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Metering and Market Operations
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Dear Ayena,

DCC Price Control: Regulatory Year 2018/19

Consumer benefits of the Smart meter roll-out are extremely sensitive to cost increases and so effective governance of the DCC's budget is vital to success. In our view, the current ex-post regulatory approach is not achieving this. Each year, the DCC incurs costs with minimal scrutiny until their price control submission in July, at which point the strength of Ofgem's position to challenge these costs is significantly weakened. This has culminated in a situation where total DCC costs over the licence term are "**£2.117b**, or **103%**, higher"¹ than originally envisaged, a total of **~£4.14b**, whilst current operating volumes are just **6%** of the total meters covered by the roll-out². This cannot, by any measure, be acceptable.

In this context, we offer the following recommendations;

- i. Consider transitioning to an ex-ante regulatory approach to allow Ofgem greater control over the DCC's budget
- ii. Limit the DCC's budget to the cost-effective delivery of its core service; secure communications, access control and scheduled data retrieval for SMETS meters
- iii. Halt all non-core activities immediately

Rather than providing direct responses to the consultation questions, the remainder of this letter explores three key observations; costs are disproportionate to current service delivery, DCC justifications are unsatisfactory and increased allowable revenue is funding unnecessary and harmful expansion of DCC's monopoly.

We would welcome the opportunity to discuss this letter with Ofgem and look forward to the published decision on the Price Control for RY 2018/19.

¹ Ofgem (2019), *DCC Price Control: Regulatory Year 2018/19*, paragraph 1.30, p18, 24th October

² Total meters covered by rollout = 53m, DCC operated meters @ 10/12/19 = 3.116m

Costs are disproportionate to current service delivery

Total DCC costs over the licence term are now forecast to be “£2.117b, or 103%, higher” than originally envisaged, a total of ~**£4.14b**. This is despite, one year out from the 2020 deadline, when most meters were supposed to be DCC enrolled, only **6%** of total meters are currently being operated by the DCC. This is not value for money. This is a material failing, which consumers are paying for, that needs to be addressed through more effective price control.

A similar theme occurs when looking at Internal and External costs separately. Total Internal Costs over the licence term are now forecast to be **£610m**, which is **370%** higher (£445m) than originally submitted in the LABP³. The main driver for this is increased payroll costs. The highest headcount in the LABP was ~119 FTE from Dec-19 to Dec-20, with around ~60 FTE in Operations and Service Desk roles to support the mass roll-out during its peak⁴. Current total headcount is 421 FTE and total Operations headcount is 78.5 FTE; forecast to grow to 551 and 127 respectively in 2019/20⁵. Therefore, DCC operational resourcing is double that indicated in its business plan, even though the potential scale of its core service is unchanged and current operating volumes are a fraction of that. This suggests that the DCC is significantly over-resourced, which in turn indicates a concerning lack of commitment to efficiency that is unacceptably driving up costs.

Total External Costs over the licence term are now forecast to be **£3.10b**, which is **159%** higher (£1.15bn) than originally submitted in the LABP⁶. The main driver for this increase is the SMETS1 programme. Since 8th August 2019, 2,310 SMETS1 meters have been successfully adopted by the DCC out of a total 2,854 attempted⁷. This is **<1%** of total SMETS1 meters and a failure rate of **19%**, which is six times higher than that assumed in the cost benefit analysis⁸. This might be acceptable if the costs were fixed and timelines definitive, however; as SMETS1 CSP costs have not been included this year, further increases are on the horizon and given significant precedent, delays highly likely.

It is unclear whether this latest view of DCC Costs was fed into BEIS’ updated cost-benefit analysis, which assumes that DCC costs over the entire appraisal period to **2034** are £4.00b⁹. The DCC forecasts the same level of cost but to the end of its Licence Term in **2025** – nine years earlier. This discrepancy could significantly impact the business case for the Programme.

³ DCC (2014), *Licence Application Business Plan (Redacted)*, Table 4, p20. Total forecast Internal Costs over licence term = £152m = £165m in 2018 prices. Total forecast Internal Costs over licence term in RY18/19 = £610.7m.

⁴ DCC (2014), *Licence Application Business Plan (Redacted)*, Figure 3, p15

⁵ Ofgem (2019), *DCC Price Control Regulatory Year 2018/19*, Appendix 3, Table A3.2, p91

⁶ DCC (2014), *Licence Application Business Plan (Redacted)*, Table 7, p26. Total forecast External Costs over licence term = £1.79bn = £1.95bn in 2018 prices. Total forecast External Costs over licence term in RY18/19 = £3.10bn

⁷ DCC (2019), *Smart DCC Monthly Update December 2019*, p5

⁸ In a meeting between Stark and BEIS on 23rd October 2019 they indicated the working assumption was a 3% failure rate for SMETS1 DCC Adoptions

⁹ BEIS (2019), *Smart meter roll-out cost benefit analysis 2019*, p63, September – combination of “DCC Related Costs” of £2.90bn and “Communications Hubs” of £1.10bn

DCC justifications are unsatisfactory

Many of the justifications provided by the DCC for these costs are unsatisfactory. For instance, the growth in External costs is largely justified on the grounds of increased complexity and scope of the SMETS1 programme alongside a reduced timeframe. However, this situation is a direct consequence of DCC underperformance against its original project plan. Repeated failure to meet Release milestones meant the DCC went Live in November 2016, two and a half years later than planned. It was another two years before the system was stable enough to support the mass roll-out to domestic credit customers. As a result, the final SMETS1 end date was in March 2019 and the total population of SMETS1 meters is three times higher than it was ever supposed to be¹⁰. Against this backdrop, all increased costs due to the SMETS1 programme should be disallowed.

Similarly, the growth in Internal costs is mostly justified on the grounds of increased service standard exceptions. However, the scale of the project and the expectation that DCC provide a support function to its customers has not changed. Therefore, resourcing requirements should have been understood at licence application, including the necessity of a Technical Operations Centre and overall headcount requirements, making the provided justification unsatisfactory. Considering the excessive slippage from the LABP, any additional costs required to bring the customer support aspects of the DCC's core service up to standard should also be disallowed.

Increased allowable revenue is funding unnecessary and harmful expansion of DCC's monopoly

Approved adjustments to the DCC's baseline margin is being used to fund "New Scope" activities. Resourcing of this cost centre is disproportionate – the forecast headcount for RY19/20 is **92 FTE**, which is **72%** of the Operational headcount¹¹. This detracts from the cost-effective delivery of their core service and is driving up the cost of the roll-out, despite not being directly relevant (e.g. Electric Vehicles, Faster Switching). Moreover, it has significant negative impacts to competition through unnecessary and unjustified expansion of an existing monopoly, which will either foreclose emerging competitive markets or create an unmatchable advantage in existing markets.

A monopoly organisation that is required to deliver a cost-efficient regulatory service cannot also be a centre for innovation. Savings in the former act as a cross-subsidy for the latter and customers do not experience the reduction in costs that a shared central infrastructure should bring. To keep overall costs under control, Ofgem should limit the budget and activities of the DCC to the core service for SMETS meters. We would also welcome clarification from Ofgem on how they ensure that consumers are not paying for DCC monopoly expansion that may not benefit them.

¹⁰ 15m vs. 5m

¹¹ Ofgem (2019), *DCC Price Control Regulatory Year 2018/19*, Appendix 3, Table A3.2, p91

Recommendations

At a time in the roll-out when DCC costs should be stabilising they are in fact continuing to rise. There are some fundamental reasons for this; ineffective price control, unnecessary expansion of scope and lack of incentive to drive efficiency. The ex-post regulatory approach appears to have allowed Capita to underbid in order to win the licence in 2013 and is now allowing them to increase costs, and in turn funding, year-on-year. An ex-ante approach would address this by allowing Ofgem to impose stricter price controls *prior* to each Regulatory Year and thus exert greater control over the DCC's budget.

We therefore offer the following recommendations:

- iv. Consider transitioning to an ex-ante regulatory approach to allow Ofgem greater control over the DCC's budget
- v. Limit the DCC's budget to the cost-effective delivery of its core service; secure communications, access control and scheduled data retrieval for SMETS meters
- vi. Halt all non-core activities immediately

With the above in place, Ofgem's position as regulator of the DCC's Licence will be strengthened and costs to industry will become more transparent. DCC costs will become more proportional to the service they provide and appropriate incentives will be in place to ensure that resource is focussed on driving efficiency, rather than innovating. This will help secure the long-term benefits of smart metering for industry and consumers rather than continuing to erode them.

Yours Sincerely,

James Murphy
Strategy & Policy Manager