

Terms of Reference for assessment of DCC's Contract Management and Procurement activities under the Operational Performance Regime

This document sets out the draft Terms of Reference (TOR) to be used in procuring the auditor as part of the Contract Management incentive under the revised OPR. We are publishing this document as part of our January 2021 consultation on the OPR Guidance, and as part of that consultation wish to hear stakeholder views on this draft document, which we will take into account when publishing the final version of the TOR in March.

Overview

In October 2020 Ofgem published their decision¹ to incorporate a Contract Management incentive under the Operational Performance Regime (OPR), which is used to assess and incentivise the Data Communication Company's (DCC) performance. The Contract Management incentive aims to improve DCC's performance in contract management and procurement to drive efficiencies on DCC's external costs, and ultimately savings for DCC's customers.

The Contract Management incentive will operate as an annual independent audit of DCC's contract and commercial management and procurement activities, using the assessment criteria and scoring framework as set out in the National Audit Office (NAO) contractual relationships framework². In the first year of the audit (regulatory year 20/21), no DCC margin will be attached to the outcome of the assessment. In following years, 15% of DCC's margin will be at risk.

Following consultation, Ofgem decided that Smart Energy Code Administrator and Secretariat (SECAS) should undertake the procurement process for the auditor on behalf of Ofgem. DCC's customers remain concerned over DCC's performance, and this is particularly the case for contract management, where small improvements to DCC's

¹ Decision on the Operational Performance Regime Review October 2020: <https://www.ofgem.gov.uk/publications-and-updates/dcc-operational-performance-regime-review-october-2020-decision>

² NAO Contractual Relationships Framework: <https://www.nao.org.uk/wp-content/uploads/2016/11/Framework-for-publication.xlsx>

processes in this area can drive significant cost savings over the lifecycle of DCC's contracts. SECAS running the procurement process ensures a higher level of transparency over an area that is critical to DCC customers. To ensure independence of the process, Ofgem will approve the final contract award and take on the role of the contracting party.

The auditor will work with DCC on an annual basis to gather the necessary evidence for the assessment as set out in the NAO Framework. As part of the assessment, the auditor will engage with the Smart Energy Code (SEC) Panel to gather evidence on the SEC change process and assess how DCC obligations under this process are accounted for within their contractual arrangements. The auditor will share an interim report with DCC to give DCC an early opportunity to respond and provide further evidence. The auditor will then produce a final report to be shared with Ofgem, DCC and BEIS; and a non-commercially confidential version of this report - including scoring - will be provided to SEC Panel and SEC parties as one of the outcomes of the assessment. DCC and industry will have the opportunity to respond to the auditor's report as part of Ofgem's annual consultation on the price control, where Ofgem will set out their position on DCC's retained margin under the incentive.

We expect the auditor to be appointed by the end of May 2021 with the audit itself to take place from June to August that year. We acknowledge that the timeline of this procurement is tight. This is because of the need for industry consultation over the terms of reference, and with a view of ensuring DCC gets sight of their performance in the trial year of this incentive as early as possible, to make rapid improvements for the following year.

Background

The Data Communications Company (DCC) is the central communications body licensed to provide the communications, data transfer and management required to support smart metering. It is responsible for linking smart meters in homes and small businesses with energy suppliers, network operators and energy service companies. It is important that as a monopoly company DCC faces sufficient incentives to play its role well, delivering value for money and high quality services.

DCC was appointed using an outsourced service model, to manage contracted smart metering service providers. As such, external costs compose the largest proportion of DCC's costs, and it is critical that these contracts are entered into, managed and closed

out effectively and efficiently. Given the size and volume of DCC's contract portfolio, and that several original service provider contracts will require extension, it is important that DCC increases focus on this area in the coming years.

Each year, Ofgem scrutinises DCC's incurred and forecast costs through the annual Price Control process to determine whether these costs are economic and efficient. Alongside the cost assessment, DCC also faces financial incentives under the Operational Performance Regime (OPR). The majority of DCC's Baseline Margin is at risk against the OPR if DCC does not meet the performance levels set by the regime.

Given Ofgem's and industry's concerns around DCC's contract management and procurement processes, Ofgem consulted on whether it would be appropriate to financially incentivise DCC's contract management and procurement as part of the revised OPR regime in May 2020³. Stakeholders responded largely in favour of Ofgem's proposals, and in October 2020 Ofgem published their decision to implement a financial incentive based on an audit of DCC's contract management and procurement activity under the NAO contractual relationships framework.

We are now commissioning an auditor to carry out the assessment of DCC's contract management and procurement as part of the annual price control. This document sets out the terms of reference for the assurance review being requested by Ofgem.

Timings and Process

We will contract the auditor initially for a three year period. Within that three year period, the audit will take place on an annual cycle between June to August each year, with the final report issued in August. The auditor will also need to be available to Ofgem for further clarification on the auditor's report in January.

Given the risk of COVID restrictions during the timeline of the audit, we would expect this year's audit to be carried out remotely, while such restrictions are in place. We would expect the auditor's contact with representatives from DCC and SECAS to take place remotely via video conferencing, phone etc. We expect all documents to be sent electronically via email. Physical inspection of contracts or office space would not be required under the scope of this audit.

We have set out the milestones of this process for its first year of operation below:

³ DCC Operational Performance Regime Review: Consultation May 2020:
<https://www.ofgem.gov.uk/publications-and-updates/dcc-operational-performance-regime-review-may-2020-consultation>

- **Appointment of the auditor (March-May):** SECAS will run a competitive tender process on behalf of Ofgem, with Ofgem's approval over the final selection of the auditor. We expect the auditor to be appointed by the end of May. Initially, the auditor will be contracted for a three year period. The budget for the auditor contract will be set by SECAS.
- **Evaluation (June-July):** The independent auditor will then evaluate DCC's contract management and procurement activity using the NAO framework and the agreed terms of reference. The auditor will work closely with DCC during this assessment to enable access to the required evidence as well as speaking to a number of DCC user representatives and the SEC Panel, the latter in particular in regards to the SEC change process. The auditor will need to provide an interim report for DCC to comment on by **9 July**.
- **Reporting (July-August):** The independent auditor will submit a draft report to Ofgem by **23 July**, taking account of DCC's comments. This report will include the auditor's assessment on the level of attainment that DCC has reached for each supporting question and domain. Ofgem will review the report, and may request further iteration to ensure the report meets the requirements set out in the scope/terms of reference. The final report must be issued to Ofgem by **20 August**. Once the final report has been issued, Ofgem will confirm to SECAS that the work is complete. The full report will then be issued to Ofgem, DCC and BEIS, and a non-commercially confidential version of this report will be circulated to the SEC Parties and the Panel.
- **Consultation (Oct-Dec):** Ofgem will incorporate a summary of the auditor's report as part of the price control consultation, setting out the audit scores as part of Ofgem's minded-to position on DCC's performance under the OPR. Ofgem will then publish the price control consultation to provide an opportunity for all stakeholders to respond. In particular, this will provide an opportunity for DCC users, the SEC Panel and DCC to submit additional evidence to appeal the auditor's scoring.
- **Decision (Jan-Feb):** Ofgem will then consider responses and any additional evidence submitted by stakeholders. This may include further clarification with the auditor around the scores. Ofgem will then determine whether to make any adjustments and publish the final decision.

Note, in future years we may amend these timelines, particularly with a view to ensure the auditor submits its final report to Ofgem on 31st July in line with DCC's price control submission.

Assessment Framework

The auditor will assess the DCC's contract management and procurement activity using a modified version of the NAO Contractual Relationships Audit Framework. The modified version of the framework amends two of the supporting questions to be relevant to the assessment of the SEC change process. The full modified version of the framework has been published alongside this document for reference – a high level summary of the framework is set out at the end of this document.

The NAO Framework sets out seven 'domains' of assessment covering contract management, procurement and re-procurement. Each domain is broken down into three supporting questions, setting out the information that an auditor would need to collect, judgement questions, evidence to be gathered and indicators of good practice.

The framework defines three levels of attainment for each supporting question. The auditor will collect evidence within the scope of the audit based on the information and judgement questions specified in the framework to determine DCC's level of attainment for each supporting question.

Evidence sources given as non-exhaustive examples in the framework include business cases, commercial strategy, risk assessments, performance reports, financial models, board papers and minutes.

Required outputs

As stipulated under the milestone timeline, we would expect the auditor to submit their final report to Ofgem by 20 August.

We expect this report to state DCC's level of attainment for each supporting question under the NAO framework, providing a detailed rationale for this level of attainment based on the evidence assessed. We expect the report to highlight areas of good practice from DCC and areas where their performance could be improved as per the assessment. The auditor may also give their general reflections on the audit process as part of their report.

A non-commercially confidential version of the report will also be made available to SEC Panel and SEC parties. We expect this report to be redacted only in areas where there are strict commercial confidentiality concerns with the aim of as much transparency as possible.

Scope of the audit

The assessment criteria in the modified NAO Framework cover DCC's activities in contract management, procurement and re-procurement, and will cover DCC's activities over the course of a Regulatory Year. We have set out the scope for the first year of the audit below, which we may amend for future years.

The auditor will provide a detailed review of DCC's contract management of DCC's Communication Service Providers - Arqiva and Telefonica – and Data Service Provider – CGI.

The auditor will also assess DCC's contract management of the three SMETS1 service providers that incurred the highest costs over the Regulatory Year.

The auditor will assess procurement and re-procurement activity under DCC's Network Evolution programme. This will cover the procurement of 4G Comms Hubs and Networks and re-procurement of the Data Services Provider (DSP) and Smart Metering Key Infrastructure (SMKI).

The auditor will also assess DCC's contract management in terms of adherence to the SEC modification change process. The auditor will not assess individual Change Requests/Project Requests, but may draw on evidence relating to a sample of these to assess DCC's overall delivery of SEC change.

Summary of NAO Framework domains and supporting questions, incorporating modifications for DCC

Domain	Key question	Supporting questions
1. Commercial strategy	Is there an overarching commercial strategy, with a clear rationale for the approach being taken?	1.1. Is there a clear and consistently held view of what the contract is producing, the type of commercial relationship desired, the basic contract structure and how it will be managed?
		1.2 Has there been an assessment of strategic drivers, including policy drivers, and the internal and external environment?
		1.3 Has the commercial strategy been based upon the assessment of strategic drivers and the internal and external environment?
2. Capability & governance	Does DCC have the capability needed to manage the contract and is it developing capability for the future?	2.1 Does DCC have the necessary capability, skills and systems?
		2.2 Does DCC understand its future needs and is it working towards meeting them?
		2.3 Has DCC deployed its capability in a balanced way across the lifecycle and is commercial capability effectively integrated with the business?
3. Market management & sourcing	Has sourcing supported the commercial strategy and followed recognised good practice to optimise VFM?	3.1 Has market management driven long term value for money?
		3.2 Was there a defensible process that resulted in the selection of a capable supplier?
		3.3 Was there optimum use of competitive pressure?
4. Contract Approach	Does the balance of risk and reward encourage service improvement, minimise perverse incentives and promote good relationships?	4.1. Is there an appropriate allocation of risk between DCC and the supplier?
		4.2. Are there incentives to encourage the supplier to act in the interest of DCC?
		4.3. Are suitable mechanisms established to drive the desired relationship?
5. Contract management	Is the service being managed well, with costs and benefits being realised as expected?	5.1 Do DCC and the supplier have comprehensive knowledge of service performance?
		5.2. Are the suppliers delivering in accordance with the contracts, and are they actively managed by DCC to meet or exceed requirements (including delivering accurate, timely Impact Assessments)?

Domain	Key question	Supporting questions
		5.3 Is DCC meeting its obligations?
6. Contract lifecycle	Will the service continue to demonstrate VfM through its lifecycle?	6.1. Does the contract continue to support DCC's strategic intent?
		6.2. Are VFM mechanisms used to ensure the contract continues to deliver VFM over its life?
		6.3. Is change controlled and well managed and does the contract remain current?
7. Transition & termination	Is DCC ready for the end of the contract?	7.1 Has market management been undertaken to support new contracts?
		7.2 Has the end of the contract been managed effectively to allow re-bid or handover?
		7.3 Are insights from the operation of the contract brought to bear in developing the new contract?