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DCC Price Control Consultation: Regulatory Year 2016/17

Consultation

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Overview:

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

In this document we review the costs DCC reported for regulatory year 2016/17. We set out our proposals. We also explain our assessment of DCC's application to amend its baseline margin and External Contract Gain Share values. We also assess DCC's performance against the final implementation milestones. We would like to hear your thoughts on our proposals.

The DCC, service 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 and provide incentives to counter its monopoly position to deliver more efficient, better performance and innovation.

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

DCC submitted its price control reporting templates for 1 April 2016 to 31 March 2017 on 31 July 2017. On the same day it submitted a proposal for an adjustment to its baseline margin and External Contract Gain Share values.

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

Associated documents

- Data Communications Company (DCC): Regulatory Instructions and Guidance
  https://www.ofgem.gov.uk/publications-and-updates/data-communications-company-dcc-regulatory-instructions-and-guidance-2017

- Guidance Document: Processes and Procedures
  https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-guidance-processes-and-procedures-0

- Smart Meter Communication Licence
  https://epr.ofgem.gov.uk/Document

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

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

Contents

Executive Summary

The DCC has a pivotal role in ensuring the successful roll-out and ongoing operation of smart metering in the GB energy market. As a monopoly service provider, it is vital that appropriate controls are in place over its costs and that it is subject to an appropriate incentive regime which focusses it on providing a good quality of service to its customers, including energy suppliers. This is a challenging role for the DCC and one which will require it to engage with and understand their customers and the value they place on the services DCC offers. Through the DCC's price control, Ofgem is seeking to ensure that DCC continues to be able to make the required investments to deliver a good quality of service, whilst also focusing the organization on delivering an efficient operation.

Regulatory year 2016/17 (RY16/17) was a significant year for DCC consisting of the final stages of development and completion of the first stage of release of the live service. During this regulatory year, the effects of the move to a two-stage release for DCC going-live crystalised. This change was in part driven by the need to update enduring metering specifications (GB Companion Specifciation (GBCS)) on security grounds. DCC also progressed with developing – always anticipated - programmes to expand smart metering capability including the development of Dual Band Comms Hubs (DBCH), the SMETS1 (first generation smart meters) enrolment and adoption and the beginning of the transitional phase of the switching programme.

This activity has led to a significant increase in costs compared to last year's price control submission. In RY16/17 total costs were £210.8m, £68.2m or 48% higher than forecast last year. Over the licence term, total costs were £566.7m or 27% greater than last year's forecast.

As part of its Price control submission, DCC must explain any variation between costs incurred or forecast in RY16/17 and costs forecast as part of its Licence Application Business Plan (LABP) and in the previous year's price control submission. DCC must demonstrate through its reporting that it has incurred costs as efficiently and economically as possible, doing everything it reasonably can to ensure value for money.

Cost assessment

DCC's submission in RY16/17 was largely clearly laid out and evidenced providing reasonable justification for the majority of costs incurred. However, the submission has revealed two main issues where we have concerns and where as a result we are proposing some cost disallowances or removing expected costs from their forecasts:

- **Resource efficiency.** DCC's headcount grew significantly in RY16/17 and is set to increase to 340 full time equivalents (FTEs) in RY17/18 with no indication that DCC expects to realise efficiencies and reverse this trend over time. We expect DCC to publish and commit to efficiency targets for these years in order to demonstrate to customers that cost efficiency is central to their business planning strategy.

- **Contract management performance.** There is evidence that DCC has incurred additional costs at consumers' expense on activity that that should be delivered by their fundamental service providers. It is DCC's responsibility to ensure that all

contracts are fit for purpose and that they hold their service providers to account for delivery.

In addition to costs related to the above we do not consider the level of remuneration for some contractors in RY16/17 as economic and efficient. We also consider that DCC did not provide sufficient justification for forecast costs relating to external services and service management.

Overall, we propose that £1.751m from DCC's total cost in RY16/17 are unacceptable costs, and propose not to allow a £71.295m increase in their forecasts over the remaining terms of the licence. Please see Appendix 4 for the detailed breakdown on the proposed unacceptable costs.

Any costs that we consider were not economically and efficiently incurred will either be excluded from the future calculation of allowed revenue or be subject to an undertaking about their future management.

Performance

We have assessed DCC's performance against the final milestones in the Implementation Performance Regime (IRP). Implementation milestones 9 and 10 relate to the delivery of the first and second release of live DCC services. We propose that DCC has largely failed to meet these milestones.

We therefore propose to disallow a total of £4.702m from DCC's allowed revenue through the Baseline Margin Performance Adjustment term.

Baseline margin

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.

For RY16/17 DCC has applied for a £13.955m adjustment to their Baseline Margin (BM) for RY16/17 to RY20/21 due to five key drivers which has lead to increased complexity of DCC's solution, shifts in timelines and the volume of resources required to deliver on DCC's scope of work. These include:

- changes in the baseline requirements for SMETS2 programme
- changes in SMETS2 programme operational requirements
- new scope requirements stemming from release 2.0 (including DBCH)
- SMETS1 programme work
- DCC's role in the switching programme's Centralised Registration Service (CRS).

We propose to adjust DCC's application to reflect the price control decisions on unacceptable costs. We also propose to reject the part of DCC's application relating to SMETS2 programme operational requirements. It is unclear from DCC's application how the rationale for the size and associated volumes of its operational function relative to the LABP meets the criteria in the licence for an adjustment. Based on the information

submitted by the DCC, we consider that any ramp up in operations activity is evidence of DCC underestimating the operational requirements at bid stage rather than directly as a result of activity relating to new requirements. We consider it is appropriate for DCC to have applied a 15% margin to those areas of the application which we propose to approve. **Taking this all into account we propose amending their application to an adjustment of £5.134m between RY16/17 and RY18/19.**

External Contract Gain Share

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. This term is zero unless DCC applies to vary the relevant term within Allowed Revenue.

Similar to last year, DCC has applied to adjust this term for RY2018/19-2020/21 reflecting a reduction in External Costs as a result of a further refinancing agreement for a fundamental service provider's (FSP's) set-up charges. **We propose to accept DCC's application to adjust the ECGS term by a total of £3.261m.**

Next steps

We welcome your views, and will consider them when we take our decision. Please send responses to smartmetering@ofgem.gov.uk by 21 December 2017. We will publish our decision in February 2018.

1. Introduction

DCC Price control

1.1. We have a role in ensuring that DCC's costs are incurred economically and efficiently. We review DCC's costs and performance after the end of the regulatory year in which the costs were incurred and forecast costs that DCC deem certain enough to include in their forecast allowed revenue. This approach is referred to as an 'ex post' price control. DCC must submit price control information by 31 July following each regulatory year in line with the Regulatory Instructions and Guidance (RIGs)[3]. Price control reporting covering the regulatory year from 1 April 2016 until 31 March 2017 was submitted on 31 July 2017.

1.2. Over the licence term the majority of DCC costs are incurred by their fundamental service providers (FSPs), comprising of the communication service prviders (CSPs) and the data service provider (DSP), who are responsible for delivering the data and communications services to support smart metering, and were appointed through a competitive tender process. One of DCC's key responsibilities is to effectively manage these large external contracts and ensure value for money and good quality service for consumers. The costs incurred by the FSPs are referred to as External Costs within DCC's allowed revenue.

1.3. All other costs incurred by DCC in relation to the provision of the service with the exception of pass through costs[4] are referred to as Internal Costs.

1.4. 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 in allowed revenue. The level of baseline margin allowed each year is fixed in the licence. Each July, DCC can propose an adjustment be made to the value in the licence. The licence provides criteria related to actual, or likely, material changes to their business activities, risks and timescales or deadlines, which DCC must demonstrate in its proposal. It also makes clear that applications can only be made in the regulatory year immediately after the grounds for an adjustment first arose. DCC proposed an adjustment be made to the value of its baseline margin with their RY16/17 price control submission.

[3] https://www.ofgem.gov.uk/publications-and-updates/data-communications-company-dcc-regulatory-instructions-and-guidance-2017

[4] The amount equal to the total fee paid by the licensee to the Authority and the payments to SECCo Ltd for purposes associated with the governance and administration of the SEC.

1.5. DCC also submitted an application to amend the External Contract Gain Share (ECGS) term of their allowed revenue following External Cost savings. The ECGS is a mechanism within the price control for DCC to apply to increase their allowed revenue recognising their instrumental role in reducing External Costs.

Our approach

1.6. As required by the licence, our assessment of DCC costs is grounded in comparing DCC's incurred costs and revised forecast with DCC's Licence Application Business Plan (LABP) and the previous year's forecast. Our guidance document published in 2017 sets out the approach in detail and the information we expect to be provided with to enable us to determine whether DCC's costs are economic and efficient[5].

We are restricted as to the detail we can include in this document due to the commercially sensitive nature of much of the analysis we undertake. We know that some users have in the past found it difficult to provide meaningful input to the price control process given limited detail of cost information. This year we have encouraged DCC to publish parts of their submission particularly relating to key drivers of change in RY16/17 and the Baseline Margin (BM) application. Please refer to the DCC website[6].

Purpose of consultation

1.7. Our proposals are based on a detailed cost assessment following the submission of DCC's price control reporting and accompanying baseline margin adjustment and ECGS proposals in July 2017. We are seeking your views on our proposals regarding:

- **Costs:** whether DCC incurred costs economically and efficiently during regulatory year 2016/17 and if it did not, how those costs should be treated. Also, whether we accept the updated forecasts for the licence term.
- **Baseline margin and ECGS:** whether the baseline margin and ECGS values in the licence should be adjusted based on DCC's applications.
- **Implementation milestones:** whether DCC achieved the implementation milestone that fell due during regulatory year 2016/17 and what the implications are for DCC's allowed revenue.

[5] https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-guidance-processes-and-procedures-0
[6] https://www.smartdcc.co.uk/about-dcc/201617PriceControl

DCC's summary of RY2016/17

1.8. DCC provided, in its regulatory submission, an overview of the key activities in RY16/17 and factors which drove the overall levels of activity and spending across the organization. More information is available on the DCC website[7], but we have provided a short summary here.

1.9. DCC considers RY16/17 as a significant year of delivery which included the first stage release of the SMETS2 service in November 2016. DCC also undertook significant work focused on delivering future smart metering capability, including planning the development of Dual Band Communications Hubs (DBCH), exploring the feasibility of the SMETS1 Enrolment and Adoption Programme and mobilising the switching programme.

1.10. DCC identify a number of key themes in their submission that represent their experience through RY16/17. They include:

- **A determination to deliver in a highly challenging environment.** DCC faced challenges in incorporating significant upgrades to the specification before the infrastructure build could begin, while also implementing the changes to the commercial contracts. Significant work was required to identify and fix issues in the testing phase, which meant DCC drew down on the entire contingency allowed for the programme.
- **Planning for Scale.** DCC's 'readiness to scale' project was a key focus for RY16/17 to ensure that the service can be delivered at the scale and pace required to support customers with their rollout activities.
- **Finding the right balance between cost and risk.** DCC continued to find it challenging and time consuming to negotiate the level of change required to the FSP contracts. DCC took actions to manage these contracts including further investing in their commercial capability, reducing cost though contract negotiations, refinancing FSP costs to achieve a better value rate and making changes to their internal governance and finance structures to better support cost management.
- **Improving how DCC delivers change.** DCC began transforming the way they manage change in the future including the creation of an enduring release model and 'delivery hub', with the ambition of giving customers predictable, timely and efficient delivery of change.
- **Changing business focus.** DCC considered RY16/17 the turning point in its development with a view to becoming a more complex business operating the national service, maintaining the stability and quality of that service and planning and delivering major and minor infrastructure change.

[7] https://www.smartdcc.co.uk/about-dcc/201617PriceControl

- **Developing new services.** The focus of RY16/17 was devoted to the core SMETS2 solution but DCC began preparing for the additional services and products to support future smart metering capability.

Summary of DCC costs

1.11. Over the licence period (RY13/14-RY25/26), DCC's latest total cost forecast is £2.7 billion as reported in DCC's RY16/17 price control submission. This represents a 27% increase compared to last year's forecasts. Table 1.1 below breaks this down by cost type and shows how costs reported in the RY16/17 price control have changed compared to last year's forecast.

Table 1.1: RY16/17 forecast and variation compared to RY15/16 forecast over the licence period (RY13/14-RY25/26)

	RY15/16 forecast	RY16/17 forecast		
	(£m)	(£m)	Var (£)	Var (%)
External-Baseline[8]	1,453	1,471	18	1%
External New Scope[9]	371	714	343	92%
Total External Costs	**1,824**	**2,185**	**361**	**20%**
Internal-Baseline	167	253	86	52%
Internal New Scope	31	60	29	94%
Shared Service	17	26	10	60%
Total Internal Costs	**214**	**338**	**124**	**58%**
Pass Through Costs	53	128	75	141%
Baseline Margin	30	30	0	0%
Total Costs	**2,121**	**2,681**	**560**	**26%**

1.12. External Costs over the licence term have increased by 20% compared to the RY15/16 forecast to £2.185bn. The single biggest driver of the increase in External Costs is the new scope changes that led to the split initial release of DCC's live service (referred to as release 1.2 and 1.3). Chapter 2 summarises the External Cost variations, DCC's justification and our proposals.

[8] Baseline refers to activity with delivering the requirements provided to the Licensee during the DCC Licensing Competition and that the Licensee was expected to fully cost. For External Costs, these include set up costs such as User Integration Testing and System integration. Internal cost examples include costs such as service management and accommodation.

[9] New Scope refers to activity associated with delivering requirements additional to those that the Licensee was expected to fully cost in the LABP. External Cost examples include impact assessments and changes such as implementation of releases 1.2 and 1.3. Internal cost examples include SMKI, the SMETS 1 programme and the introduction of Dual Band Comms Hubs.

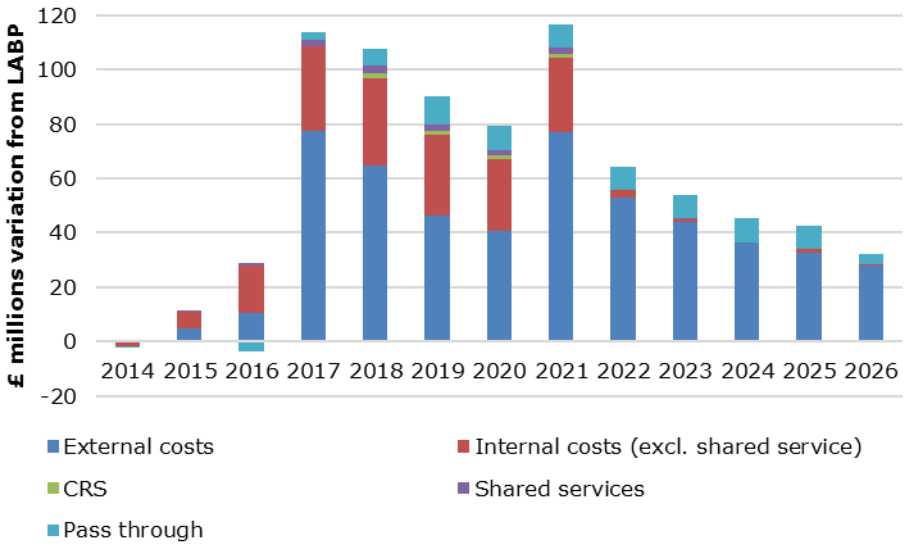
1.13. Internal Costs have increased by 58% compared to last year's forecast of £214m to £338m over the licence term. DCC explain in their submission that this due to increases in resources, external services for new scope programmes such as SMETS1 and Dual Band Comms Hubs, additional accommodation costs and additional activity costs for Smart Metering Key Infrastructure (SMKI), IT Services and automated testing of GBCS (ATG)[10]. Chapter 3 summarises the Internal Cost variations, DCC's justification and our proposals.

Comparison to the Licence Award Business Plan (LABP)

1.14. As the length of time since the DCC licence award increases, we will continue to place a greater weight on comparison to the previous year's forecasts to inform our cost assessment rather than DCC's Licence Award Business Plan (LABP). However, comparing costs back to the LABP remains an important benchmark for DCC costs and allows us to hold DCC to account for its competitive bid position.

1.15. The graph below shows how the main cost categories in RY16/17 compare to the forecast at LABP. Overall, costs are £781m or 42% higher over the licence term compared to DCC's forecast as part of the bid.

Figure 1.1: Comparison to LABP



[10] Note that the numbers presented here will not be comparable to other DCC cost information, such as those presented in DCC's business plan. This is because any costs included in the price control submission must pass the threshold of being significantly more likely than not to occur.

2. External Costs

Chapter Summary

This chapter summarises the costs incurred by DCC's fundamental service providers (FSPs) or DCC 'External Costs' for regulatory year 2016/17 and updated forecasts for the rest of the licence term. We present the costs and the variance from the previous year's economic and efficient forecast and DCC's justification for any variance as provided in their submission. We propose to find these costs economic and efficient but we believe DCC needs to strengthen performance in contract management.

Question box

Question 1: What are your views on our proposal to consider External Costs as economic and efficient?

Question 2: Do you have any views on DCC's contract management performance?

External Costs comprise a part of DCC's allowed revenue and are the costs incurred by DCC's fundamental service providers (FSPs). They include the data service provider (DSP) who is CGI and two communication service providers (CSPs); Arqiva and Telefonica. Together the FSPs are responsible for delivering the data and communications services to support smart metering, and were appointed through a competitive tender process by government.

External Costs are reported as a combination of baseline and new scope costs in the price control. Baseline costs refer to costs associated with delivering the requirements associated with the original contract award to the FSP. New scope costs include any requirements that are considered by DCC to be additional to the requirements associated with the original contract award.

How have External Costs changed?

2.1. Table 2.1 below shows the variation in RY16/17 and licence term External Costs relative to RY15/16 and LABP forecasts.

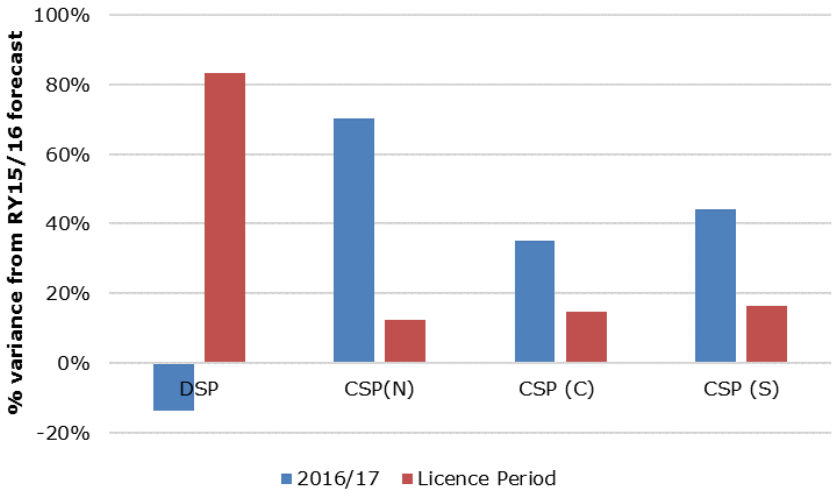
Table 2.1: External Costs variation compared to last year's forecast and the LABP

	Variation for RY 16/17		Total variation over the full licence term	
	£m	*%*	*£m*	*%*
From 15/16 forecasts	44.3	39	360.9	20
From LABP	77.6	96	516.7	31

2.2. Total External Costs increased in RY16/17 for both the year itself and for the full licence period forecast. In RY16/17 External Costs increased 39% compared to last year

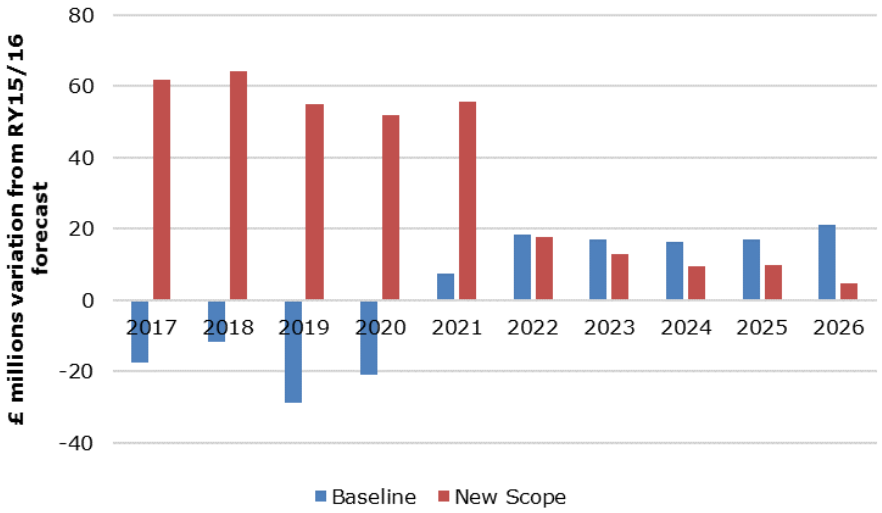
with lower DSP costs more than offset by increased costs across all three CSP regions. Costs are expected to increase for all of the FSPs over the licence period resulting in an aggregate 20% rise in External Costs over the licence compared with last year's forecast. The relative changes in each FSP's costs from last year's forecast is shown below in Figure 2.1.

Figure 2.1: Cost variations by FSP compared to the RY15/16 forecast



2.3. A number of baseline costs have been reprofiled to later years reflecting that DCC go-live was delivered later than expected. However, this has been more than offset by the volume of changes required to align the design, development, and delivery of SMETS2 with the updated GBCS and Smart Energy Code (SEC) obligations resulting in rising new scope costs. This is demonstrated by the larger variations in the near term in Figure 2.2.

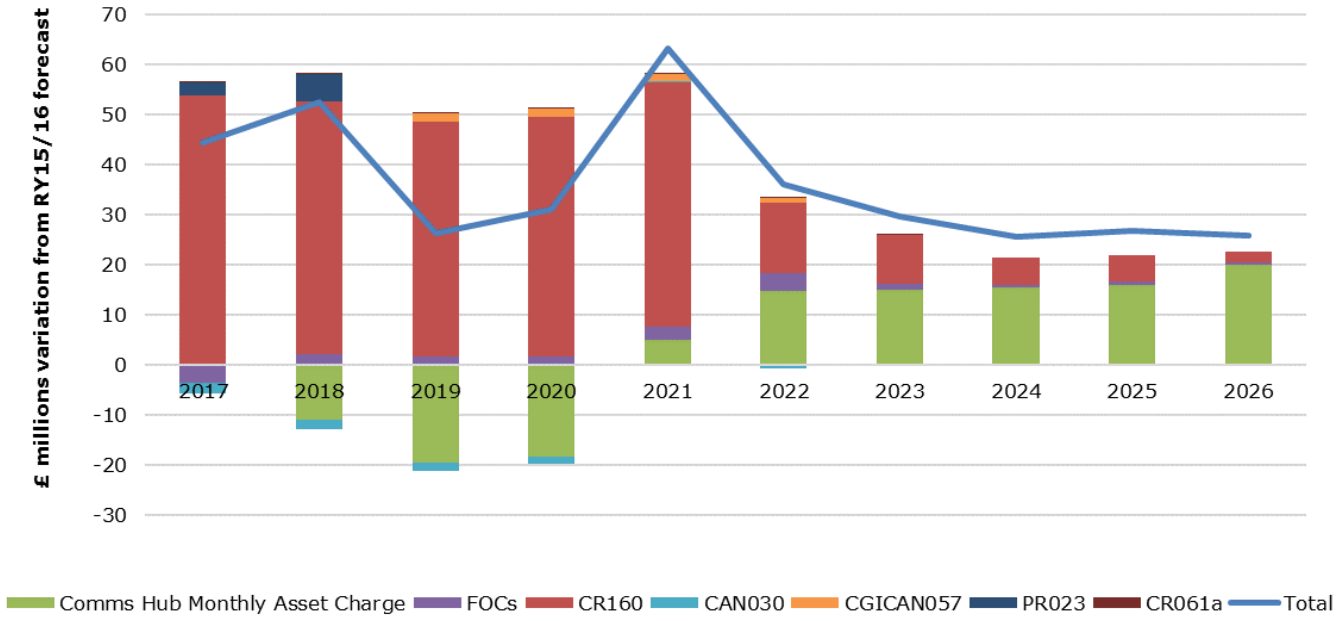
Figure 2.2: Annual variation by baseline and new scope costs compared to RY15/16 forecast



DCC's justification

2.4. Figure 2.3 shows the material drivers of variation in External Costs over the licence period, compared with last year's forecast.

Figure 2.3: External Cost variation by cost driver and key below



Key	Description
Comms Hub monthly Asset Charge	Reprofiling of Comms Hubs costs in the Central and South regions following the delay to go live
Fixed Operation Charges (FOCs)	Changes in RY16/17 that led to changes to the FSPs' operating costs as the context and scope of their services are modified in line with contractual requirements
CR160	Change request to implement release 1.2 and 1.3
CAN030	Change to amalgamate outstanding charges which were affected by the delays in achieving payment milestones, partly reflecting changes to the GBCS
CGICAN057	Change to amalgamate four new change requests related to correcting misalignments with updated SEC obligations for release 1.4
PR023	Project to progress the development of detailed DBCH specifications
CR061a	Changes to align new SEC obligations regarding remote testing

2.5. The primary driver of increased External Costs, both in RY16/17 and over the licence period, is Change Request 160 (CR160), which introduced a new version of GBCS and the re-plan to a multi release strategy for go-live (releases 1.2 and 1.3). While this change request was raised in RY15/16, it was over RY16/17 that DCC was able to negotiate and agree the requirements of CR160 with the FSPs. DCC provided additional

narrative and evidence specifically for these costs. This documentation explained and evidenced DCC's approach, how it was implemented, and their management of (and results from) due diligence during these negotiations.

2.6. DCC identified a number of other material new scope costs affecting incurred and forecast External Cost variations during RY16/17 as listed in the key table above. More details on these costs are included in Appendix 2.

Our view

2.7. **It is our view that the variation in External Costs was explained and evidenced as economic and efficient in DCC's RY16/17 submission and through subsequent communications.** DCC provided sufficient narrative regarding the need to comply with modifications to the GBCS and SEC without delaying the rollout of smart meters. The documentation demonstrated savings from the commercial negotiations with all three FSPs and described how a clear, consistent scope was agreed with each FSP.

2.8. We recognise that DCC had to manage a number of contractual modifications during RY16/17, ensuring a coherent, consistent, and coordinated approach was agreed with FSPs. Their attempts to advance the work in a manner consistent with the timelines agreed with the Department for Business, Energy and Industrial Strategy (BEIS), and in accordance with contractual obligations established with FSPs in 2013, presented further challenges. In particular, the requirement to ensure FSPs are no better or worse off in terms of margin and risk profile following a major contractual change affected the CR160 negotiations. We encourage the DCC to continue to explore all options available to them to ensure costs remain economic and efficient for consumers.

2.9. We note this year a number of material baseline costs were initially left unexplained or unevidenced. In particular, variations in the Comms Hub monthly asset charges and FOCs were initially either not justified or attributed to reprofiling these costs. We have been clear in our guidance that we will not accept statements that are not corroborated with further information. While DCC subsequently provided sufficient information and evidence, these costs should have been explained in the initial submission. It is important that all cost variations meeting the DCC's materiality threshold are both explained and evidenced in their submission.

DCC performance in Contract Management

2.10. DCC's submission for the RY16/17 price control highlighted many positive elements demonstrating their improved processes in managing their major external contracts. For example, DCC is strengthening their documentation of discussions and agreements with FSPs to ensure clear, auditable records of decisions for contractual changes. In addition, DCC has established structured feedback forms for subject matter experts (SMEs) to challenge FSP assumptions. DCC has also continued to reinforce their processes and approach with FSPs regarding the progression of change requests to

commercial agreements, including the level and focus of due diligence required. These changes will all contribute to promoting efficient, robust engagement with FSPs.

2.11. DCC has made efforts to explore alternative options available. For example, DCC and CSPs provided Comms Hubs delivery options "above and beyond the scope of the SEC" to provide Service Users with more flexibility and mitigate the impact of uncertain timelines. Although DCC occasionally felt no alternative was possible as they worked to align the FSPs with changes to mandatory GBCS and SEC obligations. DCC also continued to pursue the amalgamation of related change requests and relevant costs with FSPs. This has resulted in clear benefits for consumers through increased efficiencies in implementing related changes and offering scope for further commercial negotiations.

2.12. DCC provided a summary of their consideration of governance provisions and value for money tools defined in Schedules 7 and 8 of the FSP contracts. See Appendix 2 for more details.

2.13. However, there were some elements of the submission and feedback from stakeholders that have raised concerns regarding DCC's contract and change management. For example:

- The late delivery against plans of release 1.2 (and release 1.3 which took place in RY17/18) (see chapter 4 for the implications of this on DCC's implementation performance regime).
- Industry feedback that even when release 1.2 was delivered, stakeholders couldn't use the service effectively and proceed with their plans.
- DCC also reported instances where they decided to deviate from established procedures to enable work to continue at the pace required by their timelines, and it was unclear how such decisions were made. This included acknowledgement that SMEs did not always use the structured feedback forms to provide clear, documented challenge to all FSPs.

2.14. We were also concerned about the risk of DCC incurring additional Internal Cost related to fundamental service capability. This approach creates the potential for consumers to bear additional costs as FSPs continue to be paid to deliver the work that DCC is resourcing through additional contracts or in-house. A particular example of this relates to System Integration duties which we discuss in more detail under external services in chapter 3, where we are proposing to disallow costs.

3. Internal Costs

Chapter Summary

This chapter summarises DCC's incurred Internal Costs for RY16/17 and updated forecasts up until RY20/21. We present DCC's actual costs and the variance from the previous year's economic and efficient forecast and DCC's justification for any variance as provided in their submission. We then give our minded-to position on these cost variances to disallow £1.751m in RY16/17 largely related to operations resource and external services. We also have concerns about the future efficiency of the DCC so we propose to remove £64.726m of cost from the forecast. We also propose to disallow CRS forecasts (£6.568m). Please see Appendix 4 for the full detail on costs we propose to find unacceptable.

Question box

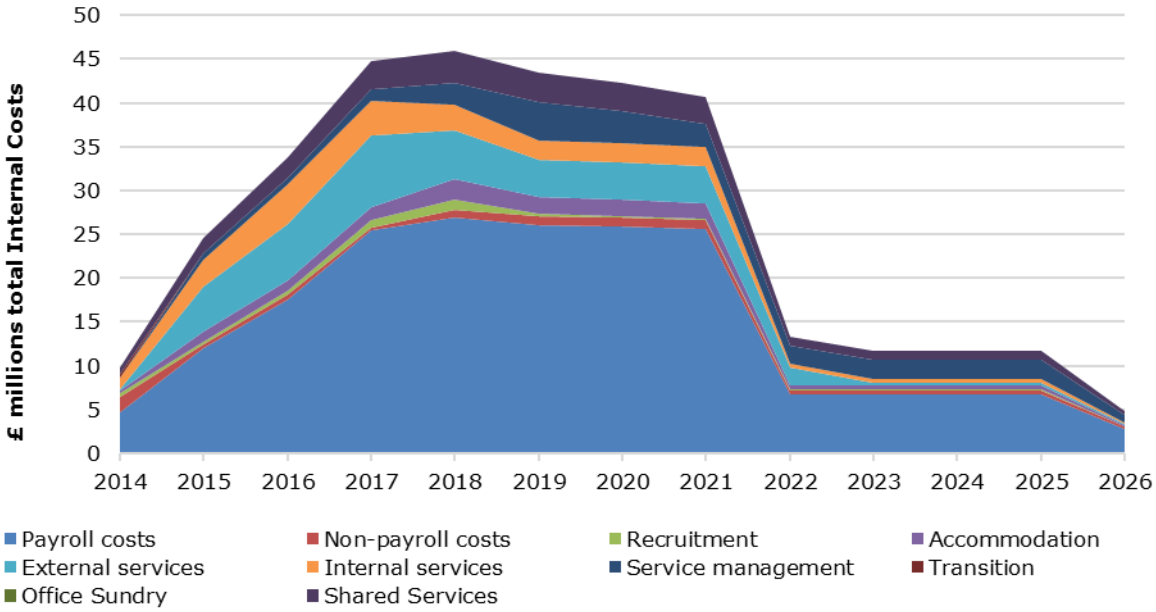
Question 3: What are your views on our proposals on DCC's Internal Costs?

3.1. Internal Costs comprise the part of DCC's allowed revenue for the purposes of provision of the DCC service (excluding External Costs and pass-through costs). These include internal payroll and associated costs, accommodation, external and internal services, IT costs and service management costs. Internal Costs are reported by 'cost centre' which cover the main activities where DCC incurs costs. Please see appendix 3 for more detail.

How have Internal Costs changed?

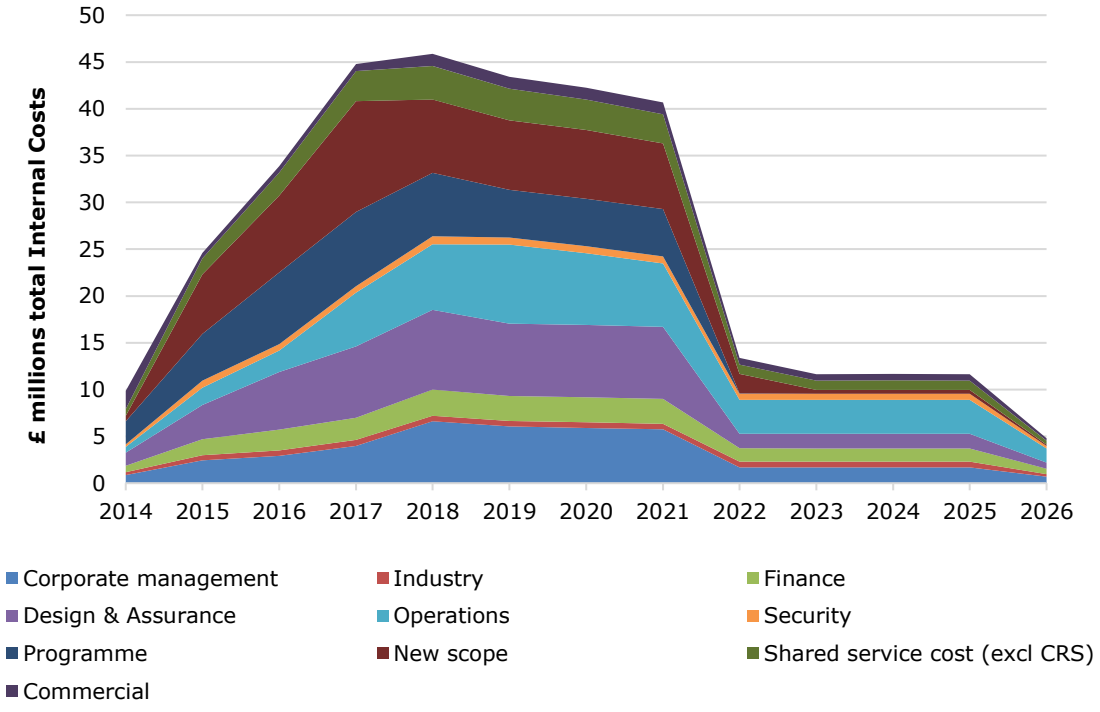
3.2. Figure 3.1 shows the distribution of costs by general ledger (GL) codes over the licence period based on DCC's RY16/17 submission. The majority of Internal Cost forecasts were only updated this year from RY17/18 to RY20/21 as the criteria for inclusion of whether activity and costs were significantly more likely to occur than not had not been met past 2021. Internal Costs are set to peak in RY17/18 according to DCC's price control forecast. The GL codes are dominated by payroll costs reflecting the fact that DCC is a relatively asset light company with a primary focus on contract management and programme delivery.

Figure 3.1: Internal Costs by cost type or GL code



3.3. Figure 3.2 shows Internal Costs by cost centre. The costs associated with obligations not foreseen at LABP (New Scope) have become an increasingly significant driver of Internal Costs.

Figure 3.2: Internal Costs by cost centre



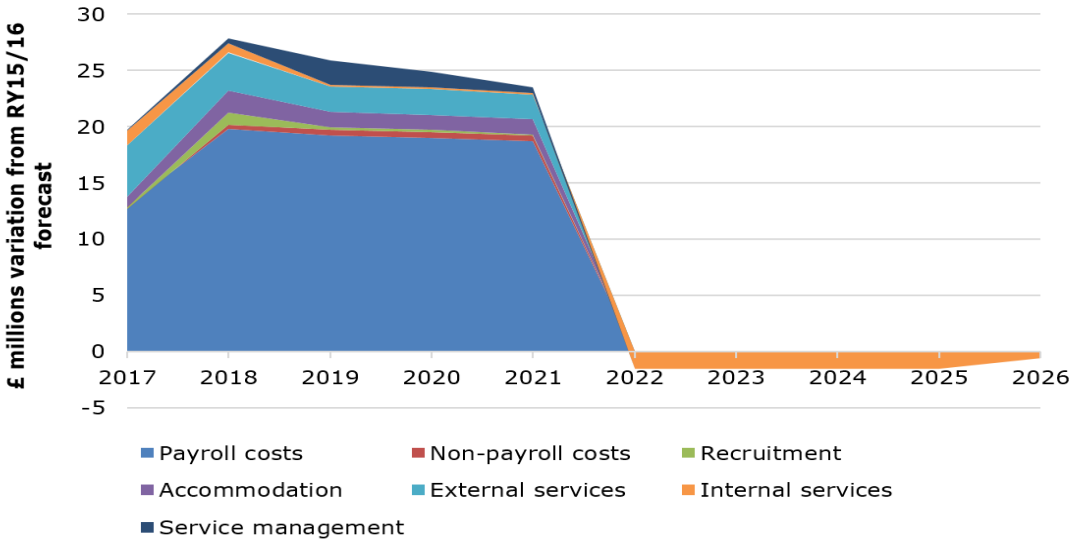
Variance on last year's forecast

3.4. In RY16/17 Internal Costs were £41.6 million, excluding shared services[11]. This is £19.7 million (90%) higher than forecast in RY15/16 and £31 million higher (nearly three times greater) than the LABP forecast. Over the remainder of the licence period, Internal Costs are forecast to increase a further £95.2 million (85%) relative to RY15/16 forecasts, and £120.4 million (138%) compared to LABP, to total £207.6 million.

3.5. Figure 3.3 shows the variance in costs by GL code compared to the last forecast of economic and efficient costs in RY15/16. This clearly illustrates that increasing payroll costs represent the vast majority (78%) of the variation in Internal Costs. Payroll costs across the whole organisation were a major driver of Internal Costs as the headcount for DCC increased to 257.4 FTE for both contractors and permanent staff in RY16/17. This is a substantial increase from the 179.4 FTE employed during RY15/16. DCC expects their headcount to continue to rise in the near term.

3.6. The reduction in Internal Costs post 2021 reflects efforts by the DCC to streamline their business intelligence and management information (BIMI) reporting systems and remove unnecessary structures and automation to reduce costs for consumers.

Figure 3.3: Internal Cost variance by cost type or GL code relative to RY15/16 forecasts (excludes shared services)



[11] The shared service charge adds an additional 9.5% to Baseline and approved New Scope Internal Costs. This will be covered in relation to incurred and forecast costs, as well as DCC's application to extend the coverage of New Scope costs, in a later section.

3.7. Further details and a breakdown of costs by cost centre are included in Appendix 3.

Payroll

Payroll costs

3.8. DCC have applied for the following payroll costs which shows a significant increase in payroll costs compared to last year's forecast.

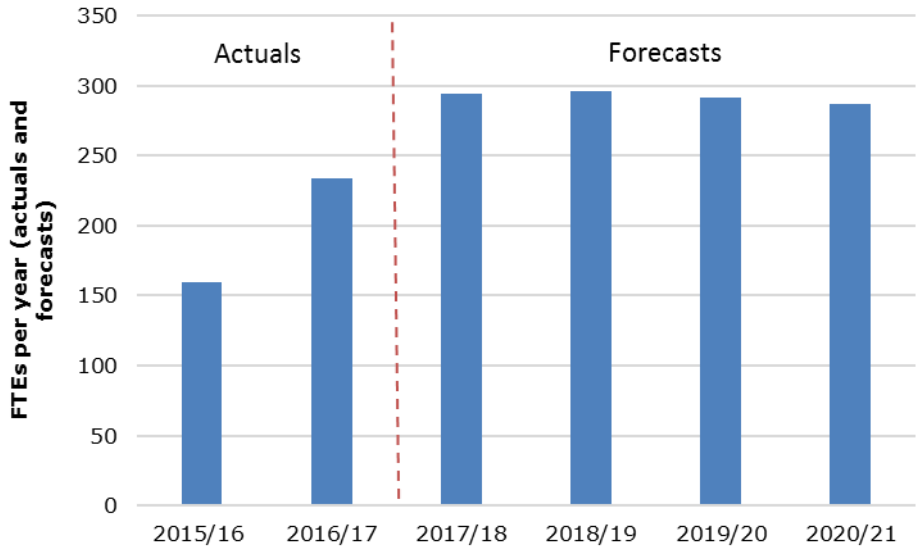
Table 3.1: Payroll costs compared to last year's forecast

Payroll (£m)	RY16/17	RY17/18	RY18/19	RY19/20	RY20/21
15/16 accepted forecast	12.524	7.097	6.903	6.903	6.903
Variation proposed in 16/17	12.964	19.765	19.199	18.980	18.695
Total	**25.488**	**26.863**	**26.102**	**25.883**	**25.599**

Headcount

3.9. As Figure 3.4 shows, DCC headcount is set to increase from around 150 FTE in RY15/16 to nearly 300 from RY17/18 to RY20/21. Note this analysis excludes the service desk staffing which DCC estimate to be an additional 45 staff in RY17/18 as these costs are included under service management GL code rather than payroll.

Figure 3.4: DCC headcount (full time equivalents, excluding service desk staff)



Benchmarking

3.10. Under the price control we expect DCC to employ staff at economic and efficient remuneration levels. Consistent with the previous two price controls, DCC provided evidence of this through a benchmarking exercise that compared salaries to equivalent roles in the wider employment market using Hay Group's salary database[12].

DCC's justification

Headcount

3.11. DCC provided an account of the activities and outputs for the majority of its internal resource requirement for RY16/17 and for the following two years up until RY18/19. DCC explained activity at a team level and provided role profiles for every new role created by DCC in the last year. There were some roles included that DCC clarified should not have been included as they did not meet the certainty threshold.

3.12. DCC stated that the number of staff[13] was forecast to increase from 233 to 340 by the middle of 2017 and that this is due to the increased complexity and resulting changes to the initial SMETS2 solution, greater clarity on the future multi-release strategy, the ramping-up of activity on SMETS1, DBCH, Switching, the growth of the operations function and the general maturing of the organisation. DCC also referred to their 'Project to Business' programme that aims at improving DCC capability to cope with the shift from a project focused organisation to a business delivering a suite of services. Please see Appendix 3 for further information on resource cost drivers at a cost centre level.

3.13. DCC has reduced its dependence on contractors since last year. The ratio at the time of submission was 40% contractor to 60% permanent staff whereas in previous years it has been closer to a 50:50 ratio. DCC state this will provide efficiencies through retention and application of corporate knowledge, as well as decreased recruitment and onboarding costs.

Benchmarking

3.14. There are a number of teams where DCC's results for benchmarking suggest an improvement compared to last year. The majority of permanent staff in teams received remuneration in line with industry averages (50th percentile). Where this was not the

[12] Please see chapter 4 and appendix 3 in the 14/15 consultation for more detail on DCC's approach and our view: https://www.ofgem.gov.uk/sites/default/files/docs/dcc_price_control_consultation_regulatory_year_201415.pdf

[13] Individual staff members rather than FTE

case, DCC provided sufficient justification for why they consider remuneration above the 50th is acceptable for both permanent employees and contractors. This includes descriptions of why specialist skills are required over and above the most suitable industry comparators and difficulties in recruitment for crucial roles.

3.15. The exception to the general improvement we have seen is for Operations contractors where the difference between the team's remuneration and the industry average was greater than last year. DCC provided little justification beyond explaining the role of one of the five contractors with an outlying salary who were included in its benchmarking exercise. All contractors in this cost centre that were included in the benchmarking exercise were paid above the 50th percentile and some above the 75th percentile (after applying the standard uplift for contractors which is part of DCC's cost methodology).

Our view

3.16. We applied the same approach to benchmarking as we did last year. We consider that DCC has justified the majority of its payroll expenditure for RY16/17. The exception to this is the expenditure on Operations contractors where DCC has not provided sufficient justification for why the level of contractor remuneration is over the industry average. Using DCC's own benchmarking results and adjusting the results for the entire contractor spend in this cost centre[14], **we propose to find £0.451m as an unacceptable incurred cost in RY16/17**.

3.17. We do not intend to remove the unacceptable benchmark costs from forecasts. This is because we can only accurately assess incurred resource costs against benchmarks from the same regulatory year. We cannot predict with any certainty recruitment and labour market conditions in the future. We will therefore only conduct this assessment on a year-by-year basis when we receive full information from DCC.

3.18. Looking at DCC's forecasts we are concerned about DCC's growing headcount and increasing spend on payroll. DCC's headcount is forecast to increase significantly to an organisation of 294 FTE with an additional 45 people for the DCC service desk in RY17/18. At LABP the DCC was expected to be a 90 FTE organisation. We recognise that the increased complexity of the solution and new programmes such as SMETS1 and DBCH are likely to need to be supported by an increased headcount in the short term. We also recognize that the DCC plays a central role in success of the smart meter roll-out and it is important that they are able to invest in the necessary capabilities to hold their service providers to account and provide a good quality of service to their customers. However, we remain concerned that most parts of the DCC business are set

[14] We used the same methodology as last year in making the benchmarking decision on disallowance.

to continue to increase in size in RY17/18 with no indication provided in the submission that DCC expect to realise efficiencies and reverse this trend over time.

3.19. DCC needs to have appropriate resource available to support delivery, however we consider that DCC is in a position to make some efficiencies now. For RY17/18-RY18/19, we propose to disallow forecast costs associated with individual roles that are not justified, confirmed as incorrect by DCC or where we do not consider that the role meets the *significantly more likely than not to occur* threshold. In total these costs amount to £5.397m. **Therefore, for RY2017/18-2018/19 we propose to find a total of £5.397m of forecast payroll costs as unacceptable**.

3.20. We expect DCC to become an increasingly lean organisation as it matures and is delivering at mass scale. We understand DCC now has work underway to review the organisational structure and this is expected to identify opportunities for further efficiencies to be implemented in future years. **So, beyond RY18/19 we propose to find all proposed increases in payroll, related non-payroll costs and recruitment costs to be unacceptable. This amounts to a total of £38.956m of forecast cost.**

3.21. When DCC update their forecasts for the next price control submission, we would expect to see increased efficiencies, reflected by lower projected headcount than the RY16/17 forecasts, as DCC nears the end of implementation for new scope programmes such as SMETS1, DBCH and switching. Crucially, we consider DCC should publish and commit to efficiency targets in order to demonstrate to customers that cost efficiency is central to their business planning strategy.

Accommodation

3.22. DCC's main accommodation is in Ibex House in central London. DCC also has a presence in Ruddington, Nottingham where the service desk is located. In RY16/17 DCC began the process to secure a third site in Preston Brook, Runcorn for the expanding Operations team.

Material variations

3.23. DCC has reported that accommodation expenditure was just over £1.4m for regulatory year 2016/17, £0.947m (190%) more than was determined as economic and efficient in last year's price control forecast.

3.24. For the remainder of the licence term DCC reports that accommodation expenditure will be £10m noting that they consider that they are only able to forecast accommodation costs to meet the forecast certainty threshold up until RY20/21. This represents an increase of £6m compared to what was determined as economic and efficient in last year's forecast.

Table 3.2: Accommodation costs compared to last year's forecast

Accommodation(£m)	RY16/17	RY17/18	RY18/19	RY19/20	RY20/21
15/16 accepted forecast	0.497	0.477	0.476	0.476	0.475
Variation proposed in 16/17	0.947	1.942	1.368	1.368	1.365
Total	**1.444**	**2.419**	**1.843**	**1.843**	**1.840**

DCC's justification

3.25. DCC state that the variation in RY16/17 compared to the previous year's forecast relates to previously disallowed variation in the forecast from previous price control decisions and additional space at the London accommodation required for the growing SMETS1 team.

3.26. DCC state that the greater spend on accommodation was in line with the justification for increases in the number of staff (see payroll section above). The forecast accommodation cost variation is due to the previously disallowed variation in forecast, further space at the London premises and a lease for an additional Capita site in Runcorn to accommodate the extra staff and service provider representatives. DCC describes the process and due diligence it went through to choose the new premises in Runcorn and compare it to alternatives considered. DCC state that, while Runcorn is more expensive per square foot than the comparator sites, this is offset by lower IT costs and the site already having appropriate levels of security, access control and facilities management requiring less spend on basic infrastructure.

Our view

3.27. We have now been provided with further assurance on the need for additional space at the DCC accommodation in London up until 2019 given the planned activity and resource requirements outlined in the rest of the submission.

3.28. However, we do not consider that DCC has provided sufficient evidence for why the chosen site in Runcorn is an economic and efficient choice. DCC did not provide any quantitative evidence of the Cost Benefit analysis, rates achieved or any updated office space occupancy study for the new space. We require clearer quantitative evidence to show how the new space will be used efficiently and how the infrastructure benefits of the Runcorn site is expected to offset the more expensive price per square foot compared to other locations considered.

3.29. To remain consistent with our proposals on resource costs we propose to disallow all cost variance from the forecast for accommodation for 2019/20 and 2020/21.

3.30. We propose that RY16/17 accommodation cost is economic and efficient. We propose the forecast cost associated with the new premises, which

amounts to £1.216m from RY17/18 to RY18/19 is unacceptable. We also propose that the entire variation in accommodation costs for RY19/20 and RY20/21 amounting to £2.733m is unacceptable.

External services

Material variations

3.31. DCC have applied for the external services costs outlined in Table 3.3.

Table 3.3: External services costs compared to last year's forecast

External service costs (£m)	RY16/17	RY17/18	RY18/19	RY19/20	RY20/21
RY15/16 accepted forecast	3.610	2.102	2.031	2.040	2.026
Variation	4.587	3.403	2.278	2.252	2.158
Total	**8.197**	**5.505**	**4.309**	**4.292**	**4.185**

3.32. DCC primarily uses external services to provide support such as short term or urgent technical expertise and assistance in fulfilling regulatory requirements. Where DCC are procuring services in lieu of in-house work, they need to prove that it was economic and efficient to do so.

DCC's justification

3.33. DCC's use of external services reflects a range of expertise, with the highest value contracts in the application related to Smart Metering Key Infrastructure (SMKI), Enrolment Options Testing (EOT), Centralised Registration Service (CRS) consultancy support and delivery of an interim Systems Integrator. The variances on these costs are driven by contract extensions due to release delays (such as SMKI) or are contracts to meet new scope requirements (such as EOT and CRS).

3.34. DCC also contracted a consultancy to support the delivery of the Systems Integration function. Systems integration duties are part of CGI's contract in addition to their role as DSP, and are therefore part of External Costs / fundamental service capability. DCC stated that they saw a need for coordination activity beyond what CGI was delivering at the time. DCC attribute the problem to lack of definition of system integration duties in the contract. To achieve the best chance of securing timely delivery of release 1.3 DCC judged that the best option was to contract independent consultants to deliver a coordination role. DCC reported, after a request for further clarification, that they would resolve any contractual issues with CGI at later date.

3.35. Other material external service costs link to DCC's procurement of systems and tools as well as consultancy and test support. DCC incurred costs delivering the rollout of a system to enable FSPs to interact with Service Users and delivering enhancements to

the software tool for automated testing of GBCS (ATG). In RY16/17 SMEs were required to deliver systems integration testing (SIT) support, demand modelling, DBCH technical and commercial assurance, and support to DCC to meet regulatory requirements.

Our view

3.36. In the majority of cases external services have been justified and explained by DCC, with their procurement framework and due diligence processes followed to determine the delivery of value for money. DCC's justification of most of its incurred external service costs for RY16/17 are acceptable given changes to the programme, the incorporation of new functionalities within the DCC and the need to deliver on gaps identified by DCC. Most cost categories forecast by DCC have also been sufficiently evidenced and allowed.

3.37. However, DCC's decision to pay for consultancy support for the Systems Integration function has placed additional costs on consumers for which we have not seen sufficient evidence of additional value to date, and so we do not consider at this stage of the assessment that costs associated with the additional consultancy service to be economic and efficient. Consumers are already paying for the system integration function through the CGI contract; it is DCC's responsibility to ensure that contracts are fit for purpose and that they hold contractors to account for delivery. **We propose to find this contract value of £1.167m in RY 16/17 as an unacceptable cost.** We will need to consider this proposal in the light of any new information or justification which is presented through the consultation process.

3.38. **There are two further cost categories which we propose to find £6.980m worth of forecasts as unacceptable. These are DCC's external services forecasts linked to their ATG and SMKI contracts.** After further querying both of these costs with DCC, we remain of the view that there is a lack of evidence to justify the variance to the forecast ATG contract costs. Further, following a review of the SMKI forecasts after their regulatory submission for the price control was made, DCC agreed that they lacked the level of certainty required to accurately forecast them.

Service Management

Material variations

3.39. DCC has applied for the following costs linked to the delivery of their service desk capability as outlined in Table 3.4.

Table 3.4: Service management costs compared to last year's forecast

Service management (£m)	RY16/17	RY17/18	RY18/19	RY19/20	RY20/21
RY15/16 accepted forecast	1.322	2.140	2.205	2.178	2.178
Variation	0.051	0.439	2.127	1.384	0.484
Total	**1.374**	**2.579**	**4.332**	**3.562**	**2.662**

3.40. DCC's service desk is a critical component of being able to successfully deliver satisfactory core services to its users, from onboarding users to installations. It manages all user service enquiries and provides fault management and triage activity across the sub-contractor domains. The staffing levels at the service desk have increased over the last year as its operations have moved to 24/7 coverage.

DCC's justification

3.41. DCC have forecast its service management variance in line with demand projections from customers. The main drivers of the size of the service desk are the number of suppliers connected to DCC, the rate at which meters are being installed, and the size of the installed base. The installation phase represents the peak for the service desk and as installation reduce so should the service desk.

Our view

3.42. We consider the service management costs incurred in RY16/17 are economic and efficient. DCC's forecast model is underpinned by consistently varying assumptions and scenarios determining customer demand. **Given the uncertainty inherent in the forecasts for this activity we propose disallowing all service management forecast variances, amounting to £4.435m.**

Shared Services

Context

3.43. DCC pays a shared service charge to cover support services such as HR tools, property services, payroll, IT and senior management input. It is an amount paid by DCC for shared services sourced from DCC's parent company, Capita. Inclusion of the shared services charge was part of the competitive bid during the licence competition. It was calculated as a percentage of Internal Costs set out in the LABP[15].

3.44. DCC is required by the RIGs to report information on the shared service charge, including how it has been calculated and how the shared service charge provides value for money. DCC have committed as part of their procurement strategy to review these costs on a regular basis and ensure and demonstrate they remain competitive. They must also ensure there is no cross-subsidisation across affiliates and/or related undertakings[16].

[15] A cost related to the communications hubs was excluded from the charge in the LABP.
[16] This is a requirement under Licence condition 11 of the Smart Meter Communication Licence.

3.45. Given the significant increase in DCC costs since licence award and the fact that it is now performing additional activities which were not included in the LABP, it is important that DCC continues to monitor its shared services costs to ensure they are economic and efficient. For example, these activities may not draw upon the shared services from Capita in the same proportions.

3.46. Last year[17], we decided in future years we do not require further justification for the shared service charge associated with baseline activity for price control purposes. We accepted 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. We also considered it justified as DCC demonstrated that Capita's shared services delivered value for money compared to the 'stand-alone' counterfactual scenario.

3.47. At that time, we also said that for new scope activities which were not included in the DCC's licence bid, DCC must continue to provide justification to demonstrate any shared service cost relating to these activities are economic and efficient. DCC must fully justify applying any shared service charge on future new scope costs.

DCC's justification

3.48. This year, DCC has applied 9.5% shared service charge on the costs of baseline activities and did not provide justifications on value for money as we do not require further justification for the shared service charge associated with baseline activity for price control purpose.

3.49. DCC has also applied 9.5% shared service charge on the costs of new scope activities, excluding external services and testing. DCC has provided explanation on why they think shared services charges relating to following new scope actitivites are economic and efficient;

- DBCH and SMETS1 programmes should be considered as part of the baseline requirement as they were referenced in the original operational service requirements. Therefore 9.5% shared services charges applies on the costs of these programmes for RY16/17 and the forecast.
- Any new scope activities associated with SMETS2 programme should be considered as part of baseline requirement. Therefore, DCC applies 9.5% shared services charge on the costs of these programmes for RY16/17 and the forecast.
- DCC applies 9.5% shared services charge on the cost of Centralised Registration Service (CRS) for RY16/17. DCC considers that the preparatory phase of

17 https://www.ofgem.gov.uk/system/files/docs/2017/03/2017.02_data_communications_company_dcc_price_control_decision_201511.pdf

switching programme and activities in RY16/17 should be considered as core activity for establishing the foundations for Switching programme.

Our view

3.50. Based on our decision last year, we accept the 9.5% shared services charge associated with baseline activity for price control purposes. In addition, we accept DCC's justification that activity associated with DBCH, SMETS1 and SMETS2 should be considered as part of baseline requirement for the purposes of considering the application of shared services charges. As such, we consider 9.5% shared services charge on these costs to be economic and efficient.

3.51. However, it was not certain at the time of bid that DCC would have any role on CRS. For example, the licence as awarded to DCC contained permissive arrangements which could enable the Secretary of State to mandate a role for DCC on CRS; but it did not include any obligations to undertake CRS-related activity. DCC has confirmed that no costs were included in their LABP on CRS activites. We therefore consider this to be a new scope activity. DCC have not provided any evidence to show how the switching activity in RY16/17 has benefitted from the shared services provided by Capita. As a result, we do not find the 9.5% applied to switching costs as economic and efficient. **Therefore, we propose to disallow the shared services charge (£0.091m) associated with the switching programme.**

3.52. In the future price controls, for new scope activities which aren't related to the delivery of the core smart metering system (including baseline activity, SMETS2, DBCH and SMETS1), DCC must continue to provide full justification to demonstrate that any shared service cost relating to these activities are economic and efficient. We expect DCC to do this by providing sufficient evidence/justification of the benefits from the shared services provided by Capita related to any new scope activity. The application of 9.5% to any costs without this accompanying evidence will be considered unacceptable.

Centralising Registration Services (CRS) costs beyond RY16/17

3.53. DCC included CRS costs beyond RY16/17 in their price control submission. We propose to find this forecast unacceptable as the forecast can only be determined after the first full year of the ex-post plus price control arrangements. Please see Appendix 4 for the costs to be removed from DCC's allowed revenue.

4. Implementation Milestones, Baseline Margin and External Contract Gain Share

Chapter Summary

We judge that DCC has largely failed to meet Implementation Milestones 9 and 10 resulting in a proposed total of £4.702m to be removed from Allowed Revenue under the Baseline Margin Performance Adjustment term. In RY16/17 DCC submitted applications for a £13.955m adjustment to their Baseline Margin (BM) for RY16/7 to RY20/21 and a £3.261m adjustment to allowed revenue reflecting an External Contract Gain Share (ECGS). We propose to amend DCC's BM application and allow a £5.134m between RY16/17 and RY18/19. We propose to accept DCC's ECGS application.

Question box

Question 4: What are your views on our assessment of DCC's performance against IM9 and 10?

Question 5: What are your views on our assessment of DCC's application to adjust their baseline margin?

Question 6: What are you views on out assessment of DCC's application for Exteral Cost Contract Gainshare?

Performance against Implementation Milestones

4.1. RY16/17 is the final year that DCC's performance is incentivised against the implementation performance regime (IPR). From April 2018 DCC will be subjected to the Operational Performance Regime (OPR) which we directed earlier this year[18]. The IPR lists a series of implementation milestones (IMs) that DCC was expected to achieve in the lead-up to live operations. The regime is designed to encourage good performance by putting DCC's margin at risk. If DCC fails to meet an IM by the date specified in the licence then it could lose part or all of margin attached to that IM. If DCC loses margin it has the opportunity to gain some or all of it back by meeting a subsequent milestone.

4.2. The Secretary of State directed the final changes to the performance regime on 19 October 2016 to reflect the staged go-live dates of R1.2 and R1.3 (see details in Appendix 4). We have based our assessment of DCC's performance against the IM's on the new criteria. This means that during RY16/17 two IMs, IM9 and IM10, were due.

[18] https://www.ofgem.gov.uk/publications-and-updates/decision-dcc-s-operational-performance-regime

4.3. In relation to delivery of R1.2:

- For the South and Central regions, DCC submitted documentary evidence to BEIS on 27 October 2016 confirming DCC readiness to go live. Following SEC Panel and BEIS assurance processes BEIS directed DCC to go live in the South and Central regions on 8 November 2016.

- For the North region DCC submitted documentary evidence to BEIS on 17 November 2016. Following SEC Panel and BEIS assurance processes BEIS directed DCC to go live in the North region on 25 November 2016.

4.4. DCC missed the milestone for delivering relase 1.3 (IM10) completely and did not provide any evidence confirming the delivery of R1.3 as part of the price control submission[19].

Table 4.1: Proposed baseline margin performance adjustments

Term	Due Date	Achieved Date	Time Factor	Amount of term (£m)
IM9a	20/07/2016	25/11/2016	1.0000	1.188
IM9b	20/07/2016	08/11/2016	0.9643	1.138
IM10a	26/09/2016	21/07/2017	1.0000	1.188
IM10b	26/09/2016	21/07/2017	1.0000	1.188
Total				**4.702**

4.5. Based on the calculations set out by the Secretary of State (see Appendix 5) we propose that DCC should **sacrifice a total of £4.702m from Allowed Revenue under the Baseline Margin Performance Adjustment term**. Table 4.1 above shows the dates, time factors and individual amount of margin to be excluded for each sub milestone.

Baseline Margin Application

Background

4.6. The baseline margin adjustment mechanism allows DCC to apply to adjust the baseline margin values as specified in Appendix 1 LC36 of the licence. All of DCC's margin including any adjustments are 100% at risk subject to DCC's performance regime. The 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

[19] We are aware that release 1.3 has subsequently been delivered.

aspects of its Mandatory Business under the Licence including the activities it carries out, the complexity and risk it faces, or the timescales and deadlines that it must meet. We set out further detail as to the conditions and requirements for a Baseline Margin Adjustment in last year's price control consultation and this year's RIGs, as well as in the processes and procedures guidance documents.

DCC's application for a Baseline Margin Adjustment for RY16/17

4.7. Alongside their RY16/17 price control submission, DCC has applied for a £13.955m adjustment to their baseline margin over the five years between RY16/17 and RY20/21. Five relevant activities have been identified for their application notice, in addition to adjustments for accommodation costs and roles covered in previous years which now have more cost certainty. The five central drivers of the application include:

- changes in the baseline requirements for SMETS2 programme
- changes in SMETS2 programme operational requirements
- new scope requirements stemming from release 2.0 (including DBCH)
- SMETS1 programme work
- DCC's role in the switching programme's Centralised Registration Service (CRS)[20]

4.8. The licence criteria[21] of these drivers have been cited as an increase to the complexity of DCC's solution, shifts in timelines and the volume of resources required to deliver on DCC's scope of work.

4.9. DCC has calculated this proposed adjustment by quantifying the change in volume of activities as the number of FTE resources that have been involved in the above changes as well as the additional external services used in lieu of DCC recruiting more in-house resources. Margin is applied to the costs of the individual FTE roles and services driven by the relevant activities in the application at a rate of 15% on associated costs.

Reasons for our proposal

[20] From RY17/18 onwards costs related to the Centralised Registration Service (CRS) will be subject to a separate price control, incentive and margin arrangement. The inclusion of CRS in both the RY15/16 and RY16/17 annual price controls does not set any precedent for these arrangements.
[21] Condition 36, Appendix A3

4.10. We consider that the conditions for DCC to make a margin adjustment application have been made. However, we do not agree that the DCC has provided appropriate justification to support every aspect of their margin application and are proposing to amend their application to award a smaller margin adjustment.

4.11. The first step in calculating DCC's margin adjustment is to take into consideration any links between the proposed price control decision and the underlying application costs, such as role, accommodation or external service cost disallowances. The effect of this step is to reduce DCC's application to £7.793m, which is largely driven by the disallowances of FTE-related costs in RY19/20 and RY20/21.

4.12. Then, we have identified those roles which have fallen short of the criteria for earning baseline margin in previous price controls/margin applications, because the application was made after the grounds had arisen. We consider these roles, on the basis of the evidence and explaination given by DCC, are still considered to have missed the application window into which their roles would fall.

4.13. This is explained further by recapping the decisions on last years' price control and baseline margin application. In our further consultation on DCC's RY15/16 baseline margin application[22], we considered that FTEs DCC had forecast in RY14/15 and included in its RY15/16 baseline margin application lacked evidence linking these role to the drivers in the application. In response to this consultation, DCC did not provide any further justification or evidence linking these roles to drivers in the application. We therefore rejected DCC's application for an adjustment to their baseline margin relating to these roles, as we determined that the relevant application window was RY14/15, when the roles, and therefore the changes in DCC's mandatory business, were forecast.

4.14. This year baseline margin was applied for relating to some of these previously disallowed roles. DCC has not provided evidence to show why these roles first forecast in RY14/15 relate to new activity for which additional margin should be earned in RY16/17. We therefore propose to reject DCC's application for an adjustment to it's baseline margin relating to the activity delivered by these roles. We may reconsider this part of the application should DCC be able to to provide sufficient evidence to demonstrate how the activity delivered by these roles is a result of a change to mandatory business in RY16/17. The effect of this step is to further reduce DCC's application to £6.906m.

4.15. We then considered the drivers of the various activities and whether or not these meet the criteria for earning margin. We propose that costs associated with the allowed FTE roles linked to the extension of the SMETS2 programme and new scope work on SMETS1, release 2.0 and the CRS should earn margin. We also propose approving the

22 https://www.ofgem.gov.uk/system/files/docs/2017/02/2017.02_dcc_price_control_further_consultation_on_bm_adjustment.pdf

application for baseline margin on external services driven by new scope work as the support services procured were in lieu of DCC recruiting more resource to deliver these outputs in-house or additional technical resource was required on short-term or urgent basis. Where DCC have procured these external services they have evidenced that it was economic and efficient to do so and the procurement provided value for money under make or buy decisions. Therefore, no further changes would be made to the margin application based on these considerations.

4.16. For the avoidance of doubt where DCC procure and manage a new contract that is delivering a product or service that could not alternatively be delivered by DCC internal resource we do not consider it appropriate that DCC should earn margin based on the value of the contract. This remains consistent with our rejection of DCC's applications to adjust the BM for the SMKI and Parse and correlate contracts using this approach in RY13/14 and RY14/15 price controls. However, where this is not the case, we consider DCC should be able to make a margin application regardless whether it is the result of new external services or payroll costs, to prevent distorting their decision-making on how to best meet changing requirements.

4.17. We have then considered whether aspects of the margin application relate to increases in costs arising as a result of the underestimating of costs by DCC at the bid stage. Our guidance makes clear that, where the volume or scope of work was underestimated by DCC at bid stage, then the part of the application relating to this work is unlikely to meet the criteria for a margin adjustment[23].

4.18. We propose rejecting DCC's application for baseline margin on activity driven by changes in SMETS2 programme operational requirements. We believe that DCC's rationale for this application in part reflects an initial underbid for their operations costs. It is unclear from DCC's application how the rationale for the size (and the associated volumes) of its operations function relative to LABP meet the criteria for baseline margin in the licence and how any changes to scope only arose in RY16/17[24]. DCC's submission set out the justification for the variation in operational costs was underpinned by their ramp up in activities in anticipation of a live service which meets all the SEC obligations. However we consider that this should have been previously anticipated by DCC and shows that they were not prepared under their original operations structure to deliver requirements that are outlined in the smart energy code. DCC has also indicated through the course of the price control process that their operational re-structure was not to accommodate new work or a new approach, but rather to change reporting lines for greater transparency within the organisation.

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[23] https://www.ofgem.gov.uk/system/files/docs/2017/06/2017.06_processes_and_procedures_guidance.pdf, p.27

[24] Condition 36, Appendix A6 (b)

4.19. We consider that our proposal to reject this part of the application is consistent with the guidance which sets out how we will assess applications where we consider the volume or scope of work was underestimated by DCC at the bid stage.[25] We would have anticipated that DCC could have planned or alternatively built in contingency for factors identified as driving the costs such as the elaboration of service management design, service desk assumptions and change to evolve their systems. It is possible that some arguments presented by DCC could be associated with change since LABP, however DCC have not provided sufficient evidence for how these individual arguments relate to the relevant part of the BM application and why RY16/17 is the relevant application window. The effect of this step is to reduce DCC's application to £5.134m.

Margin rate

4.20. When determining any Relevant Adjustments to DCC's baseline margin the licence requires us to have regard to the DCC's expected rate of return on its activities over time. As part of last year's price control we considered a 15% margin to be acceptable and justified by DCC's evidence, given the unique nature of DCC's ex-post regulatory framework and its limited fixed and intangible assets. It is also difficult to benchmark DCC given a lack of perfect comparators and therefore the margin agreed at bid which was established through market competition and has set DCC's expectation for the duration of its licence was considered reasonable.

4.21. For RY16/17 we **regard 15% to be a reasonable margin** given that DCC's position and characteristics relevant to earning margin have not substantially changed since last year. Going forward, we also propose that all Internal Costs relating to smart metering activities under the application earn this same margin, given the activities (changes in SMETS2 delivery, SMETS1, release 2.0) are similar in nature to those included within the licence application business plan. For the CRS-related activity in this application we regard 15% to be a reasonable margin for this application only because future costs will be captured by the agreed policy of 12% margin rate to be applied for the initial stages of the Switching Programme. Applying the same margin to costs linked to FTEs and external services will prevent distortions to DCC's incentives to deliver the best possible value for money to consumers, as they will not be perversely incentivised to deliver activities through recruitment of resource rather than use external services where it would be more economic and efficient to do so.

4.22. Taking this all into account we propose amending their application to an adjustment of £5.134m between RY16/17 and RY18/19 as shown in Table 4.2.

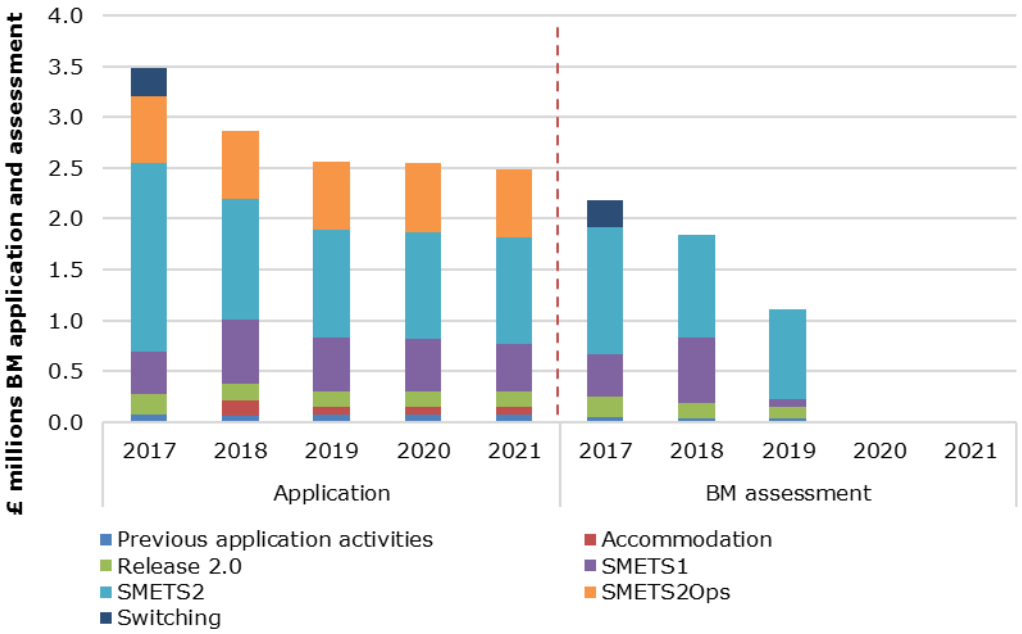
[25] Page 27.
https://www.ofgem.gov.uk/system/files/docs/2017/06/2017.06_processes_and_procedures_guidance.pdf

Table 4.2: DCC's baseline margin compared to LABP and allowed margin in RY15/16.

Baseline margin (£m)	RY16/ 17	RY17/ 18	RY18/ 19	RY19/ 20	RY20/ 21	Total
LABP	2.041	2.008	2.059	2.443	1.959	**10.510**
Allowed margin as of RY15/16 decision	2.391	3.154	2.083	2.469	1.982	**12.079**
Effect of RY16/17 application *(Difference from RY15/16)*	5.870 *(3.479)*	6.022 *(2.868)*	4.651 *(2.568)*	5.016 *(2.547)*	4.474 *(2.492)*	**26.034** ***(13.955)***
Effect of RY16/17 proposed decision *(Difference from RY15/16)*	4.578 *(2.187)*	4.990 *(1.836)*	3.195 *(1.112)*	2.469 *(0)*	1.982 *(0)*	**17.213** ***(5.134)***

4.23. Figure 4.1 below compares the margin adjustment that DCC applied for compared to what we propose to amend the baseline margin figures by following this year's application.

Figure 4.1: Comparison between DCC's application and our proposed adjustment



External Contract Gain Share (ECGS)

Background

4.24. The DCC Allowed Revenue formula includes an External Contract Gain Share (ECGS) term, which provides for an upward adjustment to the Allowed Revenue where DCC has secured cost savings in the FSP contracts.[26] This term is zero unless DCC applies to vary the relevant term within Allowed Revenue.

DCC's application of an External Contract Gain Share Adjustment

4.25. DCC has applied to adjust this term for RY17/18-RY20/21 reflecting a reduction in External Costs as a result of a refinancing agreement for an FSP's set-up charges. DCC described in its application how it was involved in the refinancing arrangement, namely by introducing a competitive element into the refinancing process through which the FSP could approach two banks in order to be able to secure lower financing rates. DCC worked with all three parties (DCC, the FSP and the finance provider) to ensure that they were all content in entering the refinancing arrangement and the relevant bilateral underlying agreements.

Reasons for our proposal

4.26. We consider that DCC's application is duly made and that DCC has provided sufficient evidence that it was instrumental in the arrangement. DCC's application justified that the overall saving from the refinancing agreement would not have been achieved without DCC's involvement.

4.27. We also consider that DCC's application for a gain share of 50% (which includes the FSP's share as set out in the contract) as a proportion of the overall saving is appropriate based on comparisons to regulatory precedent in the industry[27]. This leaves the remaining half of the savings to be passed on to consumers. **We propose to confirm DCC's application to adjust the ECGS term by a total of £3.261m between RY18/19 and RY20/21.**

4.28. DCC should note that this would not set any precedent for different activities that may be the subject of any future proposal.

[26] Condition 39, 39.3
[27] For example, from a sample of existing market gain share arrangements operational in regulated sectors in Great Britain, the retained savings for the relevant regulated monopoly are around 50%.

5. Revenue reporting

Chapter Summary

Under the 'Report and Direct' penalty interest rate regime, DCC submitted their first reporting on their reasons for over-recovery of revenue as part of the RY16/17 price control. DCC over-recovered the service charge by 122% in RY16/17 which was above the 110% threshold. We consider their reasons for over-recovery of revenue are acceptable. We propose not to impose penalty interest on their over-recovered revenues.

Question box

Question 7: What are your views on DCC's reporting which explains its reasons for over-recovery of revenue in RY16/17?

Background

5.1. The licence requires DCC to take all reasonable steps to secure that its Regulated Revenue does not exceed a prudent estimate of Allowed Revenue for each regulatory year[28]. Please see last year's consultation document[29] for further detail on Allowed Revenue, Regulated Revenue, Correction Factor and the link between Allowed Revenue, Regulated Revenue and DCC's Charging Statement.

5.2. We have introduced a penalty interest rate regime this year, which is designed to incentivise DCC to improve the accuracy of its charges to users and deter it from over-recovering[30]. The effect is to introduce a 'Report and Direct' penalty interest rate regime with a threshold for over-recovery of service charges of 110% of allowed revenue, and a penalty interest of 3% above the Bank of England base rate on any proportion of over-recovery that DCC has not justified to the Authority's satisfaction.

5.3. For DCC's RY15/16 price control submission we invited DCC to submit voluntary reporting on their reasons for over-recovery of revenue as part of the RY15/16 price control. As set out in the consultation, we considered that DCC should provide further

[28] See LC36.4

[29] https://www.ofgem.gov.uk/system/files/docs/2016/11/dcc_1516_price_control_consultation_2.pdf

[30] 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

detail in future submissions if they exceed the 110% recovery threshold, including explanation of delays in returning over-recovered service charges to users.

5.4. Last year[31], in response to our concerns of delay in returning over-recovery to users, DCC agreed that returning over-recovered revenue promptly was beneficial and explained they had already taken steps to return revenue to customers as soon as practicable.

DCC's reporting on the reasons for over-recovery of revenue

5.5. For RY16/17 the proportion of Regulated Revenue (£241.2m) to Allowed Revenue (£197.4m) is 122% and so breaches the 110% threshold.

5.6. DCC argues that, taking in to account factors that they could not reasonably have anticipated, the proportion should reduce to 106% (£236.4m/ £223.9m)[32] from 122% . They gave the following reasons for the variation:

- Uncontrollable variation in costs incurred and Regulated Revenue in RY16/17. For example, additional funds received due to increase in actual meter numbers compared to estimate (£1.5m); interest income received on cash balance (£126k);
- Proportion of the correction factor as at the end of RY16/17 which is being returned to customers in RY17/18 charges. The timing issue of returning funds through correction factor results in a mismatch (£6.4m) between Allowed Revenue and Regulated Revenue.
- £2.8m of higher pass through costs than estimated
- Savings from DSP refinancing costs and deferred set-up costs (£23.3m). Allowed Revenue should include this saving.
- Savings from non-payment of set-up charges due to milestones not being met in the period (£6.0m). This is deferred revenue or payable.

Our view

5.7. We consider that DCC has provided sufficient explanation for why Regulated Revenue exceeds Allowed Revenue in RY16/17. As a result, we do not consider it appropriate to apply the penalty interest rate for this year.

5.8. We have concerns on the size of correction factor and the size of correction factor has increased significantly this year. The correction factor reflects DCC's over-recovery,

[31] https://www.ofgem.gov.uk/system/files/docs/2017/03/2017.02_data_communications_company_dcc_price_control_decision_201511.pdf

[32] Adjusted Regulated Revenue = £241.209m+£1.47m+£0.126m-£6.42m=£236.389m
Adjusted Allowed Revenue = £179.417m-£2.78m+£23.3m+£5.97m= 223.904m

and this should be returned to users in the form of lower charges in subsequent years. It is important that charges are returned to users as early as possible.

5.9. We would like DCC to provide details on their discussion and engagement with their customers on the issue of returning over-recovered charges.

Appendices

Index

Appendix 1 – Responding to this consultation

We'd like to hear your views on any of the issues in this document. We would particularly like to hear from SEC users. We would especially welcome responses to the questions at the beginning of each chapter. These are replicated below.
Please make sure we have your response by 21 December 2017. Send them to:

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

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

If you'd like your response to be confidential, mark it clearly to that effect and include your reasons. Please restrict any confidential material to an appendix. Once we've considered the responses to this consultation, we plan to publish our final decision in February 2016.

QUESTIONS

Question 1: What are your views on our proposal to consider External Costs as economic and efficient?

Question 2: Do you have any views on DCC's contract management performance?

Question 3: What are your views on our proposals on DCC's Internal Costs?

Question 4: What are your views on our assessment of DCC's performance against IM9 and 10?

Question 5: What are your views on our assessment of DCC's application to adjust their baseline margin?

Question 6: What are you views on out assessment of DCC's application for Exteral Cost Contract Gainshare?

Question 7: What are your views on DCC's reporting which explains its reasons for over recovery of revenue in RY16/17?

Appendix 2 – External Cost Assessment

To provide further context on the External Costs that materially contributed to the variation in RY16/17 we have provided more detailed summaries below. We have also included the DCC's summary of its use of the governance provisions and value for money mechanisms defined in Schedules 7 and 8 of the FSP contracts.

CR160

As flagged in RY15/16, a new version of the GBCS (v0.8.2) was introduced to re-plan the smart meter rollout to a multi-release strategy commencing with release 1.2 in July 2016. However, it was during RY16/17 that the details and specifications underpinning the multi-release strategy were negotiated with FSPs through CR160. Therefore the costs associated with this change request have been introduced in the RY16/17 price control submission.

Given the scale of change DCC undertook extensive due diligence of the FSPs' submissions, including the level and seniority of labour costs allocated to the project. This due diligence included comparing assessments across FSPs where relevant, as well as a bottom up analysis of the DSP's costs. Particular attention was paid to the DSP as they faced the largest relative impact – CR160 represented around 80% of DSP's variance. Comparison was also made to CR091 costs for all three FSPs to support robust challenge and ensure only the additional changes were costed.

DCC outlined their approach to providing incentives, managing risk, and using contract negotiations to obtain bulk adjustments or discounts in the submission. For each FSP, DCC outlined the assumptions and risks underlying their proposals and identified areas of challenge. DCC was able to evidence savings for consumers obtained through negotiating discounts 'in the round' with all three FSPs.

COMMS HUB PRICE POINT ADJUSTMENTS

The Comms Hub monthly asset charge adjustment mainly reflects a reprofiling of Comms Hubs costs in the Central and South regions following the delay to go live. Each CSP has a unit price profile included in their contract to enable them to recover the cost of these Comms Hubs over a set period. With the delay to go live less than one per cent of the expected sales in Comms Hubs had occurred by the end of RY16/17. This means that with the 2020 deadline still in place, communication hubs are expected to be rolled out over a more condensed period and the aggregated asset charges needed to be adjusted to reflect this.

It should be noted that the delayed rollout also reduced the total number of consumers expected to have Comms Hubs installed within the DCC's licence period. This placed downward pressure on the forecast Comms Hub monthly asset charges in all three regions.

FOCs

Changes to the contractual requirements of the FSPs affect their operating costs as the context and scope of their services are modified. During RY16/17 a number of change requests resulted in higher fixed operation charges (FOCs) for the FSPs. To evidence the cause of this variance DCC provided a breakdown of the change requests affecting each FSPs' operational costs, as well as the costs associated with each change.

DSP CANs

In RY16/17 DCC continued to progress their approach to amalgamating related change requests (CR) into a single change authorisation note (CAN). This is partly based around ensuring that economies of scale related to synchronising modifications are achieved, and also to provide scope for further commercial negotiations 'in the round'. There were two material CANs identified for RY16/17; CGICAN057 and CAN030.

CGICAN057 related to amalgamating four new change requests related to correcting misalignments with updated SEC obligations for Release 1.4. This enabled DCC and the DSP to fully scope the Pre-Integration phase for Release 1.4 and ensure that corrections made to rectify one issue did not adversely impact the outcome of another.

Conversely, CAN030 amalgamated outstanding charges which were affected by the delays in achieving payment milestones, partly reflecting changes to the GBCS. This included new and existing change requests arising during CR091 negotiations, as well as selected baseline costs. DCC's focus was on renegotiating the payment of these charges to provide greater certainty on timing to the DSP while obtaining more advantageous financing arrangements to benefit consumers.

PR023

This project request (PR) was raised to progress the development of detailed DBCH specifications in advance of the CAN being negotiated to cover all of the DBCH work. This project was intended to address a number of concerns. For example, the impact on the indicative delivery plan agreed with BEIS if the hardware design awaited finalisation of the ZigBee standard. There was also a concern that work would not progress while SEC Parties were consulted on the final DBCH design(s) and the CAN was progressed. Additionally DCC raised concerns that the third party manufacturers required to support the ZigBee standard may delay or withdraw support without a prototype to work with.

DCC worked with the CSPs to commence work, including authorising work on a time and materials basis until a fixed price could be agreed, and continued to monitor their progress and review all completed products. This strong involvement in the work of the CSPs enabled DCC to robustly engage with and challenge their fixed price offerings to obtain savings for consumers through the removal of extraneous work. It also enabled DCC to ensure consistency between the CSPs.

CR061a

This CSP specific change request was required to ensure the new SEC v3 obligations regarding enabling remote testing at Service Users' premises could be met.

Contract Management

To support the DCC's contract management of the FSPs, there are a number of governance provisions included within Schedule 8 of each FSP's contract. In RY16/17 DCC employed the following:

- Schedule 8.4: which enabled DCC to re-engage PwC to undertake an annual audit of the DSP and CSP focusing on incurred costs relating to CR091, as well as compliance with the selected contractual requirements which presented the largest risks.

- Schedule 8.6: to ensure each FSPs' required Business Continuity and Disaster Recovery (BCDR) plan was updated to reflect changes introduced through recent SEC and GBCS modifications.

- Schedule 8.7: which involved updating the Co-operation Agreements to reflect CR160 changes and ensure the FSPs had clear frameworks to meet their obligation to cooperate with DCC and other DCC FSPs.

- Schedule 8.8: to ensure compliance with the established process for agreeing the scope of a project and how it is to be implemented for the Project Requests concluded in RY16/17.

- Schedule 8.9: which involved continuing to work with Service Providers to agree the format and content of their Operating Model documents to meet requirements for Operations Manuals.

In addition, DCC reported on FSP performance against their obligations in Schedule 7.3 of FSP licences to provide value for money (VfM) as they continue to progress into the delivery phase:

- Benchmarking: DCC is waiting until there is at least a full year of FSP data relating to reasonable service activity, i.e. post go-live, to undertake Benchmark Reviews. Accordingly this provision was not used in RY16/17.

- Gainsharing: no opportunities to implement improvements or changes to reduce the cost of delivering Services were identified in RY16/17. DCC expects material opportunities will not be identified till after go-live.

- Refinancing Gainsharing: DSP expanded their review of Set Up Charges as part of CR091 which started in RY15/16 by introducing a second bank to further reduce

financing costs. More information is contained in the ECGS section of this consultation. CSP refinancing gainsharing obligations relate specifically to monthly asset charges for Communications Hubs. DCC expects opportunities to renegotiate the financing arrangements which commenced in RY16/17 will arise in future years.

- Non-Mandatory Activities: DCC did not receive any requests from FSPs to approve use of Relevant Assets for Non-Mandatory Activities in RY16/17.

- Financial Audit: opportunities to realise cost savings and/or other financial gains were not pursued through the Audit performed under the Governance Framework as this VfM obligation relates to post go-live activities.

- Efficiency Gains: no Efficiency Gains were identified for RY16/17. Although gains were identified for the DSP through CR160 which will impact RY17/18.

Appendix 3 – Internal Cost assessment

For the benefit of stakeholder understanding, DCC's internal Baseline costs are reported by cost centre. DCC report separately on New Scope costs. This is an overview the types of costs associated with each cost centre:

Cost Centre	Function costs include
Corporate Management	• Costs for the managing director, the senior management team, and the DCC board • Regulation, policy and legal services • Accommodation costs
Industry	• Leads engagement with service users, the SEC panel and other industry bodies
Finance	• Commercial finance activities including supporting change management, producing budgets and developing and applying the charging methodology • Operational finance activities including managing the billing and credit cover aspects of DCC • Regulatory finance activities including the price control and other regulatory and statutory reporting
Commercial	• Leads the contract and commercial management of the fundamental service providers • Evaluating services procured from Capita and additional contracts which require management, such as SMKI, Parse and Correlate. • Oversees DCC's procurement strategy
Design and Assurance	• Leads the development and maintenance of DCC technical architecture and service design • Works closely with the FSPs • Responsible for technically assuring DCC services and overseeing the delivery and implementation of the test strategy and test approach
Operations	• Ensuring that DCC services meet the needs of all service users • Designing and providing the day-to-day operational interface for service users including a first line service desk. Responsible for operational reporting and the provision of any transitional services ahead of go-live, early life support and enduring operations
Programme	• Coordinating delivery across the whole DCC ecosystem during the implementation phase • Ensuring that the services, systems, resources and assets are all in place in accordance with the programme plan • Allow DCC to appropriately design and build activities to be completed to facilitate integration and user integration testing
Security	• Assuring the security of all DCC systems • Establishing an information security policy, including security assurance standards, processes, procedures and implementation timescales • Maintains information security standards and certification throughout the licence

Figure A3.1 shows the variance in Internal Costs by cost centre, compared to RY15/16 forecasts. This shows that the increased costs are relatively evenly spread across the organisation. Internal Costs are expected to peak in RY17/18 as SMETS2 achieves Go

Live and the DCC begins to transition towards ongoing operations. As the DCC moves away from rolling out the various releases towards ongoing operations with an established design, costs are expected to reduce.

Figure A3.1: Cost variance by cost centre

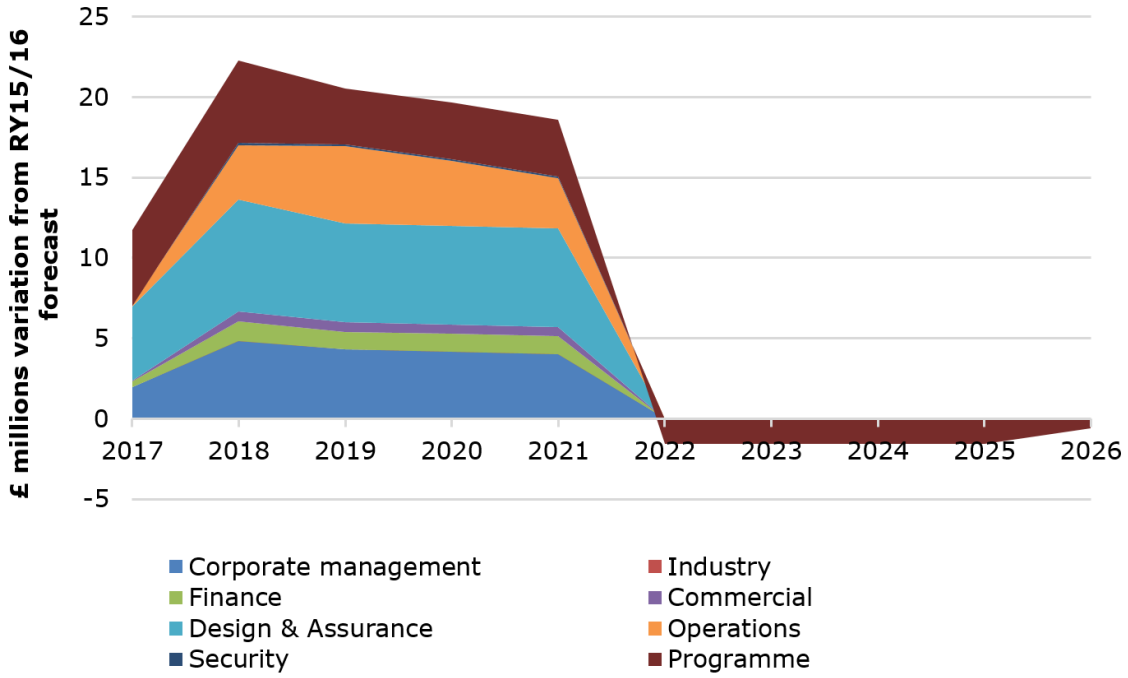
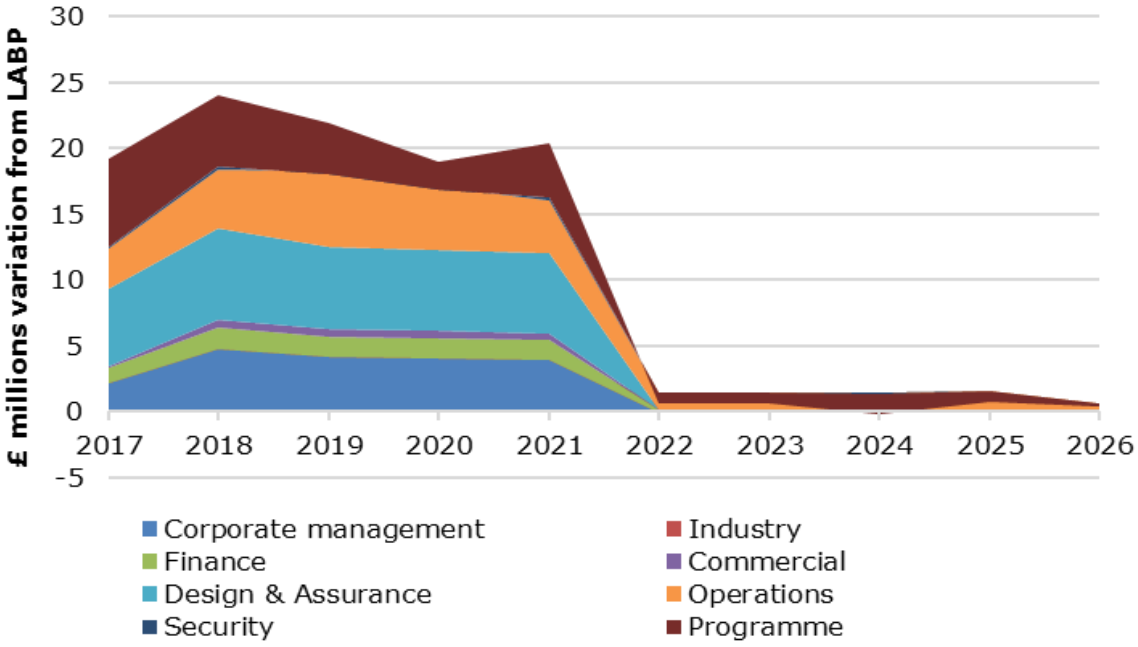


Figure A3.2: Cost variance compared to LABP by Internal Cost cost centres



Payroll costs are a major driver of Internal Costs across the different cost centres Table A3.1 summarises the DCC's headcount from RY15/16 to RY20/21 as measured in full time equivalents (FTE) by cost centre. The 32% year on year increase in FTE is a significant factor in the RY17/18 peak in Internal Costs.

Table A3.1: FTE by cost centre

Cost Centre	RY15/16	RY16/17	RY17/18	RY18/19	RY19/20	RY20/21
Corporate management	12.93	18.21	31.61	32.45	31.95	31.95
Industry	6.19	7.32	6.00	6.00	6.00	6.00
Finance	21.6	25.87	29.32	29.00	29.00	29.00
Commercial	4.56	5.04	7.67	8.00	8.00	8.00
Design & Assurance	52.37	78.02	82.65	84.50	83.38	83.00
Operations	12.05	34.36	46.72	50.80	50.80	50.80
Security	5.27	6.96	8.94	9.00	9.00	9.00
Programme	27.76	38.50	36.13	34.00	34.00	34.00
New Scope	17	13.69	25.20	26.09	25.25	23.00
Service Desk	12.9	23.71	45.46			
Centralised Registration Service (CRS)		*5.71*	*19.91*	*16.58*	*13.67*	*12.17*
Total	**172.63**	**257.39**	**339.61**	**296.42**	**291.05**	**286.92**

The following table summarises the Internal Cost variations reported by DCC, the explanations and evidence provided by DCC, and our proposed positions based on this information.

Variation between RY16/17 incurred costs and previous RY15/16 forecast (%)	DCC's justifications for material variations	Our proposed position considering DCC's evidence and justification
Total (excl. Shared Services) DCC's submission: Our proposed position: Incurred Costs Incurred Costs 90% increase 83% increase Over the licence Over the licence 58% increase 27% increase	**Increasingly complex environment** DCC felt that the changes to their scope (SMETS1, DBCH, etc.), GBCS and SEC modifications, and reprofiling releases continued to be a major driver for Internal Costs. They felt that additional resources were required to ensure the associated obligations were met. This includes resources to ensure FSPs deliver the services required to satisfy these duties.	The majority of DCC's Internal Costs were justified as economic and efficient, with the exception of the cost centre specific issues identified below. However, we remain concerned about the overall size of the DCC. We understand DCC has work underway to review the organisational structure and this is expected to identify opportunities for further efficiencies to be implemented in future years. We therefore propose to disallow all forecast Internal Cost variation relating to headcount across cost centres from RY19/20 onwards. This will affect the payroll, on-payroll and recruitment cost forecasts for each cost centre.
Corporate management DCC's submission: Our proposed position: Incurred Costs Incurred Costs 99% increase 99% increase Over the licence Over the licence 86% increase 41% increase	**Resourcing** Increased resource required particularly in the regulation and strategy and development teams to manage implications of system releases, new scope programmes and SEC developments on these support functions. **Accommodation**	We are concerned with the growing size of DCC's business support services. We propose to disallow forecast roles that DCC have not justified and the entire forecast variance from RY19/20. Our proposals on accommodation are in line with this and we do not consider that DCC has provided sufficient evidence for

Variation between RY16/17 incurred costs and previous RY15/16 forecast (%)	DCC's justifications for material variations	Our proposed position considering DCC's evidence and justification
	More space required to accommodate increasing headcount at the London office. Growing operations function led to DCC acquiring a new site in Runcorn.	the value for money secured for the new site in Runcorn.
Industry DCC's submission: Our proposed position: <u>Incurred Costs</u> <u>Incurred Costs</u> 2% increase 2% increase <u>Over the licence</u> <u>Over the licence</u> 3% decrease 3% decrease	Materiality was below DCC's threshold of £150k so justification was not required.	We consider this appropriate.
Finance DCC's submission: Our proposed position: <u>Incurred Costs</u> <u>Incurred Costs</u> 18% increase 18% increase <u>Over the licence</u> <u>Over the licence</u> 25% increase 11% increase	**<u>Resourcing</u>** Increased headcount to focus on business operations activity, such as a new dedicated HR function, and to boost the commercial finance team to support and advise each cost area's strategic and operational decision-making through driving better performance and cost management.	We are concerned with the growing size of the finance teams in DCC and want to see efficiencies in this area over the coming years. We propose to disallow forecast roles that DCC have not been justified and the entire forecast variance from RY2019/20.
Commercial	**<u>Resourcing</u>**	We accept the variations in this cost centre to be economic and efficient.

Variation between RY16/17 incurred costs and previous RY15/16 forecast (%)	DCC's justifications for material variations	Our proposed position considering DCC's evidence and justification
DCC's submission: Our proposed position: Incurred Costs Incurred Costs 8% increase 8% increase Over the licence Over the licence 25% increase 12% increase	Payroll has increased as part of the general move from using Contractors on an ad hoc basis to using permanent employees. Intended to strengthen Corporate Knowledge and enhance DCC's negotiation capabilities. **Strengthening capabilities** There has also been more effort to further support consistent engagement with FSPs and external service providers across the supply chain. This has required additional resource to coordinate.	In line with all Internal Costs, we propose disallowing forecast variances relating to headcount costs from RY19/20.
Design & Assurance DCC's submission: Our proposed position: Incurred Costs Incurred Costs 150% increase 150% increase Over the licence Over the licence 110% increase 64% increase	**Resourcing** Staff have been brought in-house to provide a consistent approach and ensure learning is captured and applied. **Ensuring Quality** There has been an increasing number of variations/releases and it's important each stage is thoroughly QA'd to prevent further delays to the roll-out. This requires higher	After clarifying our understanding of DCC's role in the assurance of FSP testing, we accept that the variations in this cost centre have been evidenced as economic and efficient.

Variation between RY16/17 incurred costs and previous RY15/16 forecast (%)	DCC's justifications for material variations	Our proposed position considering DCC's evidence and justification
	headcount to deal with overlapping processes and additional external services to support it.	
Operations DCC's submission: Our proposed position: <u>Incurred Costs</u> <u>Incurred Costs</u> 2% increase 6% decrease <u>Over the licence</u> <u>Over the licence</u> 38% increase 11% increase	**<u>Resourcing</u>** DCC's introduction of the Customer Operations and Business Improvement (COBI) model in anticipation of ramping up for live service has increased headcount in delivering the various outcomes required by this structure. The operations function is in place to deliver effective service management processes through teams dedicated to transition services, operational readiness, forecasting, diagnostics and service development amongst others. Notably there is a move away from using contractors to more permanent staff. **<u>Delivering the service desk</u>** The service desk has moved to being a 24/7 operation in place to manage service	In RY16/17 we propose a disallowance of DCC's contractor benchmarking over the 50th percentile as these costs are not evidenced as being economic and efficient. We are concerned with the growing size of the operations function in DCC and want to see efficiencies in this area over the coming years. We propose disallowing the payroll costs associated with vacant roles forecast in Operations' Service Development, Service Management and Operational Performance teams, and the entire forecast variance for FTEs in this cost centre from RY2019/20. Given the uncertainty around the scenarios underlying the service management forecasts we propose disallowing all service management forecasts.

Variation between RY16/17 incurred costs and previous RY15/16 forecast (%)	DCC's justifications for material variations	Our proposed position considering DCC's evidence and justification
	queries, provide fault management and triage to its users.	
Security DCC's submission: Our proposed position: <u>Incurred Costs</u> <u>Incurred Costs</u> 8% decrease 8% decrease <u>Over the licence</u> <u>Over the licence</u> 5% increase 4% increase	**<u>Resourcing</u>** The Security function is responsible for upholding all security aspects of the Smart DCC Licence and the Smart Energy Code (SEC) with respect to Smart DCC's Authorised Business. This team provides support for DCC programme related activites, develops operational security capability, and establishes and maintains the security relationship with the Smart Metering user community. As an internal support function, any increase in team size will be proportional to other developments within the organization.	We consider variances in this support function to be appropriate. However, as with all Internal Costs, we propose disallowing forecast variances relating to headcount costs from RY19/20.
Programme DCC's submission: Our proposed position: <u>Incurred Costs</u> <u>Incurred Costs</u>	**<u>Resourcing</u>** There has been a move from hiring contractors at cost centre level to project manage on ad hoc basis to developing an	DCC explained and evidenced their plans to restructure away from the single project structure originally envisaged at LABP towards a flexible, multi-project

Variation between RY16/17 incurred costs and previous RY15/16 forecast (%)	DCC's justifications for material variations	Our proposed position considering DCC's evidence and justification
144% increase 144% increase <u>Over the licence</u> <u>Over the licence</u> 43% increase 22% increase	in-house resource pool. With this there is a strong focus on enhancing best practice and ensuring it is disseminated throughout the organisation. **<u>Striving for efficiencies</u>** Developing a more flexible approach to enable resource pool to move between projects as needed but ensuring consistent oversight through establishing Delivery Director roles. Efficiencies also sought through supporting secure, coordinated distribution of information between SEC parties and FSPs and ensuring streamlined BIMI information reporting.	organisation. We consider the relevant variations to have been incurred economically and efficiently. It is encouraging to see DCC review their IT Service requirements and reduce costs where opportunities have been identified.
New Scope DCC's submission: Our proposed position: <u>Incurred Costs</u> <u>Incurred Costs</u> 207% increase 177% increase <u>Over the licence</u> <u>Over the licence</u> 94% increase 39% increase	**<u>Resourcing</u>** DCC have teams of resources delivering testing assurance, enrolment and adoption, release 2.0 (including DBCH) and switching. These activities either provide enhancements to the core Smart Metering Programme or are new services.	In RY16/17 we propose disallowing DCC's procurement of consultancy support for the Interim Systems Integrator role as we feel that this could have been avoided and was not the most efficient course of action. We propose disallowing the forecasts for the SMKI and ATG contracts given the lack

Variation between RY16/17 incurred costs and previous RY15/16 forecast (%)	DCC's justifications for material variations	Our proposed position considering DCC's evidence and justification
	Support in delivering enhancements and new functionality Various external services have been procured / altered / extended by DCC to deliver new scope work. Among these services are the contracts for delivering the Smart Metering Key Infrastructure (SMKI), the automated testing of GBCS (ATG), Enrolment Options Testing, consultancy support on the Switching programme and delivery of an interim systems integrator.	of evidence and certainty provided in justifying these costs. We propose disallowing DBCH payroll costs from RY18/19. This is in light of the July 2017 consultation with SEC parties on the plan for the delivery of Release 2.0 as it would be more appropriate evaluate the project's resourcing when this consultation and decision is further advanced. In line with our overall proposal on Internal Costs to encourage efficiencies within DCC we propose disallowing forecast variances relating to headcount costs from RY19/20.

Appendix 4– Proposed unacceptable costs

Proposal for unacceptable costs from RY16/17 to the end of the licence in RY25/26 for this price control period

	RY16/17 (£m)	RY17/18 (£m)	RY18/19 (£m)	RY19/20 (£m)	RY20/21 (£m)	RY21/22 (£m)	RY22/23 (£m)	RY23/24 (£m)	RY24/25 (£m)	RY25/26 (£m)	Total (£m)
LABP Allowed Revenue (AR)	98.948	126.316	151.812	187.506	217.129	221.219	218.165	224.327	231.618	97.962	**1,775.002**
AR reported in RY16/17	**197.417**	**193.234**	**242.967**	**267.118**	**333.792**	**285.743**	**272.166**	**269.655**	**274.394**	**130.120**	**2,466.605**
Proposed reductions											
Resource costs	0.000	1.092	4.304	19.680	19.276	0.000	0.000	0.000	0.000	0.000	**44.353**
Benchmarking	0.451	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	**0.451**
Accommodation	0.000	0.783	0.433	1.368	1.365	0.000	0.000	0.000	0.000	0.000	**3.949**
Service management	0.000	0.439	2.127	1.384	0.484	0.000	0.000	0.000	0.000	0.000	**4.435**
External services	1.167	1.354	1.876	1.874	1.876	0.000	0.000	0.000	0.000	0.000	**8.146**
CRS (including shared services)	0.000	2.269	1.494	1.553	1.252	0.000	0.000	0.000	0.000	0.000	**6.568**
Shared services	0.134	0.220	0.652	2.131	2.007	0.000	0.000	0.000	0.000	0.000	**5.144**
Total reductions	**1.751**	**6.158**	**10.887**	**27.990**	**26.261**	**0.000**	**0.000**	**0.000**	**0.000**	**0.000**	**73.046**
Adjusted forecast AR	**195.665**	**187.076**	**232.080**	**239.129**	**307.531**	**285.743**	**272.166**	**269.655**	**274.394**	**130.120**	**2,393.559**

Note: Allowed Revenue (AR) for RY16/17 (reported by DCC and adjusted by Ofgem) excludes both the RY16/17 Baseline Margin and ECGS applications.

Appendix 5– Implementation Performance Regime

Context

This appendix explains the methodology used to calculate the amount of margin that DCC can retain following an assessment of its performance under the Implementation Performance Regime.

In accordance with Part B of Condition 38 (Determination of the BMP Adjustment), Smart Meter Communication Licence Schedule 3 applies for the purposes of calculating the amount of each of the algebraic terms in the formula set out at paragraph 5 of that condition that determines the value of the BMIPA term in Regulatory Year t.

Part E of Schedule 3 sets out the statement of Implementation Milestone Criteria[33]. The Secretary of State directed the final changes to the performance regime in relation to the Implementation Due dates and Implementation Milestone Criteria. IM9 required DCC live (R1.2) by 20 July 2016 with complete failure to meet the milestone if go-live was after 23 November 2016. IM10 required R1.3 by 26 September 2016 with complete failure to meet the milestone if the release was after 30 January 2017.

IM9

Implementation Milestone 9: Licensee is ready for DCC Live (R1.2)
Algebraic term: $IM9_t$
Where $IM9_t = IM9a_t + IM9b_t$

Implementation Milestone 9a: Licensee is ready for DCC Live (R1.2) in the North
Region
Algebraic term: $IM9a_t$
Implementation Due Date: 20 July 2016
Implementation Milestone Criteria: As specified in the Statement of Implementation Milestone (IM) Criteria set out at Part E of this Schedule.
Amount of term: $IM9a_t = BMIT \times \{(15\% \times TF_{9a}) + (½ \times (4\% \times TF_5 + 4\% \times TF_6 + 4\% \times TF_7) \times (TF_R - 1)) + ((7.5\% \times TF_{8a}) \times (TF_{Ra} - 1)\}$, where,

[33] https://epr.ofgem.gov.uk/Content/Documents/Smart%20DCC%20Limited%20-%20Smart%20Meter%20Communication%20Consolidated%20Licence%20Conditions%20-%20Current%20Version.pdf

TF_{9a} (Time Factor for IM9a) is the Column C figure aligned to the date from Column
A on which the specified criteria are achieved;
TF_R (Time Factor for Recovery) is the Column C figure aligned to the date from Column A on which the specified criteria for both IM9a and IM9b are achieved;
TF_{Ra} (Time Factor for 'a' Recovery) is the Column C figure aligned to the date from
Column A on which the specified criteria for IM9a are achieved;
TF_5, TF_6, TF_7 and TF_{8a} are the value of the Time Factor (TF) determined for IM5, IM6, IM7 and IM8a by Ofgem.

Implementation Milestone 9b: Licensee is ready for DCC Live (R1.2) in the Central
& South Regions
Algebraic term: $IM9b_t$
Implementation Due Date: 20 July 2016
Implementation Milestone Criteria: As specified in the Statement of Implementation Milestone (IM) Criteria set out at Part E of this Schedule.
Amount of term: : $IM9b_t = BMIT \times \{15\% \times TF_{9b} + ½ \times (4\% \times TF_5 + 4\% \times TF_6 + 4\% \times TF_7) \times (TF_R - 1) + (7.5\% \times TF_{8b}) \times (TF_{Rb} - 1)\}$, where,
TF_{9b} (Time Factor for IM9b) is the Column C figure aligned to the date from Column A on which the specified criteria are achieved;
TF_R (Time Factor for Recovery) is the Column C figure aligned to the date from Column A on which the specified criteria for both IM9a and IM9b are achieved;
TF_{Rb} (Time Factor for 'b' Recovery) is the Column C figure aligned to the date from
Column A on which the specified criteria for IM9b are achieved;
TF_5, TF_6, TF_7 and TF_{8b} are the value of the Time Factor (TF) determined for IM5, IM6, IM7 and IM8b by Ofgem.

IM10

Implementation Milestone 10: Licensee is ready for Release 1.3
Algebraic term: $IM10_t$
Where $IM10_t = IM10a_t + IM10b_t$

Implementation Milestone 10a: Licensee is ready for Release 1.3 in the North Region
Algebraic term: $IM10a_t$
Implementation Due Date: 26 September 2016
Implementation Milestone Criteria: As specified in the Statement of Implementation Milestone (IM) Criteria set out at Part E of this Schedule.
Amount of term: $IM10a_t = BMIT \times 15\% \times TF_{10a}$, where
TF_{10a} (Time Factor) is the Column D figure aligned to the date from Column A on which the specified criteria are achieved.

Implementation Milestone 10b: Licensee is ready for Release 1.3 in the Central and South Regions
Algebraic term: $IM10b_t$
Implementation Due Date: 26 September 2016
Implementation Milestone Criteria: As specified in the Statement of Implementation Milestone (IM) Criteria set out at Part E of this Schedule.
Amount of term: $IM10b_t = BMIT \times 15\% \times TF_{10b}$, where
TF_{10b} (Time Factor for IM10b) is the Column D figure aligned to the date from Column A on which the specified criteria are achieved.

Schedule 3, Part G: Time Factor Table

Column A	**Column B**	**Column C**	**Column D**
Date Milestone Achieved	**TF_{8a} & TF_{8b}**	**TF_{9a}, TF_{9b} TF_{Ra} & TF_{Rb}**	**TF_{10a} & TF_{10b}**
28/09/2015	0.09000	0.00000	0.00000
08/11/2016	1.00000	0.96429	0.11905
25/11/2016	1.00000	1.00000	0.44286
30/01/ 2017	1.00000	1.00000	1.00000

Appendix 6 - 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