Data Communications Company (DCC): Price Control Decision 2015/16

Publication date: 28 February 2017

Contact: Robyn Daniell

Team: Smarter Metering

Tel: 020 7901 3000

Email: smartmetering@ofgem.gov.uk

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 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 2016 we consulted on our proposals following a review of the report and information submitted by DCC. We also published a further consultation specifically on one aspect of the DCC's baseline margin application.

This document sets out our decisions and the reasons for them on the costs DCC reported under its price control for the regulatory year 2015/16 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.

Associated documents

- Data Communications Company (DCC): Price Control Consultation 2015/16 https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-consultation-regulatory-year-201516

- Further consultation on DCC Baseline Margin adjustment RY 2015/16: https://www.ofgem.gov.uk/publications-and-updates/further-consultation-dcc-baseline-margin-adjustment-ry-201516

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

- 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. 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 used interchangeably.

Contents

Executive Summary

These are our final determinations for the DCC price control for the regulatory year 2015/16. These determinations reflect our conclusions on: the economic and efficient level of costs incurred in 2015/16 and in the cost forecasts, DCC's performance against agreed milestones, and DCC's applications for an adjustment to the Baseline Margin (BM) and External Contract Gain Share (ECGS) values set out in the licence. It follows our assessment and November consultation on DCC's costs, performance and relevant notices as well as our further consultation in February 2017. You can find links to these in the associated documents above.

Cost assessment

Significant changes in 2015/16 led to increased DCC costs compared to last year's forecast, with a £6.1m or 6% increase for 2015/16 and a £190m or 10% increase over the licence period. The key cost drivers for this increase included changes to the Great Britain Companion Specification (GBCS) and the associated deferral of the go-live date and the resulting move to a multi-release strategy.[3]

The majority of respondents to the November consultation agreed with our proposals relating to costs we did not consider to be economic and efficient. However, DCC did not support our proposals and questioned why we have sought to disallow certain internal costs.

Having considered the consultation responses, we have concluded that the majority of costs incurred by DCC in RY15/16 were economic and efficient. However, we consider that DCC did not provide enough justification for some internal costs. We therefore determine £0.579 million of those costs are 'unacceptable' under the price control conditions of the licence.

We consider that the costs explained as real price effects by DCC are acceptable this year. However, we will work with DCC to provide clarity on the treatment of real price effects that we expect within the price control framework.

We consider that £79.483 million of costs in DCC's forecasts are unacceptable costs and should be removed. This is a greater amount than specified in our proposed decision published in November, and results from consideration of DCC's consultation response which brought into question the certainty of a greater proportion of forecast costs.

For shared services provided by DCC's parent company Capita, we determine that DCC has demonstrated value for money over the course of the licence in its 2015/16 price control submission. We accept that a shared service charge, as a proportion of internal costs for baseline activity, formed part of Capita's bid for the DCC licence and as such was tested through competition as being economic and efficient. However, for new scope activities which were not included in the DCC's licence bid,

[3] Please see the November consultation for more detail on cost drivers.

DCC must continue to provide justification to demonstrate any shared services cost relating to these activities are economic and efficient.

Baseline Margin

Following our further consultation in February 2017, we have determined that DCC's baseline margin values as stated in the licence should be increased by £1.109 million in RY 2017/18.

External Contract Gain Share (ECGS)

The DCC Allowed Revenue formula includes an External Contract Gain Share term. The effect of the application of External Contract Gain Share is to provide for an upward adjustment to the amount of Allowed Revenue that reflects some part of the reduction in External Costs that DCC helped achieve through amendments to DCC's External Service Provider Contracts. This term is zero unless DCC applies to vary the relevant term within Allowed Revenue.

Most respondents agreed with our proposal to accept DCC's application to amend this term reflecting a reduction in external costs as a result of a refinancing agreement for an FSP's set-up charges. The ECGS term of DCC's allowed revenue will be increased by a total of £2.911m over RY2017/18-2019/20.

Performance

Respondents agreed with our proposal that DCC achieved the implementation milestone (IM8b) in line with the specified deadline in 2015/16, but only met IM8a after the deadline. This results in a £53,462 reduction in DCC's Allowed Revenue.

Throughout our assessment we identified a number of examples where DCC has incurred costs related to issues in managing its service providers. In response to this some respondents raised the importance of DCC diligently following processes and managing service provider costs. We expect DCC to make sure that contract specifications are clear and that they have the right commercial levers in place to avoid additional cost and manage performance. We then expect DCC to demonstrate through its reporting that it has incurred contract costs as efficiently and economically as possible, doing everything it reasonably can to ensure value for money.

Next Steps - Future Price controls

We will engage with DCC on a number of issues before the submission of the 16/17 price control submission in order to improve DCC's reporting and ensure we have a shared understanding of the price control framework. We will also consider how to increase transparency of our price control assessment.

1. Introduction

1.1 DCC is a central communications body licensed to provide the communications, data transfer and management required to support smart metering. It is responsible for linking smart meters in homes and small businesses with the systems of energy suppliers, network operators and other companies. Under the DCC regulatory framework, Ofgem have the role of determining the outcome of the DCC price control on an annual basis.

1.2 We published a consultation in November 2016 with our detailed proposals concerning regulatory year 2015/16. This documents sets out our decisions on DCC's:

- economic and efficient incurred and forecast costs for regulatory year 2015/16
- application for an adjustment to its Baseline Margin
- application for an adjustment to External Contract Gain Share
- performance against Implementation Milestones 8a and 8b.

1.3 We also consider DCC's voluntary reporting under the penalty interest regime.

1.4 We have fully considered all responses received to our consultation. We have summarised the key points received from the consultation and provide an explanation of the reasons for our decisions in light of these. Please note that we may provide feedback to DCC directly on the detailed points it raised in its consultation response.

1.5 A Notice of our price control decision, determinations and directions accompanies this document. We also include a Notice providing DCC with consent so that it can reflect our decisions in its next charging statement.

1.6 For further context to these decisions **please read this document alongside our November 2016 consultation**.[4]

[4] https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-consultation-regulatory-year-201516

2. Cost Assessment

Chapter Summary

Most respondents were broadly supportive of our cost proposals. Many mentioned the cost increases over the licence term as a concern, and noted the importance of Ofgem's scrutiny of these costs. DCC disagreed with a number of our proposals.

We consider, based on the information provided by DCC, a small proportion of their costs not to be economic and efficient. We have therefore determined these costs as unacceptable costs under the licence. As such we direct that £0.579 million from DCC's internal costs in 2015/16 are unacceptable and that £79.483 million should not be included in forecasts.

2.1. DCC's 15/16 price control submission stated that total costs over the whole licence term were forecast to be £2.172 billion. This represents a £190 million (10%) increase in costs relative to forecasts submitted in RY 2014/15 and a £294 million (16%) increase compared to the initial costs included in the Licence Application Business Plan (LABP).

2.2. For the majority of costs, DCC has provided sufficient justification and evidence for the costs incurred in 2015/16. However, our cost assessment has revealed some incurred and forecast costs which we do not consider to be economic and efficient. We also consider that there is not sufficient certainty in some of DCC's forecast costs post go-live.

2.3. Under Licence Condition 37, costs that we find were not economically and efficiently incurred by DCC are described as "unacceptable costs". In respect of such costs we are required to direct whether unacceptable costs are to be excluded from any future calculation of DCC's Allowed Revenue, or to accept an undertaking from DCC on how it will manage unacceptable costs and future procurement of relevant service capability. 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 2.1.

Table 2.1: Unacceptable costs[5]

Cost Category	Total 2015/16 (£m)	Remaining years of licence (£m)
Internal Costs *(including shared service charge)*	**0.579**	**79.483**
Resource costs	0.529	72.687
Accommodation costs	0.00	6.298
IT Services	0.050	0.498
External Costs	**0**	**0**

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

- Resource costs
- Accommodation
- External Services
- IT Costs
- Shared Service costs
- External costs

2.5. We conclude this chapter with a summary of other relevant issues raised by respondents.

Resourcing: incurred costs

Proposal at consultation: £0.633m of unacceptable incurred costs (RY15/16) not justified as economic and efficient compared to resource benchmarks

Decision: £0.529m of unacceptable incurred costs (RY15/16) not justified as economic and efficient compared to resource benchmarks

Respondent's views

2.6. Based on the information provided to them in the consultation, most respondents agreed with the proposal. Many recognised the need for DCC to have specific expertise, but there was widespread concern about the levels of increase to resourcing costs for 2015/16 as well as future years. In light of this many respondents emphasised the importance of these costs being managed and evidenced by DCC and scrutinised by Ofgem.

2.7. One respondent raised a concern that there had been double counting in the number of FTE reported for the Service Desk and Operations cost centre on page 32

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

of the consultation. They had compared the data in the consultation to that in DCC's annual report for 15/16.

2.8. One respondent was of the opinion that overuse of contract resources had meant they had experienced duplication of conversations with DCC due to contractor succession. Therefore, they considered contractors were uneconomic in long term roles. They also considered the increase in FTE for corporate management was not adequately explained within the consultation, which we discuss in the reasons section below.

2.9. DCC and one respondent who requested their response remain confidential disagreed with our proposal. DCC consider that they have appropriate resourcing and recruitment processes in place to manage costs. They argue that benchmarking is not an exact measure and was given too much weight in the proposed position. They stated there was not enough consideration of issues such as the impact of a shortage of skills in the market and the wider value to the organisation of having highly skilled employees.

2.10. DCC also consider we should assess DCC's resourcing in light of the outputs delivered and the company's performance as a whole rather than looking at an individual cost centre level.

Reasons for our decision

2.11. Our view on what permanent and contractor costs over the relevant benchmark are unacceptable remains unchanged. We do not consider that DCC has provided sufficient justification for levels of remuneration in some cost centres.

2.12. We recognise there are some cases where remuneration above the 50th percentile compared to relevant resource benchmarks can be justified for permanent staff, where DCC provides sufficient evidence. For some cost centres we acknowledge the specialist and complex activity and have accepted a higher benchmark this year. Nevertheless our starting point for future years, assuming the same benchmarking methodology, will remain that we expect DCC's permanent staff remuneration to be on average at the 50th percentile when compared with similar roles in wider industry, unless clearly justified by DCC.

2.13. We also acknowledge the need for contractors in the short term and the challenge in benchmarking for this resource, although we have used the approach adopted by the DCC itself as the basis of our considerations. For certain cost centres where workload is closely linked to go-live activities, we recognise DCC requires highly skilled contractors in the short term, meaning paying above the benchmark is justified. However, we still do not consider this justification should extend to all areas of contractor use by DCC.

2.14. DCC mention in their response that in general resource costs above the relevant benchmarks are due to shortage of skills in the market and the wider value provided by highly-skilled employees. However, this statement alone without supporting evidence is not sufficient for us to reconsider our proposals. We also acknowledge that benchmarking is not an exact measure and we consider our decision reflects this and is proportionate.

2.15. We have considered DCC's suggestion to take a more holistic view of resourcing. However, taking this approach would not allow us to consider DCC's individual justification for how resource costs compare to industry benchmarks for each cost centre.

2.16. To clarify one respondent's concern about double counting the number of FTE, although we have included the service desk in DCC's total FTE to illustrate the size of the team, these services are provided externally and reported under the price control as external services within DCC's internal costs. DCC have not included the service desk in staff costs as part of their annual report and therefore have not double-counted these costs.

2.17. In response to one respondent's request to provide additional information on the drivers of increase in FTE in corporate management, the main driver is that a larger regulatory team is required beyond that anticipated at bid and in previous years.

2.18. We have revised the disallowed cost following the final quality assurance of our analysis. For the avoidance of doubt, the value has changed due to further quality assurance work on our calculations rather than a change in policy or approach. Therefore, we determine that £0.325m of permanent resource and £0.204m of contractor resource costs in RY15/16 are unacceptable.

Resourcing: forecast costs

Proposal at consultation: £52.336m of forecast costs are not economic and efficient due to insufficient evidence that the volumes of activity and subsequent costs are certain enough to be included in forecasts

Decision: £72.687m of forecast costs are not economic and efficient and therefore have been removed from DCC's forecast costs

Respondent's views

2.19. As mentioned in the above section, many respondents had concerns about costs escalating over the licence and supported our proposal to remove a proportion of them from DCC's cost forecasts.

2.20. DCC state that they make forecasts with careful consideration and the level of disallowance is concerning. They are aware however that they can still incur these costs in the future and provide justification as to why they are economic and efficient.

Reasons for our decision

2.21. Considering respondents' views, we maintain our position that there was not sufficient justification in DCC's submission that these costs were likely enough to be included in forecasts. We note that DCC can come back in future years to justify these costs.

2.22. After considering DCC's response on this issue and the BM application it has become clear from DCC's response that Ofgem and DCC have taken different interpretations of the relevant licence conditions that govern which costs DCC should include in their forecasts. When justifying forecasts, it is important that the likelihood and size of variations is justified for the duration of the licence to ensure that it creates a reasonable baseline for subsequent price controls. We plan to engage with DCC prior to the next price control to provide greater clarity on what should be included in price control forecasts.

2.23. Given the above we consider a further proportion of forecast costs in DCC's reporting over and above our consultation proposal are not sufficiently likely to occur compared to our proposal and therefore should be removed from price control forecasts.

Accommodation

Proposal at consultation: £6.298m of forecast costs not economic and efficient due to insufficient certainty and given the flexibility that DCC has to lease back office space back to Capita in future years.

Decision: £6.298m of forecast costs not economic and efficient (as proposed).

Respondent's views

2.24. Many respondents agreed with our cost proposals or had no specific comments regarding our assessment of DCC's costs relating to accommodation. One respondent expressed concern about escalating costs. Another questioned whether it is appropriate for DCC to be located in London given the associated premiums to expenditure.

Reasons for our decision

2.25. Broadly respondents agreed with our proposal and we have concluded that a proportion of forecast accommodation costs are not economic and efficient. This reflects the flexibility for DCC to reconsider accommodation options in the future to ensure it delivers value for money as moves into operational stages.

External Services

Proposal at consultation: £0.013m incurred costs and £0.038m forecast costs not economic and efficient relating to external services procured to evidence their proposal for an adjustment to their Baseline Margin.

Decision: Determine these costs as being economic and efficient.

Respondent's views

2.26. Similar to our accommodation proposals, most respondents had no comments beyond their wider agreement for our proposals.

2.27. DCC disagreed with the principle that they should not incur external services costs to justify the commercial position of their parent company, Capita. They consider that the need to justify their margin applications in line with the licence require them to seek external advice to assist them in response. They also consider it is in DCC's interest, not just their parent company's, to achieve the right margin as it is their main mechanism to absorb disallowed costs and consider it a regulatory cost. Secondly, DCC stated the immateriality of proposal means we should not disallow the costs regardless of other considerations.

Reasons for our decision

2.28. We do not agree with DCC's point about the immateriality of the proposal. Materiality thresholds apply to DCC's reporting not to the Authority's determinations.

2.29. However, we do accept that this cost is related to providing justification following scrutiny and questions from Ofgem regarding the appropriate rate of return for DCC activity. We therefore agree with DCC that this should be considered as a justifiable cost as part of price control and regulatory costs.

2.30. In future price controls, we will continue to scrutinise external service regulatory costs alongside the value and expertise delivered by DCC's regulatory teams. As set out in our consultation, where the use of external services is likely to be required on a regular basis, we expect DCC to consider recruiting the necessary skills to be able to take on these activities in house.

IT Services

Proposal at consultation: £0.050m incurred costs and £0.498m forecast costs not economic and efficient. These costs relate to a change in timescales and requirements relating to the FTP server[6] that should not have been borne by DCC.

Decision: £0.050m incurred costs and £0.498m forecast costs not economic and efficient.

Respondent's views

2.31. One respondent believes the 'not paying twice' principle should apply to other cost types such as additional costs incurred by FSPs. DCC consider that these costs have not been considered in the wider context of optimising costs of the whole programme. They argue that recovering these costs could impact their commercial relationship with the FSP, and that Ofgem disallowing these costs creates an incentive for DCC to be commercially risk averse resulting in longer timescales and higher costs.

Reasons for our decision

2.32. We maintain our position that these costs were not economic and efficient. It is important that DCC is incentivised to manage their contracts efficiently and effectively. If DCC consider their approach to service provider management, including the ultimate apportionment of costs between DCC and service providers, is economic and efficient in the wider context of the programme and delivers greater benefit for consumers, they must be able to evidence and justify it as such. This is particularly true where their actions would otherwise result in consumers' paying twice for a service.

2.33. We have not seen sufficient evidence to suggest that the issue of consumers paying twice for something extends to other costs in RY 15/16. However, especially given the continued magnitude of change in RY16/17 and beyond, DCC must provide explanations for how they have ensured commercial negotiations, separately and in aggregate if appropriate, have resulted in economic and efficient outcomes.

[6] File Transfer Protocol server. This provides an interface between numerous DCC systems enabling the transfer of data.

Shared Services[7]

Proposal at consultation: DCC has demonstrated value for money associated with the incurred and forecast shared service costs in its 2015/16 price control submission, conditional on the impact of our decision on uneconomic and efficient costs. We proposed to cap costs associated with shared service charge based on DCC's approach to estimate costs to DCC if they could not draw on support from Capita.

Decision: We determine that DCC has demonstrated value for money for its shared service charge over the course of the licence in its 2015/16 price control submission, conditional on the impact of our decision on uneconomic and efficient costs. DCC must fully justify applying any shared service charge on future new scope costs.

Respondent's views

2.34. DCC and one confidential response disagreed with the concept of a cap on shared services. Both consider the level of service charge on Internal Costs was agreed at licence award. They therefore disagree with Ofgem requiring DCC to justify this cost on an ongoing basis.

2.35. If there were a cap on shared service, DCC question the level of the cap. This is because they consider the evidence they provided as part of the price control was to provide greater insight, not a full cost-benefit analysis.

2.36. Two other respondents were supportive of the idea of a cap. One of these respondents had concerns that we based the value of the cap on DCC's evidence, rather than an independent source. They thought that DCC needed to explain the additional benefits they enjoyed from the shared services costs that were initially not included in LABP.

Reasons for our decision

2.37. We recognise the benefits provided by Capita and accept that a shared service charge, as a proportion of internal costs for baseline activity, formed part of the LABP which was determined as a result of a competitive process. Taking this into account and other information provided by DCC through the 15/16 price control, we consider that DCC has provided sufficient evidence demonstrating value for money for the shared service charge over the course of the licence, conditional on the impact of current and future decisions on uneconomic and efficient costs.

2.38. As a result, in future years we do not require further justification for the shared service charge associated with baseline activity for price control purposes. Nor will we be implementing a cap. We encourage the DCC to continue to monitor its

[7] The definition of the shared service charge is taken from the RIGs and is the amount paid by the Licensee for shared services sourced from the Licensee's parent company. This is similar to a corporate overhead charge as it recovers an allocation of group overhead.

shared services charges and to improve the way in which it tracks the value arising from the shared services charge, including to better understand any intangible benefits provided from Capita.

2.39. However, we know that costs relating to new activities that were not included at LABP are expected to rise in coming years. As these new scope activities were not part of the LABP and therefore not subject to competition, DCC will need to provide full justification that any shared services costs related to these activities are economic and efficient. We consider the methodology used by DCC in their 2015/16 price control submission for estimating the tangible benefits of the services provided by Capita as reasonable. However, we encourage DCC to improve their processes and methodology for estimating the intangible benefits as part of any future justification.

2.40. As such, we do not consider it appropriate for DCC to automatically apply shared services charges to new scope costs. DCC should only do so where it can justify that it is economic and efficient to do so.

External costs

Proposal at consultation: Incurred external costs are economic and efficient for the regulatory year 2015/16.

Decision: Incurred external costs are economic and efficient for the regulatory year 2015/16 (as proposed).

Respondent's views

2.41. Respondents largely supported the proposal that external costs were economic and efficient for 2015/16. One respondent asked for more information about why the CSP North costs have increased, which we discuss in the reasons section below.

Reasons for our decision

2.42. Broadly respondents agreed with our proposal. Reflecting the rationale we outlined in our consultation we consider the external costs economic and efficient. For the avoidance of doubt, we did not propose any forecast external costs as not being economic and efficient.

2.43. In response to the query on the causes on cost increases to CSP North costs, the main driver is greater new scope cost related to uplifting the solution to GBCS v.0.8.1 (CR091) and some costs associated with the two phase release (CR160) which were already reportable for the CSP North in 15/16.[8] DCC evidenced and justified these as economic and efficient for 2015/16.

Other points raised by respondents

Transparency

2.44. Many respondents, including DCC, considered there could have been more transparency on the amount of detail (i.e. further cost breakdowns and disallowance calculations) provided in the consultation.

Our view

2.45. We believe the consultation had sufficient information to enable informed responses from all parties. However, we have taken on board these comments and will review the level of detail that is provided to all interested parties in future years' consultations, taking into account commercial confidentiality.

Ex post vs ex ante price control

2.46. DCC raised a number of points in their consultation response stating that the ex post price control framework is more penal than an ex ante regime and that we should calibrate our assessment accordingly. DCC refer to the greater flexibility afforded by businesses regulated under an ex ante control including the ability to trade off over and under spends, share inefficient costs with consumers and earn additional revenue through outperformance. DCC also mention that under an ex ante regime, efficiency is usually set at an upper quartile, upper third or average.

Our view

2.47. DCC's licence sets out the specific price control framework to set Allowed Revenue. We recognise the points raised by DCC are characteristics of some ex ante models. However, we do not consider them valid arguments for amending our cost assessment process under the ex post regime. Any price control framework is designed to ensure that the various component incentives work together and do not contradict each other in any way. Therefore, we do not consider it appropriate to directly apply a limited number of ex ante principles to the ex post regime.

2.48. We are open to further engagement on possible amendments or alternative models to DCC's price control framework. Our long-term preference remains to move to an ex ante price control, once there is sufficient stability in the DCC's business.

---

[8] Note that the large majority of external costs associated with CR160 are not included RY15/16 price control.

Central Registration Service

2.49. One respondent asked for clarification on the price control arrangements for the central registration service. More information on these specific arrangements can be found in the decision document on DCC's role in developing a Centralised Registration Service.[9]

[9] https://www.ofgem.gov.uk/publications-and-updates/decision-dccs-role-developing-centralised-registration-service

3. Baseline Margin and ECGS applications

Chapter Summary

Our decision is to adjust the Baseline Margin (BM) and External Contract Gain Share (ECGS) terms within its Allowed Revenue. We have directed an adjustment of £1.109m to the BM term in 2017/18 and adjustment of £2.911m to the ECGS term between 2017/18 and 2019/20.

Baseline Margin

3.1. 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.

3.2. For RY15/16, DCC applied for a £1.604m adjustment to their baseline margin. Their notice explains this related to two drivers. The first was a significant increase of volumes of activity they have been required to undertake as a result of re-planning to a multi-release strategy during RY15/16. The second was the additional new scope activities they have undertaken.

3.3. When considering DCC's consultation response it became clear we had differing interpretations of when the grounds for a baseline margin application arise. In recognition of this uncertainty we took the decision to use our discretion to reconsider DCC's application, notwithstanding that DCC did not apply in the correct Application Window. In February 2017, we updated our proposal and consulted on directing an adjustment to DCC's Baseline Margin from the £0.647m consulted on in November 2016 to £1.109m. Please see the February consultation for further detail.[10]

Proposal at consultation (November 2016): Direct an adjustment to DCC's Baseline Margin of £0.647m. We consider it appropriate for DCC to have applied a 15% margin rate to the variation.

Proposal at consultation (February 2017): Direct an adjustment to DCC's Baseline Margin of £1.109m. We consider it appropriate for DCC to have applied a 15% margin rate to the variation.

---

[10] https://www.ofgem.gov.uk/publications-and-updates/further-consultation-dcc-baseline-margin-adjustment-ry-201516

Decision: Direct an adjustment to DCC's Baseline Margin of £1.109m. We consider it appropriate for DCC to have applied a 15% margin rate to the variation.

Respondent's views

Value of adjustment

3.4. One respondent to the November consultation specifically mentioned the methodology we used to form our proposal. They agreed with our approach to consider the variation between forecast and actual 15/16 FTE. DCC disagreed with our proposal and stated that they had interpreted the licence differently and had understood that they should only apply for BM when costs were sufficiently certain to attract margin; in this case when costs were incurred. In recognition of this ambiguity in the licence conditions, we considered it appropriate to re-assess DCC's application and issued the February consultation.

3.5. We had four responses to the February consultation including DCC. One respondent stated that the proposed increase to the BM was too high and called for greater transparency on the process. One respondent supported the increase to the proposed adjustment, but stated that future variances from LABP should be scrutinised carefully. They stated that DCC's approach to providing sufficient justification to their BM applications should be extended to their annual charging statement forecasts.

3.6. Another respondent stated that they consider that DCC would have been entitled to an adjustment but did not apply in accordance with the licence. They consider that determining whether discretion should be applied is a matter for Ofgem. The same respondent suggested that if the difference in interpretation could have been identified any sooner, they would not expect the full (if any) of the increase in margin between the November and February proposal to be made.

3.7. DCC's response to the February consultation stated that the element of the application which we did not consider justified in the February proposal, has the same merits as the rest of the claim and hence should be accepted, but did not provide further explanation or evidence to support this position.

Margin rate

3.8. Three respondents disagreed with our proposal to allow DCC a 15% margin rate on the variation. One considered that the level should be lower given that DCC are a low risk monopoly business, another thought that the level should be 8-12% in line with code bodies such as Electralink or Gemserv. One supplier was supportive of a 15% margin this year, but considered that this should be reconsidered once DCC is fully established.

3.9. One confidential respondent considered it was a commercial expectation for DCC to receive a 15% margin for the licence term.

Reasons for our decision

Value of adjustment

3.10. DCC did not provide sufficient additional information or analysis to justify an adjustment to their BM above the level we consulted on in February. It therefore remains our view that a £1.109m adjustment is appropriate.

3.11. We acknowledge one respondent's suggestion to reduce the amended adjustment if the difference in interpretation could have been identified any sooner. However, we consider it fair in this circumstance to award the full proportion of the margin that DCC was able to justify, given the uncertainty this year.

3.12. We note the requests for greater transparency on the mechanism in order for other stakeholders to be able to engage more on this issue and hold DCC to greater accountability.

3.13. We will carry out further work to address the uncertainty discussed above. Further, we will also be considering whether we can introduce greater transparency around our consideration of DCC's costs and adjustments to DCC's BM.

Margin rate

3.14. We have decided that the 15% margin rate on the RY15/16 variation is appropriate given that DCC was still in implementation phase and the relative proximity to licence award. However, DCC should not interpret us accepting the 15% margin rate pertaining to the specific application it put forward this year as setting a precedent for future applications.

3.15. 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. DCC agreed to the £m million figures in the licence with a mechanism to apply for adjustments to these figures in future years. We consider that the margin applied to any future variations that form the basis of a BM application should be properly justified. This should include supporting evidence on why any new activity should attract a specific rate of return which could include comparisons to other providers of similar types of activity.

External Contract Gain Share

3.16. The effect of the application of External Contract Gain Share is to provide for an upward adjustment to the amount of Allowed Revenue that reflects some part of the reduction in External Costs that DCC helped achieve. This term is zero unless DCC applies to vary the relevant term within Allowed Revenue.

Proposal at consultation: To confirm DCC's application to adjust the EGCS term by a total of £2.911m between 2017/18 and 2019/20 reflecting a reduction in external costs as a result of a refinancing agreement for an FSP's set up charges.

Decision: To confirm DCC's application to adjust the EGCS term by a total of £2.911m between 2017/18 and 2019/20 (as proposed at consultation)

Respondent's views

3.17. Overall respondents supported that we intend to adjust the EGCS based on DCC's application to amend this term reflecting a reduction in external costs as a result of a refinancing agreement for an FSP's set-up charges. However, one respondent considered a combined 44% gain share for the DCC and service provider as unacceptably high.

Reasons for our decision

3.18. The reasons set out in our November consultation still stand. In summary, DCC provided sufficient evidence to demonstrate that they were instrumental in an arrangement that resulted in an overall saving for energy consumers. The level of gain share awarded is appropriate as evidenced through benchmarking of other comparable regulatory processes.

4. Performance

Chapter Summary

Respondents agreed with our assessment that DCC delivered against Implementation Milestone 8 in the North region later than the due date as directed by BEIS. This is reflected in DCC's allowed revenue calculation in 2015/16 through the Baseline Margin Performance Adjustment ($BMPA_t$) factor in the price control calculation.[11] This will result in a £53,462 reduction.

Performance against Implementation Milestones (IMs)

Proposal at consultation: Disallow £53,462 from RY15/16 Allowed Revenue

Decision: Disallow £53,462 from RY15/16 Allowed Revenue (as proposed)

Respondent's views

4.1. The majority of respondents, including DCC, agreed that IM8a was delivered after the deadline and that IM8b was delivered on time. The value of the disallowance was also noted as correct by DCC.

4.2. One respondent considered that DCC did not meet IM8b as the deadline for the milestone was moved on a number of occasions. Another did not consider that it was appropriate for DCC to have met the milestones, as they propose the milestone dates themselves. Both considered that the small size of the disallowance for IM8a was not proportionate.

Reasons for our decision

4.3. We consider our proposal consistent with the regulatory framework, the majority of respondents' views and the evidence provided by DCC.

4.4. Ofgem's role in the IM regime is to determine if DCC has met milestones on time and calculate the subsequent impact on Allowed Revenue. The development of this section of the regulatory framework is not within the scope of Ofgem's responsibilities, being overseen by the Secretary of State.

[11] Licence Condition 36.7

Fundamental Service provider contract management

4.5. Two respondents responded to the consultation, stating that the importance of DCC diligently following processes and managing costs of FSPs. One respondent stated concerns that we found contract management issues in our assessment.

4.6. We noted in our November consultation that DCC has taken a number of steps to improve these areas of activity during 2015/16. We expect DCC to make sure that contract specifications are clear and that they have the right commercial levers in place to avoid additional cost and manage performance.

4.7. We then expect DCC to demonstrate through its reporting that it has incurred contract costs as efficiently and economically as possible, doing everything it reasonably can to ensure value for money. As noted in the consultation, we consider that DCC needs to provide clearer evidence of benchmarking wherever possible to demonstrate that alternative options including the counterfactual have been considered.

5. Revenue Reporting

Voluntary reporting with respect to the penalty interest regime

5.1. All future price control submissions will be subject to a 'Report and Direct' penalty interest rate regime. If DCC over-recovers revenue from users beyond 110% of Allowed Revenue then a penalty interest of 3% above the Bank of England base rate may apply (subject to a direction from the Authority) on any proportion of that over recovery not justified by DCC to the Authority's satisfaction[12].

5.2. For DCC's 15/16 price control submission we invited DCC to submit voluntary reporting on their reasons for over-recovery of revenue as part of the 15/16 price control. As set out in the consultation, we consider that DCC should provide further detail in future submissions if they exceed the 110% recovery threshold, including explanation of delays in returning over-recovered service charges to users.

Respondent's views and our response

5.3. Two respondents agreed that DCC needs to provide further detail to justify over-recovery beyond the threshold. DCC said that they will factor in the need to include further detail in future submissions.

5.4. Another respondent said they would like additional information on the probability of DCC recovering costs by greater than 110% of allowed revenue, how the 3% penalty would be applied and who would ultimately bear the cost. In response to these questions, DCC bears the cost of the penalty through a reduction in Allowed Revenue that they may recover from users. We expect the probability of DCC recovering by greater than 110% of Allowed Revenue to diminish significantly as DCC becomes more established and the penalty interest rate comes into effect.

5.5. One respondent considered that DCC's rationale for over-recovery was commercially driven and that Ofgem should not set a precedent of accepting forecasting errors without penalty. We consider that the penalty interest rate regime which takes effect this year provides sufficient incentive on DCC to make appropriate use of its prudent estimate[13].

[12] https://www.ofgem.gov.uk/system/files/docs/2016/05/decision_to_modify_smart_meter_communication_licence_for_dcc_penalty_interest_rate_web_version.pdf

[13] DCC's charges to Service Users are based on a prudent estimate of Allowed Revenue that is sufficient to cover their anticipated costs for the year so that charges will not need to be changed within the Regulatory Year

5.6. In response to our concerns of delay in returning over-recovery to users, DCC agree that returning over-recovered revenue promptly is beneficial and explain they have already taken steps to return revenue to suppliers as soon as practicable. DCC are happy to discuss charging arrangements more broadly with Ofgem and the rest of industry.

6. Next Steps

Future Price controls

6.1. We are pleased that DCC has continued to make further improvements to its price control submission. However, there are still areas where we consider DCC's reporting should improve, notably the level of justification provided in relation to resource benchmarking.

6.2. We also consider that there are a number of areas that would benefit from us providing greater clarity to DCC on the price control framework. DCC needs to be clear on what costs should be included in the price control forecasts based on the level of likelihood that these costs would be incurred. Linked to this we will provide further clarity to ensure that DCC understands the framework that permits DCC to apply for a relevant adjustment to the baseline margin.

6.3. We recognise other respondents' views that through the consultation process they often feel they don't have enough information to provide a meaningful response to our price controls proposal. However, while we are confident that the consultations supporting this decision provided sufficient information for parties to make informed responses, we are keen to explore if it is possible to increase the of transparency provided to stakeholders without compromising commercial confidentiality relating to DCC costs.

6.4. We will be engaging with DCC on all of these points bilaterally before the submission of the 16/17 price control submission by 31 July 2017.

Appendices

Index

Appendix 1 - 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.

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

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

Department for Business, Energy & Industrial Strategy (BEIS)
The UK government department responsible for business, industrial strategy, science, innovation, energy, and climate change.

C

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

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

D

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

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

E

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

F

FTE
Full Time Equivalent

G

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

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

H

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

I

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

L

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

R

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

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

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

S

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 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

Smart Meter

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

Smart Meter Communication Licence

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

M

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

O

Ofgem
Office of Gas and Electricity Markets

ONS
Office for National Statistics

P

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

Appendix 2 - Feedback on this consultation

We want to hear from anyone interested in this document. Send your response to the person or team named at the top of the front page.

We've asked for your feedback in each of the questions throughout it. Please respond to each one as fully as you can.

Unless you mark your response confidential, we'll publish it on our website, www.ofgem.gov.uk, and put it in our library. You can ask us to keep your response confidential, and we'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004. If you want us to keep your response confidential, you should clearly mark your response to that effect and include reasons.

If the information you give in your response contains personal data under the Data Protection Act 1998, the Gas and Electricity Markets Authority will be the data controller. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. If you are including any confidential material in your response, please put it in the appendices.

General feedback

We believe that consultation is at the heart of good policy development. We are keen to hear your comments about how we've conducted this consultation. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

Please send your comments to stakeholders@ofgem.gov.uk