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Data Communications Company (DCC): Price Control Decision 2014/15

Final decision

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Overview:

The Data and Communications Company (DCC) is required to report price control information by 31 July, following each regulatory year. It must report in accordance with the Regulatory Instructions and Guidance that we publish.

Each July DCC can also propose an adjustment to its baseline margin values. We assess this proposal and determine whether or not to change the level of margin values agreed when the licence was awarded. We also assess DCC's performance against a set of implementation milestones.

In November 2015 we consulted on our proposals following a review of the report and information submitted by DCC. This document sets out the decisions and reasons for them on the costs DCC reported under its price control for the regulatory year 2014/15 and its application to adjust the baseline margin values under the licence.

We publish alongside this document notices of our Price Control Decisions and Determinations and Directions relating to the calculation of Allowed Revenue set out in the Price Control Conditions in the DCC's Licence.

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

Context

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

Under its licence DCC has to submit cost, revenue, and incentive reporting to the Gas and Electricity Markets Authority (the Authority)[2]. DCC must report on the basis of Regulatory Instructions and Guidance (RIGs) that we publish. DCC must report the relevant data and submit any proposals to adjust its baseline margin values no later than 31 July following each regulatory year.

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

We have assessed and consulted on DCC's costs, revenue and performance against incentives. We have also assessed DCC's proposal for an increase in its baseline margin values. In November 2015 we consulted on our proposed decisions in respect of DCC's price control, its performance against its implementation milestones, and its application to change the baseline margin values. We have duly taken into account all responses received to our consultation. This document sets out our final decisions in respect of DCC's price control and proposal to adjust the baseline margin values. It also summarises the key points received from the consultation and an explanation of the reasons for our decisions.

Associated documents

- Data Communications Company (DCC): Price Control Consultation 2014/15
  https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-consultation-regulatory-year-201415
- Data Communications Company (DCC): Regulatory Instructions and Guidance
  https://www.ofgem.gov.uk/ofgem-publications/88046/dccrigs2014.pdf
- Smart Meter Communication Licence
  https://epr.ofgem.gov.uk/Document

[1] The Smart Meter Communication Licences granted pursuant to Sections 7AB (2) and (4) of the Electricity Act 1989 and Sections 6(1A) and (1C) of the Gas Act 1986. This consultation is in respect of both those licences. Those licences are together referred to as 'the licence' throughout this document.

[2] The Office of the Gas and Electricity Markets Authority (Ofgem) supports the Gas and Electricity Markets Authority ('the Authority') in its day to day work. In this document, 'us/we', 'Ofgem' and 'Authority' are often used interchangeably.

Contents

Executive Summary

DCC has an essential role to play in the energy market. Its performance is critical to the success of the smart meter rollout and enabling suppliers to provide a good service to their customers thereafter. The quality of DCC's service is of paramount importance to the smart metering programme. It is important that DCC receives sufficient funds to play its role well. And it is equally important that we hold DCC to account for delivering high quality services. DCC must ensure these services are provided economically and efficiently as required by the price control mechanism under its Licence.

These are our final determinations for the DCC price control for the regulatory year 2014/15. Our decisions reflect our conclusions on the economic and efficient level of costs incurred in 2014/15 and in the cost forecasts, DCC's performance against agreed milestones, and whether to make an adjustment to the baseline margin values set out in the licence. It follows our assessment and consultation on DCC's costs, revenues, and activities during its first full regulatory year of operation.

Our decisions:

- **During 2014/15 DCC did not provide enough justification for some internal costs therefore £0.409 million are 'unacceptable costs' under the price control conditions of the licence.**
- **We consider that £11.278 million of costs in DCC's forecasts are unacceptable costs and should be removed. This is slightly less specified in our proposed decision published in November, and is because we have concluded that some costs from the industry team are justified, reflecting positive feedback from stakeholders on DCC's engagement.**
- **DCC achieved the implementation milestone (IM) due in 2014/15.**
- **DCC's baseline margin values as stated in the licence should be increased by £0.483 million over the period between 2016/17 and 2021/22.**

In 2014/15 DCC faced some uncertainty given the evolving requirements of the Smart Energy Code (SEC) and a longer lead time for the development of the Great Britain Companion Specification (GBCS) and changes to it. We consider that overall the DCC has made significant progress towards the development and implementation of the smart metering solutions, and managing associated costs during 2014/15. In our cost assessment of 2014/15 costs, we consider that the majority of incurred costs are economic and efficient.

However, we still think that in some cases DCC has not fully explained or provided sufficient evidence and we have concluded that certain costs have not been economically and efficiently incurred[3]. These will need to be excluded from the future calculation of allowed revenue, and correspondingly in DCC's charges. The forecast costs that have not been justified sufficiently should not appear in DCC's forecast. It is possible that in future price controls DCC may be able to justify some of these

[3] We have therefore concluded that some of the Internal Costs are Unacceptable Costs, as is defined under Licence condition 37.8. We have taken into consideration the issues listed in licence Condition 37.9.

costs such that they can be included in the allowed revenue calculation for future regulatory years. If this is the case then DCC must explain variations from the forecasts and justify them as being economic and efficient in the appropriate regulatory year.

The baseline margin adjustment mechanism was included in the licence in recognition of the uncertainty over the nature and risk of DCC's business over time. We have decided to make an adjustment of £0.483 million to the baseline margin values this year, based on the evidence submitted, having regard to responses to the consultation and recognising DCC's increasing role and the complexity of the dependencies it is now managing.

Table 1: Determination summary[4][5]

Cost area	2014/15	Remaining years of licence (Forecasts)
Internal costs	• £0.409 million of costs were unacceptable in 2014/15 - £0.067 million unacceptable resource costs and payments. - £0.056 million unacceptable real price effects (RPEs). - £0.286 million unacceptable costs associated with the shared service charge	• £11.278 million have not been justified as economic and efficient and should not be reported in the forecasts over the licence term. - £5.600 million of resource costs. - £0.581 million of RPE costs - £3.339 million of accommodation costs - £1.757 million of shared service charge costs
External costs	• Costs are economic and efficient and acceptable	
Milestones	• DCC met the Implementation Milestone (IM7)	
Margin adjustment		• Margin adjustment of £0.483 million.

We welcome DCC's commitment to make improvements to their internal policies and procedures, including their risk management, change control and procurement strategies, based on findings from our assessment and the forensic audit review.

We will continue to develop our price control assessment procedure drawing on our knowledge and approaches used elsewhere and feedback from stakeholders. We will build on this learning to establish DCC's Operational Performance Regime later in the year in consultation with industry and to further consider the price control arrangements for DCC's future role in centralising registration.

[4] We have provided DCC with consent so that it can reflect our decisions in its 2015/16 charges.
[5] Note figures may not sum perfectly due to rounding.

1. Introduction

Background

1.1. DCC is a central communications body licenced to provide the communications, data transfer and management required to support smart metering. It is responsible for linking smart meters in homes and small businesses with the systems of energy suppliers, network operators and other companies.

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

1.3. DCC incurs costs and passes these onto users. We have a role in ensuring that these costs are incurred economically and efficiently. Over the licence term the large majority of these costs are incurred by DCC's external service providers, who were appointed through a competitive tendering process. We review these costs after the end of the regulatory year in which the costs were incurred, an approach we call 'ex post'. One of DCC's key responsibilities is to effectively manage these large external contracts and ensure value for money and a good quality of service for consumers. DCC must submit price control information to Ofgem by 31 July following each regulatory year.

1.4. The licence contains an implementation performance regime. This consists of a series of implementation milestones (IMs) 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 margin. We assess DCC's performance against the implementation performance regime.

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

1.6. DCC submitted price control reporting covering the regulatory year from 1 April 2014 until 31 March 2015 in July 2015. DCC also proposed an adjustment be made to the value of its baseline margin at the same time. During this regulatory year DCC had one IM to achieve. In November 2015 we consulted on our proposed minded to position on each of these areas.

1.7. We have fully considered all responses received to our consultation. This document sets out our final decisions in respect of DCC's price control and proposal to adjust the baseline margin values. It also summarises the key points received from the consultation and an explanation of the reasons for our decisions. Please note that we may provide feedback to DCC directly on the detailed points it raised in its consultation response.

Regulatory year 2014/15

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

1.9. This is the second ex post review, and first full year, of DCC's price control. We recognise there have been changes since DCC put forward the LABP, and since it reported last year. The requirements of the SEC have continued to evolve and changes to the GB Companion Specifications (GBCS)[6] have required DCC to re-profile and re-assess the costs and timescales. DCC has also undertaken a number of procurements in response to changes in requirements and scope. However it must provide robust justifications for variations above the competitive costs agreed as part of the competition for licence grant. We also expect DCC to have a strategy in place for ensuring that costs are economic and efficient over the duration of the licence.

1.10. Our ambition for the DCC price control over time remains to move to an ex ante model, similar to the approach taken for gas and electricity networks, and to introduce upfront incentives on DCC to manage the costs of running the data and communications network for smart meters. Introducing ex ante controls for certain costs is something we have sought views on in our consultation on DCC's role in developing a Centralised Registration Service and penalty interest rate proposals.[7]

[6] Both of which have been developed after the licence was granted.
[7] https://www.ofgem.gov.uk/publications-and-updates/dccs-role-developing-central-registration-service-and-penalty-interest-rate-proposals

2. Approach

Chapter Summary

Most respondents agreed with our approach to assessing DCC's costs and performance. In this chapter we outline respondents' views to our approach and specific suggestions on further ways to benchmark DCC's costs in future price controls.

Overview of our approach

2.1. In our November 2015 consultation we explained how we assessed DCC's costs. In accordance with licence condition 37 we assess whether DCC's costs have been incurred economically and efficiently. We compared the costs in the Licence Application Business Plan (LABP), our reference for DCC's bid position, with those DCC submitted in its price control reporting.

2.2. DCC bears the burden of justifying any variations in cost from the LABP and any updated forecast. DCC must provide sufficient justification to demonstrate that the variation in costs is economic and efficient. If we conclude that the costs are not economically and efficiently incurred we will need to consider whether to direct that they be excluded from future calculations of DCC's Allowed Revenue or accept an undertaking in respect of the future management of those costs and future procurement of Relevant Service Capability.

2.3. Our review focused on obtaining a detailed understanding of:

- DCC's cost base (both internal and external),
- the activities DCC undertakes,
- the cause of differences from DCC's licence bid submission and last year's updated forecast,
- the processes it has in place to control costs, and
- the processes it has in place for procurement and risk management.

2.4. To inform our assessment we:

- Conducted a cost visit to help us further understand the drivers behind various cost variances,
- Undertook some initial benchmarking of salaries and benefits to sense check DCC's own benchmarking approach and the conclusions from our cost assessment, and
- Commissioned a forensic audit review of DCC's price control reporting and processes and procedures relating to cost control, planning and budgeting, procurement and risk management.

Consultation responses

2.5. In general respondents supported our approach to assessing DCC's price control submission. The majority of respondents stressed the importance of ensuring that DCC is held account to the LABP and that justification of any cost variations are sufficiently robust. Some respondents welcomed the additional transparency provided by the independent forensic audit report that we commissioned to support our cost assessment and review of DCC's processes. DCC agreed in principle with our approach to cost assessment. They provided more detailed feedback on our approach to specific cost assessment proposals, which is discussed in chapter 4.

2.6. A couple of respondents noted that they were not in a position to understand the true nature of DCC's costs, baseline margin and processes and were therefore reliant on Ofgem to assess whether costs have been incurred economically and efficiently. One respondent mentioned that they would like to see Ofgem take further actions to scrutinise costs to help ensure DCC delivers value for money. Another respondent suggested that Ofgem should also acknowledge that smart meter rollout delays within the DCC may cause external supplier prices to increase.

2.7. Respondents provided a number of suggestions for how to improve our approach, these included:

- Relying less on comparisons to LABP as there has been re-planning and re-baselining and that all costs should be scrutinised even if costs are below LABP.

- Providing stakeholders with a more detailed breakdown of unreasonable costs to improve understanding of costs and to aid future cost reviews.

- Drawing more on our experience of regulating networks and implementing ex ante controls when and where possible. It would give greater confidence to users if costs were subject to scrutiny before they were incurred.

Our response

2.8. Due to the commercially confidential nature of much of the price control information submitted to us by DCC, we are unable to provide a more detailed breakdown of our cost assessment and proposals. DCC has a responsibility to ensure its activities and charges are as transparent as possible for its users. The price control process has a role to play to ensure costs are efficient, but it shouldn't be the main vehicle for DCC's transparency.

2.9. In response to the suggestion that we need to rely less on comparisons to LABP, the price control framework has mechanisms which recognise that the scope of DCC's activities is subject to change over the course of the licence term. DCC must always explain and provide evidence that it has made the most economic and efficient decisions. Licence Condition 37 requires DCC to provide an explanation of material variations between the costs actually incurred and those estimated in the LABP. The RIGs reporting template also required DCC to compare costs against the updated forecasts from the previous price control. The latter will reflect changes in scope since licence award iteratively every regulatory year.

2.10. We consider that an ex ante price control is the best way to provide industry and DCC with cost certainty on an enduring basis. However, while DCC is in the implementation phase, ex post control remains the most suitable approach for determining whether DCC's costs are economic and efficient. We will continue to explore introducing ex ante controls in the longer term through our work on regulating the DCC's post implementation phase.

Suggestions on benchmarking

2.11. We are looking for further ways to benchmark DCC's costs in future DCC price controls. We asked respondents if they had any other sources of data or potential comparators to recommend for subsets of DCC costs.

Consultation responses

2.12. Responses suggested that we should compare DCC costs to other comparable organisations. One respondent proposed it may be useful to benchmark DCC costs against other national infrastructure projects such as Digital Switch Over, HS2 and 800MHz clearance. Another respondent suggested subsets of DCC's activities could be benchmarked against other relevant regulated entities in other sectors.

2.13. Respondents also advised there may be suitable comparators within the energy industry. Project Nexus was recommended as a good comparator in terms of the impact of time slippage on cost, also as a benchmark for accommodation costs.

2.14. There were also ideas about how we could further benchmark DCC's resource costs. Roles within Xoserve, Elexon and Gemserv were suggested as potentially comparable in terms of required skill sets and grades. One respondent suggested there may be comparable roles and skill sets within the telecoms sector.

Our response

2.15. We appreciate respondents' recommendations on potential sources of information and data for benchmarking DCC costs. The responses indicate that there may be further suitable comparators to benchmark DCC's costs. We plan to work with DCC to explore these potential comparator options as part of benchmarking in future price controls.

2.16. We have addressed respondents' specific points about our benchmarking proposals for DCC's 2014/15 price control in chapter 4.

3. Performance

Chapter Summary

DCC achieved the implementation milestone (IM) due in 2014/15. This chapter also summarises respondent views on our assessment of DCC's processes including their approach to risk management and procurement and also summarises User's views of their experiences of engaging with DCC.

Performance against implementation milestones

Our decision

3.1. Our main measure of DCC's performance during the implementation phase is against the implementation performance regime.[8] This lists a series of implementation milestones (IMs) that DCC must achieve in the lead-up to live operations. The regime is designed to encourage performance by putting DCC's margin at risk. If DCC fails to meet an IM by the date specified in the licence then it could lose part or all of margin attached to that IM.[9]

3.2. The licence required DCC to carry out and consult on a review of the due dates and criteria of all the Implementation Due Dates and Implementation Criteria that remain in force in Schedule 3 at the due date of IM4[10]. The Secretary of State directed the changes to the regime on 12 November 2015. We have based our assessment of DCC's performance against the IM's on the new criteria. This means that during RY14/15 only one IM, IM7 (Approval of the Service Management System Design) was due. We proposed in the November 2015 consultation that we consider DCC to have met this IM.

3.3. Having considered consultation responses our position remains unchanged. We determine that DCC is entitled to the entire baseline margin that this milestone puts at risk (£0.314 million).

Responses to our consultation

3.4. The respondents that provided views on DCC's performance against IM7 agreed with our assessment that DCC had met the milestone. One respondent noted that although they did not have access the relevant documentation to make a judgement, they accept that Ofgem have performed a rigorous assessment to determine that DCC had met IM7.

[8] Licence Condition 38 and the implementation milestones are listed in Schedule 3.
[9] Some of the IMs allow DCC to recover any revenue lost if a future IM is achieved.
[10] 28 February 2014

DCC policies and procedures

3.5. DCC now has in place policies and procedures that are designed to ensure value for money and controls on costs. As set out in the November consultation, this is the first year we have reviewed costs that were incurred subject to these policies and procedures, for example in relation to procurement and risk management. In the consultation we outlined the findings from our review of DCC's approach to procurement and risk management.

3.6. We considered that on balance DCC provided sufficient evidence to support procurement outcomes in 2014/15 as being economic and efficient. However we did identify a number of areas where it was unclear whether DCC's procurement policy was being followed. We also had some concerns with DCC's approach to risk management. Based on the information provided to us as part of this year's submission, it was not clear that DCC is managing risk sufficiently through effectively valuing risk and identifying clear mitigation strategies.

3.7. The findings from the independent forensic audit review were consistent with our own review and provided a number of recommendations to DCC to consider in relation to its internal processes.[11]

Responses to our consultation

3.8. DCC disagreed with some of the findings from the forensic audit review on their approach to risk management. DCC disagreed that its approach to risk management lacks clarity. DCC noted that its hierarchical approach to risk management is a response to risks needing to be assessed at various levels within the organisation. They noted that they are taking steps to improve the traceability of risk escalation and that this would be addressed in the risk management strategy which is due to be refreshed in early 2016.

3.9. DCC also responded to the forensic audit assessment on its approach to valuing risk. DCC stated that there was a deliberate decision not to attach a monetary value to risk, and is consistent with their risk management strategy, as they are not convinced that this exercise improves risk management within the DCC. DCC noted that they now plan to use a range of risk values as one of the determinants of risk impact and will continue to value risks that relate to any baseline margin application.

3.10. DCC accepted some of the forensic audit review findings on procurement processes including the lack of evidence that DCC's procurement process had been followed. In response, DCC has reviewed and updated its procurement procedures

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[11] Grant Thornton, Forensic accounting review to inform price control and ex post review analysis for the Smart Metering Data Communications Company – Redacted version, November 2015

which take the findings and recommendations on board and that the procedures will be reviewed again after implementation.

3.11. Some other respondents raised the importance of DCC ensuring that any procurement exercises are robustly administered such that the user community can be confident that services are procured efficiently. One respondent thought that greater scrutiny is required where DCC procures services from the parent company.

Our response

3.12. We welcome DCC's commitment to taking forward the recommendations from the forensic audit review and that any changes will be reflected in their risk management and procurement strategies. We will review this document as part of our broader compliance monitoring activity and continue to provide any further feedback to DCC directly. As part of the price control we will continue to assess any procurement activity each regulatory year to ensure the outcomes are economic and efficient.

Stakeholder engagement

3.13. Our consultation asked for stakeholders and industry parties to provide feedback on their experiences of engaging with DCC in regulatory year 2014/15. The purpose of this was to gain further understanding of the success and potential changes in DCC's engagement strategy. This is to help inform our analysis of the associated costs.

Responses to our consultation

3.14. Overall respondents had positive feedback on DCC's external engagement in 2014/15. Some respondents commented that there was a general improvement in DCC's engagement in the year. Four respondents noted that industry days were helpful. Two responses mentioned that bilateral meetings were also useful. One respondent also found that DCC were particularly good at seeking and responding to feedback.

3.15. Some respondents noted that further improvements could be made in transparency and keeping relevant stakeholders informed of progress. These respondents specifically mentioned being kept informed of changes in costs, plans and charges, the need for DCC to increase its understanding of PPM issues and for greater consistency of approach across teams in DCC. Some respondents also suggested further areas of engagement that might be beneficial in the future, more time on webinars on finance statements in the future, for example.

Our response

3.16. We are encouraged that respondents noted an increasing improvement in DCC's engagement activities in regulatory year 2014/15, and that industry have had positive experiences of engaging with DCC.

3.17. Respondents have highlighted that there are aspects of DCC's engagement strategy that could possibly be improved on in future. Particularly around transparency and keeping stakeholders informed of changes. We encourage DCC to consider these suggestions for future engagement with their users.

3.18. We stated in our November 2015 consultation that feedback from this question would inform our evaluation of DCC's industry performance relative to costs incurred. We include our reasoning for our decision relating to forecast costs in the industry cost centre in chapter 4.

4. Cost Assessment

Chapter Summary

Respondents to our consultation broadly agreed with our proposals. Based on the evidence we have received we consider that the majority of the costs incurred by DCC in regulatory year 2014/15 were economic and efficient.

A small proportion of DCC's costs were considered to not be economic and efficient and we have therefore determined these costs as unacceptable costs under the licence. As such we direct that £0.409 million from DCC's internal costs in 2014/15 are unacceptable and that £11.278 million should not be included in forecasts.

Our decisions

4.1. Over the licence period, DCC's total cost forecast was £1.996 billion. This represented a total increase in costs of £116 million relative to LABP over the licence term, a 6% increase. This is a £49 million or 3% increase on last year's forecast.

4.2. At the bid stage DCC faced a significant degree of uncertainty about future costs. DCC did not know which service providers would be selected; what the service provider solutions entails; and what its obligations to service users would be under the SEC. In 2014/15 a large proportion of the cost deviations from LABP related to external change faced by DCC. These include changing requirements of the SEC and longer lead time and changes to the Great Britain Companion Specification (GBCS) which are a continuation of costs triggered in 2013/14.

4.3. We consider that overall the DCC has made significant progress towards the development and implementation of the smart metering solutions, and managing associated costs during 2014/15. Despite this, the LABP remains a key benchmark for DCC costs in terms of assessing their allowed revenue as required under the licence. We therefore must hold DCC to account for its competitive bid position. Each year DCC needs to provide us with evidence that its incurred costs are economic and efficient and explain any material deviations from LABP and the previous year's forecast.

4.4. In response to our consultation, the majority of stakeholder agreed with our approach and proposals relating to costs. Having analysed responses and any accompanying new evidence we maintain our view about those costs we identified in for 2014/15 as not being economically and efficiently incurred. We have revised down slightly the costs we consider should be removed from DCC's forecasts in relation to the industry cost centre. Stakeholder feedback on engagement with DCC and some further evidence from DCC do satisfy us of the need for increased activity in the industry team in future so we have concluded that these costs are economic and efficient and so are not Unacceptable Costs.

4.5. Under Licence Condition 37, costs that we find were not economically and efficiently incurred by DCC are described as "unacceptable costs". In respect of such costs we are required to direct whether unacceptable costs are to be excluded from any future calculation of DCC's allowed revenues, or to accept an undertaking from DCC on how it will manage unacceptable costs and future procurement of relevant service capability. DCC did not propose an undertaking therefore our determinations on unacceptable costs to be excluded from any future calculation of DCC's allowed revenues are shown in Table 3.

Table 3: Unacceptable costs[12]

Cost Category	Total 2014/15 (£m)	Total over licence period (£m)
Internal Costs		
- Resource costs	**0.067**	**5.600**
- RPEs	**0.056**	**0.581**
- Accommodation costs	**0**	**3.339**
New Scope Shared Services	**0.286**	**1.757**
External Costs	**0**	**0**
Total	**0.409**	**11.278**

4.7 In the remainder of this section we set out our reasoning and decisions on:

- internal costs
- shared service costs
- external costs

Internal costs

4.6. DCC reported an increase of £16 million or 9% in internal costs over the licence term compared to the cost forecasts submitted in last year's price control. This is in addition to the £34 million increase in internal costs over the licence term relative to the LABP, the majority of which related to new scope costs (Smart Meter Key Infrastructure (SMKI) and Parse and Correlate). These are costs relating to activities that were explicitly excluded from the LABP as agreed with DECC during the tender process as requirements were not fully developed at that time.

4.7. Incurred internal costs for regulatory year 14/15 were 11% lower than forecast last year. This was due to DCC re-planning during 2014/15 and further details of their obligations over the licence term being clarified.

[12] Note figures may not sum perfectly due to rounding.

4.8. The remainder of this subsection on internal costs outlines our decision, a summary of consultation responses and reasons for our decision on the following internal costs:

- Resource costs
- Real Price effects (RPEs)
- Accommodation costs

Resource costs

4.9. Our decision is that £0.067 million of inefficient costs from 2014/15 are unacceptable costs, the same position that we consulted on in November. We have also determined that £5.600 million of future costs have not been justified as economic and efficient. This is a slight reduction from our proposal and reflects some future costs that we now consider acceptable as part of the industry cost centre[13].

4.10. Costs removed from forecasts may be allowed in future price controls if DCC provides sufficient evidence that they are economic and efficient in the future at the time they are incurred. Our decision that these costs are unacceptable follow from DCC's failure to sufficiently evidence the need for certain roles in the future, and the lack of justification for assumptions underpinning DCC's resource benchmarking methodology.

4.11. These costs fall into three categories:

- Unacceptable resource costs in both 2014/15 and forecasts owing to poor justification of the assumptions underpinning DCC's benchmarking analysis.
- removing resource costs from the forecast due to insufficient justification and certainty that they will be needed on an enduring basis.
- removing forecast increases in industry cost centre due to insufficient justification and certainty.

Benchmarking: Consultation responses

4.12. Most respondents were supportive of our proposals. Three respondents commented that benchmarking resource costs at the 50th and 75th percentiles seems very high. Some commented that the 50th should be the maximum percentile to benchmark against. DCC said they consider benchmarking a useful guide, but not a definitive answer to determine cost. DCC also provided some examples in their

[13] See the section on industry costs below for more detail.

response where they had experienced practical difficulties recruiting appropriately qualified staff at below the 50th to 75th percentile.

4.13. In relation to contractor roles, one respondent noted the advantage of contractors in terms of flexibility and their ability to gain knowledge quickly. They noted however, that contractor arrangements should include plans to transition to the use of permanent employees over time. The same respondent also stated that there was a risk that contractors sourced from DCC's parent company or affiliates without external benchmarking could lead to uneconomical rates.

4.14. DCC noted that contractors are a difficult area to obtain appropriate benchmarks for but said that it will look to provide additional evidence for future recruitments. DCC anticipates that rates will continue to be above the 50th percentile going forward, due to the specialist nature of the resource involved.

Reasons for our decision

4.15. We recognise that benchmarking is not always a definitive comparison for every role, and it may be appropriate to benchmark different roles to different percentiles. However in the cases of costs that we have determined are unacceptable, we do not consider this sufficient justification for why remuneration in some cases has been above the 50th or 75th benchmark percentiles.

4.16. We agree that there should be further work done by DCC to provide evidence that their contractor rates are economic and efficient. We expect to see this in future years.

4.17. We do not consider that the additional information provided by DCC suggesting they had difficulty recruiting a sample of roles is sufficient to change our decision from that set out in our consultation paper.

Justification for roles: Consultation responses

4.18. DCC remains of the view that a number of the roles that we proposed should be removed from forecasts will be required on an enduring basis to meet key team objectives. This includes the finance team providing analysis on DCC's changing cost base to internal and external stakeholders.

4.19. One respondent commented that they had concerns about DCC's increasing staff numbers in general.

Reasons for our decision

4.20. We maintain our proposed position on the removal of roles from forecast that we do not think are enduring. If DCC does consider that these roles are economic and efficient in future, they will need to provide sufficient evidence.

Industry costs: Consultation responses

4.21. DCC disagrees with our proposal to remove cost increases above 2014/15 levels from the industry cost centre. DCC clarify that some of the staff in Industry were recruited during 2014/15, and therefore resource costs will increase next year as they will incur a full year costs for these roles.

4.22. DCC also outlined that there is still more that can and should be undertaken by the industry team.

4.23. As part of our consultation we asked stakeholders for views from DCC's stakeholders and industry participants to evaluate performance relative to cost[14]. Respondents overall were positive about their experiences with DCC and also noted that there were further activities or improvements they expect to see from DCC in future years.

Reasons for our decision

4.24. We recognise that DCC may need to increase their engagement, and therefore increase cost above the amount spent in 2014/15. However DCC did not evidence that these costs were likely enough to be included in their forecasts.

4.25. Stakeholder responses to Question 5 of our consultation, along with some of the further activities listed by DCC in their response, do evidence the need for increased activity in the industry team in future. However we maintain our position that DCC has not provided evidence to give sufficient certainty as to when or why deferred roles in this cost centre will be needed.

4.26. Therefore we determine that the total cost of the deferred roles over the licence term should be removed from the forecasts but that non-resource costs such as services employed to facilitate engagement with industry within the forecast are acceptable. This represents a small reduction in costs that we proposed DCC should remove from forecasts in the consultation.

Real Price Effects (RPEs)

4.27. RPEs are the assumptions DCC uses to take account of input inflation over time. The purpose of this is to ensure that costs reported for the relevant regulatory year are reported in nominal terms. We proposed a reduced RPE for generalist jobs, and that a consistent approach to RIIO[15] should apply given the lack of any evidence to justify a different approach. We have only allowed RPE increases of 0.5% for

[14] A summary of these responses can be found in Section 2
[15] RIIO (Revenue=Incentives+ Innovation+Outputs) is Ofgem's framework for setting price controls for network companies.

generalist roles as we believe the RIIO approach is appropriate. We do not think that DCC generalist roles are significantly different. Where cost areas include specialist resource we have accepted DCC's methodology.

4.28. As a result we determine that £0.056 million of inefficient RPE costs from 2014/15 are unacceptable costs, and £0.581 million future costs have not be justified as economic and efficient and should be removed from the forecasts.

Consultation responses

4.29. Most stakeholders were broadly supportive of our proposals. There was acknowledgement that RIIO was not a perfect comparator but that it should still be an important reference point for DCC. One respondent questioned why RPI was being used as the reference point rather than CPI, given RPI is no longer a designated national statistic by the Office for National Statistics.

4.30. DCC disagreed with our proposals. Its view is that following the RIIO approach was not appropriate given it faces an ex-post price control framework.

Reasons for our decision

4.31. In making our decision, we assessed the assumptions made by DCC. Our decision to disallow costs relating to general labour RPEs is because we think an RPE of 0.5% is more appropriate for generalist roles than the assumptions proposed by the DCC. We recognise the position for specialist roles may be different.

4.32. The 0.5% is based on the RIIO approach. This approach uses a sample of DNOs to estimate the RPEs. We recognise the RIIO estimate is not completely comparable to DCC, for example its general labour composition is likely to differ to some extent. However, we consider it to be the most robust, evidence-based estimate of general labour input inflation for DCC. In the absence of a well-justified alternative set of assumptions put forward by DCC we consider it reasonable to use the RIIO approach.

4.33. In coming to our decision we considered DCC's suggestion that it's not appropriate to apply the RIIO approach given its ex-post price control framework. However, we do not consider DCC's price control framework to be relevant context for the purposes of estimating its input inflation rate for generalist roles.

4.34. In future, we would welcome alternative RPE assumptions that are more specific to DCC, providing they are well-evidenced and based on an element of external benchmarking.

4.35. There was some confusion from stakeholders on how we applied the RIIO approach. For example one respondent said, "we do not agree that the generalist roles in effect gain +2.6% versus their RIIO counterparts (from -1.9% to +0.5%)". To clarify, the RIIO RPE for generalist labour is -1.9% *relative* to RPI in 2014/15. Given an RPI of 2.4%, this implies an inflation increase of 0.5%.

Forecast accommodation costs

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

4.37. DCC's justification for the amount of space required was not sufficient. We found a lack of evidence supporting their assumptions regarding visitor numbers and also the growth expectations DCC provided were unclear and in some places inconsistent. We think DCC is well placed to make savings on accommodation in the years ahead and the commercial arrangements have been struck to enable this. As such we consider that the £3.339 increase in accommodation costs are unacceptable costs and so should be removed from the forecasts. DCC may in future be able to justify the amount of space procured or make arrangements with Capita to lease back the excess space.

4.38. Our decision is that the £3.339 million are unacceptable costs and should be removed from the 2014/15 forecast costs. This is consistent with our November 2015 consultation position.

Consultation responses

4.39. DCC emphasised that its methodology to decide on the sizing of its office was to avoid under or over investment, in order to have an office that could deliver requirements efficiently. They say that the accommodation space they have procured is primarily driven by headcount requirements, square footage utilisation and percentage of agile working. DCC noted that Ofgem have accepted the majority of DCC's additional forecast resource costs as economic and efficient, and therefore the additional space in future should be justified for this additional resource.

4.40. DCC also provided additional evidence on visitor numbers for September to mid December 2015.

4.41. Other respondents thought that DCC should seek greater efficiencies in accommodation costs. This was particularly in regard to location and also long term needs of DCC services. One respondent noted that a central London office adds additional costs, such as London premium on salaries.

Reasons for our decision

4.42. We continue to hold the view that DCC has not sufficiently justified the space it requires within its office. This is due both to the uncertainty involved in DCC's assumptions for future headcount and visitor numbers and the justification for the amount of space required per person. We therefore do not agree that we should simply allow accommodation costs associated with additional roles we have allowed in its 14/15 forecast.

4.43. Given the uncertainties that exist around DCC's headcount and visitor numbers during implementation, we think it is important for DCC to maintain flexibility in their accommodation arrangements. This is to enable them to be able to adapt and incur costs economically and efficiently in the future.

Shared Service Charge

Our decision on shared service charge

4.44. The shared service charge is an amount paid by DCC for shared services resourced from DCC's parent company, Capita. The charge is applied as a percentage of internal costs set out in the LABP and was agreed as part of the licence competition. We recognise that the costs within the LABP (including the shared service charge) should be considered as economic and efficient. However, we remain concerned that DCC has not provided any evidence that the shared service charge applied to new scope costs is economic and efficient.

4.45. Our position remains unchanged from our consultation. We have not received any new evidence from DCC to allow us to determine that the shared service charge applied to new scope third party contracts is economic and efficient.[16] As a result, we determine that £0.286 million costs in 2014/15 are unacceptable and that £1.757[17] million costs over the remainder of the licence term should be removed from forecasts.

4.46. We expect DCC to provide evidence that the shared service charge delivers value for money for users and ultimately consumers. A lack of evidence to support that the shared service charge is economically and efficiently incurred could lead to a conclusion of a cross subsidy to Capita, which is prohibited under the conditions of the DCC licence.

Consultation responses

4.47. DCC and one other confidential respondent disagrees with our proposal on shared services stating it is inconsistent with what was agreed at licence award and that the benefits delivered via the shared service charge are essential for DCC. Both respondents stated that without these central service benefits provided by the parent company, DCC would not have sufficient flexibility to meets it requirements and the service it provides could be more expensive. DCC stated that there is not a linear relationship between the shared service charge and the services that it benefits from.

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[16] The third part contracts are associated with the Smart Meter Key Infrastructure (SMKI), Parse and Correlate, and Automatic Testing of GBCS (ATG) contracts, and with the financial stability and security.
[17] Note this small reduction compared to the figure we consulted on is due to the shared service charge associated with the reduction in internal costs that we require DCC to remove from forecasts.

4.48. Other respondents who mentioned shared services specifically supported our view that DCC must demonstrate that shared service costs deliver value for money. One respondent questioned the appropriateness of shared services being linked to internal costs given that internal costs have increased significantly.

Reasons for our decision

4.49. We accept that the level of shared service charge applied to baseline costs is economic and efficient because they were included as a result of the licence competition. We recognise that the DCC benefits from its parent company's services. However, the DCC needs to provide evidence to support and explain the benefits it receives in relation to its shared service charge.

4.50. We have not received any evidence from DCC on how the new scope third party contracts have drawn on the shared services or why the specific charge applied delivers value for money. We therefore do not determine this cost as being economic and efficient. We remain concerned that DCC has not provided any evidence of a process for checking that the ongoing cost it is charged by Capita is economic and efficient.

External costs

4.51. External costs comprise the costs of the communication service providers (CSP) and the data service providers (DSP), which are defined under the licence as fundamental service providers.

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

Our decision on external costs

4.53. DCC has provided evidence that the variation in external cost was economic and efficient for regulatory year 2014/15. We therefore determine that these are acceptable costs.

Consultation responses

4.54. DCC welcomed our proposal to accept changes that the variation in external cost was economic and efficient. DCC also plans to take on board the recommendations provided in the forensic audit review in relation to the external change processes and have put improvement plans in place. No other respondents commented specifically on our proposal on external costs.

Reasons for our decision

4.55. As outlined in the November consultation, in our view the variation in external cost has been made on reasonable grounds. The forensic audit review of the key contracts that DCC has with external providers raised no areas of concern in relation to verifying the external costs reported in DCC's price control submission.

4.56. DCC provided sufficient justification for drivers of change, options considered, benchmark assessments, savings they achieved from contractual negotiations and the final component costs of each solution. However the forensic audit review made some recommendations about the approval process of change requests. Approval documentation was inconsistent across the sample of change requests reviewed and the auditors found incomplete evidence trails in some cases.

4.57. External costs are expected to increase significantly for 2015/16 compared to the magnitude of increase for 2014/15 and we expect DCC to provide clear evidence that these variations are economic and efficient. We are encouraged to note that DCC is putting improvements in place in response to the forensic audit review regarding the change control process.

5. Revenue reporting

Chapter Summary
DCC calculated its allowed revenue as being £33.8 million in 2014/15. As a condition to our direction on the unacceptable costs, we are also requiring DCC to restate its calculation of the 2014/15 allowed revenue to reflect our determinations by 31 July 2016.

5.1. Allowed revenue is defined in licence condition 35 and calculated in accordance with the Principal Formula set out in licence condition 36.[18] It is the total revenue DCC is entitled to recover from users. Under the price control arrangements DCC incurs costs and passes these onto users by way of service charges. DCC's regulated revenue is the actual revenue, measured on an accruals basis, received through service charges.

5.2. The costs published under the indicative charging statements and budgets are different to those under the price control. This is because under the price control DCC can only report economic and efficient costs. When it sets its charges, DCC must take all reasonable steps to secure that its regulated revenue does not exceed a prudent estimate of its allowed revenue. We have no role in approving DCC's service charges in advance; these are set in the DCC's charging statement. Indicative charging statements and budgets are available on DCC's website (www.smartdcc.co.uk).

Allowed revenue

5.3. In 2014/15 DCC's reported allowed revenue was £33.792 million, almost £1 million less than forecast in the previous year. Our determinations mean that £0.409 million should be reflected in lower charges in future years, this will be reflected through the calculation of the correction factor in the Principal Formula. This reflects our decision to exclude internal costs we found not to be economically and efficiently incurred in 2014/15.

Allowed revenue in forecasts

5.4. DCC's forecast allowed revenue over the licence term increased by £101.8m in its 2014/15 reporting compared to the previous year.

5.5. We have also determined that £14.108 million are unacceptable costs and should be removed from the forecast costs over the remaining licence term. A calculation error in pass-through costs accounts for £2.830 million of these costs, we

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

propose that the £11.278 million of unacceptable costs should be removed from forecasts as DCC has not justified them as economic and efficient.

When charges should be returned

5.6. We are providing DCC with consent to allow it to adjust its 2016/17 charges with less than 3 months' notice, so that it can reflect the decisions on the unacceptable costs and adjustment to the baseline margin.[19]

5.7. As a condition of our direction on the unacceptable costs, we are also requiring DCC to restate its calculation of the 2014/15 allowed revenue to reflect our determination on unacceptable costs by 31 July 2016.

Consultation Responses

5.8. There was broad support from respondents that our determination on allowed revenue adjustments should take effect from April 2016.

Prudent estimate

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

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

5.11. As stated in the consultation document, while we recognise the level of uncertainty DCC has faced in its first years of operation, we remain concerned by DCC's approach to the prudent estimate in 2014/15. We asked for respondents views on the DCC's approach to the prudent estimate in the November 2015 consultation.

Consultation Responses

5.12. Consistent with consultation responses from last year's price control consultation, a number of respondents raised concerns with DCC's approach to the prudent estimate provision and on the issue of potential over recovery. Some

[19] Under Licence Condition 19 our price control decision can be an exception to the requirement for three months' notice.

respondents provided recommendations on how the approach could be improved including a suggestion that excess balances are invested in the short term with yields returned to contributors and that greater transparency could be provided to Users on DCC's working capital. A couple of respondents mentioned their support of our proposals on introducing a penalty interest rate for over recovery beyond a materiality threshold.

5.13. DCC responded stating that they consider their approach to the prudent estimate of Allowed Revenue in 2014/15 to be appropriate. They provided explanation of how they develop their cash flow forecasts and the controls in place to manage the prudent estimate of Allowed Revenue efficiently.

5.14. One respondent disagreed with the DCC's use of the prudent estimate and raised a concern that the industry has not received the full over-recovery from regulatory year 2013/14.

Our response

5.15. Given the continuing uncertainty in future costs we consider that the prudent estimate provision is still appropriate to ensure that service charges do not need to be amended in the course of the year except in response to a reasonably unlikely event.

5.16. We share respondents concerns on whether DCC has the right incentives to manage the prudent estimate. As a result we consulted on whether the prudent estimate provisions in DCC's licence should be amended. In December 2015 we consulted on our proposal to amend the licence to introduce the power for the Authority to direct some form of penalty interest rate for over-recovered charges. This proposal was strongly supported by stakeholders to ensure DCC has the right incentives to forecast accurately. We plan to reissue our statutory consultation in March 2016 to clarify the intended effects of our proposals and propose revised licence drafting to bring into effect our proposals.

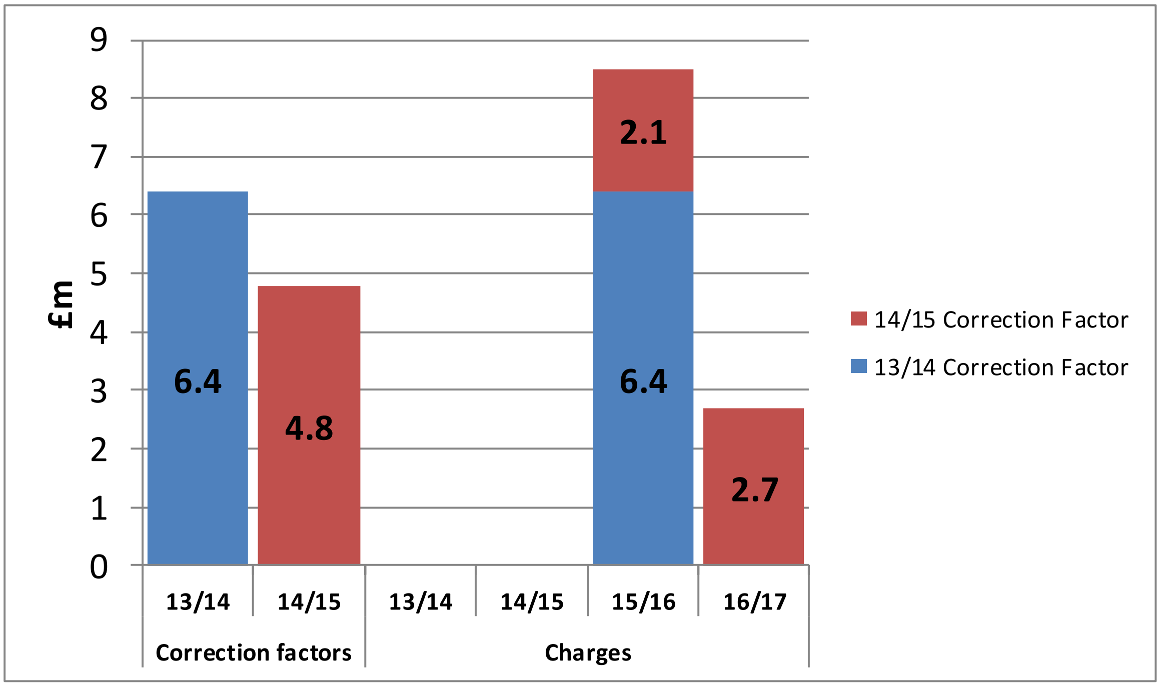
Clarification regarding the repayment of over-recoveries

5.17. In response to a respondent's concern that industry has not received the full over-recovery from regulatory year 2013/14, we have clarified below how this is returned to the industry via charges.

5.18. The correction factor element of the Principal Formula reflects DCC's over-recovery, and this is returned to users in the form of lower charges in subsequent years. It is important that charges are returned to users as soon as possible. However, given the correction factor is only finalised after the end of the regulatory year, and part way through the following regulatory year, there will always be a lag in returning the over-payments. This lag can be offset to some extent by DCC's forecasts of the correction factor which it factors into its charges.

5.19. In the consultation, we noted that the correction factor for 2014/15 was reported in the RIGs as £11m. This is made up of a correction factor of £4.8m for 2014/15, in addition to the correction factor for 2013/14 of £6.4m. The 2013/14 correction factor is incorporated in 2015/16. The 2014/15 correction factor will be returned to users via charges in 2015/16 and 2016/17.[20] DCC estimated that the 2014/15 correction factor would be £2.1m and built this into its 2015/16 charges. The remainder from the actual correction factor will be passed back to users via the 2016/17 charges. The figure below provides an illustration.

Figure 5.1. Timing of how DCC returns overpayments to users via lower charges



Source: DCC charging statements

[20] The final correction factor for 2014/15 will be finalised when DCC updates its RIGs to reflect the decisions on the unacceptable costs and baseline margin adjustment.

6. Baseline Margin Adjustment

Chapter Summary

DCC proposed an adjustment to the value of its baseline margin values for each of the remaining years of the licence term. We assessed its proposal against the criteria in the licence. One element of our consideration in making our determination was the appropriate level of the rate of return, which we consider should be 15% in respect of this regulatory year, therefore we determine that a relevant adjustment be made to DCC's baseline margin of £0.483 million over the licence.

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

6.2. We assessed a proposed DCC adjustment over the course of the licence term to the baseline margin value of £3.114m. The proposed adjustment composed of two variations:

- **Variation one** - £0.474m relating to changes to the volume and timescales of the activity in 2014/15.
- **Variation two** - £2.637m relating to changes in DCC's exposure to risk between 2014/15 and 2021/22 related to the new contracts for SMKI services and Parse & Correlate (P&C) software.

Our decision

6.3. We determine that DCC's proposed adjustment was duly made this year.[21] As outlined in the consultation document, we assessed DCC's proposal and amended the variations proposed by DCC based on the following:

- **Variation one** - we removed any resource costs that were either deemed to be uneconomic and inefficient under our price control assessment or that should have been included at bid. We consider that the remainder meets the criteria.
- **Variation two** – we reassessed the variation relating to risk based on the residual risk value rather than the contract value as originally applied for by DCC. Our position remains unchanged from the November consultation.

[21] As stated in the licence and in our Guidance document an application for a baseline margin adjustment from DCC must be duly made.

We continue to hold the view that there has been some increase in DCC's contract risk exposure due to the SMKI and P&C contract, which also includes some reputational risk. Our position remains unchanged that the evidence provided by DCC against the remaining risk categories does not warrant an adjustment.[22]

Consultation responses

6.4. Most respondents who commented on this question were supportive of our assessment. One respondent felt that DCC's proposals related to risks it should have priced into its bid for the licence. They believe that an "exceptionally good case" with "compelling evidence" must be made for any increase in margin in order to remunerate DCC for risks it did not price in at bid.

6.5. DCC welcomed our proposal to adjust the baseline margin value to reflect the additional activity and risks. However, it disagreed with our proposals to not consider the majority of the risk categories it identified in its application as being eligible. DCC also clarified that it did not price in the margin and risk for SMKI services and P&C at bid as the scope and costs could not be quantified with any degree of certainty at the time. As such, DCC considers that the baseline margin values agreed at bid did not reflect these contracts, and it envisaged that it would be able to adjust its margin through this adjustment mechanism.

Reasons for our decision

6.6. In coming to our decision we assessed DCC's proposed adjustment against the criteria in the licence. We paid particular attention to the evidence provided by DCC. We assessed whether it was sufficiently strong to demonstrate a material change relative to bid and the information available at the time.

6.7. Where DCC provided sufficient evidence to demonstrate a material change we considered it to be eligible for a margin adjustment. For example, we consider that the increased complexity of SMKI services and P&C relative to the expectation at bid may lead to an increase in DCC's residual contract risk exposure. However, where there was not sufficient evidence to demonstrate a material change then we considered DCC to be ineligible for a margin adjustment. We will provide DCC with more detailed feedback on the aspects of its application that failed to meet the criteria.

[22] See chapter 6 in the preceding consultation document for more discussion on this: https://www.ofgem.gov.uk/sites/default/files/docs/dcc_price_control_consultation_regulatory_year_201415.pdf

Rate of Return

6.8. In determining any Relevant Adjustments to DCC's baseline margin the licence requires us to have regard to the DCC's expected rate of return on its activities over time[23]. We considered the unique nature of DCC's ex-post regulatory framework, and its limited fixed and intangible assets. We have also considered the definition of baseline margin in the licence as an amount above the licensee's costs, and the influence of this on DCC's expected return in bidding for the role. We proposed that the sales margin (or its earnings as a proportion of revenue) to be the most appropriate measure of DCC's return.[24]

6.9. As outlined in the consultation document, recognising the challenges in making an assessment of the expected rate of return, we proposed two options for the percentage margin to apply to DCC's proposed variation to arrive at the final adjustment to the baseline margin, and sought views rather than setting out a proposed approach. The options were:

- **10%-** We proposed this margin rate based on a comparison with different types of companies which have some similar characteristics to DCC. We proposed the higher end of the IT systems providers in the energy sector margin range is justifiable due to the level of risk, uncertainty and innovation that DCC faces.
- **15%-** This margin is what was agreed as the rate of return at licence award, which was established as a competitive market rate through the licence tender process. We proposed that this could be justified on the basis of proximity to the time when the margin was agreed at licence award.

Our decision

6.10. Having considered the issue and the responses to the consultation, we consider that 15% is the appropriate of return for the specific application for a baseline margin adjustment made by DCC alongside its 14/15 price control submission. Therefore we determine that DCC's baseline margin adjustment should be adjusted by £0.483 million over the course of the licence[25].

Consultation responses

6.11. DCC and one other confidential respondent consider that 15% is the appropriate rate of return. DCC stated that this is the margin agreed at licence award and was the outcome of a competitive process. They also noted it has only been two

[23] Licence condition 36 Appendix 2 para A10.
[24] It is challenging to apply approaches that measure return on capital to an asset light company such as DCC.
[25] The accompanying decision notices to this document states how the adjustment affects the baseline margin for each year of the licence.

years since the licence award and that during this period the volume and complexity of activities required of DCC has increased due to factors outside of DCC's control and which were not envisaged at the time of Licence award. Specifically in relation to the variation on risk, DCC noted that the risk that it is exposed to in relation to the SMKI and P&C Software contracts is at least as great as other third party contracts to which a 15% margin was applied in calculating the baseline margin at licence award.[26]

6.12. DCC also included an external report to challenge the conclusions from our comparator methodology and the choice of 10% as a reasonable comparator. The key findings from the report state that DCC does not have a perfect comparator and that a rate of return of 15% was reasonable on the basis of a greater number of comparators compared to our methodology. The report also notes that given DCC is still in its implementation phase that perhaps established companies do not make appropriate comparators. DCC concluded that they do not consider that any such methodology is fit for purpose given the lack of suitable comparators.

6.13. The remaining respondents who responded to this question had varying strength of views on why the 10% should be the rate applied. Some respondents supported our proposal that 10% is a reasonable margin rate to consider relating to the baseline margin application. Some went on to say that they believed there to be reasonable comparators in the competitive energy sector even though DCC is a regulated company. One respondent noted that they are sympathetic towards DCC for expressing that the margin should be 15% but that in their opinion this rate of return is too high for a regulated company.

6.14. Other respondents voiced a stronger opinion that no more than a 10% rate of return is acceptable and that Ofgem should make sure DCC provides sufficient justification for the case that it has greater risk exposure compared to IT projects in a similar environment. One respondent stated that they were not convinced by our approach for why a rate as high as 10% should be applied.

6.15. In response to our request for views on the rate of return methodology some respondents agreed with our approach, stating that it provides good benchmarks for assessing the DCC baseline margin adjustment rate. One respondent suggested that we could consider weighting the different comparator margins based on the proportions of work the DCC undertakes that are similar to comparator groups of companies.

6.16. Other respondents felt that they did not have enough detail of our approach to comment. One company mentioned that greater justification is needed for how we arrived at 10% especially if we plan to use this approach for future adjustments. Finally one respondent disagreed with our approach stating that the net margin should be derived from the cost of capital. They went on to say that the cost of

[26] DCC also state that these contracts in fact carry more risk to DCC than enterprise systems such as the billing system.

capital should be similar to the risk free rate of return as DCC is a monopoly and not liable for external service provider risk.

Reasons for our decision

6.17. The primary reason for our decision is due to the proximity of time since licence award and the link to DCC's expected rate of return. The volume of activity deemed acceptable under variation one refers to activity that began 6 months after DCC was established. DCC knew at bid that the SMKI and Parse and correlate (P&C) contracts were required of them but did not have sufficient certainty to consider them fully in their bid so they were explicitly excluded.

6.18. Reflecting on the broad range of views about comparator companies, we recognise that the groups of comparator companies identified in our rate of return methodology are established businesses which may limit their suitability as benchmarks for DCC's activity outlined in their 2014/15 baseline margin application. For these reasons we consider that the rate of return established as part of the competitive tender process remains a reasonable estimate of the return that the market would have determined for those costs.

6.19. We do not agree that DCC should expect a rate of return of 15% on any activity or internal cost over and above LABP over the course of its licence simply because this was what was secured at bid. The baseline margin figures were stated as £ million figures in the licence to protect against establishing a "cost-plus" regime, which would create perverse incentives on the DCC's behaviour and would not be in consumers' interests. DCC should not interpret us accepting the 15% margin rate pertaining to the specific application it put forward as setting a precedent for future applications.

6.20. We welcome the support that respondents gave on our comparator approach to determining the rate of return. We will consider using a comparator methodology as a way to benchmark the appropriate rate of return relating to any future baseline margin applications by DCC. In considering this approach for the future, we have concern with some aspects of the external report submitted by DCC. The wider range of comparators included companies that we had discounted because of a lack of similarities. The report did not consider other regulated companies to be suitable comparators. We do not agree with this – the fact that DCC is a regulated monopoly means its risk profile has similarities to other regulated entities such as having certainty of revenue stream.

6.21. We note that the majority of respondents voiced support for the 10% option with some saying that even that was too high. However, respondents provided limited evidence to support their opinion. In response to the specific respondent's view that the DCC's rate of return should be derived from DCC's cost of capital, we do not consider this an appropriate approach to rely on solely, given DCC's thinly capitalised structure and lack of intangible assets.

7. Next steps and future price controls

Chapter Summary

In this chapter we set out our intended next steps on the price control and related policy areas.

Changes to the RIGs

7.1. We published the latest version of the regulatory instructions and guidance (RIGs) in May 2015[27]. The RIGs provide the basis on which DCC must report price control information, and provide a framework that enables us to collect data from DCC in a consistent format.

7.2. The current RIGs are appropriate for 2014/15 and future reporting. However we may choose to make minor changes to the reporting template to allow for minor formatting issues and any relevant policy changes over the past year including changes to the implementation milestones and the potential role of DCC in centralising registration. Any necessary modifications to the RIGs will be in place before the licensee is required to submit its 15/16 Price control by 31 July 2016.

Future price controls

7.3. We have noticed a marked improvement in the quality of DCC's reporting compared to the 13/14 price control. However there remain areas where we expect further improvement in the quality and clarity of information provided. These broadly relate to the areas where we have found unacceptable costs or require DCC to remove costs from the forecasts, including:

- Clear justification for future resource requirements in DCC's forecasts. The updated forecasts should only contain economic and efficient costs, so that they represent a reasonable baseline against which to compare costs at the next price control[28].

- Further justification for the assumptions underpinning DCC's resource benchmarking activity

[27] https://www.ofgem.gov.uk/publications-and-updates/data-communications-company-dcc-regulatory-instructions-and-guidance-2015
[28] Data Communications Company (DCC) price control guidance: process and procedures: https://www.ofgem.gov.uk/sites/default/files/docs/2015/07/2707_dcc_pc_guidance.pdf

- Clearly justified evidence on how DCC benefits from shared services provided by its parent company and how any associated charge delivers value for money

- A well-defined approach to how DCC accounts for real price effects (RPEs)

- Clearer evidence on DCC's accommodation requirements

7.4. We will provide more detailed feedback direct to DCC.

Operational performance regime

7.5. As part of the price control arrangements, the Licence requires that 100% of DCC's margin should be put at risk each regulatory year under an operational performance regime.

7.6. Ofgem is responsible for determining DCC's allowed revenue for each regulatory year as part of the price control following an ex-post review of DCC's costs. Ofgem is also responsible for developing and implementing the operational performance regime no earlier than 31 March 2016 but no later than 31 October 2018 following consultation with DCC the SEC Panel and SEC Parties.[29]

7.7. We plan to consult on initial proposals in relation to the operational performance regime in March 2016.

Consultation responses

7.8. Some respondents referenced operational incentives in their response to the price control consultation. The main point raised by stakeholders was that DCC's incentive regime should be rebalanced to ensure that industry's needs are prioritised and all stakeholders are consistently well informed of any developments or cost changes.

7.9. We welcome industry's appetite for informing the development of DCC's incentive regime and are keen to engage further on this as part of the incentive design phase.

DCC's role in centralising registration

[29] Licence condition 38, Part C of the Licence

7.10. Ofgem is leading a programme to deliver reliable and fast switching on a new Central Registration Service (CRS). DCC will have a crucial role in developing the new registration and switching arrangements, including the procurement of the CRS.

7.11. We are nearing the end of making changes to DCC's licence to establish its role in supporting the development of the new switching arrangements, including how this activity would be funded.

Appendix 1 – List of responses

1.2 We received 11 responses to our consultation, one of the responses is confidential and another respondent has provided some additional analysis that is confidential.

1.3 We have published the non-confidential responses on our website.

The non-confidential respondents to our consultation were:

- British Gas
- Citizen's Advice
- DCC
- EDF
- Electricity North West
- Eon
- Npower
- Scottish Power
- SSE
- Utilita

We also received a confidential response from Capita, which we have not published on our website.

Appendix 2 - Glossary

A

Allowed Revenue

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

Authority

The Gas and Electricity Markets Authority

B

Baseline Margin

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

C

Centralised registration service (CRS)

A future service, procured and run by DCC to facilitate switching at gas and electricity premises.

Communications Service Provider (CSP)

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

D

Data and Communications Company (DCC)

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

Data Services Provider (DSP)

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

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

E

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

F

FTE
Full Time Equivalent

G

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

I

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

L

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

R

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

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

S

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

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

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

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

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

Smart Meter

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

Smart Meter Communication Licence

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

M

Mandatory Business Costs

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

O

Ofgem

Office of Gas and Electricity Markets

ONS

Office for National Statistics

P

Pass-Through Costs

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