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Data Communications Company (DCC): Price Control Decision 2016/17

Final decision

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Team: Smarter Metering

Tel: 020 7901 3000

Email: smartmetering@ofgem.gov.uk

Overview:

The Data and Communications Company (DCC) is required to report Price Control Information by 31 July each year. It must report in accordance with the Regulatory Instructions and Guidance that we publish.

Each July DCC can also propose an adjustment to its baseline margin and external contract gain share values. We assess these proposals and determine whether any adjustments are justified. We also assess DCC's performance against a set of implementation milestones.

In October 2017 we consulted on our proposals following a review of the report and information submitted by DCC in July 2017 for the regulatory year from 1 April 2016 until 31 March 2017.

This document sets out our decisions and the reasons for them on the costs DCC reported under its price control for the regulatory year 2016/17 (RY16/17) and its application to adjust the baseline margin and external contract gain share values under the licence.

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

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

Context

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

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

Associated documents

- Data Communications Company (DCC): Price Control Consultation 2016/17 https://www.ofgem.gov.uk/system/files/docs/2017/10/2017.10_1617_price_control_consultation_document.pdf

- DCC Price Control Guidance: Processes and Procedures https://www.ofgem.gov.uk/system/files/docs/2017/06/2017.06_processes_and_procedures_guidance.pdf

- Data Communications Company (DCC): Regulatory Instructions and Guidance https://www.ofgem.gov.uk/system/files/docs/2017/11/2017.11_rigs_word_qos_consequential_amendment.pdf

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

[1] The Smart Meter Communication Licences granted pursuant to Sections 7AB (2) and (4) of the Electricity Act 1989 and Sections 6(1A) and (1C) of the Gas Act 1986. Those licences are together referred to as 'the licence' throughout this document.
[2] The Office of the Gas and Electricity Markets Authority (Ofgem) supports the Gas and Electricity Markets Authority ('the Authority') in its day to day work. In this document, 'us/we', 'Ofgem' and 'Authority' are used interchangeably.

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Executive Summary

The DCC has a pivotal role in ensuring the successful rollout 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. 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 to its customers, whilst also focusing the organization on delivering an efficient operation.

Since the DCC was awarded its licence in 2013, the requirements and detailed design for the smart metering system have been developed and refined, including to introduce new security requirements. This has resulted in some changes to timelines and costs, including a decision that DCC should go-live in two stages instead of one. Regulatory year 2016/17 (RY16/17) was an important year for the implementation of DCC's service culminating with the completion of the first stage of the release of the live service, further development of the final release and development of the necessary programmes to expand smart metering capability. It was during this year that the costs of the two-stage release were largely incurred. While DCC systems are now live, DCC failed to meet the deadlines for both go-live release dates due in RY16/17 and we have used the tools in the regulatory framework to impose a financial penalty.

These are our final determinations for the DCC price control for the RY16/17. These determinations reflect our conclusions on: the economic and efficient level of costs incurred in RY16/17 and forecast over the term of the current DCC licence to 2025; DCC's performance against agreed milestones; and DCC's applications for an adjustment to the Baseline Margin (BM) and External Contract Gain Share (ECGS) values set out in the licence. It follows our assessment and October consultation on DCC's costs, performance and relevant notices.

Cost Assessment

After considering all consultation responses and reconsidering some of DCC's evidence where relevant, we consider that DCC has justified the significant majority of the cost variances in RY16/17. We have determined that a total of £0.923m incurred internal costs as unacceptable. DCC pointed to evidence in their consultation response that has led to us determining a smaller disallowance compared to the £1.751m proposed at consultation.

Our determination on unacceptable costs includes: unjustified levels of remuneration for some DCC operations contractors; and partly unjustified consultancy costs for System Integration support where, from the evidence provided, we were unable to determine whether the contract delivered an additional function or was delivering part of the Data Service Provider (DSP) duties. We have allowed some of the cost for the System Integration consultancy reflecting relevant offsetting savings achieved by DCC.

We have determined a total of £67.092m forecast internal costs between RY17/18 – 20/21 as unacceptable. This relates to resource, service management, external services and Centralised Registration Service (CRS) internal costs that we consider are not sufficiently certain to include in DCC's future allowed revenue. We have disallowed all proposed variation in RY19/20 - 20/21 because DCC's forecasts did not incorporate any efficiency and headcount reduction plans which we expect to see from an increasingly mature organisation. Compared to the consultation proposal to disallow £71.295m forecast internal cost, we have allowed further forecast cost relating to SMETS1 and DBCH activity following further clarification from DCC.

Performance

Respondents agreed with our proposal that DCC largely failed to achieve the final implementation milestones related to the multi-stage live release in line with the specified deadline in RY16/17 (IM9 and 10). This results in a £4.702m reduction in DCC's Allowed Revenue.

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.

DCC applied for a £13.955m adjustment to their Baseline Margin (BM) for RY16/17 to RY20/21 due to the increased complexity of DCC's solution, shifts in timelines and the volume of resources required to deliver on DCC's scope of work compared to what was expected at licence award. We have determined that DCC's BM should increase by £6.769m across RY16/17 and RY18/19. Compared to our consultation position, we now partially accept the application for BM related to SMETS2 programme operational requirements following further justification from DCC.

External Contract Gainshare

The DCC Allowed Revenue formula includes an External Contract Gain Share term that allows for an upward adjustment to DCC's revenue in recognition of a reduction in External Costs that DCC helped achieve. DCC applied to adjust this term for RY18/19-20/21 reflecting a reduction in External Costs as a result of savings from a further refinancing agreement for a fundamental service provider's (FSP's) set-up charges. The ECGS term of DCC's allowed revenue will be increased by a total of £3.261m over RY17/18-19/20.

Difference between regulated and allowed revenue

We can direct a penalty interest rate on any proportion of over recovered revenue that is not sufficiently justified under the 'Report and Direct' penalty interest rate regime. DCC over-recovered the service charge by 122% in RY16/17 which was above the 110% threshold. In line with our consultation position, we consider DCC's reasons for over-recovery of revenue to be acceptable. We have not imposed a penalty interest on any proportion of DCC's over-recovered revenues.

Allowed Revenue Decision

Our decisions on the various components outlined above results in a total allowed revenue over the entire licence period of £2.404bn. Please see appendix 1 for allowed revenue as proposed by DCC and the impacts of this year's decision.

Further discussion points

Looking forward, it is apparent from the consultation responses that many of DCC's customers are unhappy with the level of transparency and influence they have over DCC's costs and performance. We fully support DCC customers' request for further engagement from DCC ahead of any changes to scope or DCC activity, and increased transparency on costs and resourcing structures.

1. Introduction

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 as well as 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 providers (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 Internal Costs and External Costs is included in allowed revenue. This is the baseline margin. Each July, DCC can propose an adjustment to its baseline margin values. We assess this proposal and determine whether to change the level of margin values agreed when the licence was awarded. DCC's margin is 100 percent at risk against their performance previously under the Implementation Performance Regime (IPR) and against the Operational Performance Regime (OPR) and government directed project incentives from 1st April 2018. We will determine the outcome of this performance as part of our price control assessment.

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.

[3] https://www.ofgem.gov.uk/publications-and-updates/data-communications-company-dcc-regulatory-instructions-and-guidance-2017
[4] Amounts payable by DCC to AltHanCo Ltd for the purposes associated with the Alt HAN Arrangements, to SECCo Ltd for the purposes associated with the governance and administration of the SEC and any annual fee paid by the Licensee to the Authority.

Our approach

1.6. As required by the licence,[5] 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.[6]

1.7. We published a consultation in October 2017[7] with our detailed proposals concerning regulatory year 2016/17. This documents sets out our decisions on DCC's:

- economic and efficient incurred and forecast external and internal costs for regulatory year 2016/17 (Chapters 2 and 3);
- application for an adjustment to its Baseline Margin (Chapter 4);
- application for an adjustment to External Contract Gain Share (Chapter 4);
- performance against Implementation Milestones 9 and 10 (Chapter 4); and
- justification for over-recovery of revenue under the 'Report and Direct' penalty interest rate regime (Chapter 5).

1.8. We received 14 responses including two confidential responses. The non-confidential response are published on our website.[8] We have fully considered all responses received to our consultation. We have summarised the key points received from the consultation and provide an explanation of the reasons for our decisions in light of these.

1.9. We have also considered a number of points raised by respondents that were not directly related to the questions we posed in the October consultation. These were either points raised by DCC's customers for DCC's consideration or points from DCC in relation to the price control framework, and are considered in Chapter 6.

[5] Licence condition 37 of the Smart Meter Communication Licence
[6] https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-guidance-processes-and-procedures-0
[7] https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-consultation-regulatory-year-201617
[8] Ibid.

1.10. Please note that we may provide feedback to DCC directly on the detailed points it raised in its consultation response.

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

1.12. For further context to these decisions please read this document alongside our October 2017 consultation. The consultation document describes how DCC's costs have changed since the previous year and outlines our view on whether we think DCC's explanation in their price control submission justifies the cost variances. It also summarises our proposals on whether to accept DCC's application to adjust the BM and ECGS terms. The appendix includes a more detailed overview of DCC's costs.

2. External Costs

Chapter Summary

The majority of respondents broadly agreed with Ofgem's assessment of the DCC's external costs and management of these contracts with FSPs. However, there is consensus among respondents that there is room for improvement in DCC processes, particularly regarding engagement with the SEC Panel and DCC customers on decisions with cost implications.

We consider, based on the information provided by DCC, the external costs reported under the price control in RY16/17 were economic and efficient.

2.1. In DCC's price control submission, external costs associated with the fundamental service providers (FSPs) were forecast to be £2.2 billion over the licence term in RY16/17. This is a 20% increase relative to external costs reported in RY15/16 and 31% above the Licence Application Business Plan (LABP) estimates.

2.2. The increase in FSP costs largely reflect a number of contract changes required to align the design, development and delivery of DCC systems with updates to the Great Britain companion specifications (GBCS) and Smart Energy Code (SEC), and to deliver the two stage release of live services.

2.3. The annual price control includes a review of the DCC's contract management processes by Ofgem. DCC's role is to coordinate and oversee the performance of the FSPs so it is vital that its processes enable effective management of these contracts.

External Cost Assessment

Proposal at consultation: Incurred and forecast external costs are economic and efficient as reported in regulatory year 2016/17.

Decision: Incurred and forecast external costs are economic and efficient as reported in regulatory year 2016/17 as proposed.

Respondent's view

2.4. Seven respondents were broadly supportive of finding the DCC's external costs economic and efficient. However, one of these respondents queried whether CR160 costs were economic and efficient given costs increased despite perceived reduced delivery expectations. Another respondent also queried how economic and efficient DCC's costs could be given concerns with delays and quality of service.

2.5. Three respondents requested further information to enable them to reach a conclusion. It was suggested this could include information on whether higher costs related to a change of scope or overspending by the DCC.

2.6. The majority of respondents noted the importance of Ofgem thoroughly scrutinising the DCC's external costs. This was considered particularly important as the majority of costs arise from FSP activities and only Ofgem is able to access the required information given commercial confidentiality. The perceived inability of customers to hold DCC accountable for cost increases, either directly or through the SEC panel, was also raised by a number of respondents as a major concern.

Reasons for our decision

2.7. Broadly respondents agreed with our proposal that incurred and forecast external costs are economic and efficient for RY16/17.

2.8. It should be noted that in accepting these costs as economic and efficient, we are associating the cause of these costs with a change in scope or scale of requirements. DCC is required to provide information on all variances exceeding the materiality threshold. Were any of these variances found to be the result of overspending, they would not meet the criteria of economically and efficiently incurred variances. Accordingly, these costs would not be passed on to consumers.

2.9. We would also like to acknowledge that while we cannot make confidential information public, we are satisfied with the level of explanation and evidence DCC provided for cost variances observed and forecast over RY16/17. DCC management and commercial leads also provided additional commentary during the cost visit conducted by Ofgem in September 2017 at the DCC's offices. DCC's commercial team are responsible for delivering value for money through its FSP contracts and evidences this to Ofgem through explaining how it has made use of the levers in the contracts and its due diligence processes in negotiating with FSPs and finalising contract amendments (such as processes in CR160).

2.10. We acknowledge the difficulty imposed by information constraints on assessing the DCC's performance. With a view to being as transparent as possible, our October 2017 consultation contained more information on the causes of external cost increases than we have included as part of previous consultations. This included additional information on the main change requests and projects driving material variances. An additional annex was added to provide information on these change requests and projects, as well as the DCC's handling of them. Ofgem will continue to review our consultation structure for future price controls with a view to increasing transparency for stakeholders.

Contract Management performance

2.11. We noted in our October consultation that DCC has demonstrated a number of advances in its approach to managing external contracts. Respondents were broadly supportive of these improvements and the benefits they offer consumers, including realised savings.

2.12. However there was consensus that DCC still has opportunities to improve going forward. Respondents generally agreed with our concerns regarding DCC self-reporting deviations from established policies and procedures, such as experts not consistently using standardised documentation. One respondent suggested addressing these concerns through establishing trackable milestones to monitor DCC's contract management during the year. Another respondent proposed Ofgem commission independent assurance of the fundamental service providers.

2.13. DCC, in its response, highlighted recent efforts to strengthen its internal resources for contract management.

2.14. Through consultation responses, concerns regarding the quality of service from, and communication with, FSPs and the DCC were also raised by the majority of respondents. They queried whether this reflected badly on the DCC's contract management. A number of possible areas for improvement were suggested in relation to the framework within which the DCC and FSPs operate. For example, there was general support for initiatives such as enhancing the specification of FSPs' contractual obligations, clarifying the split between DCC and FSP responsibilities, and ensuring appropriate commercial levers to prevent additional costs. Additionally, it was suggested that there was a need for greater engagement with customers to provide transparency, with one respondent suggesting that the costs of modifications were misaligned with industry expectations.

2.15. In its response to the consultation, the DCC outlined a number of initiatives it has already begun to progress to address these concerns. These initiatives have been enabled through a range of developments including SMETS1 enrolment and adoption, modification of the SMETS2 contracts to include ongoing updates, and the addition of new service providers. Accordingly, the DCC has been developing new contractual levers, such as "cost of failure" clauses to align penalties and rewards for FSPs with the DCC's regulatory framework. The DCC concluded it was looking forward to providing more information in ongoing discussions with Ofgem and customers.

Our view

2.16. We require DCC to evidence its processes and procedures enabling it to meet the obligations defined in its licence in an economic and efficient manner as part of the price control. DCC must ensure its established processes and procedures are followed consistently.

2.17. We are concerned by the indications of substandard quality of service reported by respondents. FSPs are accountable to the DCC for their service provision, which includes the quality of this service. DCC's margin is also in part at risk against the performance of its FSPs against certain performance measures under the DCC's OPR that commences in RY18/19. Under the FSP contracts the

DCC is provided with contractual levers to hold FSPs accountable. The DCC's use of these levers was summarised in Annex 2 of our October 2017 consultation, including the potential for the DCC to benchmark FSP performance. We encourage the DCC to keep these mechanisms under review, particularly in light of the issues raised by customers. The DCC's use of these mechanisms will be assessed again in the context of its broader contract management in the next price control. We also look forward to further detail regarding the finalised structure of the new contractual levers that the DCC are developing.

2.18. We encourage DCC to respond to the request from other respondents for greater transparency on external contracts and the ultimate cost of change requests. Wider points of feedback on customer engagement and transparency are discussed in Chapter 6.

3. Internal Costs

Chapter Summary

Following consideration of consultation responses, our decisions on a number of areas are different to our proposals at consultation. This chapter summarises respondents' views and states our final decision.

We consider, based on the information provided by DCC, a small proportion of their internal costs not to be economic and efficient. We have therefore determined these costs as unacceptable costs under the licence. As such we direct that £0.923 million from DCC's internal costs in 2016/17 are unacceptable and that £67.092 million should not be included in internal cost and Centralised Registration Service (CRS) cost forecasts.

3.1. DCC's RY16/17 price control submission stated that internal costs over the whole licence term were forecast to be £338 million.

3.2. For the majority of costs, DCC has provided sufficient justification and evidence for the costs incurred in RY16/17. However, our cost assessment has revealed some incurred costs which we do not consider to be economic and efficient. We also consider that a significant proportion of DCC's forecast costs are not sufficiently certain enough for us to allow as forecast allowed revenue at this stage.

3.3. Under Licence Condition 37, costs that we find were not economically and efficiently incurred by DCC are described as "unacceptable costs". In respect of such costs we are required to direct whether unacceptable costs are to be excluded from any future calculation of DCC's Allowed Revenue, or to accept an undertaking from DCC on how it will manage unacceptable costs and future procurement of relevant service capability. DCC did not propose an undertaking therefore our determinations on unacceptable costs to be excluded from any future calculation of DCC's allowed revenues are shown in Table 3.1.

3.4. As a result of our decision, we determine that DCC's internal costs over the whole licence term are £270m in RY16/17. This is a 26% increase relative to internal costs determined in last year's price control and 89% above the LABP estimates.

Table 3.1: Unacceptable internal costs and CRS costs – final decision

Unacceptable internal cost	Incurred costs RY16/17 (£m)	Forecast costs RY17/18-RY20/21 (£m)
Resource costs	-	41.731
Benchmarking	0.282	-
Accommodation	-	2.733

Service management	-	4.435
External Services	0.524	6.980
Shared Services	0.118	4.645
CRS costs	-	6.568
Total	**0.923**	**67.092**

3.5. The remainder of this chapter sets out our reasoning and decisions on our proposals on internal costs outlined in the October consultation.

Payroll: incurred costs

Proposal at consultation: £0.451m of unacceptable incurred costs in RY16/17 not justified as economic and efficient owing to the lack of justification for the benchmarking results of operational contractors.

Decision: £0.282m of unacceptable incurred costs in RY16/17 not justified as economic and efficient owing to the lack of justification for the benchmarking results of operational contractors.

Respondent's view

3.6. From those respondents that specifically mentioned the operations benchmarking results, there was support for our proposal to find the proportion of remuneration above the industry average which was not justified as unacceptable.

3.7. DCC was the exception. They stated that they use a market-based approach to the sourcing of contractors, in effect testing the market with every recruitment of a contractor. They also stated that contractors were likely to remain a part of their resource mix and that arriving at an enduring method for benchmarking contractor rates was challenging using the Hay PayNet database.

3.8. DCC challenged our methodology for disallowing contractor costs based on all operations contractors, which they saw as overly punitive on DCC. DCC supplemented their response by highlighting justification for some individual contractor roles stating that they were tested against the market and asked that we exclude those roles from our analysis of unacceptable costs.

Reasons for our decision

3.9. We recognise that contractors need to remain part of DCC's resource mix as they may be the most economic and efficient choice where there is not a permanent need for a specific skill. We also note the challenges in DCC's benchmarking approach, which uses the Hay PayNet database and uses permanent roles only to generate a benchmark. We are happy to engage with DCC on alternative methods to benchmark whether contractor resource is economic and efficient.

3.10. Following further scrutiny of DCC's submission and consultation response, we consider that DCC has provided sufficient evidence for the remuneration levels for 7 of the 20 FTE operations contractor roles in RY16/17. DCC clarified that these roles were sourced through competitive market frameworks. As a result we agree with DCC that it is proportionate to exclude these roles from our unacceptable cost analysis. This ensures that the disallowance reflects only above average remuneration for those roles where DCC provided insufficient evidence. As such, we determine that £0.282m of payroll costs are unacceptable in RY16/17.

Payroll: forecast costs

Proposal at consultation: £5.397m of unacceptable forecast payroll cost for RY17/18-18/19 and £38.956m of unacceptable forecast payroll, related non-payroll and recruitment costs for RY18/19-20/21.

Decision: £2.775m of unacceptable forecast payroll cost for RY17/18-18/19 and £38.956m of unacceptable forecast payroll, related non-payroll and recruitment costs for RY18/19-20/21.

Respondent's view

3.11. Some respondents recognised the need for adequate staffing in order to deliver a quality service and recognise that there have been changes to policy and additional activity that has driven elements of the increase in head count such as concurrent work on enrolment and adoption of SMETS1, DBCH and Switching functions. Nevertheless, the majority of respondents share our concern about the growing size of the DCC and the lack of clear plan to date to reduce headcount in the medium term. It was argued that other sectors facing competitive pressures, such as suppliers, would not be able to sustain an organisation of this size.

3.12. Some respondents mentioned that they would welcome DCC publishing and committing to efficiency targets publically. Some respondents provided suggestions for how DCC could provide more transparency and clarity on resourcing strategy. These are summarised in Chapter 6 where we collate more general points of feedback from stakeholders for DCC to consider.

3.13. DCC stated that they are committed to demonstrating year on year efficiency gains but asked us to consider the timing of when to commit to targets. DCC state that they have internal cost efficiency targets in place for 2018/19 totalling £5m and that they plan to show in the RY17/18 price control how efficiencies are captured in the forecasts included in the price control submission.

3.14. However, more generally DCC note in their response that setting targets would be more effective after DCC is operating at scale. DCC stated that they will face many challenges over the next two years with the implementation of R2.0, SMETS1 and the move to a routine release management model. Alongside this DCC stated that their operational services will be ramping up to support the SMETS2 rollout and that the processes and systems have yet to be proven at scale. DCC argue that the focus should be on process effectiveness rather than efficiency at this point.

3.15. DCC state that they are open to discussing realistic cost reduction targets for inclusion in the forecasts presented in the RY17/18 submission.

Reasons for our decision

3.16. In the near term (RY17/18-18/19) we find 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 as unacceptable.

3.17. The exception to this are the costs relating to SMETS1 enrolment and adoption and R2.0 projects in RY18/19 which we proposed to find unacceptable owing to lack of certainty. We now propose to allow these forecast costs in RY18/19. This follows clarification in DCC's response that plans for both programmes have been subject to considerable engagement with BEIS as well as customers and that the forecast costs provided by DCC were based on resource required irrespective of the chosen delivery options.

3.18. Turning to RY19/20-20/21, without clearer efficiency and headcount reduction plans from DCC at this stage we find the variations in payroll, related non-payroll and recruitment costs to be unacceptable.

3.19. We would welcome discussions with DCC ahead of the next price control submission to discuss how they plan to include cost reduction plans in their future forecasts and how they plan to make these plans transparent to their customers.

Accommodation

Proposal at consultation: The forecast cost associated with the new premises in Runcorn, which amounts to £1.216m from RY17/18 to RY18/19 is unacceptable owing to lack of evidence on the cost benefit analysis for the site. Furthermore, the entire variation in accommodation costs for RY19/20 and RY20/21 amounting to £2.733m is unacceptable.

Decision: The forecast cost associated with the new premises in Runcorn is acceptable. The entire variation in accommodation costs for RY19/20 and RY20/21 amounting to £2.733m is unacceptable.

Respondent's view

3.20. DCC supplied the evidence to show the cost benefit analysis and decision making process alongside their consultation response and confirmed that they followed their internal governance and due diligence processes. The cost benefit analysis confirmed that, while not the cheapest location, the Preston Brook site delivered the greatest benefits including good access to target resources and proximity to FSP testing facilities.

3.21. One respondent stated that if DCC wishes to sublet from its parent company then it must prove that any new site is in the best interest of the DCC and SEC parties not Capita. Another respondent stated that DCC should focus any new expanding activities at the sites that deliver most value to its customers.

Reasons for our decision

3.22. Following scrutiny of additional evidence supplied by DCC that demonstrated the new site in Runcorn delivered the greatest net benefit we find the costs for RY17/18-18/19 as economic and efficient.

3.23. Remaining consistent with our decision on resource costs,[9] we find all forecast cost variance for accommodation for RY19/20 and RY20/21 as unacceptable.

3.24. We encourage DCC to note other respondents' concerns around choice of location for new or expanding activities in locations that deliver most benefit to their customers and ultimately consumers.

Service Management

Proposal at consultation: £4.435m unacceptable forecast service management variation due to lack of sufficient certainty.

Decision: remains unchanged from the consultation proposal.

Respondent's view

3.25. The majority of respondents did not refer specifically to the proposal on service management. Those that did stated their support.

Reasons for our decision

3.26. We remain of the view that DCC's forecast service management costs are unacceptable given the inherent uncertainty in the volumes of activity, and so customer demand, at this stage.

3.27. To clarify our position on service management costs incurred in RY16/17, we find these costs as economic and efficient considering DCC's justification of activity undertaken in RY16/17 and the immaterial variance from the previous

[9] See para 3.18

year's economic and efficient forecast. In their submission, DCC referred to the increase in SEC parties from 124 to over 200 throughout RY16/17 as a key driver of service management activity in RY16/17.

External Services

Proposal at consultation: £1.167m contract cost for consultancy support relating to the Systems Integration (SI) function is an unacceptable cost. £6.980m forecast cost relating to the ATG and SMKI contracts is unacceptable owing to lack of evidence to justify the variance from last year's forecast.

Decision: £0.524m of the contract cost for consultancy support relating to the Systems Integration (SI) function is unacceptable. Remaining unchanged from the consultation proposal, we find £6.980m forecast cost relating to the ATG and SMKI contracts is unacceptable.

Respondent's view

3.28. With the exception of DCC and one confidential respondent, most respondents who specifically mentioned external services supported our proposal to disallow the consultancy support relating to the SI function and forecast costs relating to the ATG and SMKI contracts. Consultation responses raised strong concerns about the need to ensure DCC diligently follows its established processes for contract management.

3.29. In relation to the SI function, DCC stated that CGI delivered under the terms of their existing contract and that the consultancy contract delivered an additional function to assist in the management of SI resources in place at the DSP. DCC state that the use of external consultancy was the most economic and efficient choice and, by virtue of the difference in scope, did not constitute paying twice for the same service.

3.30. DCC's response also highlighted significant offsetting cost-savings that were made around the same time as the introduction of external consultants. These include resources from the DCC delivery assurance team, contractors from the DCC programme team, and a contribution received from the DSP in relation to the removal of their SI management team. DCC state that the introduction of a third party to support the DSP was more time-efficient and cost effective than a Change Request to the DSP's contract and hence gave DCC a much better chance of achieving its delivery objectives.

Reasons for our decision

3.31. We acknowledge that the SI support consultancy contract delivered some activity that would have otherwise been delivered by a combination of existing resource. Where this was the case, DCC offset the costs ('offset savings') associated with the work that would have otherwise been delivered by taking the following action:

- Removal of services contracted to support DCC and the DSP with management of SI functions, and some positions within the DCC Delivery Assurance team[10] that focussed on SI support, totalling £0.493m. After further consideration, we are satisfied that these resources (which were considered economic and efficient in the 2015/16 price control review) were delivering SI management activity that was no longer required as result of the SI consultancy support; and

- A £0.150m reduction in DSP costs following the removal of senior SI resource offset part of the DCC consultancy cost. While we recognise that this is a relevant offsetting saving, we note that this reduction in scope by the DSP does suggest that the consultancy was not brought in to deliver an entirely additional activity.

3.32. Accordingly, we have allowed the DCC £0.643m of the consultancy contract value to acknowledge the offset costs associated with existing SI support.

3.33. However, we remain unclear on the added value delivered by the consultancy contract over and above the offsetting resource identified by DCC to provide more thorough oversight of the SI. The submission from DCC included a timeline of 2-3 years of System Integration challenges that had not been satisfactorily resolved. We received conflicting reports, both in writing and in person, which did not enable us to identify whether the DCC was re-competing aspects of the SI function or commissioning additional support. Nor were we given proper evidence to show how the chosen approach was more economic and efficient than the existing arrangements. Therefore, we do not consider the full contract value over and above the existing resource cost identified above as sufficiently justified. This results in the remaining part of the contract value as an unacceptable cost of £0.524m.

3.34. With respect to the ATG and SMKI forecast costs, we remain of the view that these costs were not sufficiently justified by DCC and therefore find them unacceptable.

3.35. We consider that the treatment of external services has revealed two important principles to help ensure the most economic and efficient outcome for consumers:

- The first is that DCC should have the **flexibility** to re-compete FSP functions and commission additional support to provide stronger oversight of FSPs if it identified either mechanism as a more economic and efficient means to serve consumers. We would like to ensure the DCC continues to

[10] Note we do not have evidence to suggest that the Delivery Assurance team only focused on the management of the SI function at the DSP. We consider only the two roles explicitly dedicated to SI assurance, and no longer required following the change in strategy, are relevant to this contract.

explore all available options and that any justification in the price control clearly evidences the reduction in scope from the original contract.

- The second is that DCC should **be looking for efficiencies wherever possible** and cannot use unrelated savings as justification for a new activity or contract as part of the ex post price control. DCC must be able to demonstrate clearly that any offsetting saving is related directly to the new activity or contract and how DCC's change in approach is the economic and efficient choice.

Shared Services

Proposal at consultation: £0.091m unacceptable cost relating to the shared services charge associated with the switching programme.

Decision: remains unchanged from the consultation proposal related to the switching programme. Note that a further £0.027m is unacceptable relating to the shared service costs associated with the other disallowed incurred costs in RY16/17. This brings the total shared service cost disallowance to £0.118m for RY16/17. A total of £4.645m of forecast shared service costs are unacceptable in relation to the other costs removed from the forecast.

Respondent's view

3.36. Few respondents specifically mentioned our proposal on shared services. Those that did, agreed with the proposal. DCC stated that they accept our proposal to disallow shared service costs associated with switching and that they are building the case for justifying any future shared services costs with the programme in line with the guidance.

3.37. One respondent raised a concern that shared services may not represent value for money.

Reasons for our decision

3.38. We remain of the view that the shared service costs associated with the switching programme were not justified and therefore are unacceptable. DCC did not provide any evidence to show how the switching activity in RY16/17 benefitted from the shared services provided by Capita.

3.39. In response to the respondent's concern about DCC shared services costs representing value for money we accept the 9.5% shared services charge associated with the delivery of the baseline requirements of the DCC's core smart metering service, including SMETS2 systems, SMETS1 enrolment and provisions of DBCH.

3.40. However, DCC must continue to provide full justification to demonstrate that any shared service cost relating to any new scope 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.

Centralising Registration Services (CRS) costs beyond RY16/17

3.41. DCC included CRS costs beyond RY16/17 in their price control submission. We have determined this forecast as unacceptable as the forecast can only be determined after the first full year of the ex-post plus price control arrangements. No respondents specifically commented on this proposal at consultation stage.

4. Implementation Milestones, Baseline Margin and ECGS

Chapter Summary

We have decided to reduce DCC's Allowed Revenue as a penalty for failing to meet Implementation Milestones 9 and 10. This results in DCC losing £4.702 million of its margin through the baseline margin performance adjustment term.

We have also decided that the Baseline Margin (BM) and External Contract Gain Share (ECGS) will be adjusted to reflect changes to DCC's Mandatory Business and efforts on its part to reduce financing costs. We have directed an adjustment of £6.769 million to the BM term between RY16/17 and RY18/19 and adjustment of £3.261 million to the ECGS term between RY18/19 and RY20/21.

4.1. In addition to internal and external costs, three other variables that can directly affect the DCC's Allowed Revenue are: implementation milestones (IMs); baseline margin (BM) adjustments; and the external contract gain share (ECGS) term.[11]

4.2. Until RY16/17 DCC was incentivised to deliver against the implementation performance regime (IPR) through rewards and penalties for performance against Implementation Milestones (IMs). These IMs were required to be met in the lead-up to live operations and involved adjustments to the DCC's Allowed Revenue for performance against them. The DCC was expected to deliver functionality through two releases R1.2 and R1.3, respectively IM9 and IM10, in RY16/17 to enable timely delivery of go live. DCC's margin for the first three years of the licence was put at risk against the IPR totalling £7.9m including price adjustments. DCC has lost a total of 70% or £5.552m this margin across all the milestones since 2013.

4.3. Adjustments to the DCC's BM are permitted under Appendix 1 LC36 of the DCC's licence in the event of material changes in certain aspects of its Mandatory Business under the Licence. Eligibility for adjustments requires specific criteria to be met, such as additional complexity or changes to its scope and scale. The RIGs and Processes and Procedures Guidance Documents provide further information on this point.[12]

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[11] ARt = ECt + ICt + CRSRt + PTCt + BMt +BMPAt + ECGSt – VASCt +Kt
(specified under LC36.7 of the licence)

[12] The DCC Price Control Guidance: Processes and Procedures are available here: https://www.ofgem.gov.uk/system/files/docs/2017/06/2017.06_processes_and_procedures_guidance.pdf. The Data Communications Company (DCC): Regulatory Instructions and Guidance (RIGs) can be found here: https://www.ofgem.gov.uk/system/files/docs/2017/11/2017.11_rigs_word_qos_consequential_amendment.pdf

4.4. The ECGS term was introduced to incentivise the DCC to secure additional savings in relation to financing the original FSP contracts. This term is zero unless DCC applies to vary the relevant term within Allowed Revenue. The ECGS is provided through an upward adjustment to the DCC's Allowed Revenue to reflect (a portion of) the savings achieved.

Performance against Implementation Milestones

Proposal at consultation: Disallow £4.702 million from RY16/17 Allowed Revenue.

Decision: Disallow £4.702 million from RY16/17 Allowed Revenue as proposed.

Respondent's view

4.5. The majority of respondents agreed with our proposal to find the DCC had failed to meet these IMs to enable go live as targeted.

4.6. A few respondents queried the use and structure of implementation milestones. One respondent suggested that the focus should be on delivering the required quality of service, rather than to a specific delivery date. Another suggested the IMs had not been sufficient to achieve the desired outcome and queried whether this experience had informed the approach to incentives for? SMETS1 enrolment and adoption and DBCH.

Reasons for our decision

4.7. Our decision is consistent with the regulatory framework, evidence provided by the DCC and views of respondents.

4.8. Ofgem's role in the IM regime is to determine if DCC has met milestones on time and calculate the subsequent impact on Allowed Revenue. One of Ofgem's considerations in assessing the achievement of the IM is whether the right product (as defined by the regulatory framework) has been delivered.

4.9. From RY18/19 the DCC will be subject to the Operational Performance Regime, which places DCC's margin at risk against its performance in five operational areas which are consistent with the code performance measures outlined in the SEC.[13] BEIS is also in the process of placing additional incentives on DCC specifically in relation to Release 2 and SMETS 1 activity.

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

Baseline Margin Application

Proposal at consultation: Direct an adjustment to DCC's Baseline Margin of £5.134 million between RY16/17 and RY18/19. We consider it appropriate for the DCC to have applied a 15% margin to the variation.

Decision: Direct an adjustment of £6.769 million between RY16/17 and RY18/19. We consider it appropriate for the DCC to have applied a 15% margin to the variation.

Respondent's view

4.10. There was consensus among respondents that the general principles driving Ofgem's proposed position were appropriate.

4.11. However, in general, respondents suggested a tougher stance was required with a number suggesting greater reductions to the BM adjustment beyond DCC's initial application.

4.12. Additionally, the 15% margin was questioned by the majority of respondents. One respondent drew a parallel with Ofgem strengthening its position on energy networks after they earned 10% margins. Another respondent rejected Ofgem's proposal on the basis that the DCC faces relatively low risk so should receive lower margins than those firms exposed to market risk. Yet another respondent stated that competitive market pressures prevent suppliers earning a 15% margin and queried if this was too generous.

4.13. The DCC and a confidential respondent felt Ofgem's proposed reductions were too strong. The confidential respondent suggested that the DCC would not be incentivised to provide the best possible service for consumers without the additional operations margin. Both provided additional information on the factors they felt justified a higher BM adjustment. These included: significant gaps in operational service requirements at bid; increasing complexity from technical standards and SEC provisions; and substantially higher than expected customer numbers.

Reasons for our decision

4.14. We retain our position that disallowed costs and roles previously applied for are not eligible for BM. It should be noted that, as there have been adjustments to which costs are disallowed between the consultation and decision for this price control review, the BM has been adjusted accordingly. For example, the allowance of forecast payroll costs for SMETS1 and Release 2 activity in RY18/19 will result in additional £0.496m margin for the DCC.

4.15. In addition, we maintain our position that external services procured economically and efficiently in lieu of developing in-house services and resources will earn margin. This requires sufficient evidence of how the decision between in-house or external services, and business as usual, was made. It should be noted that while offsetting savings against the Interim SI contract were partially allowed, it is not eligible for margin as we do not consider the full contract value over and above the existing resource cost identified as sufficiently justified (see para 3.33).

4.16. In light of additional information provided by the DCC in response to the consultation, we reviewed our disallowance of margin on SMETS2 Operations. This involved an assessment of whether the additional justification provided by DCC sufficiently demonstrated a clear change in the scale, complexity and scope of operational requirements that could not have been anticipated at bid. We accept customer numbers have increased substantially from 24 to 60 within a few years, with an associated impact on customer demand. We also acknowledge additional complexity was introduced through developments in SEC requirements and the inclusion of multiple Comms Hub variants. However, the remainder of the factors suggested by the DCC were considered inappropriate or insufficiently evidenced.

4.17. We have reviewed how these the factors affect the teams within Operations. There were five teams whose activity is explicitly linked to the accepted drivers given the nature of their work with consumer engagement, capacity building, and support through complex issues. These teams are Service Management, Service Development, Escalation, Diagnostics and operational readiness / operations changes and implementation management. Accordingly additional margin of £0.322m in RY16/17,[14] £0.357m in RY17/18 and £0.338m in RY18/19 will now be allowed.

4.18. Given that DCC's additional accommodation in Runcorn was primarily driven by the new operations team under DCC's Customer Operations and Business Improvement (COBI) model, margin on accommodation has been allowed in proportion to the operations teams considered eligible for margin. We have adopted a pro rata approach in determining the amount of margin DCC can earn on its accommodation by taking the margin allowed for the selected operations teams as a proportion of the margin applied for the operations function overall. This accounts for £0.081m and £0.041m in the margin adjustment for RY17/18 and RY18/19 respectively.

4.19. Regarding the application of a 15% margin, we still consider this appropriate 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 core 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. We consider this vital implementation activity is consistent with the activity on which the LABP and original BM was awarded following the competitive process. Any additional margin successfully applied for

[14] This includes the margin disallowed for the operations contractor roles that were not considered to have sufficient justification for the above average remuneration.

by DCC is 100% at risk under the performance incentive in the OPR or the project incentives currently in development by BEIS.

External Contract Gain Share (ECGS)

Proposal at consultation: To confirm DCC's application to adjust the ECGS term by a total of £3.261 million between RY18/19 and RY20/21 reflecting a reduction in external costs as a result of a refinancing agreement for an FSP's set up charges.

Decision: To confirm DCC's application to adjust the ECGS term by a total of £3.261 million between RY18/19 and RY20/21 as proposed.

Respondent's view

4.20. The majority of respondents supported Ofgem's proposal as outlined in our October 2017 consultation. There was general support for rewarding behaviour that led to cost reductions. However a few queried the appropriateness of rewarding the DCC for a relatively minor saving in the face of substantial increases in total FSP costs. Only one respondent disagreed as they argued the DCC should be looking for cost reductions anyway.

4.21. A number of respondents noted they were accepting the decision at face value, based on the principles presented by Ofgem, or as consistent with regulatory precedent. One respondent sought reassurance that Ofgem had not just accepted the DCC's claim but had independently validated the values involved.

Reasons for our decision

4.22. As with the IM incentives and BM adjustments, the regulatory framework for ECGS is set out in the DCC licence. The ECGS mechanism was included in the price control framework to provide a clear incentive for DCC to find ways to reduce FSP costs.

4.23. We would like to reassure respondents that the DCC provided sufficient evidence to demonstrate their integral role in achieving an overall saving for consumers. This confidential evidence, including the original contracts and funding addendums, has been robustly analysed by Ofgem.

5. Revenue Reporting

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.[15]

The figure below provides an illustrative example of how the charging statements link to the price control process (for RY18/19 charging statements).

End 2017: notice of service charges issued by DCC for April 2018 to March 2019 (RY18/19). This is done at least 3 months before the start of next regulatory year

April 2018: annual charging statement for RY18/19 is issued by DCC based on a prudent estimate of allowed revenue for the year

July 2019: Ofgem receive DCC's price control submission for RY18/19. This will include what DCC actually spent and what was accrued through service charges (regulated revenue)

Summer / Autumn 2019: Ofgem considers the variations in DCC's costs from the costs approved in the previous price control

Winter / Spring 2020: Ofgem determines DCC's "allowed revenue" following the conclusion of the ex-post process

RY20/21: the impact of the RY18/19 decision is reflected in the RY20/21 charging statement (through the correction factor mechanism)

5.2. If DCC over-recovers revenue from users beyond 110% of Allowed Revenue then a penalty interest of 3% above the Bank of England base rate may apply (subject to a direction from the Authority) on any proportion of that over recovery not justified by DCC to the Authority's satisfaction.

Justification for over-recovery

Proposal at consultation: We consider DCC's reasons for over-recovery of revenue to be acceptable. We propose not to impose penalty interest on their over-recovered revenues.

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[15] Please see last year's consultation document for further detail on Allowed Revenue, Regulated Revenue, Correction Factor and the link between Allowed Revenue, Regulated Revenue and DCC's Charging Statement

Decision: remains unchanged from the consultation proposal.

Respondent's view

5.3. 10 out of the 14 respondents to the consultation gave views on our proposal not to impose a penalty interest rate on DCC's over recovered revenue. Four respondents agreed with our proposal.

5.4. A common message from respondents was that any over recovery by DCC should be returned to customers as soon as possible and that there is the potential for DCC to be particularly conservative at the cost of its customers.

5.5. DCC stated that the upward trend in costs means the risk that DCC may need to re-open the charging statement to obtain additional funds justifies their risk-averse approach to setting charges. DCC goes on to confirm its commitment to returning money to customers in a prompt fashion and refers to its latest consultation to amend the RY17/18 charging statement to return £25m back to its customers more quickly than would be possible via the correction factor.

5.6. Two respondents disagreed with our assessment and proposal not to apply the penalty interest rate. Both consider DCC could have better planned its charges and so significantly reduced the over-recovery.

Reasons for our decision

5.7. After considering responses, our decision remains that we consider DCC's justification for over-recovery as acceptable and therefore we will not apply the penalty interest rate to the over recovery. While respondents argued DCC could have better foreseen the factors leading to the over recovery we still consider them valid justification.

5.8. It is worth clarifying the term 'prudent estimate' and DCC's duty with respect to regulated revenue. DCC must take all reasonable steps to secure that its regulated revenue does not exceed a prudent estimate of its Allowed Revenue for each regulatory year. Licence condition 36.5 of the licence also requires that this prudent estimate of allowed revenue is set such that the Service Charges will not need to be amended in the course of the year except in response to a reasonably unlikely contingency.

5.9. DCC has recently issued an updated Charging Statement following consultation to reduce charges by £25m for the remainder of RY17/18. While this is not relevant for RY16/17 we consider it evidence that the threat of a penalty interest rate does provide a credible incentive to DCC not to over-recover more revenue than is necessary as a prudent estimate of Allowed Revenue in any year.

5.10. Nevertheless we would prefer DCC not to have to amend its charges within-year even if it is to return money to is customers. DCC has had as a number of years of dealing with a significant over-recovery at the cost of its customers and it is apparent this remains an important concern for DCC's customers. While we are satisfied with the DCC's justification for Regulated Revenue exceeding 110% Allowed Revenue we will not hesitate to apply the penalty interest rate in the future should it be necessary.

5.11. We encourage DCC to respond to their customers' concerns around the prudent estimate of Allowed Revenue in advance of issuing the final charging statement each year.

6. Further discussion points

Chapter Summary

Respondents raised a number of points that weren't directly related to the questions we posed in the October consultation. These were either points raised by DCC's customers for DCC's consideration or points from DCC in relation to the price control framework. We summarise them here and provide our view on the points where relevant.

Additional points from DCC

Certainty threshold

6.1. DCC state in their response that disallowing a significant proportion of the forecast means that costs are "disallowed even where it is plain that costs will occur". They state that this gives a false view of the future to customers and gives a misleading picture of the variances in future years.

6.2. DCC then go on to suggest that we could record either DCC's forecasts as per the submission rather than the decision or publish a 'best view' of future costs as part of the decision. DCC considers that the benefits of this approach are as follows:

- A best view provides a more accurate picture of likely future costs
- Gives DCC a better idea of which costs are disallowed from forecasts either for failing to persuade us that they are economic and efficient costs or simply that they have failed a certainty test
- Recognise that most of DCC functions will exist through to the end of the licence
- Avoids painting a misleading picture of the variances
- Prevents a disincentive to forecast costs

Our view

6.3. The threshold for allowing costs in the DCC price control forecast must be set at a high bar to ensure we provide sufficient scrutiny to DCC costs and encourage DCC efficiencies. DCC are only obliged to explain any variation from the forecast. Lowering the certainty threshold for acceptable forecast costs may mean that any future efficiencies made by DCC could mask other cost variations that we should be scrutinising.

6.4. For this reason we will continue to scrutinise DCC's forecast costs, setting a high bar, and only allowing costs that we judge both as economic and efficient and sufficiently more likely than not to occur. We do acknowledge DCC's point that the forecast costs determined by the price control do not necessarily give a full picture of potential future costs. However, that is not the intention of the price control.

6.5. We agree that DCC customers need to have a reasonable view of DCC's potential future costs for their own business planning purposes. We consider it to be DCC's responsibility to communicate cost projections to their customers and observe that that DCC has already established a numbers of finance communication channels such as the business plan, indicative charges and budgets and finance webinars.

6.6. We acknowledge that, where we disallow a considerable proportion of DCC's forecast that we consider does not meet the certainty criteria, then any updated forecast the following year by the DCC will register a significant variation. We note DCC's concern that this may cause some confusion for customers and could undermine DCC's reputation for 'management of its activities and its costs in a way that is not justified'.

6.7. While we do not plan to change the way we consider forecast costs against the certainty threshold in the price control, we are happy to engage with DCC ahead of the next price control to discuss ways to improve the presentation of cost variations to DCC customers and other stakeholders.

Definition of Baseline costs

6.8. DCC stated that they have a different understanding of the definition for baseline and new scope compared to our definition in the October consultation. They go on to state that they believe there is benefit in being more explicit of what is new scope and what is baseline activity and the implications for cost reporting.

Our view

6.9. The RIGs and Processes and Procedures documents defines 'baseline' as: *Activity associated with delivering the requirements provided to the Licensee during the DCC Licensing Competition and that the Licensee was expected to fully cost in the LABP.*[16]

16
https://www.ofgem.gov.uk/system/files/docs/2017/11/2017.11_rigs_word_qos_consequential_amendment.pdf
https://www.ofgem.gov.uk/system/files/docs/2017/06/2017.06_processes_and_procedures_guidance.pdf

6.10. Although the full costs of SMETS1 and DBCH activity were not known at bid, we have accepted this as baseline activity given it was always the expectation that DCC would deliver this activity. We may consider making amendments to the RIGs to better distinguish between baseline activity that was anticipated but not costed at LABP. We will engage with DCC on any changes that may be required.

6.11. Note DCC also raised realising cost efficiencies through targets in their response. Please see Chapter 3 for our views on this in relation to internal costs.

Issues for DCC's consideration

6.12. In reviewing the consultation responses, a number of overarching issues were identified that we feel need to be raised with the DCC. While these concerns are to some extent addressed in the body of this decision, we feel there is value in explicitly bringing them to the DCC's attention. The concerns can be broadly grouped into three main areas; perceptions of the DCC's costs and performance, customer engagement prior to costs being incurred, and the DCC's broader approach to resourcing.

Perceptions of costs and performance

6.13. Feedback suggests that DCC needs to communicate more proactively with customers regarding developments in its approach, timelines, and related costs. The majority of respondents accepted that costs have been required to increase year on year, but found the scale of these increases concerning. One respondent specifically mentioned that scale of costs revealed through the SEC Modification proposals are prohibitively high and are becoming a barrier to raising changes to the SEC. Another respondent stated that the higher costs reduced the gains from rolling out smart meters and potentially adversely affect consumers' perceptions, undermining the delivery of the rollout. These concerns were consistently attributed to perceived issues with transparency. Respondents stated a lack of transparency led them to believe the cost escalation was due to poor risk mitigation by the DCC and/or FSP underperformance. They also queried whether the DCC had appropriate risk matrices in place as part of its change management processes.

6.14. Respondents felt they were often afforded little notice of changes in the DCC's plans and timelines. A number of respondents were concerned about the significant costs arising from suppliers' resources and assets becoming stranded by these unforeseen changes. Respondents wanted reassurance that consideration was being paid to the cost impact on suppliers, and ultimately consumers, from the DCC's perceived failure to meet regulatory plans and milestones. They were concerned that despite the move to a multi-release strategy to resolve implementation issues, the system is still not seen as capable of handling rollout at scale. It was suggested that key performance indicators (KPIs) could be introduced to help customers monitor the DCC's performance more accurately.

Our view

6.15. We note that, in its consultation response, the DCC flagged it had plans to enhance its communications with customers. This is consistent with a number of respondents highlighting improvement in DCC's communications with them, although they still felt more was required. We strongly encourage the DCC to continue to review its communications with customers to ensure they are well informed of the reason for any changes well in advance, as well as the strategy being pursued. This should help align customers' expectations with the DCC.

6.16. More specifically, we urge DCC to respond to the request from participants at the December stakeholder event to reconcile any differences between the price control allowed revenue forecasts with their business plan forecasts. This will help highlight to customers the areas of activity which are currently too uncertain to include in forecast allowed revenue but still may be incurred in the future.

Engagement with customers

6.17. It is clear that respondents want more than just greater communication from DCC. The majority of respondents also felt there needed to be more proactive engagement or consultation by the DCC with customers on its costs, either directly or via SEC processes. There was consensus that the aforementioned concerns regarding the magnitude of the DCC's costs were exacerbated by customers' inability to interrogate or challenge costs before they are incurred. Instead customers, and ultimately end consumers, had to accept whatever cost was passed through with no ability to influence these costs.

6.18. It was suggested that a threshold could be introduced so that if a change were to exceed this threshold, such as the CR160 modification, customers could engage and potentially curtail DCC spending. At the very least they could hold the DCC accountable to agreed timescales. This engagement could fall between the impact assessments of alternative options and the decision on the optimal approach to address the requirements of the situation. Respondents felt there could be substantial advantages from the DCC drawing on the experience of its customers to help reframe issues, influence decisions, and prioritise when costs are incurred.

6.19. Another proposal from respondents was for the DCC to create clearer, more detailed business plans and consult on these with customers. This would be consistent with other regulated monopolies who provide customers with the opportunity to analyse and query costs and proposals. For example, customers could be engaged regarding the DCC's plans to change prevailing arrangements or develop new test environments to ensure they are appropriate and necessary. This could also help to overcome customers' difficulties reconciling perceived delays, defects and increasing costs with the standard of economic and efficient activity.

Our view

6.20. We support customers' request for further engagement with the DCC on whether change requests should be progressed, and, if so, the manner in which they are addressed. Irrespective of whether change requests arise at the request of a customer or from GBCS or SEC modifications it is important customers' views inform consideration of the manner in which to address these changes. We advise DCC to take note of the suggestions above and consider modifying their current change process to ensure that customer input is central to the process and does not become a tick-box add-on.

Transparency on DCC resourcing

6.21. As highlighted in Chapter 3 respondents had significant concerns over the increase in internal costs. Requests were made for the DCC to provide a more detailed organogram to help customers understand the distribution of resources to activities within the organisation. There appeared to be consensus that this would help address concerns as to whether the forecast scale of the organisation was appropriate. Additionally there was a request for further information on how the DCC intended to translate its desire to seek efficiencies into action. For example, what steps it will take to identify potential efficiencies, redeploy staff, and prevent the retention of high cost contractors after they have delivered the services internal staff were not capable of providing. There was concern that despite statements to the contrary, the DCC may just rely on attrition to reduce its headcount.

Our view

6.22. We support the call from stakeholders for greater detail on the steps taken to ensure efficiency in the allocation and retention of resources within the DCC. While it is important the DCC is adequately resourced to meet the needs of its customers, it is required to do so in an economic and efficient manner. We understand the DCC are taking steps to review the structure and resourcing of the organisation and look forward to the timely provision of further information on the concrete steps being taken to achieve these aims.

7. Next steps for the DCC price control

7.1. A number of respondents to the consultation questioned whether the current price control arrangements applied sufficient scrutiny to DCC's costs and whether the ex post framework was still fit for purpose. One respondent suggested that a move towards an ex-ante approach for specific projects or activity could be an option. Respondents stated their wish to be closely involved in any review to the DCC's price control and that any change must subject DCC's future costs to stronger scrutiny, to provide greater certainty about future costs, and to feature better incentives for efficiency.

7.2. The current ex-post framework has allowed Ofgem to scrutinise DCC's costs and apply the Government milestone incentives as the DCC system was being designed and implemented.

7.3. It was always anticipated that the price control framework would be reviewed as DCC moved beyond the implementation phase. The DCC is now delivering a live service that is preparing to deliver at scale as the ramp up of smart meter installations begins in earnest. We recognise that an assessment of the price control framework is necessary and have plans in place to review what would need to change in order to:

- Provide stronger efficiency incentives
- Provide more certainty to DCC and their customers
- Involve DCC's customers more explicitly in the price control process
- Reduce the resource burden on DCC and Ofgem

7.4. Input from stakeholders will be vital in ensuring any change to the framework delivers the above outcomes.

Appendices

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Appendix 1 – Determined Allowed Revenue (AR)

	RY16/17	RY17/18	RY18/19	RY19/20	RY20/21	RY21/22	RY22/23	RY23/24	RY24/25	RY25/26	TOTAL
LABP (AR)	98.948	126.316	151.812	187.506	217.129	221.219	218.165	224.327	231.618	97.962	**1775.002**
AR submitted by DCC 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	1.682	19.680	19.276	0.000	0.000	0.000	0.000	0.000	**41.731**
Benchmarking	0.282	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	**0.282**
Accommodation	0.000	0.000	0.000	1.368	1.365	0.000	0.000	0.000	0.000	0.000	**2.733**
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	0.524	1.354	1.876	1.874	1.876	0.000	0.000	0.000	0.000	0.000	**7.504**
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	0.118	0.145	0.362	2.131	2.007	0.000	0.000	0.000	0.000	0.000	**4.763**
Total reductions	**0.923**	**5.301**	**7.541**	**27.990**	**26.261**	**0.000**	**0.000**	**0.000**	**0.000**	**0.000**	**68.016**
Adjusted forecast AR	**196.493**	**187.933**	**235.425**	**239.129**	**307.531**	**285.743**	**272.166**	**269.655**	**274.394**	**130.120**	**2,398.589**
Implementation Milestone	0.000	-4.702	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	**-4.702**
ECGS	0.000	0.000	1.630	0.815	0.815	0.000	0.000	0.000	0.000	0.000	**3.261**
Baseline Margin Adjustment	0.000	0.000	6.769	0.000	0.000	0.000	0.000	0.000	0.000	0.000	**6.769**
Total adjusted AR	**196.493**	**183.231**	**243.824**	**239.944**	**308.347**	**285.743**	**272.166**	**269.655**	**274.394**	**130.120**	**2403.916**

Appendix 2 - Feedback on this consultation

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

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

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

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

General feedback

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

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

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