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DCC Price Control Consultation: Regulatory Year 2014/15

Consultation

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Overview:

The Data and Communications Company (DCC) is required to report price control information by 31 July, following each regulatory 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 values. We assess this proposal and determine whether or not to change the level of margin values agreed when the licence was awarded. We also assess DCC's performance against a set of implementation milestones.

In this document we review the costs DCC reported for regulatory year 2014/15. We set out our proposals and would like to hear your thoughts on these. We also explain our assessment of DCC's application to change its baseline margin values. We're interested in your comments on this as well.

The DCC, services users and other interested parties should read this document.

Context

Smart DCC Limited is referred to as the Data and Communications Company (DCC). It is a central communications body appointed to manage communications and data transfer for smart metering and it holds the Smart Meter Communication Licences[1]. Price control arrangements restrict DCC's revenues, to counter its monopoly position.

Under its licence DCC has to submit cost, revenue, and incentive reporting to the Gas and Electricity Markets Authority (the Authority)[2]. DCC must report on the basis of Regulatory Instructions and Guidance (RIGs) that we publish. We have also published a guidance document that sets out the processes and procedures we will follow when assessing costs and changes to the baseline margin values. DCC must report the relevant data and submit any proposals to adjust its baseline margin values no later than 31 July following each regulatory year.

DCC submitted its price control reporting templates for the first full regulatory year from 1 April 2014 to 31 March 2015 on 31 July 2015. On the same day it submitted a proposal for an adjustment to its baseline margin values.

We have assessed DCC's costs, revenue and performance against incentives. We have also assessed DCC's proposal for an increase in its baseline margin values. We are now consulting on our proposed decisions in respect of DCC's price control and baseline margin values adjustment.

Associated documents

- Data Communications Company (DCC): Regulatory Instructions and Guidance https://www.ofgem.gov.uk/publications-and-updates/data-communications-company-dcc-regulatory-instructions-and-guidance-2015
- Data Communications Company – Regulatory reporting template https://www.ofgem.gov.uk/sites/default/files/docs/2015/05/dccrigs2015.pdf
- Guidance Document: Processes and Procedures https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-guidance-processes-and-procedures
- Smart Meter Communication Licence https://epr.ofgem.gov.uk/Document

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[1] The Smart Meter Communication Licences granted pursuant to Sections 7AB (2) and (4) of the Electricity Act 1989 and Sections 6(1A) and (1C) of the Gas Act 1986. This consultation is in respect of both those licences. Those licences are together referred to as 'the licence' throughout this document.
[2] The Office of the Gas and Electricity Markets Authority (Ofgem) supports the Gas and Electricity Markets Authority ('the Authority') in its day to day work. In this document, 'us/we', 'Ofgem' and 'Authority' are often used interchangeably.

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Executive Summary

DCC has an essential role to play in the energy market. Its performance is critical to the success of the smart meter rollout and enabling suppliers to provide a good service to their customers thereafter. The quality of DCC's service is of paramount importance to the smart metering programme. However it is important that we ensure these services are provided in an economic and efficient manner.

This document sets out our proposals for DCC's costs and revenues for the regulatory year 2014/15. Our proposals reflect a fair but challenging assessment of DCC's costs, revenues and related activities during this first full year of operations. It reinforces the clear boundaries and principles for the management of costs that we established in last year's review. It also recognises the increased risks and complexity that DCC now faces. We assess DCC's performance in this context.

2014/15 was a year of relatively small variances in DCC's costs, with costs 3% higher than last year's forecast and 6% higher than LABP over the licence term. A large proportion of these variances were expected as they are predominantly a continuation of the costs incurred by DCC as a result of new activity during 2013/14. The costs associated with the latest re-planning of the programme[3] were not finalised until the Regulatory Year 2015/16 and these costs have not been assessed as part of these price control proposals.

DCC has applied to us to adjust the margin values specified in its licence so that its margin will not be reduced by changes to its circumstances or the scope of its work. We have assessed whether there are grounds for adjusting the baseline margin values in the licence and the substance of DCC's application. We have also considered whether DCC has met the delivery milestones due in 2014/15.

Our approach

Our proposals are based on a detailed cost assessment following the submission of DCC's price control reporting in July 2015.[4] We have also built on the benchmarking work we initiated last year and have received input from DCC on their own benchmarking exercise, which we welcome.

DCC now has in place policies and procedures that are designed to ensure value for money and controls on costs. This is the first year we have reviewed costs that were incurred subject to these policies and procedures, for example in relation to procurement and risk management. As an indicator of efficiency, we have looked carefully at how DCC has followed its procedures. We instructed an independent forensic audit review of DCC's price control reporting and policies and procedures to provide additional assurance.

[3] As approved on 5 March 2015. https://www.smartdcc.co.uk/consultations/dcc-consultations/dcc-plan-and-implementation-milestones/

[4] The reporting reflects the information available up to March 2014

Where costs have not been demonstrated to have been economically and efficiently incurred, we may find costs unacceptable. These costs will be excluded from any future calculation of DCC's Allowed Revenue. Alternatively, if DCC proposes one, we may accept an undertaking given by DCC with respect to the unacceptable costs[5]. If DCC fails to justify any forecast costs as being economic and efficient, DCC should remove them from the forecasts.

Our proposals

DCC and its service providers made significant progress towards the development and delivery of the smart metering solution in this implementation phase of the programme. There have been a number of changes that were not anticipated when DCC agreed its business plan at licence award. These included changes to the GB Companion Specifications (GBCS) and the Smart Energy Code (SEC). These required the re-setting of the DECC programme and as a consequence DCC has incurred additional costs. It is important that the DCC is able to access the necessary skills and expertise to undertake its role in overseeing the development of the new end-to-end smart metering system. DCC also underwent an office move in 2014/15 which was another cause of cost variances in this period.

Costs

In most cases DCC has put forward reasonable grounds and evidence for the costs it incurred or forecasted for its new activity. There is also evidence that it has some controls in place to put downward pressure on costs. Despite these positive developments, DCC has not fully explained or justified all of the additional costs or provided sufficient evidence to demonstrate value for money (i.e. that they were economically and efficiently incurred) in every case. The independent forensic audit report has made some recommendations for process improvement. Some recommendations reflect issues highlighted in last year's price control, for example demonstrating the value for money obtained from the shared service charge. The forensic audit report is published alongside this consultation.

We propose £0.409 million of costs incurred in during 2015 are unacceptable, where we do not think DCC has demonstrated costs were economically and efficiently incurred. DCC may propose an undertaking for some or all of these unacceptable costs. We will take this into consideration in reaching our final decision on whether to remove these costs or accept an undertaking.

Also, DCC has not provided sufficient justification for some categories of forecast costs. We propose that £11.721 million should be removed from the updated cost forecasts. If costs are removed from the forecast DCC is still able to incur them but it will need to explain the variation as part of its price control reporting in the appropriate regulatory year. We also require DCC to establish more processes to demonstrate value for money on certain cost items.

DCC has taken steps to respond to and improve its evidence base following last year's determination, for example developing a benchmarking methodology, and providing a better level of justification for most costs. These positive developments

[5] Licence Condition 37 Part B sets out the terms on which our determination can be made.

are welcomed but there is scope for DCC to provide a more consistent approach to reporting across all costs.

Baseline Margin and Performance

We have assessed DCC's proposal to adjust the baseline margin values in the licence and propose to determine an increase of £0.322 million or £0.483 million, recognising DCC's increasing role and the complexity of the dependencies it is now managing.

We also propose that DCC achieved Implementation Milestone 7, which was the only milestone at risk during this review period.

Finally, we are proposing that DCC takes on board the process improvement recommendations highlighted by the forensic audit report. These largely relate to risk management and procurement.

In summary, we propose:

Table 1: Summary of our proposals

Cost area	2014/15	Remaining years of licence (Forecasts)
Internal costs	• £0.409 million of costs were unacceptable in 2014/415 - £0.067 million unacceptable resource costs and payments. - £0.056 million unacceptable real price effects (RPEs). - £0.286 million unacceptable costs associated with the shared service charge	• £11.721 million have not been justified as economic and efficient and should be removed from the forecast. - £6.006 million of resource costs. - £0.581 million of RPE costs - £3.339 million of accommodation costs - £1.796 million of shared service charge costs
External costs	• Costs are economic and efficient and acceptable	
Milestones	• DCC met the Implementation Milestone (IM7)	
Margin adjustment		• Margin adjustments £0.322 million or £0.483 million.

Next steps

We welcome your views, and will consider them when we take our decision. Please send responses to Robyn Daniell (smartermarkets@ofgem.gov.uk) by 20 January 2016. We will publish our decision on DCC's price control in February 2016.

1. Introduction

1.1. DCC is a central communications body licenced 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. DECC granted the licence to DCC on 23 September 2013 following a licence competition. The Licence is for 12 years and will remain in place until 22 September 2025, unless it is extended or revoked. DECC also established price control arrangements that restrict DCC's revenues, to counter its monopoly position.

1.3. We have a role in ensuring that DCC's costs are incurred economically and efficiently. We will assess this through an annual review. DCC incurs costs and passes these onto users. Over the licence term the large majority of these costs are incurred by their external service providers, who were appointed through a competitive tendering process. We review these costs after the end of the regulatory year in which the costs were incurred, an approach we call 'ex post'. 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. DCC must submit price control information by 31 July following each regulatory year.

1.4. The level of baseline margin allowed each year is fixed in the licence. Each July, DCC can propose an adjustment be made to the value in the licence. The licence provides criteria related to likely and material changes to their business activities, risks and timescales or deadlines, which DCC must demonstrate in its proposal.

1.5. We published the Regulatory Instructions and Guidance (RIGs) in May 2015[6]. The RIGs provide the basis on which the licensee must report price control information, and provide a framework that enables us to collect data from DCC in a consistent format. We also published a guidance document on the processes and procedures.[7] This document sets out our approach to the cost assessment and also to the determination of the baseline margin.

1.6. Price control reporting covering the regulatory year from 1 April 2014 until 31 March 2015 was submitted in July 2015. DCC also proposed an adjustment be made to the value of its baseline margin at the same time. The issues and findings this year are particularly important as we understand there will be further cost variations associated with re-planning activities agreed in 2015/16.

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[6] https://www.ofgem.gov.uk/publications-and-updates/data-communications-company-dcc-regulatory-instructions-and-guidance-2015

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

Purpose of consultation

1.7. This consultation describes our proposals in relation to the:

- ex post review of DCC's price control
- proposal for an adjustment to the baseline margin values.

1.8. Our proposals are based on a detailed cost assessment following the submission of DCC's price control reporting and baseline margin adjustment proposal in July 2015. We are seeking your views on our proposals regarding:

- **Costs:** whether DCC incurred costs economically and efficiently during regulatory year 2014/15 and if it did not, how those costs should be treated. Also, whether we accept the updated forecasts for the licence term.
- **Implementation milestones:** whether DCC achieved the implementation milestone that fell due during regulatory year 2014/15 and what the implications are for DCC's allowed revenue.
- **Baseline margin:** whether the baseline margin values in the licence should be adjusted. Specifically whether DCC has met the criteria set out in the licence and the considerations we have taken into account when having regard to the rate of return.

DCC ex post review

1.9. This is the second ex post review, and first full year, of DCC's price control. This price control regime is different from that of other companies we regulate.[8] DCC has inherited a set of competitively procured contracts from government. We expect the competitive procurement process to have delivered value for money in the pricing of those contracts. Over time we expect DCC to be managing and mitigating risks associated with changes, as well as taking a long term approach to ensuring costs are economic and efficient.

1.10. The competitive application process for the DCC licence has ensured the efficiency of the initial costs stated in the licence application business plan (LABP). Our reviews look at how DCC's actual internal costs and external costs differ from those in the LABP, and the updated forecasts from last year. The updated forecasts must reflect any costs that were removed as part of last year's determination. Only costs that DCC has justified as economic and efficient costs can be part of the forecasts.

[8] Under RIIO, the networks are subject to an ex ante price control where the costs are agreed in advance (ie before they are incurred).

1.11. We expect DCC to demonstrate through its reporting that it has incurred contract costs and its own internal costs as efficiently and economically as possible, doing everything it reasonably can to ensure value for money. The data we collect, together with information from other sources, will allow us to monitor and assess whether costs were economically and efficiently incurred.

1.12. We recognise there have been changes since DCC put forward the LABP, and since it reported last year. The requirements of the SEC have continued to evolve and changes to the GB Companion Specifications (GBCS)[9] have required DCC to re-profile and re-assess the costs and timescales. DCC has also undertaken a number of procurements in response to changes in requirements and scope. However it must provide robust justifications for variations above the competitive costs agreed as part of the competition. We also expect DCC to have a strategy in place for ensuring that costs are economic and efficient over the duration of the licence.

1.13. DCC consulted on changes to the Joint Industry Plan in December 2014. The Secretary of State approved the Revised Plan in March 2015.[10] However, the costs associated with the re-plan were not finalised before the end of 2014/15. In future reviews, we will need to consider any associated changes in costs of the re-plan and DCC will need to sufficiently justify these are economic and efficient.

1.14. Our ambition for the DCC price control over time remains to move to a more ex ante model, similar to the approach taken for gas and electricity networks, and to introduce up-front incentives on DCC to manage the costs of running the data and communications network for smart meters. Introducing ex ante controls for certain costs is something we have sought views on in our consultation on DCC's role in developing a Centralised Registration Service and penalty interest rate proposals.[11]

[9] Both of which have been developed after the licence was granted.
[10] https://www.smartdcc.co.uk/consultations/dcc-consultations/dcc-plan-and-implementation-milestones/
[11] https://www.ofgem.gov.uk/publications-and-updates/dccs-role-developing-central-registration-service-and-penalty-interest-rate-proposals

2. Our approach

Chapter summary

We compared the costs in the LABP and last year's forecast with those DCC submitted in its price control reporting. To inform our assessment we scrutinised the evidence DCC provided, conducted a cost visit and some benchmarking analysis. We also had a forensic audit review undertaken of DCC's reporting, its processes and procedures.

We also scrutinised updated forecasts. We propose DCC remove costs from forecasts that are unlikely to be incurred, or where we have found that they are not economic and efficient.

Question 1: What are your views on our approach to assessing DCC's costs?

Question 2: Do you have any suggestions on where we can improve our approach?

2.1. The licence requires DCC to send us price control information each year. This must provide comparisons between the LABP and:

- the internal (DCC) and external (fundamental service provider[12]) costs actually incurred.
- any updated forecasts.

2.2. DCC also must explain:

- any material divergence revealed by the comparisons.
- any material revisions to any financial or operational matters arising from that divergence.
- any material deviations from the forecast costs at LABP or any updated forecast.

2.3. The RIGs inform DCC about the information and level of detail we require. They were designed to allow us to compare actual costs with forecasts. They should also guide DCC on creating systems to collect the data we require. The information provided under the RIGs is the basis for our determination on whether costs are economic and efficient.[13]

2.4. The guidance document we published in July sets out the general cost assessment process that we follow for the DCC price control. It describes our approach and the information we expect to be provided with to enable us to

[12] External services that are not provided by the fundamental service providers are included in internal costs.

[13] We used additional sources of information to supplement the RIGs where appropriate.

determine whether DCC's costs are economic and efficient. It explains what factors we may consider in deciding whether to accept an undertaking for Unacceptable Costs, as well as the way we determine whether to adjust DCC's baseline margin values.

2.5. DCC submitted their price control report for the regulatory year 2014/15 to us, together with a proposal for a baseline margin values adjustment, on 31 July 2015. This is DCC's first full year of price control reporting.

2.6. We requested additional information and evidence where appropriate. We have also conducted a cost visit to gain a better understanding of DCC's processes for managing its costs.

2.7. This year we also had a forensic audit review of DCC's reporting undertaken. [14] The objective of the review was to substantiate the costs reported under the price control and the cost allocation. In addition we asked the auditors to review the processes and evidence relating to DCC's controls over cost variance, planning and budgeting, procurement, and risk management.

2.8. To inform our assessment last year we carried out some initial benchmarking of salaries. Our primary comparator for salaries and bonuses was the Annual Survey of House and Earnings (ASHE) data provided by the Office for National Statistics (ONS). We updated this analysis this year. DCC has undertaken its own benchmarking of their resource costs using the Hay Group methodology and PayNet dataset (provided by Hay Group). Our assessment of this evidence and the assumptions they have made are in chapter 4 and appendix 3.

2.9. Licence Condition 37 requires us to assess whether DCC's costs have been incurred economically and efficiently. We have scrutinised both the changes in internal and external costs. We are aware that next year, due to the re-planning exercise finalised in 2015/16, it is likely there will be significant variation in these costs.

2.10. As required by the licence, our assessment is grounded in comparing DCC's outturn costs and revised forecasts with the costs DCC submitted in the LABP. We accept that the scope of DCC's activity might differ from what it expected, and this could increase or decrease the economic and efficient level of costs.

2.11. Our review has focused on obtaining a detailed understanding of:

- DCC's cost base (both internal and external)
- the activities DCC undertakes

[14] The forensic auditors report is published alongside this consultation.

- the causes of differences from DCC's licence bid submission and last year's updated forecast
- the processes it has in place to control costs
- the processes it has in place for procurement and managing risks.

2.12. We use the LABP as our reference for DCC's bid position. DCC bears the burden of justifying any variations in cost from the LABP and any updated forecast. DCC must provide sufficient justification to demonstrate that the variation in costs is economic and efficient. If we conclude that the costs are not economically and efficiently incurred we will need to consider whether to exclude them from future calculations of DCC's Allowed Revenue or accept an undertaking in respect of those costs.

The Licence Application Business Plan

2.13. The licence requires DCC to have an LABP.[15] This document contains estimates of revenues, costs, and cash flows for each regulatory year over the 12-year licence term. It is based on the bid DCC submitted, which was taken into account as part of the application process. It therefore reflects DCC's bid position in terms of the scope, outputs, requirements, tasks, assumptions and solutions as anticipated at the time. When DCC was granted the licence it also committed itself to the LABP.

2.14. DCC submitted the LABP on 24 December 2013,[16] and published a redacted version on its website in April 2014.[17] As these costs were secured through the competition we assume they are economic and efficient. So we can monitor and assess its costs each year, DCC compares the internal and external costs to those in the LABP. DCC must also provide updated forecasts for the remaining regulatory years.

Updated forecasts

2.15. Each year we will continue to compare cost variations to the LABP. We will also compare variations to the updated forecasts provided by DCC. As part of this year's analysis we have scrutinised the updated forecasts.

2.16. DCC should remove costs from the forecasts which have not been sufficiently justified as economic and efficient, or are uncertain and it is not possible to make accurate estimates. If costs are removed from the forecast DCC is still able to incur

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[15] The definition of the LABP is provided in Licence Condition 37.
[16] Under Licence condition 37.4 (a) the LABP can be submitted as a consequence of the licence application process but it must reflect the agreement and position at licence grant.
[17] DCC's redacted LABP is available from:
http://www.smartdcc.co.uk/media/7417/redacted_licence_application_business_plan_-_30_april_2014_2_.pdf

them but it will need to explain the variation as part of its price control reporting in the appropriate regulatory year.

2.17. This will mean the price control forecasts provided are likely to be lower than the charges in the indicative budgets and charging statements, where DCC is allowed to make a prudent estimate of its allowed revenue.

2.18. To provide transparency we encourage DCC to publish an update to the redacted LABP. Appendix 5 provides the updated forecasts based on our proposals.

Quality of reporting

2.19. Last year DCC largely complied with the RIGs reporting requirements. However there were initial issues with the level of detail and evidence in its supporting commentary and justifications for the actual cost changes.

2.20. This year DCC demonstrated a better understanding of the process. The quality of its reporting was improved from last year. During the assessment, we asked some further questions to seek more information and evidence to support the cost variations reported. As a result DCC provided enough detail for us to conduct our review and develop proposals.

2.21. DCC was also open and transparent during our cost visit and that undertaken by the forensic auditors. We also had good engagement and collaboration with DCC in the lead-up to this year's report.

2.22. If DCC fails to demonstrate that costs are economically and efficiently incurred, it is likely that we will find they have not been. Any costs that we consider were not economically and efficiently incurred will either be excluded from the future calculation of allowed revenue or be subject to an undertaking about their future management.

3. Performance

Chapter summary

As a result of the implementation milestone (IM) review, only one IM was due in 2014/15 – IM7 (approval of the service management design). We consider DCC to have achieved this IM7.

In our review, we found some examples of DCC applying its procurement and risk management processes inconsistently. While we consider DCC has reached efficient outcomes this year, it needs to review its processes and ensure there is supporting evidence they are being followed consistently.

Question 3: What are your views on our assessment of DCC's performance against IM7?

DCC's performance

3.1. DCC has a vital role in the implementation, operation, management, and ongoing improvement of the smart metering infrastructure. During regulatory year 2014/15 DCC has made significant progress towards the development and implementation of the smart metering solution. It has undertaken a number of procurements, one of which was for an innovative software tool, which allows for the automated testing of the GBCS.

3.2. There have been a number of changes during 2014/15 that were not anticipated at LABP, which are largely a continuation of the cost variances that were triggered in 2013/14. These included changes to the GBCS and the SEC. These required the re-setting of the DECC programme and DCC as a consequence has incurred additional costs. It is important that the DCC is able to access the necessary skills and expertise to undertake its role in overseeing the development of the new end-to-end smart metering system, but it must clearly justify any cost variances.

Performance against implementation milestones

3.3. Our main measure of DCC's performance is against the implementation performance regime.[18] This lists a series of implementation milestones (IMs) that DCC must achieve in the lead-up to live operations. The regime is designed to encourage performance by putting some of DCC's margin at risk. If DCC fails to meet an IM by the date specified in the licence then it could lose part or all of margin

[18] Licence Condition 38 and the implementation milestones are listed in Schedule 3.

attached to that IM.[19] If DCC loses some of its margin it has the opportunity to gain some or all of it back by meeting a subsequent milestone.

3.4. The licence required DCC to carry out and consult on a review of the due dates and criteria of all the Implementation Due Dates and Implementation Criteria that remain in force in Schedule 3 at the due date of IM4. The Secretary of State directed the changes to the regime on 12 November 2015. We have based our assessment of DCC's performance against the IM's on the new criteria. This means that during RY14/15 only one IM, IM7 (Approval of the Service Management System Design) was due. **We consider DCC to have met this IM.**

Our assessment of the implementation milestones

3.5. DCC provided evidence to demonstrate compliance with IM7. We verified this evidence and assessed it against the new criteria for the IM regime as directed by DECC on 12 November 2015. The evidence provided clearly demonstrated that, following the review of the IM regime, DCC had met its obligations under the licence. We therefore propose that DCC is entitled to all of the baseline margin that this milestone puts at risk (£0.314 Million).

Assessment of process

Procurement

3.6. DCC procures specific goods and services in order to deliver the Mandatory Business Services during the Licence period[20]. DCC published its procurement strategy in September 2014[21] which sets out how DCC plans to procure Relevant Service Capability and how it will meet the obligations as set out under the licence.[22] As part of the RIGS, we require DCC to provide us with any assessments and evidence of how it has met the terms of its procurement strategy and how value for money has been secured.

3.7. DCC procured various Relevant Service Capability requirements from External Service Providers in 2014/15 including SMKI, GBCS software simulator and the billing system. DCC also set up two procurement frameworks for audit and assurance and consultancy services.

[19] Some of the IMs allow DCC to recover any revenue lost if a future IM is achieved.
[20] Mandatory Business Services are those services the DCC must provide. Licence Condition 6, Part B.
[21] DCC procurement strategy and statement of service exemptions. Available here: https://www.gov.uk/government/consultations/dcc-procurement-strategy-and-statement-of-service-exemptions
[22] Licence condition 16: Procurement of Relevant Service Capability.

3.8. Upon review we have found examples of DCC not consistently adhering to the principles that are applicable to procurement activities as outlined in the licence.[23] This is supported by the conclusions from the forensic audit review.

3.9. While in some cases DCC followed a robust procurement process we found some evidence of policies not being followed. However, there is evidence to support the conclusion that the outcomes of the procurements this year were economically and efficiently incurred. Some have come below the LABP amount and others have delivered valuable innovative services.

3.10. If DCC does not follow a robust procurement process or have evidence to support the outcomes it reaches, it may in future make it difficult for DCC to demonstrate that procurement outcomes are economic and efficient. This may lead to some costs being found to be unacceptable. It would increase DCC's risk of not meeting its licence obligations. For a number of procurements, although we were provided with evidence the outcomes were economic and efficient, DCC's explanation to support the sourcing strategies being used and why a certain procurement route was chosen was lacking sufficient explanation. In other cases DCC could have been clearer about the evaluation criteria that were used to assess bidders and therefore why some shortlisted bidders were discounted.

3.11. We support the forensic audit review recommendations that for future procurements DCC should ensure it has sufficient detail on the evaluation process, particularly how cost and quality are assessed and weighted.

3.12. As outlined in the procurement strategy, DCC can procure services from its parent company, if this is the most economic and efficient option or if it is immaterial in terms of its value or use of resources within the overall context of the DCC's Mandatory Business. In some cases, DCC's evidence to support the award of contracts to the parent company in 2014/15 was lacking in detail. On balance we think there is sufficient evidence to support the outcomes being economic and efficient in these instances. In some cases costs were lower than the costs anticipated at LABP. In future, DCC may find it difficult to justify that procuring services from its parent company is the most economic and efficient outcome if it does not improve its ability to evidence its process and governance arrangements. This is especially relevant in cases where there have been changes to requirements within the procurement process period.

3.13. For all future procurement we expect DCC to:

- fully reflect on the feedback from the forensic audit review in its review of its procurement strategy. DCC should clarify when it considers it appropriate to use the different approaches it outlines in its strategy
- provide clear evidence to confirm that consistent sourcing strategies have been used and why different procurement routes have been chosen

[23] Licence condition 16, Part B.

- ensure that appropriate due diligence is carried out sufficiently early on in any procurement process
- provide consistent evidence on the evaluation processes and criteria used and sufficient justification for discounting shortlisted bidders and for award recommendations
- confirm that the most economic and efficient procurement outcome remains that which was chosen if changes in requirements occur midway through a procurement exercise
- provide clear explanations of governance arrangements where its parent company is involved in any procurement process and to ensure that DCC follow their procurement strategy regardless of whether its parent is the chosen provider or not.

Risk management

3.14. DCC is required by its licence to manage and mitigate its risks to ensure that the service provided by DCC is, and will remain, fit for purpose.[24] Based on the information provided to us as part of this year's submission, it is not clear that DCC is managing risk sufficiently through effectively valuing risk and identifying clear mitigation strategies. These concerns are supported by the findings from the forensic audit review which assessed DCC's Risk Management Strategy (RMS) and related documentation.

3.15. A number of these concerns arise from the complexity of DCC's risk management framework. This includes various approaches and documents depending on whether the risks are classified as strategic, programme, corporate or by individual work stream. This makes it difficult to track the flow of risk throughout the hierarchy and show how risk is managed overall in relation to the RMS. Furthermore the impact and probability of risks appear to be scored differently within the various risk registers. Ultimately there is a lack of clarity over DCC's overall risk management approach and how risks relating to costs are being managed.

3.16. Change in risk (financial or operational) to which DCC is exposed in the carrying on of its Mandatory Business is a criterion for which DCC can propose a change in its baseline margin values. Any adjustment to the baseline margin values should be linked to and consistent with the risks that DCC is actively managing. These risks shouldbe valued and DCC should provide supporting evidence to justify their approach. As such, we expect to see greater consistency between the risks within the DCC risk registers and the risks identified in the baseline margin application.

3.17. We expect DCC to review, update and streamline its documentation and registers to enable it to better justify how it is managing and mitigating risks more effectively in the future. If DCC is not meeting its licence obligations in relation to

[24] Licence condition 7

risk there could be compliance issues. We also expect DCC to quantify risk values such that there is a clear relationship between risks included in any baseline margin adjustment proposal and DCC risk registers. DCC's approach to risk is important in demonstrating that it has incurred additional costs economically and efficiently. If in managing change DCC incurs cost that could have been avoided through better risk management we may find associated costs unacceptable. If DCC is unable to evidence how it is effectively managing risk this could undermine its proposals for future baseline margin adjustments.

Next steps

3.18. In future years we expect this chapter in our consultation documents to expand as we begin to report on DCC's performance and results in delivering smart metering services. As DCC is still in the implementation phase of its licence term we are yet to develop quality of service reporting. We expect to add this to the RIGs in the future, and DCC will be required to report in line with it.

3.19. We are planning to engage with stakeholders on the design of the operational incentives in early 2016. The licence requires DCC's operational performance regime to be in place not before 31 March 2016 but no later than 31 October 2018.[25] The structure and contents of that regime cannot substantially differ from the illustrative provisions in Parts A to D of schedule 4 of the licence. The performance measures will therefore contain metrics on measures for service users, service delivery, development and improvement, and value for money.

[25] Licence condition 38, paragraph 38.10.

4. Cost Assessment

Chapter Summary

We assess changes in DCC's costs in comparison to the LABP and the updated forecasts. Total costs are £116 million higher than at the time of contract award and £49 million higher than last year's forecast over the licence term.

Based on the evidence we have received we consider that the majority of the costs reported were economically and efficiently incurred and so are not Unacceptable Costs.

In our view, a small proportion of DCC's costs have not been justified as economic and efficient and so are Unacceptable Costs. We propose £0.409 million from DCC's total costs in 2014/15 have not been justified as economic and efficient. We will consider any undertaking for these unacceptable costs. We have also identified £11.721 million that has not been justified as economic and efficient and we propose should be removed from the forecasts.

Question 4: What are your views on our cost proposals?

Question 5: We are interested in feedback from stakeholders and industry parties on DCC's external engagement. What were your experiences of engaging with DCC in regulatory year 2014/15?[26]

Question 6: We welcome views on DCC's benchmarking methodology, including on what you consider the appropriate percentile is that DCC should use when carrying out benchmarking, and approach to benchmarking benefits?

Question 7: We are looking for ways to further benchmark DCC costs. What other sources of data or potential comparators can you recommend for subsets of DCC costs?

Question 8: Do you agree with our approach to real price effects (RPEs)?

Our proposals

Cost assessment

4.1. Over the licence period DCC's latest total cost forecast is £1.996 billion. DCC forecast a total increase in costs of £116 million relative to LABP over the licence term, a 6% increase. This is £49 million increase on last year's forecast and a 3% increase over the licence term. A comparison of DCC submitted costs for the 2014 price control to LABP is provided in appendix 2.

[26] Context to this question is included in the Industry section of Appendix 3

4.2. At the bid stage, DCC faced a significant degree of uncertainty about future costs. DCC did not know which service providers would be selected; what the service provider solutions entailed; and what its obligations to service users would be under the SEC.

4.3. A large proportion of the cost deviations from LABP relate to external change faced by DCC. In its price control forecasts and outturn 2014/15 costs, several factors have caused DCC's costs to change relative to the LABP, including:

- changing requirements of the Smart Energy Code (SEC)
- longer lead time and changes to the Great Britain Companion Specification (GBCS) which are a continuation of costs triggered in 2013/14

4.4. In this context, we consider that overall the DCC has made significant progress towards the development and implementation of the smart metering solution, and managing the associated costs during 2014/15. However, the LABP remains an important benchmark for DCC costs. DCC is required in its reports to compare its costs incurred against those estimated in LABP and updated expenditure forecasts. We will therefore hold DCC to account for its competitive bid position.

4.5. Despite this, there are a number of areas where in our view costs have not been justified as economic and efficient. **We propose that £0.409 million from DCC's total costs in 2014/15 are unacceptable costs, and propose not allow a £11.721 million increase in their forecasts over the remaining term of the licence.**[27] Table 3.1 below, shows the breakdown of these unacceptable costs.

Table 3.1: Overview of our proposals

Cost Category	Total 2014/15 (£m)	Total over licence period (£m)
Internal Costs		
- Resource costs and payments	**0.067**	**6.006**
- RPEs	**0.056**	**0.581**
- Accommodation costs	**0**	**3.339**
New Scope Shared Services	**0.286**	**1.796**
External Costs	**0**	**0**
Total	**0.409**	**11.721**

4.6. Our view on DCC costs is based on the following areas where some of DCC's internal costs are not considered to be economic and efficient:

[27] Note that appendix 5 also includes the correction of an error in DCC's reporting for pass through costs in the adjusted forecast allowed revenue amounting to £2.830m.

- **Increased resource costs:** There has been some increase in staff costs for specific roles within DCC relative to LABP for which DCC has not provided sufficient justification. We also consider that DCC's approach to real price effects and future accommodation costs have not been justified as economic and efficient.

- **Shared service charges:** We remain concerned with how DCC continues to justify its arrangement for its shared service costs, which are charged from DCC's parent company. We accept there are benefits to DCC in obtaining shared services from its parent, and recognise the shared service charge was competitive at licence award. However DCC has an obligation to demonstrate the efficiency of the charge on an ongoing basis. It has failed to provide evidence of this, and we propose to require DCC to establish a process to demonstrate the economic efficiency of this charge in future. In addition, DCC has applied a shared service charge to new scope activities, which have been confirmed after licence award once DCC is in a monopoly position. However, it has not provided sufficient justification that this charge is economic and efficient, for example how the new scope will result in an increase in the volume of services provided.

4.7. In the remainder of this section we set out the following:

- Review of internal costs and justifications
- Review of shared service costs and justifications
- Review of external costs and justifications
- Summary of our views on DCC's costs and our proposals

Internal Costs

4.8. In this section we set out our assessment of whether DCC's internal costs are economic and efficient. We provide in turn:

- a summary of movements in costs relative to LABP and last year's forecast costs
- a summary of the initial benchmarking analysis we have undertaken
- current conclusions and our position on cost disallowances.

Changes to internal costs relative to LABP

4.9. DCC reported a £50 million change in internal costs over the licence term. Half of this change (£25 million) relates to new scope costs. These activities were explicitly excluded from the LABP as agreed with DECC during the tender process, because the requirements were not fully developed at that time. It was always expected DCC would incur costs associated with these activities. Our review of new scope costs and baseline changes is explained in detail in appendix 2. The bulk of the remainder resulting from changes in staff costs.

Changes from last year's forecast

4.10. DCC reported an increase of £16 million in internal costs over the licence term, representing a 9% difference from costs forecast submitted in last year's price control. The large proportion of this increase is resource and accommodation cost.

4.11. Incurred internal costs for this year came below the 2013/14 forecast by 11%. However the majority of these costs have been redistributed over the licence term. This is due to DCC re-planning during 2014/15 and DCC's increased understanding of their requirements over the licence term.

Resource costs

Our proposal

4.12. We are proposing £0.067 million of inefficient resource costs from 2014/15 are Unacceptable Costs, and £6.006 million future costs have not be justified as economic and efficient and should be removed from the forecasts. Costs removed from forecasts may be allowed in future price controls if DCC provides sufficient evidence that they are at that time economic and efficient. These Unacceptable Costs reflect inefficient resource costs as a result of DCC not having provided sufficient evidence to support the need for certain roles in the future and the assumptions underpinning the justifications for how it has applied its resource benchmarking methodology.

Resource benchmarking

4.13. The licence places an obligation on DCC to demonstrate at each price control that its costs are economic and efficient. In the 2013/14 price control[28] and price control guidance document[29] we flagged that we considered an essential part of this would be the use of external comparators against which DCC resource costs can be benchmarked. DCC responded by carrying out benchmarking of their resource costs using the Hay Group methodology and PayNet dataset (provided by Hay Group). Further detail of the methodology DCC used can be found in Appendix 3.

Our views on DCC's benchmarking exercise

4.14. We welcome the work that DCC has done on benchmarking and consider it to be a positive step in terms of justifying its resources costs. However, we do not consider DCC has provided sufficient evidence to support how it has applied its benchmarking to some areas of the business. This includes assumptions on:

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

- percentiles used as benchmarks;
- justification provided when over the benchmark;
- the method for calculating benefits; and
- benchmarking of contractors.

4.15. We consider each of these in turn in appendix 3. We welcome views and evidence on DCC's benchmarking approach. Following this assessment we find that a proportion of the DCC's remuneration increases are unacceptable costs.

4.16. In 2013/14 we carried out some initial benchmarking of salaries to inform our cost assessment. In particular, we used it as a sense-check of our conclusions. Our primary comparator for salaries and bonuses was the Annual Survey of House and Earnings (ASHE) data provided by the Office for National Statistics (ONS).[30]

4.17. For 2014/15 we updated our benchmarking analysis using ASHE data. Further detail on our approach can be found in appendix 3. As DCC conducted their own resource benchmarking this year, the purpose of our analysis was used to sense-check DCC's results as well as the conclusions of our cost assessment. This exercise supports our view and the proposals we are making on the economic and efficient level of costs.

Real Price Effects

4.18. Real Price Effects (RPEs) are the assumptions used in DCC reporting to take account of the impact of inflation over time. The purpose of this is to ensure that costs reported for the relevant regulatory year are reported in nominal terms. DCC have increased some costs due to Real Price Effects (RPEs) between 13/14 and 14/15. Internal costs were increased by RPI on 25 roles and some aspects of forecast external costs were increased in line with CPI as stated in the FSP contracts.

4.19. The RPE is interpreted as the input price trend relative to Retail Price Index (RPI). RIIO has an established methodology for calculating and applying RPEs, and as such we consider the RIIO decision to be a good reference point for DCC's RPEs. The RIIO decision has an RPE for 2014/15 of -1.9% for generalist labour and +0.3% for specialist labour. This means that general labour cost are increasing year-on-year at 1.9% less than RPI, and specialist labour costs are increasing year-on-year at 0.3% above RPI. While some of DCC's generalist roles are different to those analysed under RIIO, it has not provided sufficient evidence for why the RPE would be higher.

Our proposals

4.20. We propose a reduced RPE for generalist jobs, and that a consistent approach to RIIO should apply given the lack of any evidence to justify a different approach.

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[30] http://www.ons.gov.uk/ons/rel/ashe/annual-survey-of-hours-and-earnings/index.html

We have only allowed RPE increases of 0.5% for generalist roles as we believe the RIIO approach is appropriate. We do not think that DCC generalist roles are significantly different. Where cost areas are looking at specialists we have accepted DCC's methodology. As a result we are proposing £0.056 million of inefficient RPE costs from 2014/15 are unacceptable costs, and £0.581 million future costs have not be justified as economic and efficient and should be removed from the forecasts.

Accommodation costs

4.21. Accommodation costs over the licence term have increased compared to LABP by £3.339 million. DCC's lease was due to expire in March 2015, and it negotiated a lease for new premises in 2014/15. DCC has provided evidence that it achieved an economic and efficient price per square metre and we believe the arrangements are capable of providing long term value for money.

4.22. DCC's justification for the amount of space required was not sufficient. We found a lack of evidence supporting their assumptions regarding visitor numbers and also the growth expectations DCC provided were unclear and in some places inconsistent.

Our proposals

4.23. We think DCC is well placed to make savings on accommodation in the years ahead and the commercial arrangements have been struck to enable this. As such we propose removing the increase in accommodation costs from forecasts. DCC may in future be able to justify the amount of space procured or make arrangements with Capita to lease back the excess space.

Shared service charge

4.24. DCC pays a shared services charge to cover support services.[31] It is an amount paid by the DCC for shared services sourced from DCC's parent company, Capita. DCC have explained that the shared service charge is a corporate overhead charge that it pays to its parent. Inclusion of the shared services charge was part of the competitive bid during the licence competition. It was calculated as a percentage of internal costs set out in the LABP.[32]

4.25. Our approach to the shared service charge is set out in the RIGs. DCC is required to report information on the shared service charge, including how it has been calculated and how the shared service charge provides value for money.

Our proposals

[31] The support services covered by the charge are listed in section 3.3.1 of the redacted LABP and examples given in paragraph 5.19 of the RIGs.
[32] A cost related to the communications hubs was excluded from the charge in the LABP.

4.26. We propose the shared service charge associated with all new scope activities (the Smart Meter Key Infrastructure (SMKI), Parse and Correlate, and Automatic Testing of GBCS (ATG) contracts, and with the financial stability and security are Unacceptable Costs. Following our proposals on inefficient resource costs, accommodation costs and RPEs, we also propose that the service charge applied to these costs is not economic and efficient. As a result, we propose that £0.286 million costs in 2014/15 and £1.796 million forecast costs over the remainder of the licence term are unacceptable.

Description of cost changes

4.27. Following our price control decision in 2013/14 to exclude the shared service charge associated with new scope delivered by third parties, DCC has changed its approach. In 2014/15 DCC calculated the shared service charge by:

- Applying a lower shared service rate than that agreed at bid to new scope delivered by third parties; and
- applying the percentage agreed at competition to all other internal costs,[33] including to changes in costs from baseline and new scope work delivered by DCC.

Justification for cost changes

4.28. DCC has separated the benefits it receives from the shared service charge into three areas:

- Transactional services that would be need to be procured from an alternative source;
- Access to relevant Group infrastructure outside the scope of directly charged costs; and
- Access to governance, expertise, management and experience from the wider Capita Group on both a structured and ad hoc basis.

4.29. DCC are of the view that work delivered by a third party draws on two of the three benefits identified. Therefore in calculating the shared service charge for this work DCC have applied a rate approximately two thirds of the rate that was agreed in the LABP. For all other internal costs DCC have used the same level of charge and methodology as was included in the LABP. This means that the shared service charge has been applied to all internal costs, but at two different rates. DCC considers that this is economic and efficient since the original shared service charge formed part of the bid during the competitive tender process.

Our position on cost changes shared services

[33] Apart from the cost that was excluded in the LABP.

4.30. Our position on shared services remains as we set out in the 2013/14 price control and in the price control guidance document. We expect DCC to demonstrate that it is obtaining value for money from this charge. The RIGs require DCC to provide evidence that the shared service charge is economic and efficient.

4.31. The services provided under the shared services charge are part of the relevant service capability. DCC has an obligation to procure this on a competitive basis. [34] The licence allows services to be procured from an affiliate or a related undertaking if this is the most economic and efficient option, or if the amount is immaterial in terms of its value or use of resources within the overall context of the Mandatory Business.[35] DCC should have evidence that it has met this obligation.

4.32. As stated previously, we appreciate the benefits for the shared services charge and recognise the shared service charge was competitive at licence award. However, on an ongoing basis, DCC must demonstrate that these costs are economic and efficient[36] and the ongoing value for money of this charge.[37] The lower rate for third party contracts that DCC has applied has not been justified. DCC did not provide sufficient evidence or a robust methodology to support the percentage applied. Our view is that if a new scope activity has not drawn upon the shared services the charge should not apply. This is an important principle given we expect to see economies of scale and efficiencies over time.

4.33. There are reporting lines in the RIGs for costs that are excluded from the service charge. The only costs that have been reported here relate to communications hubs which did not attract the charge at bid.

4.34. In our view DCC has not provided sufficient justification to demonstrate that the charge should apply to the procurement of the SMKI, Parse and Correlate or ATG contracts. DCC incurred additional direct costs for procurement and management of these contracts, however DCC has not provided sufficient evidence these costs have increased the volume of activity associated with the shared services.

4.35. As was the case in the 2013/14 price control, DCC did not provide sufficient justification for applying the shared service charge to the costs related to the financial stability and security. These are standing charges and involve limited additional activity for DCC.

4.36. DCC must develop a process to ensure that the shared service charge provides value for money. DCC have not yet come forward with such a process but indicated during the 2014/15 cost visit that it expects to finalise its process in the next three to six months.

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[34] Relevant service capability is defined in Licence Condition 16.2 as capability that is used (or is to be used) for the purposes of securing the provision of Mandatory Business Services under or pursuant to the SEC (and includes Fundamental Service Capability).
[35] This criteria is set out in Licence Condition 16.
[36] Under Licence Conditions 16 and 36.
[37] This is specified in the qualitative questions in the RIGs.

External costs

4.37. External costs comprise the costs of the communication service providers (CSP) and the data service providers (DSP), which are defined under the licence as fundamental service providers. This means that costs associated with other externally procured services, for example the SMKI and Parse and Correlate contracts are reported under internal costs.

4.38. DCC stated that the key material projects and change requests for 2014/15 included:

- The development of service management within DCC
- The development of the security architecture for DCC
- Information provision around communication hubs

4.39. Around £33 million of the total cost increase compared to last year's forecast reflects changes in external costs. The main drivers for the cost increase were attributed to the new version of GBCS and resulting delay; associated auxiliary activities (eg providing workshops and impact assessments); and additional functionalities such as DCC Service Management System (DSMS) enhancements and extended coverage of the project. This is an increase in external cost of 1.9% when compared with the LABP external costs (and a 4% increase compared to LABP).

4.40. The external costs mostly reflect the contracts that were competitively-procured by government. We expect the procurement process conducted to have delivered value for money in the pricing of those contracts. However, we expect DCC to demonstrate through its reporting that it has incurred contract costs as efficiently and economically as possible, doing everything it reasonably can to ensure value for money.

Our position on changes in external costs

4.41. We propose the changes in external costs are economic and efficient for the regulatory year being assessed. In our view the variation in external cost has been made on reasonable grounds. The forensic audit review of the key contracts that DCC has with external providers raised no areas of concern in relation to verifying the external costs reported in DCC's price control submission.

4.42. DCC provided varied evidence in its price control reporting to explain the cost changes in 2014/15. For some changes DCC provided detailed justification including drivers of change, options considered, benchmark assessments, savings they achieved from contractual negotiations and the final component costs of each solution. Explanations for other changes contained less detail and did not provide as much justification including a quantified breakdown of the increase in costs.

4.43. Explanations of the savings achieved through contract negotiation do provide some evidence of DCC securing value for money. Nevertheless, DCC needs to

provide clearer evidence of benchmarking wherever possible to demonstrate that alternative options, including the counterfactual, have been considered.

4.44. The forensic audit review made some recommendations about the approval process of change requests. Approval documentation was inconsistent across the sample of change requests reviewed and the auditors found incomplete evidence trails in some cases.

4.45. External costs are expected to increase significantly for 2015/16 compared to the magnitude of increase for 2014/15. Based on the quality of evidence provided by DCC for the justification of external cost increases in 2014/15, DCC should take on board the recommendations from the audit. This will help to ensure that any contract variations resulting from the change control process can be clearly evidenced as economic and efficient in next year's price control submission. We expect detailed justification for cost variations and will be interested in how DCC uses the levers under the contracts to ensure value for money.

4.46. Last year we encouraged DCC to be more transparent when consulting on changes to costs. We recommended that DCC provides industry with more detail of costs in its documents. We welcome DCC's response in 2014/15 through increased engagement and actions to increase transparency on its progress and costs. We would be interested in users' views as to whether they have experienced an improvement in the DCC's engagement and transparency.

5. Revenue reporting

Chapter Summary

Provides an overview of DCC's Allowed Revenue and the impact of our proposals.

Question 9: What are your views on DCC's approach to the prudent estimate?

Question 10: Do you agree that our allowed revenue proposals should take affect from April 2016?

Allowed Revenue

5.1. Allowed revenue is determined in accordance with licence condition 36[38] and is the total regulated revenue DCC is entitled to. An explanation of how it is calculated is provided in appendix 5.

5.2 Under the price control arrangements DCC incurs costs and passes these onto users. DCC's regulated revenue is the actual revenue, measured on an accruals basis, received through service charges.

5.3 We have no role in approving DCC's service charges in advance; these are set in the DCC's charging statement. Indicative charging statements and budgets are available on DCC's website (www.smartdcc.co.uk).

Allowed revenue reported

5.4 In 2014/15 DCC reported its allowed revenue to be £33.8 million, almost £1 million less than forecast. Over 60% of its reported allowed revenue was internal costs and almost 20% was external costs.[39] The baseline margin was 7% and pass-through costs were 12%.[40]

5.5. DCC did not deliver any minimal or value added services in 2014/15. It is not expected to deliver any value added services in 2015/16.

5.6 DCC published its charging statement for 2014/15 in March 2014. Its prudent estimate of its allowed revenue for 2014/15 was £43.8 million. Appendix 6 provides a breakdown of the charging statement breakdown and compares it to the costs reported in 2014/15.

5.7 The correction factor[41] reported in 2014/15 to be applied in 2015/16 was £11 million. This mechanism is designed to correct variances between allowed and

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[38] Allowed revenue is defined in the RIGS in part 4.
[39] Calculated as a percentage of allowed revenue excluding the correction factor.
[40] The pass through costs are SECCo Ltd costs as the Authority has not charged a fee.
[41] The correction factor is defined in licence condition 36.

regulated revenue. A breakdown of the correction factor is provided in appendix 6. As with last year, the correction is very high in proportion to allowed revenue. In part this is because the high correction factor from last year was not reflected in the 2014/15 charging statement. This is because the charging statement was published before our decision on the correction factor for 2013/14 was made. The other components of the correction factor relate to uncertainties of cost and revenues. In future, the correction factor from previous years will start to be reflected in charging statements. However, we will continue to monitor DCC's use of its prudent estimate.

Allowed revenue in forecasts

5.8 DCC forecasts its allowed revenue for the licence term in its reporting. DCC's forecast costs over the licence term have increased in its 2014/15 reporting. DCC will need to prove that its costs are economic and efficient each year as part of our review.

5.9 The costs reported under the indicative charging statements and budgets are different to those under the price control. This is because under the price control DCC can only report economic and efficient costs. When it sets its charges it can take a prudent approach to estimating its allowed revenue.

Adjusted allowed revenue and forecasts

5.10 As a result of our proposals there is a £0.409 million reduction in the allowed revenue in 2014/15. This brings it down to £33.383 million. We have also not allowed £14.551 million from the forecast costs over the remaining licence term. A calculation error in pass-through costs accounts for £2.830 million of these costs, we propose to remove £11.721 million of costs from forecasts as DCC has not justified them as economic and efficient. See table A5.1 in appendix 5 for a breakdown of our proposals and the subsequent changes to allowed revenue.

5.11 We propose that the reductions in charges should take effect in the 2016/17 charges. If we publish our final decisions in February 2016, this will slightly reduce the proposed charges that will take affect from 1 April 2016.[42]

Prudent estimate

5.12 DCC must take all reasonable steps to secure that regulated revenue does not exceed a prudent estimate of allowed revenue for each regulatory year. The concept of a prudent estimate is unique to DCC. Other companies we regulate have an obligation to take reasonable steps to ensure regulated revenue does not exceed their allowed revenue.

5.13 The prudent estimate is designed to ensure that service charges do not need to be amended in the course of the year except in response to a reasonably unlikely contingency. This aims to provide certainty for service users over their charges for the regulatory year.

[42] Under Licence Condition 19 our price control decision can be an exception to the requirement for DCC to give three months notice to amend its Service Charges.

DCC's approach to the prudent estimate

5.15 Given concerns about the significant size of the prudent estimate as a proportion of DCC's charges, we have continued to monitor the use of the prudent estimate and DCC's cash flow position over 2014/15.The prudent estimate as a proportion of DCC's charges has decreased. However, DCC's 2014/15 reporting of its cash-balances indicate that it continues to be in a very liquid position.

5.16 We acknowledge the level of uncertainty DCC has faced in its first years of operation, given the volume of changes to the programme during the implementation phase. This led to a high correction factor in 2013/14 which could not be reflected in 2014/15 charges. As a result, DCC had a high opening cash balance in 2014/15. This element of the cash balance should reduce in size over time as the correction factor is beginning to flow through charges.

5.17 In monitoring DCC's cash-flows, we have accounted for the regulatory year 2013/14 as a partial year. We have also taken into account the uncertainty faced at the time of setting the 2014/15 charges given the volume of change requests dealt with in the relevant regulatory year.

5.18 We remain concerned by DCC's approach to the prudent estimate in 2014/15. DCC's regulated revenue is steady over the year, and it is able to borrow or adjust charges in year if there is an unforeseen event. Given this context, it is important for DCC to accommodate peaks in its service provider payments in the most economic and efficient manner.

5.19 In July, we consulted on whether the prudent estimate provisions in DCC's licence should be amended. We proposed to introduce a penalty interest rate for over-recoveries beyond a threshold[43]. This mechanism would serve to act as an incentive for DCC to improve the accuracy of its forecasting and to manage short-term spikes in liquidity needs in the most economic and efficient manner. We intend to publish an initial conclusion later this year having taken account of responses to the consultation on the prudent estimate.

[43] https://www.ofgem.gov.uk/publications-and-updates/dccs-role-developing-central-registration-service-and-penalty-interest-rate-proposals

6. Baseline Margin Adjustment

Chapter Summary

In July 2015 DCC applied for a £3.114 million baseline margin adjustment. We assessed its proposal against the criteria in the licence. Following our assessment against the criteria and having regard to DCC's expected rate to return we are consulting on a variation of £0.322 million or £0.483 million.

Question 11: Do you agree with our assessment against the criteria in the licence?

Question 12: What margin do you think should apply, 10% or 15%?

Question 13: Do you have any views on the rate of return methodology we have developed?

6.1. The baseline margin adjustment mechanism was included in the Licence to recognise the uncertainty when the Licence was granted over the nature and risk of DCC's Mandatory Business over time. It is intended to ensure that DCC is compensated for material changes in certain aspects of its Mandatory Business under the Licence including the activities it carries out, the risk it faces or the timescales and deadlines that it must meet.

6.2. During 2014/15 DCC has undertaken the significant task of delivering against a shifting baseline of requirements. There have been unforeseen changes to the GBCS and to the SEC and the DCC has had to undertake replanning activity. These changes to requirements and operating environment have impacted on DCC's activities. As a consequence DCC has applied for baseline margin adjustments in relation to variations in the total volume of the activities comprising its Mandatory Business, and also a variation in risks (financial and operational) to which DCC is exposed.

6.3. In determining any adjustment to any of the baseline margin values set out in the licence the Authority may confirm, reject or amend the proposed Relevant Adjustment.[44] We have assessed DCC's adjustment and propose that it has met the criteria set out under the licence.[45] We propose amending the value of the Relevant Adjustments proposed by DCC.

6.4. When making our determination, the licence requires us to have regard to the DCC's expected rate of return on its activities over time. DCC has proposed the margin at bid should apply, as this is equal to DCC's expected rate of return and has

[44] Licence Condition 36 Appendix 2 paragraph A11
[45] Under Licence Condition 36 we have discretion to determine relevant adjustments to the baseline margin.

been established as a competitive market rate through the licence application process. Alternatively, we have developed a methodology to assess the margin based on DCC's application and we're interested in your views.

6.5. We are seeking views on two options in relation to the rate of return:

- A £0.322m variation based on a 10% margin derived from a methodology set out in this chapter.
- A variation of £0.483m based on applying the bid margin of 15% established through the licence competition. DCC have stated that this percentage margin applied to internal costs only at the time of the bid on the scope outlined in the bid documentation specifically.

6.6. The baseline margin values in the licence[46] are not adjusted retrospectively. Due to the ex post review any Relevant Adjustment applied for this year can only be reflected in baseline margin values from regulatory year 2016/17 onwards.

Background

6.7. The baseline margin is the amount for each Regulatory Year of additional revenue over and above the sum of internal and external costs that is included in allowed revenue (subject to the operation of the baseline margin performance adjustment)[47]. The level of baseline margin allowed in each regulatory year is fixed in value and set out in the licence.[48]

6.8. Each July, under certain circumstances,[49] DCC may apply for an adjustment to baseline margin values in the licence. Any adjustment proposed ('a Relevant Adjustment') by DCC must relate to a material variation[50] that has taken place or is likely to take place in any one or more of the following aspects of the Mandatory Business[51] of DCC:

- the total volume of the activities comprising that business;
- the characteristics of the activities comprising that business;
- the mixture (whether by category or volume) of the activities comprising that business;
- the risks (whether financial or operational) to which the Licensee is exposed in the carrying on of that business; and

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[46] Licence condition 36, appendix 1.
[47] The sum of the baseline margin is determined in accordance with the provisions of Licence Condition 36 Part C.
[48] Licence condition 36, appendix 1.
[49] Detailed in Licence condition 36, appendix 2.
[50] This may be due to a discrete but material change, or aggregation of incremental but non-material changes.
[51] The mandatory business means the part of DCC's activities that consists of the operation or provision, on behalf of or to SEC parties, of mandatory business services under or in accordance with the SEC.

- the timescales or deadlines that the Licensee is required to meet (whether under this Licence or otherwise) in the carrying on of that business.

6.9. The licence also details the mechanism that DCC must follow when proposing such an adjustment. The baseline margin adjustment mechanism was included in the licence to protect DCC against margin dilution due to a material change in the activities DCC carries out, the risk DCC faces, or the timescales or deadlines that DCC must meet. As outlined in the Processes and Procedures[52], it is DCC's responsibility to make a case for any proposed adjustment and to provide sufficient evidence to support its case.

6.10. It is not a cost plus arrangement and it is not intended to be an annual review of the margin level agreed at bid, or to protect against increases in costs that do not correspond to a material change in one of the five categories outlined above.

DCC's proposal

6.11. DCC has proposed an adjustment over the course of the licence term to the value of £3.114m. The proposed adjustment composed of two variations. One related to volume for £0.474m and the other for risk for £2.637m. We consider that DCC's proposed adjustment was duly made this year.[53]

6.12. Variation one is related to changes to the volume and timescales of the activity in 2014/15. The volume of activity related to a number of incremental changes ranging from additional programme planning and project management, to the redesign of some services, to re-planning negotiations with providers, to managing enhanced stakeholder engagement.

6.13. Variation two related to changes in DCC's exposure to risk between 2014/15 and 2021/22. DCC's additional risk exposure related to the new contracts for SMKI services and Parse & Correlate (P&C) software. DCC conducted a risk assessment which concluded it faced additional risk for the following reasons:

- Increased risk of missing Baseline Margin Implementation Milestones (BMIT);
- Risk of cost disallowances;
- Risk of enforcement action;
- Additional contract risk that cannot be backed off to Users as to do this fully would result in uneconomic contracts;
- Increased risk of reputational damage; and

[52] https://www.ofgem.gov.uk/sites/default/files/docs/2015/07/2707_dcc_pc_guidance.pdf, section 4
[53] As stated in the licence and in our Guidance document an application for a baseline margin adjustment from DCC must be duly made.

- Increased risk of missing targets in the future set in the Operational Performance Regime.

Our assessment of DCC proposal

We assessed this proposal against the criteria in the licence.[54] DCC originally used the contract values as the basis for valuing the increased risk relating to the variation. We do not consider the contract value to be the correct basis for the valuation because DCC should be managing and mitigating where possible. We consider the value of the risk should be the residual risk.

Variation One

6.14. DCC's proposed adjustment for Variation One is based on an increased volume of activity in 2014/15. To be eligible for a baseline margin adjustment, these additional costs must relate to a material variation to the relevant aspects of DCC's Mandatory Business.

6.15. We have assessed the resource costs associated with Variation One by comparing the 2014/15 FTE roles within each cost centre against the LABP. We removed any resource costs that were deemed to be uneconomic and inefficient under our price control assessment. We consider that the remainder meets the criteria. The Rate of Return section discusses the percentage margin to be applied to this cost base.

Variation Two

6.16. DCC's proposed adjustment for Variation Two is based on increased risk exposure due to the contracts for SMKI Services and P&C Software.[55] DCC outlined a number of risk categories and submitted their estimates on the valuation of this additional risk exposure.

6.17. We have assessed DCC's submission for each risk category it has put forward to determine whether there has been a material change to the risks DCC faces within the overall context of the Mandatory Business as a result of these new contracts relative to the risk position at LABP. Our assessment by risk category considered the following considerations:

- Have the risks DCC faces materially changed?
- If the risks have materially changed, is DCC's valuation of the expected residual risk exposure reasonable and well justified?

6.18. We consider there may have been a material increase in DCC's contract risk exposure due to the SMKI and P&C contracts. We have included a proportion of the residual value of the reputational risk DCC identified under contract risk.

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[54] Licence condition 36, appendix 2, paragraph A9.
[55] New information was known about the specifications for these requirements after bid stage.

6.19. We do not consider that DCC is eligible for a margin adjustment on the other categories of risks[56], because DCC did not provide sufficient evidence that its risk has materially increased in these categories.[57] DCC's arguments in relation to the implementation milestones and the operational incentives were not sufficiently strong. For example, it is unlikely the outcomes of the operational incentives will be linked to outcomes beyond DCC's control. The risk of cost disallowances and enforcement action put forward by DCC are risks that are within its control, and therefore not within the residual risk. As with Variation One, the next section, *Rate of Return*, discusses the percentage margin to be applied to this additional estimated risk.

Rate of Return

6.20. In determining any Relevant Adjustments the licence requires us to have regard to the expected rate of return on DCC's activities overtime[58]. We have considered different approaches to measuring DCC's return, including return on capital approaches.

6.21. We have taken into account the unique nature of DCC's ex-post regulatory framework, and its limited fixed and intangible assets. We have also considered the definition of baseline margin in the licence as an amount above the licensee's costs, and the influence of this on DCC's expected return in bidding for the role. We consider sales margin (or its earnings as a proportion of revenue) to be the most appropriate measure of DCC's return.[59]

6.22. We regard the existing baseline margin term values to be a competitive outcome of a tender process. In assessing adjustments to the baseline margin, we have considered multiple factors. We think it is appropriate in the absence of a competitive process for new requirements to consider a commercially reasonable margin for the variations for which DCC has applied. We have taken the approach of considering the adjustment in the context of the risks and margin of comparator companies, as well as the expected margin.

Methodology

6.23. We have first considered the characteristics of DCC's regulatory framework and external environment. Our risk characterisation aims to establish the baseline risk environment DCC faced before the variation occurred which changes can be assessed against.

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[56] These were missing BMIT, risk of cost disallowances, risk of enforcement, and risk of missing future operational incentives.
[57] Due to commercial sensitivity we will provide DCC more detailed feedback on our assessment of the risks they proposed.
[58] Licence condition 36 Appendix 2 para A10.
[59] It is challenging to apply approaches that measure return on capital such as a Capital Asset Pricing Model (CAPM) to an asset light company such as DCC.

6.24. We consider that DCC's contracts with external service providers to deliver the key infrastructure of DCC services mitigate many of the direct risks that DCC itself could face. Its monopoly position and the design of its charging and price control arrangements also provide significant mitigation against indirect risks it faces to its costs, revenue and margin. However, DCC faces some residual risks for which these mitigating factors cannot fully compensate. For example, the price control regime does not provide the cost certainty that an ex ante control would give.

6.25. Our qualitative risk-assessment suggests that within its regulated framework, DCC faces risk of political uncertainty[60] over its requirements and role. This is particularly relevant during the implementation phase of the smart metering programme. It also faces some risk of damage to its reputation associated with implementing a novel programme which could have an impact on its opportunities to provide future regulated services.

6.26. We have considered different types of companies which have some similarities with DCC as a basis for comparison. The categories of comparator include:

- Service providers operating a network, such as rail service operators and asset-light telecoms service providers (-3-16% margin[61]).
  These companies can have low fixed assets and a large proportion of their charges can consist of pass-through costs.

- IT systems providers in the energy sector (6-10% margin).
  These companies facilitate energy market processes as DCC does and either have regulated charges or face limited competition.

- Contract management companies (-1.5-6%).
  These companies have a similar business model to DCC of earning margin on large-scale contracts and often procuring physical infrastructure from third party providers

- Regulated retail companies in other sectors such as water, transport operations, and telecommunications (1-10% margin).
  These companies share aspects of DCC's cost and revenue protections.

6.27. We have considered the range of actual sales margins achieved or allowed by the relevant regulators by these companies. This range spans from -3-16%.

6.28. We have qualitatively compared the risk characteristics faced by the comparator groups and by DCC prior to the variations for which they have applied.

[60] This includes factors such as changes in broader political priorities.
[61] The sales margins referenced in this chapter for the unregulated comparator companies are three year averages taken from the latest available data.

This risk comparison has provided us with a guide for benchmarking DCC's margin against other companies.

Assessment

6.29. We have considered the variations to DCC's activities on which it has applied for a Relevant Adjustment. In particular, we have considered how these variations have altered DCC's risks since licence award, and the evidence it has provided to justify a Relevant Adjustment. We consider the variations to have changed the scope and complexity of DCC's requirements.

6.30. We have taken into account the comparators we have identified, and given the length of time since licence grant and the level of complexity associated with overseeing the development of a nationwide, first-of-a-kind IT system, we consider the higher end of the IT systems providers in the energy sector margin range is justifiable due to the level of risk, uncertainty and innovation that DCC faces. We therefore consider a 10% margin rate to be reasonable for the portion of the baseline margin adjustment that we have found acceptable within these particular variations. This results in a £0.322 million adjustment to DCC's baseline margin.

6.31. Alternatively a 15% margin, proposed by DCC[62], could be justified on the basis of how close we are to the time when the margin was agreed at licence award. DCC has argued that the margin should be consistent with the margin applied at Licence Award. Also, DCC has argued that it is appropriate that a rate commensurate with that included in the BAFO (Best and Final Offer) model be used. The 15% rate in this model is equal to DCC's expected rate of return and has been established as a competitive market rate through the licence application process.

6.32. We are interested in views on the margin that should apply. We welcome any comments particularly on the methodology we have used to assess DCC's baseline margin adjustment rate. We intend to keep this methodology under review. For any future applications for Relevant Adjustment, we also expect DCC to put forward its own assessment of variations to its activities and risks and to provide evidence to justify the margin variation, related to the expected rate of return, it proposes.

[62] DCC have stated that this percentage margin applied to internal costs only at the time of the bid on the scope outlined in the bid documentation specifically.

7. Next Steps

We welcome views on the proposals in this document. We may consult in 2016 on changes to the RIGs to reflect changes in the IM regime once the final milestones are directed by DECC. We will review the RIGs in light of the outcome on the Consultation on DCC's role in developing a centralised registration service.

Views on our proposals

7.1. We welcome views on the proposals in this document. Please get in touch with us early if you'd like to:

- discuss or provide feedback on our proposals, or
- provide any additional information that will help us assess DCC's costs.

7.2. We will consider any views provided when we take our decision. Please send responses to smartermarkets@ofgem.gov.uk by 20 January 2016. We intend to publish our decision on DCC's price control in February 2016.

Changes to the RIGs

7.3. We are not expecting major changes to the RIGs for price control purposes. However, we understand DECC will be directing changes to IMs 8 to 14 set out in the licence, which will be determined after the completion of the current re-planning activity. We will review the RIGs once these remaining IMs have been confirmed, and we will consult on any changes. We will also review the RIGs once the consultation on DCC's role in Centralised Registration has been concluded. If there are changes to the DCC's price control we will consult on the RIGs to ensure they remain consistent with the licence.

Developing operational incentives

7.4. We intend to engage and consult with stakeholders on the design of DCC's operational incentives in early 2016.[63] We will be looking to develop quality of service reporting and we expect the ex post review to look at the outputs DCC provides.

Future of the DCC price control

7.5 We see benefits in moving to more ex ante controls once DCC reaches a steady state. This would give the industry and DCC certainty about costs. We will explore introducing more ex ante controls in the current regime, aiming to move to a full ex ante control in the longer term. Introducing ex ante controls for certain costs is something we have sought views on in our consultation on DCC's role in developing a Centralised Registration Service and penalty interest rate proposals.[64]

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[63] Licence Condition 38, Part C, and Schedule 4.

[64] https://www.ofgem.gov.uk/publications-and-updates/dccs-role-developing-central-registration-service-and-penalty-interest-rate-proposals

Appendix 1 - Consultation response and questions

We'd like to hear your views on any of the issues in this document. We would particularly like to hear from SEC users. We would especially welcome responses to the questions at the beginning of each chapter. These are replicated below.

Please make sure we have your response by 20 January 2016. It would be helpful if you could submit your comments both electronically and in writing. Send them to:

Robyn Daniell
Smarter Metering
Ofgem
9 Millbank
London
SW1P 3GE
020 7901 3132
smartermarkets@ofgem.gov.uk

Unless you mark your response as confidential, we'll publish it in our library and on our website (www.ofgem.gov.uk). If you ask us to keep your response confidential we'll respect this request unless a legal duty means we can't, for example under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

If you'd like your response to be confidential, mark it clearly to that effect and include your reasons. Please restrict any confidential material to an appendix.

Once we've considered the responses to this consultation, we plan to publish our final decision in February 2016.

CHAPTER: Two

Question 1: What are your views on our approach to assessing DCC's costs?

Question 2: Do you have any suggestions on where we can improve our approach?

CHAPTER: Three

Question 3: What are your views on our assessment of DCC's performance against the IM7?

CHAPTER: Four

Question 4: What are your views on our cost proposals?

Question 5: We are interested in feedback from stakeholders and industry parties on DCC's external engagement. What were your experiences of engaging with DCC in regulatory year 2014/15?[65]

Question 6: We welcome views on DCC's benchmarking methodology, including on what you consider the appropriate percentile is that DCC should use when carrying out benchmarking, and approach to benchmarking benefits?

Question 7: We are looking for ways to further benchmark DCC costs. What other sources of data or potential comparators can you recommend for subsets of DCC costs?

Question 8: Do you agree with our approach to real price effects (RPEs)?

CHAPTER: Five

Question 9: What are your views on DCC's approach to the prudent estimate?

Question 10: Do you agree that our proposals should take affect from April 2015/16?

CHAPTER: Six

Question 11: Do you agree with our assessment against the criteria in the licence?

Question 12: What margin do you think should apply, 10% or 15%?

Question 13: Do you have any views on the rate of return methodology we have developed?

[65] Context to this question is included in the Industry section of Appendix 3

Appendix 2 – Detailed review of DCC costs and justification

1.1. This appendix contains our detailed review of the justifications DCC provided for the movements in its costs relative to LABP and 2013/14 forecast costs.

Overview of DCC's total cost base and movement from LABP

1.2. Figure A3.1, below, describes DCC's total cost base as reported in its price control submission for 2014/15. DCC's costs[66] are made up of:

- **External costs** – costs economically and efficiently incurred in procuring fundamental service capability from external service provides, i.e. infrastructure costs.[67]
- **Internal costs** – costs (excluding external costs and pass-through costs) economically and efficiently incurred for the purposes of the provision of Mandatory Business Services[68] under or pursuant to the SEC, and also include any shared service charge. [69]
- **Pass through costs** – defined[70] under the licence as the sum of the total annual fee paid by the licensee to the Authority and the payments made by the licensee to SECCo Ltd for purposes associated with the governance and administration of the SEC.

1.3. DCC's external costs are expected to make up the significant majority of DCC's cost base in future. However, to date DCC has mainly only incurred internal costs. Over the course of the licence DCC's internal activities will play a central role in managing external costs to an efficient and economic level.[71]

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[66] The categories of costs are defined in Licence condition 35

[67] As defined in licence condition 35 of the Licence. The fundamental service capability is defined in Licence condition 16 .40 and predominately comprises capability provided by the communication service providers (CSP) and the data service providers (DSP). This definition means that costs associated with other externally procured contracts, for example the Smart Metering Key Infrastructure (SMKI) contract are reported under internal costs.

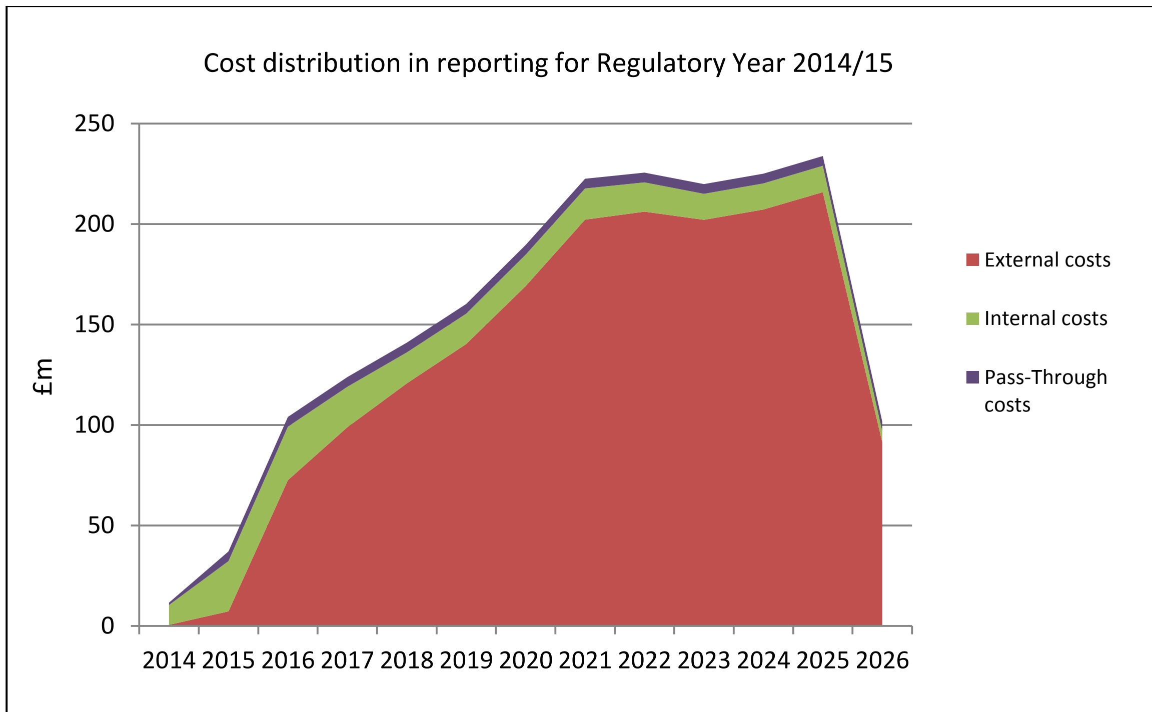
[68] As defined in licence condition 1 of the Licence, this means the services comprising the mandatory business of the Licensee, namely (i) the Core Communication Services, (ii) the Elective Communication Services, and (iii) the Enabling Services in each case as operated or provided by the Licensee in accordance with the requirements of the Licence.

[69] Internal Costs may include governance and administration costs of the SEC that are not included in pass-through costs. The shared service charge is a percentage of eligible internal costs paid to the parent company for use of shared services

[70] Defined in licence conditions 35 and 36.8

[71] The definition of 'external costs' in the licence captures only costs economically and efficiently incurred in procuring the fundamental service capability during each Regulatory

Figure A3.1: DCC total cost base over the licence as reported for 2014/15



1.4. Over the licence period DCC's latest total cost forecast is £1.996 billion, which is broken down into the components in table A3.1 below.

Table A3.1: DCC total cost forecast

Cost category	Total (£m)
External costs	1,735
Internal costs	202
Pass through	59
Total	**1,996**

1.5. DCC total costs are forecast to increase steadily between 2015/16 and 2020/21. This corresponds with the current timetable for the smart meter roll out and the

Year. The same applies to the definition of 'internal costs'. The nature of the contracts with fundamental service providers means that they are not paid until they achieve the testing milestones set out in their contracts.

expected delivery of infrastructure projects by the external service providers. The costs of these projects flow through DCC from the fundamental service provider contracts.[72] Following the mass rollout period, DCC costs are expected to broadly flatten out, before tailing off as DCC winds down in 2025/26.

1.6. In the 2014/15 regulatory year DCC incurred a total cost of £37.1 million[73], nearly 3% under last year's forecast. This has primarily been because of a significant underspend in internal services due to delays in the programme. The procurement of some internal services, have come under forecast and LABP costs, and some of this cost has been spread across the licence term. There has been an increase in some costs areas, for example payroll cost.

1.7. Over the course of the licence, external costs make up the large majority of DCC total costs. However, the structure of the DSP and CSP contracts means that these costs do not flow through until systems integration testing. This means that there is comparatively little in the way of external costs until 2015/16 (£7.3 million was incurred in 2014/15). These costs are explained in the external costs section of this appendix.

1.8. The significant majority of 2014/15 costs (£25 million) therefore relates to internal costs. One of the components of internal costs is DCC's shared service costs.

1.9. Pass through costs were £4.8 million in 2014/15 and relate the SECCo Ltd costs.[74] No Authority fee was charged. We do not scrutinise the pass through costs as part of the price control assessment as DCC has no control over these.

1.10. Figure A3.2, below, shows the changes in costs DCC reported in price control compared to those forecast in 2013/14 and LABP.

Figure A3.2: Change in DCC costs compared to 2013/14 forecast and LABP over the licence

[72] These contracts were competitively procured by DECC during the tender stage.
[73] This does not include the baseline margin value.
[74] SECCo Ltd is the Smart Energy Code Company which was established to enter into any contractual arrangements necessary to assist the SEC Panel in fulfilling its objectives and obligations.

1.11. Table A3.2 below shows the costs incurred in 2013/14 relative forecast costs and to the costs agreed as part of the licence competition. Reported costs in 2014/15 are lower than forecast, mostly due to DCC re-planning and some other costs being re-profiled into subsequent years. The increase in external cost this year has been due to new scope, which was not included at LABP.

Table A3.2: Changes in DCC incurred costs in 2014/15 compared to 13/14 forecast and LABP

Cost category	Change from 2013/14 forecast		Change from LABP	
	Total (£m)	%	Total (£m)	%
External costs	2.0	38%	4.7	185%
Internal costs	-3.0	-11%	6.9	38%
Pass through	0.0	0	0.0	0
Total[75]	**-1.0**	**-3%**	**11.6**	**45.5%**

[75] Figures may not sum precisely due to rounding

1.12. Over the course of the licence DCC is forecasting a total change of £49 million in costs relative to 2013/14 forecasts, a 2.5% change. This is a difference of £116 million from LABP, a 6.2% change.

1.13. The breakdown of the changes in the various cost categories shown in table A3.3, below.

Table A3.3: Changes in DCC costs compared to forecast costs and LABP over the licence period

Cost Category	Change from 2013/14 forecast		Change from LABP	
	Total (£m)	%	Total (£m)	%
External costs	32.8	2%	66.3	4%
Internal costs (including shared service costs)	16.1	9%	50.1	33%
Pass through	0	0%	-0.3	-1%
Total[76]	**48.8**	**3%**	**116.1**	**6%**

Materiality

1.14. DCC is required[77] to explain any material[78] variations in its incurred costs compared to the LABP and the previous year's forecast. The aim of requiring DCC to explain *material* variations rather than *all* variations is to ensure the regulatory reporting burden on DCC is proportionate.

1.15. There is no definition of 'material' specified in the licence. The RIGs outline that DCC must explain how and why it has chosen materiality thresholds to apply to its cost variations.[79] DCC must also outline what proportion of costs it considers immaterial under its approach.

1.16. Given this, it is Ofgem's role to assess DCC's approach to materiality and determine whether it is reasonable.

[76] Figures may not sum precisely due to rounding
[77] Licence Condition 37.6
[78] As outlined on p.9 of DCC price control guidance: process and procedures, https://www.ofgem.gov.uk/sites/default/files/docs/2015/07/2707_dcc_pc_guidance.pdf
[79] https://www.ofgem.gov.uk/sites/default/files/docs/2015/05/dccrigs2015.pdf, p.40. Licence condition 37.7 requires the presentation of costs to be set out in the manner and at such levels as specified in the RIGs.

DCC's position on materiality

1.17. For 2013/14 DCC used a fixed materiality threshold of £0.05m.

1.18. In DCC's 2014/15 submission, they have determined a materiality threshold of 1%. DCC considers a percentage threshold to provide better flexibility and consistency than a fixed one. A fixed materiality threshold risks that too much or too little will meet the threshold and, consequently, a disproportionate amount of explanation would have to be provided.

1.19. DCC have applied 1% to total internal and total external cost bases to create an absolute materiality for each. This equates to a £0.250m variation for internal costs and £0.33m for external costs.

1.20. For example, in the case of internal costs, we assess cost variations by GL code[80] within each cost centre. If the variation from the previous year's forecast or LABP is less than £0.250m then it is immaterial.

1.21. DCC has made an exception for payroll costs, for which they set a materiality threshold of £0.150m. They have also considered qualitative materiality. Some variances DCC see as significant even if this is a very small cost variation. In these cases DCC uses a set of qualitative criteria to determine if costs are justified.

Our view on DCC's materiality approach

1.22. In the application of this method, DCC have defined a small proportion of cost variations in the RIGs as immaterial. Following an assessment of the materiality we do not have any concerns this year about unexplained cost variations.

1.23. We propose to accept DCC's materiality approach this year. We will consider whether DCC's approach is appropriate in future years' submissions, given that future years' costs are expected to be higher than those incurred in 2014/15.

Real Price Effects

1.24. DCC have increased some costs due to Real Price Effects (RPEs) between 13/14 and 14/15.

1.25. In the case of external costs, the FSP contracts define how indexation should be calculated. This was included at LABP. Certain types of cost in these contracts should be increased by CPI. There have been no increases in external costs due to

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[80] General Ledger (GL) accounting code

RPE this year; however DCC forecast RPE increases to equate to £10.41m over the licence term.

1.26. DCC have adjusted salaries of 25 employees using RPI as the basis. These roles were selected for an increase based on eligibility criteria set by DCC's Remuneration Committee. DCC reported the impact of these adjustments to be an additional annual cost of £0.156m for 2014/15 and for the remainder of the licence term.

Our view on RPE adjustments

1.27. External cost increases for future years have been included since LABP, and are written into FSP contracts. Therefore we do not propose removing these forecast costs.

1.28. Adjustments to payroll costs we have considered in the context of the RIIO decision on RPEs for 2014/15. The RIIO decision has an RPE for 2014/15 of -1.9% for generalist labour and +0.3% for specialist labour. DCC's criteria for RPI eligibility and adjustment do not distinguish between specialist and generalist roles.

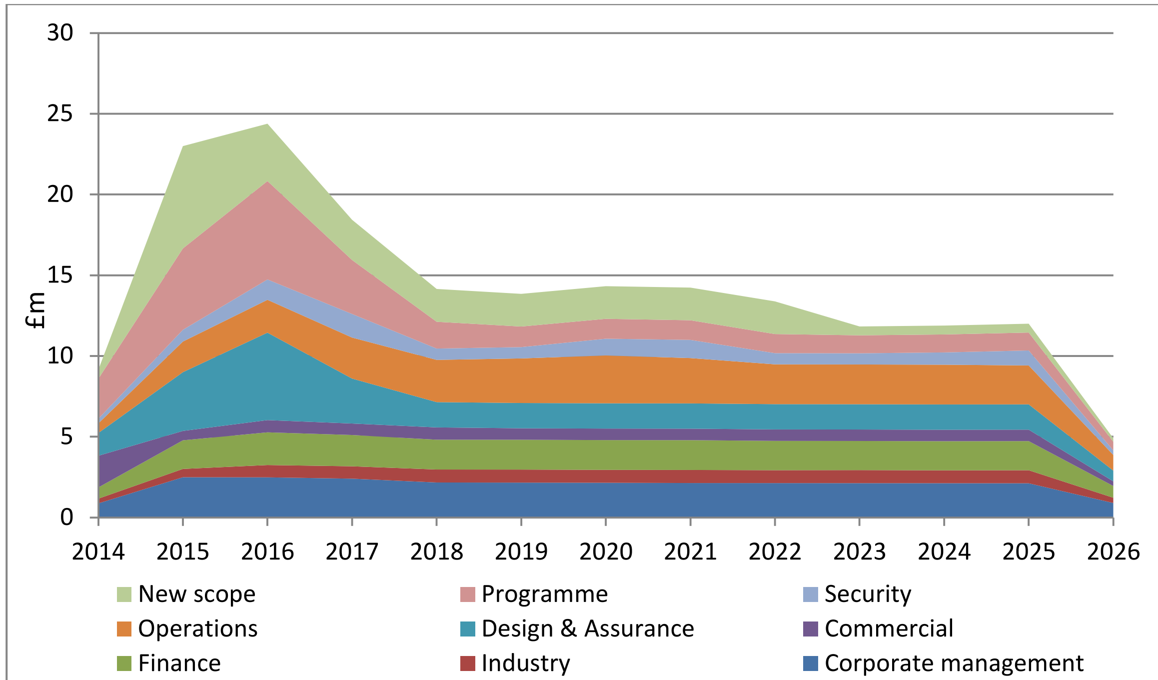
1.29. We have assessed which RPE increases we consider to be generalist roles by cost area, and have applied the RIIO RPE methodology for generalist roles to these adjustments. As a result we are proposing £0.056 million of inefficient RPE costs from 2014/15 are unacceptable costs, and £0.581 million future costs have not be justified as economic and efficient and should be removed from the forecasts. The remaining adjustments we determine to be economic and efficient.

1.30. Ofgem recognise that real price effects for DCC are not necessarily always going to be directly comparable to RIIO. However DCC's justification for why they implemented the method they chose was insufficient, so in the absence of further evidence, we think that in this case RIIO is a suitable comparator.

Internal Costs Detailed Review

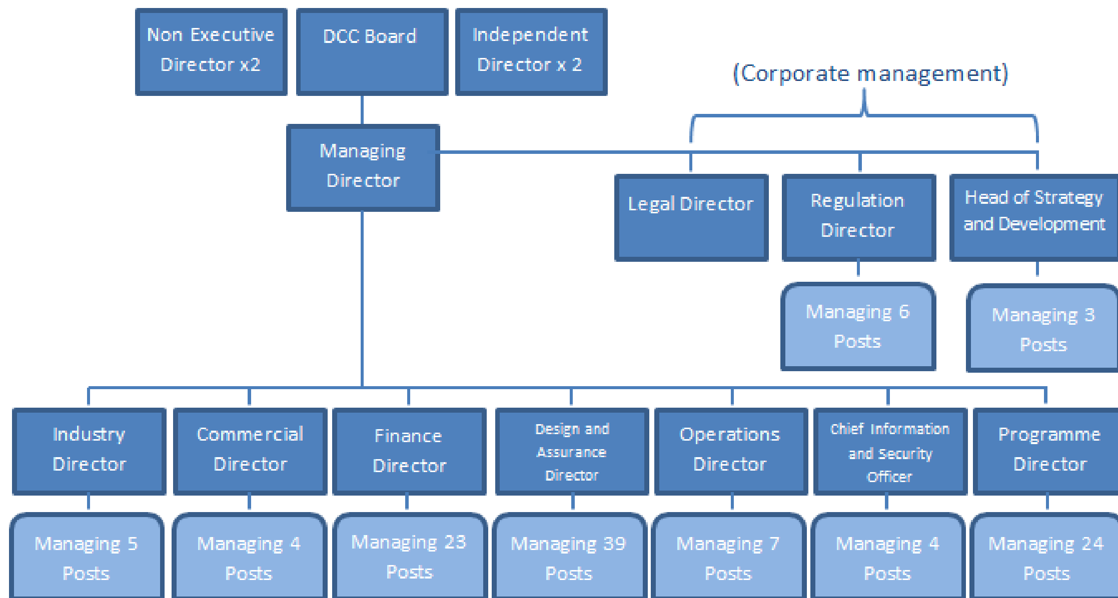
1.31. DCC reports its internal costs to us both by cost centre and expense type. Figure A3.3, below shows the DCC's forecast of the evolution of its internal costs over time by cost centre. There are peaks in costs in 2015/16 in Design and Assurance and Programme cost centres.

Figure A3.3: Internal costs by cost centre



1.32. Figure A3.4 below provides an organisational chart showing the cost centre structure DCC employed as of April 2015:

Figure A3.4: Roles by cost centre



1.33. Table A3.5 below shows FTE employed by DCC for regulatory year 2014/15 as reported by DCC in its price control. This also shows you the forecast FTE for 2015/16.

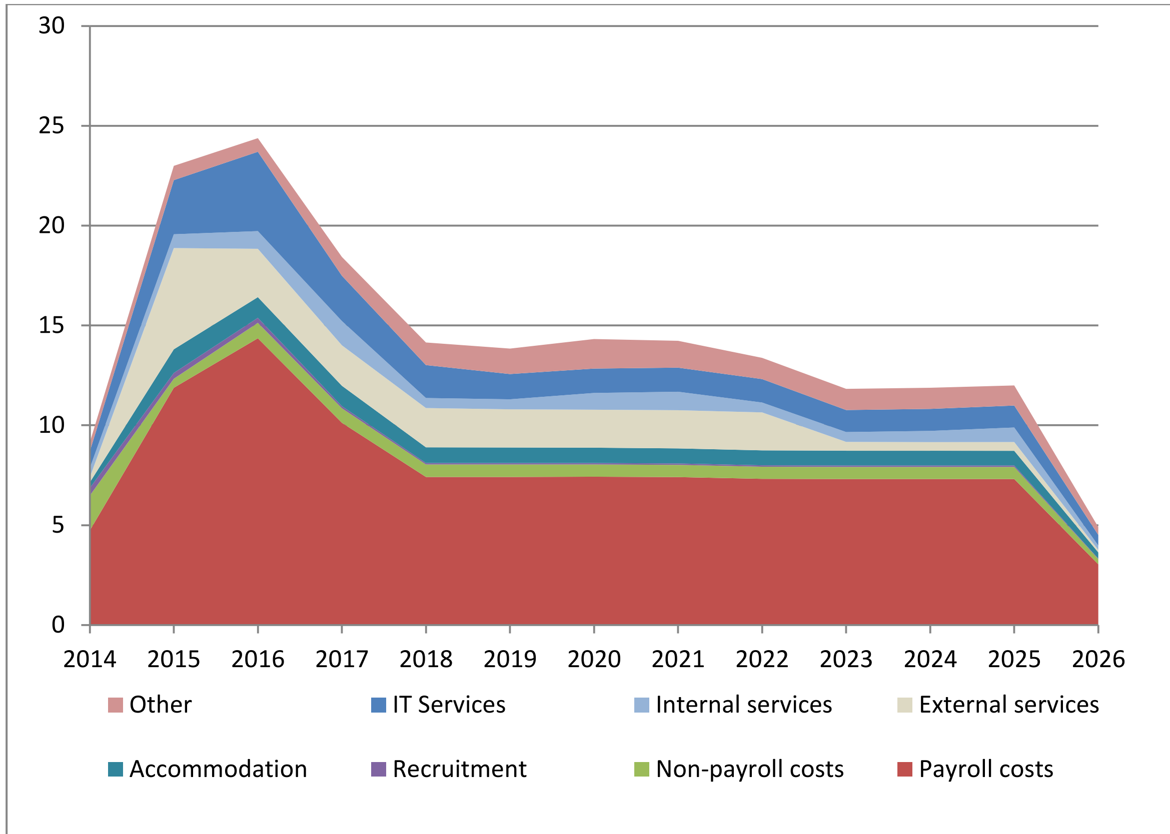
Table A3.5: Regulatory year FTEs by cost centre

Cost centre	2014/15	2015/16 forecast
Corporate management	9.3	9.8
Industry	5.2	7.5
Finance	16.9	21.5
Commercial	4.4	5.3
Design & Assurance	29.3	47.3
Operations	8.7	11.5
Security	5.3	6.7
Programme	19.0	17.7
New Scope	7.6	9.7
IT Resources	2.7	3.42
Service Desk	1.5	20.4
Total	**109.9**	**160.7**

1.34. We provide a detailed review of each cost centre later in this Appendix.

1.35. DCC's costs are predominantly payroll costs. Total internal costs are therefore driven primarily by salaries and headcount. There is no significant capex programme.

Figure A3.4: Internal costs by expenditure type



1.36. The primary changes from 2013/14 forecast costs are a reduction in incurred costs for 2014/15, with an increase in costs for 2015/16 and 2016/17. DCC has explained that the main drivers for changes from the previous forecast are due to:

- Payroll
- Accommodation

Payroll Costs

1.37. DCC report that increases in payroll costs are due to increases in volume and complexity of work, as well as a need to keep staff longer over the licence due to re-planning. DCC expect payroll costs to peak in 2015/16. These costs level off from 2017/18 until the end of the licence term.

1.38. The cost centres with the biggest increases are Finance and Design and Assurance. However there are reductions in forecast and incurred payroll costs for Industry and New Scope cost centres

1.39. We have assessed payroll costs within each cost centre and have evaluated resourcing as set out in the cost assessment section of this document.

Accommodation

1.40. Accommodation costs have increased as a result of the office move and increased headcount. These costs are consulted on as part of the corporate management cost centre.

Corporate Management

1.41. The corporate management cost centre includes costs for the managing director, the senior management team, and the DCC board, as well as any direct support provided to these roles in discharging their licence obligations.

Description of cost changes

1.42. Over the licence term there is an £8.3 million (46%) increase in corporate management costs relative to 13/14 forecasts and an 80% increase relative to LABP. This is primarily due to a £3.3 million increase in accommodation costs[81].

1.43. DCC has transferred a number of roles from various cost centres to corporate management in 2013/14. This means some increases the payroll costs in corporate management are counteracted by reduced costs in other cost centres. However they have also incurred additional payroll costs above this over the licence term.

1.44. There has been a £0.6m increase in costs above 2013/14 forecast this year. This is mainly due to increases on payroll costs. There have been no increases in accommodation costs above forecast for 2014/15.

DCC justification for cost changes

1.45. Accommodation costs have increased as a result of the office move and increased headcount. DCC report that they include space for visitors in their office, to whom they allocate the same amount of space as they would their permanent staff. They have said that this is important to encourage a collaborative working environment. They also state that it is important for them to be located in London due to proximity to stakeholders.

1.46. Resource costs have increased due to an increase in the capabilities of the regulation and strategy team, as they have had to work on new projects in 2014/15.

Our view on cost changes in the corporate management cost centre

[81] In their reporting, accommodation cost increases in this cost centre appear higher than £3.3 million due to a reallocation of accommodation costs from other cost centres into corporate management.

1.47. We accept that DCC have secured an economic and efficient price for their accommodation per square meter, considering their central location. However we do not think that DCC's assumptions and evidence around the amount of space required is justified for the licence term. In future years we expect DCC to better evidence how they are using the space.

1.48. DCC is able to lease excess space back to Capita under the commercial arrangements of the lease. Therefore we think it is reasonable to remove the £3.3 million increase in forecast accommodation costs over the licence term. DCC will need to provide sufficient evidence of this cost being economic and efficient if they incur these costs in future years.

1.49. DCC have had to increase resource in the cost centre, due to an increase in work load. Our analysis suggests that DCC has justified the need for extra resources.

1.50. We have found there are a number of roles in this cost centre where DCC failed to justify the level at which they were benchmarked. We have considered these as Unacceptable Costs as part of our benchmarking analysis.

Industry

1.51. The industry team leads engagement with service users, the SEC panel and other industry bodies. As such it is the primary external 'face' of DCC. This includes leading the DCC relationship with the SEC panel, and ensuring that DCC services are compliant with the licence and SEC obligations.

Description of cost changes

1.52. Over the course of the licence DCC is forecasting a 42% decrease in the costs of the Industry cost centre relative to LABP and 20% below their 2013/14 forecast. Their incurred costs for 2014/15 were £0.3m below their 2013/14 forecast for the year.

DCC justification for cost changes

1.53. The primary cause of these savings is FTE transfers into the corporate management cost centre. For 2015/16 there have also been some delays in recruiting, although these have not impacted DCC's ability to carry out required activities. These changes therefore do not amount to overall cost savings.

1.54. DCC has also explained that it has made some savings due to employing a mix of different levels of staff to engage with different types of stakeholders and areas of their business.

Our view on cost changes in the industry cost centre

1.55. Headcount transfers to other cost centres are permitted under the RIGs and are for DCC to manage internally within the overall costs set out in the LABP.

1.56. DCC organised and participated in a wide variety of industry and stakeholder events and meetings in 2014/15. They have also developed their website and reviewed their external communications to improve transparency. We are interested in opinions from DCC's stakeholders and industry participants to evaluate DCC's performance relative to costs incurred. Therefore we would appreciate views from industry parties of their experiences of engaging with DCC in the regulatory year 2014/15[82].

1.57. DCC have provided evidence of their industry outputs for 2014/15 year, and have come under forecast costs. Costs for industry are forecast to increase in future years, primarily due to recruitment of additional staff. DCC has deferred recruiting roles until next year, but do not provide sufficient evidence as when or why these roles will be needed in future years. We are proposing increases in resource forecast costs above 2014/15 costs are removed for the duration of the licence term, as they remain uncertain at this time.

Finance

1.58. The finance cost centre includes costs associated with:

- Commercial finance activities including supporting change management, producing budgets and developing and applying the charging methodology;
- Operational finance activities including managing the billing and credit cover aspects of DCC; and
- Regulatory finance activities including the price control and other regulatory and statutory reporting.

Description of cost changes

1.59. Over the course of the licence DCC is forecasting a 65% increase in the costs of the finance centre relative to LABP and a 25% increase relative to last year's forecast. For this reporting year DCC's costs were £0.74 million higher than forecast in the LABP and broadly the same as last year's forecast for 2014/15.

1.60. Since licence award the number of FTEs in the finance cost centre has increased markedly which can in part be attributed to the transfer of roles from Operations, Corporate and Commercial cost centres into Finance last year. Last year

[82] As part of question 5 of this consultation

DCC projected expansion of the Finance team for this regulatory year through new recruitment. There has been a small further increase in headcount and resourcing cost compared to last year's forecast.

1.61. DCC anticipates that staff numbers in this cost centre will increase in 2015/16 compared to the actual staff employed in 2014/15 by 27%.

DCC justification for cost changes

1.62. DCC reports a number of key drivers of the increase in this cost centre, including:

- The need for more resource including more senior commercial finance capability to lead on the financial assessment of external cost changes and related discussions with service providers and users.
- Greater engagement with Service Users on their charging statements and forecasting as part of their initiative to improve transparency.
- New resource to develop and implement new financial systems and to support effective internal control.

1.63. The projected increase in resource requirements for Finance across the remainder of the licence term DCC explain are related to its Commercial finance capability. This is stated to be in part to meet the ongoing need to assess a potentially large volume of change requests and their impact on DCC's financial position and forecasts.

1.64. DCC stated that 'go-live' should not be seen as the beginning of a 'business as usual' phase as further change requests will arise under the SEC modification process. As a result, DCC reported that it is too early to reduce the level of resource forecast in the Finance team to support change control and manage the impacts of change.

Our view on cost changes in the finance cost centre

1.65. We remain of the same view as last year that DCC had sufficient information about the finance capability required to discharge its charging and forecasting obligations, and regulatory reporting requirements when the Licence was awarded. Despite this knowledge, DCC appears to have underestimated the level of resource for engaging with service users on its costs, managing financial processes, and fulfilling regulatory reporting requirements.

1.66. Therefore any applications for additional margin for the associated increase in resource for this activity is unlikely to be accepted.

1.67. We do accept that DCC has had to create and fill additional posts in the finance team in order to fulfil its duties, particularly to provide support for the change control process. We also accept that additional posts may be required during the start-up phase to develop and implement financial systems.

1.68. However, we do not consider that the enduring growth in the finance team is sufficiently justified and we would expect to see cost-efficiencies from the financial systems implemented and once volume of change has fallen. We propose to strip out forecast costs for roles that are not necessarily enduring until more robust justification is provided.

1.69. As explained in further detail in the resourcing section, there are a number of permanent and contract roles with remuneration that is above the acceptable benchmarking level and have not been justified as economic and efficient. We propose that the resource costs above the appropriate benchmark are unacceptable costs for 2014/15 and the remainder of the licence term.

Commercial

1.70. The commercial function leads the contract and commercial management of the fundamental service providers, evaluating services procured from Capita and additional contracts which require management, such as SMKI, Parse and Correlate. Commercial also oversees DCC's procurement strategy.

Description of cost changes

1.71. Over the course of the licence DCC is forecasting a 4% decrease in the baseline costs of the commercial cost centre relative to LABP and a 3% reduction compared to last year's forecast. In 2014/15 DCC's baseline costs were £0.16 million lower than forecast in the LABP and £0.15 million lower than last year's forecast. The Commercial team did not recruit any new roles in 14/15.

1.72. In 2014/15, £0.64 million new scope costs were incurred associated with the commercial cost centre including the procurement of the ATG solution, audit and compliance services and procurement resource to set up the audit and assurance and consultancy frameworks.

DCC justification for cost changes

1.73. DCC stated that the decrease in baseline costs for 2014/15 compared to last year's forecast is due to a delay in recruiting for a new role. The lower forecast costs over the remainder of the licence compared to last year's forecast can be explained by a decrease in ongoing procurement support from Capita now that DCC have implemented the new procurement frameworks.

1.74. In terms of new scope costs, DCC stated that the procurement of the ATG was not considered at bid as the development of the GBCS is Government responsibility.

DCC identified the need to support the development of a robust GBCS by testing the emerging specification. The ATG has been welcomed by industry.

1.75. DCC have stated that procurement frameworks are a well-recognised practice and will allow on-going services to be procured quickly and without the support of procurement specialists that will realise savings in future years.

Our view on cost changes in commercial cost centre

1.76. Overall DCC's baseline cost forecasts remain below LABP. We consider costs at present to be economic and efficient. However, we propose to find forecast resource costs for expected new roles which are above benchmark as unacceptable.

Design and assurance

1.77. The design and assurance function leads the development and maintenance of DCC technical architecture and service design. It works closely with the FSPs. This function is responsible for technically assuring DCC services and overseeing the delivery and implementation of the test strategy and test approach.

1.78. The role of the design and assurance function is primarily quality control. Each system is developed for the DCC by external developers and vendors (eg DSP, CSPs, SMKI, Parse and Correlate). These systems vendors have their own quality control, design and assurance functions. It is not DCC's role to duplicate these functions, but to ensure that external parties carry out their roles properly. It provides an additional layer of assurance and, importantly, plays the key role in successful integration of various elements of DCC system developed by service providers.

Description of cost changes

1.79. In 2014/15 DCC's costs were 28% higher than forecast in the last years forecast. For the next two years DCC is forecasting a 91% increase in the costs of the Design and Assurance function relative to last years' forecast. After 2016/17 DCC is forecasting a 12% decrease, which is a 3% increase from the LABP forecast.

DCC justification for cost changes

1.80. DCC explained that changes are driven by the need for additional expert resource. As with other cost centres this has been due to changes to GBCS and new requirements. During 2014/15 six roles were transferred from the Operations team to the Design team as part of the Service Design team.

1.81. Costs in future years are forecast to increase; DCC explain this is primarily as the Test Assurance team ramps up for testing activity prior to DCC Live. After DCC Live, resource levels will reduce back to a level consistent with the LABP as the volume of activity declines longer term.

Our view on cost changes in the design and assurance cost centre

1.82. There are many causes of changes in scope for this cost centre which are largely beyond the control of DCC. This is likely to cause changes in the cost base and until the requirements are more certain it will be difficult to estimate the appropriate long term costs. Many of the roles required in the design and assurance function are technical and specialist in nature.

1.83. If there is an increase in internal costs associated with testing and quality assurance, we might expect to see some demonstration of avoided external costs associated with these roles, or an improved ability to negotiate those costs downwards. Clearly this will also depend on DCC's ability to maximise value from its contractual arrangements with the FSPs.

1.84. Given the challenging context we consider that DCC has provided sufficient evidence to justify its costs in its 2014/15 submission. However we will continue to carefully assess any new additional costs that flow through as a result of re-planning, and this is likely to be a key area we focus on in 2015/16. In future years we will expect DCC to provide evidence that changes in salary or benefits packages are competitive.

Operations

1.85. The operations cost centre includes the cost of ensuring that DCC services meet the needs of all service users. This includes designing and providing the day-to-day operational interface for service users including a first line service desk. The operations function is also responsible for operational reporting and the provision of any transitional services ahead of go-live, early life support and enduring operations.

Description of cost changes

1.86. Over the course of the licence DCC is forecasting a 3% increase in the baseline costs of the operations cost centre relative to LABP. In 2014/15 DCC's baseline costs were £0.58 million higher than forecast in the LABP. Compared to last year, DCC is forecasting a 1% reduction in baseline costs over the remainder of the licence and £0.05 million increase for 2014/15.

1.87. There were a number of baseline cost reductions in 2014/15 compared to last year's forecast due to the transfer of roles and accommodation costs to other cost centres and the deferral of roles to 2015/16 to reflect the change in timelines as result of the re-plan. While the number of FTEs is lower for this year, the average cost per permanent and temporary contractor FTE is higher than forecast last year and at LABP.

1.88. Overall the impact of the transfers of costs to other cost centres were more than offset by a significant increase in service management costs largely attributable to an increase in service desk set up costs.

1.89. Beyond 2015/16, resource costs are expected to increase compared to last year's forecast due to new roles being anticipated to manage transitional services, operational management and problem management. Over the course of the licence, service management costs, including service desk costs, are forecast to be 17% higher than DCC's estimates at BAFO.

1.90. New scope costs incurred relating to service management and engagement roles were lower than forecast last year due to DCC requiring specialist resource for a shorter time than forecast.

DCC justification for cost changes

1.91. DCC explained that the increase in service management costs are due to the evolving SEC (which included the requirement for an interim service desk to be up and running quickly) and new learning from foundation experience. Examples of cost drivers specifically for the service desk include uplift on service desk salaries and expected incident rates compared to what was anticipated at bid and the need for disaster recovery provision. DCC also reported an increase in service desk set up costs and IT hardware and network infrastructure requirements following further clarification on requirements.

1.92. The increase in complexity of the service management model and the need for further engagement with users are also the reasons that DCC provides as justification for the increase in FTE volume and the average cost of FTE against LABP over the course of the licence.[83]

Our position on cost changes in operations cost centre

1.93. We appreciate that DCC had to make sure capability was in place quickly to deal with changes in requirements and the need for the interim service desk to be up and running. However, average resourcing costs for some roles, in particular those filled by contactors, appear high against the benchmarking analysis and we do not expect above-benchmark salaries to endure. Therefore we propose that the difference above benchmark salaries are Unacceptable Costs and that these costs are also to be removed from the forecasts. We expect DCC to provide clear evidence demonstrating they are taking an economic and efficient approach going forward.

1.94. A number of the changes made to the service desk capability are expected to increase the level of automation of the service. We have seen limited evidence from DCC on how the efficiencies from greater automation will play out in internal service management costs. In future, where cost forecasts have been included in the forecast, we would expect them to be net of any benefits or at least for the benefits to be clearly explained in the submission reporting. Failing to provide this evidence will increase the risk of having costs found unacceptable.

[83] Once the transfers of FTE to other cost centres have been adjusted for.

1.95. We understand that ongoing changes to the programme have led to changes in service management requirements that DCC could not have anticipated at bid. However, we think that some of DCC's assumptions about the level of service desk capability and technical capability required made at bid were not realistic estimates. Where DCC has underestimated the requirements at bid, we have been clear that this would not meet the baseline margin criteria.

Security

1.96. The security team is tasked with assuring the security of all DCC systems. This involves establishing an information security policy, including security assurance standards, processes, procedures and implementation timescales. The team also maintains information security standards and certification throughout the licence.

Description of cost changes

1.97. Over the licence period, DCC is forecasting a 7% increase in the baseline costs of the security cost centre relative to LABP and a 4% increase compared to last year's forecast. In 2014/15, DCC's baseline incurred costs were £0.41 million lower than forecast in the LABP and £0.48 million lower than last year's forecast increase for 2014/15.

1.98. The variation in FTE volume and average cost per FTE is immaterial compared to LABP and last year's forecast for 2014/15. The DCC stated that the security team will need to grow operationally but that promotion within the team and recruitment of more economical resource will help to achieve a wider coverage at reduced overall cost.

DCC justification for cost changes

1.99. DCC has explained that incurred costs for 2014/15 are lower than forecast at LABP and last year due to a delay in DCC procuring the security solution. The forecast has been re-profiled to delay the costs by a year, resulting in savings of 12 months' worth of costs at the end of the Licence.

1.100. DCC explained that salaries within the security team are consistent with benchmarking results given the specific security skills and previous experience required for the roles. The variation in forecast resource and recruitment costs fall below DCC's materiality threshold, they therefore provided no justification for any increase in costs.

Our position on cost changes in security cost centre

1.101. Overall DCC's baseline cost forecasts for the security team remain below LABP and last year's forecast for 2014/15. We consider costs for this year to be economic and efficient.

Programme

1.102. The programme cost centre includes costs for coordinating delivery across the whole DCC ecosystem during the implementation phase. It will ensure that the services, systems, resources and assets are all in place in accordance with the programme plan. This will allow DCC to appropriately design and build activities to be completed to facilitate integration and subsequent user integration testing.

Description of cost changes

1.103. Over the course of the licence DCC is forecasting a 6% increase in the costs of the programme function relative to LABP and 5% increase against 2013/14 forecast. Overall, in 2014/15 DCC's costs were £2.1 million lower than forecast in the LABP and £3.3 million below 2013/14 forecast.[84] There has been an increase above forecast in resource costs in 2014/15. There has been a significant redistribution of costs across the licence term. The majority of the costs in this cost centre relate to IT services costs.

DCC justification for cost changes

1.104. DCC has procured a series of IT systems this year under a competitive procurement process:

System	Procured from
Corporate Performance Management (CPM)	Rhinedata
Business Intelligence/Management Information (BI/MI)	IBM Cognos
Billing System	Capita Group Systems, part of Capita plc.
Document Management System	Foundation SP

1.105. The costs of these systems were forecast in LABP, and all four procurements came below these forecast costs. As these costs have become more certain, DCC has

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incurred less IT systems costs in 2014/15, and increased in future years' forecasts to reflect actual cost.

1.106. Resource costs have increased above forecast this year. DCC reports it had to recruit short-term contractors to fill roles at the beginning of the year, before permanent employees could be recruited. This was due to a lack of quality and quantity of resource.

Our position on cost changes in programme cost centre

1.107. We recognise that DCC has procured four IT systems at below LABP forecast cost. In the case of these particular procurements we find the outcomes economic and efficient.

1.108. DCC spent considerably more on consultancy costs in 2014/15 than was forecast in either LABP or 2013/14 forecasts. DCC justified these costs due to a lack of sufficient capability in the team at the beginning of 2014/15. As such we consider that a number of roles in this team have been benchmarked at an inappropriate level and propose associated costs are unacceptable as part of our benchmarking analysis.

New Scope Internal Costs

1.109. DCC has forecast £25 million of new scope internal costs over the licence period. This is 3% less than forecast in 2013/14. Incurred new scope costs for 2014/15 came under 2013/14 forecast by £0.3 million.

1.2. The main driver of new scope costs has been the procurement of several external service provider contracts. Many of these were explicitly excluded from LABP, but have been procured competitively. Based on the evidence in DCC's reporting we have found that all new scope costs were economic and efficient in this price control.

Explanation of new scope costs variations from 2013/14 forecast

- **SMKI contract**: We allowed the forecast cost of the SMKI contract in our last price control, as it was procured competitively. In 2014/15 DCC incurred 36% of the cost of SMKI, the rest spread out over the rest of the 8 year contract. Over the licence term costs for SMKI have decreased by 6% compared to 2013/14 forecast. This is mainly due to a reduction in the amount of time the system will be operational, due to delays to go live.

External Costs Detailed Review

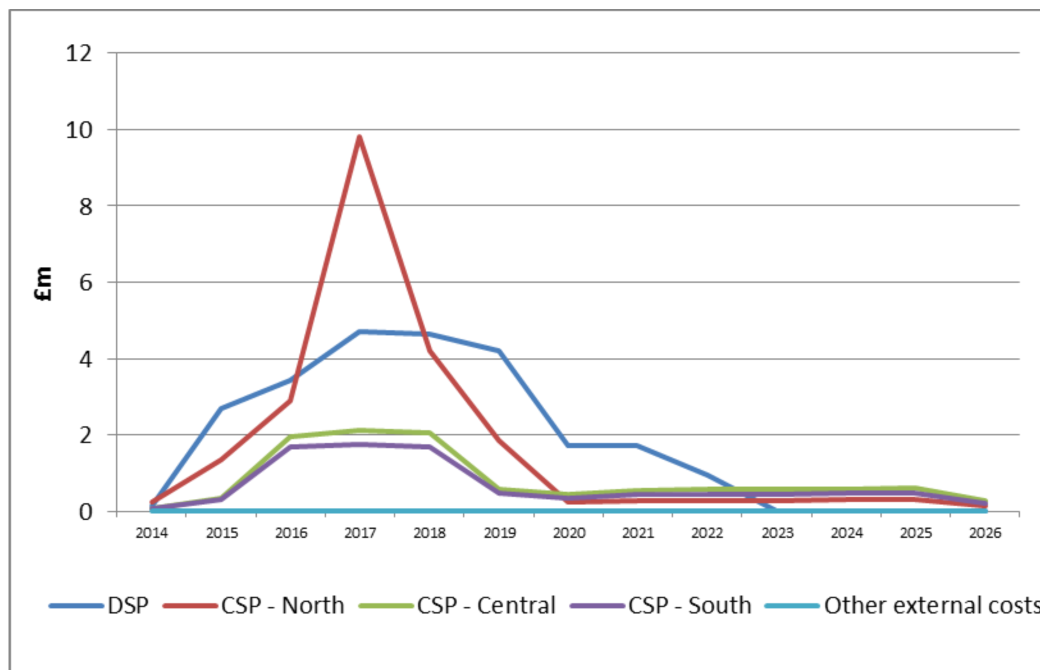
1.110. Table A3.6 below shows the increases in external costs relative to LABP over the full licence.

Table A3.6: External cost changes to LABP

Cost centre	Total increase relative to LABP £m	As a % of LABP[85]
DSP	**24.3**	**32.4%**
CSP - North	**22.3**	**4.8%**
CSP - Central	**10.8**	**1.7%**
CSP - South[86]	**9.0**	**1.8%**
Other	**0.0**	**-**
Total	**66.3**	**4.0%**

1.111. Figure A3.5 below shows the profile of these increases over time.

Figure A3.5: External costs relative to LABP over time



1.112. The total cost difference to LABP is an increase of £66.3 million over the licence period, which is a 4% external cost increase. DCC has reported that these are entirely due to new scope costs, and there have been no changes to the baseline.

1.113. The main drivers for the cost increase were attributed to the new version of GBCS and resulting delay; associated auxiliary activities (eg providing workshops

[85] Note that the licence term is different to the length of the service provider contracts (eg the CSP contracts are longer than the licence term)
[86] Note that the CSP for Central and South is the same provider

and impact assessments); and additional functionalities such as DCC Service Management System (DSMS) enhancements and extended coverage of the project.

General Management of External Contracts

1.114. DCC stated that a majority of the contract management activities during 2014/15 were associated with change control. In the submission, DCC explained how improvements were made to the change control process to ensure that there is a clear rationale for each change, that the impact is accepted by relevant stakeholders and that these points are revisited throughout the process. DCC noted in its submission that further improvements would be made in 2015/16 including the introduction of a portfolio management approach for managing changes. We are pleased that further improvements to change control management are underway given the findings from the forensic review which found incomplete evidence trails for a number of sample contract variations for 2014/15.

1.115. There were no formal disputes with any of the FSP's in 2014/15. Final approved versions of the FSP's business continuity and disaster recovery plans were submitted to DCC in 2014/15. These plans are reviewed twice a year.

1.116. The contracts contain a number of provisions that should enable DCC to efficiently manage the FSPs.[87] These include the following value for money provisions and DCC's reasons for whether these provisions were exercised or not in 2014/15:

- **Benchmarking reviews:** These cannot be undertaken until 3 years after the effective dates of the contracts.
- **Gainsharing:**[88] There were no gainshare opportunities identified by DCC or service providers in 2014/15.
- **Refinancing gainsharing:** The CSPs have set up the finance arrangements for the first tranche of communication hubs. Financing for future financing arrangements will be provided in 2016/17. Following a review of its set up charges, details of the DSP's refinancing arrangement and expected refinancing gain will be provided in 2015/16 price control submission.
- **Non-mandatory activities:** During 2014/15 no requests were made for DCC approval of the use of relevant assets for providing non-mandatory activities.
- **Financial audit:** DCC carried out financial audits for each FSP in 2014/15. The scope of the audits focused on assessing the evidence that supports the material costs that have been requested by the FSPs though change

[87] Schedule 7.3 in contracts sets out the main value for money levers these are benchmark reviews, gainsharing mechanism, refinancing mechanism, non-mandatory activities, and financial audit.
[88] Gainsharing is where service providers are able to implement efficiency improvements or through implementation of other changes costs of delivering services is reduced. The cost savings would be shared.

requests over 2013/14. Recommendations from the report are to be fed into the DCC Continuous Improvement Plan.

DCC justification for the changes in external costs

1.3. DCC categorised the material projects and change requests for 2014/15 as follows:

- **The development of service management within DCC.** Following the changes to the technical requirements of the DSMS in 2013/14, further work was required to define how specific modules of the DSMS needed to be further customised to meet the needs of the programme.
- **The development of the security architecture for DCC.** Developments to the security architecture were required in 2014/15 in response to more requirements from DECC, the evolution of the SEC and industry-driven change.
- **Information provision around communication hubs.** DCC raised change requests in 2014/15 to ensure that DCC has robust and timely information regarding communications Hubs from the CSPs. This follows from evolving SEC obligations to ensure that Communication hubs asset state can be tracked and that DCC is obliged to charge Parties on the basis of the Communications Hubs status.

Appendix 3 – Further information on our initial benchmarking analysis

This appendix provides more detail of the external benchmarking we have updated from last year. For 2014/15 we updated our benchmarking analysis using ASHE data. As DCC conducted their own resource benchmarking this year, the purpose of our analysis was used to sense-check DCC's results as well as the conclusions of our own cost assessment.

DCC's approach to benchmarking

DCC carried out benchmarking of their resource costs using the Hay Group methodology and PayNet dataset (provided by Hay Group).

The Hay Group methodology involves assigning each role a 'Hay Group level' based on the capabilities required to fill that role, rather than the capability of the individual in the role. It allows comparison of a role relative to others and enables comparison of roles across different functions of DCC. The approach involved three stages:

I. **Job evaluation:** A job evaluation of DCC's executive level roles was carried out. This included the following roles:
   - Manging director;
   - COO (future role);
   - Programme director;
   - Policy director (future role);
   - Finance director; and
   - Design and assurance director.

This involved a discussion between a Hay Group consultant and DCC's managing director about the requirements of each role. The consultant then used their experience to compare this description to other roles and assign a Hays Level, creating a corporate ceiling.

II. **Job mapping:** DCC ran a workshop process involving its management team and consultants from Hay Group to assign each role in DCC a level. This involved placing the roles into a matrix based on its relationship to evaluated

roles, other roles within its job family,[89] and across other job families. Hay Group quality assured the final matrix of job levels.

III. **Benchmarking analysis:** DCC then accessed the PayNet dataset provided by Hay Group and, where sample sizes allowed, filtered the data by applying relevant parameters to it (for example in relation to location). The results were compared its own resource costs. DCC compared remuneration at three levels:

- Base salary;
- Total cash; and
- Total remuneration.

Our detailed view on DCC's benchmarking exercise

We welcome the work that DCC has done on benchmarking and consider it to be a positive step in terms of justifying its resources costs. As stated in chapter 4, we disagree with some of the assumptions used in this exercise, including the:

- percentiles used as benchmarks;
- justification provided when over the benchmark;
- method for calculating benefits; and
- benchmarking of contractors.

Percentiles used

DCC has used the 50th and 75th percentile as comparators. We do not think that DCC has adequately justified using these percentiles as a universal benchmark across all of its business. When using benchmarking as a means of informing future remuneration we expect DCC to benchmark at an appropriate level. Where DCC deems it is justified in using a higher percentile, it should provide clear and robust evidence to support this decision. We note that lower percentiles tend to be used when benchmarking resource costs of other regulated entities, although we recognise there are some differences between these organisations and DCC.[90]

Justification when over benchmark

In many cases total remuneration is above the 50th percentile and in several cases it is also above the 75th percentile. Where this has occurred, DCC's explanation has not

[89] Groups of jobs that involve similar work.
[90] For example RIIO tend to refer to the lowest 25th percentile of costs. Para A 3.9 https://www.ofgem.gov.uk/sites/default/files/docs/2014/11/riio-ed1_final_determination_overview_-_updated_front_cover_0.pdf

always provided sufficient evidence to support its position that the role had been difficult to fill or was particularly specialist.

We expect DCC to set remuneration at a level comparable to external benchmarks. We accept that it can be difficult to obtain like-for-like comparators for some of the more specialist activities that DCC undertakes which may include technical roles and specialist skills. However we do not think that this is justification alone for the extent to which DCC exceeds its own benchmarks in certain areas.

Calculation of benefits

When calculating the level of benefits to be included in total remuneration DCC has included the average bonus paid and other benefits where applicable and then has applied a generic percentage to cover all other benefits received.[91]

We do not think that this is an appropriate approach. Our analysis shows that the percentage applied to cover all other benefits frequently, and sometimes significantly, understates the level of benefits actually received. This results in total remuneration comparing more favourably to the benchmark than it otherwise would have. In future, DCC should use actual benefits received when benchmarking resource costs. We welcome views on this.

Benchmarking of contractors

DCC has provided some limited benchmarking on contractor rates, however has noted the difficulty in doing so. For example, the PayNet dataset does not provide contractor rates. To overcome this, DCC has calculated an annual equivalent rate for contractors[92] and has used the PayNet data plus a premium as a proxy. Using this method, the benchmarking result shows many contractors are employed at rates above the 50th percentile of contractors.

ASHE benchmarking

In 2013/14 we carried out some initial benchmarking of salaries to inform our cost assessment. In particular, we used it as a sense-check of our conclusions. Our primary comparator for salaries and bonuses was the Annual Survey of House and Earnings (ASHE) data provided by the Office for National Statistics (ONS).[93]

We undertook a detailed mapping exercise to derive salaries from the ASHE database which could be compared to DCC's staff costs. The results of this comparison were used to support our views on DCC's cost changes from the LABP.

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[91] Other benefits include pension, health care, life insurance and other sundry benefits.
[92] Reduced to allow for employer's National Insurance should the role have been permanent.
[93] http://www.ons.gov.uk/ons/rel/ashe/annual-survey-of-hours-and-earnings/index.html

We appreciate that benchmarking salaries using ASHE data in this way has limitations, and must be treated with caution. For these reasons, we did not use our analysis as a basis for calculating cost disallowances last year. However, the assessment gave an indication that changes above the LABP need to be justified with supporting evidence. We were unable to use more sophisticated benchmarking techniques (e.g. econometric techniques) at this stage due the lack of sufficient data available.

For 2014/15 we updated our benchmarking analysis using ASHE data. As DCC conducted their own resource benchmarking this year, the purpose of our analysis was used to sense-check DCC's results as well as the conclusions of our cost assessment.

We updated our analysis this year to reflect DCC's new roles and mapped these to comparators in the ASHE data. However, ASHE data is published once a year, typically in November. This means that updated data for 2015 was published too late in the year for us to use it to conduct our analysis, so our data was based on 2014 data. Assuming salaries and bonuses have grown across the economy since the data was published, it is likely our analysis would underestimate the benchmark resource costs.

Notwithstanding this, our benchmarking analysis provided a useful cross-check on both individual job roles, DCC cost centre, and job grade. Our analysis suggests that total remuneration is above the 50th percentile for all cost centres, with the variation differing significantly by cost centre. In terms of job grade, our analysis also suggests that total remuneration is above the 50th and 75th percentile for each grade on average, with the exception of the assistant level which is below the median.

We accept that benchmarking analysis, particularly during the early start-up phase of the DCC is challenging. Nevertheless, the benchmarking evidence that DCC has provided us with and our own benchmarking using the ASHE data supports our views and the proposals we are making on the economic and efficient level of costs.

ASHE comparator benchmarking methodology

ASHE is based on a 1% sample of employee jobs which is drawn from HM Revenue and Customs Pay as you Earn (PAYE) records. It collects information on the levels, distribution and make-up of earnings and hours paid. Results are produced for various industrial, occupational and geographic breakdowns, as well as by public and private sectors and age groups.

The salaries published in ASHE are in nominal terms ie in the price base of the year. We have therefore made inflation adjustments to the wage data to bring it in line with the DCC reported price base, using the Retail Price Index (RPI).

We use ASHE data to inform benchmarking in the RIIO price control reviews. For the energy networks the data is used to understand regional variations in wages for the purposes of comparing the networks on a like-for-like basis. In the context of DCC,

we have used the absolute levels of earnings in the ASHE database to compare with the salaries DCC is paying to its staff. We are therefore using this data for a different purpose and in a different way than the RIIO controls.

To assess like-for-like salaries we undertook a detailed mapping exercise to align standard occupational classification (SOC) codes[94] in the ASHE data to DCC data on roles and salaries. DCC provided us with a breakdown of its salary costs into director, senior manager, manager base grade and assistant. We used our understanding of the nature of the roles within these grades to align them to SOC codes.

We compared DCC salaries to the ASHE data across a number of dimensions:

- We compared DCC costs to the mean, median and percentiles of the ASHE data;
- We looked at London and national wages; and
- We used both the confirmed ONS 2012 data and the provisional 2013 data.

We also assessed ONS SOC codes at the 1-digit, 2-digit and 4-digit level. The more disaggregated approach potentially allowed for closer alignment of roles.

In general, DCC's salaries are higher than our generated benchmark at the higher staff grades within DCC. At the lower grades DCC salaries appeared to be at or below the ASHE data. We tested this analysis across a range of different assumptions and using different cuts of the data and the conclusions were broadly consistent.

The fact that there are a number of specialist activities and technical roles is likely to explain at least some of the performance of DCC against these benchmarks. We recognise that it is difficult to calculate a completely like-for-like comparator set.

For these reasons, we have not used this analysis as a basis for mechanistically calculating unacceptable cost. However, the assessment does indicate that there are reasonable grounds to require DCC to provide more robust evidence for increases in the level of salaries. The analysis therefore supported our decision to find some of the costs unacceptable on the basis of our comparison to LABP and the updated forecast.

[94] The Standard Occupational Classification (SOC) is a common classification of occupational information for the United Kingdom. It is used to classify workers into occupational "categories" which are differentiated in terms of their skill level and skill content.

Appendix 4 – DCC updated forecasts

The table below compares the LABP forecasted cost, with those reported under the price control, and the forecasts adjusted for our proposals.

£m	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2
LABP (AR)	28.692	85.573	98.948	126.316	151.812	187.506	217.129	221.219	218.165	224.327	231.618	97
AR reported in 2014/15	33.792	95.597	125.987	143.067	162.389	192.133	224.613	227.563	221.867	227.212	235.794	10
Reductions												
Resource costs	0.067	0.726	0.717	0.620	0.532	0.532	0.532	0.532	0.532	0.532	0.532	0
Accommodation	0.000	0.429	0.525	0.308	0.302	0.293	0.278	0.279	0.276	0.272	0.268	0
RPEs	0.056	0.056	0.056	0.056	0.056	0.056	0.056	0.056	0.056	0.056	0.056	0
Service charge	0.286	0.234	0.239	0.203	0.194	0.193	0.191	0.191	0.103	0.102	0.102	0
Pass through costs*	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	2
Total Reduction	0.409	1.445	1.536	1.188	1.083	1.073	1.056	1.058	0.966	0.961	0.957	3
Adjusted forecast AR	**33.383**	**94.152**	**124.451**	**141.880**	**161.306**	**191.061**	**223.557**	**226.506**	**220.901**	**226.250**	**234.837**	**99**

*The row for Pass through costs is the correction of an error in DCC's reporting, rather than a cost disallowance

Appendix 5 – Allowed Revenue

1.1 This appendix provides an explanation of DCC's allowed revenue.

1.2 Allowed revenue is defined in licence condition 36[95] and is the total revenue DCC is entitled to. It is calculated using the following formula:

$$ARt = ECt + ICt + PTCt + BMt + BMPAt + ECGSt - VASCt + Kt$$

1.3 1.3 Where for the regulatory year being reported (t):

Term	Definition
AR	Allowed revenue
EC	External cost
IC	Internal cost
PTC	Pass through cost
BM	Baseline margin
BMPA	Baseline margin adjustment
ECGS	External gain share
VASC	Value added services contribution
K	Correction factor

1.4 Table A6.1 provides a breakdown of the charging statement and compares it to the costs reported in 2014/15.

Table A6.1: Charging statement compared to costs actually incurred, 2015

Estimated fixed revenue by category RY2014/15		**Charges (£m)**	**Reported (£m)**
Internal	Baseline Costs	18.6	18.2

[95] Allowed revenue is defined in the RIGS in part 4.

Cost	Changes baseline	-1.7	0.1
	Changes new scope	7.2	6.8
Baseline margin		3.3	3.3[96]
External cost	Baseline	2.6	2.6
	Changes	1.3	4.7
Pass through costs (SECCo costs)		4.9	4.8
Prudent Estimate		7.6	-
Correction factor		-	-6.3
Revenue		43.8	33.8

1.5 DCC reported that there were **two** significant components contributing to the correction factor for 2014/15. These were:

- **Increase in actual meter numbers compared to estimate (-£1.0m).** The number of meters actually installed was higher during the year compared to the estimate for the Charging Statement from October 2013. The average number of monthly meters was 678,071 higher than the estimate. This resulted in higher than expected revenue for DCC.
- **Unspent prudent estimate (-£3.4m).** Of the £7.6m prudent estimate in the charging statement, £3.4m was used to cover additional external costs and £0.9m was used to cover additional internal costs. This left £3.4m of the prudent estimate unused. DCC gave notice of the change to service charges for RY2014/15 in December 2013, at which point there was uncertainty with the costs and cash outflow of SMKI and Parse and Correlate. The procurement for these services was completed in April 2014.
- In addition to the **correction factor from 2013/14 (-£6.1m)** which was not reflected in the RY2014/15 final charging statement set in March 2014 which was before the final decision was published detailing the 2013/14 correction factor.

1.6 There were also a number of less significant components:

- Baseline Margin Implementation Performance Adjustment (-£0.3m)
- Variation in actual pass-through cost compared to estimate (-£0.1m)
- Rounding of Baseline Margin in charging statement (-£0.01m)

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[96] Note that this does not include the baseline performance margin adjustment value of -0.315m which is reported separately.

Appendix 7 - Glossary

A

Allowed Revenue
Total amount of revenue determined on an accruals basis in relation to each regulatory year in accordance with the Principal Formula set out in Part C of Condition 36 after the deduction of value added tax (if any) and any other taxes based directly on the amount concerned.

Annual Survey of House and Earnings (ASHE)
Annual survey that provides fata on levels, distribution and make-up of earnings and hours worked for UK employees by sex and full-time/part-time status in all industries and occupations

Authority
The Gas and Electricity Markets Authority

B

Baseline Margin
In each Regulatory Year an amount of additional revenue, over and above the sum of the Licensee's Internal Costs and External Costs, that the Secretary of State has agreed shall be included (subject to the performance of the Baseline Margin Performance Adjustment) in the Licensee's Allowed Revenue, and is determined in accordance with the provisions of Part C of Condition 36.

Baseline Margin Implementation Performance Adjustment
The amount (if any) of reduction in the Baseline Margin determined in accordance with the provisions of Part B of Condition 38 so as to secure, with respect to the applicable period, the effect set out in Part A of that condition.

Baseline Margin Implementation Total
The Licensee's Baseline Margin, in total, for the period running from 23 September 2013 until the end of the Regulatory Year 2015/16.

C

Communications hub
A Device which complies with the requirements of CHTS and which contains two, logically separate Devices; the Communications Hub Function and the Gas Proxy Function.

Communications Service Provider (CSP)

Bodies awarded a contract to be a service provider of the DCC's communications services. Arqiva Limited and Telefónica UK Limited have been currently appointed to provide these services.

D

Data and Communications Company (DCC)
This is a company that manages the data and communications to and from domestic consumers' smart meters. Smart DCC Ltd was granted the Licence by the Secretary of State with effect from 23 September 2013.

Data Services Provider (DSP)
Body awarded the contract to deliver systems integration, application management and IT hosting services to the DCC. CGI IT UK Limited has been appointed to provide these services

Department for Energy and Climate Change (DECC)
The UK government department responsible for energy and climate change policy

E

External Costs
As defined in licence condition 35 of the smart meter communication licence. The fundamental service capability predominately comprises of the communication service providers (CSP) and the data service providers (DSP). This definition means that costs associated with other externally procured contracts, for example the Smart Metering Key Infrastructure (SMKI) contract are reported under internal costs.

F

FTE
Full Time Equivalent

G

Gainsharing
Gainsharing is where Service Providers are able to implement efficiency improvements or through implementation of other changes costs of delivering services is reduced. The cost savings would be shared.

Great Britain Companion Specification (GBCS)
The GBCS describes the detailed requirements for communications between Devices in consumers' premises, and between Devices and the Data and Communications Company (DCC).

H

HMRC

Her Majesty's Revenue and Customs - the tax authorities in the UK.

I

Internal Cost

In relation to each Regulatory Year the sum of the costs (excluding external costs and pass-through costs) that were economically and efficiently incurred by the Licensee for the purposes of the provision of Mandatory Business Services under or pursuant to the SEC (and may include costs incurred in respect of the governance and administration of the SEC that are not included in the pass-through costs).

L

Licence Application Business Plan

The plan of that name that was submitted by the Licensee in the course of or as a consequence of the licence application process. It contains the Licensee's estimates (which may be estimates that have been modified by the Licensee as a consequence of the Licence Application Process) of its revenues, costs, capital investments and cashflows for each regulatory year of the Licence Term, and was taken into account by the Secretary of State in determining the grant of the Licence and to which the Licensee committed itself as a condition of that grant.

R

Regulatory Instructions and Guidance (RIGs)

The document of that name issued by the Authority under Licence Condition 33 for purposes relating to the obligations of the Licensee under Licence Condition 31 (Reporting of Quality of Service Information) and Licence Condition 32 (Reporting of Price Control Information). Provide the basis on which the licensee must report price control information as required under the Licence.

Regulated Revenue

The actual revenue in a regulatory year, measured on an accruals basis received by the Licensee through Service Charges that are levied in accordance with the provisions of Licence Conditions 18 and 19 or otherwise received by the Licensee in relation to the carrying on of the Mandatory Business, after the deduction of value added tax (if any) and any other taxes based directly on the amount concerned.

Relevant Services Capability

Capability procured (or provided from within the Licensee's own resources) in accordance with Licence Condition 16 for the purposes of securing the provision of Mandatory Business Services under or pursuant to the Smart Energy Code. The internal and external resources which the DCC relies upon in order to provide services to DCC Users

S

Smart Energy Code (SEC)

The SEC is an industry code which is a multiparty agreement which will define the rights and obligations between the DCC and the users of its services. Suppliers, network operators and other users of the DCC's services who will all need to comply with the Code

SECCo Ltd

The joint venture company established under the SEC for the purpose of acting as a corporate vehicle to assist the SEC Panel in exercising its powers, duties, and functions, including by entering into contracts for that purpose, owned by SEC Parties.

SEC Panel

Panel established under the SEC to oversee the Smart Energy Code with powers and duties as set out in Section C of the SEC.

Service Charges

The charges levied by and payable to DCC in connection with the operation or provision of Mandatory Business Services under or pursuant to the SEC (and such charges may reflect, among other things, expenditure incurred for the purpose of investigating or securing the future operation or provision of such services as well as expenditure incurred in connection with the governance and administration of the Smart Energy Code).

Shared services

Support services sourced from the licensee’s parent company and covered by the Shared services charge under Section 3.3.1 of the Business Plan. The terminology used in the RIGs is shared services but this charge covers corporate overheads.

Smart Meter

Smart meter is a meter which, in addition to traditional metering functionality (measuring and registering the amount of energy which passes through it) is capable of providing additional functionality, for example two way communication allowing it to transmit meter reads and receive data remotely. It must also comply with the technical specification set out by the Smart Metering Programme.

Smart Meter Communication Licence

The Smart Meter Communication Licences granted pursuant to Sections 7AB (2) and (4) of the Gas Act 1986 and Sections 6(1A) and (1C) of the Electricity Act 1989.

M

Mandatory Business Costs

Costs associated with the provision of Mandatory Business Services under pursuant to the SEC.

O

Ofgem
Office of Gas and Electricity Markets

ONS
Office for National Statistics

P

Pass-Through Costs
In relation to each Regulatory Year the amount equal to the total annual fee paid by the licensee to the Authority during that Regulatory Year and the payments made by the Licensee to SECCo Ltd for purposes associated with the governance and administration of the SEC.

Appendix 8 - feedback questionnaire

Consultation is at the heart of good policy development. We're keen to consider any comments or complaints about the way we've conducted this consultation. We'd particularly value your answers to these questions:

Do you have any comments about the overall process for this consultation?
Do you have any comments about the tone and content of the report?
Was the report easy to read and understand? Could it have been better written?
To what extent did the report's conclusions provide a balanced view?
To what extent did the report make reasoned recommendations for improvement?

Please add any further comments and send your response to:

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