Grant Thornton

# Forensic accounting review to inform price control and ex post review analysis for the Smart Metering Data Communications Company

## Non-confidential version of Report of Grant Thornton UK LLP dated 25 November 2015

# CONTENTS

## APPENDICES



## EXHIBITS

# GLOSSARY

| | |
|---|---|
| Arqiva | Arqiva Smart Metering Limited |
| ATG | Automated Testing of GBCS |
| ATO | Authorisation to Offer |
| ATR | Authorisation to Recruit |
| BAFO | Best And Final Offer |
| CAN | Contract Authorisation Note |
| Capita | Capita plc |
| Capita ITS | Capita Information Technology Services ITS |
| CBSL | Capita Business Services Ltd |
| CGI | CGI IT UK Ltd |
| Critical | Critical Software Technologies Ltd |
| CSP | Communication Service Provider |
| DCC | the Data and Communications Company |
| DECC | the Department of Energy and Climate Change |
| DMS | Document Management System |
| DOA | Delegation of Authority |
| DSP | Data Service Provider |
| ESP | External Service Provider |
| FD | Finance Director |
| FSP | Fundamental Service Provider |
| GBCS | Great Britain Companion Specification |
| Grant Thornton | Grant Thornton UK LLP |
| IA | Impact Assessment |
| ICB | Internal Change Board |
| IM | Implementation Milestone |
| IRP | Issue Resolution Proposal |
| LABP | Licence Application Business Plan |
| the Licence | the Smart Meter Communication Licence |
| MD | Managing Director |
| NTS | Network Technology Solutions |
| Ofgem | the Office of Gas and Electricity Markets |

| | |
|---|---|
| PA | Preliminary Assessments |
| P&C | Parse and Correlate |
| PMO | Programme Management Office |
| PO | Purchase Order |
| the Price Control Decision | Ofgem's report reflecting the decision it has made on the Price Control Information |
| RCM | Risk Control Matrix |
| RIGs | Regulatory Instructions and Guidance |
| RFP | Request for Proposal |
| RFQ | Request for Quote |
| RMS | Risk Management Strategy |
| ROM | Rough Order of Magnitude |
| RSC | Relevant Service Capability |
| RY | Regulatory Year |
| SEC | the Smart Energy Code |
| SECCo | Smart Energy Code Company Ltd |
| SMIP | Smart Metering Implementation Programme |
| SMKI | Smart Meter Key Infrastructure |
| the Submission | the Price Control Submission |
| Telefonica | Telefonica UK Limited |
| TSP | Trusted Service Provider |
| VFM | value for money |

# 1 EXECUTIVE SUMMARY

1.1 The government is mandating the roll-out of smart meters to all domestic and smaller non-domestic gas and electricity customers by the end of 2020. A new regulatory and contractual framework underpins the smart meter roll-out. This includes the creation of a new licensed monopoly, the Data and Communications Company (DCC), a central communications body appointed to organise the communications and data transfer and management required to support smart metering.

1.2 Following the DCC Licensing Competition, Smart DCC Ltd, a wholly owned subsidiary of Capita plc (Capita), was granted the Smart Meter Communication Licence (the Licence) by the Department of Energy and Climate Change (DECC) on 23 September 2013. The Licence runs for 12 years until 22 September 2025, unless it is extended or revoked.

1.3 The Office of Gas and Electricity Markets (Ofgem) has responsibility for regulating DCC and each Regulatory Year[1] (RY) undertake an annual ex-post price control review of its costs. This involves scrutiny of internal costs and the costs DCC has incurred through contracts with External Service Providers (ESPs), to assess whether the costs are economic and efficient and provide assurance that DCC's reporting, allocation of costs, and transactions are accurate and follow due process. In July 2015, DCC reported on its first full Regulatory Year (RY2014/15).

1.4 Under the Licence conditions, Ofgem have prepared Regulatory Instructions and Guidance (RIGs), which set out the regulatory reporting requirements and are the basis on which DCC must report the Price Control Information[2].

1.5 In line with this guidance, DCC produces the Submission (described in further detail in paragraph 3.10) and the Reporting Template, an excel workbook comprising the templates for the Price Control Information reporting referred to in Condition 32 and Condition 33 of the Licence.

1.6 Grant Thornton UK LLP (Grant Thornton) has been instructed by Ofgem to carry out a forensic review (in accordance with our instructions set out in **Section 2**) of the cost information prepared by DCC for RY2014/15.

[1] A Regulatory Year runs from 1 April in any calendar year to 31 March in the following calendar year. DCC's first Regulatory Year is deemed to have begun on 1 April 2013 (Licence Condition 1.4).

[2] Price Control Information means the specified information contained in the RIGs (see paragraph 3.12).

1.7 This report reflects information and explanations received by Grant Thornton up to and including 6 November 2015. Our report does not therefore reflect any information or the outcome of discussions held after that date.

## RY2014/15 REPORTING TEMPLATE

1.8 Costs within the Reporting Template are classified as either external costs, internal costs (including a shared service charge (see paragraph 1.11 below)) or pass-through costs.

1.9 External costs are costs incurred in relation to 'Fundamental Service Capability', ie costs which relate to the contracts with the three Fundamental Service Providers (FSP)[3], being:

- the Data Service Provider (DSP), CGI IT UK Ltd (CGI);
- the Communication Service Provider (CSP), Arqiva Smart Metering Limited (Arqiva); and
- the CSP, Telefonica UK Limited (Telefonica).

1.10 Internal costs are all costs not classified as external costs or pass-through costs. They are reported by costs centres, as set out in the table at paragraph 1.14 below.

1.11 We note that in the RY2014/15 Reporting Template DCC have applied the shared service charge to all internal costs (as described in paragraph 1.39 below). However, internal costs do not automatically attract this charge as there is potential for Ofgem to determine that the charge should not apply to some costs[4].

1.12 External and internal costs are split between baseline costs and new scope costs. These are defined in the RIGs as follows:

- Baseline costs should only include costs associated with delivering the requirements provided to the Licensee during the DCC Licensing Competition[5], ie costs relating to work of the same scope that was always contracted to be carried out. For internal costs, this is irrespective of whether the costs are associated with a shared service charge.

[3] As defined under the Licence. These contracts were procured by DECC at the same time the Licence was awarded to DCC.

[4] For instance, in RY2013/14 (Year 1) there is £REDACTED in relation to a 'sub-set of internal costs not incurring shared service charge', as Ofgem proposed that the shared service charge should not apply to the procurement of two new contracts: SMKI and P&C.

[5] These are the requirements and activities that were used by the Licensee to produce the LABP.

- New scope costs should include any requirements that are considered by the Licensee to be additional to the requirements provided during the DCC licensing competition[6] and the development of the Licence Application Business Plan[7] (LABP). For internal costs, this is irrespective of whether the costs are associated with a shared service charge.

1.13 Pass-through costs are amounts paid (or expected to be paid) by the Licensee to the Authority in respect of its licence fee[8]. and the costs incurred by the Smart Energy Code Company Ltd (SECCo) for the purposes associated with the governance and administration of the Smart Energy Code (SEC)[9]. These are in line with the LABP.

1.14 The costs included within the RY2014/15 Reporting Template are summarised below:

**Reporting Template cost summary**

| | 2015 £m |
|---|---|
| **External costs** | |
| DSP costs | AMOUNTS REDACTED |
| CSP North costs | |
| CSP Central costs | |
| CSP South costs | |
| Other External costs | - |
| | **7.269** |
| **INTERNAL COST BREAKDOWN REDACTED** | |
| **Internal costs inclusive of Shared service charge and Pass-Through costs** | **29.833** |
| **TOTAL COSTS** | **37.102** |

## SUMMARY OF FINDINGS

### DCC'S PROCESSES

1.15 We were instructed by Ofgem to review the processes and policies that support the costs included within the Reporting Template, ie controls over cost variations, planning and budgeting, procurement and risk management and to establish the processes and policies undertaken by DCC in relation to shared costs and cost allocation.

1.16 Further details in relation to our instructions are set out in paragraphs 2.2.1 to 2.2.8.

[6] This includes the cost of the evolving requirements, volumes, risk, complexity or timescales. It also includes specific exclusions from the DCC licensing competition that were subject to finalisation following the grant of the Licence.

[7] See paragraph 3.4.

[8] As determined in accordance with Part A of Condition 4 of the Licence.

[9] See paragraph 3.25.

1.17 Our detailed findings and recommendations to Ofgem in relation to each of the processes we have reviewed are set out in turn below.

### Controls over cost variations

1.18 We have reviewed DCC's internal control processes and policies for approving cost variations for Internal and External Service Provider costs set out in their supporting documentation.

#### *Internal variations*

1.19 The internal control process for internal variations is managed through the Internal Change Board (ICB) which is governed by the Commercial Finance team. The objective of the ICB is to manage any variations to the annual budget position by requiring the relevant managers to provide a detailed business case outlining the reasons behind the change, the benefits sought and outcomes delivered and for this to be reviewed and approved by the board.

1.20 For a sample of cases, we have reviewed the available internal approval documentation including business case forms and we confirm that, on the basis of our review the internal control processes described in **Section 5** are being followed.

#### *External variations*

1.21 As the Smart Metering Implementation Programme (SMIP) develops and increases in complexity, DCC's requirements evolve both in terms of increased knowledge of what is needed and new obligations being introduced. As a result, DCC will identify that a change to the original requirements (and baseline costs) is required and a change request will be raised with the affected Service Provider[10]. Each change request follows the change process before it is finalised as a contract change, as set out in paragraph 5.24.

[10] This can either be an FSP in relation to external costs included within the Reporting Template, or a non-fundamental service provider in relation to internal costs included within the Reporting Template.

### *Our findings*

1.22 Several change requests and internal variations have been approved during the year, and although these appear to follow the formal process documented, we note that, based on DCC's forecasts, costs are likely to increase. From what we have seen, DCC could do more to ensure that costs are being adequately controlled. For example, to control internal costs, DCC have introduced a cost challenge process (see paragraph 5.19) but, for the majority of departments, the targets set have not been met. Due to external factors, many departments have had to increase their headcount and these increased resource costs have led to the departments being unable to meet the cost challenge. This is an issue, along with how DCC plan to manage future increases in costs, that Ofgem may wish to raise with DCC.

1.23 In addition, in our review of cost variations, we identified that there are a large number of change requests being processed which may result in additional costs, which have been estimated, but these have not been captured in the costs forecast in the Reporting Template because the approval process has not yet been completed. Unapproved requests are not reflected in the forecast costs in the Reporting Template as they are not considered to be certain. This represents a potential risk in terms of cost control and managing future increases in costs. We consider that a separate category should be shown for these to give a full picture.

### *Specific contract variations*

1.24 Our review of the specific contract variations (specified by Ofgem) has indicated that in relation to the approval of change requests, approval documentation was inconsistent across the change requests reviewed and for two out of the six contract variations the documentation was incomplete (see paragraphs 5.31 to 5.33).

### *Cost variance analysis*

1.25 The RY2014/15 Submission reports significant cost increases against those identified in the LABP and those forecast in the RY2013/14 Submission. DCC report that these increases are driven by external changes including development of both SEC and Great Britain Companion Specification[11] (GBCS). The majority of internal cost increases result from recruitment of additional staff to respond to the additional requirements and to mitigate delays, as well as change requests in relation to non-fundamental service provider costs. External cost increases result from change requests in relation to FSP contracts.

[11] See paragraph 3.23.

## Planning and budgeting approach

1.26 In relation to DCC's planning and budgeting approach, we reviewed the relevant parts of the Submission and supporting evidence, the forecasts included in the Reporting Template and DCC's RY2015/16 Charging Statement (submitted as part of its Submission). We also discussed DCCs planning and budgeting approach with DCC during our site visit.

1.27 Towards the end of each calendar year, DCC forecasts charges for the following financial year. DCC uses a range of internal processes to forecast future costs and manages its forecast costs through a series of spreadsheets. In **Section 5** of the report, we set out the detail of the budget process followed by DCC.

1.28 The concept of a prudent estimate is unique to DCC, allowing it to estimate its Allowed Revenue on a prudent basis so that it has sufficient cash available to ensure that it does not have to change charges to service users during the RY.

1.29 Details in relation to the prudent estimate are provided in the Submission. We have not been able to clarify the position further in relation to what cost items go into the prudent estimate model and how DCC determines the level of prudency to apply to cost estimates and then to overall revenue requirements for the year because DCC was unable to provide commentary above what was included in the Submission[12]. As a result, we suggest that Ofgem challenge DCC to provide a more detailed commentary in support of the detailed calculations/spreadsheets which have been provided in relation to the prudent estimate.

## Procurement

1.30 Licence Condition 16 sets out the requirements DCC must meet in relation to its procurement activity. We reviewed DCC's procurement strategy, frameworks and relevant supporting information.

[12] Although DCC provided us with calculations in support of the prudent estimate, these are complex spreadsheets which require a more detailed analysis which is beyond the scope of our review.

1.31 DCC has undertaken a relatively small number of procurement exercises, the majority of those falling into RY2014/15. DCC has identified a wide range of different procurement approaches from full competitive tendering process to sourcing additional services from existing providers on a non-competitive basis. DCC stated that the approach utilised is generally determined by the contract value. However, the procurement strategy and related documentation do not provide clarity on how the method is selected and the selection process does not appear to be consistent. For example, smaller procurements have been undertaken using the Request for Proposal (RFP) approach, which DCC stated is generally used for procurements under £1 million, but the SMKI contract was also procured through this approach (although we note that this was procured before the formal procurement strategy was in place) and this contract was worth around £15 million. We do not disagree that using the RFP approach may be competitive and appropriate for these levels, but note that the procurement strategy is not clear on maximum or minimum contract values for each procurement approach.

1.32 DCC relies on its parent company, Capita, for the provision of a range of infrastructure and services. DCC has stated that this approach was outlined in their Best And Final Offer (BAFO) proposal for the Licence, in order to obtain services to support business operations, minimise organisational fixed costs and provide flexibility. It is not within our scope to consider if this approach matches the contract requirements.

### *Review of specific procurement exercises*

1.33 We were instructed by Ofgem to review the procurement processes followed and evidence in relation to the outcome reached for the following four specific procurement exercises:

- the frameworks for the provision of consultancy services and audit and assurance services;
- the billing system;
- the Document Management System (DMS); and
- Automated Testing of GBCS (ATG).

1.34 A summary of findings on each of these are set out below:

1.34.1 **Frameworks** - DCC set up two frameworks for the provision of audit and assurance services and consultancy services in December 2014 and April 2015 respectively. The procurement exercise for both frameworks followed the RFP approach rather than full competitive tender. As a result, DCC may have excluded suppliers who would otherwise have applied.

On page 5 of the audit and assurance framework procurement report, DCC note that several companies withdrew, primarily stating lack of industry specific experience and, as a result of this, some lots under the framework have an insufficient number of suppliers for an effective mini competition. This makes it more challenging for DCC to ensure it is obtaining value for money.

The relevant procurement reports state that evaluation was undertaken based on quality criteria (although no explanation is provided in relation to how the evaluation criteria to be used were chosen). DCC have provided a document which sets out the individual scores and associated comments given by each of the five evaluators against each criteria. The averages of these scores are then weighted and consolidated to generate the overall quality score. The comments provided by the evaluators consider the merits of each of the various tenders and appear to support the basis of score awarded. .

Ofgem may wish to further explore the circumstances around the inclusion of two suppliers in the audit and assurance framework rate card tables, who did not participate in the initial framework procurement exercise and evaluation. DCC has stated that they were evaluated on the same basis as the other tenders but were added to the framework after the initial group of suppliers. We have not discussed this further with DCC or reviewed the evaluation documentation in relation to the additional two suppliers.

1.34.2 **Billing system** - In the LABP and as part of BAFO, Oracle had been put forward as the Service Provider for billing requirements but following award of the Licence, DCC better understood the necessary requirements, and that the service needed to be procured under a novatable contract, and therefore it made the decision to go to market[13]. DCC, Capita Information Technology Services (Capita ITS)[14] and CGI were all involved in leading on different stages of the procurement exercise. CGI was engaged to assist with the initial stages and shortlisting. Following CGI's recommendations, DCC, with assistance from Capita ITS, narrowed the shortlist down to two suppliers (REDACTED) and the Board made the final decision on contract award. The winning bidder was Capita Group Systems offering a SAP based product.

[13] Billing systems procurement report dated 13 April 2015, section 4.1.

[14] Now Capita ITES.

We have identified three issues which Ofgem may wish to address with DCC:

- there was not a clear sourcing strategy for this procurement at the outset;

- the governance arrangements are not clear in relation to the roles of Capita ITS and DCC at various stages in the process; and

- there is a lack of evidence on evaluation between shortlisting and final award to support the procurement outcome.

1.34.3 **DMS** - From our review of the documentation provided, it appears that DCC followed a robust procurement process to choose Foundation SP (Sharepoint) in relation to the DMS using the RFP approach. However, as noted above in relation to procurement of the frameworks, by using the RFP approach, rather than going out to the market for competitive tender, DCC may have excluded suppliers that would otherwise have applied if it had been an open competition.

1.34.4 **ATG** - DCC followed the RFP approach (which may have excluded external suppliers who would otherwise have applied) and we have seen that a detailed evaluation has been undertaken of the four suppliers who submitted proposals. Following this, the two highest scoring suppliers, REDACTED, the contract was awarded to Critical Software, REDACTED.

Although, DCC appears to have run a robust procurement process, there is a potential question as to why the fact that REDACTED did not meet the requirements was not picked up earlier in the evaluation process. We also cannot comment on whether those terms were appropriate and truly required.

1.35 Our review of DCC's procurement processes has identified two particular issues. These are:

1.35.1 in some cases, DCC is not following its own procurement processes as identified in its procurement strategy. For example, there is inconsistent use or lack of use of sourcing strategies; and

1.35.2 in relation to the four specific procurement exercises we were instructed by Ofgem to review (set out in paragraph 1.33), we found that in some cases there was insufficient evidence and detail on the evaluation processes and justification for award recommendations.

1.36 It is recommended that Ofgem raises these issues with DCC to ensure that it is following the procurement processes it has set out and develops sourcing strategies in line with this. For future procurements, DCC should ensure that there is sufficient detail on the evaluation process including who carries out the evaluation, how cost and quality are assessed and weighted and sufficient justification for rejecting shortlisted suppliers.

## Cost allocation

1.37 Costs are specific to cost centres. We have confirmed that, with the exception of Telefonica invoices for impact assessments and some IT services costs (all of which are immaterial) which have been allocated across projects[15], there have been no cost allocations across cost centres or GL accounting codes in the RY2014/15 Reporting Template and therefore it has not been necessary to carry out any specific review work in relation to checking cost allocation. However, we note that of those reviewed, these appear to have been allocated correctly.

## Shared service charge

1.38 We reviewed the relevant part of the Financial Reporting Commentary provided with the Submission and relevant supporting evidence. In addition, we discussed the shared service charge methodology with DCC at our site visit.

1.39 The shared service charge of REDACTED, as identified in the LABP, is applied to all internal costs, except for identified new scope and third party costs where the REDACTED (as determined by DCC) applies (see paragraphs 5.148 and 5.149 for further detail).

1.40 There is no calculation or supporting documentation for the REDACTED% rate used to calculate the shared service charge. REDACTED, but due to commercial confidentiality they are not able to provide any evidence in support of this.

1.41 DCC are therefore unable to justify the basis for the £REDACTED charge included in the RY2014/15 Reporting Template. We cannot comment on whether this was clear as part of the BAFO, but if not we suggest that Ofgem raise the lack of a clear and reasonable rationale with DCC.

1.42 DCC note that the 'shared service charge' is in fact an overhead charge from Capita and therefore it is very difficult to demonstrate value for money (VFM). Developing a process to demonstrate VFM is still an area of ongoing review for DCC which it expects to finalise in the next three to six months.

[15] See paragraph 5.136.7

1.43 As the review is only in its early stages, DCC was not able to provide any details in relation to the development of the process. DCC stated that it would want to discuss the review process with Ofgem in order to determine what was needed to provided adequate cover. It is therefore difficult to determine what steps DCC have already undertaken and we would suggest that Ofgem follow this up with DCC. We note that in order to demonstrate VFM, it will be necessary for DCC to set out the services that Capita provide and the associated costs for those services.

### Risk management

1.44 We reviewed DCC's Risk Management Strategy (RMS) and related documentation. Although DCC has a risk management framework in place, during our site visit DCC stated that some risk management information requires updating (eg the categories used in the RMS) and that the RMS is due a refresh to add some additional information to users. There is a complex risk management framework, which we note that DCC states arises due to the significant number of workstreams and the need to meet requirements of different stakeholders. It is beyond the scope of our review to evaluate the risk management framework in further detail.

1.45 The inherent level of complexity of the risk management framework makes it difficult to trace the risks through the risk hierarchy (see paragraph 5.159). We suggest that the flow of risk through the hierarchy and how risk is managed overall in accordance with the RMS is raised by Ofgem with DCC as an area to address.

1.46 Furthermore, based on our review, there appears to be a lack of clarity over DCC's overall risk management approach and how risks relating to the wider programme are being managed. This is an issue Ofgem may wish to consider discussing further with DCC.

1.47 Risk is a criteria for which DCC can apply for a change in its baseline margin[16]. Any additional baseline margin should be directly linked to the risks that DCC is actively managing and these risks should have an identified cost with supporting evidence to justify this. At present, the link between the risk registers and the risks identified in the baseline margin application is not apparent. DCC states that the risks in the baseline margin application do map to higher level risks in the risk registers but to demonstrate this would require review of all of the risk registers spreadsheets. That would be beyond the scope of our review.

[16] The baseline margin is the amount of additional revenue that DCC is permitted to retain over and above its baseline. Its baseline or 'Allowed Revenue' represent the costs that DCC is permitted to pass onto service users.

1.48 A further weakness in DCC's risk management approach is that it does not translate the scoring of its risk into a monetary value, where it is possible to do so. DCC has identified its risk management methodology in terms of scoring the probability and impact of risk. However, as DCC does not attach any monetary value to its risks, the costs of these cannot currently be directly reflected in its Submission. As a result, there are no contingency amounts included within the Reporting Template which reflect the risks that DCC has identified.

1.49 Part C of Licence Condition 7 states what the RMS must cover, and in the table in paragraph 5.183 of this report we note our findings in relation to the actions DCC has taken to meet these requirements within the RMS.

1.50 In respect of these, it is not always obvious as to whether the Licence conditions in relation to risk management have been met. For example, one requirement is that DCC maintains a permanent register of Authorised Business Risk. DCC explained that they do not hold one document for this, instead they have addressed this by having the Strategic, Corporate and Programme risk registers in place. Therefore, Ofgem may want to consider our findings and whether it is satisfied that the Licence conditions have been met.

## COSTS

1.51 We were instructed by Ofgem to review the six key contracts[17] DCC has with the external providers responsible for building the smart metering data and communications infrastructure (set out below) and agree a selected sample of the costs reported in the price-control submission to these contracts.

- CGI IT UK Ltd (CGI)
- Arqiva Smart Metering Limited (Arqiva) – CSP North version
- Telefonica UK Limited (Telefonica) – CSP Central 12ersión
- Telefonica UK Limited (Telefonica) – CSP South version
- British Telecommunications Plc – Smart Meter Key Infrastructure (SMKI) Services
- Critical Software Technologies Ltd (Critical)- Parse and Correlate (P&C) Services

1.52 Our review of the contract documentation raised no areas of concern.

[17] Including the versions of Schedule 7.1 (Charges and Payment) which were in effect as at 31 March 2015.

1.53 We were instructed by Ofgem to carry out certain procedures in relation to verifying material[18] external and internal costs included within the RY2014/15 Reporting Template, which included vouching costs to supporting documentation and tracing the costs through the purchasing and payment systems, as detailed at paragraph 6.8 for external and internal, new scope costs and paragraph 6.21 for internal, baseline costs).

1.54 The above procedures have been carried out as required and a summary of our findings are set out below:

**External costs**

| | Baseline £m | New scope £m | **TOTAL £m** | Total costs tested £m | % of costs tested |
|---|---|---|---|---|---|
| DSP costs (CGI) | AMOUNTS REDACTED | | | | 85% |
| CSP North costs (Arqiva) | | | | | 82% |
| CSP Central costs (Telefonica) | | | | | 54% |
| CSP South costs (Telefonica) | | | | | 52% |
| | | | | | 77% |

**Internal costs - New scope**

| | 2015 £m | Total costs tested | % of costs tested |
|---|---|---|---|
| **TOTAL** | **6.338** | 5.392 | 85% |

1.55 In relation to internal baseline costs we reviewed and carried out testing as set out above in relation to the costs included within the four material GL accounting codes (being payroll, accommodation, service management and IT services which all have costs totalling over £250,000 in a particular cost centre) on a sample basis. Costs in these four GL accounting codes total **£REDACTED, ie 76% of the total internal baseline costs of £REDACTED.**

[18] Being external costs over £330,000 and internal costs over £250,000 as defined in paragraph 4.11.

## CONCLUSION

1.56 Our review of DCC's processes and procedures has indicated that DCC has various processes in place to ensure that the costs incurred by DCC are economic and efficient and that transactions are accurate and follow due process. However, as noted above, our findings have raised various issues about the processes not being followed or the evidence for decisions for costs not being clearly documented, which we suggest Ofgem follow up with DCC.

1.57 On the basis of our review of the information and explanations received to date in relation to the sample of costs that we have reviewed, we can confirm that where applicable they can be reconciled back to contracts, they are supported by invoices (or other supporting documentation), ledgers and bank statements that indicate that they have been incurred and paid (or are due to be paid), the services have been delivered[19] and that the relevant costs are included within the RY2014/15 Reporting Template.

**Grant Thornton UK LLP**
**London**
**25 November 2015**

[19] In accordance with the purchase order.

# 2 INTRODUCTION

## INSTRUCTIONS

2.1 Grant Thornton has been instructed by Ofgem to prepare a report on its forensic review of the cost information prepared for Ofgem by DCC.

2.2 The main objective of our review is to substantiate costs and cost allocation reported by DCC in July 2015 as part of its price-control reporting requirements, in addition to reviewing processes relating to controls over cost variations, planning and budgeting, procurement and risk management. In particular we have been asked to review:

2.2.1 **controls over cost variation** - review supporting information and explanations for any cost variations for Internal Services and External Service Providers between the cost estimates submitted in the previous price-control reporting submissions and the incurred and forecasted costs in the current price-control submission. Review information on the internal control processes and policies used by DCC to approve cost variations internally. Agree cost variations to contract variations, and confirm that internal control processes have been followed, through review of internal approval documentation;

2.2.2 **planning and budgeting approach** - review supporting information on processes and tools used by DCC to plan expenditure and to form assumptions that inform its indicative budgets. Verify the application of these tools and processes to a selected sample of incurred and forecasted costs in DCC's price-control reporting submission;

2.2.3 **procurement** - review the processes and policies used by DCC to procure staff resources from within its Parent company group, and services from external providers. For each of the Internal Service and External Service Provider procurements in DCC's price control reporting submission, verify through review of the internal procurement sourcing proposal that the processes described in the policy have been followed. Agree the chosen Service Provider and contract value reported to Service Provider internal evaluation documents. Agree the chosen Service Provider and contract value reported to a contract;

2.2.4 **cost allocation** - review supporting information and explanations of the methodology used to allocate internal costs to business areas and activities in DCC's price-control reporting submission. Confirm that the amounts reported under each business area and activity have been determined as prescribed in the cost allocation methodology and metrics DCC has indicated. Confirmation would include ensuring calculations are arithmetically correct;

2.2.5 **shared service charge** - review supporting information and explanations of the methodology used to allocate shared service charges (for shared infrastructure and corporate overhead services) from the Parent company to DCC. Verify that this methodology has been correctly applied to derive the shared service charge and volume of shared services in DCC's price-control reporting submission;

2.2.6 **risk management** - review supporting information and explanations on how DCC is taking different risks into account in forecasting its costs such as risk of delay, and technical risk. Verify that the risk assessment methodology described by DCC has been applied correctly in the calculation of contingency amounts incorporated into the costs in its price-control reporting submission;

2.2.7 **quality assurance for reporting spreadsheet** - review the source data and supporting information for the methodology used to derive costs in DCC's price-control reporting submission. Substantiate the costs through review of the source data and performing calculations where necessary; and

2.2.8 **checking contract costs** - agree for a selected sample of the Internal Service and External Service Provider costs reported in the price-control submission to contracts and contract variation agreements. From the contracts, trace the amounts to an invoice; trace the amount to the purchase day book or equivalent purchase ledger (purchasing system); trace the amount from the purchase ledger through to the general/nominal ledger (payment system); trace the payments made from the general ledger through to a debit entry on the bank account. Verify that the goods or services have been delivered as per the contractual agreement.

2.3 Grant Thornton's review of the ex-post cost information prepared by DCC is limited to the procedures set out above (which are summarised in **Section 4**), and in particular to the sample of costs and review areas which have been selected by Ofgem. Our work does not include any review of technical or legal issues.

2.4 This work does not constitute an audit performed in accordance with Auditing Standards.

2.5 If further information is produced and brought to our attention after service of this report, we reserve the right to revise our opinions as appropriate.

2.6 Except to the extent set out in this report, we have relied upon the documents and information provided to us as being accurate and genuine. To the extent that any statements we have relied upon are not established as accurate, it may be necessary to review our conclusions.

2.7 The report has been prepared using Microsoft Word and Microsoft Excel. The report may contain minor rounding adjustments due to the use of computers for preparing certain calculations.

## RESTRICTION ON CIRCULATION

2.8 Grant Thornton does not accept or assume responsibility, duty of care, liability or other obligation to any third party other than Ofgem, who as a result, either directly or indirectly, of disclosure of the whole or any part of this report by Ofgem receives, reads or otherwise obtains access to this document. Any party relying on this report does so entirely at their own risk.

2.9 In the preparation of this report, Grant Thornton has been provided with material by Ofgem (and by third parties at Ofgem's request) relating to third parties. We have relied upon warranties and representations provided by Ofgem that:

2.9.1 Ofgem is fully entitled to disclose such information to us for inclusion within our report, free of any third party rights or obligations; and

2.9.2 Ofgem will only permit circulation of this report in accordance with any rights to confidentiality on the part of any third party.

2.10 Any objections to the inclusion of material should be addressed to Ofgem. Accordingly, Grant Thornton acknowledges no duty or obligation whatsoever to any party in connection with the inclusion in the report of any material referring to any third party material or the accuracy of such material.

## DISCLOSURES OF INTEREST

2.11 To the best of our knowledge, we have no connection with any of the parties or advisors involved with the Smart Meter Communication Licence that would in any way impact upon our independence in preparing this report. Whilst we are involved in other pieces of work for other Capita entities and for Ofgem, this does not impact on our independence.

## FORMS OF REPORT

2.12 For your convenience, this report may have been made available to recipients in electronic as well as hard copy format. Multiple copies and versions of this report may therefore exist in different media and in the case of any discrepancy the final signed electronic copy should be regarded as definitive.

# 3 BACKGROUND

## SMART METERS

3.1 The government is mandating the roll-out of smart meters to all domestic and smaller non-domestic customers by the end of 2020 through the SMIP. The strategic aim of this programme is to roll out an estimated 53 million smart electricity and gas meters to 30 million consumers and micro businesses across Great Britain by 2020[20]. It is expected that most households will have smart meters installed by their energy company between 2015 and 2020. This type of programme is unprecedented for the UK but has been undertaken in a number of other countries.

3.2 A new regulatory and contractual framework underpins the smart meter roll-out. This includes the creation of a new licensed monopoly. DCC is the central communications body appointed to organise the communications and data transfer and management required to support smart metering.

## THE SMART METER COMMUNICATION LICENCE

3.3 Following a licensing competition, Smart DCC Ltd, a wholly owned subsidiary of Capita plc, was granted the Licence by DECC on 23 September 2013, pursuant to the relevant sections[21] of the Gas Act 1986 and Electricity Act 1989. The Licence runs for 12 years until 22 September 2025, unless it is extended or revoked.

3.4 The LABP was produced by DCC as part of the licence application process and covers the 12 year Licence period. This plan reflects the scope, outputs, requirements, tasks and assumptions relating to DCC's role in delivery of the SMIP, as understood as a result of the Licence Application process.

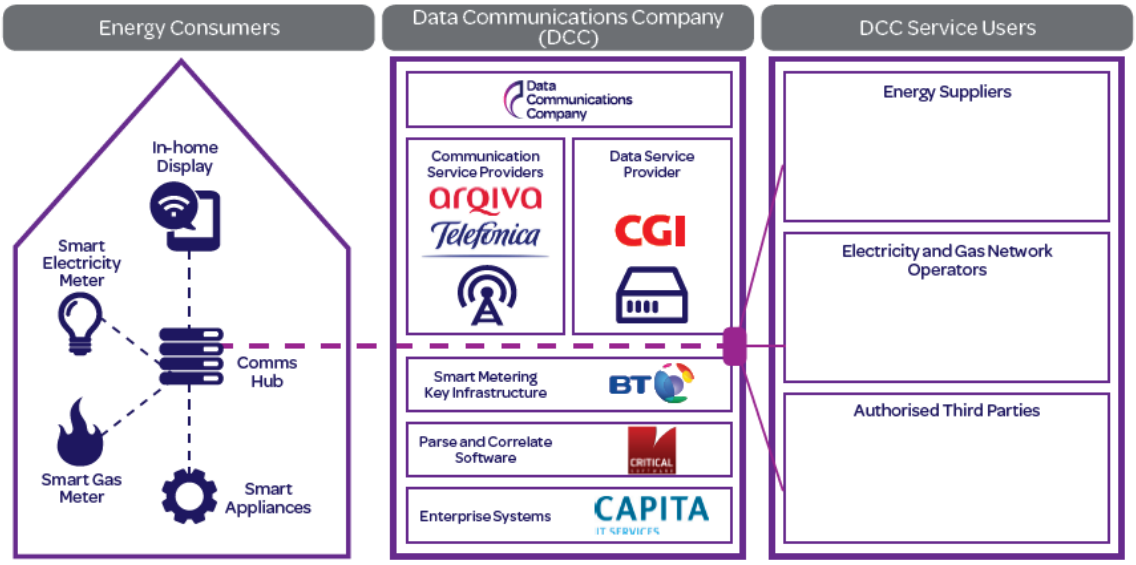
## DCC

3.5 DCC's role is to establish, coordinate and organise the data and communications network required to manage data transfer and to provide the management required to support smart metering. This includes connecting smart meters to enable messaging between smart meters and the business systems of energy suppliers, network operators and other authorised service users of the network. DCC then invoices these service users for their usage of DCC services.

[20] DCC factsheet – Building a smart metering network for Great Britain.

[21] Sections 7AB(2) and (4) of the Gas Act 1986 and sections 6(1A) and (1C) of the Electricity Act 1989.

3.6 The below diagram[22] provides a simple overview of the structure of the SMIP and the relevant Service Providers and service users.




3.7 DCC incurs costs and passes these onto service users. It therefore must always act in the interests of the public, deliver value for money and be open to scrutiny. One of DCC's key responsibilities is to effectively manage its external contracts and ensure value for money and good quality service for consumers.

3.8 As DCC is a monopoly service, there are a number of regulatory bodies involved in its governance and auditing, such as Ofgem, DECC and the SEC Panel. Due to DCC's unique nature and the new regime it is operating, price control arrangements are in place to restrict its revenues and counter its monopoly position in the absence of a competitive market.

3.9 Ofgem has responsibility for regulating DCC and under the Licence, DCC must submit cost, revenue, and incentive reporting to Ofgem. DCC must submit Price Control Information by 31 July following the end of each Regulatory Year ending 31 March.

[22] DCC factsheet – Building a smart metering network for Great Britain.

3.10 Each year, DCC produces a Price Control Submission (the Submission) which sets out:

- how DCC has met its obligations;
- the strategy and commercial framework;
- the controls and efficiency measures it has in place;
- how DCC is managing change and capability;
- how DCC is providing value for money; and
- how DCC is preparing future services to meet policy objectives.

3.11 Each Regulatory Year, Ofgem undertake an annual ex-post price control review of DCC's costs. Ofgem reviews DCC's Submission and produces a report reflecting the decision it has made on the Price Control Information provided (the Price Control Decision). This involves scrutiny of the internal costs and the external costs DCC has incurred through contracts with ESPs, to assess whether they are economic and efficient.

3.12 Each year Ofgem also considers DCC's performance against the relevant performance incentive regime in force (see paragraph 3.16) and any application for a baseline margin adjustment (see paragraphs 3.17 and 3.18).

3.13 It is important that Ofgem and consumers have assurance that DCC's reporting, allocation of costs, and transactions are accurate and follow due process. As a result, under Condition 33 of the Licence, Ofgem have prepared RIGs, which set out the regulatory reporting requirements and are the basis on which DCC must report the Price Control Information.

3.14 In line with this guidance, DCC produces the Submission (outlined in paragraph 3.10 above) and Reporting Template, an excel workbook comprising the templates for the Price Control Information reporting referred to in Condition 32 and Condition 33 of the Licence.

3.15 The Reporting Template requires DCC to collect and provide Ofgem with Price Control Information in such a manner to:

a ensure that Ofgem is provided with such information on a consistent basis in respect of each year of each Regulatory Year of the Licence;

b enable Ofgem to monitor DCC's compliance with the Price Control Conditions in Chapter 9 of the Licence; and

c facilitate any review or modification by Ofgem of those conditions.

### Implementation Milestones

3.16 The Licence also contains an implementation performance regime. This consists of a series of Implementation Milestones (IMs)[23] that DCC must achieve by specified dates. Failure to meet an IM by its due date results in DCC sacrificing a pre-agreed amount of its baseline margin. Ofgem also assesses DCC's performance against the relevant performance incentive regime in force and any application for a baseline margin adjustment. DCC must provide sufficient evidence to support its application, demonstrating the material changes to its business activities, risks and timescales.

### Baseline margin

3.17 The charges passed on to service users include DCC's costs (the 'Allowed Revenue' that may be recovered through service charges) as well as a margin on this baseline (baseline margin), the amount of which is fixed for each Regulatory Year, as determined in Condition 36 of the Licence.

3.18 Each July, DCC can apply to Ofgem for an adjustment to the values in the Licence. The Licence provides criteria related to likely and material changes to its business activities, risks and timescales or deadlines, which DCC must demonstrate have been met in its application. Ofgem assesses proposals for increases in baseline margin and determines whether or not to change the level of margin values agreed when the Licence was awarded.

### RY2013/14 SUBMISSION

3.19 The first price control report covering the partial Regulatory Year from 23 September 2013 to 31 March 2014, was submitted on 31 July 2014. DCC also submitted an application for an adjustment to its baseline margin values at the same time. During this Regulatory Year DCC had six IMs to achieve and failed to meet one.

3.20 In the RY2013/14 Submission, DCC projected that it would incur a further £71 million costs (including the cost of its ESPs), which was 3.8% higher relative to the LABP.

3.21 In Ofgem's Price Control Decision, it acknowledged that DCC and its Service Providers had to manage additional complexity and incurred further costs during 2013/14 as a result of this. This was due to new activity that was unexpected and activity that was not sufficiently clear when DCC put forward its LABP in 2013.

[23] Licence Schedule 3: The Implementation Performance Regime.

3.22 In most cases, Ofgem considered that the additional costs identified were economic and efficient, and so acceptable under the Licence. However, there were some costs that were not fully explained or evidenced and Ofgem concluded that costs which have not been economically and efficiently incurred, are considered 'unacceptable' and should not appear in DCC's forecasts. Ofgem advised that DCC may be able to justify these costs in future price control submissions, provided it is certain that these have been incurred on an economic and efficient basis.

### Further programme changes

3.23 There have been a number of changes to the programme and timetable. We understand that these have been driven predominantly by development of the SEC (as described in paragraphs 3.25 to 3.26 below) and evolution of the GBCS, a technical document issued by DECC which describes the detailed requirements for communications between smart metering devices in consumers' premises and DCC.

3.24 As a result of these issues, DCC reviewed the timetable for the programme and undertook a consultation on its proposed replan (the replan). In response to this, the Secretary of State issued a direction on 5 March 2015 which contains current agreed milestone dates as set out in the table below:

| Milestone | Completion Date |
|---|---|
| System Integration Testing (SIT) commences | 01/09/15 |
| Comms Hub Forecasting and Ordering Mechanism active | 01/10/15 |
| Parse & Correlate Software (V2.0) available | 27/11/15 |
| Pre-Integration Testing (PIT) complete | 31/12/15 |
| Smart Meter Key Infrastructure (SMKI) Live Certificates available | 04/01/16 |
| Solution Build complete | 29/01/16 |
| Interface Testing commences | 02/02/16 |
| System Integration Testing (SIT) complete | 31/03/16 |
| DCC Live (non-contingent) | 01/04/16 |

## SMART ENERGY CODE

3.25 Under the Licence, DCC is also required to comply with the SEC. The SEC came into force on 23 September 2013 when DCC's Licence was granted. The SEC is a new industry code and multiparty contract which defines the rights and obligations between DCC and the users of its services, suppliers, network operators and other users of DCC's services who all need to comply with the Code. The SEC also specifies other provisions to govern the end-to-end management of smart metering in gas and electricity.

3.26 DCC is responsible for modifications to its services in order to meet SEC requirements and it is also responsible for the development of a number of SEC appendices known as subsidiary documents. Therefore, both the Licence and the SEC define DCC's core remit in relation to its role in the implementation of the SMIP.

# 4 THE SMART METERING DATA COMMUNICATIONS COMPANY REVIEW

## INFORMATION PROVIDED

4.1 Grant Thornton has relied upon the following information in reviewing the Price Control Information provided to Ofgem :

- i the RY2014/15 Price Control Submission;
- ii the relevant supporting documents referenced in the Submission;
- iii Ofgem's Regulatory Instructions and Guidance (RIGs), which sets out the regulatory reporting requirements and the basis on which DCC must report Price Control Information;
- iv Ofgem's price control guidance document, which sets out the general cost assessment process Ofgem follows for the DCC price control;
- v Ofgem's Price Control Decision 2013/14;
- vi the Smart Meter Communication Licence (the Licence);
- vii DCC's Procurement Strategy and related documentation;
- viii DCC's Risk Management Strategy (RMS) and related documentation
- ix information and other documentation uploaded to the DCC Sharepoint site; and
- x information and explanations provided to us by DCC. This included a visit to DCC's offices on 30 September 2015 to discuss the Price Control Information and DCC's policies and process and subsequent telephone calls and email correspondence with DCC.

## EX POST REVIEW

4.2 The main objective of our review is to substantiate costs reported by DCC in July 2015 as part of its price control reporting requirements and review the processes that support those costs. The particular areas we have been asked to address are to:

- i review the processes and policies relating to controls over cost variations, planning and budgeting, procurement and risk management;
- ii establish the processes and policies undertaken by DCC in relation to shared costs and ascertain the metrics in respect of the allocation of costs;
- iii perform a general check in relation to the figures reported in the Reporting Template and the accompanying narrative documents;

iv review the six key contracts[24] DCC has with external providers and agree a selected sample of the costs (external and internal) reported in the Submission to these contracts and contract variation agreements; and

v from the contracts, for all material costs (see paragraph 4.11), trace the expenditure through the purchasing and payments system (ensuring the processes described in paragraphs 5.46 to 5.51 are being followed), reconcile the costs included on the invoice to the Reporting Template and verify that the goods or services have been delivered as per the contractual agreement.

4.3 Further details in relation to our instructions are set out in **Section 2**.

4.4 The starting point in our review of the Price Control Information reported by DCC was the Reporting Template for RY2014/15 which sets out DCC's incurred and forecast costs in line with regulatory requirements.

4.5 The costs included within the RY2014/15 Reporting Template are summarised below:

**Reporting Template cost summary**

| | 2015<br>£m |
|---|---|
| **External costs** | |
| DSP costs | AMOUNTS REDACTED |
| CSP North costs | |
| CSP Central costs | |
| CSP South costs | |
| Other External costs | - |
| | **7.269** |
| **COST BREAKDOWN REDACTED** | |
| **Internal costs inclusive of Shared service charge and Pass-Through costs** | **29.833** |
| **TOTAL COSTS** | **37.102** |

[24] Including the versions of Schedule 7.1 (Charges and Payment) which were in effect as at 31 March 2015.

4.6 As set out in the table above, costs within the Reporting Template are classified as either external costs, internal costs (including a shared service charge[25]) or pass-through costs.

4.7 External costs are costs incurred in relation to 'Fundamental Service Capability', ie costs which relate to the contracts with the three FSPs, being:

- the DSP, CGI ;
- the CSP, Arqiva; and
- the CSP, Telefonica.

4.8 Internal costs are all costs not classified as external costs or pass-through costs.

4.9 External and internal costs are split between baseline costs and new scope costs. These are defined in the RIGs as follows:

- Baseline costs should only include costs associated with delivering the requirements provided to the Licensee during the DCC Licensing Competition, ie costs relating to work of the same scope that was always contracted to be carried out. For internal costs, this is irrespective of whether the costs are associated with a shared service charge.
- New scope costs should include any requirements that are considered by the Licensee to be additional to the requirements provided during the DCC licensing competition and the development of the LABP. For internal costs, this is irrespective of whether the costs are associated with a shared service charge.

4.10 Pass-through costs are amounts paid (or expected to be paid) by the Licensee to the Authority in respect of its licence fee and the costs incurred by SECCo for the purposes associated with the governance and administration of SEC. These are in line with the LABP.

[25] We note that in the RY2014/15 Reporting Template DCC have applied the shared service charge to all internal costs. However, internal costs do not automatically attract this charge as there is potential for Ofgem to determine that the charge should not apply to some costs.

4.11 For our review, we were instructed by Ofgem to use the materiality thresholds determined by DCC, as described in pages 35 and 36 of the supporting document 'Financial Reporting Commentary'[26]:

4.11.1 The threshold for **external costs** is 1% of the total value of change requests approved in the year, impact assessments on change proposals done in the year, and new projects approved and incurred in the year. The value derived is **£330,000.**

4.11.2 For **internal costs**, the threshold is 1% of internal baseline and new scope costs inclusive of corporate overhead charge/shared services charge. The value derived is **£250,000.**

4.12 Our work in relation to DCC's processes and the review of the above costs is set out in **Sections 5 and 6** respectively.

[26] We note that in determining a materiality threshold, DCC consider several factors and therefore some elements to its materiality approach are not relevant to our review, such as consideration to materiality from a qualitative perspective, ie there may be minimal cost variance but the activity itself is considered material in the context of the programme or the focus of work undertaken in the year, eg the resourcing materiality threshold.

# 5 DCC PROCESSES

## INTRODUCTION

5.1 In this section, we set out our review of DCC's processes and policies relating to controls over cost variations, planning and budgeting, procurement, cost allocation and risk management.

5.2 From our discussions with DCC and our review of the information it has prepared, it is evident that there are various processes in place to ensure that the costs incurred by DCC are economic and efficient and that transactions are accurate and follow due process. These processes include;

5.2.1 controls over cost variations;

5.2.2 specific planning and budgeting tools;

5.2.3 competitive tendering; and

5.2.4 a risk management strategy.

5.3 However, we note our detailed findings in relation to each of these areas below.

## CONTROLS OVER COST VARIATIONS

5.4 DCC has internal control processes in place to ensure that any variations to the annual budget are thoroughly reviewed and only approved if appropriate.

5.5 We have reviewed DCC's internal control processes and policies for approving cost variations for Internal and External Service Provider costs set out in their supporting documentation and summarise our findings below.

### INTERNAL COST VARIATIONS

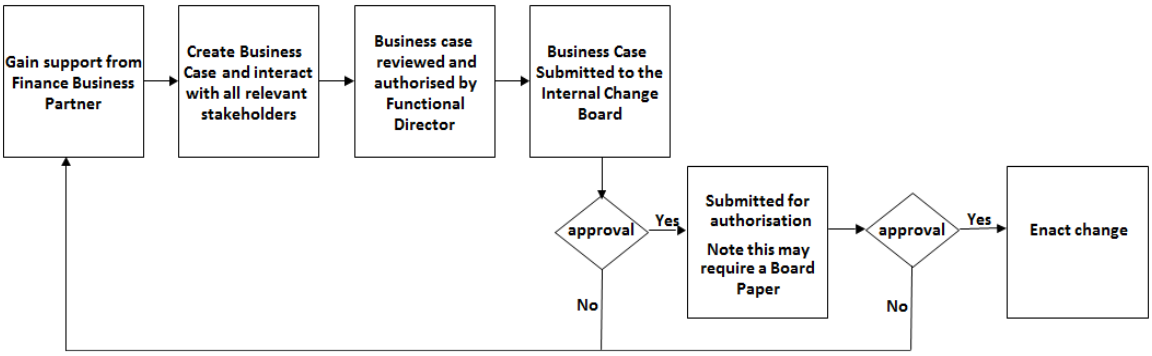
5.6 During RY2014/15, there have been a significant amount of internal cost variations in DCC due to the consultation replan (the replan). The external impact of change was easier to assess but the internal impact was more challenging. This has been predominantly driven by staff recruitment as capital costs are relatively small. Significant additional resource has been required to enable DCC to deliver its commitments.

5.7 The current system for approving additional staff resources was implemented in RY2014/15. Prior to that, requests and approvals were made following a process of raising the various recruitment forms, with approvals and reviews being documented on paper copies, Authority To Offer forms or Authority to Recruit forms. Under the current system, before recruitment, a business case is developed (with consideration given as to whether costs will be funded by underspend or through other parts of the business, as well as how the recruitment will satisfy the aims of the implementation programme) and presented to the ICB, following the process described below.

## Internal control process

5.8 The internal control process is managed through the ICB which is governed by the Commercial Finance team. The ICB is chaired by a finance analyst from the Commercial Finance team who manages the logistics and initial stage of the process, with the Head of Commercial Finance acting as the chairperson.

5.9 The below diagram sets out the various stages of the internal control process:




5.10 ICB meetings are held weekly on a Tuesday. Prior to each meeting the relevant managers are required to provide a detailed business case outlining the reasons behind the proposed change, the benefits sought/any savings made (set out in a simple cash flow projection) and a description of all the available options and outcomes to be delivered. Each business case also requires explanation if the project was not originally included in the LABP, consideration of whether the proposed project is economic and efficient and what the benefit to the end customer will be.

5.11 Businesses cases are to be submitted by close of play Friday and the Commercial Finance team ensure each business case is distributed across the relevant decision makers for review. Questions are then raised to the proposer via email on a Monday to allow the proposer time to investigate the issues raised, so that all answers can be prepared in advance for the Tuesday ICB meetings.

5.12 Each manager is provided a 15 minute slot to present their case to the board at which point they are required to outline the reasons the requirement was not covered in the original budget submission, the reasons why the change is necessary and how it benefits DCC's objectives.

5.13 ICB meetings are reviewed by:

- Head of Commercial Finance
- Commercial Manager – for non resource related business cases
- Head of Technology Practice
- Implementation Director
- Finance Director

5.14 Following the outcome of the ICB review, cases are either approved or sent back for further investigations to be carried out. The approval of a business case will be declined if the board feels the information provided is inadequate or the change cannot be justified and is out of alignment with business objectives. In general, business cases take between seven days and one month to approve.

5.15 The ICB has the authority to approve variations, in principle, of up to £1 million, with amounts over £100,000 being subject to the subsequent Delegations of Authority (DOA) commitment limits (see paragraph 5.26 below). For amounts greater than £1 million a board paper is required. Approved cases are presented for signature from the Finance Director and the Managing Director .

5.16 Following approval of a business case for additional staff resource, an Authorisation to Recruit (ATR) form is completed by the hiring manager. Once this has been reviewed, an Authorisation to Offer (ATO) is made. The relevant details and forms are then transferred to HR to enable them to enact the changes that have been approved as a result of a business case.

5.17 DCC provided a summary of the business cases submitted during RY2014/15, the majority of which have come from the Programme, Operations and Design & Assurance cost centres, for which additional costs will be incurred for a limited period of time until the SMIP goes live. Of the 76 cases submitted, 61 (80%) with a total value of £13.213 million have been approved.

5.18 For a sample of cases, we have reviewed the available internal approval documentation including business case forms and confirm that the internal control processes described above are being followed.

### *Cost challenge*

5.19 As noted in the RY2014/15 Submission[27], in order to control internal costs, DCC introduced a cost control challenge (in November 2014) as part of its business planning process last year. This was discussed with DCC.

5.20 In order to monitor the amount of spend, this internal control is applied to each cost centre. The cost challenge is £3 million in total, applied as a uniform percentage of 13% across all cost centres. This meant that each department was aiming to come within 13% of their identified budget for that year. Due to external factors, many cost centres required increased headcount during the year and therefore the cost challenge was not met by any cost centres. As noted in paragraph 5.43 below, Programme and Design & Assurance in particular overspent significantly.

## EXTERNAL COST VARIATIONS

### Change requests

5.21 As the SMIP develops and increases in complexity DCC's requirements evolve both in terms of increased knowledge of what is needed and new obligations being introduced. As a result, DCC will identify that a change to the original requirements (and baseline costs) is required and a change request[28] will be raised with the affected Service Provider.

5.22 Change requests are triggered for a number of reasons and are predominantly driven by external changes such as development of the SEC and GBCS, specification changes or changes which are triggered as a result of previous or concurrent change requests due to interdependencies.

5.23 In addition to developments for the GBCS and the SEC, the business case is changing, and as a result, additional functionality is required. Other changes relate to the evolution of the design of DCC's services and are driven by the increased scope of the service desk and 'early life support', as well as SMKI[29], a critical part of the programme with regard to security.

[27] Core document, Part 3, page 8

[28] There is a standard change request template in which the reasons for the proposed change are set out.

[29] The original DSP (CGI) contract contained an element in relation to provision of the SMKI service. However, change requests were issued by the DSP to bring the DSP contract in line with the revised SMKI repository requirements and to procure links between SMKI users and the SMKI service (which was outside the scope of the initial change request).

5.24 Each change request follows the change process set out in Figure 5-1, Part 3 of the Submission, before it is finalised as a contract change. The process includes the below steps:

5.24.1 **Issue Resolution Proposal (IRP)** – these are a source of change (which lead to the issue of a change request), used as part of the replan specifically. These potential changes have become known to DCC through its Service Providers and need to be assessed so as to confirm whether it will result in further changes. At this stage the Commercial Finance Manager will create a provision for potential costs based on conversations held of levels of complexity, potential man days required and time taken to fix any issues identified.

5.24.2 **Preliminary Assessments (PA)** – these are produced in response to the raising of a change request. The Service Providers are required to provide a high level assessment of the change request /IRP and potential time, tasks and costs of the changes that may be required. The cost identified at this stage is usually a potential range (Rough Order of Magnitude (ROM)). The high range number was used as a forecast entry at this stage of the process. However, DCC has recently adopted the mid-point cost as basis for its forecasting requirements.

5.24.3 **Impact Assessment (IA)** – at this stage the Service Provider has been tasked with providing a detailed solution plan with a realistic timeline and final value cost breakdown. At this stage DCC will internally review every aspect of the IA received, to fully understand the impact of the change across the programme, and provide a detailed response on any issues that may require further elaboration from the Service Provider. The range of queries raised cover all technical, timing and cost related issues. The costs that are captured in the budget model reflect the final agreed price as approved by DCC's external change board (if, due to timing, the IA has not been approved, but the forecast cost varies from the PA, then the IA costs are typically used as the baseline in the forecast[30]).

[30] The task of consolidating DCC's review queries and subsequently getting a response from the Service Provider can take time and therefore if a forecast needs to be submitted, the IA cost position, being the most reliable source of a detailed breakdown of costs, will be used as the basis for the forecast.

The repayment profile of impact assessed changes are aligned back to the last contract position for consultation replan (see paragraph 3.24), unless there has been a different agreement made to original structure[31].

5.24.4 **Contract Authorisation Note (CAN)** – this is the last stage of change agreement process where the contract changes are agreed between DCC and Service Providers. At this stage the final costs, the repayment profile and any changes to the contract schedules are agreed by all parties.

5.25 The process from change request to authorisation (CAN) can take from a few weeks to complete, up to a year depending on the nature of the request.

### *Delegation of Authority*

5.26 All external contracts and contract variations are approved in accordance with the Smart DCC Ltd DOA matrix, which sets out the relevant levels of approval for the commitment to spend.

5.27 The DOA matrix for Smart DCC Ltd as the contracting entity is set out below:

| Commitment Value | Approver 1 | Approver 2 | Contract Signatory |
|---|---|---|---|
| <£0.01m (£10k) | Member of DCC Executive Board | N/A | Any DCC Executive Board member or named role holder |
| >£0.01m and <£0.1m | Internal or External Change Board (where applicable)<br>**Or**<br>DCC Nominated Approver[2] | N/A<br>Smart DCC Ltd Director[3] | DCC Nominated Approver, proxy[4], or named role holder |
| >£0.1m and <£1.0m | DCC Nominated Approver | Smart DCC Ltd Director | DCC Nominated Approver, proxy, or named role holder |
| >£1.0m | Smart DCC Board Resolution | N/A[5] | DCC Nominated Approver, proxy, or named role holder |

[31] The replan negotiations resulted in a series of changes to the expected repayment profile of change requests. The revised position, which is currently being used as a precedent for all change requests in negotiation, is REDACTED for CSPs and REDACTED for the DSP. We note that the repayment profile for each contract change is negotiable and whilst existing contractual engagements are used as a guide for what the repayment profile may be, these do not create an enforceable precedent for future changes.

5.28 Approvals 1 and 2 can be demonstrated either by physically signing the contract or providing written evidence of the required approval to the contract signatory, eg email approval or a copy of the board resolution.

5.29 DCC hold a schedule of change requests, which is updated daily to reflect the progress and cost of each of the requests. Each change request may trigger other change requests. DCC stated that there have been around 150 change requests which have already resulted in or will result in cost increases. These are then frozen at Quarter 4 each year to provide the final position for the Charging Statement[32]. Only approved change requests are reflected in the Reporting Template.

### *Our findings*

5.30 In our review of cost variations, we identified that there are a large number of change requests being processed which may result in additional costs, which have been estimated, but these have not been captured in the costs forecast in the Reporting Template because the approval process has not yet been completed. Unapproved requests are not reflected in the forecast costs in the Reporting Template as they are not considered to be certain. As a result, if approved in future years this will lead to a greater variance against both the LABP and forecasts. This represents a potential risk in terms of visibility of cost control and managing future increases in costs. We consider that a separate category should be shown for unapproved change requests in the Reporting Template to give a full picture. In addition, this would ensure that DCC explain any unapproved change requests in the accompanying commentary to the Reporting Template.

## Review of specific contract variations

5.31 We carried out testing, ensuring that the relevant approval documentation is in place, in relation to the following contract variations as specified by Ofgem:

- DSP service management work (CR065 and CR098);
- Communications Hubs Status Update (CR032a); and
- Order Management System (CR075).

5.32 Our findings are set out in **Appendix 1**.

5.33 Our review raised concerns in relation to approval of change requests. Approval documentation was inconsistent across the change requests reviewed and for two out of the six contract variations, the approval documentation provided by DCC was incomplete.

[32] Forecast costs included within the Reporting Template are based on the budget set in January 2015 for the RY2015/16 Charging Statement prepared by DCC (adjusted to remove forecasts which were uncertain as at 31 March 2015).

## COST VARIANCE ANALYSIS

5.34 Variations from the LABP and those forecast in the RY2013/14 Submission are reported in sheets 10a to 10d of the Reporting Template[33]. Explanations for these variances are provided in the Submission and supporting documents.

5.35 In summary:

### RY2014/15 variance against LABP

5.36 There has been an £11.3 million increase in overall costs since the LABP. This is comprised of:

- an increase of £4.7 million in External Costs, stated to be driven by new requirements and changes to requirements which are supported by formal change requests from the applicable Service Providers;
- an increase of £6.9 million in Internal Costs, primarily reflecting the evolution of the DCC organisation to meet the changing requirements on DCC and the addition of significant third party contracts explicitly excluded from the LABP (for P&C software and SMKI Services); and
- a reduction of £0.3 million in Baseline Margin, following the determination that an Implementation Milestone had not been met in RY2013/14.

5.37 There has been no variance in Pass-Through Costs.

### RY2014/15 variance against prior year forecast

5.38 The majority of the variance against LABP above was included within the prior year forecast. However, there has been a £1.0 million decrease in actual costs against the prior year forecast. This is comprised of:

- an increase of £2.0 million in **External Costs**, driven by further new requirements and changes to requirements which are supported by formal change requests from the applicable Service Providers; and
- a decrease of £3.0 million in **Internal Costs,** primarily driven by re-profiling of costs into future RYs to reflect the re-setting of the DCC programme during the year (and therefore the costs are decreasing in the current year only rather than over the whole programme).

5.39 There has been no variance in **Baseline Margin** or **Pass-Through Costs**.

[33] Note: By definition (see paragraph 4.9), all new scope costs will be variations compared to the LABP.

5.40 In addition, from our discussions with DCC we note the following.

5.41 The RY2014/15 Submission reports significant cost increases against those identified in the LABP and those forecast in the RY2013/14 Submission. DCC report that these increases are driven by external changes including development of both the SEC and GBCS. The majority of internal cost increases result from recruitment of additional staff to respond to the additional requirements and to mitigate delays (see paragraph 5.43) whereas external costs increases result from change requests in relation to FSP contracts (considered above).

5.42 DCC have provided us with a spreadsheet which sets out the variance analysis for internal costs, focusing on Programme, Design & Assurance, Corporate management and Security cost centres.

5.43 For Programme, Design & Assurance and Corporate management, all material variances relate to increased resource costs (payroll and non-payroll costs). Detailed descriptions of the variance drivers (on an per employee basis) are included in the spreadsheet provided, such as whether the increase is due to a new role being required, a change in role, salary increase or a timing change/extension. The reasons behind the variance drivers are explained on a team by team basis in the supporting documentation 'Resourcing the Organisation'. In general, the increases are as a result of:

i the project being pushed back, with a later live date and therefore people have to be kept on for longer than initially thought;

ii increased resource to mitigate any further delays in the project; and

iii the new obligations introduced by SEC have led to an increased volume of resource being required, as well as the requirement for a different type of resource and skill set and DCC has responded to this by recruiting the relevant skills, particularly in relation to Design & Assurance.

5.44 For Security, the increases relate to internal services and relate to LogRhythm software. DCC has not yet determined whether the software will be required and therefore this has not been procured. As a result, the original budget has shifted so that the forecast costs are included in later years.

5.45 We have not requested any information from DCC in relation to how any additional costs associated with the replan as set out in paragraphs 3.23 to 3.24 will be met. We assume that DCC expects to pass these costs onto service users and understand that the RY2014/15 Submission reflects some costs increases as a result of the replan. However, a significant proportion of increases have not been reflected in the Submission because they are still uncertain and cannot be justified as economic and efficient.

## PROCESS FOR MAKING PAYMENTS

5.46 As part of our cost verification work (see **Section 6**), we have traced costs included in the Reporting Template through the purchasing and payment systems. We therefore discussed with DCC the processes in place for making payments.

5.47 There are two types of payments made by DCC:

5.47.1 **Payments direct from Smart DCC Ltd to a supplier** – this applies to payments of all of the external costs to the three FSPs, as well as for some contracts such as ATG, DMS, SMKI, and P&C.

5.47.2 **Transactions paid for by Capita Business Services Ltd (CBSL) and then recharged to Smart DCC Ltd** – where Smart DCC Ltd is charged costs from CBSL, such as for payroll, accommodation, internal services, some smaller costs to external suppliers (eg Foundation SP, Deloitte) and for contracts with Capita divisions, eg Billing, Service Desk, the total amount paid by CBSL (along with the REDACTED corporate overhead) is recharged to DCC through monthly invoices and then one amount is paid to CBSL as a lump sum payment to cover all transactions for the month.

5.48 The main process for making payments is broadly the same for Smart DCC Ltd and Capita. The below table sets out the purchase and payment processes followed (including the segregation of duties). These are then discussed in further detail in the following paragraphs:

| Process Step | Head of Finance Operations/ Finance Operatons Manager | Capita AP - Offsite, Darlington | Finance Operations Analyst | Cost Centre Manager [1] | Group Finance - Offsite, Rochester Row |
|---|---|---|---|---|---|
| NEW SUPPLIER SET-UP | | | | | |
| New supplier request received [2] | ✓ | ✓ | ✓ | | |
| Set up new supplier on SAP | | ✓ | | | |
| Approve new supplier on SAP via workflow | ✓ | | | | |
| PURCHASE ORDER | | | | | |
| Open manual PO | | | ✓ | | |
| Approve PO by email [3] | | | | ✓ | |
| PROCESSING OF INVOICE | | | | | |
| Record invoice received on SAP via scanning system [4] | | ✓ | | | |
| Match invoice to PO [5] | | | ✓ | | |
| Confirm Goods/Services received on SAP | | | ✓ | | |
| Approve invoice for payment up to £100k [6] | ✓ | | | | |
| Approve invoice for payment > £100k [7] | | | | | ✓ |
| Instruct payment [8] | ✓ | | | | |
| Make payment [9] | | | | | ✓ |
| Perform bank reconciliation | ✓ | | | | ✓ |

5.49 The purchasing and payment process set out in the above table is described in further detail below (using the numbering in square brackets as per the table):

5.49.1 For Smart DCC Ltd payments, approval by a cost centre manager is generally from the Commercial team as (as noted in paragraph 5.47.1 above) these primarily cover payments to the key Service Providers[34] [1]. All purchase orders (PO) are approved by a representative from Commercial and Commercial Finance.

[34] Being the providers of the six key contracts as set out in paragraph 1.51.

5.49.2 Before setting up a new supplier on SAP [2], Capita AP submits a new supplier request to DCC Finance for approval (sent to the Finance Operations Analyst for checking and then to the Head of Finance Operations or the Finance Operations Manager for approval). A new supplier will either initially be requested by DCC Finance at the point it raises a PO and knows the supplier is new or Capita AP will submit the request to DCC Finance upon receiving an invoice from a new supplier.

5.49.3 Notification of a new supplier is 'workflowed' through to the Head of Finance Operations or the Finance Operations Manager via the SAP invoicing system for approval. If a new supplier request isn't approved by DCC Finance then no invoices can be processed and paid until this is done. DCC Finance will check that the vendor account details are correct and correspond to the details captured upon raising the PO. Capita AP will also carry out checks of banking details.

5.49.4 Currently POs are managed manually using Excel (and a PDF of each PO generated) but going forward, this will be transferred to a SAP based system (which will enable an automatic link between each business case, PO and invoice and remove the need for authorisation by email, as described below).

5.49.5 There are no PO approval limits. However, all invoices charged directly to Smart DCC Ltd will have an associated PO raised for them, these POs are instigated by the Commercial team to ensure compliance with Servicer Provider contracts and the invoicing details are provided to the Finance Operations Analyst to raise the PO.

5.49.6 DCC Finance is unable to process an invoice on behalf of Smart DCC Ltd without having the PO raised. This is because the supplier will be unable to send an invoice without a valid cost centre code which is provided on the PO and the invoice will be not be able to be processed without this. POs for Smart DCC are requested by Commercial and approved by Commercial Finance [3], before being issued.

5.49.7 Invoices are sent from suppliers directly to Capita's invoicing scanning centre in Darlington via e-mail [4] and coded with the cost centre as provided from the PO. Capita AP will then workflow this invoice through to the Finance Operations Analyst (as the nominated default recipient for that cost centre) via Capita desktop for PO checking and for forwarding on for invoice approval (SAP). The invoice is pending in SAP at this stage but will not be posted in the AP ledger or General Ledger until approved.

5.49.8 The Finance Operations Analyst will check that the invoice matches the PO value [5] and also checks with the PO approver that the goods or services have been received before forwarding on for invoice approval. If the invoice doesn't match then this will be held pending resolution or rejected back to Capita AP with justification given.

5.49.9 Once the invoice has been checked successfully it will be 'workflowed' through to either the Finance Operations Manager (approval limit of £50,000) or the Head of Finance Operations (approval limit of £100,000) for approval [6] with a message alert appearing in desktop notifying of a pending approval. The Head of Finance Operations or the Finance Operations Manager will confirm with the Finance Operations Analyst that the invoice has been checked and is valid for payment before approving.

5.49.10 When the invoice value is greater than £100,000 this cannot be approved within DCC so will be forwarded on by the Head of Finance Operations to the Group Financial Controller (pre October 2015) and the Divisional Finance Director (post 1 October 2015) for final approval [7].

5.49.11 DCC Finance will instruct Group AP to make payments via e-mail to ensure payments are made within contract payment terms [8].

5.49.12 Group AP will make payments via SAP BACS/CHAPS system as instructed above [9].

5.49.13 Group Finance reconciles bank accounts, but the Finance Operations Manager also does this for financial reporting purposes on a monthly basis.

5.50 The process for CBSL procuring goods and services is governed by the CBSL to Smart DCC Ltd trading agreement. However the process as described above for Smart DCC Ltd is broadly the same for CBSL suppliers and invoicing, with the exception of IT consumables which are purchased via an on-line tool and business travel and hotels which can be booked directly by the staff member via a self-service tool. Finance review the costs in relation to these two exceptions monthly for billing accuracy and level of spend.

5.51 As noted above, as part of our cost verification work carried out in **Section 6**, we ensured that the above processes were being followed by DCC, obtaining a sample of the relevant paperwork including purchase orders, authorisation emails, invoices, SAP approvals tracker (to show the lifecycle of the invoice through the systems) and screenshots of the SAP payment screen.

## PLANNING AND BUDGETING APPROACH

5.52 In relation to DCC's planning and budgeting approach, we reviewed the relevant parts of the Submission and supporting evidence, the forecasts included in the Reporting Template and DCC's RY2015/16 Charging Statement (submitted as part of its Submission). We also discussed DCCs planning and budgeting approach with DCC during our site visit.

5.53 Towards the end of each calendar year, DCC forecasts charges for the following financial year. DCC uses a range of internal processes to forecast future costs and manages its forecast costs through a series of spreadsheets.

5.54 A diagram setting out DCC's budget process is at **Exhibit 1**.

### INTERNAL BUDGET PROCESS

5.55 The Internal budget and forecasts are managed through a rolling monthly process that is incorporated into the monthly management review meetings held with each of the cost centres. DCC stated that the process has evolved over the past 18 months as priorities have changed and the finance partnering of the business has been seen as critical to understanding the impact of changes agreed to the structure of each department and their functional ability to plan and deliver against agreed objectives.

5.56 Each month the Internal Commercial Finance manager undertakes a detailed management review with each cost centre manager who provides updates on progress and cost of operations to date. In addition to reviewing the historical cost position, they discuss the outlook on expected outturn costs for the current year and additional activities that have become known and may impact future operations.

5.57 After the monthly meetings the various internal budget models are updated with new details received in order to understand the impact of changes agreed since the last reported forecast date. This model incorporates the change at two levels:

5.57.1 Internal change board adjustments which are changes agreed in the current year but which may also impact the costs for future years; and

5.57.2 Changes notified by manager which will impact the business in the next year and beyond. These may be related to increase in headcount or other non-staff related resources.

5.58 The output from each department is subsequently reviewed internally in Finance and further reiterations of review process with cost centre managers may be required until the position is agreed and ready for sign-off by the Finance Director (FD) and Managing Director (MD).

5.59 The consolidated model provides a detailed view of costs across all departments for the current year until 2025 (the License end date). The output produced for MD and FD review and sign-off incorporates a breakdown of costs for DCC, plus assumptions, risks and opportunities that have been identified through the forecasting process.

5.60 Any further queries that may be raised are subsequently followed up by the Commercial Finance Manager to resolution unless the matter is deemed so significant where a further meeting between FD, MD and relevant cost centre managers may be deemed necessary. Once finalised the consolidated internal output is merged with the external cost models and the Prudent Estimate (described below) to form the Consolidated Budget Model which in turn feeds into the Charging Statement.

5.61 We note that there appear to be limited incentives for cost centre managers to keep expenditure in line with budget. Staff bonuses are not linked to budget management. DCC advised that this was because there have been too many factors impacting on costs which are outside of the control of cost managers. However, DCC provided assurance that activities for next year are much clearer.

5.62 DCC stated that they plan to implement another 'cost control challenge' ‘cost control challenge’ next year. Ofgem may wish to explore with DCC how they can strengthen the approach used in RY2014/15 to ensure it is effective in controlling internal costs.

## EXTERNAL BUDGET PROCESS

5.63 The budget and forecasting process for external costs is also a continuous activity due to the ever changing volume of activities that are agreed with the three FSPs. The process of monitoring external costs is managed by the External Commercial Finance manager who monitors the financial impact of all change requests as well as the original base contracts for Arqiva, Telefonica, CGI, BT and Critical.

5.64 The structure of the original external budget model is based around the various milestones that trigger commencement of cost payments in baseline contracts. Additionally, the impact of the costs from change requests, IAs, projects and contingency (the potential cost of future activities that will be identified in the future release plans) is assessed.

5.65 The consolidated external budget position is reviewed and may be further adjusted after meetings with Commercial, Programme and Design Assurance teams who provide further input on the commercial, timeline and design prospects of existing and future changes. The agreed external costs from this point is presented to MD and FD for review, challenge and sign-off.

5.66 As noted above, the final budget model consolidates the internal, external and prudent estimate into its final format for a final sign-off by MD and FD before it is presented to the DCC board for review.

### PRUDENT ESTIMATE

5.67 The prudent estimate is used to manage cash flow over the year ahead. The concept of a prudent estimate is unique to DCC, allowing it to estimate its Allowed Revenue on a prudent basis so that it does not have to change charges to service users during the RY. DCC must take all reasonable steps to ensure that regulated revenue does not exceed a prudent estimate of Allowed Revenue for each RY.

5.68 Details in relation to the prudent estimate is set out in Section 6A of the Financial Reporting Commentary which notes the following:

> *A prudent estimate of Allowed Revenue for any year is first set in the Charging Statement for a particular Regulatory Year. This prudent estimate of Allowed Revenue is built up from our budgeting and forecasting of cash-flow, resulting in two models; an Internal cost model and an External cost model. These models are maintained independently and consolidated to provide the total estimated Allowed Revenue, which forms the budget for that Regulatory Year.*

5.69 The Financial Reporting Commentary also sets out assumptions that are made in determining the prudent estimate. We discussed this further with DCC in order to understand what cost items go into the prudent estimate model and how DCC determine the level of prudency to apply to cost estimates and then to overall revenue requirements for the year. However, DCC were unable to provide commentary above what was included in the Submission.

5.70 Although DCC have provided calculations in support of the prudent estimate and total budget model, these are very detailed spreadsheets which we have not reviewed. As a result, we suggest that Ofgem challenge DCC to provide a more detailed commentary in support of these detailed calculations/spreadsheets and the prudent estimate.

### RY2016/17

5.71 DCC has just commenced its business planning process for next year (RY2016/17), which is a critical year for DCC for completion of the implementation programme as the programme is expected to go live in April 2016. DCC intends to introduce a similar cost challenge process (as described in paragraph 5.19) to control internal costs. During October and November this year, forecast review meetings will be undertaken for RY2016/17. These meetings will focus on the year ahead but will consider forecasts over the next four years.

### CONTINGENCY

5.72 Contingency is only considered by DCC in relation to the forecast external costs. There is no contingency relating to internal costs (with the exception of IT services due to the uncertainty of costs at the start of each IT project).

5.73 However, DCC confirmed that there is no contingency included in the RY2014/15 Reporting Template as the forecasts are based on costs incurred, and DCC have removed forecasts which are included in the model for the Charging Statement which they cannot justify as being economic and efficient (as prescribed by Licence). DCC stated that this has been discussed with Ofgem[35].

## PROCUREMENT

5.74 The Licence requires DCC to ensure that its procurement is in accordance with Licence Condition 16 Part A, Procurement requirements and Part B, Procurement principles.

5.75 We reviewed DCC's Procurement Strategy, frameworks and relevant supporting information.

5.76 We note that in Section 9.1 of its Procurement Strategy DCC references the EU Procurement Directives and the UK Procurement Regulations including Utilities Directives. However, DCC has stated that as it is not a public organisation, it is of the view that it is not subject to the Public Procurement procedural rules of these directives and regulations. Ofgem may wish to consider what the requirement actually is.

[35] Tricia Quinn, Senior Economist, Ofgem

5.77 DCC procures specific goods and services in order to deliver Mandatory Business Services[36] during the period of the Licence. DCC's Procurement Strategy sets out information on how DCC will procure Relevant Service Capability (RSC)[37], as well as meet the obligations set out in Licence Condition 16: Procurement of Relevant Service Capability.

5.78 DCC relies on its parent company, Capita, for the provision of a range of infrastructure and services. DCC has stated that this approach was outlined in their BAFO proposal for the Licence, in order to obtain services to support business operations, minimise organisational fixed costs and provide flexibility. Ofgem may wish to confirm that this is its understanding.

5.79 The services that have been sourced from Capita Shared Service Infrastructure include:

- Company Secretariat Services;
- Audit and Assurance Services;
- Capita SAP procurement solution and general ledger;
- ICT hardware, software and support services including telecommunications; and
- Legal services.

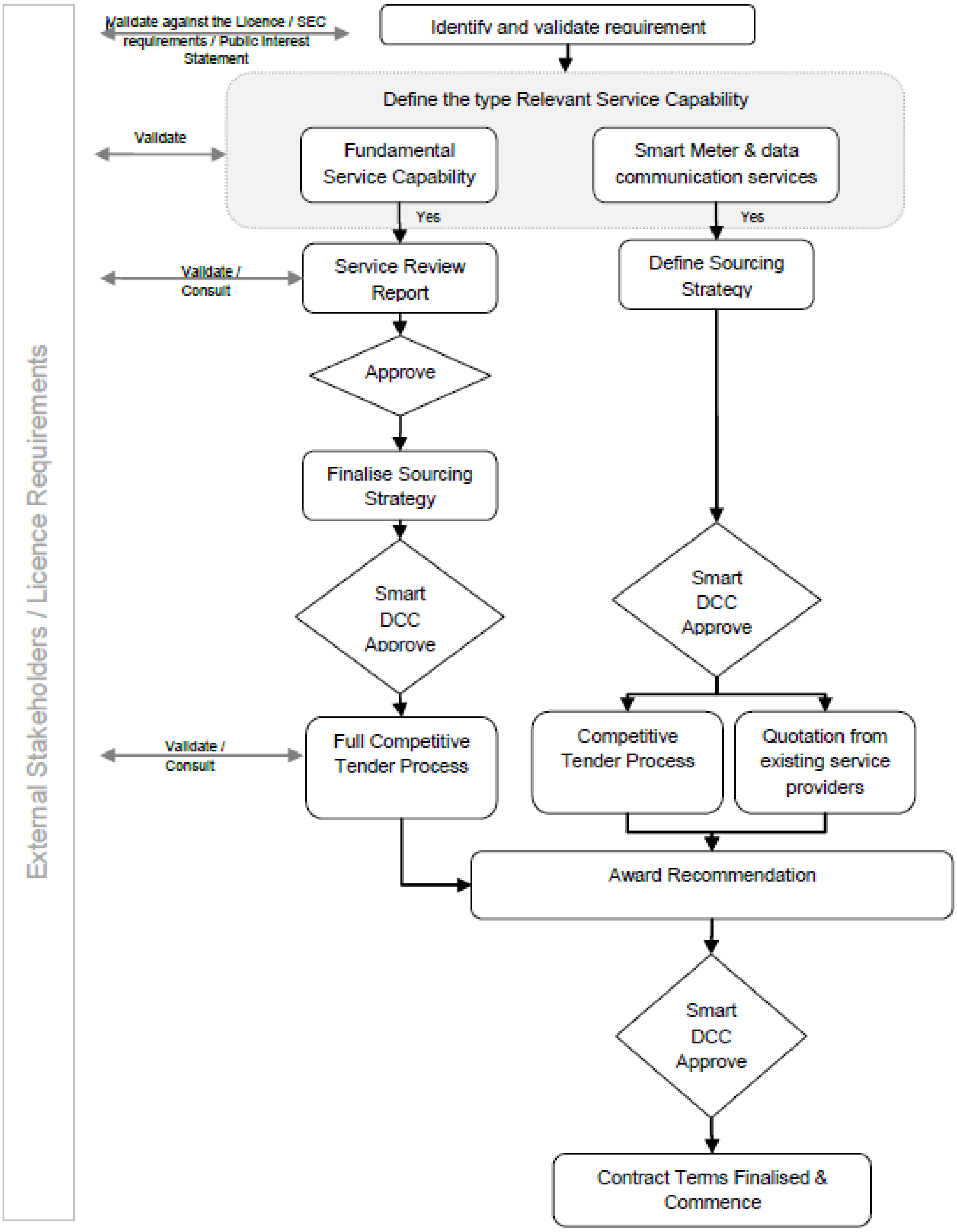
5.80 With regard to overheads, DCC stated that in line with the requirement of the Licence, all contracts have to be capable of being transferred to another company (ie a novatable contract), should DCC's contract be terminated for any reason. Therefore, on all contracts with Capita, the gross value, including the margin and overhead are stated on the face of the invoice but DCC pays the net cost, to ensure that overhead and margin has not been charged twice.

[36] Mandatory Business Services are defined in the Licence as "*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 relevant provisions of Condition 17 (Requirements for provision of Services)*".

[37] Relevant Service Capability is defined in the Licence as "*capability procured (or provided from within the Licensee's own resources) in accordance with Condition 16 (Procurement of Relevant Service Capability) for the purposes of securing the provision of Mandatory Business Services under or pursuant to the Smart Energy Code*".

## PROCUREMENT PROCESS AND APPROACHES

5.81 DCC must satisfy the requirements set out in Licence Condition 16. In response to this, DCC has developed a high level procurement process, as set out in the flow chart below.



5.82 DCC has identified a wide range of different procurement approaches as set out in the table below:

| **Process and Approach** | **Features** | **Rationale & Benefit** | **Example** |
|---|---|---|---|
| Competitive Procurement<br>Full Tendering Process | Defined multi-stage or gateway approach.<br>Create a preferred bidder short list against complex specification<br>Duration: Nine months+ | Multi layer capability review. Refine solution options, test assumptions (both parties). Control and rigour.<br>Early relationship building. | FSP Re-Procurements. |
| Competitive Procurement<br>Request for proposal (RFP) | Optional multi stage or gateway approach against detailed specification<br>Duration: Three months+ | Competition from a short list of identified suppliers.<br>Control and rigour applied in shorter timescales. | P&C solution.<br>SMKI service. |
| Competitive Procurement<br>Request for quote (RFQ)<br>eg Three suppliers | Standard or non complex specification to obtain quote<br>Duration: Two weeks+ | Competition against simple specification.<br>Speed and agility. | Consultancy support. |
| Procurement<br>Preferred Supplier Lists, Frameworks, Affiliates (RFQ) | Existing negotiated contracts for goods and services. RFQ confirms ability to deliver<br>Duration: One week+ | Access to services at agreed rates.<br>Speed and agility.<br>Leverage Capita purchasing power to achieve economies of scale. | Technical specialist consultancy services.<br>ICT products and services.<br>Office and supplies. |
| Additional services from Existing Service Providers | RFQ against a specification confirms scope and ability to deliver<br>Duration: One week+ | Speed and agility.<br>Lower access costs.<br>Coherence and alignment with Smart DCC architecture.<br>Knowledge and understanding of FSPs. | Testing Services. |
| | The execution and contractual delivery of this service may be in the form of a:<br>a) Change control process, if the existing contract had included the goods/ services as an existing set of services; or<br>b) A discrete and separate contract | | |

5.83 DCC explained that the approaches set out above are generally determined by the contract value, with the contracts at the top of the table being of highest value and then descending in value towards the bottom of the table.

5.84 The FSP contracts are worth around £REDACTED and any re-procurements (or new contracts of a similar nature and value) will follow the full competitive tendering process. The RFP approach is used for smaller contracts, generally worth around £1 million or less, although this approach was also used for the procurement of the SMKI service, won by BT and worth around £REDACTED[38]. The other approaches are used for lower value procurement exercises.

5.85 DCC has also noted in its Procurement Strategy that in relation to the first two competitive procurement approaches identified in the table at paragraph 5.82 above (full tendering process and RFP), these procurements will be conducted utilising an e-sourcing portal (currently Curtis Finch). We have not considered the utilisation of the e-sourcing portal as part of this review.

5.86 DCC has identified key procurement documentation as including:

- the sourcing strategy, project initiation document or business plan;
- RFP or quotation;
- evaluation documentation; and
- award recommendation.

5.87 For all procurements, DCC has stated that it will prepare an award recommendation report for approval. Approval is granted according to the delegated authority and this may include the Board. The award recommendation report summarises the outcome of the procurement exercise explaining how it has met the principles set out in the licence and how it demonstrates value for money. The report is provided as a paper to the Board meeting and subsequently approved.

[38] We note that this was procured before the formal procurement strategy was in place.

### Procurement exercises planned and undertaken

5.88 As part of its procurement forward plan, DCC sets out a list of the services it has procured to date, the majority of which have taken place in RY2014/15. These include

- SMKI;
- GBCS software simulator;
- source code review for P&C;
- the billing system;
- the DMS;
- audit and assurance framework;
- consultancy services framework;
- performance auditor;
- independent testing auditor; and
- business intelligence and management information systems.

5.89 DCC has identified other services that they will need to procure the following over the next three years but has not set out the detail of these in its procurement strategy. These are:

- difficult property solutions;
- registration service; and
- benchmark audit.

5.90 DCC has also identified a list of 13 requirements in relation to ESPs that will need to be procured and sets out the procurement process for each[39].

[39] Section 5.2 of the Procurement Strategy.

5.91 In its Procurement Strategy, DCC sets out a table on how it has evidenced its action against each of the principles set out in Licence Condition 16, Part B. A summary of our findings in relation to how DCC has met the Licence conditions is set out in the table below.

| Principle | Our findings |
|---|---|
| 1 | There are procurement processes in place but we have not seen sufficient evidence of the sourcing strategies (not a defined document) or project initiation documents being utilised. |
| 2 | DCC have undertaken some competitive procurements. In considering specific procurement exercises (from paragraph 5.94 below), we have identified some specific issues in relation to the competitions. In most cases, where services are provided from the parent company, we have not seen any procurement documentation. |
| 3 | Reviewing due diligence work undertaken on suppliers was not within the remit of our instructions. |
| 4 | We have not seen sufficient detail to demonstrate how quality and cost are considered and weighted in procurement evaluations. |
| 5 | Contracts are in place with the ESPs. |

## REVIEW OF SPECIFIC PROCUREMENT EXERCISES

5.92 We were instructed by Ofgem to review the procurement processes followed and evidence in relation to the outcome reached for the following four specific procurement exercises:

- the frameworks for the provision of consultancy services and audit and assurance services;
- the billing system;
- the DMS; and
- ATG.

5.93 Our findings on each of these are discussed in turn below.

### Procurement frameworks

5.94 DCC has set up two frameworks for the provision of (i) consultancy services and (ii) audit and assurance services. We have reviewed the available reports on both frameworks which detail the procurement process and outcome.

5.95 DCC advised that the frameworks took approximately two months to set up. A procurement project team was established for each framework. DCC stated that the benefits of the frameworks will outweigh the set up cost of the frameworks as they contain set terms, the charges in the frameworks were benchmarked and set, competitive rates were secured and they enable DCC to efficiently procure the services it needs. In addition, there is a time saving benefit, as having the frameworks in place allows DCC to act rapidly in securing the relevant services.

5.96 The audit and assurance framework was agreed in RY2014/15 and the consultancy services framework was agreed in RY2015/16. Contracts under the frameworks are in place for an initial term of four years with the option to extend for a further 12 month period. Mini competitions are held under the frameworks for relevant work.

5.97 The procurement exercise for both frameworks followed the RFP approach rather than full competitive tender. This was justified as offering a robust level of process control without a protracted timescale. For each framework, a long list of suppliers was drawn up through research. Approaches were then made to the long list to establish the level of interest. All suppliers were invited to return a signed Non-Disclosure Agreement if they wished to be invited to participate in the opportunity to be on the framework.

5.98 Evaluations of submissions were conducted by evaluation teams including representatives from technical, design and assurance, strategy, programme and commercial personnel as relevant to the nature of the framework. The procurement reports state that evaluation was undertaken based on quality criteria (although no explanation is provided in how the evaluation criteria were selected).

5.99 Submissions were initially evaluated individually by the members of the team and then consolidation meetings were held to discuss the quality scores and agree final scoring values. DCC have provided a document which sets out the individual scores and comments given by each of the five evaluators against each evaluation criteria, which in turn feed into the overall quality score. The comments provided by the evaluators consider the merits of each of the various tenders and appear to support the basis of score awarded.

### *Consultancy services framework*

5.100 The procurement for the consultancy services framework was structured into three lots:

- Lot 1 Management Consultancy Services;
- Lot 2 Specialist Consultancy Services; and
- Lot 3 Product and Technology Consultancy Services.

5.101 A long list of 23 suppliers was generated. The RFP was issued to 18 suppliers on 12 February 2014. The procurement and evaluation exercise resulted in 15 suppliers being considered to be of an acceptable standard and included on the framework with eleven suppliers for each lot. Contracts were awarded on 1 April 2015. With eleven suppliers across all lots there is a sufficient number to achieve value for money under a mini competition.

### *Audit and assurance framework*

5.102 The procurement for the audit and assurance framework was also structured into three lots:

- Lot 1 Audit Services;
- Lot 2 Assurance Services; and
- Lot 3 Security Assurance Services (divided into three sub-lots, 3a, 3b and 3c).

5.103 A long list of 22 suppliers was generated. The RFP was issued to 16 suppliers on 26 June 2014. Several companies withdrew, primarily stating lack of industry specific experience[40], and five submissions were received on 17 July 2014 from the following organisations:

- REDACTED

5.104 Following evaluation, all five suppliers were considered to be of an acceptable standard and included on the framework. The contracts were awarded on 3 December 2014. From review of the documentation, we note that REDACTED have been included in the framework rate card tables but their participation in the framework procurement exercise and evaluation is not evidenced.

5.105 Excluding REDACTED, the procurement exercise resulted in REDACTED (as others pulled out due to conflicts). The fewer the suppliers on each lot, the more challenging it is to demonstrate value for money when work is awarded.

### *Our findings*

5.106 We note that whilst the frameworks have been established through a competitive procurement process, this was not a full competitive tender. As a result, DCC may have excluded suppliers who would otherwise have applied. This limits DCC's ability to demonstrate evidence value for money, particularly with regard to the audit and assurance framework, where there are fewer suppliers.

5.107 Ofgem may wish to further explore the circumstances around inclusion of two suppliers on the audit and assurance framework that do not appear to have been included as part of the initial competitive procurement exercise for the framework.

[40] Audit and assurance procurement report, page 5.

### Procurement of the billing system

5.108 We have reviewed documentation relating to procurement of the billing system on a sample basis and discussed the approach with DCC.

5.109 In the LABP and as part of BAFO, Oracle had been put forward as the Service Provider for billing requirements. However, DCC explained that it was only following award of the Licence that they understood the necessary requirements (and that this was not the most appropriate approach) and that all RSC needed to be procured under a novatable contract. For these reasons DCC made the decision to go to market and commence a procurement exercise.

5.110 The procurement process for the billing system included the following stages:

i market testing and supplier engagement;
ii evaluation of shortlisted suppliers;
iii preferred bidder selection; and
iv award recommendation.

5.111 The timetable for the activities undertaken for this procurement exercise are summarised in the table below:

| **Date** | **Procurement activity** |
|---|---|
| October 2013 | CGI engaged to generate a list of potential suppliers (overseen by Capita ITS). |
| February 2014 | Proposals and cost quotations from REDACTED. |
| March 2014 | Board paper on the approval of 'Group SAP' as the supplier. |
| April 2014 | Report produced on the billing systems procurement exercise |
| July 2014 | Contract award approval recommendation paper for the Board |

5.112 As per the above table, DCC commenced the initial stage of the procurement process in October 2013. A decision was made to outsource part of the procurement process to CGI (who is also the FSP for Data Services). The rationale for this is set out in the billing systems procurement report. DCC explained that that was outsourced because specialist knowledge was required and it wanted to use the utilities billing expertise (that it did not have) of CGI.

5.113 It is stated that Capita ITS were "*tasked with overseeing the CGI engagement*". We have not seen any documentation relating to the engagement of CGI by or information on how CGI was procured for this service. This is an issue Ofgem may wish to explore further with DCC.

5.114 It appears that DCC, Capita ITS and CGI were all involved in leading on different stages of the procurement exercise for the billing system. CGI, overseen by Capita ITS, undertook the first two stages of the procurement; market testing and supplier engagement as well as evaluation of the shortlisted suppliers.

5.115 CGI shortlisted five suppliers to take part in an RFP exercise. CGI evaluated these proposals and summarised these as set out in the tables[41] below:

TABLE REDACTED

5.116 As shown in the tables above, the SAP billing system, offered by Capita Group Systems (the Capita SAP billing system) was the highest scoring. However, it was around this time that the requirements/ design for the billing system were changed due to changes in the SEC which had implications for the charging methodology.

5.117 DCC then instructed Capita ITS to assist with completion of the procurement exercise including preferred bidder selection and award recommendation.

5.118 The shortlist was narrowed down to three suppliers (REDACTED). Following the changes to the requirements, all three suppliers increased their bids – REDACTED, although at this stage REDACTED were excluded from the procurement process by DCC on the grounds their solution was no longer 'fit for purpose' and also deemed excessive for DCC requirements as a feasible solution. Following the changes to the requirements no formal exercise was taken to revisit the other suppliers and therefore it is not known whether these would have been able to better accommodate the changes and therefore be a more economic and efficient option.

5.119 The board made the final decision on the contract award. We have seen the award recommendation report which went to the board but we have not seen evidence of the board's confirmation.

5.120 The winning bidder was Capita Group Systems offering a SAP based product, chosen as the best technical and commercial fit at a cost of £REDACTED. DCC have not provided sufficient evidence of the evaluation on which the final award was based and therefore we are unable to comment on the application of the evaluation criteria.

Capita Group Systems.

5.121 We note that the total cost identified for the winning bidder, Capita Group Systems offering a SAP based product, is identified in the second table at paragraph 5.115 above as REDACTED. We have not reviewed proposals and comparability for each of the shortlisted suppliers, nor do we have sufficient information on the cost increases between shortlisting and award and cost comparability at shortlisting.

### *Our findings*

5.122 On review of the procurement of the billing system, we identified the following issues which Ofgem may wish to address with DCC:

5.122.1 there was not a clear sourcing strategy for this procurement at the outset;

5.122.2 the governance arrangements are not clear in relation to the roles of Capita ITS and DCC at various stages in the process; and

5.122.3 there is a lack of evidence on evaluation between shortlisting and final award to support the procurement outcome.

## Procurement of the Document Management System

5.123 We reviewed documentation relating to the procurement of the DMS including the original business case[42] and the board paper on DMS contract approval.

5.124 We understand that the original proposal in the LABP was for Capita (Capita ITS holding facilities) to provide the DMS. However, DCC subsequently identified that Capita could not meet its requirements under the original approach in the LABP as hosting on the Capita cloud was no longer an option due to a security issue. As a result, the original price was no longer available and DCC decided to undertake a competitive procurement.

5.125 Capita Procurement Solutions sourced 11 suppliers able to respond to the DMS RFP. Three suppliers (each offering Sharepoint based solutions) were then invited to demonstrate the suitability of their proposed solution:

- REDACTED.

[42] ICR0006 – Internal Change Request

5.126 A decision was made by the Steering Committee to choose Foundation SP as the Preferred Supplier. The decision criteria were: overall solution costs, value for money; design; implementation; delivery and user adoption. Details of all the evaluation criteria considered are clearly set out in the the board paper on DMS contract approval.

### *Our findings*

5.127 From our review of the documentation provided, it appears that DCC followed a robust procurement process in relation to the DMS using the RFP approach.

### Procurement of ATG

5.128 We reviewed the documentation provided by DCC in relation to the procurement of ATG[43].

5.129 DCC followed the RFP approach and we have seen that a detailed evaluation has been undertaken of the four suppliers who submitted proposals. Following this, the two highest scoring suppliers, REDACTED, were invited to a undertake a presentation.

5.130 Although REDACTED, the contract was awarded to Critical Software. This is because DCC had concerns with REDACTED planning, technical solution and ability to meet DCC's requirements. DCC stated that they would not have been able to contract with REDACTED.

5.131 PARAGRAPH REDACTED.

5.132 We also reviewed correspondence relating to board approval of the business case and authorisation of contract award. A query was raised by a board member on whether DECC was aware of the business case and we have not seen evidence that this was addressed before the contract was awarded.

### *Our findings*

5.133 Although, DCC appears to have run a robust procurement process, there is a potential question as to why the fact that REDACTED did not meet the requirements was not picked up earlier in the evaluation process.

[43] To build a software simulation to enable GBCS to be tested for ambiguity, completeness and accuracy.

### OVERALL FINDINGS

5.134 Our review of DCC's procurement processes has identified two principal issues. These are:

- in some cases, DCC is not following its own procurement processes as identified in its procurement strategy. For example, there is inconsistent or lack of use of sourcing strategies; and
- we found that there was insufficient evidence and detail on the evaluation processes and justification for award recommendations in relation to some procurements undertaken by DCC.

5.135 It is recommended that Ofgem raises these issues with DCC to ensure that it is following the procurement processes it has set out and develops sourcing strategies in line with this. For future procurements, DCC should ensure that there is sufficient detail on the evaluation process including how cost and quality are assessed and weighted and sufficient justification for discounting shortlisted suppliers.

## COST ALLOCATION

5.136 DCC have confirmed that costs are specific to cost centres and there is no allocation or distribution of costs across cost centres in DCC. In particular:

### External costs

5.136.1 Costs for each FSP are specific to that FSP, ie costs are not allocated across CGI, Telefonica and Arqiva. However, for Telefonica, which is split into Telefonica Central and Telefonica South because of the regions they were awarded, one invoice with the total cost of an Impact Assessment is provided. This charge is then split equally between the two Service Providers. Invoices in relation to the cost of a change are issued separately, one for Telefonica South and one for Telefonica Central.

## Internal costs

5.136.2 **Payroll, non-payroll and recruitment** - all resource related costs are allocated to a particular cost centre from the date a person joins the company. The cost centre is the equivalent of a person's team.

5.136.3 **Accommodation** - all accommodation costs are charged to the Corporate management cost centre.

5.136.4 **External services** - the cost of the service is allocated to a particular cost centre depending on the team that has requested/procured or manages the service, eg the cost for the Compliance Officer is all included in the Commercial cost centre as they are the managers of this contract. This was also where the original cost was included in the LABP.

5.136.5 **Internal services** - as for external services, costs are allocated to a cost centre dependant on the team that has requested/procured or manages the service.

5.136.6 **Service management** - relates only to the cost of the Service Desk, which sits in the Operations cost centre.

5.136.7 **IT services** - consists of several IT projects. Costs are allocated to these projects based on direct charges, ie costs invoiced in relation to the Billing project are charged to Billing. Costs received from Capita ITES are broken down by work stream on their monthly invoice and charged accordingly to the correct project. Resources in the business that are working on IT projects are allocated to the projects as relevant, for example the BIMI Project Manager is allocated to the BIMI project. In RY2014/15 most resource costs were allocated 100% to a particular project during a particular period.

5.137 Based on the above, with the exception of Telefonica invoices for impact assessments and some IT services costs (all of which are immaterial) which have been allocated across projects there have been no cost allocations across cost centres or GL accounting codes in the RY2014/15 Reporting Template and therefore it has not been necessary to carry out any specific review work in relation to checking cost allocation.

5.138 We note that there have been a number of transfers of costs between cost centres during RY2014/15. We confirmed with DCC that these transfers are all for resource costs and have been made as a result of roles being moved from one cost centre to another due to changes in work remits in response to external changes, eg service design roles have moved from Operations to Design & Assurance and the testing team no longer report to Design & Assurance but Programme, as the whole activity has moved due to changes in organisational responsibility.

5.139 Therefore, we can confirm that the transfers between cost centres have been correctly accounted for and reported in the RY2014/15 Reporting Template.

## SHARED SERVICE CHARGE

5.140 We reviewed the relevant part of the Financial Reporting Commentary[44] provided with the Submission and relevant supporting evidence. In addition, we discussed the shared service charge methodology with DCC at our site visit.

### REDACTED CHARGE

5.141 A charge of REDACTED was identified in DCC's original LABP. In the RY2014/15 Reporting Template, DCC have applied this REDACTED charge to all internal costs except for identified new scope and third party costs where the lower overhead charge of REDACTED applies (see paragraph 5.148 for further detail). Therefore, the only costs which do not incur the overhead charge are external costs relating to the three FSP contracts.

5.142 The shared service charge of £REDACTED included in the RY2014/15 Reporting Template is therefore calculated as follows:

TABLE REDACTED

5.143 The terms 'overhead charge' and 'shared service charge' are used interchangeably by DCC. DCC describes the REDACTED charge as an overhead charge rather than a shared service charge. Services that are available to all Capita divisions/businesses, including DCC, are covered in this charge.

[44] Section 6 (pp. 19-23).

5.144 We reviewed the list of services[45] provided by Capita included in the supporting evidence folder on Sharepoint (and provided as **Exhibit 2** to this report). These range from traditional indirect overhead costs to services commonly defined as 'shared service activity' such as secretariat services to specific items such as provision of a Non-Executive Director.

5.145 No documentation is available on how the REDACTED charge has been calculated. Our understanding is that Capita undertakes a cost allocation exercise across all its businesses/divisions, allocating costs which do not relate to a limited number of divisions on a number of different bases, as set out in the table included in paragraph 6.1.1 of the Financial Reporting Commentary, including as a division's percentage of total group employees, total group cost base or total group revenue[46]. However, we were advised that additional information in relation to the calculation of the charge is not available due to confidentiality and commercial sensitivity.

5.146 There is no policy documentation in support of the charge from Capita, rather it is based on a commercial decision. DCC state that as far as they were aware this is the rate charged to other Capita divisions. However, it is not able to provide any evidence to support this methodology being applied to other Capita businesses, again due to confidentiality and commercial sensitivity.

5.147 We suggest that Ofgem raise the lack of a clear and reasonable rationale in relation to the shared service charge[47] with DCC and review what the expectation was in relation to this and whether such a charge is appropriate given the services provided.

## THIRD PARTY CONTRACTS

5.148 In the RY2013/14 Price Control Decision, Ofgem queried whether the overhead charge of REDACTED should apply to new scope and third party contracts and has been in discussions with DCC over this issue. As a result of these discussions, the overhead charge has been reduced from REDACTED to REDACTED[48] for new scope and third party contracts (SMKI and P&C).

[45] SE050 Smart DCC Corporate Overheadv0.2.

[46] We note that as revenue and costs in relation to the FSPs are not consolidated into the division and group profit and loss accounts, FSP costs are not included in the calculation of the division's revenue.

[47] Including the rates applied of REDACTED.

[48] REDACTED.

5.149 DCC stated that all available information in relation to the REDACTED charge is included in the Submission and were not able to provide any further commentary. The REDACTED is an amount determined by DCC, based on REDACTED, the rationale for which is set out on page 22 of the Financial Reporting Commentary. We have not been provided with evidence to confirm whether or not the REDACTED is an appropriate rate as it is impossible to determine what additional transactions/costs have been incurred by Capita.

### VALUE FOR MONEY

5.150 Under Licence Condition 16, DCC must demonstrate ongoing VFM in relation to the shared service charge. This was raised by Ofgem in the RY2013/14 Price Control Decision.

5.151 DCC note that due to the nature of the overhead charge it is very difficult to demonstrate VFM. In many cases, it is difficult to quantify as they do not get charged from Capita for some of the services, such as HR workflows, and therefore DCC does not know what these services cost and therefore there is no value to compare.

5.152 However, we note that DCC have committed to undertaking a full review of the overhead charge for the RY2015/16 reporting year and, where possible, will identify values for benefits which can be compared to alternative Service Providers[49].

5.153 During our site visit, DCC confirmed that the review was only in the early stages so the scope had not yet been considered but that it was looking at the options that week and taking a paper to Capita for discussion the following week (early October 2015). DCC stated that it would want to discuss this with Ofgem in order to determine what was needed to provide adequate comfort.

5.154 It was estimated that the review would take three to six months to complete and would therefore be completed by the end of the 2015/16 financial year. It was not yet known whether it would be an internal or independent review.

## RISK MANAGEMENT

5.155 Under Licence Condition 7[50], DCC is required to manage and mitigate its risks. Following the changes and replan (described in paragraphs 3.23 and 3.24) this is of particular importance to ensure that costs are being incurred efficiently. In addition, risk is a criteria for which DCC can apply for a change in its baseline margin.

[49] Financial Reporting Commentary, p.23 (first paragraph).

[50] General controls for the Authorised Business.

5.156 We have reviewed DCC's RMS, and the relevant sections of DCC's Submission for RY2014/15[51]. In addition, we reviewed a sample of supporting evidence and documentation (uploaded to Sharepoint by DCC) including DCC's Risk Management Approach document and risk registers, which are maintained at a number of levels. During our site visit we discussed DCC's risk management approach with DCC's Head of Risk and Internal Control.

5.157 DCC distinguish between governance arrangements for Smart DCC Ltd, the holder of the licensed monopoly contracted to deliver the SMIP and the entity legally responsible for the three FSP contracts, and DCC more broadly, ie including the legal entity and the Service Providers (described in the procurement documentation as 'the DCC ecosystem'). However, there is a lack of clarity in relation to how the 'wider DCC' service is defined and its governance arrangements as a business division within the parent company, Capita. This is an issue Ofgem may wish to consider discussing further with DCC.

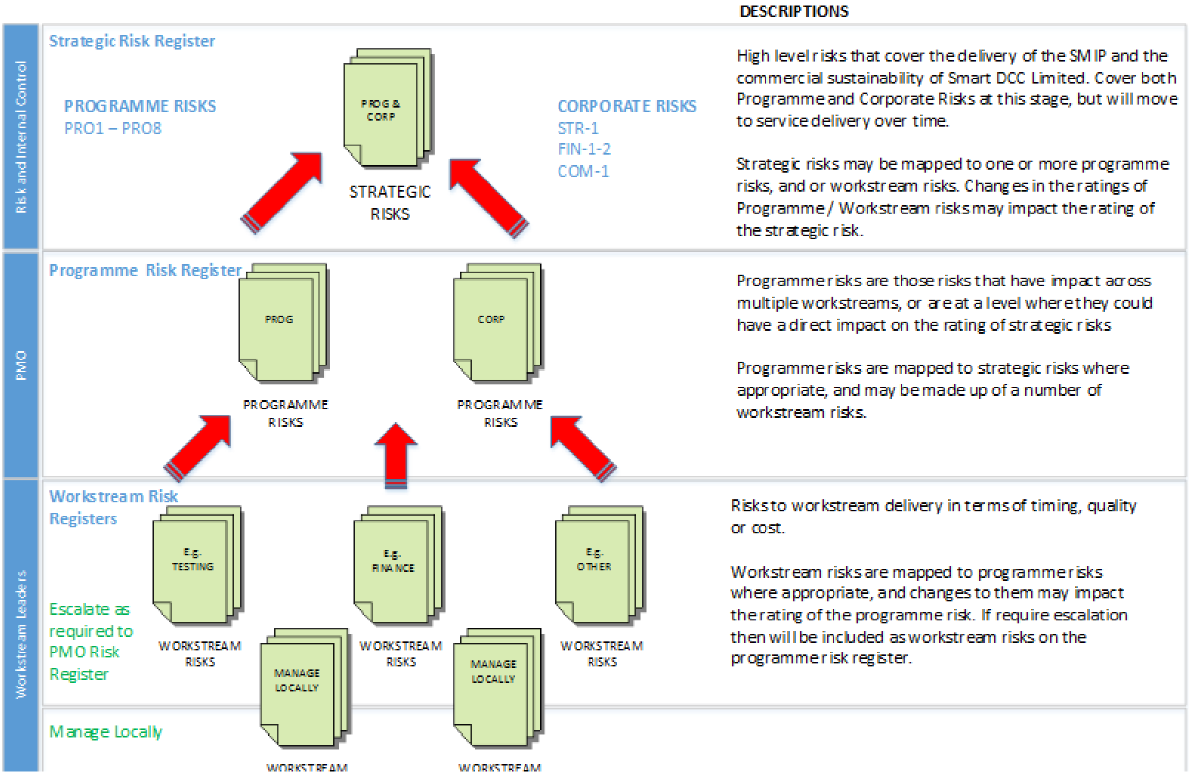
5.158 DCC has a complex risk management framework, partly due to interdependencies with Capita and partly due to the risk management approach and framework it has established for the SMIP.

5.159 In line with licence conditions, there is a risk management strategy in place for Smart DCC Ltd. The risk management hierarchy is summarised in the below table and diagram and explained further in the subsequent paragraphs.

| Level | DCC's risk management hierarchy | | |
|---|---|---|---|
| 1 | Risk management policy and approach for DCC | | |
| 2 | Risk Management Strategy (Smart DCC Ltd) | | |
| 3 | Strategic risk register | | |
| 4 | Programme risk register | Risk Control Matrix | Corporate risk register |
| 5 | Workstream and project risk registers | N/A (standalone document) | Workstream and project risk registers |

[51] Part 2 (Section 4) and Part 3 (Section 2.3).

## Summary diagram of DCC's Risk management hierarchy




5.160 DCC's RMS is a high level document which sets out risk appetite in relation to five broad categories[52]:

- programme;
- economic;
- regulatory;
- reputational; and
- operational.

5.161 DCC's appetite for risk for each of these categories is classified as high, medium or low. All categories are classified as low apart from programme risk where DCC has a 'medium' appetite for risk. The board review DCC's risk appetite each year.

[52] We were asked by DCC to note that some of the categories identified require updating.

5.162 A set of 12 strategic risks have been identified and captured in DCC's Strategic risk register, which is maintained by the Head of Risk and Internal Controls. These risks reflect the high level threats to the delivery of the SMIP by DCC and as a Capita corporate entity, and therefore do not change much month on month. Reports in relation to these risks are provided to the board to review on a monthly basis. The board performs a quarterly risk review to validate the status of Strategic Risk.

5.163 Underneath the Strategic level, risks are divided between two main areas; Programme and Corporate.

5.164 There are various processes and procedures in place for managing these two areas. There is a Programme risk register and a Corporate risk register and there are a suite of workstream risk registers underneath each. The risks included in the workstream registers are day-to-day risks which do not impact the wider programme.

5.165 The Programme risk register is managed by the Programme Management Office (PMO) as per the RMS format. Programme risks tend to be more temporary in nature and can change on a daily basis. The risks identified primarily relate to ensuring that all the technology works effectively on implementation. Below the programme level, risks are broken down into workstream level risks that are maintained by the different workstreams and managed locally. These include:

- programme management;
- design and assurance;
- testing; and
- projects eg billing, SMKI.

5.166 The Programme risk register is currently held on an Excel spreadsheet. DCC informed us that they are planning to transfer Programme risk management to a governance, risk and compliance system (Aspire) to enable them to manage programme risks more effectively.

5.167 The Corporate risk register relates primarily to risks to DCC as a whole, its operations, commercial and financial risks and regulatory obligations. However, DCC recognises the overlap and interdependencies with programme risks[53]. Corporate risks may be identified from a number of sources, the main ones being non-compliance with:

- Licence Conditions;
- SEC administrative requirements eg credit control;
- DCC policies / procedures;
- Capita policies; and
- good business practices.

5.168 At the corporate level, risks are broken down into workstreams including;

- the major replan in 2015;
- financial;
- commercial;
- regulatory; and
- industry.

5.169 In relation to the major replan which was undertaken between February and June 2015, a full risk register was developed, identifying project risks for the replan itself.

5.170 The Head of Risk and Internal Control meets with the PMO each month to consider the impact of each risk to determine whether there are any events which need to be reflected in or promoted in their own right to the Strategic risk register. The Strategic risk register is updated as necessary to reflect the outcome of these discussions and then reported to the board.

5.171 Regular meetings are held between the Head of Risk and Internal Control and workstream managers, who are responsible for ensuring that risks are actively managed and that mitigating actions are reviewed and followed through, to review the workstream registers to determine if any risks need to be promoted to the Programme or Corporate risk register for more detailed risk management.

[53] If control impacts are identified through the review of programme risks then they will be evaluated for their impact on corporate risks.

5.172 DCC stated that the assessment of how robust the mitigating actions are primarily lies with the workstream manager. This is because although the PMO can question the quality of the description noted in the risk register in relation to the mitigation, they are not in a position to assess the actual appropriateness of it.

5.173 On reviewing a sample of risks from risk registers provided, we noted that the impact and consequences of risks materialising were often not sufficiently articulated or described. This makes it challenging for DCC to assess the cost impact. In addition, due to the complexity of the risk management framework, it is not possible to trace some risks through the hierarchy, ie from workstream and project risk registers, to the Programme and Corporate risk registers, to the Strategic risk register and to the categories identified in the RMS. We suggest that this is raised by Ofgem with DCC.

5.174 DCC explained that they measure the impact and probability of risk using a scoring system. It appears that the risks are scored differently in each of the Programme and Corporate risk registers. In the Corporate risk register, risks are scored as per the standard Capita approach (with 1 -4 ratings) whereas Programme risks are as per the RMS (with 1 – 5 ratings). Strategic risks are reported using the same scoring as corporate risks. Furthermore, the 'DCC Major Risk Log – Replan – February 2015' uses percentages to reflect the risk score. DCC stated that the different scoring systems reflect the different nature of risks between the wider DCC (including the Service Providers) and Smart DCC Limited as the Licensee.

5.175 In the Corporate risk registers, the total score for each risk is a multiplication of the two scores identified in relation to impact and probability. However, this does not translate to a monetary value. DCC stated that they are not in a position to identify a monetary value for their risks.

5.176 In addition to the Programme and Corporate risk registers, DCC holds a Risk Control Matrix (RCM) which covers corporate risks/ risks of non compliance. DCC described the RCM as a static document which is not a risk register in itself[54] but sits between the corporate and programme areas.

5.177 The RCM was developed in the first quarter of RY2014/15 and uses a risk/control format to identify controls against the risk of non-compliance with commitments/ requirements. Although it includes risks as a tool, it is not actively used by DCC in the process of managing its risks. It is part of the internal control framework rather than directly part of risk management. Unlike the risk registers, which assess the impact and likelihood of the risks, the RCM only includes the

[54] It is in the same format as the Corporate risk register

outcome of this assessment. Current risks are recorded and managed under the Programme and Corporate areas.

5.178 The Head of Risk and Internal Control will be responsible for ensuring that any new risks, or changes to existing risks, are reflected in the RCM.

### Risk and Baseline Margin application

5.179 As mentioned above, risk is a criteria for which DCC can apply for a change in its baseline margin[55]. There is an expectation that any additional baseline margin applied for should be directly linked to the risks that DCC is actively managing and that these risks should have an identified cost with supporting evidence to justify this.

5.180 We discussed the relationship between risks in the risk registers and those highlighted in the baseline margin application with DCC. DCC stated that the application refers to the specific contractual risk registers for the SMKI and P&C contracts and sets out risks on a macro level, in a level of detail which may not be covered in the risk registers. The criteria for a change baseline margin is that the risks need to be material and therefore there is a concern that if the risks in the baseline margin application are not connected to the risk registers (and this connection is not apparent) then these risks are not being appropriately managed and mitigated in line with the RMS.

### Valuing risk

5.181 As mentioned above, DCC has identified its risk management methodology in terms of scoring the probability and impact of risk. However, DCC does not attach any monetary value to its risks and therefore, the costs of these cannot currently be directly reflected in its Submission. This means that there are no contingency amounts included within the Reporting Template which reflect the risks that DCC identify.

### Licence Condition 7

5.182 Licence Condition 7 sets out the requirements relating to DCC's governance arrangements and risk management and requires DCC to establish and maintain effective arrangements for corporate governance, internal control and risk management so that the environment in which the 'Authorised Business' is carried on is, and will remain, fit for purpose.

[55] The baseline margin is the amount of additional revenue that DCC is permitted to retain over and above its baseline. Its baseline or 'Allowed Revenue' represent the costs that DCC is permitted to pass onto [consumers].

5.183 Part C of Licence Condition 7 states what the RMS must cover. The table below sets out each of the requirements from Section 7.13 of the Licence against which we note the actions DCC has taken to meet these requirements within the RMS.

| **Licence Reference** | **Requirement specified for Risk Management Strategy** | **Our findings** |
|---|---|---|
| 7.13 (a) | Explain the Licensee's attitude to, capacity for, and tolerance of Authorised Business Risk. | DCC sets out its risk appetite in its RMS. |
| 7.13 (b) | Enable Authorised Business Risk to be identified across all of the Authorised Business Activities along with an assessment of the materiality in each case. | Risks are assessed for materiality using different scoring systems for programme, corporate and strategic risks – see paragraph 5.174. Furthermore, the 'DCC Major Risk Log – Replan – February 2015' uses percentages to reflect the risk score. |
| 7.13 (c) | Requires the maintenance of a permanent register of Authorised Business Risk. | The permanent register of Authorised Business Risk is not referenced in DCC's RMS. DCC do not hold one document for this. DCC is of the view that they have addressed this condition by having the Strategic, Corporate and Programme risk registers in place. |
| 7.13 (d) | Requires the maintenance of a plan for the purpose of recovering or continuing Authorised Business Activities after any natural or human-induced disaster. | It is outside the scope of our review to determine whether business continuity and disaster recovery plans are in place. |
| 7.13 (e) | Contain evaluation criteria in respect of Authorised Business Risk that are to be reviewed annually. | There are no evaluation criteria set out in the RMS against which risk will be reviewed on annual basis. The Board reviews strategic risks on a monthly basis and risk appetite on an annual basis. |
| 7.13 (f) | Provide for the allocation of resources in respect of Authorised Business Risk. | Risks have not been valued and therefore no resource provision has been made. We note that DCC do not consider any provision is necessary as they interpret this requirement as providing resource for risk management of Authorised Business Risk, rather than to provide resource for any potential risk outcome. |

5.184 Ofgem may wish to consider our findings in respect of the above requirements and whether, based on these, it is satisfied that DCC has met all of these, as it is required to do so under the Licence.

# 6 COSTS

## INTRODUCTION

6.1 The costs included within the RY2014/15 Reporting Template are summarised in the table in paragraph 4.5.

6.2 Our review has looked at each of these costs in turn, agreeing all material[56] costs included within the Reporting Template to supporting documentation and re-performing calculations where necessary, as set out from paragraph 6.7 onwards below.

### REVIEW OF CONTRACT COSTS

6.3 Our review of the six key contracts DCC has with the external providers responsible for building the smart metering data and communications infrastructure (set out below) raised no areas of concern.

- CGI
- Arqiva – CSP North version
- Telefonica – CSP Central version
- Telefonica – CSP South version
- British Telecommunications Plc - Smart Meter Key Infrastructure (SMKI) Services
- Critical Software Technologies Ltd - Parse and Correlate (P&C) Services

6.4 In managing these providers, DCC distinguishes between the three FSPs who, as noted in paragraph 4.7, were originally contracted by DECC then transferred to DCC when the Licence was awarded, and the Service Providers for other RSC[57].

6.5 In the Reporting Template, costs relating to the FSPs are classified as external costs, whilst costs relating to other RSC are classified as internal costs.

6.6 Our work in relation to these two types of costs is set out below.

[56] As described in paragraph 4.11.

[57] As defined in the Licence and footnote 37 of this report

## EXTERNAL COSTS

6.7 The Reporting Template contains external costs for RY2014/15 amounting to £7.269 million, which is broken down as follows:

TABLE REDACTED

6.8 As set out in **Section 4**, Ofgem has directed that our work in relation to external contracts covers the following:

- trace expenditure from the Reporting Template to the relevant contact (if applicable), and from the contract trace to an invoice(s) or journal;
- trace the invoice through the purchasing systems;
- trace the invoice through the payment system; and
- trace the payments through to the bank account.

6.9 For all RY2014/15 external costs, we have reviewed amounts in excess of the materiality limit of £330,000 (see paragraph 4.11), obtaining an invoice and tracing the payment through systems (ensuring the processes described in paragraphs 5.46 to 5.51 were being followed) as set out above.

6.10 Our detailed testing in relation to external costs is set out in **Appendix 2**, and our findings are summarised, for each of the FSPs, in the below tables[58]:

TABLES REDACTED

6.11 For each of the FSPs, there is an adjustment in the new scope costs[59] for CR035 to reduce the baseline incentive payment in RY2014/15 (and increase it in RY2015/16). This was agreed as part of CR035. This is reflected in the above tables. However, the actual figure included in the Reporting Template for RY2014/15 for baseline costs has not been adjusted as this reflects the amount of incentive payment as the per the baseline contract.

6.12 A breakdown of the impact assessment costs (new scope) for each of the FSPs is included in the Reporting Template sheets 7a to 7d. These were reviewed and it was noted that only two[60] were

[58] REDACTED.

[59] As a result the amounts tested in relation to new scope costs are skewed (with the amount tested being before the baseline incentive payment adjustment), however the total costs tested reflects the true percentage of costs tested for each FSP.

[60] DSP - PR009 Translation of documents to SEC Ready and CSP North - CR084 GBCS v8.0

above £330,000. All others were below £150,000 and therefore no detailed testing was carried out for the majority of impact assessment costs as they comprise several individually immaterial amounts. Hence, the amounts tested in relation to impact assessment costs is low (and £nil for CSP Central and CSP South).

6.13 As set out in **Appendix 2**, some amounts included within the Reporting Template relate to accrued amounts. These represent firm amounts where, in the majority of cases, invoices have been received post year end but as at 31 March 2015 were yet to be paid.

6.14 We have checked the basis for calculation of the accrued amounts and consider that these amounts have been determined appropriately based upon the underlying evidence that we have seen.

### Conclusion

6.15 Our testing of external costs has identified no areas of concern.

## INTERNAL COSTS

6.16 The Reporting Template contains internal costs for RY2014/15 amounting to £REDACTED million, which is broken down as follows:

TABLE REDACTED

### Cost centres

6.17 The Smart DCC team is divided into various functional areas, each headed up by a director, as set out in the DCC organisation chart at **Exhibit 3**.

6.18 It is these functional areas, which form the eight cost centres (as described in paragraph 5.14 of the RIGs) under which DCC report its baseline internal costs in the Reporting Template (as set out in the tables in paragraph 6.22 below).

6.19 Within the Reporting Template, baseline internal costs are reported by costs centres, and then by General Ledger (GL) accounting codes (as set out in the table below). New scope internal costs are also reported by these GL accounting codes.

TABLE REDACTED

6.20 We have therefore split our detailed testing in relation to internal costs between baseline and new scope costs.

6.21 For all RY2014/15 internal costs, we have reviewed amounts in excess of the materiality limit of £250,000 (see paragraph 4.11), agreeing amounts to supporting documentation and tracing a sample of the costs through the purchasing and payment systems (ensuring the processes described in paragraphs 5.46 to 5.51 were being followed).

## Baseline costs

6.22 The below table sets out the RY2014/15 baseline internal costs by costs centres, and then by GL accounting codes[61]:

TABLE REDACTED

6.23 For the majority of cost centres, the only material cost is payroll costs, with the exception of accommodation in Corporate management, service management in Operations and IT services in Programme. Our detailed testing has therefore focused on these four GL accounting codes. Costs in these four GL accounting codes total £REDACTED, ie 76% of the total internal, baseline costs of £REDACTED.

6.24 However, we note that the following in relation to the other GL codes:

- Non payroll costs are resource related costs which can be attributed to individual employees or contractors excluding salaries.
- External services relate to professional/ consultancy fees for services DCC have procured from a provider outside of the Capita group, eg to the auditors, KPMG.
- Internal services relate to the cost of company secretarial services from Capita. (This is a direct service rather than a central service Capita offer to all group companies, which are covered by the shared service charge).

### *Payroll costs*

6.25 The below table sets out a summary of payroll costs by cost centre included in the Reporting Template for RY2014/15:

TABLE REDACTED

6.26 DCC have provided a spreadsheet in relation to payroll costs, setting out payroll data by person by month for each cost centre. This includes the monthly amounts paid to all employees and contractors for salary, benefits, expenses etc. We have reviewed this spreadsheet and performed

[61] REDACTED.

a random sample check of the calculations and reconciliations to the amounts included in the Reporting Template.

6.27 A bonus was paid in February 2015 relating to the calendar year ending 31 December 2014. We have confirmed that amounts in the summary spreadsheet exclude the bonus amount that was paid in RY 2014/15 relating to Jan to March 2014 (which was accrued in the RY2013/14).

6.28 Our work in relation to the testing of payroll costs involved selecting five permanent employees (set out below) and tracing the monthly costs for the selected sample to the costs included in the monthly payroll reports (excel downloads) for May 2014 and February 2015, and then agreeing these amounts to the SAP payroll reports.

| Role | Total £ | May-14 £ | Feb-15 £ | Traced to monthly reports | Agreed to SAP reports |
|---|---|---|---|---|---|
| Managing Director | AMOUNTS REDACTED | AMOUNTS REDACTED | AMOUNTS REDACTED | ✓ | ✓ |
| Regulatory Officer | | | | ✓ | ✓ |
| Industry Partnership Manager | | | | ✓ | ✓ |
| Risk & Internal Control Manager | | | | ✓ | ✓ |
| Design & Assurance Director | | | | ✓ | ✓ |

6.29 Contractors are resourced in one of two ways, dependant on the arrangement DCC have in place.

6.29.1 They can either be managed by Capita Internal Resourcing, who will set up the contract and organise payments to the contractor, and then each month they will send DCC an invoice detailing all the contractors it is being charged for, the number of days worked and the day rate; or

6.29.2 they can be charged to DCC via (i) a recruitment agency (and DCC will approve timesheets through the recruiters online portal), or (ii) a business who will send an invoice with a timesheet attached.

6.30 In relation to contractor costs, we selected five contractors and agreed the costs incurred in August 2014 to the available supporting documentation, ie agreeing costs from each individuals timesheet to the system.

6.31 Our findings are summarised in the following table:

| Role | Aug-14 £ | Agreed to ledger | Detail | Supporting document | Agreed to supporting documenation | Agreed to ledger |
|---|---|---|---|---|---|---|
| Procurement Manager | REDACTED | ✓ | REDACTED | Intercompany journal | ✓ | ✓ |
| E2E Information Architect | REDACTED | ✓ | REDACTED | Timesheets | ✓ | ✓ |
| CSP Testing Assurance Senior Test Analyst | REDACTED | ✓ | REDACTED | Intercompany journal | ✓ | ✓ |
| Business Process Analyst | REDACTED | ✓ | REDACTED | Invoice | ✓ | ✓ |
| Programme Mgr - Service Desk | REDACTED | ✓ | REDACTED | Timesheets | ✓ | ✓ |

6.32 For the avoidance of doubt, we have not verified the suitability of the hourly rates charged to DCC.

### *Accommodation*

6.33 Included within 'Corporate management' is £REDACTED in relation to accommodation costs incurred in RY2014/15, which can be broken down as follows:

TABLE REDACTED

6.34 The Ludgate House charge relates to 11 months of charges (at REDACTED per month) for the space at Ludgate House, which DCC vacated at the end of February. The Ludgate House lease was shared between three Capita businesses, REDACTED. We have agreed the monthly charge to the Internal Accommodation agreement dated 29 May 2014.

6.35 Accommodation costs include an accrual for three months of charges (January to March 2015) in relation to the lease of the second floor of Ibex House totalling £REDACTED and other costs which relate to moving and fitting costs and legal fees associated with the lease of £REDACTED.

6.36 The Ibex house lease is shared between three Capita businesses, REDACTED. The annual cost represents the agreed costs with CBSL for the charge for the whole floor including rent, rates, service charges, utilities, insurance and capex, which is then allocated between the businesses based on square footage occupied.

6.37 As accommodation costs are charged from Capita there are no invoices in support of the costs. DCC have provided a spreadsheet which sets out a breakdown of the accommodation costs, which we have reviewed. In addition, the spreadsheet includes the calculation of the cost structure on which the monthly charge from CBSL to DCC is based. The cost amounts allocated to DCC were estimated to be a monthly charge of £REDACTED as per these workings.

6.38 We have agreed these calculations and agreed the rent, rates, service charges and insurance to supporting documentation including the lease agreement dated 9 September 2014 and email confirmation from the Property and Infrastructure Director of Capita.

### *Service management*

6.39 Included within 'Operations' is £REDACTED in relation to service management charges from Capita ITS for the delivery and provision of the Service Desk services.

6.40 DCC have provided a breakdown of the various transactions which make up the total balance, as well as a breakdown of the monthly charge from ITS. We have reviewed these and agreed the monthly charge to supporting ITS invoices (which are produced in Excel), as well as letters of intent dated 14 August 2014 and 22 December 2014, which provide commercial cover up to a limit of approximately £1 million as there is currently no contract in place.

### *IT services*

6.41 Included within 'Programme' is £REDACTED in relation to IT services incurred in RY2014/15, which can be broken down into the following projects[62]:

TABLE REDACTED

6.42 DCC have provided a breakdown of costs for the five largest projects (in black text in the table above). Our detailed testing in relation to these projects (including agreeing costs to invoice and contracts, where applicable, and to the various ledgers) is set out in **Appendix 3**.

### *CBSL payment testing*

6.43 As noted in paragraph 5.47.2, payroll, accommodation and contracts with Capita divisions, eg Billing, Service Desk, IT services, are paid for by CBSL and then recharged to Smart DCC Ltd in one monthly amount.

6.44 With regards to payments made to CBSL from Smart DCC Ltd, the process for invoicing is as follows:

i calculate total costs, overhead and margin to be recovered in the month;

ii accrue revenue in CBSL with matching cost accrual in Smart DCC Ltd;

iii in following month raise an intercompany invoice and charge to Smart DCC Ltd; and

iv settle invoice 30 days later

[62] The costs in blue text (marked with an asterisk) are below the materiality limit of £330,000 and therefore no detailed testing has been carried out.

6.45 Therefore our testing in relation to transactions paid for by CBSL looked at two months of charges (July and August 2014). We agreed a sample of ten individual transactions to the list of total costs charged in each of these two months. The total value of each month (costs, overhead and margin) was then agreed to the monthly payment to CBSL, as per the CBSL vendor account for August and September 2014 (with payment being made in September and October 2014).

### *Conclusion*

6.46 Our testing of internal, baseline costs has identified no areas of concern.

### New scope costs

6.47 The Reporting Template contains internal, new scope costs for RY2014/15 amounting to £REDACTED.

6.48 Our detailed testing in relation to internal, new scope costs followed the same approach to our testing of external costs (as set out in paragraph 6.8 above) and is set out in **Appendix 4**.

6.49 Our findings are summarised in the below table[63]:

**Internal costs - New scope**

| | GL code | 2015 £m | Total costs tested | % of costs tested |
|---|---|---|---|---|
| Smart Metering Key Infrastructure (SMKI) | ES | AMOUNTS REDACTED | AMOUNTS REDACTED | 100% |
| Testing* | PR | | | - |
| Service Management | PR | | | 88% |
| Performance Auditor* | ES | | | - |
| Industry* | PR | | | - |
| Procurement* | IS | | | - |
| Competent Independent Organisation | ES | | | 100% |
| Financial security & stability | IS | | | 100% |
| Service Provider Audits* | ES | | | - |
| Parsing and Correlation Service | ES | | | 100% |
| ATG | ES | | | 100% |
| Service Provider Compliance Officer* | ES | | | 0% |
| SEC Subsidiary | PR | | | 39% |
| **TOTAL NEW SCOPE** | | REDACTED | **REDACTED** | **85%** |

[63] REDACTED.

6.50 SEC Subsidiary costs comprise monthly contractor fees from August 2014 onwards. All amounts are individually immaterial and therefore our testing involved agreeing a sample of monthly costs to invoices and the relevant ledgers.

6.51 As set out in **Appendix 4**, some amounts included within the Reporting Template relate to accrued amounts. These represent firm amounts where, in the majority of cases, invoices have been received post year end but as at 31 March 2015 were yet to be paid.

6.52 We have checked the basis for calculation of the accrued amounts and consider that these amounts have been determined appropriately based upon the underlying evidence that we have seen.

### *Conclusion*

6.53 Our testing of internal, new scope costs has identified no areas of concern.

## SPECIFIC QUERIES RAISED BY OFGEM

6.54 Ofgem identified some specific queries they had in relation to the 'Quality assurance for reporting spreadsheet', being discrepancies between the figures included in the Reporting Template and the narrative documents which accompanied the Submission.

6.55 We discussed these with DCC and note the following:

6.55.1 'Section 8 – Industry function' of the 'Resourcing the Organisation' document refers to the deferral of two Industry Partnership Managers roles in RY2014/15. We have reviewed the payroll workings spreadsheet provided by DCC and confirm that these two roles are included in the forecast costs for 2016/17.

6.55.2 The average FTE cost change reported in Sheet 9 of the Reporting Template does not appear to tie into the description in paragraph 4.3.2 of the 'Resourcing the Organisation' document. In order to verify the figure included in the Reporting Template, DCC have provided a calculation setting out the workings of how the 8% and the information in Sheet 9 is determined, which we have reviewed. We also note that:

- The information in Sheet 9 for the forecast for RY 2014/15 does not show the new scope costs for each cost centre (instead the FTE in relation to new scope projects are shown as a separate category), whereas in the 'Resourcing the Organisation' document figures the new scope FTE costs are consolidated into the explanation of each cost centre. In addition, Sheet 9 for the forecast for RY2014/15 does not account for the transfers that were made between departments during the year.
- The RY2013/14 forecast in the 'Resourcing the Organisation' document has been adjusted to account for these transfers so that the explanation is provided for a 'real' movement. Sheet 9 represents the figures as they were provided in the prior year report and so does not account for the transfers.

6.55.3 The Financial Reporting Commentary notes that the Operations costs reported for accommodation and external services have decreased relative to forecast costs due to accommodation costs being moved to the Corporate management cost centre. However the increase to the Corporate management outweighs the decrease in Operation costs. We confirmed that this is because there is also a reduction in Programme costs due to accommodation from this cost centre also being moved to Corporate management. (All accommodation costs are now reported in Corporate management cost centre).

# 1 CONTRACT VARIATION TESTING

| Change Request | Change Request Form Completed? | Preliminary Assessment Completed? | Impact Assessment Completed? | Change Authorisation Note? | Cost Challenge | Approval Documentation |
|---|---|---|---|---|---|---|
| CR065 | Yes | No PA (or IA) as the initial work was done as part of a project, through PR003. | No IA as the initial work was done through PR003. Proposal document/ presentation on cost clarification provided | Yes | Challenges made and proposal and costs were reviewed as a result. | Board papers provided. Board resolution confirming approval of £1.25 million but insufficient documentation relating to approval of £7.4 million. |
| CR098 | Yes | Yes | Yes | Yes | Queries raised eg on labour costs. | Board paper and approval seen. |
| CR032a (Telefonica) | Yes | The PA provided relates to CR032b | Yes | N/A – CAN document outstanding | DCC raised queries raised on fixed costs. | Board paper provided. Approval granted by email (confirmation from three Board members seen). |
| CR032a (Arqiva) | Yes | Yes | Yes | Yes | DCC sought clarification on technical and commercial issues. | Board paper provided. Approval granted by email (confirmation from three Board members seen). |
| CR075 (Telefonica) | Yes | Preliminary Assessment provided is not the final version. | Yes | N/A – CAN document outstanding | DCC challenged Telefonica on rates and contract terms. | Email confirming approval by Change Committee seen. |
| CR075 (Arqiva) | Yes | Yes | Yes | Yes | Clarification sought on commercial issues. | Insufficient evidence and clarity on approval (email dated 18.12.14 from Ali Damirchi which refers to elements not approved). |

# 2 EXTERNAL COST TESTING – SCHEDULE REDACTED

# 3 IT SERVICES TESTING – SCHEDULE REDACTED

# 4 INTERNAL COST (NEW SCOPE) TESTING – SCHEDULE REDACTED