Decision

DCC Price Control: Regulatory Year 2017/18

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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.

In October 2018 we consulted on our proposals following a review of the report and information submitted by DCC in July 2018 for the Regulatory Year from 1 April 2017 until 31 March 2018.

This document sets out our decisions and the reasons for them on the costs DCC reported under its price control for the Regulatory Year 2017/18 and its application to adjust the Baseline Margin and External Contract Gain Share values under the Licence.

Alongside this document we have published 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 Licence.

DCC, its service users and other interested parties should read this document.

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Executive summary

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 that focuses DCC on providing a good quality of service to its customers, which include energy suppliers. Through the 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 organisation on delivering an efficient operation.

In Regulatory Year 2017/18 (RY17/18), DCC's primary focus was on delivering the core smart metering infrastructure, working with customers to identify and resolve defects identified through end-to-end system testing, and investing in service operations to support the move from testing to mass rollout. In parallel, DCC has progressed with plans for the delivery of Dual Band Communications Hubs, which will extend eligibility for smart metering to more challenging premises; and the enrolment of SMETS1 meters into the DCC system, which will enable those meters to retain their smart functionality when consumers switch supplier.

These are our final determinations for the DCC price control for RY17/18. These determinations reflect our conclusions on: the economic and efficient level of costs incurred in RY17/18 and forecast over the term of the current DCC licence to 2025; and DCC's applications for an adjustment to the Baseline Margin (BM) and External Contract Gain Share (ECGS) values set out in the Licence. Our final determination follow from our assessment and October consultation on DCC's costs, performance and relevant notices.

Cost Assessment

There has been an increase in costs compared to last year's price control. Following our decision, in RY17/18 total costs (excluding pass-through costs) were £256m, £39.9m or 19% higher than forecast last year. Over the Licence term, total costs (excluding pass-through costs) are now forecast to have increased by £337m, or 14%, compared to last year's forecast.

After considering all consultation responses, including that from DCC, we consider that DCC has justified the significant majority of the cost variances in RY17/18. We have determined that a total of £1.307m incurred **Internal Costs** and **Centralised Registration Service Costs** as unacceptable. DCC provided additional evidence in its consultation response that has led to us determining a smaller disallowance compared to the £2.345m proposed at consultation. Our determination on Unacceptable Costs includes unjustified levels of remuneration for some DCC contractors, the cost of the Systems Integration Consultancy contract disallowed last year, and the Shared Services Charge on switching.

We have determined a total of £132.484m forecast Internal Costs between RY18/19-RY25/26 as unacceptable. This primarily relates to resource costs DCC has not justified, and that we consider are not sufficiently certain to include in DCC's future Allowed Revenue. DCC did not incorporate any efficiency and headcount reduction plans which we would expect to see as the organisation matures and enters a steady state operation once its core systems have been built.

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 £7.761m adjustment to its Baseline Margin (BM) for RY17/18 to RY19/20 due to the increased volume of its activities, an increase in the complexity of its activities, and a reduction in the timescales within which it is expected to carry out its activities. DCC provided sufficient additional evidence for two of the nine sub-drivers which originally did not meet the conditions for a Relevant Adjustment. We have determined that DCC's BM should increase by £7.014m (RY17/18 price base) across RY17/18, RY18/19, and RY19/20.

Baseline Margin Inflation and Distribution

We are changing the way in which we are adjusting the Baseline Margin for inflation, as we identified an issue with our previous approach. All future Baseline Margin applications will be deflated to the RY13/14 price base before determination. We, and DCC, have corrected past Baseline Margin adjustments to retrospectively apply the same approach.

We are redistributing the Baseline Margin adjustment from the RY16/17 price control so that the amount awarded for work done in multiple years is recovered across the same number of years, rather than in a single year. As the margin is at risk against DCC's performance, we believe that this places a more consistent incentive on DCC to perform well. We have taken the same approach with this year's Baseline Margin adjustment and, going forward, we intend to continue to distribute the Baseline Margin in the same manner.

External Contract Gain Share

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 RY19/20 to RY24/25 reflecting a reduction in External Costs as a result of savings from further refinancing agreement for the fundamental service providers' (FSPs') set-up charges. The ECGS term of DCC's Allowed Revenue will be increased by a total of £13.204m over RY19/20 to RY24/25.

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 116% in RY17/18 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 £2.732bn. Please see Appendix 1 for Allowed Revenue as proposed by DCC and the impacts of this year's decision.

Understanding customers' needs

DCC's customers have an important role to play in scrutinising DCC costs because, as customers, they are particularly well-placed to judge value for money. We want to see DCC decisions strongly informed by an understanding of its customers' needs, replicating the pressures a company would experience in a competitive market. In addition, we want to see DCC provide greater transparency on its costs, so that DCC's customers understand what they are paying for and why.

DCC has taken steps to strengthen its engagement with customers, but it is apparent from the consultation responses that DCC customers are not always offered the right opportunities to inform or understand DCC decisions. DCC itself has acknowledged the need to improve.

We expect DCC to agree with its customers and the SEC Panel, processes and governance structures that facilitate timely, informed, transparent and proportionate engagement. We expect that, for future price control submissions, DCC will provide robust evidence of how it has taken customer views into account in its decision-making.

1. Introduction

Context

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 its 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). Price control reporting covering the Regulatory Year from 1 April 2017 until 31 March 2018 was submitted on 31 July 2018.

1.2. Over the licence term the majority of DCC costs are incurred by its 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 are either Internal Costs, Pass-Through Costs[1], or costs associated with the Centralised Registration Service[2].

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 the 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 adjust the values agreed when the Licence was awarded. DCC's Baseline Margin is at risk against its performance previously under the Implementation Performance Regime (IPR) and now against the Operational Performance Regime (OPR) and government directed Project Performance Regimes. We will determine the outcome of this performance as part of our price control assessment.

1.5. Separately, DCC receives a percentage margin on the Centralised Registration Service programme. This margin is subject to a separate performance regime.

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

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[1] Principally the cost of the Alternative HAN Company and the Smart Energy Code administration secretariat.
[2] Centralised Registration Service refers to the switching programme.

Our decision-making process

1.7. The DCC Price Control process can be viewed in the wider context of helping to achieve three of Ofgem's key priorities:

- Enabling a better functioning retail market;
- Facilitating change in the energy system; and
- Ensuring network companies deliver for consumers in a changing system.

1.8. As required by the DCC 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[3] 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.

1.9. We published a consultation in October 2018[4] with our detailed proposals concerning RY17/18 and conducted a stakeholder meeting on the consultation in December 2018. This document sets out our decisions on DCC's:

- economic and efficient incurred and forecast External Costs and Internal Costs for RY17/18 (Section 2 and Section 3);
- payments to Capita and the Shared Service Charge on external services and the Centralised Registration Service (Section 4);
- engagement with its customers (Section 5);
- application for an adjustment to its Baseline Margin (Section 6);
- application for an adjustment to External Contract Gain Share (Section 6);
- justification for over-recovery of revenue under the 'Report and Direct' penalty interest rate regime (Section 7).

1.10. We received 11 responses, all of which are published on our website. We have fully considered all responses received to our consultation. We have summarised the key points raised in the consultation responses and provide an explanation of the reasons for our decisions in light of these.

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

1.12. 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.

1.13. For further context to these decisions please read this document alongside our October 2018 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 its price control submission justifies the cost variances. It also

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[3] https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-guidance-processes-and-procedures-0
[4] https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-consultation-regulatory-year-201718

summarises our proposals on whether to accept DCC's application to adjust the BM and ECGS terms.

Related Publications

1.14. The 2017/18 Price Control Consultation Document is at: https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-consultation-regulatory-year-201718

1.15. The DCC Regulatory Instructions and Guidance 2017 is at: https://www.ofgem.gov.uk/publications-and-updates/data-communications-company-dcc-regulatory-instructions-and-guidance-2017

1.16. The DCC Price Control Guidance: Processes and Procedures is at: https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-guidance-processes-and-procedures-0

1.17. The DCC Licence is at: https://epr.ofgem.gov.uk/Content/Documents/Smart%20DCC%20Limited%20-%20Smart%20Meter%20Communication%20Consolidated%20Licence%20Conditions%20-%20Current%20Version.pdf

Your feedback

1.18. We believe that consultation is at the heart of good policy development. We are keen to receive your comments about this report. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall quality of this document?
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. Are its conclusions balanced?
5. Did it make reasoned recommendations?
6. Any further comments?

Please send any general feedback comments to smartmetering@ofgem.gov.uk.

2. External Costs

Section summary

The majority of respondents broadly agreed with our assessment of DCC's External Costs and management of its contracts with FSPs. However, respondents raised concerns around large variations in costs from the LABP, delays and quality of service. Based on the information provided by DCC, we consider that the External Costs reported under the price control in RY17/18 were economic and efficient. However, we encourage DCC to continue to strengthen its approach to commercial negotiations, customer engagement and risk management in particular.

Questions

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

Proposal at consultation: We consider External Costs are economic and efficient as reported in RY17/18.

Decision: Remains unchanged from the consultation proposal.

Respondents' views

2.1. Nine respondents expressed views on this question, the majority of whom stressed the importance of Ofgem thoroughly scrutinising DCC's External Costs. This was considered particularly important as the majority of costs arise from the FSPs' activities and DCC's customers have little visibility of these costs due to commercial confidentiality. Four respondents stated that, on the basis of evidence made available to them, they were unable to determine whether or not those costs had been incurred economically or efficiently.

2.2. Three respondents disagreed with our proposal, highlighting concerns about the large variation in costs from the LABP, delays and quality of service. Two respondents cited specific cost elements contained within DCC's Charging Statements and their inability to reconcile those with DCC's price control submission. Respondents considered that costs associated with testing activities were principally due to DCC's underestimation at bid stage and/or as a result of poor planning for release delivery.

Reasons for our decision

2.3. We acknowledge the difficulty, created by information constraints, faced by respondents in assessing DCC's performance. With a view to being as transparent as possible, our October 2018 consultation contained information on the main change requests, projects driving material variances, as well as DCC's handling of them.

DCC shared parts of its Price Control submission for RY17/18 on its website which provides further information on external costs.[5]

2.4. In response to questions raised at our stakeholder meeting on 5 December 2018, DCC provided additional details on costs incurred as a result of additional scope added to FSP contracts. Please see our website for more details.[6]

2.5. While we cannot make confidential information public, we are satisfied with the level of explanations and evidence DCC provided for the cost variances observed in RY17/18. DCC is responsible for delivering value for money through its FSP contracts and evidences this to us by 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. As part of our scrutiny of External Costs, we assess whether the DCC contract management process has been sufficiently rigorous and robust.

2.6. DCC has demonstrated a number of advances in its approach to managing external contracts. Overall we remain satisfied with the evidence on contract management processes and procedures provided by DCC.

2.7. We are concerned by the indications of poor quality of service and delays reported by respondents. FSPs are accountable to DCC for their service provision, which includes the quality of this service. Under the FSP contracts, DCC is provided with contractual levers to hold FSPs accountable. DCC's use of these levers was summarised in Annex 2 of our October 2018 consultation. We encourage DCC to keep these mechanisms under review, particularly in light of the issues raised by customers. DCC's use of these mechanisms will be assessed again in the context of its broader contract management in the next price control.

2.8. Under DCC's Operational Performance Regime (OPR), which commences in RY18/19, DCC's margin is also in part at risk against the performance of the FSPs against certain performance measures.

2.9. We encourage DCC to take note of the concerns of respondents around specific cost elements, delays leading to higher costs, transparency and the ultimate cost of change requests. Wider points of feedback on customer engagement and transparency are discussed in section 5.

[5] https://www.smartdcc.co.uk/about/price-control/
[6] https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-consultation-regulatory-year-201718

3. Internal Costs

Section summary

Following consideration of all consultation responses, as well as the receipt of additional evidence from DCC, we have decided to reduce the disallowance we proposed at consultation. This section summarises respondents' views and states our final decision on Internal Cost disallowances.

We consider some of DCC's Internal Costs not to be economic and efficient and have, therefore, determined these costs as Unacceptable Costs under the Licence. As such, we direct that £1.016m from DCC's Internal Costs in RY17/18 are unacceptable and that £132.484m should not be included in Internal Cost forecasts.

Questions

Question 2: What are your views on our proposals on DCC's Internal Costs?

Question 3: What are your views on our proposals on DCC's approach to benchmarking of staff remuneration?

3.1. DCC's RY17/18 price control submission stated that Internal Costs (excluding Shared Service Charges) over the whole Licence term were forecast to be £443.7m. This was an increase of £187.9m on the previous year.

3.2. DCC has provided sufficient evidence that the majority of Internal Costs incurred in RY17/18 are economic and efficient. However, we have identified some incurred costs that we do not consider to be economic and efficient. We also consider that DCC has not provided sufficient evidence for a large proportion of its forecast costs.

3.3. Under Licence Condition 37, costs that we find were not economically and efficiently incurred by DCC are described as "Unacceptable Costs". We are required to direct that 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. As DCC did not propose an undertaking, our determination of Internal Costs which are Unacceptable Costs (and which are to be excluded from any future calculation of DCC's Allowed Revenue) is shown in Table 3.1.

3.4. We determine that £1.016m of DCC's incurred and £132.484m of DCC's forecast Internal Costs are unacceptable, such that DCC's Internal Costs (excluding Shared Service Charges) over the whole Licence term are £320.1m.

Table 3.1: Unacceptable Internal Costs

Unacceptable Internal Costs	Incurred costs RY17/18 (£m)	Forecast costs RY18/19-RY25/26 (£m)
Payroll costs	-	120.940
External services	0.326	-
Benchmarking	0.603	0.050
Shared Service Charges	0.087	11.494
Total	1.016	132.484

Payroll Costs and External Services

Proposal at consultation: DCC provided limited evidence of customer demand for the Technical Operations team, the cost of which we were minded to disallow for both RY18/19 (£0.808m) and RY19/20 (£0.855m). We were also minded to disallow £0.326m associated with the System Integration consultancy support disallowed last year. Finally, we were minded to disallow £120.802m of forecast costs from RY20/21 to the end of the Licence term due to a lack of justification provided by DCC.

Decision: Following receipt of additional information and support from respondents, we have decided to allow the costs of the Technical Operations team. However, we have decided to disallow the £0.326m associated with the System Integration consultancy support in RY17/18, and £120.802m of forecast costs from RY20/21 to the end of the Licence term (as well as a single role DCC recommended we disallow, £0.138m).

Respondents' views

3.5. Respondents generally supported our proposals for the disallowance of Internal Costs.

3.6. Several respondents stated that there was a lack of customer engagement before the Tech Ops team was established. Although DCC provided some evidence of customer engagement, where the team and associated plans were presented as part of a wider discussion, it appears that much of this engagement occurred after the decision had been made to establish the Tech Ops team.

3.7. Nevertheless, a couple of respondents stated that they believed the Tech Ops team will be useful. DCC also provided additional evidence to show that the Tech Ops team is a necessary and useful improvement upon ITIL (which is the set of service management practices currently being used). The need for the team was identified in an external audit, and DCC stated that all of the high impact incidents experienced in the last few months could have been avoided or the impact significantly reduced if DCC had a fully operational Tech Ops team.

3.8. Several respondents explicitly supported our proposal to disallow all increases in forecast costs from RY20/21 to the end of the Licence term. DCC stated that they are not challenging the proposal. It also stated that it expected workload to peak in RY19/20 and then start to reduce in RY20/21.

3.9. Respondents were concerned about the accuracy of DCC's forecast costs, the level of increase in DCC's forecast costs, the disparity between DCC's forecast costs and our allowed forecasts, and the difference between these forecasts and the Charging Statement.

3.10. We received a response explicitly supporting our disallowance of the System Integration consultancy support. DCC made no comment on this disallowance – this can be seen as the External Services disallowance in Table 3.1.

Reasons for our decision

3.11. We have decided to allow the costs of the Tech Ops team as there is sufficient evidence that it is a useful and necessary improvement to the service DCC provides, and we do not want to restrict DCC from making such improvements. However, we consider that DCC did not sufficiently engage with its customers on the issue. In future, we expect DCC to consult meaningfully with customers on significant decisions that affect the services provided to customers. Please see Section 5 to read more about the responses we received, and our views on customer engagement.

3.12. Our decision to disallow the increase in forecast costs from RY20/21 to the end of the Licence term remains unchanged from our consultation position.

3.13. We wish to clarify that the forecast costs in the price control are established for regulatory purposes and do not necessarily reflect DCC's best forecast of future costs. In the annual price control process, we scrutinise the variation between the forecast costs accepted the year before, and the incurred and revised forecast costs submitted to us by DCC. We only accept forecast costs that are significantly more likely than not to occur, and that we consider have been fully justified as economic and efficient. In this way we ensure that DCC's costs receive a high degree of scrutiny. This means that there is a high barrier to acceptance of forecast costs, as there should be.

3.14. DCC provides its best forecast of future costs directly to customers, taking into account activities that did not meet the required threshold at the point of the price control submission in July each year. The Charging Statement is based on this DCC forecast, so that customers have certainty on how much they will be charged throughout the year.

3.15. Our decision to disallow the System Integration consultancy support and the single role DCC recommended remain unchanged from our consultation position.

3.16. When calculating the cost disallowance we also disallow the Shared Service Charges associated with the costs we are disallowing.

Benchmarking

Proposal at consultation: Insufficient evidence had been provided to support DCC's new approach to benchmarking contractor remuneration, as a result of which we proposed to disallow £1.476m of contractor cost in RY17/18 and £0.286m of contractor cost in RY18/19.

Decision: £0.603m of unacceptable incurred costs in RY17/18 and £0.050m of unacceptable forecast costs in RY18/19 not justified as economic and efficient owing to the lack of justification for the benchmarking results of operational contractors.

Respondents' views

3.17. Respondents generally supported our approach. One questioned the methodological basis of DCC's approach to benchmarking contractors; several considered that the 50% "contractor premium" was unjustified.

3.18. Wider concern was expressed about the continued increase in FTE numbers – staff numbers are considered to have far exceeded the peak level envisaged in DCC's original LABP submission. There was also a perception that there is a disproportionate number of senior management staff within DCC. One respondent suggested benchmarking the number of staff needed to operate as a "lean and agile" Licence holder of similar stature and responsibility.

3.19. One respondent considered that DCC had adopted a reasonable approach to benchmarking for contractors; another was pleased to see DCC focussing on reducing the number of contractors versus permanent staff. DCC and another respondent suggested the adoption of an approach based on the audit of DCC's processes could be appropriate for the benchmarking of contractor recruitment in the future.

3.20. In response to the consultation, DCC provided additional evidence by commissioning an independent IT recruitment consultant to determine minimum and maximum market rates over the year for a large proportion of contractor roles across four cost centres. DCC then compared the market rate with the actual rate paid to contractors for those roles in order to determine whether its procurement of contractors had been economic and efficient. DCC argued that, as all contractors were recruited using the same processes, the results from the benchmarking exercise should be applicable across all recruitment.

3.21. Of the 114 individual contractor recruitments benchmarked, 20 fell under the market range, 69 fell within the market range and 25 were over the market range. DCC argued that this distribution demonstrated that it was hiring contractors at rates which are consistent with the market. As a result, it argued that its recruitment of contractors was economic and efficient. DCC did not provide any other additional evidence to explain why some contractors were recruited above the market range.

Reasons for our decision

3.22. In the absence of any additional evidence as to the robustness of DCC's recruitment processes, we do not accept DCC's argument that the results from the benchmarking exercise should be applicable across all recruitment. This position is reinforced by the very real differences in the expertise and skills required of the roles benchmarked and those not benchmarked (i.e. IT-related and non IT-related roles) in the additional evidence provided by DCC.

3.23. We consider that a proportion of the costs of the contractors who have not been explicitly benchmarked is not economic and efficient. We have determined this amount using the same methodology as in previous years and have decided to disallow £0.315m in RY17/18 and £0.031m in RY18/19.

3.24. We consider that DCC has justified as economic and efficient the cost of the contractors who have been benchmarked and for whom the daily fee rate fell below the maximum market rate for that role. We have therefore decided to allow their costs.

3.25. We consider that DCC has not demonstrated as wholly economic and efficient those contractors whose roles have been benchmarked and who have been paid above market rates. As a result, we have decided to disallow some of their costs where they fall above reasonable market rates.

3.26. We have determined the disallowance at £0.288m in RY17/18 and £0.018m in RY18/19.

3.27. The total cost (disallowance) of contractors whose roles have not been justified as economic and efficient has thus been determined as £0.603m in RY17/18 and £0.050m in RY18/19.

4. Shared Services

Section summary

Following consideration of all consultation responses, one decision is different to our proposals at consultation.

Following the receipt of additional evidence from DCC, we have decided to allow the cost of the Shared Service Charge on the emulators' contracts (we had proposed to disallow £0.113m for RY17/18 and £0.038m for RY18/19, a total of £0.151m). We welcome the commitment by DCC to take account of all costs and benefits, including the shared service cost, when carrying out cost-benefit analysis in the future.

We consider that the £0.291m of cost relating to the Shared Service Charge associated with Centralised Registration Service (CRS) remains unacceptable. We welcome the commitment by DCC, supported by Capita, to carry out an in-depth review of Capita Shared Services and expect to see the outcome of that review reflected in the next Price Control submission.

Questions

Question 4: What are your views on our proposals for Shared Services?

Shared Services provided by Capita

Proposal at consultation: We had some questions over whether DCC understands the full range of services that should be provided under the Shared Service Charge and whether it is ensuring that those services are provided in full. We were concerned that this could lead to increased costs for customers, and strongly encouraged DCC to actively ensure and demonstrate that it is achieving value for money from the Shared Service Charge.

Decision: Remains unchanged from the consultation proposal.

Respondents' views

4.1. One respondent welcomed our investigation of this issue which they considered had been a concern for some time. In general, respondents were concerned about the lack of clarity over the services that should be provided by Capita, that Capita was minimising the services that it provides under the Shared Service Charge (SSC), and that this was leading to DCC duplicating the services that Capita should be providing (resulting in higher costs to customers).

4.2. Our approach of disallowing costs where no justification has been provided was commended by one respondent.

4.3. In its response, DCC proposed to "undertake an in-depth review of Capita Shared Services to provide greater assurance of their value for money. This will ensure also that there is no "double-counting" between services provided by DCC and those same equivalent services that should be provided under the Shared Service Charge." This review, in which Capita has agreed to participate, is expected to take place "at the earliest possible opportunity".

Reasons for our decision

4.4. As in previous years, we continue to accept the 9.5% Shared Service Charge associated with the delivery of the baseline requirements of DCC's core smart metering service, including SMETS2 systems, SMETS1 enrolment and provision of DBCH.

4.5. However, we remain concerned about the lack of clarity over the services that should be provided under the Shared Services and, in addition, expect DCC to provide full justification to demonstrate that any Shared Service Charges on New Scope activities are economic and efficient.

4.6. We welcome the commitment by DCC, supported by Capita, to carry out an in-depth review of Capita Shared Services. We expect to see the outcome of that review reflected in the next Price Control submission.

Shared Service Charge on external services

Proposal at consultation: Having seen no evidence that DCC considered the cost of Shared Services when it decided to directly procure the emulators rather than through the CSP, we did not consider that DCC had justified the Shared Service Charge on emulators as being economic and efficient. We proposed to disallow the Shared Service Charge on the emulators' contracts (£0.113m for RY17/18 and £0.038m for RY18/19, a total of £0.151m). In addition, we strongly encouraged DCC to ensure that it considers all costs and benefits (including the shared service charge) in future cost-benefit analyses.

Decision: Following the receipt of additional evidence from DCC, we propose to allow the cost of the Shared Service Charge on the emulators' contracts. We reiterate the need for DCC to ensure that it considers all costs and benefits (including the shared service charge) in future cost-benefit analyses.

Respondents' views

4.7. DCC provided additional evidence which demonstrated the significant cost savings achieved by procuring the emulators directly. These cost savings, combined with the other benefits of direct procurement, provided a reasonable, albeit ex-post, justification for DCC's decision.

4.8. In addition, DCC committed to amending its processes to ensure that the cost associated with the overhead charge is considered in procurement decisions in the future.

4.9. Capita supported DCC's views and stated its expectation that DCC would take on-board our recommendations in relation to the future conduct of cost-benefit analyses.

4.10. Other respondents who specifically mentioned our proposal on Shared Service Charges on the emulators' contract agreed with our proposal.

Reasons for our decision

4.11. Although not included as part of its initial submission, we found the additional evidence on the costs savings associated with procuring the emulators directly reasonable. The cost savings, combined with the other (non-monetary) benefits of DCC's approach, provided justification for DCC's decision being economic and efficient.

4.12. DCC has acknowledged that it should take all costs and benefits into account when carrying out cost-benefit analysis, including the shared service cost, and has committed to altering the way in which it develops business cases in such instances in the future.

4.13. We consider that there are likely to be circumstances in the future when DCC will face a similar type of procurement decision. We remind DCC that, in order to demonstrate that such decisions are economic and efficient, it will have to consider all costs and benefits (whether attributed a monetary value or not) in future cost-benefit analyses undertaken to support a business case.

Shared Services on Centralised Registration Service (CRS)

Proposal at consultation: £0.291m unacceptable costs relating to the Shared Service Charge associated with the Centralised Registration Service (CRS) programme.

Decision: Remains unchanged from the consultation proposal.

Respondents' views

4.14. Only a few respondents specifically mentioned our proposal on Shared Services on CRS (Switching). Those that did, agreed with the proposal.

4.15. DCC did not contest our proposal to disallow Shared Service Charges associated with switching, proposing to carry out a review (in conjunction with Capita and Ofgem) of the whole approach to Shared Service Charges on New Scope activities.

Reasons for our decision

4.16. We remain of the view that the Shared Service Charges associated with the switching programme were not justified and therefore are unacceptable. DCC did not provide evidence to show how the switching activity benefitted from £0.291m of Shared Services provided by Capita in RY17/18.

4.17. As we have stated in previous years, DCC must provide full justification to demonstrate that any Shared Service Charges relating to any New Scope activities are economic and efficient.

5. Understanding customer needs

Section summary

We want to see DCC decisions strongly informed by an understanding of its customers' needs, replicating the pressures a company would experience in a competitive market. In addition, we want to see DCC provide greater transparency on its costs, in particular so that DCC's customers understand what they are paying for and why.

DCC has taken steps to improve its engagement with customers, but it is clear from the consultation responses that DCC is still not meeting industry expectations on engagement on decision-making or transparency. DCC recently consulted on proposals for further steps it could take and is currently considering the responses.

We expect DCC to work with customers and the SEC Panel, to establish processes and governance structures which facilitate timely, informed, transparent and proportionate engagement. We also expect that, for future price control submissions, DCC will provide more robust evidence of how it has taken customer views into account.

Questions

Question 5: What are your views on our proposal to expect more robust evidence from DCC on how it has taken customer views into account in future price control submissions?

Question 6: What are your views on the processes that DCC should establish to enable meaningful customer input to decision-making?

Proposal at consultation: DCC's customers have an important role to play in scrutinising DCC costs because, as customers, they are particularly well-placed to judge value for money. We want to see DCC decisions strongly informed by an understanding of its customers' needs, replicating the pressures a company would experience in a competitive market.

We would also expect that, for future price control submissions, DCC will provide more robust evidence of how it has taken customer views into account, with our expectations reflected in revised guidance processes and procedures.

Decision: Remains unchanged from the consultation proposal.

5.1. All 11 respondents expressed views on DCC's customer engagement processes. In reviewing those responses, we have identified a number of overarching issues that we feel need to be addressed individually: steps taken so far; transparency in both costs and performance; engagement with customers; governance; and next steps.

Steps taken so far

Respondents' views

5.2. DCC stated that it has taken steps to strengthen its engagement with customers and most respondents acknowledged its efforts. However, respondents also felt strongly that the current processes are not effective and made it clear that DCC is not meeting industry expectations on either transparency or engagement.

5.3. DCC itself has acknowledged the need to make engagement with its customers more structured and systematic and embed it within the decision-making process, and to improve transparency. DCC recently conducted its own consultation[7] on how it can improve its engagement with customers and stakeholders, and is currently considering the responses.

5.4. One respondent pointed out that while certain teams and individuals within DCC are making efforts to engage meaningfully with customers, more systemic and cultural change is required if good practice is to be embedded across DCC.

Our view

5.5. We agree with respondents' views that DCC needs to take significant further steps to strengthen its engagement with customers and to ensure that it is meaningful, and that this is likely to need to be supported by cultural change across the organisation. We welcome DCC's own consultation on these issues, and intend to engage with DCC as it develops its next steps. We are clear about the outcomes that we want to see but remain open-minded at this stage on how these should be achieved.

Transparency - costs and performance

Respondents' views

5.6. The majority of respondents were concerned about the scale of the increase in DCC's costs. Two respondents specifically mentioned that scale of costs associated with delivering SEC Modifications are prohibitively high and risk becoming a barrier to raising industry changes. Another respondent stated that higher costs were reducing the gains from rolling out smart meters and that this could adversely affect consumers' perceptions, undermining the overall delivery of the rollout. These concerns, which have been expressed in previous years, are exacerbated by the level of transparency currently offered by DCC on the drivers of costs and how they are managed.

5.7. One respondent considered that DCC should provide a breakdown of costs by customer charging group in order to ensure that costs are fairly apportioned and, if necessary, ring-fenced to the correct customer group. The respondent also suggested that DCC's Charging Statements and Indicative Budgets should include the distribution of costs by customer category.

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[7] https://www.smartdcc.co.uk/media/2947/dcc-consultation-on-engagement-v10.pdf

5.8. A further respondent pointed out that there had been some inaccuracies in DCC's Performance Measurement Reports (PMR) and that they would benefit from greater transparency.

Our view

5.9. Transparency of DCC's costs has been a long-standing concern for its customers. We want it to be easy for customers to understand what they are paying for, why, and what DCC is doing to manage costs. We urge DCC take further steps to improve transparency, including helping customers to understand how the Charging Statement relates to the costs allowed through the price control process.

5.10. With regard to costs for implementation of SEC modifications, we expect DCC to continue to work with the SEC Panel to explore options for managing costs; and we also expect DCC to work with the SEC Panel to resolve concerns about DCC's Performance Measurement Reports.

Engagement with customers

5.11. In our consultation we identified four principles that we considered should underpin DCC's efforts to facilitate meaningful customer input to its decision-making process: that such engagement should be timely, informed, transparent and proportionate. The responses to the consultation highlights that much work is still needed in each of these areas.

Respondents views

Timely, with customers able to feed in views at appropriate points in the life cycle of a decision, from initial scoping to final decision

5.12. Most respondents felt that they are not always offered timely opportunities to inform DCC's decisions. This was also apparent from DCC's evidence of customer engagement on the Tech Ops team. The Tech Ops team and associated plans were presented as part of a wider discussion and it appears that much of this engagement occurred after the decision had been made to establish the team.

5.13. Two respondents pointed out the importance of monitoring or tracking of benefit realisation of any Releases, Changes and Improvements made by DCC which would require customer engagement throughout the lifecycle of a project.

5.14. One respondent pointed out that although engagement and dialogue with DCC had improved over the previous year, in particular through the quarterly finance briefings, these are based on standard financial and regulatory cycles and are not necessarily connected to key DCC decision points. Consequently, while the quarterly updates are useful, they are not always timed to enable customers to input into key decisions with the necessary insight and information.

Informed, with customers provided with information that enables them to compare the costs and benefits of different options

5.15. Most respondents were of the view that, before any decision to proceed with new activity was made, DCC should share information on the scope, business case, benefits and governance approval processes. Without this information, respondents felt that they could not engage meaningfully.

5.16. Most respondents pointed out that there is a lack of clarity around the scope of engagement and confusion around which forum is best suited for a particular decision. For example, one respondent pointed out that DCC has included issues for discussion at meetings where customer representatives do not have the necessary financial authority to comment on the level of expenditure being requested.

Transparent, with customers clear about when and how they can contribute views and how these are taken into account

5.17. Most respondents considered that DCC's attempts at customer engagement often lacked clarity – for example, whether DCC is using a meeting to provide information, to seek customers' views or to make or endorse a decision.

5.18. Two respondents stated that there was not enough clarity around DCC's decision making process and cited instances where DCC proceeded with a decision, despite receiving negative feedback from customers.

Proportionate, which would mean greater customer input for those decisions with greater potential impact. It may, for example, be appropriate to establish cost thresholds above which different arrangements for customer input and scrutiny would apply.

5.19. One respondent suggested that, in light of DCC's rising costs, Ofgem should increase scrutiny of DCC by requiring it to seek customer input in areas such as corporate decisions and the management of external contracts. Some respondents suggested that DCC should implement a standardised process for customer engagement for any changes to scope or service that have an impact on its cost base. Such a process could vary depending on the materiality of the change, with impacts being defined (e.g. high, medium, low) on the basis of agreed thresholds. One respondent suggested that a monetary threshold could be introduced – customers would become involved in the decision-making process if a proposed change exceeded this threshold.

Our view

5.20. There are two enduring routes through which decisions on changes to DCC's services to its customers are made. The first is through the SEC modifications process, where options for changes to the core DCC functions and systems as defined by the SEC are considered collectively by DCC's customers, informed by costed impact assessments, and supported by a structured and transparent governance and decision-making process. The second is through DCC's internal governance processes, where decisions on those aspects of service delivery that are not defined in the SEC are made. We want to see DCC improve transparency on costs across all areas of activity. It remains our view that is in the second area of decision-making where we want to see DCC establish better processes for engaging customers and taking their views into account. We do not believe that it is proportionate for DCC to invest effort in strengthening customer input on corporate decisions or in the management of external contracts, as these are not areas where we see customers as having a particular unique perspective to bring.

5.21. We note the responses and support customers' requests for greater engagement and transparency. We expect DCC to meaningfully engage with its customers and we want to see DCC decisions strongly informed by an understanding of its customers' needs.

5.22. There are some areas where we expect DCC could take immediate action. For example:

- DCC to be clear about why they are engaging with customers – for example, for transparency, to inform a decision or to make a decision.
- if DCC provides clear and relevant information against agenda items in good time in advance of a meeting, attendees can ensure that they can come prepared to engage in informed discussion.
- DCC to clarify if any other factors or trade-offs are being taken into account in the decision making process, for example a service can be expensive but may be required to meet quality standards or certain timelines.

5.23. Some of the other points raised in the consultation responses will require new processes. For example:

- What a standard engagement process should look like for decisions on those aspects of service delivery that are not defined in the SEC.
- How engagement should look like throughout the lifecycle of a project so that customers have an opportunity to review whether costs/benefits are as expected and if any further changes are required.

5.24. We expect DCC to reflect on responses to our consultation, alongside its own, and to engage with SEC Panel in developing processes and governance structures which address the above and meet the following key outcomes:

- We want to see DCC provide greater transparency on its costs, in particular so that DCC's customers understand what they are paying for and why.
- We want to see DCC strengthen engagement with customers in making internal decisions on changes to the services that it provides to its customers and are not defined in the SEC.
- We expect DCC to work with customers and the SEC Panel to establish processes and governance structures which facilitate timely, informed, transparent and proportionate engagement.
- We also expect that, for future price control submissions, DCC will provide more robust evidence of how it has taken customer views into account.

Governance

Respondents' views

5.25. In our consultation we stated that meaningful input from customers is likely to be best achieved by a combination of activities led by DCC and the SEC Panel/sub-groups, and that DCC should work with the SEC Panel to develop and agree a clear set of defined activities and procedures. Respondents mostly agreed with this view.

5.26. A few respondents provided specific suggestions as to how the governance processes could be set up. One respondent proposed that a new SEC Panel subcommittee should be established, containing representatives from each of the current subcommittees and DCC's customers (large suppliers, small suppliers and DNOs). This subcommittee would scrutinise (possibly under NDA) any decision on changes to the DCC services by examining each business case and challenging and moulding DCC's plans for the industry and future customer base.

5.27. Another respondent suggested that a formal 'Financial Controls Framework' is needed to manage the process of assessing investments which increase User charges or create a financial risk for Users. Two respondents suggested that a SEC Finance sub-committee could be established to act 'in confidence' on behalf of SEC Parties and engage with and assist DCC in assessing the costs and benefits of any proposed change. One respondent highlighted the positive role that such a sub-committee could have in informing future Price Controls.

5.28. Another respondent suggested modifying existing Industry forums, such as the SEC Panel and associated working groups, by revising terms of reference and membership to ensure that they are set up for effective customer engagement.

5.29. Most respondents considered that there should be a formal sign-off process for customers. Two respondents pointed out that there had been instances where DCC had assumed that it had secured approval from customers, despite the fact that no formal approval had been received from those customers.

5.30. One respondent pointed out that there is little incentive for DCC to engage with its customers and suggested implementing a formal requirement for stakeholder engagement in the DCC price control process. Another respondent suggested that a customer/stakeholder engagement incentive should be considered for inclusion within DCC's performance measures the next time the Operational Performance Regime (OPR) is due for review.

Our View

5.31. We urge DCC to take note of the above suggestions when it establishes processes governing customer engagement. In particular, we consider that any governance process should be proportionate, which would mean greater customer input for those decisions with greater potential impact. We also expect DCC to clearly identify and explain the role of customers in the engagement process, to communicate clear, accurate and timely information throughout the life cycle of the decision, and to agree with customers on information and feedback processes.

5.32. We also expect that, in future submissions, DCC will provide robust evidence of how it has taken customers' views into account in determining the way forward for decisions that have an impact on the cost of customer services. We consider that the requirement to provide robust evidence on customer engagement in future price control submissions will incentivise DCC to understand its customers and the value that they place on the services DCC offers.

5.33. We expect to regularly review the OPR and ensure that it is fit for purpose. As DCC's operation becomes more established, we may look to introduce additional or alternative measures of performance. We would, therefore, consider inputs from stakeholders on any proposed changes to the OPR, including any measures to improve stakeholder engagement.

Next Steps

Revised guidance on processes and procedures

5.34. We scrutinise DCC's costs through the price control process, seeking to ensure that costs are economically and efficiently incurred, and we are continually looking for opportunities for improvement. We expect, in future submissions, that DCC will provide more robust evidence of how it has taken customer views into account in determining the way forward for decisions that have an impact on the cost of customer services.

5.35. We will publish an updated guidance[8] on processes and procedures before the next price control, stating our expectations of what constitutes robust evidence on how customer inputs have been taken into account in DCC's decision-making processes.

Price control process

5.36. A number of respondents 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.

5.37. 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. It was always anticipated that the price control framework would be reviewed as DCC moved beyond the implementation phase.

5.38. 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 its customers
- Involve DCC's customers more explicitly in the price control process

[8] https://www.ofgem.gov.uk/system/files/docs/2018/06/2018.06_processes_and_procedures_guidance.pdf

- Reduce the resource burden on DCC and Ofgem

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

6. Baseline Margin adjustment, inflation and distribution, and External Contract Gain Share

Section summary

This section summarises DCC's application for adjustments to its Baseline Margin and External Contract Gain Share. It also covers a clarification in how inflation is adjusted for, and in how the Baseline Margin is distributed across future years.

The Baseline Margin will be adjusted to reflect changes to DCC's Mandatory Business. Following consideration of consultation responses, we have changed our position on two sub-drivers we had proposed to disallow. We have directed an adjustment of £7.014m across RY19/20, RY20/21, and RY21/22 (RY17/18 price base).

The External Contract Gain Share will be adjusted to reflect the cost savings DCC has achieved through refinancing. Our position regarding the External Contract Gain Share Relevant Adjustment has not changed from consultation. We have directed an adjustment of £13.204m across RY19/20 to RY24/25.

Questions

Question 7: What are your views on our assessment of DCC's application to adjust its Baseline Margin?

Question 8: In its submission, in support of its application for an adjustment to its Baseline Margin, DCC states that there has been a significant unanticipated change in customer expectations, and in customer and service provider demands. What are your views?

Question 9: What are your views on our assessment of DCC's application for External Contract Gain Share?

Baseline Margin adjustment

Proposal at consultation: Direct an adjustment to DCC's Baseline Margin of £5.948m (RY17/18 price base) for work being performed between RY17/18 and RY19/20. That DCC provided insufficient evidence for nine of the 22 sub-drivers it had identified. That 15% was an acceptable margin.

Decision: Direct an adjustment to DCC's Baseline Margin of £7.014m (RY17/18 price base) for work being performed between RY17/18 and RY19/20. That DCC provided sufficient additional evidence for two of the nine sub-drivers which originally did not meet the conditions for a Relevant Adjustment. That 15% is an acceptable margin.

6.1. The formula for DCC's Allowed Revenue contains a Baseline Margin term which was included so that DCC would earn a margin above its costs. This is a fixed amount that is given for each year in the Licence. However, it can be altered through the Baseline Margin adjustment mechanism if there are material changes in certain aspects of DCC's Mandatory Business.

6.2. The Baseline Margin adjustment mechanism allows DCC to apply for a Relevant Adjustment to the Baseline Margin values specified in Appendix 1, Condition 36 of the Licence. The adjustment mechanism is detailed in Appendix 2, Condition 36 of the Licence.

6.3. DCC's Baseline Margin (including awards) is held at risk by a range of different performance regimes. Initially this was done through the Implementation Performance Regime. In future, this will be done through a combination of the Operational Performance Regime and the Project Performance Regimes.

Respondents' views

6.4. Generally respondents were supportive of our proposals for the Baseline Margin adjustment.

6.5. However, five respondents did not consider that they had sufficient information to provide a detailed response on the individual sub-drivers DCC had identified.

6.6. DCC accepted our position on six of the nine sub-drivers which did not meet the conditions for a Relevant Adjustment. However, it contested those sub-drivers associated with Operating Model, Moving Beyond ITIL, and Service Standard Expectations.

6.7. DCC requested that some of the roles connected to the Operating Model sub-driver should be changed to a sub-driver from the previous year (SMETS2Ops), and be allowed on the basis that the roles are similar to those previously allowed.

6.8. For Moving Beyond ITIL, DCC provided additional evidence explaining in greater detail how the Tech Ops team is an unexpected addition to the service level that was initially expected.

6.9. For Service Standard Expectations, DCC provided additional evidence explaining in greater detail how its improvements to the Self Service Interface were above what was initially expected.

6.10. Some respondents questioned whether the 15% margin was consistent with recently developed Ofgem revenue regulation, such as the Price Cap and RIIO2.

Reasons for our decision

6.11. We have reviewed the responses we received, including DCC's additional evidence and explanation, regarding the Moving Beyond ITIL and Service Standard Expectations sub-drivers. We have decided that there is now sufficient evidence that these two sub-drivers meet the conditions for a Relevant Adjustment.

6.12. We do not accept, in the case of the roles connected to the Operating Model sub-driver, that DCC can change the sub-driver associated with a role post-consultation. We also note that Baseline Margin is awarded based on the activity performed by a role, not on the role itself.

6.13. We maintain our position that 15% is an acceptable margin for the core smart metering activities, as DCC's position and characteristics relevant to earning margin have not substantially changed since last year.

6.14. As a result of the changes in the accepted sub-drivers and changes to the cost assessment, the additional margin is calculated as £2.180m for work performed in RY17/18, £2.424m for work being performed in RY18/19, and £2.410m for work being performed in RY19/20 (all in RY17/18 price base). DCC will recover additional margin of £7.014m (RY17/18 price base) in total.

Baseline Margin inflation

We are changing the way in which we are adjusting the Baseline Margin for inflation, as we identified an issue with our previous approach. All future Baseline Margin applications will be deflated to the RY13/14 price base before determination. We, and DCC, have corrected past Baseline Margin adjustments to retrospectively apply the same approach.

6.15. The original values for DCC's Baseline Margin are given in Appendix 1, Condition 36 of the Licence. These values were defined when the Licence was awarded in 2013 and these values are in the RY13/14 price base.

6.16. As these values are fixed, the Licence specifies how to account for inflation in DCC's Baseline Margin. This is done using the price index adjuster specified in Condition 36.8.

6.17. Having been awarded, all Baseline Margin adjustments are also adjusted by the price index adjuster when calculating DCC's Allowed Revenue.

6.18. To ensure that Baseline Margin adjustments correctly take into account inflation, we first need to deflate Baseline Margin adjustments so that they are in the same price base as the Baseline Margin set out in the Licence. For example, a Baseline Margin adjustment applied for under the RY17/18 price control will be deflated by the RY17/18 price index adjuster – resulting in RY13/14 price base values.

6.19. Going forward, we will continue to consult on the Baseline Margin in the price base of that year's price control. We believe that this is the best way for stakeholders to understand the true value of the Baseline Margin adjustment they are being consulted on. However, we will also include values in the RY13/14 price base for transparency and clarity where necessary.

6.20. This year's Baseline Margin adjustment of £7.014m (RY17/18 price base) will be deflated to £6.472m (RY13/14 price base) and allocated as follows: £2.012m for work in RY17/18, £2.237m for work in RY18/19, and £2.223m for work in RY19/20 (all in the RY13/14 price base).

6.21. The Baseline Margin adjustment of £6.769m made in RY16/17 (RY16/17 price base) is being recovered in RY18/19 price control. DCC has agreed that the values in the previous determination should be deflated: to £2.363m for work in RY16/17, £2.141m for work in RY17/18, and £1.872m for work in RY18/19, a total of £6.376m (all in the RY13/14 price base).

6.22. Previous years' Baseline Margin adjustments that have been recovered also need to be adjusted on this basis. We have calculated that DCC's Allowed Revenue to date is, in total, £0.071m higher than it should have been. DCC fully agrees with us on this issue, and has agreed to return £0.071m to customers as soon as possible.

Baseline Margin distribution

We are redistributing the Baseline Margin adjustment from the RY16/17 price control so that the amount awarded for work done in multiple years is recovered across the same number of years, rather than in a single year. As the margin is at risk against DCC's performance, we believe that this places a more consistent incentive on DCC to perform well. We have taken the same approach with this year's Baseline Margin adjustment and, going forward, we intend to continue to distribute the Baseline Margin in the same manner.

6.23. In the RY16/17 price control DCC applied for an adjustment to its Baseline Margin based on work it had done and will do in RY16/17, RY17/18, and RY18/19. We determined an adjustment of £6.769m, and made the entire adjustment to the Baseline Margin in RY18/19.

6.24. We have identified two issues with this approach:

6.24.1. It results in a spike in the Baseline Margin for a particular year and requires DCC's customers to pay for a Baseline Margin adjustment associated with multiple years of work in one year.

6.24.2. It results in disproportionate incentives under the Operational Performance Regime (OPR). In accordance with Licence Condition 31.10(b) we have to hold at least 100% of the total Baseline Margin in any given year, accountable in that year under the OPR. This means that BM adjustments made due to work spread across several years, but recovered in a single year, would result in a disproportionately high BM at risk in that year. We believe this could lead to an unfair outcome if DCC either performed unusually well or unusually poorly in that year.

6.25. We will therefore be redistributing the recovery of the Baseline Margin adjustment made in the RY16/17 price control over three years: £2.363m in RY18/19, £2.141m in RY19/20, and £1.872m in RY20/21 (RY13/14 price base).

6.26. We will likewise be distributing the recovery of the Baseline Margin adjustment applied for in this year's price control across three years, as follows: £2.012m in RY19/20, £2.237m in RY20/21, and £2.223m in RY21/22 (RY13/14 price base).

6.27. Going forwards we intend to follow this approach of distributing the Baseline Margin, so that the amount awarded for work done in multiple years is recovered across the same number of years, rather than in a single year.

External Contract Gain Share

Proposal at consultation: Direct an adjustment to DCC's External Contract Gain Share of £13.204m from RY19/20 to RY24/25 on the basis of £44.161m of savings from refinancing agreements for set-up payments.

Decision: Remains unchanged from the consultation proposal.

6.28. The formula for DCC's Allowed Revenue includes an External Contract Gain Share (ECGS) term which allows for an upward adjustment to the Allowed Revenue where DCC has secured cost savings in the Fundamental Service Provider (FSP) contracts. This is so that DCC has an incentive to seek and achieve cost savings in the FSP contracts. This term is zero unless DCC applies for a Relevant Adjustment to this term.

Respondents' views

6.29. Several respondents supported our proposal. However, several others stated that not enough detail had been provided in the consultation for them to be able to provide a view on the ECGS adjustment.

6.30. Some respondents wished for greater clarity on a range of issues, including how the cost savings were shared, and whether the costs were deferred rather than actually reduced.

6.31. DCC welcomed our proposal.

Reasons for our decision

6.32. ECGS provides an incentive for DCC to reduce the cost of the existing contracts with its FSPs.

6.33. This ECGS adjustment is being made on the basis of the refinancing of the set-up payments. Much of the detail of the ECGS application is commercially sensitive information and is therefore confidential.

6.34. DCC has reduced costs for customers by negotiating with third party financial institutions and the FSP to agree lower interest rates for the set-up payments. This led to a significant saving of £44.161m over the period from RY18/19 to RY24/25. These are cost savings, not deferred payments.

6.35. These cost savings are shared between customers, DCC and the FSPs, with customers receiving the largest proportion of the savings. For this ECGS adjustment, in total, customers are receiving 55% of the cost savings through reduced charges. DCC has benchmarked this split of the cost savings against other gain share arrangements in regulated sectors in the UK, to which it compares favourably.

6.36. This type of cost saving activity by DCC helps to reduce costs for customers, and therefore, the costs of the smart metering infrastructure. Our decision remains unchanged from our consultation position.

7. Over-recovery of revenue

Section summary

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.

We consider that DCC's reasons for over-recovery of revenue of 116% this year are acceptable and note the improvement since last year (when DCC exceeded the 110% threshold by 12%). We are not imposing penalty interest on its over-recovered revenues.

Questions

Question 10: What are your views on our proposal on DCC's over-recovery of revenue?

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

Decision: Remains unchanged from the consultation proposal.

Respondents' views

7.1. Ten respondents commented on our proposal not to impose a penalty interest rate on DCC's over-recovered revenue. All of them agreed with our view that DCC could take further steps to improve the accuracy of its estimates for the Charging Statement.

7.2. Five respondents agreed with our proposal. A common message from respondents was that the DCC should strive to improve the accuracy of its forecasts, especially when similar issues had been raised in RY16/17.

7.3. Four respondents disagreed with our assessment and proposal not to apply the penalty interest rate. All of them considered that DCC could have better planned its charges and, as a result, significantly reduced the over-recovery. One respondent pointed out that not imposing a penalty when the key reasons for the over-recovery had been identified in previous years may set an uncomfortable precedent. Two respondents specifically pointed out that imposing a penalty would strengthen our message that DCC should have reasonably predicted interest income and the future number of meters.

7.4. Respondents suggested that unless a penalty is imposed there will be no incentive for DCC to improve its forecasts. One respondent also suggested that we should examine whether the existing penalty interest rate is an adequate deterrent.

7.5. One respondent commented on how the price control decision gets reflected in the Charging Statement and one respondent had a query on how the over-recovery is calculated.

Reasons for our decision

7.6. After considering all of the responses to the consultation, we still consider DCC's justification for over-recovery as acceptable and, therefore, will not apply the penalty interest rate to the over-recovery.

7.7. While DCC could have better foreseen the factors leading to the over-recovery, we note that there has been an improvement since last year when DCC exceeded the 110% threshold by 12%. We consider this improvement evidence that the threat of the imposition of the penalty interest rate does provide a credible incentive to DCC not to over-recover more revenue than is necessary. However, we expect DCC to continue to improve its forecasts in future years, particularly in areas which have already been identified as below standard.

7.8. DCC has acted on last year's key message that any over-recovery by DCC should be returned to customers as soon as possible. Last year DCC issued an updated Charging Statement to return £25m back to its customers more quickly than would be possible via the correction factor for the remainder of RY17/18. DCC has recently issued an updated Charging Statement following consultation to reduce charges by £14.3m for the remainder of RY18/19. Like last year, this year we also facilitated the process by consenting to less than three months' notice for proposing changes to the Charging Statement. We expect DCC to continue to return any over-recovery to customers as soon as possible

7.9. It is worth clarifying that the over-recovery amount is calculated as the difference between Regulated Revenue and Allowed Revenue. We consider whether to impose the penalty interest rate on the over-recovered revenue if the ratio of Regulated Revenue to Allowed Revenue is above the 110% threshold. Section 5 on Revenue Reporting in last year's decision document provides a detailed explanation of how the Charging Statements link to the price control process.[9]

7.10. DCC has over-recovered revenue for a number of years and this has become a significant concern for its customers. While we are satisfied with DCC's justification for Regulated Revenue exceeding the 110% threshold this year, we will not hesitate to apply the penalty interest rate in the future should it be necessary.

7.11. Finally, we encourage DCC to present customers with several alternative approaches to forecasting, and to consult with them on which approach is preferred. We also encourage DCC to provide more clarity to its customers on how the costs quoted in the Charging Statement link to the price control process. This will require DCC to engage with its customers effectively – this is discussed further in section 5.

[9] https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-decision-regulatory-year-201617

Appendices

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Appendix 1 – Determined Allowed Revenue (AR)

(£m)	RY17/18	RY18/19	RY19/20	RY20/21	RY21/22	RY22/23	RY23/24	RY24/25	RY25/26	Total
LABP Allowed Revenue (AR)	126.316	151.812	187.506	217.129	221.219	218.165	224.327	231.618	97.963	1,676.055
AR reported in RY17/18	222.722	296.256	363.601	416.633	375.052	350.588	350.067	341.666	129.563	2,846.147
Reductions										
Resource costs	0.000	0.067	0.071	22.215	22.317	22.329	22.329	22.329	9.284	120.940
Benchmarking	0.603	0.050	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.653
External services	0.326	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.326
CRS (including Shared Service Charges)	0.291	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.291
Shared Service Charges	0.087	0.011	0.007	2.110	2.120	2.121	2.121	2.121	0.882	11.581
Total reductions	1.307	0.128	0.077	24.326	24.438	24.450	24.450	24.450	10.166	133.791
Adjusted AR before BM and ECGS adjustments	221.415	296.128	363.524	392.307	350.614	326.138	325.617	317.217	119.397	2,712.356
Baseline Margin and ECGS adjustments										
Previous RY16/17 BM adjustment	0.000	-7.336	0.000	0.000	0.000	0.000	0.000	0.000	0.000	-7.336
Distributed RY16/17 BM adjustment	0.000	2.561	2.320	2.029	0.000	0.000	0.000	0.000	0.000	6.909
RY17/18 BM adjustment	0.000	0.000	2.180	2.424	2.410	0.000	0.000	0.000	0.000	7.014
ECGS adjustment	0.000	0.000	4.394	2.347	1.990	1.491	1.491	1.491	0.000	13.204
Total adjusted AR	**221.415**	**291.353**	**372.418**	**399.107**	**355.014**	**327.629**	**327.108**	**318.708**	**119.397**	**2732.149**

Note: All values in RY17/18 price base