work for the People team is in building a culture and employee offer which is attractive to the calibre of people we need to recruit and retain."

4.10. It appears from the submission that the changes are, in part, driven by a perceived shortfall with the performance of the services provided under the Shared Service Charge by Capita.

4.11. It also appears from the submission that there is a lack of clarity over the precise services that are and should be provided under the Shared Service Charge. This makes it difficult for DCC to monitor the provision of those services and ensure that those costs are incurred in an economic and efficient manner. The possibility of duplication of services risks additional cost to DCC's customers.

DCC's justification

4.12. DCC has stated that there is no conscious strategy to move away from the use of the services provided by Capita under the Shared Service Charge.

4.13. However, DCC has stated that Capita offers only basic services under the Shared Service Charge. As a result, DCC considers that any value-added services (which need to be tailored to DCC's specific needs) have to be self-provided.

Our view

4.14. In its submission, and in subsequent discussions, we have some questions over whether DCC understands the full range of services that should be provided under the Shared Service Charge and whether it is ensuring that those services are provided in full.

4.15. We are concerned that this could lead to increased costs for customers.

4.16. We would, therefore, strongly encourage DCC to actively ensure and demonstrate that it is achieving value for money from the Shared Service Charge.

Shared Service Charge on external services

4.17. The Shared Service Charge applies to external services that are procured by DCC. In RY17/18 DCC incurred a cost of £1.185m in relation to the procurement of single band and dual band emulators as external services. DCC has estimated the cost of continued monthly support under the contracts at £0.404m in RY18/19.

4.18. An emulator is a test tool which comprises a common physical enclosure with an ICHIS interface, capable of powering a communications hub. The unit can be programmed to carry out all functions of a meter other than the actual metrology.

4.19. It was originally envisaged that emulators would only be used in Pre-Integration Testing (PIT), and that they would be procured by the FSPs themselves from their suppliers. It was envisaged that actual meters would be available for System Integration Testing (SIT), provided and supported by meter manufacturers. However, meters were not available from manufacturers to be used in time for SIT. As a result, an alternative option for testing was needed, so emulators developed for use in SIT had to be used.

4.20. The DCC procured the emulators from System Level Solutions (SLS), Telefonica's emulator provider, through a single source procurement strategy (Telefonica was the only service provider who had achieved the development of emulators). DCC had also considered procuring the emulators from EDMI, Arqiva's emulator provider; changing the CSP contracts to require them to procure the emulators; and producing a specification for the emulators and going out to market to source a new provider. The DCC states that all of these other options would have been more costly and more time consuming. In addition, it was considered that SLS's product has been highly successful to date and that their support had resolved issues rapidly.

4.21. Nevertheless, as a single source procurement, DCC carried out extra levels of internal approval, seeking approval from the Executive Committee (ExCo), and passing the sourcing strategy through the Value for Money Board.

4.22. In adopting this approach to the procurement, DCC has chosen to make what was expected to be an External Cost (ie procured through the FSP) into an Internal Cost (defined as an external service within the Design and Assurance cost centre). As an Internal Cost, the value of the contract incurs the 9.5% Shared Service Charge. This cost is imposed on customers.

4.23. In coming to a decision on the preferred approach to the procurement, all the costs and benefits (whether attributed a monetary value or not) imposed on or realised by customers should be taken into account. This means that the cost of procuring the emulators through the FSP should be compared against the cost of directly procuring the emulators through SLS plus the 9.5% Shared Service Charge.

DCC's justification

4.24. DCC has set out a number of reasons for its approach to the procurement, including:

- SLS had been successfully supplying emulators to Telefonica, while EDMI, Arqiva's supplier, had not developed their emulator for SIT and their unit was more expensive than that supplied by SLS.
- DCC considered that it was preferable for the de facto acceptance standard to be supplier independent, rather than one CSP be the supplier for the other, and that DCC was best placed to do that assurance.
- At this stage of the product lifecycle it was considered extremely unlikely that any new entrant could match the level of SLS's cumulative knowledge without imposing a significant development overhead and associated time delay.
- There is a benefit to DCC in procuring emulators directly rather than incurring a mark-up applied by the CSP.
- By going direct to SLS, DCC was able to take control of a key testing tool and could ensure that it was fit for purpose for DCC requirements, as opposed to having to act through the CSPs.
- In addition, choosing SLS would minimise potential delay to the programme.

4.25. DCC also checked that SLS was not double charging for services that were already paid through Telefonica's contract. This was affirmed and the contract included a credit of £311,150.

4.26. However, DCC could neither provide evidence nor confirm that the 9.5% cost of Shared Services was taken into account in the evaluation of alternative options or in the decision-making process. In addition, DCC could not confirm that the savings had been greater than the 9.5% Shared Service Charge.

Our view

4.27. DCC has an obligation to ensure that its costs are economic and efficient. We have seen no evidence that DCC considered the cost of Shared Services when it decided to directly procure the emulators from SLS rather than through the CSP. As a result, we do not consider that DCC has justified the Shared Service Charge on emulators as being economic and efficient.

4.28. **We are therefore minded to disallow the Shared Service Charge on the emulators contracts (£0.113m for RY17/18 and £0.038m for RY18/19, a total of £0.151m).** We strongly encourage DCC to ensure that it considers all costs and benefits (whether attributed a monetary value or not) in future cost-benefit analyses.

Shared Services on Centralised Registration Services (CRS)

4.29. In RY16/17, DCC did not provide any evidence to show how switching (CRS) had benefitted from the Shared Services provided by Capita. As a result, we did not find the 9.5% applied to switching costs as economic and efficient, and disallowed the Shared Services charge (£0.091m) associated with the switching programme.

4.30. In RY16/17, we stated that, in future years, DCC must continue to provide full justification to demonstrate that any shared service cost relating to new scope activities which are not related to the delivery of the core smart metering system (including baseline activity, SMETS2, DBCH and SMETS1) are economic and efficient. We expected DCC to do this by providing sufficient evidence or justification of the benefits from the Shared Services provided by Capita related to any new scope activity.

4.31. Switching is considered to be a new scope activity.

DCC's justification

4.32. In its submission, DCC sets out its approach to estimating a shared service rate for the Switching programme, an approach which DCC hopes to use for future new scope activities.

4.33. The approach draws upon the work undertaken in RY16/17 to justify the 9.5% Shared Service Charge. In summary:

- A list of services that DCC had identified as being provided by Capita had previously been created;

- Each of the services were examined and included if it legitimately creates extra cost for Capita due to the additional new scope activity (the decision on whether to include or exclude certain services was, therefore, based on whether or not DCC believed the Switching Programme utilises these services or whether the service would be the same regardless of whether the new scope existed);
- DCC updated the cost values;
- The costs were then weighted to calculate a new rate.

4.34. In its submission, DCC provided a detailed explanation of its approach, along with the related calculations.

4.35. The result of the work was that DCC has proposed a 7.22% Shared Services rate for Switching. This was calculated at £0.291m in RY17/18.

Our view

4.36. As a new scope activity, DCC needs to provide full justification that any Shared Services costs related to Switching are economic and efficient.

4.37. We expect DCC to do this by providing sufficient evidence/justification of the benefits received by Switching from the Shared Services provided by Capita. In particular, we consider that this justification should be focused on demonstrating that the monetary value of the Shared Services received by Switching are economic and efficient. We do not consider that the approach of determining the value of the shared service charge for Switching as a percentage of the cost centre's internal costs satisfies this criterion. We also do not consider that the focus in the submission on calculating a shared service rate demonstrates that the value of the shared service charge for Switching is economic and efficient.

4.38. We do not consider that DCC has provided sufficient evidence/justification as to how the Switching business benefited from £0.291m of Shared Services during RY17/18. **As a result, we are minded to disallow the £0.291m of shared service costs for Switching.**

5. Understanding customer needs

Section summary

DCC's customers have an important role to play in scrutinising DCC costs because, as customers, they are particularly well-placed to judge value for money. We want to see DCC decisions strongly informed by an understanding of its customers' needs, replicating the pressures a company would experience in a competitive market. DCC has taken steps to strengthen its engagement with customers. But informal feedback from DCC customers remains that they feel that they are not always offered the right opportunities to inform DCC decisions, with a particular gap where DCC is making internal decisions on changes to the services that it provides to its customers. Customers have also said that, more generally, they want to see greater transparency from DCC on its costs.
We would expect that, for future price control submissions, DCC will provide more robust evidence of how it has taken customer views into account, with our expectations reflected in revised guidance processes and procedures.

Question 5: What are your views on our proposal to expect more robust evidence from DCC on how it has taken customer views into account in future price control submissions?

Question 6: What are your views on the processes that DCC should establish to enable meaningful customer input to decision-making?

Background

5.1. Respondents to the RY16/17 price control consultation made it clear that they wanted more proactive engagement from DCC with its customers on costs, either directly or via Smart Energy Code (SEC) processes. Our view, published in the RY16/17 price control decision document, was that we supported customers' requests for greater engagement and we advised DCC to take note of customers' suggestions.

5.2. There are two enduring routes through which decisions on changes to DCC's services to its customers are made.

5.3. The first is through the SEC modifications process, where options for changes to the core DCC functions and systems as defined by the SEC are considered collectively by DCC's customers, informed by costed impact assessments, and supported by a structured and transparent governance and decision-making process. We note that the SEC Panel and secretariat are looking for continuous improvements to the modifications processes, which we welcome.

5.4. The second is through DCC's internal governance processes, where decisions on those aspects of service delivery that are not defined in the SEC are made. DCC has established some arrangements to enable it to take account of customer views when it makes these decisions, for example through consultation on its business plan, engagement with the SEC operations sub-group, and bilaterals with suppliers. However, customers have told us that this engagement is not always timely or appropriately informed by cost data, and that it is not transparent to them how their views are taken into account. In turn, the evidence that we receive in the price control submission of how customer views have been meaningfully taken into account in making decisions is limited.

5.5. DCC seeks to provide broader transparency to customers on costs through activities such as a quarterly finance update, and we welcome that DCC has again this year agreed to share parts of its price control submission.[8]

DCC's justification

5.6. DCC has engaged with customers through a range of different forums and channels. However, DCC itself has acknowledged the need to make engagement with its customers more structured and systematic and embed it within the decision-making process.

Our view

5.7. We scrutinise DCC's costs through the price control process, seeking to ensure that costs are economically and efficiently incurred, and we are continually looking for opportunities for improvement. We expect, in future submissions, that DCC will provide more robust evidence of how it has taken customer views into account in determining the way forward for decisions that have an impact on the cost of customer services, with our expectations reflected in revised guidance.[9]

5.8. We would expect this to mean that DCC would establish a structured set of arrangements to facilitate meaningful input from customers, which would enable input that is:

- Timely, with customers able to feed in views at appropriate points in the life cycle of a decision, from initial scoping to final decision
- Informed, with customers provided with information that enables them to compare the costs and benefits of different options
- Transparent, with customers clear about when and how they can contribute views and how these are taken into account
- Proportionate, which would mean greater customer input for those decisions with greater potential impact. It may, for example, be appropriate to establish cost thresholds above which different arrangements for customer input and scrutiny would apply.

5.9. Our current view is that these outcomes are likely to be best achieved by a combination of activities led by DCC and the SEC Panel/sub-groups, and that DCC should work with the SEC Panel to develop and agree a clear set of defined activities and procedures.

5.10. Note that while we welcome and encourage transparency from DCC on other costs, such as those linked to corporate decisions (eg accommodation or human resources) and management of external contracts, we are not currently proposing that DCC

[8] https://www.smartdcc.co.uk/about-dcc/price-control/

[9] https://www.ofgem.gov.uk/system/files/docs/2018/06/2018.06_processes_and_procedures_guidance.pdf

should strengthen customer input into decisions in these areas. Instead, our focus is on improving the way DCC takes customer views into account in the types and range of services – and their costs - offered by DCC.

6. Baseline Margin adjustment and External Contract Gain Share applications

Section summary

This section summarises DCC's application for adjustments to its Baseline Margin and External Contract Gain Share.

DCC submitted an application for an adjustment to its Baseline Margin of £7.761m for RY17/18 to RY19/20. We find that DCC has not provided sufficient evidence to support part of its application and are minded to reduce it by £1.706m. Considering both this and the disallowances from our assessment of Internal Costs, unless we receive further information we are minded to amend DCC's Baseline Margin application and allow £5.948m.

DCC submitted an application for an adjustment to its External Contract Gain Share of £13.204m across RY19/20-RY24/25. This was as a result of refinancing agreements for set-up payments. We are minded to accept DCC's External Contract Gain Share application.

Question 7: What are your views on our assessment of DCC's application to adjust its Baseline Margin?

Question 8: In its submission, in support of its application for an adjustment to its Baseline Margin, DCC states that there has been a significant unanticipated change in customer expectations, and in customer and service provider demands. What are your views?

Question 9: What are your views on our assessment of DCC's application for External Contract Gain Share?

Baseline Margin

Background

6.1. The formula for DCC's Allowed Revenue contains a Baseline Margin (BM) term which was included so that DCC would earn a margin above its costs. This is a fixed amount that is given for each year in the Licence. However, it can be altered through the Baseline Margin adjustment mechanism. Over the Licence term the Baseline Margin is £34.939m in total, including adjustments made in previous years.

6.2. The Baseline Margin adjustment mechanism allows DCC to apply for a Relevant Adjustment to the Baseline Margin values specified in Appendix 1, Condition 36 of the Licence. The adjustment mechanism is detailed in Appendix 2, Condition 36 of the Licence.

6.3. The Baseline Margin adjustment mechanism was included in the Licence in recognition of the uncertainty of the nature and risks of DCC's Mandatory Business over the

Licence term. The adjustment mechanism is intended to ensure that DCC is compensated for material changes in certain aspects of its Mandatory Business – including the volume, characteristics, risks and timescales of these activities. Greater detail of the conditions and requirements for a Baseline Margin Relevant Adjustment can be found in the RIGs and the processes and procedures document.

6.4. DCC's Baseline Margin (including adjustments) is subject to DCC's performance regime under which its Baseline Margin may be reduced for poor performance. The Operational Performance Regime will begin in RY18/19, and Baseline Margin recovered in RY17/18 as part of the Allowed Revenue will be put at risk across the first three years of the Operational Performance Regime – RY18/19, RY19/20 and RY20/21.

DCC's application

6.5. Alongside its RY17/18 price control submission, DCC has applied for a £7.761m adjustment to its Baseline Margin over RY17/18, RY18/19 and RY19/20. This is a 22% increase in the total Baseline Margin over the Licence term, and would bring it to a total of £42.700m.

6.6. DCC has identified eight new drivers (with 22 sub-drivers) of change to aspects of its Mandatory Business (shown in Table 6.1). In addition, DCC has applied for adjustments where there is increased cost certainty associated with drivers accepted in RY16/17, including for activity related to SMETS1 and R2.0.

Table 6.1: New drivers and their corresponding sub-drivers as identified in the Baseline Margin application

Driver	Sub-driver
Moving from Project to Multiple Programme Delivery	Multi-release
	Multi-programme
	Increased Security Requirements
Operational Change	Moving Beyond ITIL
	Operating Model
	Scope of Support
	Service Standard Expectations
Supporting a Changing Business	Resource Planning and Management
	People Transformation
	Support
	PA Support
	Compliance Volume Increase
Increase in Customers	Increase in Customers
	Increase in Test Participants
Technology Driven Change	Tech Transformation Programme
	Increase in Devices
Commercially Driven Change	Increase in Key Suppliers
	Strategic Procurements

Regulatory Change	**Performance Reporting and Price Control**
	Future Incentives and Regulatory Regimes
	Regulatory Change
Moving from the Government-Led Transition Phase	**Moving from the Government-Led Transition Phase**

6.7. DCC has stated in its application that these drivers have caused an increase in the volume of its activities, an increase in the complexity of its activities, and a reduction of timescales of its activities.

6.8. To calculate the proposed adjustment, DCC first quantified the change in volume of activities associated with each driver in terms of the number of FTE resources that have worked on them, as well as the additional external services used in lieu of DCC recruiting more in-house resources. DCC then calculated all costs associated with these roles. Finally, DCC calculated the Baseline Margin such that it was 15% of the sum of the Baseline Margin and associated costs for each role (this is consistent with previous years and the original Baseline Margin given in the Licence – please see the RY16/17 price control consultation document for more information).

Our view

6.9. We consider that the conditions for DCC to make a Relevant Adjustment to the Baseline Margin have been met. However, DCC has not provided sufficient evidence to support the full amount for which it has applied.

6.10. As part of last year's price control decision we proposed that all Internal Costs relating to core smart metering activities should continue to earn a 15% margin, as the activities are similar in nature to those included within the LABP and the original BM was awarded following a competitive tender process.

6.11. For RY17/18 we continue to regard 15% to be an acceptable margin for core smart metering activities.

6.12. We have identified nine of the twenty-two sub-drivers where we have seen insufficient evidence of a material change to the named aspects of the Mandatory Business that could not have been foreseen, or for which the driver does not appear to meet the conditions for a Relevant Adjustment given in the Licence.

6.13. Within the Operational Change driver, we find three sub-drivers for which DCC has provided insufficient evidence – Moving Beyond ITIL, Operating Model, and Service Standard Expectations. Under the Moving Beyond ITIL sub-driver, DCC states that customers now expect more than ITIL as a level of support. Under the Operating Model sub-driver, DCC states that it expects its operating model to grow due to an increase in customer and service provider demands. Under the Service Standard Expectations sub-driver, DCC states that customers are expecting services beyond the original assumptions at LABP. DCC has provided us with insufficient evidence that there has been a significant unanticipated change in customer expectations, and in customer and service provider demands.

6.14. Within the Supporting a Changing Business driver, we find that one sub-driver does not meet the conditions for a Relevant Adjustment given in the Licence. Under the Compliance Volume Increase sub-driver, DCC argues that its compliance capability needs to evolve due to its larger size. Our view is that DCC's compliance work has not significantly increased beyond what could have reasonably been expected at Licence award.

6.15. Within the Regulatory Change driver, we find that all three sub-drivers do not meet the conditions for a Relevant Adjustment given in the Licence – these are Performance Reporting and Price Control, Future Incentives and Regulatory Regimes, and Regulatory Change. Under the Performance Reporting and Price Control sub-driver, DCC argues that the size and complexity of the price control has increased. Under the Future Incentives and Regulatory Regimes sub-driver, DCC argues that it requires staff to work on its transition to an ex-ante price control. Under the Regulatory Change sub-driver, DCC argues it anticipates a large number of SEC modifications and an increase in regulation due to half hourly settlement. Our view is that DCC's regulatory burden has not increased materially in any of the relevant aspects stated in the Licence.

6.16. Within the Commercially Driven Change driver, we find that one sub-driver does not meet the conditions for a Relevant Adjustment given in the Licence. Under the Strategic Procurements sub-driver, DCC states that it needs to re-procure existing contracts which are due to expire in the Licence term. Our view is that the need for this re-procurement would have been known at the time of the original procurement. As a result, this work was not unanticipated.

6.17. We find that the Moving from the Government-Led Transition Phase driver does not meet the conditions for a Relevant Adjustment given in the Licence. DCC argues that the characteristic of the business is changing as it moves from being government-led to setting its own direction. Our view is that it was always intended for DCC to set its own strategic direction.

6.18. Finally, there are a set of Finance roles for which DCC has not provided a relevant argument for their inclusion in the application.

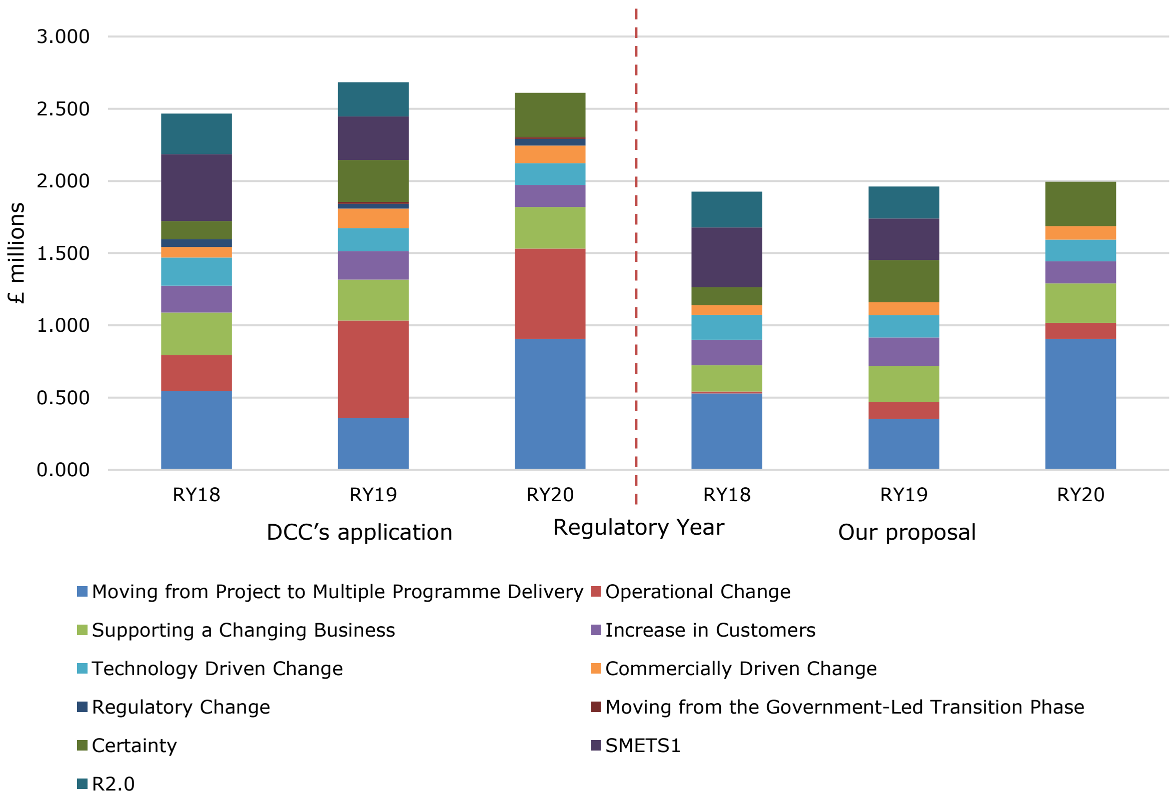
6.19. In addition to these disallowances, DCC cannot receive a Baseline Margin adjustment on costs that are not economic and efficient. We calculate the effect of the proposed disallowances in the cost assessment on the Baseline Margin application to be £0.106m.

6.20. Taking all of these disallowances into account, we are minded to amend DCC's application to an adjustment of £5.948m between RY17/18 and RY19/20, as shown in Table 6.2 and Figure 6.1 below. This is a 17% increase in the total Baseline Margin over the Licence term, and would bring it to a total of £40.888m.

Table 6.2: Proposed Baseline Margin compared to Baseline Margin as of the RY16/17 price control decision

Baseline Margin (£m)	RY17/18	RY18/19	RY19/20	Total
Allowed margin as of RY16/17 decision	3.154	8.852	2.469	14.475
Result of RY17/18 application (Difference from RY16/17)	5.620 (2.466)	11.536 (2.684)	5.080 (2.611)	22.236 (7.761)
Result of RY17/18 proposed decision (Difference from RY16/17)	5.132 (1.978)	10.829 (1.976)	4.463 (1.994)	20.424 (5.948)

Figure 6.1: Comparison between DCC's application and our proposed adjustment



External Contract Gain Share

Background

6.21. The formula for DCC's Allowed Revenue includes an External Contract Gain Share (ECGS) term which allows for an upward adjustment to the Allowed Revenue where DCC has secured cost savings in the FSP contracts. This is so that DCC has an incentive to seek and achieve cost savings in the FSP contracts. This term is zero unless DCC applies for a Relevant Adjustment to this term.

DCC's application

6.22. DCC has applied for a Relevant Adjustment to the ECGS term for RY19/20-RY24/25 that reflects a reduction in External Costs as a result of refinancing agreements for set-up payments. DCC's role in securing the refinancing savings included: setting up a specialist team within DCC to implement refinancing; launching an external procurement to assist DCC in exploring alternative finance arrangements; and securing a financier for the new arrangements.

6.23. DCC provided a justification of its proposed distribution of the savings, which included benchmarking against comparable gainshare arrangements in other regulated industries.

6.24. DCC applied for the Relevant Adjustment on the basis of £44.161m of savings. DCC has proposed a total Relevant Adjustment of £13.204m between RY19/20 and RY24/25.

Our view

6.25. 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 justified that the overall saving from the refinancing would not have been achieved without DCC's involvement.

6.26. We also consider that DCC's proposed distribution of the savings between its customers, the FSPs and DCC is appropriate based on the evidence provided by DCC, and regulatory precedent in the industry.

6.27. **We are minded to confirm DCC's proposed Relevant Adjustment to the ECGS term by a total of £13.204m between RY19/20 and RY24/25.**

7. Over-recovery of revenue

Section summary

DCC over-recovered revenue from customers by 116% in RY17/18, which is above the 110% threshold. DCC has provided reasons for the over-recovery of revenue and we consider those reasons to be acceptable. As a result, we do not propose to impose penalty interest on its over-recovered revenues. However, we encourage DCC to take steps to improve its estimates in the future.

Question 10: What are your views on our proposal on DCC's over-recovery of revenue?

Background

7.1. The Licence requires DCC to take all reasonable steps to ensure that its Regulated Revenue does not exceed a prudent estimate of Allowed Revenue for each regulatory year.[10] Detailed information on Allowed Revenue, Regulated Revenue, and DCC's Charging Statement can be found in the RY15/16 Consultation Paper.[11]

7.2. We have introduced a penalty interest rate regime which is designed to incentivise DCC to improve the accuracy of its charges to customers and to deter it from over-recovering revenues.[12] The threshold for over-recovery of service charges is equal to 110% of allowed revenue, and a penalty interest rate of 3% above the Bank of England base rate on any proportion of over-recovery that DCC has not justified to the Authority's satisfaction is to be applied.

DCC's reporting on the reasons for over-recovery for revenue

7.3. For RY17/18, the ratio of Regulated Revenue (£257.9m) to Allowed Revenue (£222.7m) is 116% – above the 110% threshold.

[10] See LC36.4
[11] https://www.ofgem.gov.uk/system/files/docs/2016/11/dcc_1516_price_control_consultation_2.pdf
[12] 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

7.4. DCC has identified various factors (listed below) that it considers could not reasonably have been anticipated. Excluding the value of these factors from the calculation, the ratio falls to 109.9% (£255.6m/£232.5m).[13]

- Additional Funds received as a result of a greater than expected number of meters being connected (£2.2m in Regulated Revenue);
- Interest income received on cash balance (£0.2m increase in Regulated Revenue);
- Lower pass-through costs than expected (£5.1m decrease in Allowed Revenue); and
- The decision on the BMPIA term for RY16/17 being determined in February 2018, after the Charging Statement was set (£4.7m decrease in the Allowed Revenue).

Our view

7.5. We consider that DCC could take further steps to improve the accuracy of its estimates for the Charging Statement, in particular as follows:

- Additional Funds received as a result of a greater than expected number of meters being connected – DCC bases its estimate of funds for the year on the actual number of installed meters at the time that the Charging Statement is prepared. Given that this approach gave rise to a variance between Allowed Revenue and Regulatory Revenue last year, we consider that DCC could have reasonably predicted that the number of meters would continue to increase over the year, and that DCC could have explored using a forecast of the future number of meters as the basis of the Charging Statement.
- Interest income – the Charging Statement does not contain any estimates of interest income. As interest income was identified as one reason for the variance between Allowed Revenue and Regulatory Revenue last year, we consider it reasonable to expect DCC to have looked to minimise the variance this year by forecasting interest income (for example, by basing it on the level of working capital required for the year).

7.6. Going forward, we expect DCC to continue to improve the accuracy of its charges to users, and to consult as appropriate with its customers.

[13] Adjusted Regulated Revenue = £257.9m - £2.2m - £0.2m = £255.6m. Adjusted Allowed Revenue = £222.7m + £5.1m + £4.7m = £232.5m

Appendices

Index

Appendix 1 – Responding to this consultation

1.1. 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 section. These are replicated below.

1.2. Please make sure we have your response by 28 December 2018. Send them to:

Andrew Roberts
Metering and Market Operations
Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU
020 7901 7000
smartmetering@ofgem.gov.uk

1.3. 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.

1.4. 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 2019.

QUESTIONS

Question 1: What are your views on our proposal to consider External Costs as economic and efficient?

Question 2: What are your views on our proposals on DCC's Internal Costs?

Question 3: What are your views on our proposals on DCC's approach to benchmarking of staff remuneration?

Question 4: What are your views on our proposals for Shared Services?

Question 5: What are your views on our proposal to expect more robust evidence from DCC on how it has taken customer views into account in future price control submissions?

Question 6: What are your views on the processes that DCC should establish to enable meaningful customer input to decision-making?

Question 7: What are your views on our assessment of DCC's application to adjust its Baseline Margin?

Question 8: In its submission, in support of its application for an adjustment to its Baseline Margin, DCC states that there has been a significant unanticipated change in customer expectations, and in customer and service provider demands. What are your views?

Question 9: What are your views on our assessment of DCC's application for External Contract Gain Share?

Question 10: What are your views on our proposal on DCC's over-recovery of revenue?

Appendix 2 – External Costs assessment

1.1. In this Appendix, we provide further background to the External Costs that materially contributed to the variation in RY17/18 (as identified in Figure 2.3). We have included the DCC's summary of its use of the governance provisions and value for money mechanisms as defined in Schedules 7 and 8 of the FSP contracts.

Key material variances

Change requests for Release 2.0/DBCH (CR184, CR194, CR253)

1.2. Release 2.0 will be a major upgrade to the DCC Smart Metering Solution and will deliver:

- A Dual Band Communications Hub (DBCH) capable of operating at the current 2.4GHz frequency, as well as operating at a sub-GHz frequency in areas where the Home Area Network (HAN) propagation is particularly challenging.
- Updates to the Technical Specification Group which include a move to Great Britain Companion Specification (GBCS) v2.0, the incorporation of the latest SEC changes, and updated DCC specifications relating to Device User Interface Specification (DUIS) v2.0 and Message Mapping Catalogue (MMC) V2.0. These updates cover both Single Band and Dual Band Communication Hubs.

1.3. Following scoping and design work of the DBCH solution in RY16/17, the focus of DCC in RY17/18 shifted towards ensuring that the solution was fit for purpose prior to implementation. To support development and implementation of R2.0, several change requests were raised. These are listed in Table A2.1 below, of which the largest are CR184, CR194, and CR253.

Table A2.1: Change requests related to Release 2.0/DBCH

Reference	Description
CR184	To enable the CSPs to begin to develop the DBCHs. The work during RY17/18 built on the design and scope of requirements work undertaken in the previous year, and was focussed on development activities associated with the introduction of new communication hub variants. This included working with the CSPs to ensure that their supply chains manufacture and procure the required hubs, and that the testing programme assures that the hubs are fit for purpose for mass rollout.
CR194	To update the DCC solution to take account of the BEIS-led changes to GBCS and SEC, and to ensure that DCC remains compliant with all regulatory and technical requirements.
CR253 and PR62	To allow Service Providers to commence System Integration Testing and Device Integration Testing of both the SBCHs and DBCHs.
CR218	To allow the DSP to plan for System Integration of the Release 2.0 solution.
CR274 and PR80	To provide the environment for DCC Users to being testing the R2.0 solution with their individual systems.

CR160 delay costs

1.4. The driver and costs for CR160 were described in detail as part of the RY16/17 submission. The CR160 delay costs that have been added this year relate to an explicit compensation mechanism provided to the CSPs for delays arising from the extension of testing beyond the key dates agreed to at the end of 2015. A part of the delay costs was finalised and submitted as part of the RY16/17 submission; the remaining costs were agreed during RY17/18 and submitted as part of this year's price control submission.

1.5. CSPs were required to submit formal claims which were then subject to the usual due diligence processes – first to review the evidence to ensure that the correct rates were being applied and, second, to instruct the relevant DCC project director to analyse the claim in detail. The project director would provide assurance that the claim was justified in terms of effort expended and tasks completed. DCC has provided evidence of applying a high level of scrutiny to determining whether the activity being claimed was in fact caused by the delay. DCC also described the negotiations with the CSPs that followed, focusing on areas of dispute, and set out how it managed the process.

1.6. Our concerns around the process leading up to the provision of the compensation mechanism have been outlined in section 2. However, given the existence of the compensation mechanism, we are of the view that DCC was able to evidence how its due diligence processes have ensured that the claims that have been paid out are appropriate.

Higher user integration testing charges

1.7. The User Integration Phase commenced around September 2016 and has been extended beyond its original 12-month term as Service Users have continued to require Integration Testing. The level of testing has increased steadily month on month and is now expected to be an enduring service rather than a time-bound service as each new Release (eg R2.0, SMETS1) will require the Service Users to carry out re-testing. In addition, DCC now has Service User testing running concurrently across multiple releases and in more than one environment.

Contract Management

1.8. To support DCC's contract management of the FSPs, there are a number of governance provisions included within Schedule 8 of each FSP's contract. In RY17/18, DCC employed the following:

- Schedule 8.4: which enabled DCC to re-engage a consultant to undertake an annual audit of the DSP and CSP contracts focusing on the price for CR160 and verification of each FSP's compliance with the requirements of its Contract in relation to financial stability. This annual audit was also used to review opportunities for re-financing CSP set-up charges and to investigate possible constraints.
- Schedule 8.6: to ensure that each FSP's required Business Continuity and Disaster Recovery (BCDR) plan was updated to reflect ongoing changes.
- Schedule 8.7: which involved updating the Co-operating Agreements to reflect CR160 changes to ensure that the FSPs had clear frameworks to meet their obligation to cooperate with DCC and other DCC FSPs.
- Schedule 8.8: to ensure compliance with the established process for agreeing the scope of a project and how it is to be implemented, for Project Requests raised in RY17/18.
- Schedule 8.9: which involved continuing to work with Service Providers to agree the format and content of various internal Operating Model documents which meet the requirements of the Schedule.

1.9. DCC also reported on FSP performance against their obligations (as set out in Schedule 7.3 of FSP Licences) to provide value for money as they continue to progress into the delivery phase:

- Benchmarking: This provision was not used in RY17/18 as delivery at scale has still not commenced. DCC is waiting until there is at least one year of a reasonable level of service activity. As a result, it expects to initiate benchmarking activities towards the end of RY18/19.
- Gainsharing: no opportunities were identified in RY17/18. DCC has indicated that more material opportunities may not be identified until after a reasonable period of live service activity.
- Refinancing gainsharing: The arrangement for the DSP to review its financing of its set-up charges that began in RY15/16 and was enhanced in RY16/17 has continued in RY17/18. DCC led an initiative during RY17/18 to introduce low cost financing for CSP (N) Release 2.0 milestones and other charges, and this arrangement is expected to apply for all future set-up charges. DCC also worked with CSP (C&S) to refinance set-up charges during RY17/18. More information is contained in the ECGS section of this consultation.
- Non-mandatory activities: DCC did not receive any requests from the FSPs to approve the use of Relevant Assets for Non-Mandatory activities in RY17/18.
- Financial audit: opportunities to realise cost savings and/or other financial gains were not pursued through the audit performed under the Governance Framework as they are designed to apply to the delivery phase of the programme.
- Efficiency Gains: no Efficiency Gains were identified in the CSP contracts in RY17/18. The Efficiency Gains identified in the DSP contract commenced in November 2017. These were 8% of the DSP Fixed Operational Charges.

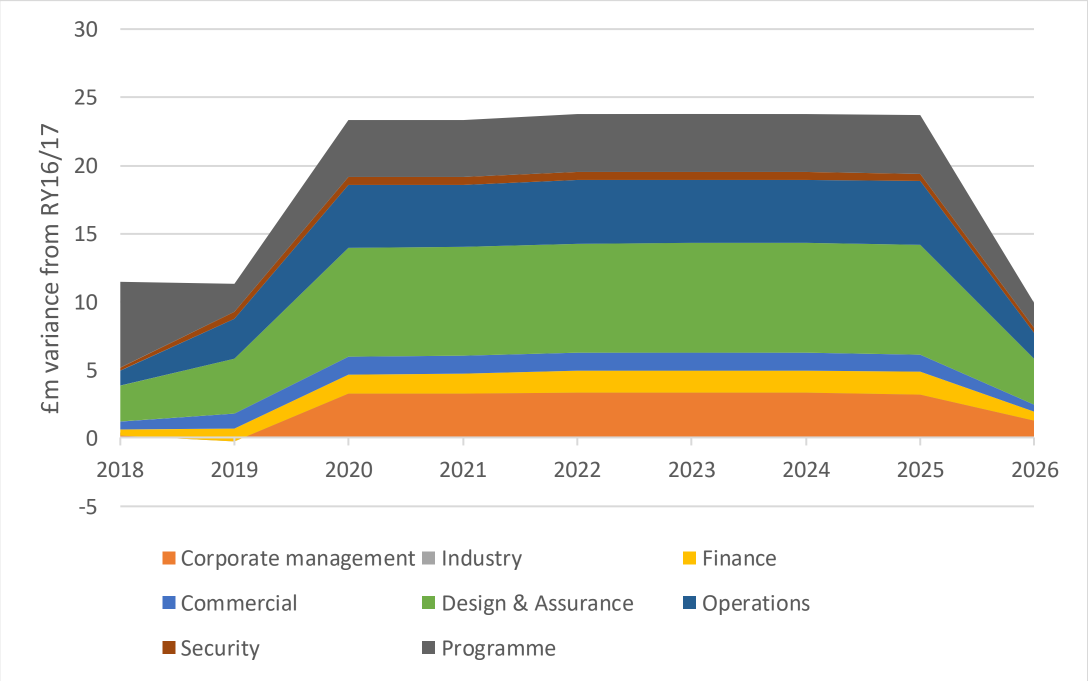
Appendix 3 - Internal Costs assessment

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

Cost centre	Functions include:
Corporate Management	• Costs for the managing director, the senior management team, and the DCC board • Communications • Regulation, and risk and compliance • Strategy and development
Industry	• Leads engagement with DCC's customers • The team is due to be disbanded in the future
Finance	• Commercial finance activities including the production of the company-wide budget and business plan, and the development and application of the charging methodology in order to set charges • Operational finance activities including cost control, cash flow management, managing billing and credit cover • Regulatory finance activities, including the price control and other regulatory and statutory reporting • Developing staff and structure of the organisation
Commercial	• Leads the contractual and commercial management of service providers • Oversees DCC's procurement strategy • Evaluates services procured from Capita and additional contracts which require management, such as SMKI, Parse and Correlate • Now includes the Legal Team (who were transferred from Corporate Management during the year)
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

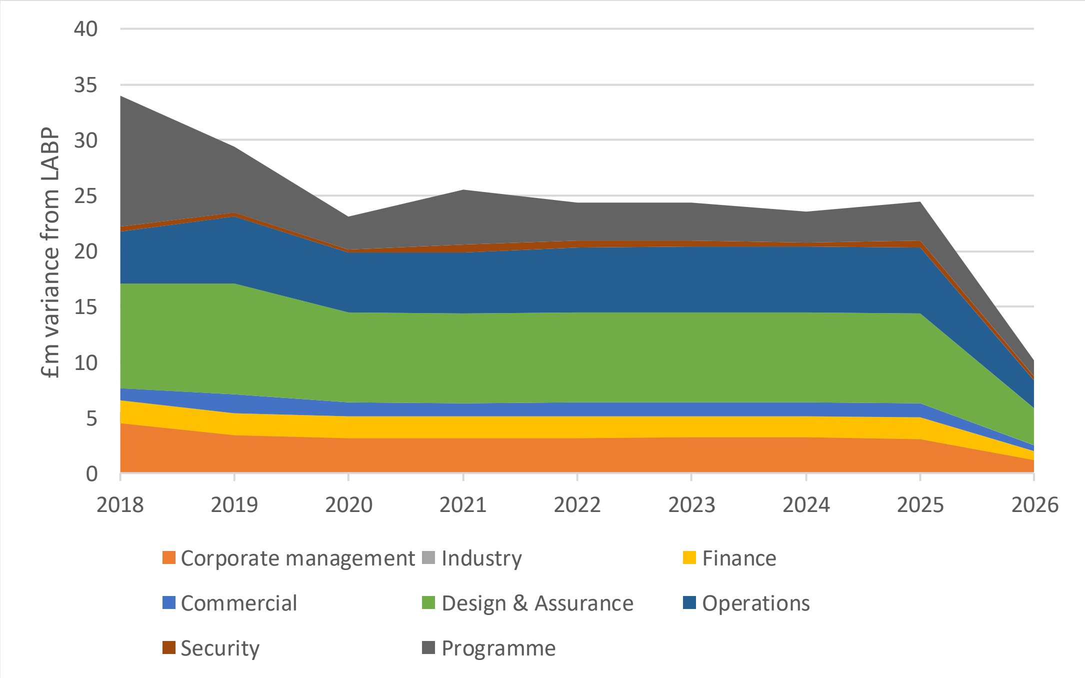
1.2. Figure A3.1 below shows the variance in Internal Costs by cost centre compared to the RY16/17 forecast. This shows that the increase in costs compared to last year are concentrated in the Design & Assurance, Programme, Operations and Corporate Management cost centres. Total Internal Costs (including New Scope costs) are expected to have peaked in RY17/18 as SMETS2 achieves Go Live and DCC begins to transition towards ongoing operations. As DCC moves away from rolling out the various releases towards ongoing operations with an established design, costs are expected to fall further before stabilising in about RY22/23.

Figure A3.1: Cost variance by cost centre – compared to RY16/17



1.3. Figure A3.2 below shows the variance in Internal Costs by cost centre compared to the LABP.

Figure A3.2: Cost variance by cost centre – compared to LABP



1.4. Payroll costs are a major driver of Internal Costs across the different cost centres. Table A3.1 summarises DCC's headcount from RY17/18 to RY19/20 as measured in full time equivalents (FTEs) by cost centre. The forecast 23% increase in FTE between RY17/18 and RY18/19 is a significant factor in the peak in Internal Costs in RY18/19; numbers are then expected to fall by 15% between RY18/19 and RY19/10.

Table A3.1: FTEs by cost centre

Cost centre	RY17/18	RY18/19	RY19/10
Corporate Management	28.8	34.8	34.3
Industry	5.0	5.0	5.0
Finance	30.4	34.1	33.9
Commercial	12.0	18.8	17.0
Design & Assurance	88.8	108.3	100.1
Operations	46.9	78.5	79.7
Security	9.0	11.8	12.0
Programme	43.2	53.0	44.0
SMETS1	27.7	43.9	5.6
Centralised Registration Service	24.7	0.1	0.0
Total	**316.4**	**388.2**	**331.6**

Appendix 4 – Proposed unacceptable costs

Proposal for unacceptable costs from RY17/18 to the end of the Licence in RY25/26 for this price control period

(£m)	RY17/18	RY18/19	RY19/20	RY20/21	RY21/22	RY22/23	RY23/24	RY24/25	RY25/26	Total
LABP Allowed Revenue (AR)	126.316	151.812	187.506	217.129	221.219	218.165	224.327	231.618	97.963	1,676.055
AR reported in RY17/18	222.722	296.256	363.601	416.633	375.052	350.588	350.067	341.666	129.563	2,846.147
Proposed reductions										
Resource costs	0.000	0.875	0.926	22.215	22.317	22.329	22.329	22.329	9.284	122.604
Benchmarking	1.476	0.286	0.000	0.000	0.000	0.000	0.000	0.000	0.000	1.762
External services	0.326	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.326
CRS (including Shared Services)	0.291	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.291
Shared Services	0.252	0.149	0.088	2.110	2.120	2.121	2.121	2.121	0.882	11.965
Total reductions	**2.345**	**1.310**	**1.014**	**24.325**	**24.437**	**24.450**	**24.450**	**24.450**	**10.166**	**136.948**
Adjusted AR	**220.377**	**294.946**	**362.587**	**392.307**	**350.615**	**326.137**	**325.616**	**317.216**	**119.397**	**2709.199**

Note: Allowed Revenue (AR) (reported by DCC and adjusted by Ofgem) excludes both the RY17/18 Baseline Margin and ECGS applications

Appendix 5 – Privacy notice on consultations

Personal data
The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally), not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer
The Gas and Electricity Markets Authority is the controller (for ease of reference, "Ofgem"). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data
Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data
As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. ie a consultation.

3. With whom we will be sharing your personal data
We are not intending to share your personal data with other organisations. We are intending to publish non-confidential consultation responses, including any personal data that may be contained within them.

4. For how long we will keep your personal data, or criteria used to determine the retention period
Your personal data will be held for six months after the consultation closes.

5. Your rights
The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data
- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at https://ico.org.uk/, or telephone 030 3123 1113.

6. Your personal data will not be sent overseas

7. Your personal data will not be used for any automated decision making

8. Your personal data will be stored in a secure government IT system

9. More information

For more information on how Ofgem processes your data, click on the link to our "Ofgem privacy promise".