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Decision

DCC Price Control: Regulatory Year 2019/20

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Overview:

The Data and Communications Company (DCC) is required to report Price Control Information by 31 July each year. It must report in accordance with the Regulatory Instructions and Guidance that we publish.

Each July, DCC can also propose an adjustment to its Baseline Margin (BM) and External Contract Gain Share values (ECGS). We assess these proposals and determine whether any adjustments are justified.

In October 2020, we consulted on our proposals following a review of the report and information submitted by DCC in July 2020 for the Regulatory Year from 1 April 2019 until 31 March 2020.

This document sets out our decisions and the reasons for them on the costs DCC reported under its price control for the Regulatory Year 2019/20 and its application to adjust the Baseline Margin and External Contract Gain Share values under the Licence.

Alongside this document we have published notices of our Price Control Decisions and Determinations and Directions relating to the calculation of Allowed Revenue set out in the Price Control Conditions in the Licence.

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Executive summary

DCC has an essential role to play in the energy market. It is important that DCC receives sufficient funds to play its role well, and it is equally important that we hold DCC to account for delivering value for money and high quality services. 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.

These are our final determinations for the DCC price control for the regulatory year 2019/20 (RY19/20). Our decisions reflect our conclusions on the economic and efficient level of costs incurred in RY19/20 and in the cost forecasts; DCC's performance under the Operational Performance Regime (OPR) and Baseline Margin Project Performance Adjustment Scheme (BMPPAS); and adjustments to the Baseline Margin (BM) values set out in the licence and the External Contract Gain Share (ECGS) term. Our final determination follows from our assessment and October consultation on DCC's costs and performance; and takes into consideration stakeholder views we have received in response to the consultation.

Cost Assessment

In RY19/20 total costs (excluding pass-through costs) were £463m, 15% higher than forecast last year. The variance in costs compared to RY18/19 can be attributed mainly to the SMETS1 programme – both internal and external costs - and in addition the corporate management cost centre, the latter largely driven by a number of procurements outside the forecast. Over the Licence term, total costs (excluding pass-through costs) are now forecast to be £3.8bn, an increase of 5%, compared to last year's forecast.

After considering all consultation responses, including from DCC, we have determined a total of £3.442m incurred Internal Costs in RY19/20 (including the associated shared service charge) as unacceptable. Our determination on Unacceptable Costs comprises expenditure on a retention scheme; inefficiencies in contractor benchmarking; growth of the strategy and product management team in DCC's corporate management cost centre; and accommodation costs from DCC's Preston Brook site.

In our decision, we have taken account of additional evidence provided by DCC as part of their consultation response to justify some of the costs associated with the retention scheme, contractor benchmarking and the strategy and product management team, and accordingly have partially reduced the disallowance amount from our consultation position. As DCC continues to grow in terms of both permanent staff and contractors, it is important that DCC applies robust processes to ensure that the pay and benefits package offered is economic and efficient, and we encourage DCC to be committed to finding payroll efficiencies over the licence term.

In regards to DCC's spend on innovation, we have taken account of evidence that some activities complement DCC's core business activity. However, given DCC's current level of maturity and the issues its customers are experiencing with service performance, we maintain that it is not an appropriate time for DCC to grow in order to expand DCC's service offerings beyond its core business and response to demand from existing customers. We have disallowed some costs on this basis, and urge DCC to seek appropriate funding models that do not place costs on existing customers, and expect greater transparency in separating costs incurred as part of its core business, and those incurred to develop future products and services for re-use of the network in future price controls.

In addition, we have determined a total of £5.096m (including the associated shared service charge) in forecast costs as unacceptable for RY20/21 and 21/22 due to the level of uncertainty connected to activities in innovation and network evolution. We have also determined a total of £211.809m increase in forecast Internal Costs (RY22/23 onwards, including the associated shared service charge, switching and SMETS1) as unacceptable. DCC has not justified these costs, and we consider these costs are not sufficiently certain to include in DCC's future Allowed Revenue.

We encourage DCC to take steps to improve its forecasting and provide clear and transparent cost forecasts for its customers and as part of the price control. As DCC matures, we would expect DCC to be in a position to forecast with more certainty, and to be able to justify costs further into the future.

Performance Incentives

All of DCC's BM (which includes adjustments) is at risk against one of DCC's performance regimes. This was the second year in which DCC's performance was assessed under the OPR and BMPPAS.

We have considered the responses received and our consultation position remains unchanged. We have determined an additional reduction to DCC's Allowed Revenue of £0.804m compared to DCC's submission to us, resulting in a total reduction of £1.644m due to DCC's performance issues in the CSP North region under the OPR, and £0.482m due to DCC's performance under the R2.0 BMPPAS in RY19/20.

Switching

Separately to the BM, DCC receives margin on the Switching Programme, which is at risk under a separate performance regime. The first of the delivery milestones under the Design, Build and Test Phase of the Switching Programme occurred in RY19/20. We have considered responses and our position remains unchanged. We determined that DCC should lose 100% of margin associated with this milestone, as the amount of delay that was within DCC's control extends beyond the four-week margin loss period of the milestone. The final values this milestone represents in terms of margin retained will be finalised when the Design, Build and Test Phase concludes.

Baseline Margin

The BM adjustment mechanism was included in the Licence to recognise the uncertainty 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.

DCC applied for an a £10.795m adjustment to its BM for RY19/20 to RY21/22 for increases in the volume and complexity of work caused by both new drivers and drivers previously identified by DCC. Following consideration of the consultation responses, we have altered our position on one of the activities that did not originally meet the conditions for a Relevant Adjustment.

We have directed a reduced adjustment of £8.747m to reflect:

- the price control decisions on Unacceptable Costs.
- 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.

External Contract Gain Share

The DCC Allowed Revenue formula includes an ECGS term that allows for an upward adjustment to DCC's revenue in recognition of a reduction in External Costs that DCC helped achieve. Between RY15/16 and RY19/20, DCC has secured cost reductions of £107.58m in External Costs based on DCC's ECGS applications, and brought benefits including this year's application of £57.4m (53% of total cost reductions) to DCC's customers through lower charges.

DCC applied to adjust this term for RY20/21 to RY25/26 reflecting a reduction in External Costs as a result of savings from further refinancing agreement for the fundamental service providers' set-up charges and for the provision of communication hubs. Following consideration of consultation responses and the additional evidence provided by DCC, we have changed our position. We are no longer rejecting £0.751m relating to the financing of communication hubs and instead we are awarding the full ECGS Adjustment of £3.812m.

Allowed Revenue Decision

Our decisions on the various components outlined above results in a total Allowed Revenue over the entire licence period of £3.826bn (including pass-through costs). Please see Appendix 1 for Allowed Revenue as proposed by DCC and the impacts of this year's decision.

1. Introduction

Context

1.1. 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 the systems of energy suppliers, network operators and other companies.

1.2. Under the DCC regulatory framework[1], we have a role in ensuring that DCC's costs are incurred economically and efficiently. We review DCC's costs and performance after the end of the Regulatory Year in which the costs were incurred, as well as forecast costs that DCC deem certain enough to include in its forecast Allowed Revenue. This approach is referred to as an 'ex-post' price control. DCC must submit price control information by 31 July following each Regulatory Year in line with the Regulatory Instructions and Guidance (RIGs).[2] Price control reporting covering the Regulatory Year from 1 April 2019 until 31 March 2020 was submitted on 31 July 2020.

1.3. Over the licence term the majority of DCC costs are incurred by its Fundamental Service Providers (FSPs), comprising of the Communication Service Providers (CSPs) and the Data Service Provider (DSP), who are responsible for delivering the data and communications services to support smart metering, and were appointed through a competitive tender process. One of DCC's key responsibilities is to effectively manage these large external contracts and ensure value for money and good quality service for consumers. The costs incurred by the FSPs are referred to as External Costs within DCC's allowed revenue.

[1] See Smart Meter Communication Licence 11 06 2020 (ofgem.gov.uk)
[2] Data Communications Company (DCC): Regulatory Instructions and Guidance 2020 | Ofgem

1.4. All other costs incurred by DCC in relation to the provision of the service are either Internal Costs, Pass-Through Costs[3], or costs associated with the Centralised Registration Service.[4]

1.5. In each Regulatory Year an amount of additional revenue, over and above the sum of the Internal Costs and External Costs is included in the Allowed Revenue – this is the BM. Each July, DCC can propose an adjustment to its BM values. We assess this proposal and determine whether to adjust the values agreed when the Licence was awarded. DCC's BM is at risk against its performance previously under the Implementation Performance Regime (IPR) and now against the OPR and government directed Project Performance Regimes. We determine the outcome of this performance as part of our price control assessment.

1.6. Separately, DCC receives a percentage margin on the Switching Programme. This margin is subject to a separate performance regime.

1.7. DCC also submitted an application to amend the ECGS term of its Allowed Revenue following External Cost savings. The ECGS is a mechanism within the price control for DCC to apply to increase its Allowed Revenue recognising its instrumental role in reducing External Costs.

Our decision making process

1.8. The DCC Price Control process can be viewed in the wider context of helping to achieve Ofgem's key priorities[5]:

- enabling a better functioning retail market which protects the interests of consumers;
- facilitating change in the energy system to enable competition and innovation; and
- a smarter, more flexible energy system to facilitate decarbonising at lowest cost.

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[3] Principally the cost of the Alternative HAN Company and the Smart Energy Code administration secretariat.
[4] Centralised Registration Service refers to the switching programme.
[5] Ofgem strategic narrative: 2019-23 | Ofgem

1.9. As required by the DCC Licence[6], our assessment of DCC costs is grounded in comparing DCC's incurred costs and revised forecast with DCC's Licence Application Business Plan (LABP) and the previous year's forecast. Our guidance document[7] 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.

1.10. We published a consultation in October 2020[8] with our detailed proposals concerning RY19/20, and conducted a stakeholder meeting on the consultation in December 2020. This document sets out our decisions on DCC's:

- incurred and forecast External Costs and Internal Costs for RY19/20 (Section 2 and Section 3);
- performance under the Operational Performance Regime (OPR) (section 4);
- performance under the Switching incentives regime (section 4);
- application for an adjustment to its Baseline Margin (Section 5);
- application for an adjustment to External Contract Gain Share (Section 5);

1.11. We received 12 responses, including two joint responses and two confidential responses. All non-confidential responses are published on our website.[9] We have fully considered all responses received to our consultation. We have summarised the key points received from the consultation and provide an explanation of the reasons for our decisions in light of these.

1.12. Please note that we may provide feedback to DCC directly on the detailed points it raised in its consultation response.

1.13. A Notice of our price control decision, determinations and directions accompanies this document. We also include a Notice providing DCC with a direction so that it can reflect our decisions in its next Charging Statement.

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[6] Licence condition 37 of the Smart Meter Communication Licence
[7] https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-guidance-processes-and-procedures-2019
[8] DCC Price control consultation: Regulatory Year 2019/20 | Ofgem
[9] Price control RY1920 decision: www.ofgem.gov.uk/publications-and-updates/dcc-price-control-decision-regulatory-year-201920

1.14. For further context to these decisions please read this document alongside our October 2020 consultation on the RY19/20 Price Control. The consultation document describes how DCC's costs have changed since the previous year and outlines our view on whether we think DCC's explanation in its price control submission justifies the cost variances. It also summarises our proposals on whether to accept DCC's application to adjust the BM and ECGS terms.

Related Publications

1.15. The 2019/20 Price Control Consultation Document is at: https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-consultation-regulatory-year-201920

1.16. The DCC Regulatory Instructions and Guidance 2020 is at: https://www.ofgem.gov.uk/publications-and-updates/data-communications-company-dcc-regulatory-instructions-and-guidance-2020

1.17. The DCC Price Control Guidance: Processes and Procedures 2019 is at: https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-guidance-processes-and-procedures-2019

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

Your feedback

1.19. We believe that consultation is at the heart of good policy development. We are keen to receive your comments about this report. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall quality of this document?
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. Are its conclusions balanced?

5. Did it make reasoned recommendations?
6. Any further comments?

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

2. External Costs

Section summary

Respondents' views were mixed on our assessment of DCC's External Costs, with concerns raised over DCC's performance in the North region and contract management processes.

Despite our concerns over aspects of DCC's contract management, we consider that DCC has provided sufficient evidence on its approach to negotiate better deals, challenge its providers on the costs of individual CRs/PRs, and achieve the best commercial outcomes. Therefore, we consider that the External Costs reported under the price control in RY19/20 were economic and efficient.

Nevertheless, our concerns strengthen our view that a Contract Management Incentive is needed to incentivise best practice in this area.

Questions

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

Proposal at consultation: We consider incurred and forecast External Costs are economic and efficient as reported in RY19/20.

Decision: Remains unchanged from consultation proposal.

Respondents' views

2.1. Respondents' views on our assessment were mixed with overall five respondents supporting our proposal.

2.2. Four respondents noted that they were unable to make their own assessment of whether these costs were incurred economically or efficiently due to the lack of information that was available to them. It is therefore important that Ofgem is satisfied that DCC's External Costs have been thoroughly scrutinised in order to provide assurances that they were incurred economically and efficiently.

2.3. Three respondents disagreed with our assessment, highlighting concerns with the costs associated with Arqiva and poor performance in the North region. This concern was

also raised by several other respondents, who questioned the justification for increasing costs in light of poor performance and encouraged Ofgem to further investigate the regional discrepancy between costs in the North compared to Central and South.

2.4. One of the respondents who disagreed also highlighted concerns around the SMETS1 programme, particularly delays caused by poor planning, failure to control risks and the management of third party service providers.

2.5. One respondent urged Ofgem to request DCC to improve its overall forecasting process for DCC to incur costs aligned to the forecast as far as possible.

2.6. Several respondents agreed with our concerns over DCC's contract management processes, and raised concerns relating to costs relating to change delivery. Two respondents questioned why Ofgem did not make a disallowance associated with this area, particularly around DCC's adherence to the change process.

2.7. Two respondents welcomed the OPR to provide further scrutiny and transparency over external costs through an independent audit.

2.8. DCC welcomed the proposal.

Reasons for our decision

2.9. We acknowledge that it is difficult for respondents to fully assess the efficiency of DCC's external costs, as respondents do not have sight of all information due to commercial confidentiality. In order to be as transparent as possible, our October 2020 consultation contained information on the main Change/Project Requests (CRs/PRs) for both SMETS2 and SMETS1, as well as information on DCC's processes to secure new contracts with SMETS1 service providers.

2.10. While not all information can be made public, we are satisfied with the level of explanation and evidence DCC provided to us for the cost variances in RY19/20. We note that DCC had followed Ofgem's recommendation from last year to better explain its assessment of trade-offs that DCC chose to make during contract negotiations, and note the evidence that DCC consistently strove to negotiate better deals and challenged its providers on the costs of individual CRs/PRs.

2.11. Despite DCC's improvements to their justification of external costs, we highlighted concerns over DCC's contract management processes in our consultation. This was particularly in regards to DCC's use of Letters of Instruction and adherence to the change management process, which may not have resulted in the best possible outcomes within the SMETS1 programme. We note that several stakeholders share our concerns in this area.

2.12. Nevertheless, we do not consider it appropriate to make a disallowance on costs associated with the SMETS1 programme in RY19/20. This is firstly due to DCC's decision to move away from the use of Letters of Instruction – one of our major concerns - towards 'Urgent Work Orders'. These provide stronger control and governance for projects while negotiations are underway in that they specify the service they relate to, comprise terms and conditions and a purchase order, and are limited to a 3-month duration. Secondly, it is challenging to precisely quantify the impact of negotiating processes – such as the decision not to undertake an impact assessment - on costs. As we stated in the consultation, these concerns strengthened our view that a Contract Management Incentive is needed to incentivise best practice in this area, and will contribute to addressing these concerns in future.

2.13. The revised OPR aims to incentivise DCC to improve performance in contract management and procurement to drive efficiencies on DCC's external costs, and ultimately savings for DCC's customers. To achieve this, we will be assessing DCC's contract management and procurement activities through an independent audit. According to our proposals in the January OPR Guidance Consultation[10] (decision expected in March 2021), the first audit will be produced in next year's price control as part of a trial year for the incentive. SEC Parties will be provided with a commercially confidential copy of the auditor's report for increased transparency. We will also draw on the findings of the auditor in our consultation.

2.14. In regards to DCC's performance in the North, we note that this remains an area of high concern for both Ofgem and our stakeholders. We have taken account of the evidence provided by stakeholders in our decision on the OPR to maintain the default position of a reduction of £1.608m (see chapter 4 on performance incentives).

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[10] See OPR Guidance Consultation January 2021 | Ofgem

2.15. In regards to the accuracy of DCC's forecasts, we note that the threshold for DCC to include costs within its price control forecasts are for those costs to be more likely to occur than not. We encourage DCC to take steps to improve its forecasting and provide clear and transparent cost forecasts as part of the price control. As DCC matures, we would expect DCC to be in a position to forecast with more certainty.

2.16. Finally, while we acknowledge that a significant driver underlying the cost differences between the North, Central and South regions is due to the different technologies, we will continue to examine those differences in next year's price control. This point was also raised as part of our December stakeholder event, and we welcome that DCC will endeavour to provide more information to customers throughout the year on contract and performance management to explain regional differences.

3. Internal Costs

Section summary

The majority of respondents agreed with Ofgem's assessment of DCC's internal costs. This chapter summarises respondents' views and states our final decision.

We consider, based on the information provided by DCC and other respondents, a proportion of internal costs not to be economic and efficient. We have therefore determined these costs as Unacceptable Costs under the Licence.

As such, we direct that £3.143m from DCC's internal costs in 2019/20; £4.654m of DCC's internal cost forecasts for RY20/21 and RY21/22; and £172.003m of DCC's internal cost forecasts for RY22/23 onwards are unacceptable (excluding the shared service charge).

Question 2: What are your views on our proposals on DCC's approach to benchmarking of staff remuneration for both contractor and permanent staff?

Question 3: What are your views on our proposals to disallow the cost of DCC's retention scheme?

Question 4: What are your views on our proposal to disallow the incurred and forecast costs associated with the product management team?

Question 5: What are your views on our proposal to disallow the forecast variance of the Commercial Operations and Vendor Management teams?

Question 6: What are your views on our proposal to disallow the incurred cost variance associated with Preston Brook?

Question 7: What are your views on our proposal to disallow all variance in forecast internal costs?

3.1. DCC's 19/20 price control submission stated that internal costs over the whole licence term were forecast to be £690m (excluding shared service cost).

3.2. For the majority of costs, DCC has provided sufficient justification and evidence for the costs incurred in RY19/20. However, our cost assessment has revealed some incurred costs which we do not consider to be economic and efficient. We also consider that a significant proportion of DCC's forecast costs are not sufficiently certain enough for us to allow as forecast Allowed Revenue at this stage.

3.3. Under Licence Condition 37, costs that we find were not economically and efficiently incurred by DCC are described as "Unacceptable Costs". In respect of such costs we are required to direct whether Unacceptable Costs are to be excluded from any future calculation of DCC's Allowed Revenue, or to accept an undertaking from DCC on how it will manage Unacceptable Costs and future procurement of relevant service capability.

3.4. DCC did not propose an undertaking therefore we determine that £3.143m of DCC's incurred costs in RY19/20; £4.654m of DCC's internal cost forecasts for RY20/21 and RY21/2; and £172.003m of DCC's forecast internal costs are unacceptable.

Contractor and Permanent Benchmarking

Proposal at consultation: Inconsistency in DCC's benchmarking approach resulted in a significant number of contractors hired above reasonable market rates, as a result of which we proposed to disallow £1.272m of contractor cost in RY19/20. We also set out a methodology to assess the efficiency of DCC's permanent contractors, but did not propose a disallowance for RY19/20.

Decision: Following further evidence from DCC on market rates for contractors, we have reduced the disallowance amount to £0.736m. Our position on the permanent benchmarking remains unchanged.

Respondents' views

3.5. The majority of respondents strongly supported our proposal on the contractor benchmarking, sharing our concerns on DCC's inconsistent approach to benchmarking, as well as more general concerns on the growth of payroll costs.

3.6. Four respondents supported the proposal on the basis that this a recurring issue. They noted DCC had not changed its approach, despite clear messages from Ofgem in previous price controls; a further disallowance was therefore appropriate.

3.7. Four respondents stated that DCC should provide clear evidence of their internal processes when hiring above the maximum benchmark. Two respondents noted that though they recognise that specialist skills would be required in some instances, there is no clear justification for DCC to pay above reasonable market rates as consistently as they appear to have done.

3.8. Two respondents disagreed with DCC's use of the maximum benchmark for contractors. One respondent further noted that the level of redundancies in the energy sector over the last few years meant there was an abundance of suitably qualified personnel, making the use of the higher benchmark unnecessary.

3.9. DCC provided two main tranches of additional evidence to illustrate that their approach to contractor benchmarking remained within reasonable market rates.

3.10. Firstly, DCC provided an internal analysis based on comparing a subset of DCC's contractor day rates to the day rates paid by their service providers for similar roles. This analysis showed that most of DCC's contractors were paid rates below the median of similar contractors employed by DCC's suppliers.

3.11. Secondly, DCC provided an analysis undertaken by an external HR consultancy. This analysis benchmarked a subset of DCC's contractors using a minimum of 20 data points for each role drawn from comparable organisations (based on turnover, geographical location, organisational structure and sector); as well as data from the consultant's in-house database. Where this data was not available, a "job levelling" approach was used to determine day rates based on a framework of 12 elements. The job levelling approach was only used for 3 of the benchmarked roles, all of which had a minimum live sample of at least 8 data points. This analysis concluded that DCC's day rates were largely not beyond reasonable market rates.

3.12. On the permanent benchmarking, the majority of respondents did not comment on our proposed methodology. Two respondents endorsed the new methodology, but argued that Ofgem should have made a disallowance in this area as there was clear evidence that it would have been appropriate.

3.13. One respondent agreed with our concerns regarding the exclusion of bonus payments from the permanent staff benchmarking. The respondent further noted that the levels of bonuses were, in their opinion, very high, and above what would be considered the industry average.

3.14. DCC did not directly comment on our proposed methodology for assessing the cost efficiency of permanent staff benchmarking.

Reasons for our decision

3.15. We have reviewed the responses we received, including the additional evidence provided by DCC. Though we maintain our position that DCC should apply a consistent approach to benchmarking contractors, we have taken account of the evidence provided by the external HR consultant. Based on the additional evidence received, we have reduced the disallowance amount from our consultation proposal of £1.272m to £0.736m. We maintain our position on the permanent benchmarking, setting out a methodology to be applied in future price controls from RY20/21.

3.16. In response to DCC's internal analysis, we note that many of the new benchmarks provided in this analysis were based on small sample sizes of equivalent roles. A significant proportion of the new benchmarks were based only on one equivalent role, and only a small proportion had a sample size of more than 10.

3.17. In addition, we note that the data supplied by DCC, where the sample size was larger than 1, showed a very wide range in the maximum and minimum day rates for each role. We consider that the extreme range in the day rates for some of the benchmarks suggested that DCC were not drawing on sufficiently comparable roles to produce a reliable benchmark. It is important that any approach to benchmarking should apply a robust methodology, and we note that DCC are unlikely to have the skills and information to undertake this internally. Given the clear limitations to this analysis, we do not consider it sufficient to take it into account for our decision.

3.18. In response to the external HR consultant analysis, we note that this analysis applied a robust methodology drawing on a sample size of 20 data points for each role to produce median, lower and upper quartile day rates, with only a few exceptions where the 'job levelling' approach was applied. We also note that the consultant produced its analysis using their standard methodology rather than developing a bespoke approach for DCC, which in our view strengthens the impartiality of the consultant's assessment.

3.19. Overall, we consider that this analysis is sufficiently robust and we incorporated the new benchmarks into our assessment, with the exception of a few benchmarks that applied a London day rate to a Manchester based role. As the external analysis only covered a subset of contractor roles, and as some of the contractor subset were paid day rates in

excess of the new benchmarks, we have only partially reduced our disallowance to the amount of £0.736m

3.20. As we set out in our consultation, we welcome DCC's policy change to move to benchmarking contractors at the median + 10%. However, in order for this policy change to be effective, DCC must apply the approach consistently going forward. We acknowledge DCC's concerns that its current provider of contractor benchmarking information has some limitations, but expect DCC apply a sufficiently robust methodology that DCC can use with confidence to determine cost efficient benchmarks.

3.21. In regards to stakeholder comments on the permanent benchmarking, given that we developed a new approach for assessing whether DCC's benchmarking was economic and efficient for permanent staff, we consider it fair and reasonable to signal this approach to DCC before making a disallowance. We intend to apply this methodology from RY20/21, with the intention of making a disallowance if DCC continue to incur an inefficiency in this area.

3.22. Finally, we noted in our consultation that DCC excludes bonus payments from permanent staff benchmarking. Given that DCC's annual bonus rates, amongst other benefits, make up a significant part of an employee's remuneration package, we encourage DCC to incorporate the benefits package into their approach to benchmarking permanent staff. We will further scrutinise this aspect of DCC's benchmarking in RY20/21.

Retention Scheme

Proposal at consultation: Insufficient evidence was provided to demonstrate that the retention scheme had been designed to be fit for purpose, or had a sufficiently positive impact, to be considered economic and efficient. As a result of which, we proposed to disallow the full incurred cost of the scheme of £2.499m in RY19/20.

Decision: Following DCC's additional evidence on the impact and recruitment cost savings of the scheme, we have reduced the disallowance amount from £2.499m to £2.111m.

Respondents' views

3.23. All respondents - with the exception of DCC - supported the proposal, with the majority strongly supporting on the basis that the benefit of the scheme was unclear; and that DCC did not sufficiently design the scheme to assure it addressed any issues with turnover in the most cost efficient manner.

3.24. One respondent noted that DCC's annual salaries and bonuses were already generous compared to the market, therefore pay was unlikely to be a key driver of attrition. Using a bonus scheme to attempt to retain staff would not seem to address the underlying cause of high turnover. Another respondent further added that DCC should explore more economic initiatives such as questionnaires to discover any cultural issues and development programmes for high performing team members.

3.25. One respondent argued that the scheme could be justified if DCC could show the positive impact of the scheme, and that targeting the scheme may lead non-eligible employees to become unmotivated, but overall deferred to Ofgem's judgement.

3.26. DCC provided further evidence in response to our consultation justifying its rationale behind the introduction of the scheme and its impacts, including additional evidence in the form of board papers and the report of an independent review of the scheme, which was carried out in February 2020.

3.27. DCC argued that it was necessary to introduce the scheme in 2018 as resource constraints were a risk to the delivery of core programmes. Though DCC acknowledged in its board papers that churn of permanent staff was "relatively low", DCC was concerned that key members of staff leaving the organisation could cause delays to core programmes

and result in costs on customers, this was particularly the case as some programmes came to an end. As core programmes grew, DCC stated that individuals risked becoming too thinly spread, which could result in high attrition, and result in a negative impact to delivery. In addition, DCC stated that it needed to improve its value proposition to prospective employees to attract the best talent, and argued that many other organisations offer a retention scheme.

3.28. DCC also argued that they considered different options for the scheme to demonstrate that it had been well designed and fit for purpose. In the board paper proposing the scheme, DCC considered two main options: one based on individual employee performance and one based on DCC's overall performance against corporate objectives, with DCC adopting the latter approach funded through savings DCC had made over the two years. Both options offered the scheme to all staff - with the exception of poor performers - and accounted for the bonus provisions in employee contracts that meant more senior staff would earn proportionately more from the scheme.

3.29. DCC argued in their response that they thought it appropriate to offer the scheme to all staff to ensure the scheme was equitable, as all staff are critical to delivery, not just staff visible in programmes. DCC also argued that senior staff should receive proportionately more in line with their contracts as they are more able to influence the success of DCC compared to more junior staff. DCC also stated that the scheme awards high performers.

3.30. We note that in parallel to introducing the retention scheme, DCC also increased its employee annual leave allowance and the provisions around maternity pay to further improve their offer to staff. We also note that DCC made the decision not to increase employee pension contributions on the basis that this would not be value for money.

3.31. DCC also argued in their response that the scheme was effective and had a positive impact. DCC provided evidence that attrition before the scheme was launched was 19.8%, and then after the launch of the scheme it was 10% for those on the scheme and 22% for those who were not. In addition, results from an employee opinion survey show that 66% of employees said the scheme encouraged them to stay with the organisation. In the same survey, 16% of employees mentioned the scheme when asked about factors that keep them at work in the DCC.

3.32. DCC calculate that based on an analysis in the difference between the attrition rates, the retention scheme resulted in a £0.388m saving on hiring costs. DCC also noted that a

100% turnover rate would result in £3.2m of hiring costs, but acknowledged in their response that this was an "extreme" scenario. DCC also highlighted that there were additional benefits to the scheme such as avoiding delay in the delivery of programmes, but were unable to quantify these benefits.

3.33. DCC also stated that the scheme drove efficiency savings and high performance across the organisation due to the corporate performance indicators that underpinned the payout of the scheme. DCC's level of success against the corporate KPI would set the overall pot available for the bonus payout. The corporate KPI included the outcome of the OPR, a customer effort score, the level of in-year cost savings,disallowances in the Ofgem price control, and the number of comms hubs installations. DCC assessed that it was at least on target in all areas, with the exception of comms hubs deliveries, which was below threshold and resulted in a reduced payout amount.

3.34. The independent review assessed how the scheme and DCC's employee value proposition compared to its competitors; the effectiveness of the scheme; and the impact of its design features. The review found no evidence of similar retention schemes being used in other organisations, stating that other schemes followed more of an ad-hoc pattern, targeted at key members of staff and linked to specific projects. Other long term incentive plans were typically based on shares aimed at the top layer of executives. On the effectiveness of the scheme, the review found some evidence that the scheme supported retention and – anecdotally – recruitment, and that the awards in line with bonus pay-outs were attractive. Nevertheless, the review found that the scheme was mainly visible in the run up to the pay out date, with awareness during the first 12 to 18 months of the scheme more limited. The review also found that there was limited evidence of awareness of the corporate objectives underpinning the scheme.

3.35. Though the review found that offering the scheme to all staff supported a culture of internal equity, the report concluded that it was difficult to justify the return of investment from offering the scheme to all employees given the strength of other factors of the employee value proposition at DCC; and that other options could have a higher impact on productivity, retention and overall performance. The review recommended that the current scheme should move towards a more targeted approach aimed at key talent, and the resources of the scheme redeployed to move towards a more recognition-driven approach.

Reasons for our decision

3.36. We have reviewed the responses we received, including the additional evidence provided by DCC. Though we maintain our position that the scheme was not value for money, we have taken account of DCC's evidence that the scheme had some positive impact and resulted in some cost savings. We have therefore allowed in full the cost savings DCC was able to demonstrate as a direct impact of the scheme from recruitment to reduce the disallowance amount from our consultation position of £2.499m to £2.111m.

3.37. In response to DCC's arguments that the introduction of the scheme was necessary to mitigate the risk of attrition, we consider DCC have not provided sufficient evidence to demonstrate that the risk was sufficient to justify the scale of potential costs. We note that DCC was concerned that high levels of attrition could result in a negative impact on delivery, but we have not received sufficient evidence to demonstrate the potential impact of this risk. We note that the board paper introducing the scheme stated that DCC had a "relatively low" attrition rate, which we note is below the private sector average DCC stated in their response. We also note that DCC mitigated the risk that attrition could be caused by individuals becoming spread too thinly across programmes by hiring new staff. DCC has increased its headcount from 316 full time equivalents (FTEs) in RY17/18, to 421 in RY18/19 to 530 in RY19/20, the majority of which would not benefit from the scheme due to joining DCC after the window of eligibility had closed. We note that DCC further mitigated the attrition risk by increasing the annual leave allowance and the provisions around maternity pay, alongside the introduction of the retention scheme.

3.38. In addition, though we acknowledge that DCC's competitors potentially have more flexibility to offer aggressive base pay, DCC benchmarks its base salaries to the median + 10% with an annual bonus. The independent review in its recommendations highlighted that this could be seen to constitute an already attractive compensation package without the retention scheme; particularly when considered alongside the strength of other factors of DCC's employee value proposition. As noted above, stakeholders agreed with this view.

3.39. In response to arguments that DCC sufficiently considered different options to ensure that the design of the scheme was fit for purpose, we consider DCC did not provide sufficient evidence to justify this. The board papers show that DCC only considered two main options for the design of the scheme, and that both options applied to all employees. We note that the independent review concluded that it was difficult to justify the return on investment from offering the scheme to all employees, and recommended that a targeted approach would be more closely aligned to market practice.

3.40. DCC has highlighted that, in considering options to reduce attrition risks, it made the decision not to increase employee pension contributions given the substantial increase in financial liabilities this would entail, and as it would likely be less effective at improving retention than the scheme, given the low net present value of an enhanced pension scheme offer. We consider it unlikely that increasing pension contributions in this way would have been value for money. However, we do not consider this demonstrates that the retention scheme itself would have been value for money.

3.41. We also note that the independent review recommended alternatives in the form of a recognition based approach that would have ensured better value for money and could have a stronger impact on retention. These included: on the spot recognition rewards (eg flowers, bottle of wine, vouchers), a dedicated budget for team celebrations, and annual cash awards for outstanding individual/team contributions.

3.42. We also note that DCC consider the scheme to have been funded through wider cost savings made throughout the organisation. In the RY18/19 price control decision, we set out our expectations for DCC to publish and commit to efficiency targets to demonstrate to customers that cost efficiency is central to its business planning strategy. We welcome DCC's efforts to continually seek cost savings, and encourage DCC to share cost savings with their customers. Nevertheless, all DCC costs should be incurred economically and efficiently; expenditures to deliver cost savings are subject to scrutiny as part of our price control, and cost savings do not ring-fence an equivalent amount of DCC's incurred costs from scrutiny.

3.43. Furthermore, though the DCC board paper states that the scheme was intended to support the retention of high-performing staff, we note that the only aspect of scheme design reflecting this was to exclude poor performers from being eligible for the bonus. In practice, this meant that only two members of DCC's staff were excluded from the scheme on the basis of their poor performance. The scheme did not offer any additional incentive to differentiate between satisfactory and high performance.

3.44. In regards to the impact of the scheme, we acknowledge that some individuals reported in staff surveys that the scheme encouraged them to stay, although the independent review suggests engagement and understanding of the scheme was mixed. We also acknowledge that DCC reported attrition after the launch of the scheme was 10% for those on the scheme compared to 22% for those who were not.

3.45. Nevertheless, we note DCC's evidence that the scheme resulted in cost savings, according to DCC's analysis of these attrition rates, as a result of avoiding hiring costs for staff that potentially may have left the organisation. We have not taken account of DCC's estimate of hiring costs in a 100% turnover scenario, as DCC acknowledged that this was an "extreme" scenario. We also note DCC's view that there would be some additional benefits from the scheme to programme delivery, which DCC did not provide further evidence in their consultation response to quantify. DCC also did not provide us with evidence showing a breakdown of the impact of the scheme across DCC.

3.46. In regards to DCC's argument that the scheme drove high performance across the organisation, we note that the independent review stated there was limited evidence of awareness of the corporate objectives underpinning the scheme. As stated in the performance incentives chapter of this document, we note that stakeholders remain concerned in particular with DCC's wider performance in the North, and ongoing concerns around DCC's customer engagement. We have not seen a sufficiently quantifiable impact from the scheme on DCC's performance to justify the scheme.

3.47. Based on the evidence of the quantifiable impact of the scheme, we have reduced the disallowance amount by £0.388m to recognise these cost savings. However, we remain concerned that these cost savings are small when compared to the £2.499m overall expenditure, further suggesting that the scheme was not value for money.We note that DCC has signalled an intention to introduce further retention schemes in the future. We urge DCC to carefully consider the following:

- whether there is a strong business need to introduce such a scheme;
- to fully analyse the issue that the scheme is attempting to address;
- consider a wide range of options that could be more cost efficient, including initiatives designed to improve the wider employee value proposition;
- ensure that the scheme is sufficiently targeted and designed to reduce costs.

Product Management team

Proposal at consultation: It was unclear that the growth of the team was sufficiently justified and underpinned by customer demand for additional products or services. In the absence of evidence demonstrating how these activities complement DCC's core service

offer, we proposed to disallow the incurred cost associated with this team of £0.509m for RY19/20. We also proposed to disallow forecast costs of £1.245m over RY20/21 and RY21/22 due to uncertainties in future demand.

Decision: Following further evidence from DCC linking some of the team's activities to the core service, we have reduced the disallowance amount for RY19/20 to £0.191m. Forecast disallowances remain at £1.245m over RY21/22 and RY22/23.

3.48. DCC expanded its Strategy and Product Management team in RY19/20, restructuring senior roles in the team, as well as recruiting new roles to form the Product Management sub-team.

3.49. In its price control submission, DCC stated that the Product Management team is responsible for the development of new value propositions based on existing capabilities, such as propositions for Electric Vehicles, supporting vulnerable customers, experimentation and testing. In response to our clarification questions, DCC further explained that the team focused on delivering product offerings for existing customers. The sub-team would also be expected to undertake increased stakeholder engagement relating to innovation and growth initiatives, ensuring that its propositions are developed in line with industry expectations.

3.50. As we consider that DCC's main focus should remain delivery of its core business, we required additional evidence at consultation demonstrating how these activities complement DCC's core service offer. We highlighted that we were open to receiving additional evidence from DCC and its customers to justify the activities of the product management team.

Respondents' views

3.51. Eleven respondents explicitly supported our consultation position to disallow the costs associated with the growth of this team.

3.52. All respondents (barring DCC) raised concerns with DCC's performance regarding its core service, with three noting issues and under-performance in the north region in particular. Many respondents highlighted that DCC's primary focus should be delivering its basic services and mandatory business functions to the level required by its customers, before looking to develop new products which may only shift focus away from DCC's core service. Respondents also commented how they did not

consider it the right time for DCC to be expanding into new areas, given that DCC needs to improve reliability and quality of its current service performance.

3.53. Four respondents raised concerns with the quality of DCC's customer engagement, with one respondent noting in particular that DCC's communication on its product offerings to date has been poor, and that DCC Users have had little opportunity to provide input. Another respondent noted that improving customer engagement for existing services should not be resource-intensive, as these requirements have already been set out clearly and should have been a basic function of DCC from the start.

3.54. Two respondents commented that DCC generally seeks to increase staff numbers and therefore expenditure on staff, in order to rectify a particular issue, noting that this is generally not a cost-effective or efficient approach.

3.55. Two respondents acknowledged that DCC, in response to market demand, would likely need to expand its service offerings in the future. However, both respondents also stated how the expansion into these new business areas would likely remove focus from the core service at present and viewed that expansion at this stage as premature.

3.56. Respondents also commented that DCC should not be carrying out activities relating to new products and innovation, which are not part of the core business, using customer money. They highlighted DCC did not have the funding models in place for new services. One respondent suggested that growth plans should be funded either by DCC itself, or by specific parties who wish to utilise the proposed services.

3.57. DCC strongly opposed our consultation position. DCC explained it made a business decision to create this team and function with the specific view to focus on products and services for existing customers. Prior to this there was insufficient resource to provide capability and expertise to take ideas formed with customers forward into delivery. The Strategy and Product Management headcount was in line with DCC's business plan and DCC argued this function did not exceed the allocated budget for the team.

3.58. DCC provided additional evidence in the form of detailed further explanation of the activities of the team over RY19/20, providing specific examples of work carried out, including the driver, business need or demand.

3.59. Some activity DCC discussed was a targeted improvement to Mandatory Business Services. For example, after engagement with BEIS's Non-Domestic Smart Energy Management Innovation Competition (NDSEMIC), DCC took steps to improve the onboarding process, demonstrating a reduction in the length of time taken to complete the process. DCC also explained how it took steps to evaluate the Elective Communications Services (ECS) process in order to make improvements. Further activity included developing guidance to support its customers, engagement as a result of SEC requirements, and developing increased testing capability in response to its customers' (and their supply chain partners) requirements.

3.60. DCC also provided evidence in the form of a 'demand log', documenting engagement with customers, government, and other stakeholders in response to demand or need for products or services.

3.61. Some of DCC's additional evidence described work DCC had been undertaking to evaluate and develop future products and services, stating that it is obligated by its licence to evaluate new products and services to facilitate innovation and competition through system reuse. DCC detailed engagement with a variety of stakeholders, some outside of the energy industry, where they discussed opportunities for future products and services as part of the potential for innovation and reuse of the DCC network. This engagement included identifying where services may be provided to existing and new DCC customers. DCC also noted it was supporting customers with BEIS-funded load control trials and that the team was defining DCC's Electric Vehicle (EV) proposition.

Reasons for our decision

3.62. We have reviewed the responses received, including the additional explanation and evidence provided by DCC. We have received sufficient evidence to change our consultation position in part, and disallow a partial amount of the cost incurred in RY19/20. We are therefore disallowing £0.191m of incurred costs associated with the expansion of this team, and disallowing £1.245m of forecast costs due to their uncertainty.

3.63. This is to address our concerns, and those raised by stakeholders, about DCC expanding into new areas past what is efficient when it should be focusing on the core service, whilst taking additional evidence into account where DCC's activities complement core business activity.

3.64. DCC's Licence contains General Objectives which describe how DCC must carry out its Mandatory Business.[11] The Licence also requires that DCC must have regard to its General Objectives in the round, weighing them as appropriate in each particular case. Although we recognise that DCC will likely need to evolve its service in future in response to market demand, it must ensure to weigh its objectives appropriately. We are concerned that DCC appears to be placing undue focus on innovation, whilst its core service, delivery of critical core projects, and delivery of the First Enduring General Objective[12] is not at a standard its customers require. DCC's Mandatory Business is of utmost priority and we consider it imperative that DCC carries out its role in facilitating the smart meter rollout to offer a high quality service.

3.65. Given DCC's current level of maturity and the issues its customers are experiencing with service performance, we maintain that it is not an appropriate time for DCC to grow in order to expand DCC's service offerings beyond its core business through developing new initiatives.

3.66. At a later date, if DCC reaches an appropriate level of maturity and service performance, it may seek opportunities to develop and offer products and services to new customers. Should this be the case DCC must ensure it has appropriate funding models in place to ensure that the costs of developing these products do not fall upon its existing customers. DCC also has an obligation to seek Ofgem approval ahead of providing any services that fall within the definition of Value Added Services (VAS)[13].

3.67. In addition, we consider it important that DCC improves its transparency around spend on innovation activities. We expect DCC to indicate clearly where costs are incurred as part of administering the smart meter rollout, and other mandated programmes, versus those which are incurred as a result of DCC expanding its business into additional activity not directly related to the core service. DCC should

[11] Conditions 5.4 and 5.5 in the Licence describe the Interim General Objective. Conditions 5.9 and 5.10 outline the First and Second Enduring General Objectives respectively.
[12] The First Enduring General Objective requires DCC to carry on the Mandatory Business in the manner that is most likely to ensure the development, operation, and maintenance of an efficient, economical, co-ordinated, and secure system for the provision of Mandatory Business Services under the Smart Energy Code and where relevant the Retail Energy Code.
[13] In accordance with Part D of LC 6 of the Smart Meter Communications Licence.

consider ringfencing areas of the business which are focused on future products and services to separate it from the core part of its business.

3.68. Based on DCC's additional evidence, we note that a significant proportion of the team's activities were aimed at delivering improvements to Mandatory Business Services. This included onboarding, testing, and ECS processes, and included evidence of engagement throughout the year with customers and other parties such as Ofgem and BEIS.

3.69. On the basis of this evidence, we have reduced the amount of disallowance compared to our consultation position. Nevertheless, DCC must ensure that it incurs costs aimed at delivering improvements economically and efficiently, seeking ways to deliver value for money. We will continue to scrutinise DCC activity in this area.

3.70. As part of the additional evidence, DCC explained that it is working to create value propositions for EVs and assisting customers with BEIS-funded EV and load-control trials. Whilst we do not discourage assistance where customers request it, we do not consider that DCC should take on additional resource to do so, particularly as these trials should be using existing DCC infrastructure and do not require DCC to develop additional products. Similarly, DCC should not need to expand in order to engage with BEIS on non-mandated activity, which is in early stages of development. We expect that DCC should seek to undertake engagement - such as responding to BEIS consultations and requests for information – using existing capability within DCC, and would not expect DCC to take on additional resource to broaden its scope.

3.71. We recognise that it may not always be apparent where activities relating to innovation sit within DCC's business, and whether they fall within Mandatory Business or Permitted Business. We also note that requirements for DCC activity come from a variety of sources such as licence obligations, government objectives, and customer demand. We are currently planning to begin work on reviewing the VAS framework[14] in the first half of 2021. We intend this work to begin to provide clarity and a shared understanding of VAS, Minimal Services, and DCC's obligations, including routes for approval of new services and requirements for appropriate

[14] As outlined in condition 6 of the Licence.

funding. We will be engaging with stakeholders in due course and welcome customer input.

Commercial Operations and Vendor Management forecasts

Proposal at consultation: Insufficient justification and cost breakdown was provided for the variance in forecast costs for the resourcing requirements of the Network Evolution Programme in the Commercial Operations and Vendor Management teams. We proposed to disallow all forecast cost variance for these teams of £3.409m over RY20/21 and RY21/22.

Decision: Remains unchanged from the consultation proposal.

Respondents views

3.72. Ten respondents agreed with our proposal to disallow the costs. Two respondents did not provide direct comment on our proposal.

3.73. Several respondents raised concerns with the level of incurred and forecast costs of the Network Evolution Programme, given that the exact scope of the programme is still to be defined. One respondent commented that the programme may be increasing complexity rather than providing simpler solutions.

3.74. We highlight that where respondents provided further discussion on this question, some showed general support for the Network Evolution Programme, particularly in cases where activity may help resolve issues experienced in the North region and mitigate the 2G/3G sunsetting risk. However these respondents also noted their concern with the level of cost-detail provided to customers.

3.75. One respondent noted that they would expect forecast costs to be included in the Cost-Benefit Analysis for each workstream as an indicator of ongoing cost. Several respondents also highlighted the importance of DCC engaging with stakeholders in a transparent manner about its planned activities, the need for them, and their cost.

3.76. DCC noted our minded-to position, explaining that it aims to provide accurate forecasts but the required certainty threshold may not always be met when considering its inclusion in the price control submission. DCC highlighted that whilst it shares forecasts with its customers on a quarterly basis, those forecasts are only included in the annual price control submission if they meet the appropriate level of certainty.

Reasons for our decision

3.77. In light of the responses received we are maintaining our consultation position to disallow all forecast costs of the Commercial Operations and Vendor Management teams. This amounts to £3.409m over RY20/21 and RY21/22.

3.78. We recognise that as the Network Evolution Programme began in RY19/20, costs may be more uncertain at an early stage of the programme. However, if DCC provides Network Evolution as a driver for change in resource and associated costs, we would expect this to be clearly broken down in the associated forecasts.

3.79. It is of great importance that DCC engages with its stakeholders in a transparent manner about its planned activities. We urge DCC to take steps to improve its forecasting and provide clear and transparent cost forecasts for its customers, ensuring forecast costs are included in any business case and cost-benefit analysis.

Accommodation – Preston Brook disallowance

Proposal at consultation: The move from Preston Brook into Brabazon House was not planned efficiently. We proposed to disallow £0.105m of the incurred variance associated with Preston Brook.

Decision: Remains unchanged from the consultation proposal.

3.80. DCC vacated its Preston Brook office as a result of the move to Brabazon House. Preston Brook had a notice period of 6 and 9 months for the two areas DCC was contracted to, and DCC later negotiated the 9 month notice period down to 6 months. DCC agreed not to give notice until it was fully transitioned into Brabazon House.

Respondents' views

3.81. The majority of respondents supported our consultation position. Respondents noted that better management of the move during the notice period could have reduced spend.

3.82. DCC opposed our consultation position, and explained that the IT provision at Preston Brook had to remain until January 2020 (whereas the office was vacated in December 2019) and this increased the risk of interrupting business should the

move be delayed. DCC explained it therefore did not give notice until it was fully transitioned into Brabazon House to ensure continuity of service to its customers.

Reasons for our decision

3.83. While we recognise that DCC negotiated a shorter notice period for one area, as noted in our consultation, we consider that better planning and management of the transition within the notice period could have further reduced the costs incurred. We do not consider that DCC's arguments counteract the need to have robust measures in place when carrying out such a move; and expect DCC to demonstrate it has incurred all of its costs economically and efficiently, showing a fully-considered assessment of trade-offs and risks.

3.84. We therefore maintain our consultation position to disallow £0.105m of incurred costs over RY19/20 associated with the transition into Preston Brook. This disallowance took into account that a buffer period was necessary to ensure continuity of service to DCC customers.

Forecast Internal Costs

Proposal at consultation: Insufficient justification was provided for the variance in internal forecast costs from RY22/23 onwards. We proposed to disallow all variance in internal forecast costs from RY22/23 to the end of the licence term which amount to £172.003m.

Decision: Remains unchanged from the consultation proposal.

Respondents' views

3.85. Ten respondents explicitly supported our consultation proposal to disallow all increases in forecast costs from RY22/23. Two respondents did not provide a direct response to this question.

3.86. Several respondents raised concerns that DCC continues to forecast increases in Internal Costs without sufficiently justifying them, noting DCC should instead be seeking efficiencies and streamlining its business, ensuring costs are robustly managed.

3.87. One respondent highlighted that these forecast costs appear to be an arbitrary increase rather than a justified estimate, and raised their concerns that this is an ongoing trend with DCC's annual price control submissions.

3.88. DCC did not disagree with our position and stated that it aims to provide accurate forecasts and reduce the volatility of cost movement, however the threshold of certainty is not always met due to the level of change that DCC and the wider industry is subject to. DCC further noted that the forecasts being shared with its customers on a quarterly basis are only included within the annual price control submission if they meet the appropriate level of certainty.

Reasons for our decision

3.89. Our decision to disallow the increase in forecast internal costs from RY22/23 to the end of the Licence term remains unchanged from our consultation position.

3.90. As noted in our consultation, we expect DCC to be committed to finding efficiencies and delivering value for money, providing more certainty over its forecast cost savings and communicating these savings to its customers.

4. Performance Incentives

Section summary

This section covers DCC's performance under the OPR and any relevant BMPPAS.

In our consultation, we proposed to increase the reduction to DCC's BM due to DCC's performance under the OPR by £0.804m (from DCC's submitted £0.840m to £1.644m). We also proposed no changes to the reduction DCC submitted due to its project performance (£0.482m of the total £0.554m in RY19/20).

Following consideration of the consultation responses our positions remain unchanged.

Question 8: What are your views on our proposed position on DCC's operational performance?

Question 9: What are your views regarding DCC's failure to ensure all CSPs met their contractual milestones and its wider performance in the North region?

Question 10: What are your views on our proposed position on DCC's project performance?

Background

4.1. All of DCC's BM (including adjustments) is at risk against one of DCC's performance regimes[15].

4.2. The margin DCC recovered in RY16/17 and RY17/18 was not put at risk against a performance regime as the Implementation Performance Regime had concluded and the OPR was yet to begin. All of the BM recovered in RY16/17 and RY17/18 is being put at risk across RY18/19, RY19/20 and RY20/21.

[15] See Part C of LC 38 of the Smart Meter Communications Licence.

4.3. This is the second year in which DCC's performance is being assessed by the OPR, and the final year of assessment of the R2.0 BMPPAS. Separately to the BM, DCC receives margin on the Switching Programme. This switching margin is at risk under a separate performance regime, which is covered in chapter 6 of this document.

Operational Performance

Proposal at consultation: Direct an additional reduction to DCC's Allowed Revenue of £0.804m due to DCC's performance under the OPR, resulting in a total reduction of £1.644m due to DCC's performance under the OPR, and £0.482m due to DCC's performance under the R2.0 Baseline Margin Project Performance Adjustment Scheme in RY19/20.

Decision: Remains unchanged from consultation proposal.

Context

4.4. As set out in Schedule 4 to the Licence, the current OPR was initially consulted on in March 2016 and the final decision and direction was published in September 2017[16].

4.5. The current OPR consists of five equally weighted performance measures: two Service User Measures (SUM) and three Service Delivery Measures (SDM). Table 4.1 lists the five measures and subdivisions.

[16] For more detail on the current OPR please refer to the decision document and consultation documents: https://www.ofgem.gov.uk/publications-and-updates/decision-dcc-s-operational-performance-regime

Table 4.1: Operational Performance Measures

Measure	Area of reporting	Metric	Weighting
SUM1	DCC service desk	Percentage of incidents resolved within Target Resolution Time	20%
SUM2a	Communication Hubs	Percentage of Communications Hubs delivered on time	10%
SUM2b		Percentage of Communications Hubs accepted by customers	5%
SUM2c		Percentage of Communications Hubs not faulty at installation	5%
SDM1a	DCC WAN coverage	All CSP contractual milestone dates met	20%
SDM1b		Percentage of first time SMWAN connectivity at install	
SDM2	Core service requests	Percentage of service responses delivered within Target Response Time	20%
SDM3	Service/System Availability	Percentage availability of Data Service, User Gateway, Service Management System and Self Service Interface	20%

4.6. These OPR performance measures are composed of a combination of the performance measures reported to the SEC and described in DCC's Performance Measurement Methodology.

4.7. In its RY19/20 price control submission, DCC submitted a reduction in its BM (Baseline Margin Operational Performance Adjustment value) of £0.840m due to its performance under the OPR relating to SDM1 and SDM2. This represented a reduction of £0.804m related to SDM1 and £0.036m related to SDM2. In relation to SDM1, the Communication Services Provider-North (CSP-N) missed one of its coverage milestones in the North which covered 8,386 delivery points. DCC proposed it retained half of the BM associated with SDM1 (£0.804m) on account of the limited impact of the missed coverage milestone, and the relatively quick resolution of the issue.

4.8. At consultation we proposed to reduce DCC's Allowed Revenue by £1.644 through the BMOPA term for its performance under the OPR. This represented a reduction of £0.036m related to the SDM2 milestone and a full reduction to the SDM1 milestone of £1.608m, £0.804m more than the reduction proposed by DCC. The proposed reduction to SDM1 reflected the default position of the OPR's quantitative methodology.

4.9. We also consulted on an alternative option of a decreased reduction up to the amount £0.804m (DCC's proposal) as DCC argued the impact of the missed coverage milestone was minimal. We sought additional evidence from DCC and its stakeholders on the impact of the missed milestone and DCC's wider performance in the North, so that we could consider whether there were sufficient grounds for us to move away from the default position.

Respondents' Views

4.10. All respondents who commented, except DCC, supported our proposal to reduce DCC's Allowed Revenue by £1.644m.

4.11. DCC provided additional justification to support its position that it should not lose the full margin in relation to SDM1. DCC stated that performance measure SDM1 is a percentage of the Total Delivery Points (TDPs) covered by the Wide Area Network (WAN). TDPs are correlated with live postcodes and increase as new postcodes are added. DCC argued that there is no visibility of where the new post codes will appear, hence there is no opportunity for the CSP to plan for additional coverage. DCC explained that this unforeseen increase to the TDPs, as a result of last minute issuance of post codes in RY18/19, had a knock on effect to the RY19/20 milestone, which is outside of DCC's control.

4.12. In addition, DCC reiterated the Impact of SDM1 on its customer's was minimal. DCC provided evidence to show only 8,386 delivery points, equating to 391 post codes, were impacted by this delay. These post codes were in rural and remote areas.

4.13. In addition, in terms of customer engagement, DCC argued it communicates with customers on a daily basis via various mediums and stated there is no record of the missed WAN coverage milestone in the North being raised as an industry issue in RY19/20. DCC added it approached customers individually about the effect of the missed milestone but customers did not respond.

4.14. Finally, DCC stated that it should not be penalised for the wider issues in the North as these issues are outside of the scope of the OPR. DCC further argued that the principles of incentivising DCC for performance issues that are controllable by DCC are being eroded. DCC questioned why Ofgem is applying different rules to DCC relative to network companies where income adjusting events have returned 'hundreds of millions of pounds' to network companies over a 20 year period.

4.15. Eight respondents highlighted that the CSP-N's performance has continued to be poor in RY19/20. Some respondents highlighted specific issues such as: the ongoing network and service stability issues; poor installation and commissioning times; and the delay in defect free prepayment functionality in Communication Hubs. The respondents explained that due to an unstable service, they were unable to deploy smart meters, with four respondents highlighting that the enrolment of smart meters in the North continues to lag behind other regions. Most of these respondents stated that the CSP-N's performance has been poor in general.

4.16. Three respondents highlighted the lack of progress on DCC's improvement plans in the North. Whilst respondents acknowledged DCC attempts to address issues in the North via the 'DCC CSP-N Common Issues Forum' – respondents questioned the speed of progress on resolving these issues. One of these respondents stated they were not informed that CSP-N were likely to miss the milestone in the North.

4.17. Two respondents stated that they do not believe DCC is managing the CSP-N effectively as an external service provider. Another respondent believed the CSP-N is not running an efficient operation due to the lack of subject matter experts to resolve network issues.

4.18. Two respondents stated that the impact of the missed milestone prevented suppliers from rolling out SMETS2 meters, though respondents didn't quantify what these precise impacts were.

Reasons for our decision

4.19. We have reviewed the responses we received, including the additional evidence provided by DCC. We believe that there is insufficient evidence for us to change our consultation position from the default position of the OPR.

4.20. We accept DCC's argument that the missed milestone had minimal impact and DCC worked with the Communications Service Provider to resolve the issue quickly.

4.21. We also note DCC's efforts in engaging with its customers compared to RY18/19, and note that in RY19/20 only one respondent reported that it was not informed of the missed milestone. We encourage DCC to continue to improve its customer engagement, particularly around issues relating to the North.

4.22. However, we need to have sufficient evidence to justify moving away from the default position of the OPR (which is to reduce the BM by the full £1.608m related to SDM1 because of the missed coverage milestone). We note that there is no provision in the current OPR framework for Ofgem to assess the context of a missed milestone in making its determination - including whether the missed milestone was within or outside of DCC's control - but consider it part of our role as a reasonable regulator to consider whether it is appropriate to use our discretion to move away from the OPR default position.

4.23. In regards to DCC's comparison between the OPR framework and "income adjusting events" as part of the regulatory framework applied to network companies, we note that the licence provides for DCC to receive an upward adjustment in the face of uncertain events that cause a material change to DCC's work as part of the BM adjustment mechanism, which is separate from the OPR.

4.24. In the RY18/19 price control, we assessed the SDM1 (missed milestone) impact more broadly, taking into account stakeholder responses and the wider issues in the North. Similar to last year, we do not believe it is appropriate to narrowly focus on the impact of the missed milestone in determining whether to use our discretion, given that the overarching purpose of the OPR is to drive DCC to deliver a good service to its customers. Therefore, we are again looking at the broader context of the issue for RY19/20.

4.25. We note DCC's argument that the issuance of post codes was outside of their control, and that this issuance that occurred in RY18/19 had a knock-on effect for RY19/20. We note DCC did not provide any evidence of proactive steps taken since RY18/19 to further understand or mitigate this risk.

4.26. In addition, DCC's performance in the North has continued to be an area of particular concern. DCC's customers have reported that the quality of service provided by CSP-N has been unacceptable in a number of areas. DCC is accountable for the

performance of its service providers, but this missed milestone is the only aspect of this poor performance that has been captured by the OPR.

4.27. Therefore, considering DCC's limited evidence to mitigate an issue occurring in RY18/19, and the full context of the situation in the North, there is insufficient evidence for us to deviate from the default OPR position of reducing the retained BM by the full value associated with the SDM1 milestone £1.608m.

4.28. Regarding SDM2 (Percentage of service responses delivered within Target Response Time), in the absence of any additional evidence we maintain our consultation position (the default position of the OPR) to reduce the retained BM by £0.036m.

4.29. Therefore, as there are no changes to our consultation position the BMOPA term is calculated to be £1.644m.

Project Performance

Proposal at consultation: DCC submitted its performance values for the R2.0 project. The total reduction in the BM this year is £0.482m, 87% of the total possible £0.554m. In addition, DCC will have its BM reduced by a minimum of £0.427m across future years because of the missed milestones. We identified no issues with DCC's reporting of its performance in the R2.0 project. We note that DCC has performed poorly in meeting the milestones set out in the BMPPAS.

Decision: Remains unchanged from consultation proposal.

Context

4.30. The Secretary of State may create a BMPPAS[17], defining a Project and an incentive regime, which determines the BM DCC retains based on its performance in the defined

[17] As set out in LC 38 of the Smart Meter Communications Licence.

Project. BM adjustments which are awarded to DCC for work associated with such a Project are held at risk by the BMPPAS incentive regime.

4.31. Any reductions made due to a BMPPAS incentive regime are made through the BMPPA term given in the Licence.

4.32. In October 2020 BEIS published their decision on whether to revise the R2.0 BMPPAS. They concluded that it was not appropriate to make changes to the scheme. Therefore, this is the final year of the BMPPAS regarding the R2.0 project.

4.33. In its RY19/20 submission, DCC submitted results for the final two milestones of the eight which comprise the R2.0 BMPPAS incentive regime, milestones 4A and 4B. DCC retained no margin associated with these milestones. The total reduction to the BM this year is £0.482m, 87% of the total possible £0.554m.

Respondents' Views

4.34. Most respondents agreed with our consultation position and believed that DCC performed poorly in meeting the milestones for this project.

4.35. Three respondents highlighted concerns around the delays to R2.0 availability in the North and its significant impact on the roll-out including the roll-out of Communication Hubs. This also impacts on suppliers operating costs.

4.36. One of these respondents agreed with our proposal, but stated that Ofgem should consider reducing the margin by its entire value ie £0.554m. This respondent argued that delays to the R2.0 project had a significant impact on deployment plans in the North which in turn affected its own performance obligations.

4.37. DCC highlighted that the delays to the delivery of the milestones were outside of its control, but did not propose any alternative value for retained margin.

Reasons for our decision

4.38. We have reviewed all the responses received. We maintain our consultation position as per values reported by DCC in its price control submission on its performance related to the R2.0 project.

4.39. Therefore, as there are no changes to our consultation position the BMPPA term for RY19/20 is calculated to be £0.482m.

5. Baseline Margin and External Contract Gain Share

Section summary

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

The BM will be adjusted to reflect changes to DCC's Mandatory Business. Following consideration of consultation responses and the additional evidence provided by DCC, we have changed our position on one activity we had proposed to reject. We have also accepted DCC's additional justification in regards to the SMETS1 resource discrepancy. We have directed an adjustment of £8.747m.

The ECGS will be adjusted to reflect the cost savings DCC has achieved through refinancing. Following consideration of consultation responses and the additional evidence provided by DCC, we have changed our position, no longer rejecting £0.751m relating to Communication Hubs financing and awarding the full ECGS Adjustment of £3.812m

The total ECGS savings secured by DCC for customers between RY15/16 (DCC's first ECGS Adjustment application) and RY19/20 (including this year's application) is £57.433m which accounts for 53% of total cost reductions.

Questions

Question 11: What are your views on our assessment of DCC's application to adjust its Baseline Margin?

Question 12: What are your views on our assessment of DCC's application to adjust its ECGS?

Baseline Margin

Proposal at consultation: Adjust DCC's Baseline Margin by £7.521m (RY19/20 prices) for work being performed between RY19/20 and RY21/22. DCC provided insufficient evidence for eight activities and one driver it had identified, and based on these grounds, it should not be awarded Baseline Margin. DCC's BM should be reduced proportional to the disparity between the SMETS1 payroll variance under internal costs and Baseline Margin for RY19/20 and RY20/21. 15% is an acceptable margin for the core smart metering activities.

Decision: Direct an adjustment to DCC's Baseline Margin of £8.747m (RY19/20 price base) for work being performed between RY19/20 and RY21/22. That DCC provided sufficient additional evidence for one of the eight activities, which originally did not meet the conditions for a Relevant Adjustment. That DCC provided sufficient additional evidence regarding the SMETS1 discrepancy. That 15% is an acceptable margin.

Context

5.1. The BM 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.

5.2. The BM 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 on the conditions and requirements for a BM Relevant Adjustment can be found in the RIGs,[18] and the processes and procedures document[19].

5.3. DCC's BM (including adjustments) is subject to DCC's performance regime under which its BM may be reduced for poor performance. 100% of the BM recovered this year is

[18] https://www.ofgem.gov.uk/publications-and-updates/data-communications-company-dcc-regulatory-instructions-and-guidance-2019

[19] https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-guidance-processes-and-procedures-2019

held to account either by the OPR, and by a Baseline Margin Project Performance Adjustment Scheme (for Release 2.0), as directed by the Secretary of State.

Respondents' Views

5.4. Most respondents supported our consultation proposals for the BM adjustment.

5.5. DCC contested four of our consultation proposals: SMETS1 discrepancy; Service Standards – Order Management Service (OMS) activity; Tech Driven Change – DSP activity; and the Future Release Driver.

5.6. In regards to the SMETS1 discrepancy, DCC provided evidence that the variance applied for in the BM application is not comparable to the cost variance as reported in the RIGs for the SMETS1 resource costs. DCC explained the variance for RY19/20 is justified and in line with previous years as they do not apply for BM on all SMETS1 resource roles as some roles have only spent a proportion of their time on the SMETS1 programme.

5.7. In addition, DCC explained the variance for RY20/21 is due to the re-adjustment of its SMETS1 forecast for RY20/21 compared to RY18/19 baselined forecasts. DCC state the reason for lowering the RY20/21 SMETS1 forecast is largely related to the majority of the SMETS1 programme's contractual arrangements being completed in early 2019.

5.8. DCC also contested our proposed rejection of the OMS activity related to the Service Standards driver. DCC argue the LABP anticipated that "design incongruence" between the solutions of the different Service Providers may necessitate changes to ensure the DCC solution is compatible.

5.9. Two respondents specifically supported our proposals to reject the OMS. One of these respondents argued that – as a SEC party – DCC are obliged to ensure its systems remain complaint with the SEC. This respondent also stated that the DCC should have expected increased SEC Modification activity given DCC was the proposer of eight of the last ten SEC Modifications. Another respondent stated they had not seen a significant improvement in service standards from the OMS.

5.10. DCC contested our proposed rejection of the Data Services Provider (DSP) re-procurement related to Tech Driven Change driver. DCC argued the BMI' levels set in the original procurement of the DSP in the LABP were only based on internal costs certain at that particular time, which did not include re-procurement of the DSP. DCC stated that re-

procurement of the DSP is explicitly listed in the LABP as one of the activities that could be subject to future change to scope, timeline or volume. On this basis, DCC argued the DSP re-procurement constitutes a material variation from the LABP.

5.11. DCC contested our proposed rejection of the Future Release driver related to SEC activity (Nov 2019 and June 2020 SEC Releases). DCC argued these activities align to the 'Multi-Release' driver raised in RY17/18, which Ofgem approved. DCC explained they had informed Ofgem in the RY17/18 BM submission that they would run a series of programmes supported by future releases. DCC also stated that SEC Modification activity was explicitly mentioned as something uncertain in the LABP.

5.12. DCC underlined that the original BM values as set out in the licence were based on the activities and assumptions known at that time and were calculated based on pre-defined costs. If these pre-defined costs change for any valid reason – they would be eligible for BM.

5.13. One respondent argued that DCC's activity related to bringing its IT infrastructure in house were not due to any new or increased security requirements, and therefore should not be considered as an increase in scope or change in requirements. The same respondent further questioned how Shared Services can be awarded on IT infrastructure given DCC are bringing this in house. The respondent considered this to be double counting of Shared Services and BM gained on IT systems.

5.14. One respondent considered the 15% margin level 'too high' in the context of the current energy market, where some of DCC's customers are achieving low or negative margins.

5.15. Finally, one respondent expressed concern that DCC continues to seek additional funding for activities they regard as an extension of their responsibilities, but the respondent considered these activities as necessary and part of DCC's core service.

Reasons for our decision

5.16. We have considered the responses we received, including DCC's additional evidence and explanation, regarding the SMETS1 discrepancy, OMS and DSP activity, and the Future Release driver. We have decided that there is now sufficient evidence that the DSP activity meets the conditions for a Relevant Adjustment. We have also made a Relevant Adjustment to take account of the resolved SMETS1 discrepancy.

5.17. In regards to the SMETS1 discrepancy, we have assessed DCC's arguments quantitatively to confirm that the applied for roles are indeed working a certain proportion of their time on the SMETS1 programme.

5.18. Regarding the OMS activity, DCC argue that they are investing in their operational capacity to meet customer demand. However, as stated in the RY19/20 consultation, SMETS1 and SMETS2 meter installation rates remain below what was envisaged at LABP. It remains DCC's responsibility to ensure that its systems remain efficient as the rollout progresses. In regards to the "design incongruence", we view that DCC's investment in the OMS was aimed at developing a more efficient solution as the number of DCC users increase with the rollout, rather than to overcome a fundamental compatibility issue between different technological solutions as envisaged in the LABP.

5.19. In relation to the DSP activity, we accept DCC's arguments that the DSP re-procurement constitutes a material variation from the LABP, based on the uncertainty and difficulty in costing for this that was noted in the LABP itself.

5.20. In regards to the Future Release Driver, though we awarded BM for this driver in RY17/18, this related to DCC's move to a consistent SEC release model. This model timetabled major SEC releases in November and June with maintenance releases in-between. However, this is different from DCC's current application, which is based on additional people resource to implement the timetabled releases in November 2019 and June 2020. In order to award BM for this activity, we would need strong evidence that a SEC Release was significantly more complex, and required a higher volume of work compared to previous SEC releases. We do not consider the BM Relevant Adjustment threshold has been met in this case.

5.21. In regards to the BM framework, we assess any Relevant Adjustment based on the criteria outlined in the licence. A Relevant Adjustment must relate to a material variation that has or is likely to take place to DCC's mandatory business in line with the conditions in the licence. This must be a material variation in the form of: volume, characteristics, risks, timescales, or a combination of these factors[20]. DCC may also propose a new activity which was not envisaged at the time the LABP was agreed. We assess DCC's BM application based

[20] Licence Condition 36, appendix 2, paragraph A3

on the evidence and justification it provides for each driver and evaluate this against the criteria outlined in the licence.

5.22. In relation to the concerns around the double counting of shared services and BM, we agree that there is a potential risk of double counting. However, we consider it reasonable that Capita IT continue to provide support to the network in the period immediately after the establishment of DCC's dedicated IT infrastructure to ensure continuity of service. However, in future price controls, DCC should ensure this in-house move is accounted for in Shared Services, and if bringing further Capita services in-house should demonstrate how this is economic and efficient.

5.23. We maintain our position that 15% is an acceptable margin for the core smart metering activities, as DCC's position and characteristics relevant to earning margin have not substantially changed since last year.

5.24. As a result of the changes in the accepted activities and resolution of the SMETS1 discrepancy, the BM adjustment is calculated as £3.384m for work performed in RY19/20, £1.052m for work being performed in RY20/21, and £4.311m for work being performed in R21/22. In total the BM adjustment is £8.747.

External Contract Gain Share

Proposal at consultation: Direct an adjustment to DCC's External Contract Gain Share of £3.062m across RY21/22 to RY25/26 on the basis of £13.106m of savings from the continuation of refinancing arrangements for the DSP and CSPs, and reject £0.751m ECGS Adjustment relating to the financing of Communication Hubs (CHs).

Decision: Direct an adjustment to DCC's External Contract Gain Share of £3.812m across RY21/22 to RY25/26. DCC provided sufficient additional evidence related to the ECGS Adjustment for the financing of CHs.

Context

5.25. The formula for DCC's Allowed Revenue includes an ECGS term, which allows for an upward adjustment to the Allowed Revenue where DCC has secured cost savings in the Fundamental Service Provider (FSP) contracts as detailed in Condition 39 of the Smart Meter Communication Licence. 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.

Respondents' Views

5.26. Most respondents agreed with our proposals.

5.27. Two respondents welcomed the savings but highlighted concerns around DCC's service and performance. One of these respondents questioned how these refinancing initiatives will improve DCC's service, and encouraged Ofgem to consider the net effect of these refinancing initiatives to ensure they are not contributing to any further degradation in service levels.

5.28. One of the respondents who welcomed these savings, highlighted how enduring issues with the services provided by DCC, particularly in the North, have a significant downstream financial impact on DCC's customers.

5.29. One respondent welcomed the savings, but encouraged DCC to pursue other methods outside of financing to reduce service provider costs.

5.30. One respondent highlighted the need for greater clarity and transparency on the cost savings made to the CSP-N contract in light of the missed milestone and under performance in the North. Another respondent welcomed the savings, but questioned the share of internal costs incurred in order to achieve these savings.

5.31. DCC welcomed our proposal in allowing ECGS adjustment of £3.006m. However, DCC contested our proposed rejection of ECGS related to the financing of CHs, and provided additional evidence around the financing of CHs beyond Tranche 1. DCC referred to Schedule 7.1 (Charges and Payments) of the original contract, which sets out the financing arrangement for CHs beyond Tranche 1. DCC argued they have followed the due process as laid out in Schedule 7.1 to finance Tranche 2 CHs, and that they provided support over 10 months via its Contract Management, Legal and Commercial functions to deliver these cost savings.

Reasons for our decision

5.32. We have reviewed the responses we received, including the additional evidence submitted by DCC in relation to CHs financing. We have decided there is now sufficient

evidence to demonstrate that ECGS related to CHs financing meets the conditions for a Relevant Adjustment. Schedule 7.1 (Charges and Payments) of DCC's FSP contracts outlines the framework for the financing of CHs beyond Tranche 1 and DCC have demonstrated they have followed the processes as laid out in this schedule. Based on the additional evidence received, we have changed our position, no longer rejecting £0.751m relating to CHs financing.

5.33. In regards to DCC's service and performance levels in the North, we acknowledge that this remains an area of particular concern, which we have taken account of in our decision on OPR (see chapter 4 on performance incentives). The ECGS is calculated as £2.001m for RY21/22, £0.556m for RY22/23, £0.572m for RY23/24, £0.595m for RY24/25 and £0.089m RY25/26. **In total, the ECGS Adjustment is £3.812m.**

5.34. Between RY15/16 (DCC's first ECGS Adjustment application) and RY19/20 (including this year's application), DCC has secured cost reductions of £107.581m in the FSP contracts and CHs financing based on DCC's ECGS applications, and brought benefits of £57.433m (53% of total cost reductions) to DCC's customers through lower charges.

6. Switching

Section summary

This section covers our assessment of the first incentivised milestone of the Design, Build and Test phase of the Switching Programme: Delivery Milestone 1. In our consultation, we proposed that DCC should lose all margin associated with Delivery Milestone 1.

Following consideration of consultation responses, which largely supported our proposal, our position remains unchanged.

Questions

Question 13: What are your views on our assessment of Delivery Milestone 1?

Proposal at consultation: Given the extent of the delay within DCC's control extended beyond the four-week margin loss period, DCC should lose all margin associated with Delivery Milestone 1.

Decision: Remains unchanged from the consultation proposal.

Context

6.1. We published our decision on an updated incentive regime for DCC's role in the Design, Build and Test (DBT) Phase of the programme in May 2019[21], with the first of the delivery milestones under the DBT Phase occurring in RY19/20. Delivery Milestone 1 (DM1) required DCC – through its service providers – to develop the CSS (Centralised Switching Service) interface specifications and the CSS Integration Approach (CSSIA), ensuring these are of a high enough quality to be approved and accepted by the programme.

[21] Decision on margin and incentives for DCC's role within the Design, Build and Test Phase of the Switching Programme: https://www.ofgem.gov.uk/publications-and-updates/decision-margin-and-incentives-dccs-role-within-design-build-and-test-phase-switching-programme

6.2. All margin on internal costs relating to the successful delivery of the DBT phase is at risk against the DBT milestones, with 30% of the margin at risk against DM1. The final values that this represents in terms of margin retained will be finalised when all delivery milestones under the DBT phase have been assessed.

6.3. Note, the margin and incentives for the Switching programme are entirely separate from the BM and the BM adjustment process.

Respondents' views

6.4. Nine respondents supported our proposal for DCC to lose all margin at risk against DM1.

6.5. One respondent highlighted that based on their engagement with the Switching programme, they did not consider any of the delay associated with the milestone as outside of DCC's control.

6.6. Two respondents stated that the missed milestone had a significant financial impact on DCC customers. One of the respondents further elaborated that the delay from the documentation for the CSS interface impacted their internal delivery, leading to resource being under-utilised and a need to re-plan activities.

6.7. DCC opposed our position, arguing that it should retain 25% of margin associated with DM1. DCC maintained it was not responsible for more than three weeks of delay, covering the period up until 23 August 2019. DCC argue that delay after this date was at the request of industry to account for the August holiday period to allow more time to respond to the consultation.

6.8. DCC also argued that the Moorhouse report - that independently assured our assessment of the milestone – explicitly confirms that it did not have evidence to prove that the delay extended beyond three weeks.

6.9. DCC did not provide any further justification around the delays caused by the procurement of the CSS provider.

Reasons for our decision

6.10. We have reviewed the responses we received, including the additional evidence provided by DCC. We believe that there is insufficient evidence for us to change our consultation position.

6.11. DM1 has a four-week margin loss period from the date of the incentivised milestone where the margin retained decreases up until the 20th day, beyond which 0% of margin is retained.

6.12. DCC does not contest that quality issues with the CSSIA resulted in three weeks of delay. In addition, we set out in our consultation how DCC's need, during the CSS procurement, to extend the negotiation period between itself and the bidders incurred a further six weeks of delay. We note that DCC did not provide any further justification on this point as part of their response.

6.13. In regards to delay caused by consultation over the summer period, the Moorhouse report attributed only two weeks of delay to the summer timing of the consultation, with the rest of the delay being predominately attributed to underestimating the level of consultation required.

6.14. We also note that the Moorhouse report only states they were unable to evidence delay in regards to late approval of the requirements of the milestone, as a draft of the requirements had been in circulation and had not changed significantly during the period leading up to the milestone. Counter to DCC's assertion, Moorhouse did not report concerns evidencing other causes of delay.

6.15. Based on the findings of the Moorhouse report, and given the 9 weeks of delay caused by the poor quality CCSIA document and the CSS procurement, we maintain our position that the delay within DCC's control exceeded four weeks, and therefore DCC should lose all margin associated with DM1.

6.16. Note, the final values that this represents in terms of margin retained will be finalised when all delivery milestones under the DBT phase have been assessed. The reductions noted in annex 1 under 'CRS performance' for RY22/23 onwards are due to the disallowed switching forecast costs, which result in a reduction in the associated margin.

7. Appendices

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Appendix 1 – Determination Allowed Revenue (AR)

(£m)	RY19/20	RY20/21	RY21/22	RY22/23	RY23/24	RY24/25	RY25/26
LABP (19/20 prices)	204.954	237.333	241.805	238.466	245.201	253.171	107.079
Previous year (19/20 prices)	413.632	544.612	470.145	433.634	430.059	427.968	186.967
Submitted AR RY19/20	**474.906**	**487.680**	**440.906**	**422.143**	**459.966**	**500.282**	**282.507**
Cost Disallowances							
Baseline forecast internal costs	0.000	0.000	0.000	-49.759	-49.271	-48.869	-24.104
CRS forecast internal costs	0.000	0.000	0.000	-5.600	-5.664	-5.664	-3.687
SMETS1 forecast internal costs	0.000	0.000	0.000	-0.791	-0.718	-0.718	-0.376
Benchmarking	-0.736	0.000	0.000	0.000	0.000	0.000	0.000
Strategy and Product Management	-0.191	-0.623	-0.623	0.000	0.000	0.000	0.000
Commercial operations	0.000	-0.435	-1.259	0.000	0.000	0.000	0.000
Vendor management	0.000	-0.655	-1.060	0.000	0.000	0.000	0.000
Retention scheme	-2.111	0.000	0.000	0.000	0.000	0.000	0.000
Preston Brook	-0.105	0.000	0.000	0.000	0.000	0.000	0.000
Shared Services	-0.299	-0.163	-0.279	-4.802	-4.749	-4.711	-2.326
Total cost disallowances	**-3.442**	**-1.875**	**-3.221**	**-60.953**	**-60.402**	**-59.962**	**-30.492**
Performance Adjustment Reductions							
OPR	-0.804	0.000	0.000	0.000	0.000	0.000	0.000
CRS Performance	0.000	0.000	0.000	-0.476	-0.461	-0.461	-0.192
R2.0	0.000	0.000	0.000	0.000	0.000	0.000	0.000
Decision AR excluding BM and ECGS adjustments	**470.660**	**485.805**	**437.685**	**360.714**	**399.103**	**439.860**	**251.823**
Baseline Margin and ECGS adjustments							
BM adjustment (19/20 prices)	0.000	0.000	3.384	1.052	4.311	0.000	0.000
ECGS adjustment	0.000	0.000	2.001	0.556	0.572	0.595	0.089
Decision AR with BM and ECGS adjustments	**470.660**	**485.805**	**443.070**	**362.322**	**403.986**	**440.455**	**251.912**

Note: All values in RY19/20 price base