Data Communications Company

DCC Price Control RY2014/15 consultation response

DCC response

Date: 20 January 2016

Classification: DCC PUBLIC (except Appendix D)

Contents

1 EXECUTIVE SUMMARY

Smart DCC Limited (DCC), was awarded the Smart Meter Communication Licence (the Licence) by the Department of Energy and Climate Change (DECC) on 23 September 2013. DCC is a special purpose vehicle created exclusively for the purpose of carrying out the Authorised Business of the Licence, which is essentially to establish and manage the smart metering data and communications infrastructure for Great Britain, thereby facilitating the delivery of the benefits of smart metering to consumers.

We therefore occupy a unique and exclusive position in Great Britain's energy market because all domestic energy suppliers will be required, as a condition of their energy supply licences, to use DCC Services. With this unique position comes rigorous regulation and governance.

We made great efforts to produce a clearly structured and high quality Price Control submission for RY2014/15. We reported in considerable detail on how the dramatic changes in the DCC programme have impacted the evolution of our costs. Our aim is to gain the trust of industry and the regulator in anticipation that the burden of reporting can reduce in future years as DCC's scope and costs become less volatile.

We would like to thank Ofgem for the opportunity to review and respond to its consultation in relation to the Price Control submission and the Baseline Margin application for RY2014/15. This document sets out our response to that consultation, the key points of our response are set out in Table 1 below.

Area	DCC view
Internal Costs	▪ We welcome Ofgem's proposal to accept that the vast majority of changes in Internal Costs were economic and efficient ▪ We disagree with the proposal to disallow costs relating to resources, real price effects (RPEs), accommodation and the corporate overhead charge
External Costs	▪ We welcome Ofgem's proposal to accept that the changes in External Costs were economic and efficient
Milestones	▪ We are pleased, and agree, with the draft decision that IM7 was achieved in full and on time
Baseline Margin	▪ We are pleased that Ofgem has proposed to increase our margin to reflect the additional activities we undertake and risks we face ▪ We disagree, however, with the proposal to disregard the majority of the categories for which we argue that risks have increased, we have provided further explanation in relation to this ▪ We consider that a margin of 15% reflects a reasonable rate of return for the additional activities we undertake and risks we face ▪ We commissioned a small piece of work to analyse what a reasonable rate of return would be; that piece of work supports our view that 15% is a reasonable rate of return (see Appendix C).

Table 1 – Summary of DCC's response

Since we were awarded the Licence, we have made significant progress towards the development and delivery of the DCC solution. In common with most significant infrastructure development projects, the DCC solution has been the subject of evolution and change as the solution has been through the design and development process.

The journey of managing this evolution has been made markedly more challenging and complex by the later than planned and iterative nature of the finalisation of the GB Companion Specification (GBCS) and the Smart Energy Code (SEC). This has led to a much more complex implementation journey and required the re-setting of the DECC programme with additional consequences for External Costs.

We anticipate that the rate of change will continue to be greater than original expectations, and we must therefore remain flexible and adaptable in order to deliver the planned benefits for consumers. We will continue to innovate as we manage the dynamic nature of the programme and will continue to report to Ofgem on the rationale for any cost changes to demonstrate that they are incurred economically and efficiently.

This document is structured as follows:

- Section 2: Our response to Ofgem's cost assessment including proposed disallowances and our approach to resource cost benchmarking
- Section 3: Explanation of DCC's internal processes including risk management, procurement and change processes
- Section 4: Our response to Ofgem's proposals on the Baseline Margin adjustment including the proposed margin adjustment, an appropriate rate of return and the work we commissioned to evaluate Ofgem's rate of return methodology
- Appendix A: cross references of our responses to the consultation questions
- Appendix B: average daily visitors information to support our accommodation cost forecasts
- Appendix C: assessment of Ofgem's rate of return methodology – a report prepared by Deloitte LLP for DCC.
- Appendix D: sets out some confidential information to support section 2.2.

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2 OFGEM'S COST ASSESSMENT

Ofgem proposes to disallow £0.409m from our Internal Costs incurred in RY2014/15 and £11.721m of our forecast Internal Costs over the remaining term of the Licence. These disallowances are made in relation to resource costs, RPEs, accommodation costs and the corporate overhead charge.

We welcome the positive feedback from Ofgem on the quality of our reporting[1], although we recognise that there is scope to improve further. We also welcome the guidance received ahead of the RY2014/15 submission, specifically through the development of the DCC Price Control guidance document in July 2015[2] and the review of the RIGs in May 2015[3]. We consider that this has resulted in a submission which is closer to Ofgem's expectations and has introduced a clearer process for considering Ofgem's proposals through to final decision.

In this section we:

- Set out a summary of the variances in RY2014/15 against the previous year's forecast and LABP;
- challenge the proposals to disallow certain resource costs (this includes discussion of our approach to resource cost benchmarking);
- challenge the proposals to disallow costs on the basis of our approach to inflation (RPEs);
- challenge the proposals to disallow forecast accommodation costs; and
- challenge the proposal to disallow costs relating to the corporate overhead charge.

Overall, we are pleased that Ofgem has proposed to accept the changes in External Costs as being economic and efficient. However, we disagree with its proposal to disallow £0.409m of costs incurred in RY2014/15 and to remove £11.721m from our forecast costs over the Licence period.

2.1 Financial summary of DCC's Price Control submission

2.1.1 Variance against LABP

During RY2014/15 there was an £11.3m increase in overall costs since the LABP. This was comprised of:

[1] Ofgem, 25 November 2015, 'DCC Price Control consultation: Regulatory Year 2014/15', paragraph 2.20

[2] Ofgem, 28 July 2015, 'DCC Price Control guidance: processes and procedures': https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-guidance-processes-and-procedures

[3] Ofgem, 29 May 2015, 'DCC: regulatory instructions and guidance 2015': https://www.ofgem.gov.uk/publications-and-updates/data-communications-company-dcc-regulatory-instructions-and-guidance-2015

- an increase of £4.7m in External Costs, driven by new requirements and changes to requirements which are supported by formal change requests from the applicable service providers

- an increase of £6.9m 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 Parse and Correlate software and SMKI Services[4])

- a reduction of £0.3m in Baseline Margin, following the determination that an Implementation Milestone 5 (IM5) had not been met in RY2013/14.

There had been no variance in Pass-Through Costs.

2.1.2 Variance against prior year's forecast

The majority of the variance against LABP above was included within the prior year's forecast. However, there had been a £1.0m decrease in actual costs against the prior year's forecast. This was comprised of:

- an increase of £2.0m in External Costs, driven by further new requirements and changes to requirements which are supported by formal change requests from the applicable External Service Providers

- a decrease of £3.0m in Internal Costs, primarily driven by re-profiling of costs into future Regulatory Years to reflect the re-setting on the DCC programme during the year.

There was no variance in Baseline Margin or Pass-Through Costs.

2.2 Resource costs

Ofgem is proposing to disallow £0.067m in RY2014/15 and to remove £6.006m from our forecast costs relating to resource costs.

In this section we:

- We challenge Ofgem's proposal to remove forecast industry team resource costs from our forecast – this includes explanation as to why the cost is justified and to clarify that £0.802m of the forecast costs relate to existing resource which Ofgem deemed to be economic and efficient in RY2014/15 and so should not be removed

- Challenge the proposal to disallow resource costs in the finance and corporate management teams

- Explain our approach to benchmarking and explain why it is appropriate, in particular the percentiles selected and our approach to benchmarking benefits.

[4] These contracts are included in Internal Costs despite being third party contracts that we manage in a similar way to how we manage the DSP and CSP contracts

2.2.1 Industry resource costs

Of the proposed total forecast resource cost to be removed, £2.624m relates to the industry team. Ofgem has proposed that all increases in forecast industry annual costs above the costs incurred in RY2014/15 should be removed from the forecasts for the duration of the Licence term[5], as it considers that insufficient evidence was provided as to when or why the additional roles will be required in future years. **We disagree with this proposal.**

Cost savings

The RY2014/15 industry resource cost forecast was 20% lower than the previous forecast (as set out in the RY2013/14 Price Control submission), which was determined by Ofgem in February 2015 to be economic and efficient.

The reduction in the forecast is largely due to a 24%[6] reduction in the average cost per FTE. This cost saving was achieved through a resourcing approach to employ a mix of permanent staff at different levels (and so different salaries) and also by recruiting at rates significantly lower than that forecast in the LABP for permanent resource.

All previous forecasts for the industry cost centre (LABP forecasts and the agreed RY2013/14 forecast) included six Industry Partnership Managers (IPMs). At the end of RY2014/15 four of these roles were in place and the remaining two were forecasted to be recruited in RY2015/16 to support the growing industry engagement activity that will be required as we approach go-live and beyond. In the LABP and RY2013/14 forecast it had been assumed that the roles would be recruited in late RY2014/15; however, as the go-live date is now later than envisaged, we have forecasted that these roles would now also be recruited later to ensure cost efficiency.

The cost of communicating to and engaging with industry is relatively low as it typically only includes actual staffing costs. Staff in the industry team is made up of FTEs and so are not contractors or agencies. This approach assists in keeping costs down and retaining expertise within the organisation.

FTE transfers

Ofgem states that the primary cause of these savings is FTE transfers into the corporate management cost centre[7]. However, we would like to clarify that the impact of FTE transfers in the savings achieved in RY2014/15, and forecast for RY2015/16 onwards, is nil. All transfers of roles from the industry cost centre to the corporate management cost centre were accounted for as part of the economic and efficient forecast in the RY2013/14 submission.[8] Therefore, during RY2014/15, no roles were transferred from the industry

[5] Ofgem, 25 November 2015, 'DCC Price Control Consultation: Regulatory Year 2014/15', Appendix 2, paragraph 1.57

[6] DCC, 31 July 2015, 'DCC Price Control submission - Resourcing the Organisation', Section 8.4.2

[7] Ofgem, 25 November 2015, 'DCC Price Control consultation: Regulatory Year 2014/15', Appendix A, paragraph 1.53

[8] The roles transferred into the corporate management cost centre in RY2013/14 were Head of Regulation and Licence (now Regulation Director), two Regulatory Officers (now Regulation Managers) and the Stakeholder and Communications Manager. This can be seen in the organisation chart provided with the RY2013/14 submission and in SE006 DCC Org Chart in the RY2014/15 submission.

cost centre to any other cost centre, in fact one role was transferred in to the industry cost centre which had the impact of reducing the real forecast savings by £0.562m.[9]

Forecast costs for existing roles

We would like to clarify that not all of the increase in the forecast annual industry costs, above the costs incurred in RY2014/15, are due to the cost impact of the additional roles. 31% of that increase is due to the full year cost impact of resources which were recruited part-way through RY2014/15, which we note Ofgem proposes to accept as economic and efficient in the draft determination. Between July and September 2014 three new resources joined the industry team. The additional annual cost in RY2015/16 onwards relating to the full year cost for these three resources is set out in Table 2 in Appendix D.

As shown in Table 2 in Appendix D, £0.802m of the forecast industry team resource costs are attributable to existing industry team roles which were recruited in RY2014/15, for which the corresponding incurred costs in the same RY are proposed to be acceptable. Therefore, we propose that the forecast disallowance associated with resource costs are reduced by at least £0.802m.

Industry team activities

We are delivering the programme for the benefit of the energy industry as a whole and for the consumer. The programme is governed by a multi-stakeholder process underpinned by the SEC. Under this arrangement, SEC Parties via the SEC Panel make a number of decisions directly relation to the solution we are delivering. To achieve a solution that is fit for purpose and successful, it is important that we obtain a thorough and comprehensive understanding of the different needs of the energy sector. Our industry team provides that important link between the industry and the teams within DCC responsible for delivering the programme, this is through managing stakeholder engagement on specific issues which has the benefit of releasing some capacity from our specialists[10].

The industry team has carried out a range of activities during RY2014/15, however there is more that can and should be undertaken. This will become more critical as we approach go live during RY2016/17. The current and future activities are discussed below.

- IPM account management – currently managing 120 accounts[11]. We have engaged with 53% of SEC Parties and we expect to reach the remaining 47% going forward

- Varied engagement with smaller suppliers – we engage with smaller suppliers as needed but we seek to increase this engagement particularly in light of there being an increasing number of new smaller suppliers becoming SEC Parties

- Engagement with network companies - over the past year engagement with network operators has increased significantly, examples include testing, response times, and network outages. We are, however, keen to engage further with network companies in order to address more issues which may be specifically related to network operators

[9] DCC, 31 July 2015, 'DCC Price Control - Resourcing the Organisation', Section 8.4.1

[10] Although some specialist support will continue to be required.

[11] These include large suppliers (9), small suppliers (33+), Network Operators and Gas Transporters (19), Consumer groups (7), Industry Bodies and Government (9), meter manufacturers (4), metering service providers (MOPs, MAPs and MAMs) (8), Trade Associations (9), "Other" SEC Parties (20), non-SEC Parties (19) and price comparison websites (2)

- Hosting industry events - we have successfully[12] hosted three industry days during 2015[13]. However, we currently rely on resources outside the industry team to support with the logistics and planning of each event, going forward we expect this to reduce as we look to recruit additional FTE in the industry team

- Preparing for DCC live - We have a significant delivery schedule over the coming months where we will need our Users to engage and our operational readiness is advancing in time for our go live

- Engagement beyond DCC live – we expect more organisations to become SEC Parties over the coming months and as we move from the implementation to the enduring phase. We will also need to prepare for more engagement on other programmes such as enrolment and adoption, dual-band communications hubs and centralised switching.

Our planned resourcing of the industry team reflects this challenging external environment and the demands of our industry stakeholders. In conclusion we suggest that Ofgem reconsider its view of the forecast industry resource costs for the reasons explained above.

We understand that the remaining resource cost disallowances relate mainly to the benchmarking approach used. We explain our approach to benchmarking in Section 2.2.4.

2.2.2 Finance resource costs

Ofgem proposes to disallow £0.409m of costs incurred in RY2014/15. Of this amount £0.023m relates to finance resource.

As set out in our RY2014/15 Price Control submission, we had to create and fill additional posts in RY2014/15 in the finance team in order to fulfil our duties, particularly to provide support for the change control process. Ofgem has disallowed these costs as it considers that there are a number of permanent and contract roles with remuneration that is above what Ofgem considers to be an acceptable benchmarking level. It is important to note that the average annual cost per FTE incurred in the year was below the level in the LABP.

Ofgem proposes to remove £6.006m from our forecast resource costs over the Licence period, of this amount, £1.570m relates to the finance team.

As set out in our RY2014/15 Price Control submission, finance resource costs are forecast to increase in future years, primarily due to the increase in commercial finance capability brought into the team during RY2014/15. Ofgem states that it does not consider that the enduring growth in finance team is sufficiently justified, and propose to remove the costs from the forecast that are not enduring until more robust justification is provided.

[12] Demand for places at our industry days tends to outstrip availability, and the feedback is generally positive: 64% of respondents found the content of the days sufficient and relevant, 75% said they found the days effective and engaging and 84% said they were very likely or likely to attend future industry days. Examples of specific comments are: “On DCC delivery live there was a lot of new material not seen before so got a lot out of it”, “Testing session was clear, simple and the easiest to follow/understand”.

[13] Full days in March 2015 and July 2015 and a half day in December 2015

In relation to the proposal to remove forecast finance resource cost, we remain of the view that a number of the roles will be required on an enduring basis to support the key objectives of the team. This includes providing analysis to both management and external stakeholders on changes to the DCC's overall cost-base, which has increased by around 50% of what was originally envisaged, and during RY2016/17 we expect this to increase to over 100% of the cost-base envisaged that year in the LABP.

Furthermore we are committed to improving the progress we have made in engaging with stakeholders on finance issues specifically to explain the financial impact of the vast amount of change that has manifested since Licence award. We are keen to continue developing our engagement to provide SEC Parties comfort in the charges they are receiving, and it is vital that we have the right resource in place to manage those relationships. We are implementing finance systems in order to increase efficiency in the finance team, and we do expect this to result in a reduction in finance resource costs from RY2017/18 onwards.

We understand that the remaining finance resource cost disallowance relates to the benchmarking approach used. We explain our approach to benchmarking in Section 2.2.4.

2.2.3 Corporate management resource costs

Ofgem proposes to disallow £0.409m of costs incurred in RY2014/15. Of this amount £0.010m relates to corporate management resource. Ofgem proposes to remove £6.006m from our forecast resource costs over the Licence period, of this amount, £1.225m relates to the corporate management team.

As set out in our RY2014/15 Price Control submission, resource costs in corporate management increase due to an increase in the capabilities of the regulation and strategy team due to the need to work on new projects. Ofgem considered that we did not provide sufficient justification for the level at which those roles were benchmarked.

We understand that the remaining corporate management resource cost disallowance relates to the benchmarking approach used. We explain our approach to benchmarking in Section 2.2.4.

2.2.4 Benchmarking

We welcome Ofgem's recognition of our benchmarking exercise and the positive step this exercise has made in terms of justifying our resource costs.

We consider that any benchmark used would have its own limitations, as noted by Ofgem in Appendix 3 of its Price Control consultation in relation to the use of the ASHE data. These were discussed within our Price Control submission, but can be summarised as:

- Roles need to be matched to an appropriate comparison role – an exact match is not always possible and job titles are only approximations of the skills required for that role

- Surveys are a snapshot – May not reflect more recent movements in specific roles or indicate current supply and demand of candidates

- The guideline value is an average, and therefore only indicative – some interpretation is required

- Roles may need to be aggregated in order to provide adequate sample sizes for comparison – data on less relevant roles may need to be included

- An element of subjectivity is always required.

As such, we consider that benchmarks are a useful guide but we do not consider that it should be treated as a ‘definitive answer’.

Similarly, we consider that the principle is the same for the percentile used; there is no one correct percentile that should be used, but the percentile approach provides useful context to remuneration setting in a fast moving and niche market.

Percentile selection

We have used the 50th (general roles) and 75th (specialist roles) percentiles as our baseline benchmarking position. We carried out extensive recruitment during RY2014/15 and experienced practical difficulties in recruiting appropriately qualified staff at levels below this, which has, in a number of cases led to delays in recruiting (either through there not being any appropriately qualified applicants, or through offers not being accepted by suitable candidates). This is due to the following factors:

- There is a limited pool of appropriately qualified technical resource in a competitive industry market

- There are limited time requirements which mean that contractors are often the only viable option – this is a fast moving market

- SMIP is a unique programme so there are few individuals with direct experience of the more technical design and delivery areas

- Certain technical areas have experienced levels of staff turnover above comfortable levels, given the steep learning curves required

We did not specifically record the challenges in recruitment during RY2014/15, but we have started to do this during RY2015/16. Table 3 in Appendix D sets out some examples of challenges we have faced in the recruitment of certain roles during RY2015/16. We are mindful of the need to justify levels that may appear high in the context of the wider industry and we keep this under continuous review.

Benefits

Ofgem notes that in calculating the level of benefits to be included in total remuneration we included the average bonus paid and applied a generic percentage to cover all other benefits received. It goes on to say that “our analysis shows that the percentage applied to cover all other benefits frequently, and sometimes significantly, understates the level of benefits actually received. This results in total remuneration comparing more favourably to the benchmark than it otherwise would have”[14]. DCC disagrees with this assessment, this is discussed below.

Bonuses

Hay Group’s PayNet comparison numbers show bonuses that were actually paid to staff. If DCC were to use the bonuses actually paid (rather than the contractual target percentage) then DCC would have understated the bonus elements. This is because a disproportionate number of staff were mobilised during RY2014/15 compared to most organisations (FTE employees at 31 December 2013 were 35.3, FTE employees at 31 December 2014 were 64.7) and therefore their actual bonuses were pro-rated for part of the year. In addition, the bonuses paid were calculated using a number of factors including personal performance, which by definition will vary by individual. It would not be appropriate for benchmarks to predict the level of performance by individual, we consider that it would be more appropriate to use a standard percentage that reflects the overall level of bonuses paid compared to the maximum potential pay-out. As DCC had paid out 75% of the total potential ‘bonus pot’, the benchmarks were adjusted to allow for this. DCC considers that the expected benefit to the employee is the most appropriate measure for a fair comparison compared to the actual bonus when staff numbers are increasing. In conclusion, we consider that the approach we have used is more transparent than using an ‘actual amounts paid’ approach. In fact, our approach has resulted in total remuneration comparing less favourably to the benchmark than it would have had the ‘actual amounts paid’ approach been used.

Please see some examples set out in Table 4 in Appendix D.

Other benefits

DCC has used a rate of 7% to cover other benefits. The largest component of this is employer’s pension contribution where we have used 5%. The actual amount ranges from 1-5%, and as noted in the Price Control submission is an average of 3.6% across DCC. Any level above 1% is optional for the employee as it requires matching contributions. DCC has assumed the maximum potential benefit is taken by all staff as this would be the package available to new recruits.

With both the bonus and benefit calculations, DCC’s intention has been to match like-with –like payments and does not accept that these understate either in terms of comparison. In fact, using actual values for each individual would have resulted in a more favourable comparison for DCC with the benchmark.

Please see some examples set out in Table 5 in Appendix D.

Contractors

This is a difficult area to obtain appropriate benchmarks. Ofgem note that the methodology DCC has used shows that rates are above the 50th percentile for contractors. DCC anticipates that this will be the case going forward and reflects the specialist nature of the resource involved. DCC will look at providing additional evidence from the recruitment process for future recruitments.

[14] Ofgem, 25 November 2015, DCC Price Control consultation: Regulatory Year 2014/15, Appendix 3, page 68

2.3 Real price effects

Ofgem is proposing to disallow £0.056m in RY2014/15 and to remove £0.581m from our forecast costs in relation to our approach to RPEs. **We disagree with this proposal.**

Where it was deemed necessary or appropriate, we applied a standard approach to uplift a proportion of our Internal Costs to the relevant price base. That methodology is the price index adjuster (PIBM) approach as set out in the Licence which is used to uplift Baseline Margin values. This approach uses average RPI over six months of the year. We considered this approach to be appropriate as Baseline Margin is calculated based on a percentage of Internal Costs.

For External Costs we uplifted using either:

- CPI in the month preceding the first month of the contract year, as required under the DSP and CSP contracts; or

- CPI on the signature date.

We note that RPE is interpreted by Ofgem as the input price trend relative to RPI. Ofgem considers that the RIIO methodology for applying RPEs is a good reference point for DCC's RPEs.

We can see the merit, under the RIIO framework, for developing a standard methodology which seeks to predict potential variations in inflation relative to RPI before costs are incurred. Given that DCC operates under an ex post Price Control framework we consider the RIIO methodology to be less relevant for application to our business, as we report on actual costs incurred after the relevant Regulatory Year has ended. For example, with resource costs, this means that we take decisions on any pay increases at that time, which are then approved by the DCC remuneration committee and are then fixed going forward.

We accept that it may be appropriate in the future to consider how any forecast costs are updated for RPI using a standardised methodology which can be agreed and fixed for the purpose of ex ante Price Control. Under the current framework we consider the differences are too great to support Ofgem's proposal to apply a similar approach as that applied under the RIIO framework. Therefore we disagree with Ofgem's proposal to disallow our cost variations relating to RPE on the basis that it is not the same as RIIO.

2.4 Accommodation costs

Ofgem is proposing that the incremental forecast accommodation cost above the agreed forecast from our prior year submission is not economic and efficient, and that £3.339m should be removed from our forecast. Ofgem concludes this is on the basis that the justification for the amount of space required was not sufficient, and that a lack of evidence had been provided with regards to our visitor number assumptions. **We disagree with this proposal**.

We are pleased that Ofgem has accepted that we have secured an economic and efficient price for our accommodation per square metre in RY2014/15. However, we challenge its draft decision with respect to the amount of space we are forecasting we will require over the Licence term. We do not agree that £3.339m should be removed from the forecast.

As at the start of RY2014/15 DCC was located in Ludgate House, Blackfriars, London – this was a temporary arrangement as the lease was due to expire in March 2015. In planning for a new office we undertook a formal analysis of our longer term requirements for office space in August 2014. The methodology was directed at sizing the accommodation to avoid:

- Over-investment in capacity resulting in low utilisation and thus an inefficient office procurement decision
- Under-investment in capacity which would result in accommodation that could not deliver requirements such as collaboration between ourselves and our Service Providers as well as with SEC Parties.

The methodology undertaken to deliver the requirements for the enduring office move (to Ibex House) comprised a four stage process:

- Stage 1 - Gather permanent headcount requirements and utilisation requirements
- Stage 2 - Gather variable headcount requirements (visitors and new business requirements)
- Stage 3 - Gather other requirements (such as industry collaboration, information security and meeting room capacity)
- Stage 4 - Conduct scenario analysis and agree requirements.

The resulting accommodation space we have procured is primarily driven by the headcount requirement assumptions, the square footage utilisation and the percentage of agile working.

The peak permanent headcount, which is all staff that operate from the London office, was forecast to be 162 staff. This forecast also forms the basis of the forecast payroll and non-payroll costs included in the Price Control submission. It should be noted that the current actual headcount is 188 staff and we have had to significantly modify the office space to accommodate this 16% increase, such as removing breakout areas and individual working spaces, and reducing the space available at reception for waiting visitors.

We note that, for the majority of our resource costs, the additional volume of FTE being forecast has been accepted to be economic and efficient. There are just two cost centres in which costs were not found to be economic and efficient on the basis of future volume of resource (they were the industry and finance cost centres).

Therefore, we consider that the need for additional space in the future is justified by the requirement for the additional resource. On the basis that the future resource has been found to be economic and efficient we consider that the associated accommodation cost should also be economic and efficient. It should also be clarified that the forecast accommodation cost already assumes a 32% reduction in the square footage utilised in RY2017/18 by using the option to release excess space back to Capita and, therefore, already reflects an economic and efficient forecast.

Ofgem has noted that there was a lack of evidence supporting our assumptions regarding visitor numbers, which was a consideration when procuring the new office space. Visitors are classified in two groups: External Service Providers that frequently visit the office and have their own access passes and tend to hot-desk for an entire day to facilitate ongoing collaboration outside of meetings, and normal visitors for occasional meetings that will use meeting room space.

Our assumption was that visitor numbers could peak between a range of 80 and 85 on any given day, and an average visitor number was approximately 34 per day.

At the time of Ofgem's cost visit we provided visitor numbers for the prior month (August/September 2015), which showed an average visitor number of 34 and peak of 65.

For the period from September 2015 to mid-December 2015[15] the average visitor number was 42 visitors per day (24% higher than our assumption), and the peak was at 82 visitors, within our assumed range[16]. Given that we have been located in Ibex House since March 2015, we have limited data to support the assumption. We started to record this information in September 2015 and the visitor numbers between September 2015 – December 2015 are set out in Appendix B.

2.5 Corporate overhead charge

Ofgem is proposing to disallow £0.286m in RY2014/15 and to remove £1.796m from our forecast costs relating to the corporate overhead charge. **We disagree with this proposal.**

The corporate overhead charge (referred to as the "shared service charge" in Ofgem's consultation document) is paid by DCC to our parent company Capita plc (Capita). The charge was set by our parent company and was included as part of the original Licence application, and recovers an allocation of group overhead. This is a standard approach that is applied by many companies, with a common methodology being to allocate group overhead on a proportionate basis, in our case the relevant driver is Internal Costs.

The provision of these central functions is essential to the stability and financial integrity of DCC; they enable us to operate in a way that provides flexibility, service assurance and resilience. The flexibility allows us to access a variety of central functions and advice as required. An example of this would be DCC's access to the central procurement function for resources and ad hoc advice. This minimises delays in procurement and we benefit from dedicated consultancy at times when it is necessary at internal rates which are lower than external consultancy rates.

In RY2014/15 our expenditure on the corporate overhead charge was 2% lower than the latest forecast due to lower Internal Costs. This is a saving which will benefit SEC Parties and therefore consumers.

Whilst we recognise that there is a link between the corporate overhead charge and some of the central function services we benefit from and use, this relationship is not linear.

We understand that Ofgem is keen to establish a principle where if a new scope activity has not 'used' a service provided in exchange for the corporate overhead charge, the

[15] The process for logging visitor numbers commenced in September 2015, therefore no data exists before then

[16] Daily visitor numbers for September to mid-December 2015 has been provided with this response.

charge should not apply - this remains to be an longstanding area of disagreement with the regulator which we seek to resolve going forward.

Paragraph 4.36 of the consultation refers to a process to ensure that the corporate overhead charge provides value for money. We can confirm that work is underway on this and we plan to update Ofgem on this in due course.

3 DCC INTERNAL PROCESSES

3.1 Risk management

As part of its assessment of our Price Control submission, Ofgem commissioned Grant Thornton to undertake a forensic accounting review. We note that in the forensic accounting report there were a number of comments relating to our approach to risk management, many of those comments focused on complexity and risk valuation. These are discussed below.

3.1.1 Complexity

We do not share the view in the forensic accounting review report that there is a lack of clarity over our overall risk management approach[17]. We note that the forensic accountants themselves state that it is beyond the scope of their review to evaluate the risk management framework in further detail than describing the approach[18]. We manage a significant number of risks at both the programme (risk to programme delivery) and the corporate level (risk to the licensee as required for e.g. Baseline Margin). Effective management requires risks to be assessed at different levels and therefore a hierarchical approach allows us to devote attention at the appropriate level. We accept however that the retrospective traceability of risk escalation could be improved and we will incorporate it in the new risk management tool which is in the process of being implemented.

3.1.2 Documentation

The Risk Management Strategy will be refreshed in early 2016 in order to ensure that all terminology and assessment methods are up to date. We would like to confirm , however, that we always follow the strategy as documented.

3.1.3 Valuation

The forensic accounting review found that there is a weakness in DCC's risk management approach as it does not translate the scoring of risks into a monetary value where it is possible to do so[19]. This has been a deliberate decision by DCC as we are not convinced that the calculation of nominal values for risks leads to improved risk management. This

[17] Grant Thornton UK LLP, 25 November 2015, 'Forensic accounting review to inform Price Control and ex post review analysis for the Smart Metering Data Communications Company': https://www.ofgem.gov.uk/sites/default/files/docs/forensic_accounting_review_redacted_version.pdf, paragraph 1.46

[18] Grant Thornton UK LLP, 25 November 2015, 'Forensic accounting review to inform Price Control and ex post review analysis for the Smart Metering Data Communications Company', paragraph 1.44

[19] Grant Thornton UK LLP, 25 November 2015, 'Forensic accounting review to inform Price Control and ex post review analysis for the Smart Metering Data Communications Company', paragraph 1.48

approach is consistent with the Risk Management Strategy[20]. We now plan to use a range of values as one of the determinants of risk impact, and will continue to value those risks that relate to the Baseline Margin application in order to demonstrate the risk variation. We do not, however, propose to provide monetary values for all risks as this inevitably involves multiplying two numbers, which by their nature are generally unknown.

We will continue to identify risk values in our risk management process where this adds value to commercial decisions made on behalf of consumers.

3.2 Procurement

We accept the forensic accounting review findings on the absence of appropriately documented sourcing strategies and award recommendations for some procurements. We always apply the principles of the Procurement Strategy within our procurement processes, and we will ensure that the consistency of the documentation to demonstrate this is improved. This will include ensuring that sourcing strategies and award recommendations are produced in a consistent format. In addition, we will ensure that evaluation criteria are consistently documented.

We have reviewed and updated procurement procedures to ensure that these issues are immediately addressed. These will be subject to a post implementation review to ensure that the required changes have been implemented appropriately.

3.3 Change processes

We welcome the feedback set out in the forensic accounting review in relation to our internal and external change processes. We have taken the comments on board and have a number of improvement plans in place. These will be reported on as part of the RY2015/16 Price Control submission due in July 2016.

3.4 Prudent estimate of Allowed Revenue

We consider that our approach to the prudent estimate of Allowed Revenue in RY2014/15 is appropriate and enables us to meet our Licence obligation to ensure service charges do not require amendment in year[21].

We take a prudent approach to estimating of Allowed Revenue to be recovered through charges. 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 are consolidated to provide the total estimated Allowed Revenue, which forms the budget for that Regulatory Year.

The development of our cash-flow forecasts takes into account the following key factors:

- Activities anticipated in the year
- Areas of uncertainties identified at the time

[20] DCC, 19 December 2013, 'Risk Management Strategy': https://www.smartdcc.co.uk/media/91857/risk_management_strategy_december_2013.pdf - note that this document was consulted on and was approved by the Secretary of State

[21] Licence condition 36.5

- Key assumptions around the timing and value of payments for contract changes and new procurements.

In our submission we detailed the key activities, uncertainties identified and assumptions made in deriving the cash-flow forecast and, therefore, setting the charges in the charging statement. There were several material uncertainties in relation to RY2015/16, the most material being with respect to changes to contracts as a result of re-plan contract negotiations, which began in early January 2015. There were a number of change requests that had arisen from the uplift to GBCS v0.8.1 and changes introduced through SEC4 that were to be finalised as part of this negotiation and, therefore, assumptions had to be made on the value and timing of External Costs that may arise from approval of these change requests in RY2015/16.

During the year we ensure that we manage the prudent estimate of Allowed Revenue efficiently through the following mechanisms:

- Maintaining a detailed cash-flow forecast, updated and reviewed monthly, with comparison to actuals and review by the Finance Director and Board of Directors. This information is used to undertake further scenario analysis to forecast the impact of forthcoming contract changes on the cash-flow forecast

- Engaging in a continuous, ongoing process of risk assessment and review with respect to costs incurred against the budget, and expectation of future costs to arise. This allows us to track expenditure in relation to the budget and determine the likelihood of over or under-spend. This exercise is carried out in parallel with the review of our cash-flow forecast, which ensures we have an appropriate level of funds to allow for potential variation in spend against the budget. This assessment is used to inform the strategy adopted in negotiation with External Service Providers, approving a change request and agreeing the timing of cash outflow

- Following a robust change process to ensure all changes to costs are approved, that process include verification as to how the costs align with the estimate in the forecast.

We note that Ofgem is currently consulting further on its proposals to set a penalty interest rate (under a 'report and direct' arrangement) for over-recovery which is beyond 10% of Allowed Revenue[22] – we will be responding to that consultation separately.

[22] Ofgem, 17 December 2015, 'Final Proposals on DCC's role in developing a Centralised Registration Service and penalty interest proposals': https://www.ofgem.gov.uk/publications-and-updates/final-proposals-dcc-s-role-developing-centralised-registration-service-and-penalty-interest-proposals

4 BASELINE MARGIN

On 31 July 2015 we submitted a Notice to the Authority setting out a proposal for Relevant Adjustment to the Baseline Margin values specified in Appendix 1 to Licence Condition 36.

4.1 Proposed margin adjustment

4.1.1 Variation one

In that proposal we identified a variation to the volume and timescales of activities in RY2014/15, for which we proposed a Relevant Adjustment to the BM values of £0.474m. We are pleased that, with the exception of those costs that the Authority deemed not to be economic and efficient under its Price Control assessment, it considers that the remainder meets the criteria. The authority has not set out the specific proportion of the BM adjustment allowed which relates to this variation.

4.1.2 Variation two

In our Baseline Margin proposal we identified a variation to our exposure to risk, for which we proposed a Relevant Adjustment of £2.637m over RY2014/15 to RY2021/22.

It is worth noting that at the time of bidding for the Licence, DECC had notified bidders that the SMKI Services and Parse and Correlate software would need to be procured through competitive tendering (they are essential features of the solution). At that time the scope and costs could not be quantified with any degree of certainty, as the requirements were not defined, and therefore the margin/risk was not factored into the bid cost model. For this reason, the Baseline Margin values agreed at Licence award did not reflect the complexity or risk associated with delivery and management of those new activities, however it was envisaged that the margin could be adjusted through this adjustment mechanism.

We explained, in our application, that were six risk categories associated with the new SMKI and P&C contracts, they were:

1. Loss of margin risk - implementation phase
2. Loss of margin risk - operational phase
3. Price Control risk
4. Contract risk
5. Enforcement action risk
6. Reputational risk.

The Authority has allowed a margin adjustment in respect of DCC's contract risk and a residual value of the reputational risk identified under contract risk, but it did not consider that we were eligible for a margin adjustment for the other categories of risk, because it does not consider that we provided sufficient evidence that the risk in these categories had materially increased.

We recognise that our monopoly position and the design of the charging and Price Control framework provide a degree of mitigation against some of the risks we face. However DCC believes that it does face considerable residual risks for which these mitigating factors cannot fully compensate. We describe these residual risks below.

Loss of margin risk

Implementation phase

As a result of managing the SMKI and P&C contracts, the risk we face in non (or late) achievement of Implementation Milestones has increased as we are now reliant on additional third parties to deliver products/services in order to achieve our Implementation Milestones. For example DECC has indicated that it may wish to introduce a new Implementation Milestone specifically linked to the availability of SMKI certificates which would result in us being wholly reliant on BT to achieve this.

Operational phase

The Operational Performance Regime will set out incentives for DCC to achieve in order to retain its margin during the operational phase. It is not yet clear what these will be, but as a result of managing the SMKI and P&C contracts, the risk we face in non (or late) achievement of any operational incentives has increased as we are likely to be reliant on third parties to deliver products/services in order to achieve those incentives. For example, the two categories identified as being relevant for SMKI and P&C are the Service User and Service Delivery Measures – for which a proportion of the margin may likely be at risk.

Price Control risk

We currently operate in an ex post Price Control framework. This framework does not provide us with sufficient certainty around our costs before they are incurred. Therefore we face higher risks as a result of managing these large contracts which increase our cost base and therefore increase the risk we face of costs being disallowed. By way of comparison we found that in an ex ante Price Control framework the difference between the business plans and the Authority's final determination was a cost reduction of 7% - we have used this as a proxy to estimate the value of our Price Control risk, although we note that this value is understated since companies which operate in an ex ante Price Control framework have more certainty before costs are incurred and therefore less risk. We note that the Authority recognises this in its consultation on rate of return[23].

Contract risk

We welcome Ofgem's proposal to allow a proportion of the residual value of the reputational risk we identified under contract risk. However, we remain of the view that the entire contract risk has increased and therefore should be reflected in the Baseline Margin adjustment.

We face additional contractual risks as a result of managing the SMKI and P&C contracts. An estimated value for this risk has been calculated by identifying a value for legal costs, damages and additional liability, as a proportion of the SMKI and P&C contract values. For example for the SMKI and P&C contracts, liability is limited to the values set out in the

[23] We note that in paragraph 6.24 of the consultation, the Authority states: "However, DCC faces some residual risks for which these mitigating factors cannot fully compensate. For example, the Price Control regime does not provide the cost certainty that an ex ante control would give."

relevant contracts for tort (including negligence), breach of contract or any DCC indemnity. In addition there are other limitations/exclusions prohibited by law, including; unlimited liabilities for death or personal injury; fraud or fraudulent misrepresentation, and breach of obligations associated with title under the Sale of Goods Act or Supply of Goods and Services Act.

Enforcement action risk

As a regulated entity we face the risk of enforcement action, often through some form of penalty. A number of regulatory obligations (as set out in the Smart Energy Code or the Licence) are to be provided by the SMKI and P&C service providers. For this reason, the management of these contracts result in an increase in the risk DCC faces in being subject to an enforcement action due where there non-delivery of those regulatory obligations. Since this risk cannot be passed to the SMKI and P&C providers, DCC bears this increased risk. Whilst the likelihood of this is low, the impact would be high.

Reputational risk

In managing the SMKI and P&C service providers, DCC has a wider scope for potential reputational damage, should those service providers fail to achieve their milestones. As noted by Ofgem[24], we are already exposed to the risk of damage to our reputation associated with implementing a novel programme which could have an impact on its opportunities to provide future regulated services. Additional new contracts further increase this risk.

Whilst we are pleased that Ofgem has proposed to increase our margin to reflect the additional activity we undertake and risks we face, **we disagree with Ofgem's proposal to disregard the majority of categories for which we argue that risks have increased**.

4.2 Rate of return

In calculating the amendment to the BM values in our July 2015 application we applied a margin of 15%. This is consistent with the margin applied at Licence award on all Internal Costs (including all activities due to be delivered by third parties). Ofgem is consulting on a rate of return of either 10% or 15%.

We consider that 15% is a reasonable rate of return because:

- this is the margin rate agreed at Licence award
- the Licence was awarded just two years prior
- it was established through market competition
- in relation to variation one - the activities are not sufficiently different in nature to justify a higher or lower margin rate and there was no significant volume of activities of a lower level of complexity or risk

[24] Ofgem, 25 November 2015, 'DCC Price Control Consultation: Regulatory Year 2014/15', paragraph 6.25

- in relation to variation two - it reflects the risk exposure to us in relation to the SMKI Services 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 values at Licence award. In fact, SMKI Services and P&C Software carry more risk to DCC than enterprise systems such as the billing system.

It has been just two years since the Licence was awarded to DCC. During this period, the volume and complexity of activities has increased significantly due to changes in external factors which were outside DCC's control and which DCC did not envisage at the time of Licence award, in particular, the development of the SEC and GBCS took longer than planned and required multiple iterations. Ofgem has also recognised the "increased risks and complexity"[25] that the DCC is facing now. DCC has noted that these changes have increased delivery risk which may have financial implications in case of late delivery against agreed Implementation Milestones and the (yet to be developed) Operational Performance regime.

We note that the Authority is required, under the Licence, to:

> *"have particular regard to the purposes the BM term is intended to serve within the Price Control Conditions and to the basis on which the values attributed to that term were agreed during the Licence Application Process with respect to the Licensee's expected rate of return on its activities over time"*

As set out in the Price Control consultation, Ofgem developed a methodology to compare DCC's expected rate of return against a set of comparators. The result of its methodology was that the range of margins span from -3-16%. Ofgem considered that DCC's business was comparable to the higher end of the IT systems providers in the energy sector margin range which resulted in a 10% margin rate. Ofgem did note that 15% could be justified on the basis that it was established through competition just two years prior.

4.2.1 Margin dilution

The complexity of activities and associated risk is expected to continue in the foreseeable future. This may lead to variations in costs from forecasts at the time of Licence award, similar to the experience of the last two years. If a margin of lower than 15% is applied to these additional allowed costs which are driven by factors outside DCC's control, it would lead to a dilution in the average rate of return that we would expect to earn over the Licence period. Indeed our actual rate of return is already lower than the expected 15%. It is important to note that we have and will continue to incur additional Internal Costs which may or may not be allowed under Price Control but for which additional margin is not applied, as they do not meet a strict interpretation of the Licence criteria in Part A: Requirements for the proposal of relevant adjustments (LC36). This further reduces the effective margin earned and is important to consider in the context of evaluating DCC's rate of return.

4.2.2 Rate of return methodology and Deloitte's report

We commissioned Deloitte to undertake a piece of work to broaden the rate of return methodology. This included work to research other potentially suitable comparators. Deloitte's research concluded that there is no perfect comparator to DCC, but that a rate

[25] Ofgem, 25 November 2015, 'DCC Price Control Consultation: Regulatory Year 2014/15', page 4.

of return of 15% was reasonable on the basis of the widened methodology, the fact that we are relatively close to the time of the bid at which the 15% was agreed and that the 15% was established through market competition.

The key findings from Deloitte's report were:

- DCC does not have comparators which are identical or very similar to its business
- Among Ofgem's comparator groups, asset-light telecoms service providers and IT systems providers in the energy sector appear more suitable relative to others
- That asset-light telecoms provider comparators but face a rapidly changing landscape thus the profile of risks is similar to DCC, the margins for this category ranged from less than 10% to 40%
- Further research indicated that the range of margins is quite wide, with a number of comparators earning margins higher than 15% margin - of the entire range of comparators researched the rates ranged from around 6% to 43%
- The volume and complexity of DCC's activities has increased substantially beyond what was envisaged at the time of Licence award.

We are pleased that Ofgem intends to keep the methodology under review, at this time we do not consider that any such methodology would be fit for purpose given the lack of suitable comparators.

In light of Deloitte's report which sets out its view that 15% is reasonable, and the fact that the 15% was established through market competition prior to Licence award **we remain of the view that 15% is a reasonable rate of return to be applied to the Baseline Margin adjustment.**

Deloitte's report is provided in Appendix C of this response.

Appendix A – Consultation questions

Consultation question	DCC response
Question 1: What are your views on our approach to assessing DCC's costs?	In principle, we agree with Ofgem's approach to cost assessment.
Question 2: Do you have any suggestions on where we can improve our approach?	See section 2 of this response
Question 3: What are your views on our assessment of DCC's performance against the IM7?	We welcome and agree with the draft decision on IM7
Question 4: what are your views on our cost proposals?	See section 2 of this response
Question 5: We are interested in feedback from stakeholders and industry parties on DCC's external engagement. What were your experiences of engaging with DCC in regulatory year 2014/15?	See section 2.2.1 of this response
Question 6: We welcome views on DCC's benchmarking methodology, including on what you consider the appropriate percentile is that DCC should use when carrying out benchmarking, and approach to benchmarking benefits	See section 2.2.4 of this response
Question 7: We are looking for ways to further benchmark DCC costs. What other sources of data or potential comparators can you recommend for subsets of DCC costs?	See section 2.2.4 of this response
Question 8: Do you agree with our approach to real price effects (RPEs)?	See section 2.3 of this response
Question 9: What are your views on DCC's approach to the prudent estimate?	See section 3.4 of this response
Question 10: Do you agree that our proposals should take effect from April 2015/16?	We agree in principle that proposals should take effect from April 2016.
Question 11: Do you agree with our assessment against the criteria in the Licence?	See section 4.1 of this response
Question 12: What margin do you think should apply, 10% or 15%?	See section 4.2 of this response
Question 13: Do you have any views on the rate of return methodology we have developed?	See section 4.2 and Appendix C of this response

Appendix B – Average daily visitor numbers in 2015

Average daily visitor numbers September to mid-December 2015

Daily visitor numbers
September to mid-De

“Average Daily visitor numbers September to mid-December 2015.xlsx”

Appendix C – Deloitte report: Assessment of the rate of return methodology

Deloitte LLP, 19 January 2016, Assessment of Ofgem’s rate of return methodology for DCC:

2016 01 19 Final Report_RoR Review_

“2016 01 19 Final Report_RoR Review_DCC_v1.0.pdf”

Appendix D – Confidential information to support Section 2.2

[redacted]