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Consultation

DCC Price Control: Regulatory Year 2018/19

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The Data Communications Company (DCC), or Smart DCC Limited, is a central communications body appointed to manage communications and data transfer for smart metering. It holds the Smart Meter Communication Licence[1] (Licence). Price control arrangements restrict DCC's revenues and provide incentives to counter its monopoly position to deliver more efficient, better performance and innovation. Price control arrangements also ensure that costs incurred are economic and efficient. DCC submitted its price control information (based on the Regulatory Instructions and Guidance (RIGs) that we publish) for 1 April 2018 to 31 March 2019 on 31 July 2019. On the same day it submitted proposals for adjustments to its Baseline Margin and External Contract Gain Share values.

This document includes our review of the DCC's costs for the 2018/19 Regulatory Year and outlines the scope, purpose and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses. We

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

want to be transparent in our consultations and will publish the non-confidential responses we receive alongside a decision on next steps on our website at www.ofgem.gov.uk/consultations. If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential and, if possible, put the confidential material in separate appendices to your response.

Contents

Executive Summary

DCC is the central communications body licenced to provide the communications, data transfer and management required to support smart metering. It 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 it 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.

DCC's price control submission for the 2017-18 Regulatory Year (RY17/18) described the delivery of the live system and capability to support the introduction of SMETS2 meters. In RY18/19 DCC continued to develop the core SMETS2 infrastructure and completed multiple code releases to support new functionality. DCC supported the accelerating rollout of SMETS2 meters, put in place the building blocks to enable migration of SMETS1 meters onto the DCC infrastructure and progressed the enactment phase of the Switching programme. One of the major capabilities that DCC built in RY18/19 is a new test lab and technical and operational control facility near Manchester.

There has been an increase in costs compared to last year's forecasts. This is largely because DCC has not previously been able to forecast the costs associated with the SMETS1 programme with sufficient certainty for them to be allowed through the price control. Overall, DCC's total reported costs for RY18/19 are £403m.[2] Excluding pass-through costs, the figure is £376m. This is a 24% increase in total costs incurred in RY18/19 compared to last year's forecasts (or a 27% increase with pass-through costs excluded). Over the Licence term (RY13/14-RY25/26), total costs (excluding pass-through costs) are now forecast to be £3.8b, 33% greater than last year's forecast.

[2] All Great British Pounds (GBP) figures given in this document are in current year (RY18/19) prices. Inflation adjustments have been calculated using the Consumer Price Inflation including owner occupiars' Housing costs (CPIH) inflation index.

Cost Assessment

DCC's submission for RY18/19 was in general, clearly laid out and provided reasonable justification for the majority of costs incurred. However, forecast costs were not sufficiently justified signalling the continued uncertainty around DCC's activities and the associated costs. Our assessment of the submission revealed three cross-cutting issues where we have concerns:

- **Customer engagement** - For costs that arise as a result of decisions made through DCC's internal governance processes we expect robust evidence of how DCC has taken customer views into account. The evidence on customer engagement submitted this year was not satisfactory. We are aware that, during 2019, DCC has started to put new processes in place that aim to provide both increased transparency to customers on DCC's costs and enable meaningful input to decisions that impact on costs. In future submissions we expect to see robust evidence of how this new engagement approach has been applied to inform decision-making.

- **Contract management** – Core to DCC's role is its negotiation and management of service provider contracts. During RY18/19, DCC established six substantial new contracts with SMETS1 service providers, and further contract negotiations are planned. In future price control submissions, we expect DCC to provide fuller assurance around how they have assessed the trade-offs they choose to make in contract negotiations and how they plan to manage contractual risks to ensure performance and delivery throughout the terms of the contract.

- **Efficiency targets** – We expect DCC to be committed to realising efficiencies over time. We recognise DCC's efforts to communicate its approach to identifying savings to its customers through the quarterly finance updates. However, DCC in its price control submission provided little evidence on how efficiency savings are planned and realised for the different cost centres. In future price control submissions, we expect DCC to publish and commit to efficiency targets in order to demonstrate to customers that cost efficiency is central to its business planning strategy.

For the cost assessment itself, unless we receive further information, our position is that £1.088m from DCC's total cost in RY18/19 are unacceptable costs, which relates partly to remuneration for contractors and partly to an external service procured to deliver a KPI dashboard. In addition, we are minded to disallow a £235.917m increase in its forecast costs over the period to RY25/26 (the remaining term of the Licence) because DCC has not justified these costs. Any costs that we ultimately decide were not economically and efficiently incurred will either be excluded from the future calculation of Allowed Revenue or be subject to an undertaking about DCC's future management.

Performance Incentives

All of DCC's margin is at risk against its performance. This is the first year in which DCC's performance is being assessed under the Operational Performance Regime (OPR) and a Baseline Margin Project Performance Adjustment Scheme (BMPPAS).

We are proposing that DCC's Baseline Margin should be reduced by up to £1.305m due to its performance under the OPR. We are, however, concerned that the OPR may not be providing the best incentives to DCC, and are therefore initiating a review of the OPR.

The BMPPAS enables the Secretary of State to create incentive regimes for specific projects and, this year, applies to the Release 2.0 (R2.0) project. We are proposing a reduction of £0.093m to its Baseline Margin in RY18/19, and a total of £0.479m across the licence period under the R2.0 BMPPAS. This represents a reduction of 74% of the BM that has been assessed under this regime.

Baseline Margin Adjustment

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.

This year DCC has applied for a £11.046m adjustment to its Baseline Margin (BM) for increases in the volume and complexity of work caused by both new drivers and drivers previously identified by DCC.

We are minded to adjust DCC's application to reflect the price control decisions on unacceptable costs. We are also minded to reject several parts of DCC's application, where we have not seen sufficient evidence of a material change that could not have been foreseen, or for which the driver does not appear to meet the conditions in the Licence, unless we receive further information. Finally, we are minded to reduce DCC's application by an amount proportionate to costs which have not been incurred, but for which DCC has previously been awarded Baseline Margin.

Taking all of these disallowances into account, we are minded to amend DCC's application to an adjustment of £8.076m between RY20/21 and RY22/23, a decrease of £2.970m from the application.

External Contract Gain Share

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

Similar to the last two years, DCC has applied to adjust this term of £8.210m across RY18/19 to RY25/26, reflecting a reduction in External Costs as a result of a further refinancing agreement for set-up payments. We propose to accept DCC's ECGS Adjustment application of £8.013m and reject £0.197m ECGS Adjustment relating to the SMETS1 programme. Between RY15/16 and RY18/19, DCC has secured cost reductions of £99.5m in the FSP contracts based on DCC's ECGS applications, and brought benefits of £53.1m (53% of total cost reductions) to DCC's customers through lower charges.

Next steps

We welcome your views, and will consider them when we make our decision. Please send responses to smartmetering@ofgem.gov.uk by 20 December 2019. We will publish our decision in February 2020.

1. Introduction

What are we consulting on?

1.1. We are consulting on our proposed positions for DCC's costs, revenues and margin application for the Regulatory Year 2018/19 (RY18/19) under the price control mechanism. As required by the Licence, our assessment of DCC's costs is based on comparing DCC's incurred costs and revised forecast with the previous year's forecast and with DCC's Licence Application Business Plan (LABP).[3] Our guidance document, published in July 2019, 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[4].

1.2. We are restricted as to the detail we can include in this document due to the commercially sensitive nature of much of the evidence we consider. We know that, some stakeholders find it difficult to provide meaningful input to the price control consultation process given limited detail of cost information provided within our consultation document.

1.3. DCC has started to provide additional transparency on costs direct to its customers through its quarterly finance forums under suitable confidentiality arrangements. Further, alongside this consultation, DCC has published parts of its price control submission for RY18/19.[5] This additional information should be helpful to stakeholders in responding to this consultation.

1.4. A stakeholder meeting will also be held in November to provide DCC's customers and other key stakeholders an opportunity to explore the issues highlighted in this consultation with both Ofgem and DCC.

[3] https://www.smartdcc.co.uk/media/1439/redacted_licence_application_business_plan_-_30_april_2014_2_.pdf
[4] https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-guidance-processes-and-procedures-2019
[5] https://www.smartdcc.co.uk/about/price-control/

1.5. The content of each section of this document is summarised below, along with the questions to which we are seeking your response.

Section 1: Introduction

1.6. This section includes a short summary of the other sections in this document, a summary of DCC's activities during RY18/19, and an overview of DCC's costs during the year. It also sets out the stages in the consultation process, specifies how you should respond, and explains how we will treat your response.

Section 2: External Costs

1.7. This section summarises the costs incurred by DCC's Fundamental Service Providers (FSPs) and SMETS1 service providers, for RY18/19, and the updated forecasts for the remainder of the Licence term. It sets out DCC's justification for any changes in those costs and our response. It also sets out our expectations to DCC on contract management.

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

Section 3: Internal Costs

1.8. This section examines DCC's Internal Costs, namely the costs that are incurred by DCC for the purposes of the provision of the DCC service (these exclude External Costs and pass-through costs). Internal Costs incurred in RY18/19 and the DCC's updated forecasts for the remainder of the Licence term are examined, focussing on changes in those costs compared with last year's forecast and the LABP. The DCC's justification for any changes in those costs and our response, specifically considering payroll and external services, are set out. This section also investigates the DCC's approach to and the results of the benchmarking of permanent staff and contractor remuneration.

Question 2: What are your views on our proposals on DCC's approach to benchmarking of staff remuneration?

Question 3: What are your views on our proposal to disallow all costs associated with the external service to develop a KPI Dashboard?

Question 4: What are your view on our proposal to disallow variance in forecast internal costs?

Section 5: Performance Incentives

1.9. This section covers DCC's performance under the Operational Performance Regime (OPR), any relevant Baseline Margin Project Performance Adjustment Schemes, and the Switching incentive regime. It sets out DCC's submission of its performance under these regimes and our response (which includes our proposed adjustments to DCC's submission).

Question 5: What are your views on our proposed position on DCC's operational performance?

Question 6: What are your views regarding DCC's failure to ensure all CSPs met their contractual milestones and our proposed performance adjustments in response to this?

Question 7: What are your views on how the Operational Performance Regime could be modified to better incentivise DCC to provide a good service to its customers and deliver upon its objectives?

Question 8: What are your views on our proposed position on DCC's project performance?

Question 9: What are your views on our proposed position on DCC's switching performance?

Section 6: Baseline Margin adjustment and External Contract Gain Share

1.10. This section summarises DCC's application for adjustments to its Baseline Margin and ECGS, and sets out our response.

Question 10: What are your views on our assessment of DCC's application to adjust its Baseline Margin?

Question 11: What are your views on cost uncertainty in relation to Baseline Margin applications and the process for dealing with this issue?

Question 12: What are your views on our assessment of DCC's application to adjust its ECGS?

Related Publications

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

1.12. The DCC Regulatory Instructions and Guidance 2019 is at: https://www.ofgem.gov.uk/publications-and-updates/data-communications-company-dcc-regulatory-instructions-and-guidance-2019

1.13. 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-2019

1.14. Last year's Consultation Document is at: https://www.ofgem.gov.uk/system/files/docs/2018/10/2018.10_1718_pc_consultation_document_-_master.pdf

1.15. Last year's Decision Document is at: https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-decision-regulatory-year-201718

1.16. The Price Control element of the DCC's website is at: https://www.smartdcc.co.uk/about/price-control/

DCC's summary of RY18/19

1.17. In its submission, DCC provided an overview of its key activities during RY18/19 and the factors which drove the overall level of activity and spending across the organisation.

1.18. In RY18/19 DCC continued to deliver the core SMETS2 infrastructure and completed multiple code releases to support the introduction of dual-band communications hubs (DBCH). DCC highlighted the following achievements during RY18/19:

- The successful delivery of the R2.0 release, DCC's maturing processes and management of DCC's service providers.
- Its support for the accelerating rollout of SMETS2 meters. By the end of March 2019, installations were running at a rate of 16 per minute and the rate of installations is increasing steadily.
- DCC put in place the building blocks to enable migration of SMETS1 meters onto the DCC infrastructure.

1.19. DCC identified a number of key themes in its submission that summarise its work through the year:

- **Developing a track record of delivery:** DCC believes that the successful delivery of full SMETS2 infrastructure and the subsequent enhancements is an important turning point – both for the programme and for DCC. DCC will shift the emphasis now to supporting energy suppliers with the mass rollout of SMETS2 meters and the enrolment of SMETS1 meters into the DCC architecture. DCC stated that it has also delivered in other areas such as the successful completion of the enactment phase of the Switching programme.
- **Internal development, learning and business improvements:** In the RY17/18 submission, DCC described a portfolio of projects which were named 'Project to Business', for example this includes the Technical Operations Centre which saw completion in RY18/19 and DCC states that customers are experiencing tangible benefits. DCC recognises the importance of continuous improvement and therefore created a small specialist function to provide Internal Audit and Continuous Improvement services to the rest of organisation.

- **Operating at scale:** DCC's focus is shifting from being a programme delivery organisation to one whose main purpose is to operate and deliver these services effectively and cost-efficiently at scale. To meet customer needs and DCC's operations, staff have built stronger relationships with, and a better understanding of DCC's customers.

- **Switching:** The Switching Programme will improve consumers' experience of switching between energy suppliers through a new faster and more reliable switching process, underpinned by a Central Switching Service (CSS), procured by DCC. To date, DCC has delivered the first two phases of the Programme and progressed work on the Enactment phase in RY18/19. In RY18/19 DCC's Licence was modified to oversee the Design, Build, Test (DBT) phase and to operate the CSS in its early years.

Summary of DCC costs

DCC RY18/19 Costs

1.20. Overall, DCC's total reported costs for RY18/19 are £403m. Excluding pass-through costs[6], the figure is £376m.

1.21. This is a 24% increase in total costs incurred in RY18/19 compared to last year's forecasts (or a 27% increase with pass-through costs excluded). Table 1.1 shows how the main cost categories in RY18/19 compare to the forecasts of DCC's RY17/18 submission.

[6] Pass-through costs include the fee paid by the Licensee to the Authority and the payments to SECCo Ltd for purposes associated with the governance and administration of the Smart Energy Code (SEC).

Table 1.1 RY18/19 reported costs compared to RY17/18 forecast in current year prices

	RY17/18 forecast (£m)	RY18/19 (£m)	Variance (£m)	Variance (%)
Total External Costs	244	297	53	22%
Total Internal Costs (excl. SS)	49	67	18	38%
CRS[7] total costs (excl. SS)	0	5	5	N/A
Total Shared Services cost (for internal costs and CRS)	4	6	1	27%
Total Costs excl. Pass-Through Costs	297	376	79	27%
Pass-Through Costs	29	27	-2	-7%
Total Costs	**326**	**403**	**77[8]**	**24%**

1.22. The greatest percentage change in the variance comes from Internal Costs. Internal costs increased by 38% between the reported costs in RY18/19 and RY17/18 forecast.

DCC costs over the Licence period

1.23. Figure 1.1 reports the trends in DCC's costs over the Licence period as reported in its latest submission. DCC's forecast costs increase with total costs peaking at £527m in RY20/21 before decreasing slightly and stabilising towards the end of the Licence term.

[7] Centralised Registration Service (CRS) – refers to the Switching Programme
[8] Numbers may not sum to total due to rounding.

Figure 1.1 Trends in DCC's costs (£m, 18/19 prices) in current year prices

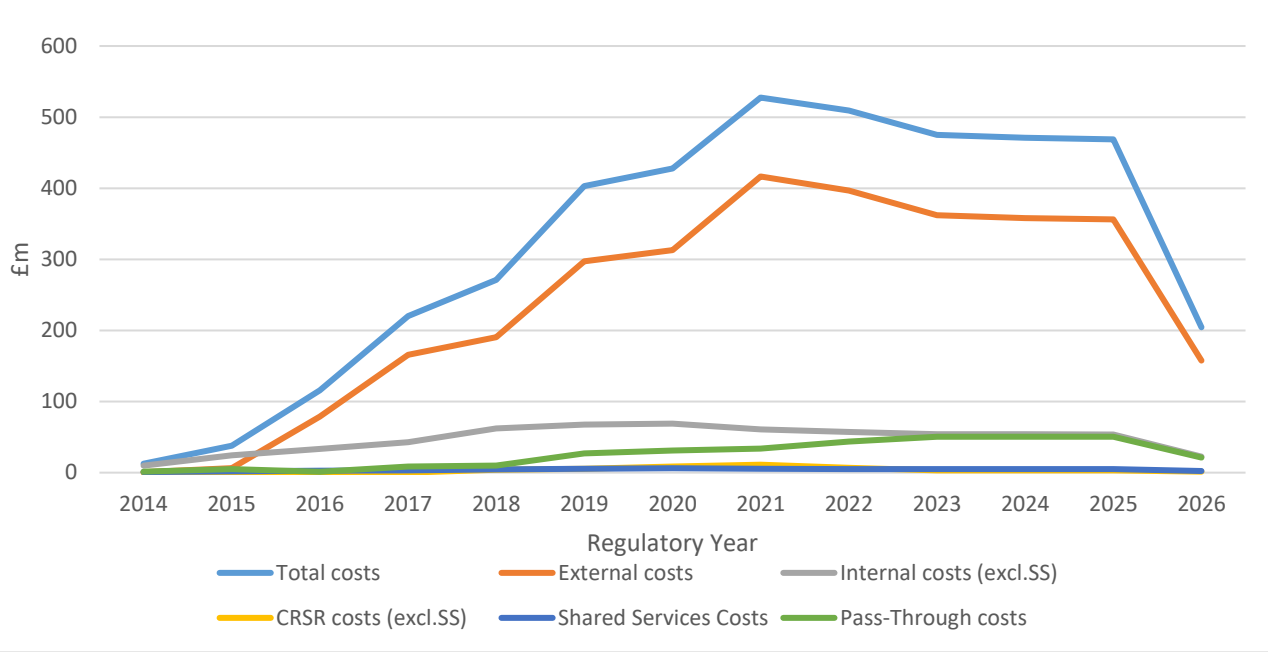


Figure 1.1 data table

£m	RY13/14	RY14/15	RY15/16	RY16/17	RY17/18	RY18/19	RY19/20	RY20/21	RY21/22	RY22/23	RY23/24	RY24/25	RY25/26
Total costs	**12.6**	**37.7**	**115.8**	**220.0**	**271.1**	**402.8**	**427.6**	**527.5**	**509.3**	**474.8**	**471.1**	**468.8**	**204.5**
External costs	0.6	6.3	78.7	165.7	190.4	297.1	312.9	416.5	396.6	361.9	358.0	356.3	157.5
Internal costs	9.9	24.4	33.3	42.7	61.9	67.6	68.9	60.7	57.4	54.1	54.2	53.6	22.4
CRSR costs (excl.SS)	0.0	0.0	0.0	0.0	4.1	5.5	8.5	11.2	6.6	3.4	3.4	3.4	1.4
Shared Services costs	0.8	1.8	2.6	3.3	4.6	5.5	6.2	5.4	5.2	5.0	5.0	5.0	2.1
Pass-Through costs	1.3	5.2	1.2	8.4	10.1	27.0	31.0	33.7	43.5	50.3	50.5	50.5	21.0

1.24. DCC's latest forecast for total costs over the Licence period (RY13/14-RY25/26), as contained in its submission, is £4.143b. Excluding pass-through costs, its forecast for costs over the Licence period is £3.810b.

1.25. This is a 29% increase in total costs compared to last year's forecasts (or a 33% increase with pass-through costs excluded) over the Licence period. Table 1.2 breaks this down by type of cost, and shows how costs reported in the RY18/19 submission have changed compared to last year's forecast over the Licence period.

Table 1.2 RY18/19 forecast and variation compared to RY17/18 forecast over the Licence period (RY13/14-RY25/26) in current year prices

	RY17/18 forecast (£m)	RY18/19 forecast (£m)	Variance (£m)	Variance (%)
External - Baseline	1,508	1,965	457	30%
External – New Scope	999	1,133	135	13%
Total External Costs	**2,507**	**3,099**	**591**	**24%**
Internal – Baseline (excl. SS)	271	502	231	85%
Internal – New Scope (excl. SS)	62	109	47	77%
Total Internal Costs	**333**	**611**	**279**	**84%**
CRS (excl. SS)	4	48	43	N/A
Total Shared Services cost (for internal costs and CRS)	27	53	25	92%
Total Costs excl. Pass-Through Costs	**2,871**	**3,810**	**939**	**33%**
Pass-Through Costs	338	334	-4	-1%
Total Costs	**3,209**	**4,143**	**934**	**29%**[9]

[9] Numbers may not sum to total due to rounding.

1.26. External Costs over the Licence term have increased by 24% compared to the RY17/18 forecast, to £3.099b. This increase in external costs is driven mainly by changes in baseline as well as new scope. Section 2 summarises the External Cost variations, DCC's justifications and our response.

1.27. Internal Costs have increased by 84% over the Licence term compared to last year's forecast, from £333m to £611m. Section 3 summarises the Internal Cost variations, DCC's justifications and our response.

1.28. The greatest proportional increase in costs has been seen in total Shared Services cost (for internal costs and CRS). These costs have increased by 92% compared to the RY17/18 forecast, to £53m.

Comparison to the Licence Application Business Plan (LABP)

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

1.30. Figure 1.2 shows how the main cost categories in RY18/19 compared to the forecast at LABP. In aggregate, costs are £2.117b, or 103%, higher over the Licence term compared to DCC's forecast as part of the bid.

Figure 1.2 Comparison of RY18/19 costs to LABP in current year prices

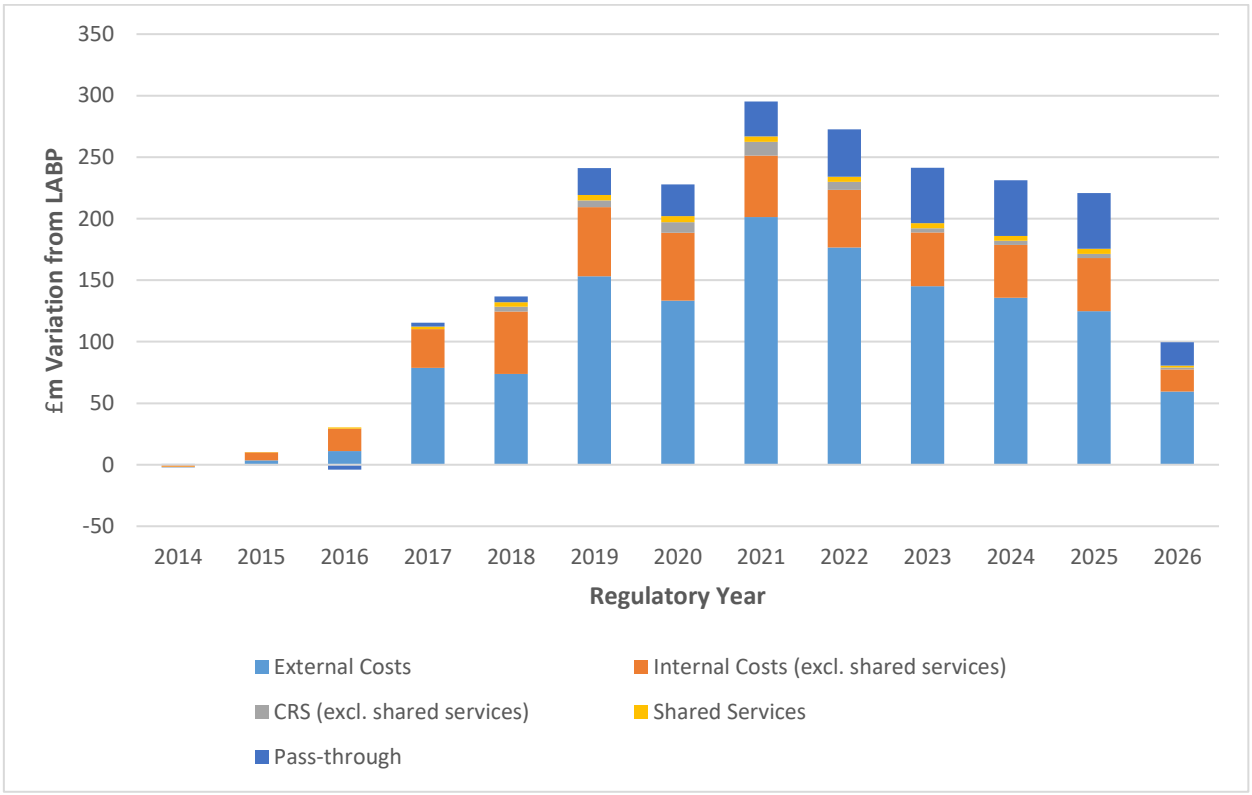


Figure 1.2 data table

£m	RY13/14	RY14/15	RY15/16	RY16/17	RY17/18	RY18/19	RY19/20	RY20/21	RY21/22	RY22/23	RY23/24	RY24/25	RY25/26
External costs	0.6	3.6	11.1	78.8	73.7	153.2	133.3	201.4	176.5	145.2	135.8	124.8	59.5
Internal costs	-1.6	6.6	18.1	31.3	50.7	56.1	55.3	49.7	46.9	43.7	42.8	43.4	18.1
CRS costs (excl.SS)	0.0	0.0	0.0	0.0	4.1	5.5	8.5	11.2	6.6	3.4	3.4	3.4	1.4
Shared Services costs	-0.2	0.1	1.2	2.2	3.5	4.4	4.9	4.4	4.2	4.0	4.0	4.0	1.7
Pass-Through costs	-0.3	-0.1	-4.1	3.1	4.8	21.8	25.8	28.4	38.3	45.1	45.3	45.3	18.9

Comparison to last year's forecast

1.31. Figure 1.3 shows how the main cost categories in RY18/19 compare to the forecast created as part of DCC's RY17/18 submission.

1.32. Overall, costs are £934m higher over the Licence term compared to the forecasts in DCC's RY17/18 submission.

Figure 1.3 Comparison to RY17/18 forecast in current year prices

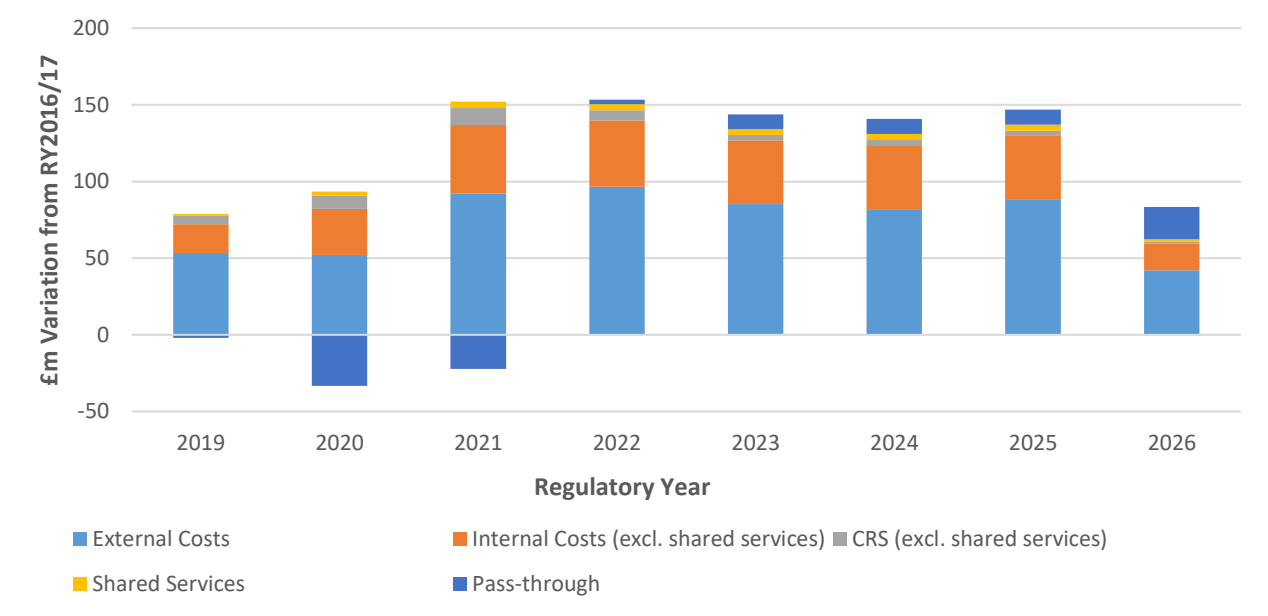


Figure 1.3 data table

£m	RY18/19	RY19/20	RY20/21	RY21/22	RY22/23	RY23/24	RY24/25	RY25/26
External costs	53.4	52.1	92.2	96.6	85.2	82.0	88.5	42.1
Internal costs	18.7	30.1	44.6	43.2	41.7	41.7	41.3	17.2
CRS costs (excl. SS)	5.5	8.5	11.2	6.6	3.4	3.4	3.4	1.4
Shared Services costs	1.2	2.7	4.1	4.0	3.9	3.9	3.8	1.6
Pass-Through costs	-2.0	-33.2	-22.3	2.9	9.7	9.9	9.9	21.0

Over-recovery of revenue

1.33. The Licence requires DCC to take all reasonable steps to ensure that its Regulated Revenue does not exceed a prudent estimate of Allowed Revenue for each Regulatory Year.[10] Detailed information on Allowed Revenue, Regulated Revenue, and DCC's Charging Statement can be found in the RY15/16 Consultation Paper.[11]

1.34. We introduced a penalty interest rate regime which is designed to incentivise DCC to improve the accuracy of its charges to customers and to deter it from over-recovering revenues.[12] The threshold for over-recovery of service charges is equal to 110% of allowed revenue, and a penalty interest rate of 3% above the Bank of England base rate on any proportion of over-recovery that DCC has not justified to the Authority's satisfaction is to be applied.

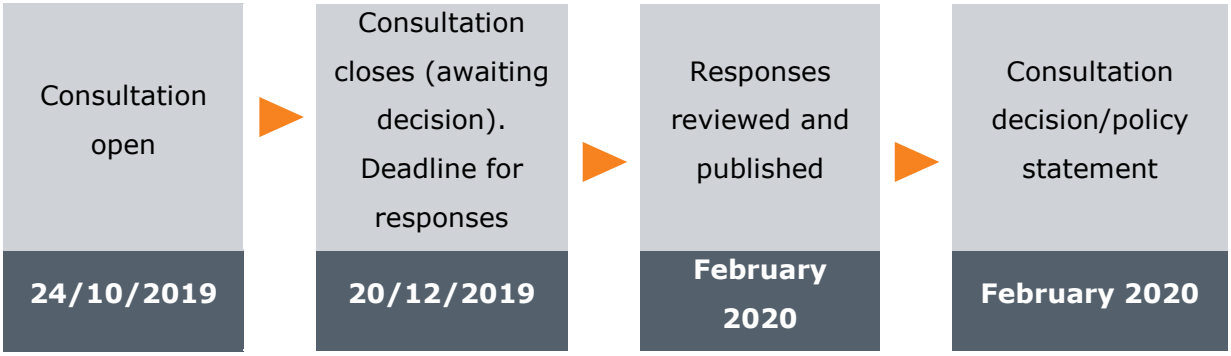
1.35. DCC over-recovered revenue from customers by 108% in RY18/19, which is below the 110% threshold. DCC has demonstrated continuous improvement – in RY16/17 over-recovery was 122% and in RY17/18 it was 116%.

[10] See LC36.4
[11] https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-decision-regulatory-year-201516
[12] https://www.ofgem.gov.uk/system/files/docs/2016/05/decision_to_modify_smart_meter_communication_licence_for_dcc_penalty_interest_rate_web_version.pdf

Consultation stages

1.36. The key dates of the consultation process are set out in Figure 1.4 below.

Figure 1.4: Consultation stages



How to respond

1.37. We want to hear from anyone interested in this consultation. Please send your response to the person or team named on this document's front page.

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

1.39. We will publish non-confidential responses on our website at www.ofgem.gov.uk/consultations.

Your response, data and confidentiality

1.40. You can ask us to keep your response, or parts of your response, confidential. We'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.

1.41. If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you *do* wish to be kept confidential and those that you *do not* wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we'll get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

1.42. If the information you give in your response contains personal data under the General Data Protection Regulation 2016/379 (GDPR) and domestic legislation on data protection, the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 4.

1.43. If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

General feedback

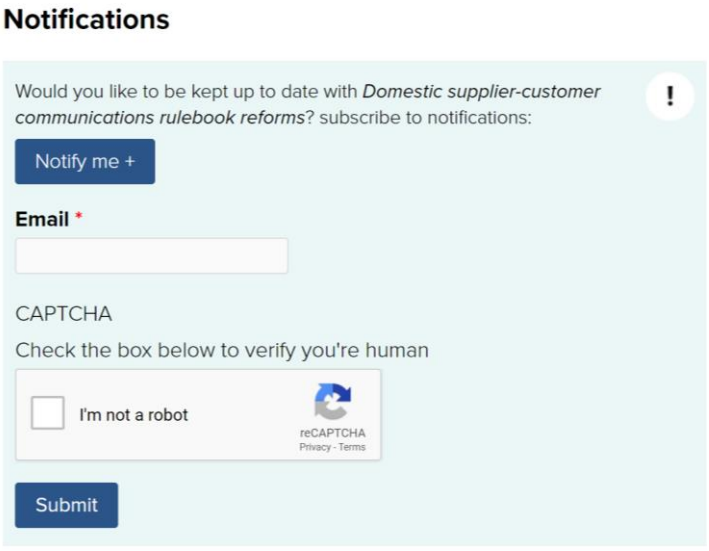
1.44. We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We'd also like to get your answers to these questions:

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?

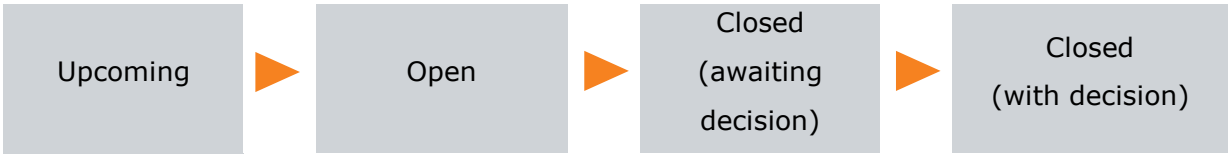
Please send any general feedback comments to stakeholders@ofgem.gov.uk

How to track the progress of the consultation

You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website. Ofgem.gov.uk/consultations.



Once subscribed to the notifications for a particular consultation, you will receive an email to notify you when it has changed status. Our consultation stages are:



2. External Costs

Section summary

One of DCC's key responsibilities is to manage the Fundamental Service Providers (FSPs) and ensure value for money and good quality service for customers. DCC is also responsible for the enrolment of SMETS1 meters into the DCC system which involves managing services from a range of existing SMETS1 service providers, along with new service providers. This would enable all DCC Users to communicate with all enrolled SMETS1 meters through the DCC infrastructure.

This section summarises the costs incurred by DCC's FSPs and SMETS1 service providers, for RY18/19, and the updated forecasts over the Licence term. We are minded to find External Costs economic and efficient.

DCC has provided evidence of a focus on driving good commercial outcomes through due diligence processes, and efforts to seek efficiencies through alternative delivery methods. However, we would expect DCC to provide fuller assurance around how they have assessed the trade-offs they choose to make in contract negotiations and how they plan to manage contractual risks to ensure performance and delivery throughout the terms of the contract.

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

What are External Costs?

2.1 External Costs comprise a part of DCC's allowed revenue, and are the costs incurred by DCC's Fundamental Service Providers (FSPs) and SMETS1 service providers.

2.2 The FSPs were appointed following a competitive tender process that was run by the government. They include the data service provider (DSP), CGI, and the two communication service providers (CSPs), Arqiva and Telefonica. Together, the FSPs are responsible for delivering the data and communications services to support smart metering.

2.3 The SMETS1 service incorporates a range of existing SMETS1 service providers (Smart Meter System Operators, SMSOs), along with new service providers, to enable a service where all DCC Users are able to communicate with all enrolled SMETS1 meters. This is the first year the costs for these SMETS1 service providers are reported in the RIGs.

2.4 As listed in Table 2.1, DCC negotiated SMETS1 service provider contracts (S1SP_1,2,3) with the SMSOs – CGI/IE, Secure and Trilliant. DCC also negotiated Dual Control Organization (DCO) software contracts with Capgemini and Critical Software. The role of the DCO is to detect whether the S1SP is compromised and prevent mass meter attack through the use of anomaly monitoring and cryptography. In addition, the Application, Network, and Security Operations (ANSO) service is provided by DXC for the Trilliant Head-End system.

Table 2.1 New contracts for the fundamental service capabilities for SMETS1 service that were completed in RY18/19.

Role + Capability	Supplier
IOC	S1SP_1: CGI IE
MOC	S1SP_2: Secure
FOC	S1SP_3a: Trilliant S1SP_3b: DXC (ANSO)
DCO (All Operating Capabilities)	DCO_a: Capgemini (ANSO) DCO_b: Critical Software

2.5 Costs for SMETS1 communications service provider contracts (S1CSPs -Vodafone and Telefonica) are not included in this year's submission and will be included in next year's submission.

How have External Costs changed?

2.6 Table 2.2 shows the variation in External Costs (adjusted to inflation) for RY18/19 and the full Licence term relative to RY17/18 and LABP forecasts.

Table 2.2 External Costs variation compared to RY17/18's forecast and the LABP (adjusted to inflation)

	Variation for RY18/19		Total variation over the full Licence term	
	£m	%	£m	%
From RY17/18 forecast	53.4	22	592.5	24
From LABP forecast	153.2	107	1,297.5	72

2.7 Compared to last year's forecast in the price control, total External Costs are 22% higher for RY18/19 and 24% higher over the full Licence term. Compare to LABP's forecast, total External costs are 107% higher for RY18/19 and 72% higher over the full Licence term.

2.8 Compared to last year's forecast, the cost variation of £53.4m in RY18/19 includes an increase in costs of the SMETS1 programme, DSP and CSP(N) amounting to £67.8m; and a decrease of £9.39m in costs of CSP (C&S).

2.9 Cost of the SMETS1 programme is the key driver of increase in External Costs compared to last year's forecast, as DCC didn't include SMETS1 service costs in last year's forecast. Figure 2.1 shows that for RY18/19, the SMETS1 programme, DSP and CSP (N) contribute 68%, 26% and 6% of the costs increase in total External Costs respectively. Change request CR279 (Testing Services) and SMETS1 related project requests (PRs) contributed to the increase in DSP costs.

Figure 2.1 Breakdown of the increase in External Costs by Service Providers for RY18/19, compared to last year's forecast.

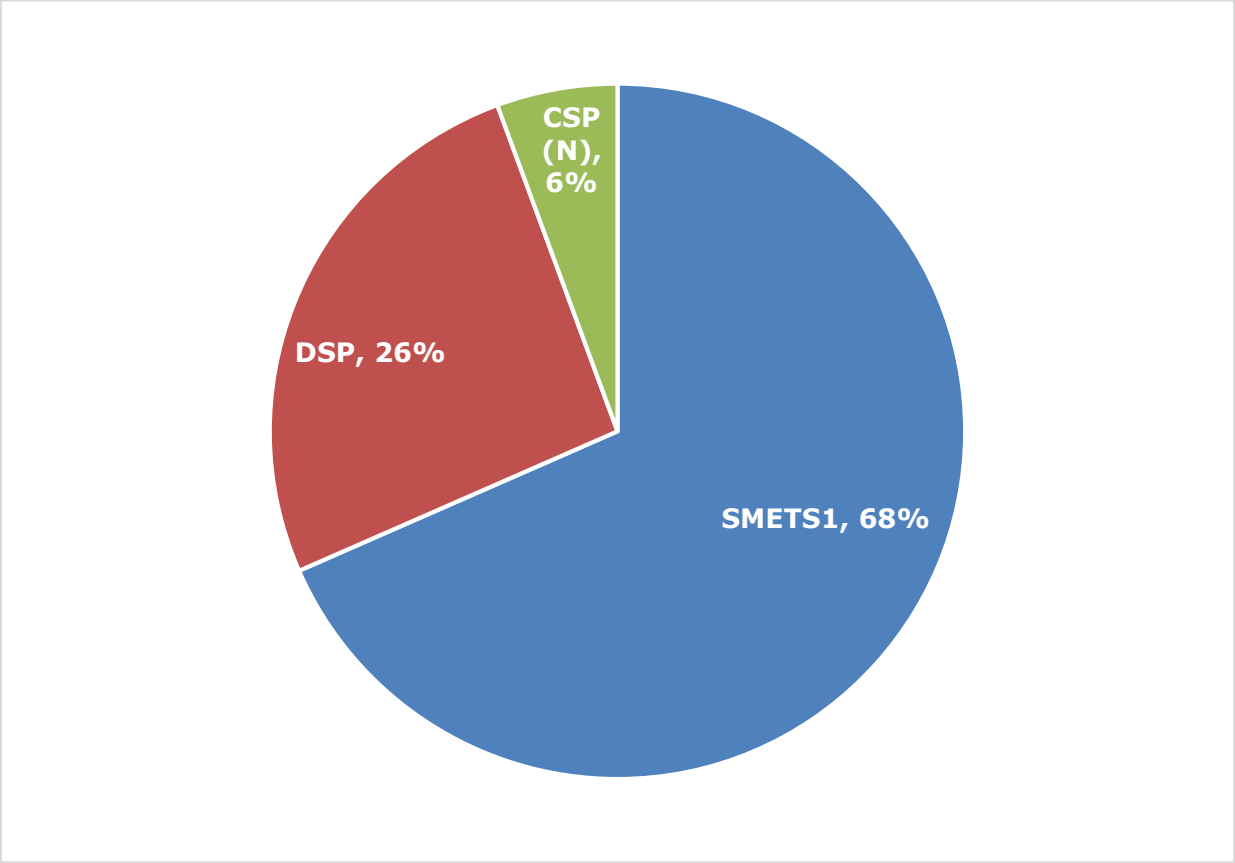


Figure 2.1 data table

RY18/19	SMETS1	DSP	CSP (N)
% of increased External Costs	68%	26%	6%

2.10 Costs of CSPs (C&S) are £9.39m less than last year's forecast. This was driven by the reduction in Communication Hub (CH) asset charges compared to the last year's forecast, as actual volumes that were ordered and delivered to suppliers were lower than forecasted in the prior year.

2.11 Figure 2.2 provides an overview of costs variations among service providers for RY18/19 and over the Licence term, compared to last year's forecast. External Costs for all service providers are forecasted to be higher than previous forecast over the Licence term.

Figure 2.2 Cost variation by FSPs and SMETS1 SPs compared to RY17/18 forecast (%)

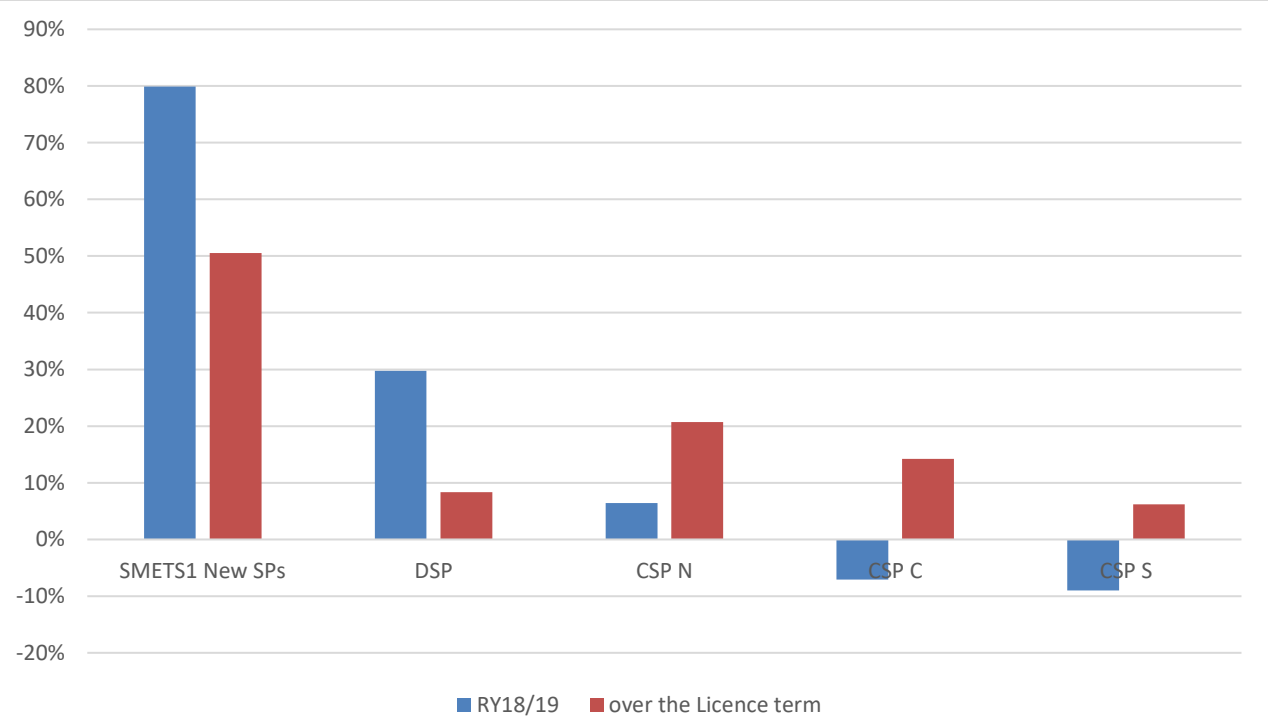


Figure 2.2 data table

Cost Variation	RY18/19	Over the Licence term
SMETS1 New SPs	80%	51%
DSP	30%	8%
CSP N	6%	21%
CSP C	-7%	14%
CSP S	-9%	6%

2.12 Figure 2.3 shows the annual cost variations in External Costs compared to RY17/18 forecast. The main cost drivers include: R2.0, SMETS1 programme and CH asset charges.

Figure 2.3 Annual cost variations of Total External Costs compared to RY17/18 forecast (£m, nominal price)

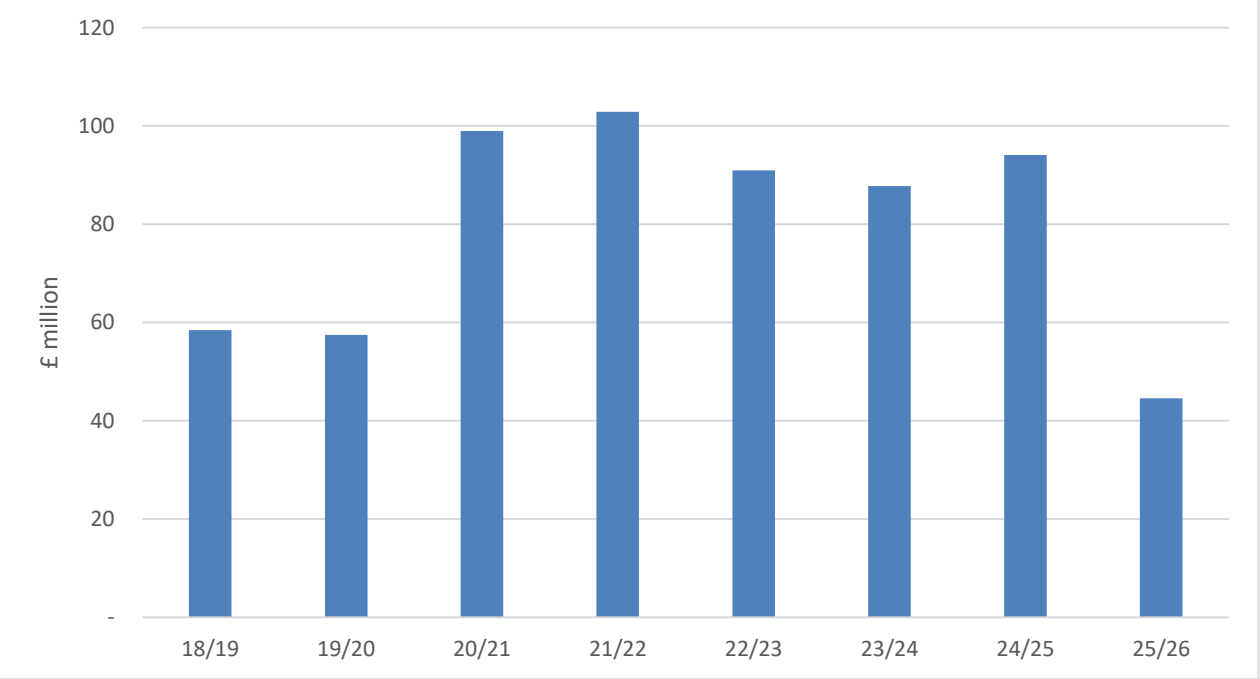


Figure 2.3 data table

£m	RY18/19	RY19/20	RY20/21	RY21/22	RY22/23	RY23/24	RY24/25	RY25/26
Variation	58.45	57.49	98.97	102.88	90.97	87.74	94.09	44.55

DCC's Justification

2.13 DCC has justified the material External Costs by programme/project related Change Requests (CRs) and Project Requests (PRs). Figure 2.4 shows the drivers of variation which are above the materiality threshold in External Costs over the Licence term, compared with last year's forecast. See Appendix 2 for further details of justified programmes with material cost variation.

Figure 2.4 Drivers of the material cost variations in External Costs across the Licence term, compared to the RY17/18 forecast

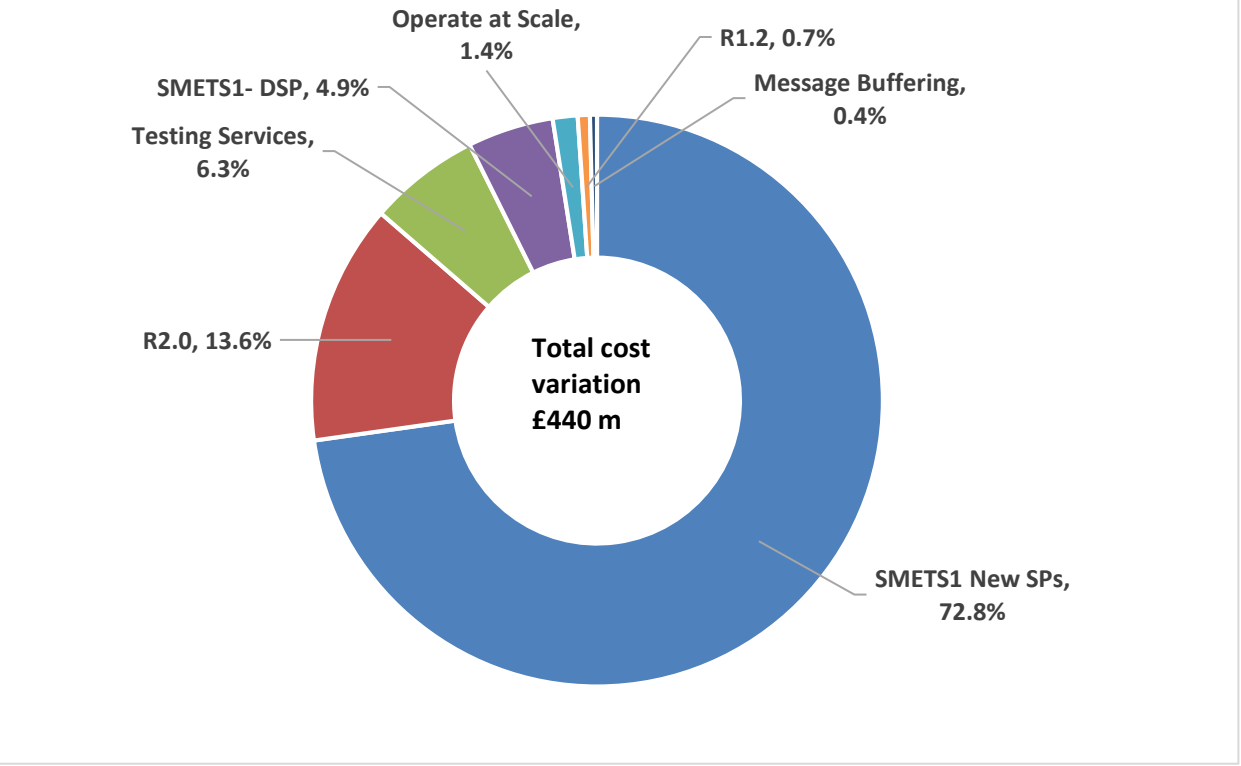


Figure 2.4 data table

Material cost	% variation over Licence term
SMETS1 New SPs	72.8%
R2.0	13.6%
Testing Services	6.3%
SMETS1- DSP	4.9%
Operate at Scale	1.4%
R1.2	0.7%
Message Buffering	0.4%

2.14 The SMETS1 programme, CRs related to R2.0 programme and CR279 which relates to the continued provisions of Testing Services to support User Entry Process Testing (UEPT) are the key drivers of cost variation in External Costs over the Licence period. They contribute more than 92% of total material cost variations.

2.15 DCC has set £1 million as materiality threshold for justifying variations in External Costs. Immaterial items from RY18/19 onwards account for 0.61% of total External Costs over the Licence term.

SMETS1 Programme

2.16 Both internal and external costs for SMETS1 programme increased significantly and materially, this is due to the increased SMETS1 delivery scope and challenging timeframes. Further information on the restructure process of the SMETS1 programme is in Appendix 2.

2.17 Six new contracts were signed by DCC and SMETS1 service providers in RY18/19, see Appendix 2 for further details. DCC has provided evidence on contract procurement and sourcing strategy for SMETS1 service suppliers. DCC also provided evidence on its due diligence for the contracts and agreements with service providers which drove down the costs and gained benefits for consumers.

2.18 Contracts for SMETS1 Communication Service Providers- Vodafone and Telefonica, were finalised after 1 April 2019, therefore will be included in next year's price control submission.

2.19 As stated above, cost for the SMETS1 programme is the main driver of the cost variations in External Costs. External Costs of the SMETS1 programme, including costs of PRs and CRs for the existing DSP, are £49.7 million for RY18/19 and £342.2 million over the Licence term (SMETS1 CSPs costs are not included).

Our view

2.20 It is our view that the variation in External Costs was explained and evidenced as economic and efficient in DCC's RY18/19 submission and through subsequent communications.

2.21 It is our view that DCC provided sufficient narrative and evidence on the SMETS1 programme and around the drivers of the various Change Requests and Project Requests raised during the Regulatory Year. DCC explained its efforts to explore all options available to ensure that costs remain economic and efficient to customers, and to ensure that commercial negotiations are centred on delivering value for money.

2.22 Core to DCC's role is its negotiation and management of service provider contracts. During RY18/19, DCC established six substantial new contracts with SMETS1 service providers, and further contract negotiations are planned. In future price control submissions, we expect DCC to provide fuller assurance around how they have assessed the trade-offs they choose to make in contract negotiations and how they plan to manage contractual risks to ensure performance and delivery throughout the terms of the contract.

3. Internal Costs

Section summary

This section summarises DCC's incurred Internal Costs for RY18/19 and updated forecasts. DCC has justified the majority of these costs. However, we propose to disallow £1.088m of costs incurred in RY18/19. This is due to insufficient justifications provided around DCC's internal processes and governance structures for recruiting contractors and procurement of an external service that we believe was not economic and efficient. We are also minded to disallow £235.9m of forecast costs from RY21/22 to the end of the Licence term due to a lack of justification provided by DCC.

Question 2: What are your views on our proposals on DCC's approach to benchmarking of staff remuneration?

Question 3: What are your views on our proposal to disallow all costs associated with the external service to develop a KPI Dashboard?

Question 4: What are your views on our proposal to disallow all variance in forecast internal costs?

What are Internal Costs?

3.1. Internal Costs comprise the costs that are economically and efficiently incurred by DCC for the purposes of the provision of the DCC service (excluding External Costs and pass-through costs). These are defined by nine general ledger (GL) categories: payroll costs, non-payroll costs, recruitment, accommodation, external services, internal services, service management, transition, and IT services. Internal Costs are reported by 'cost centres' which cover the main activities where DCC incurs costs. Please see Appendix 3 for more detail.

How have Internal Costs changed?

3.2. Figure 3.1 shows the distribution of costs by general ledger (GL) code over the Licence period, based on DCC's RY18/19 submission. Based on DCC's price control forecast, which includes only those costs that are significantly more likely to occur than not, Internal Costs peak in RY19/20, and fall in subsequent Regulatory Years. Internal Costs in RY18/19 are £67.6m, slightly less than the forecasted for RY19/20. The GL codes are dominated by payroll costs – this reflects the fact that DCC is a relatively asset light company with a primary focus on contract management and programme delivery.

Figure 3.1 Forecast internal costs by cost type or GL code in current year prices

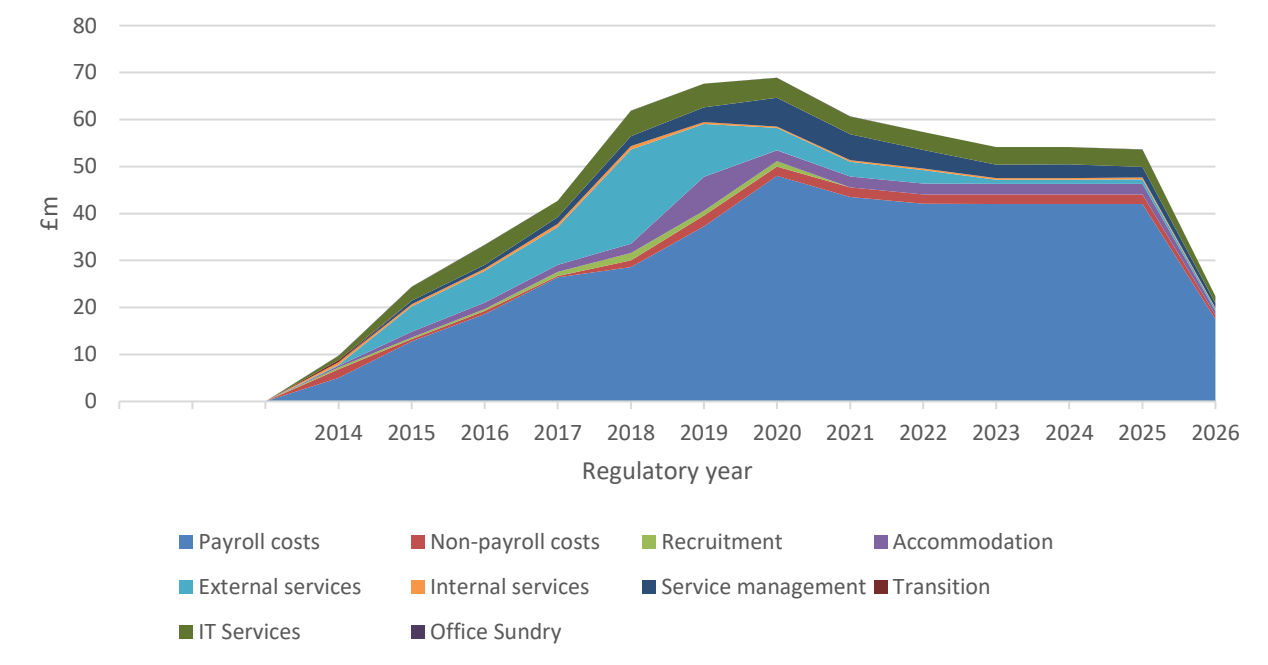


Figure 3.1 data table

£m	RY13/14	RY14/15	RY15/16	RY16/17	RY17/18	RY18/19	RY19/20	RY20/21	RY21/22	RY22/23	RY23/24	RY24/25	RY25/26
Payroll costs	5.0	12.8	18.6	26.4	28.6	37.3	48.0	43.5	42.1	42.0	42.0	42.0	17.5
Non-payroll costs	1.9	0.5	0.6	0.3	1.5	2.3	2.0	2.1	2.0	2.0	2.0	2.0	0.9
Recruitment	0.4	0.3	0.4	0.9	1.5	1.0	1.2	0.0	-	-	-	-	-
Accommodation	0.3	1.3	1.3	1.5	2.0	7.2	2.3	2.3	2.3	2.3	2.3	2.3	0.9
External services	0.2	5.3	6.7	8.0	20.0	11.3	4.8	3.2	2.9	0.9	0.9	0.9	0.5
Internal services	0.5	0.5	0.5	0.6	0.7	0.4	0.3	0.3	0.3	0.3	0.3	0.4	0.2
Service management	-	0.7	0.8	1.4	2.1	3.1	6.1	5.5	4.0	2.9	2.9	2.3	1.0
Transition	0.5	0.0	-	-	-	-	-	-	-	-	-	-	-
IT services	0.9	2.9	4.2	3.5	5.4	5.0	4.2	3.8	3.8	3.7	3.7	3.7	1.5
Office sundry	0.0	0.1	0.1	-	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

3.3. Figure 3.2 shows forecast Internal Costs by cost centre. Corporate management, Design & Assurance, and Operations are the three largest cost centres in RY18/19. The costs associated with the SMETS1 and R2.0 programmes, neither of which were costed at LABP, and costs associated with new a test lab, technical and operational control facility at Brabazon House (near Manchester) are significant drivers of Internal Costs in RY18/19.

Figure 3.2 Forecast Internal Costs by cost centre in current year prices

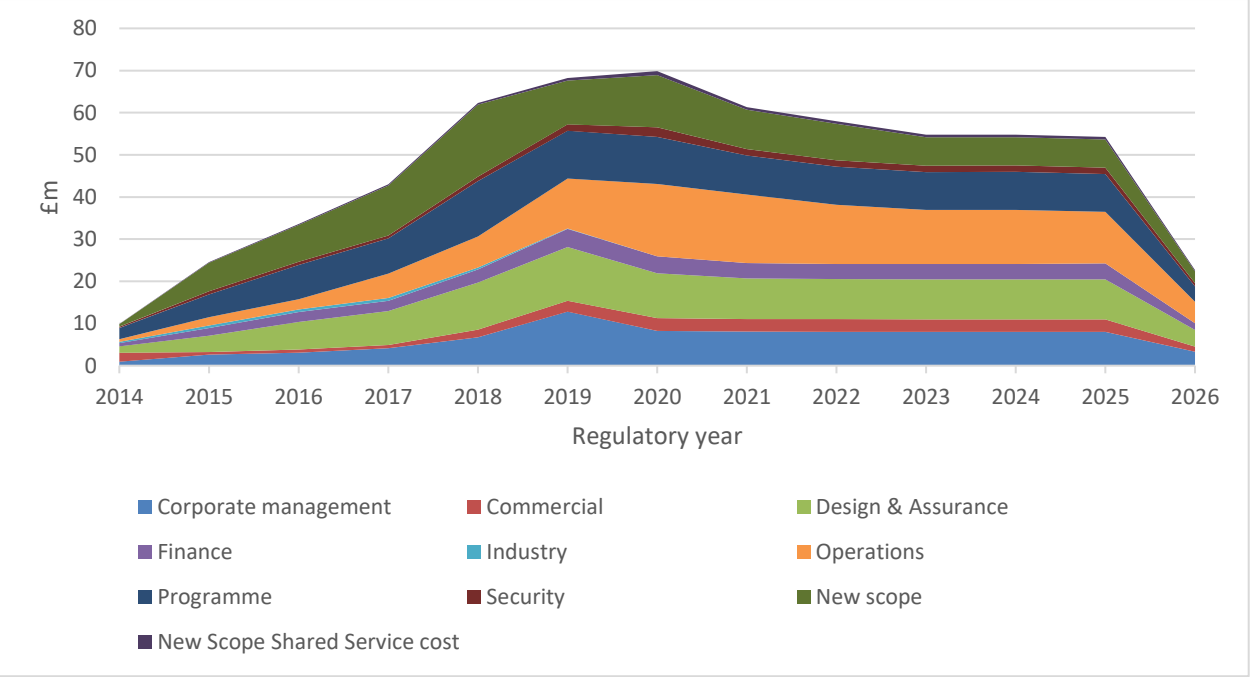


Figure 3.2 data table

£m	RY13/14	RY14/15	RY15/16	RY16/17	RY17/18	RY18/19	RY19/20	RY20/21	RY21/22	RY22/23	RY23/24	RY24/25	RY25/26
Corporate management	0.9	2.6	3.1	4.2	6.7	12.8	8.2	8.1	8.1	8.0	8.0	8.0	3.3
Commercial	2.1	0.6	0.7	0.8	1.8	2.6	3.0	3.0	3.0	3.0	3.0	3.0	1.2
Design and Assurance	1.5	3.9	6.5	8.0	11.2	12.7	10.7	9.6	9.5	9.5	9.5	9.5	4.0
Finance	0.7	1.8	2.4	2.5	3.2	4.3	4.0	3.6	3.6	3.6	3.6	3.7	1.6
Industry	0.3	0.5	0.6	0.7	0.4	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Operations	0.6	2.0	2.5	5.7	7.3	11.8	17.2	16.2	14.0	12.8	12.9	12.3	5.1
Programme	2.7	5.4	8.1	8.3	13.2	11.3	11.2	9.2	9.1	9.0	9.0	8.9	3.6
Security	0.3	0.8	0.7	0.7	1.1	1.5	2.2	1.5	1.5	1.5	1.5	1.5	0.7
New scope	0.6	6.8	8.7	11.9	17.1	10.4	12.4	9.3	8.7	6.7	6.7	6.7	2.9
New scope shared service cost	0.0	0.2	0.3	0.3	0.3	0.6	0.9	0.7	0.6	0.6	0.6	0.6	0.3

Variance on last year's forecast

3.4. In RY18/19 Internal Costs, excluding Shared Services, were £67.6m. This is £18.7m (38%) higher than forecast in RY17/18 and £56.1m higher than the LABP forecast. Over the remainder of the Licence period, Internal Costs are forecast to increase by a further £259.8m relative to the RY17/18 forecast, and by £299.9m compared to the LABP.

3.5. Figure 3.3 shows the variance in costs by GL code compared to the RY17/18 forecast. Payroll costs account for the greatest proportion of the variation in Internal Costs over all forecast years. However, in RY18/19, external services accounted for the largest proportion of the variation (36%) followed by accommodation (30%) and I.T. services (18%).

Figure 3.3 Internal Cost variance by cost type or GL code relative to RY 17/18 forecast (excluding Shared Services) in current year prices

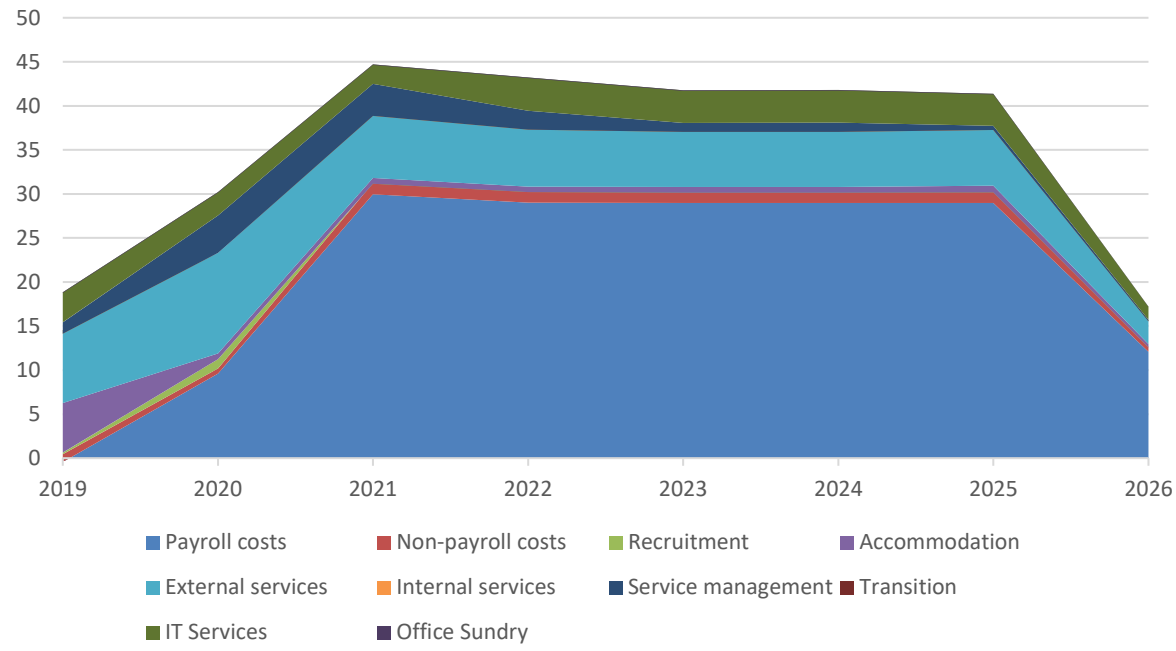


Figure 3.3 data table

£m	RY18/19	RY19/20	RY20/21	RY21/22	RY22/23	RY23/24	RY24/25	RY25/26
Payroll costs	0.9	18.9	36.5	35.1	35.1	35.1	35.1	14.6
Non-payroll costs	1.1	0.9	1.6	1.6	1.6	1.6	1.6	0.7
Recruitment	0.1	1.2	-0.1	-0.1	-0.1	-0.1	-0.1	0.0
Accommodation	5.6	0.6	0.6	0.6	0.6	0.6	0.8	0.4
External services	6.7	2.1	0.6	0.4	0.2	0.2	0.2	0.0
Internal services	-0.3	-0.4	-0.4	-0.4	-0.4	-0.4	-0.3	-0.1
Service management	1.3	4.3	3.6	2.2	1.0	1.1	0.5	0.2
Transition	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
IT services	3.4	2.7	2.2	3.8	3.7	3.7	3.7	1.5
Office sundry	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	0.0

Payroll

3.6. DCC has applied for the payroll costs shown in Table 3.1. Payroll costs incurred in RY18/19 are more than forecasted in RY17/18 and continues to increase in future years.

Table 3.1 Payroll costs compared to last year's forecast

Payroll (£m)	RY18/19	RY19/20	RY20/21	RY21/22	RY22/23	RY23/24	RY24/25	RY25/26
17/18 accepted forecast	36.394	29.160	7.050	6.932	6.922	6.922	6.922	2.878
Variation proposed in 18/19	0.876	18.875	36.472	35.149	35.109	35.109	35.109	14.635
Total	37.270	48.035	43.522	42.081	42.030	42.030	42.030	17.512

Headcount

3.7. Figure 3.4 shows that DCC's headcount has increased from 316 full time equivalents (FTEs) in RY17/18 to 421 FTEs in RY18/19 – an 8.5% increase over last year's forecasts. Headcount is then expected to increase to 551 FTEs in RY19/20. In DCC's RY17/18 price control submission DCC forecasted headcount to decrease to 332 FTEs in RY19/20. Therefore, DCC has increased its estimates for RY19/20 by 66% this year. DCC did not provide forecasts for its headcount beyond RY19/20.

Figure 3.4 DCC headcount (FTEs, excluding service desk staff)

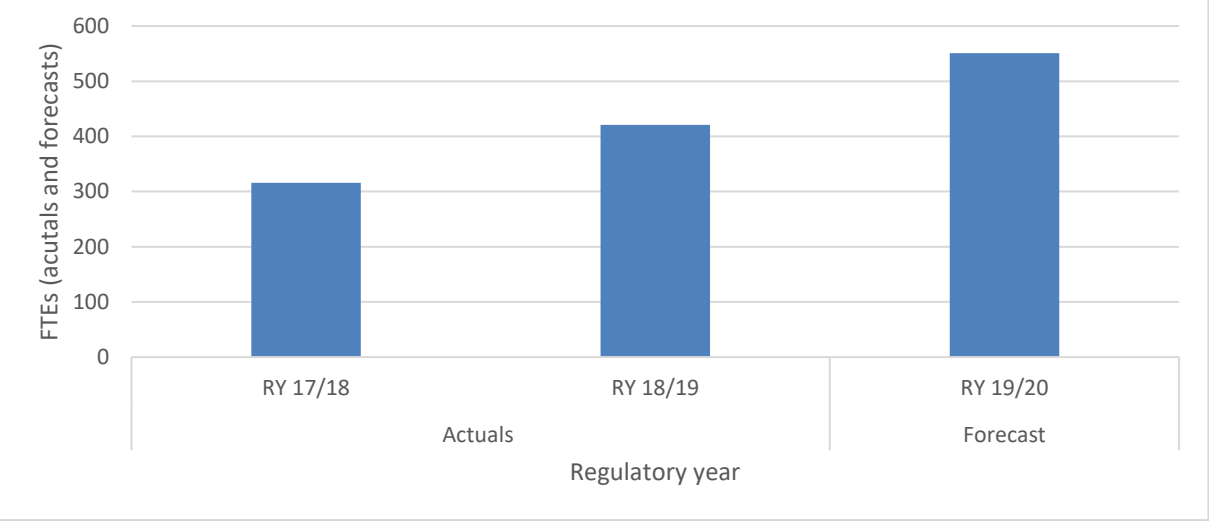


Figure 3.4 data table

	Actual RY17/18	Actual RY18/19	Forecast RY19/20
FTEs	316	421	551

Permanent-contractor staff ratio

3.8. In RY16/17 the ratio was around 40% contractor to 60% permanent staff. In RY17/18 there was a significant reduction in DCC's dependence on contractors and the ratio was 22% contractor to 78% permanent staff. The current ratio in RY 18/19 is 20% contractor to 80% permanent staff.

Benchmarking

Context

3.9. We expect DCC to recruit staff at economic and efficient remuneration levels. Similar to four previous price controls, for permanent staff DCC provided evidence of this through a benchmarking exercise that compared base salaries to equivalent roles in the wider employment market, using the Hay Group's "PayNet" salary (excluding bonus) database.

3.10. When recruiting permanent candidates DCC's default strategy is to offer remuneration packages that are in-line with market averages. For benchmarking purposes, using the Hays database, the "market average" would be defined as the 50th percentile of a distribution of salaries for comparable roles.

3.11. DCC use a different approach for contractors. In last year's submission, DCC stated the difficulty in finding commercially-available benchmarking databases for contractors and thus benchmarked contractors calculating a "contractor premium" compared to permanent staff remuneration. However, this year DCC commissioned an independent I.T. recruitment consultancy to benchmark all contractors within the I.T. and technical sectors. For the remaining roles, the recruitment agency engaged with partner organisations to benchmark these roles.

DCC's justification

Permanent staff

3.12. DCC's aim is generally to offer remuneration rates which equate to the market average for permanent members of staff or 10% below the 50th percentile, however DCC conceded that it may have to offer higher than the 50th percentile of the benchmark to attract exceptional candidates. This can be due to the role requiring niche or technical skills, or merely the lack of supply in the market. Thus, recruiting managers have the discretion to offer up to 10% above the benchmark with approval required by the Chief Regulatory Officer and Chief People Officer. However, if the salary is in excess of this, a business case is required for approval at the monthly financial performance review.

3.13. DCC stated that it benchmarks at three distinct stages during the recruitment process:

- Before the role is launched;
- Before DCC chooses to interview a candidate; and
- Prior to agreeing a remuneration package with a candidate.

3.14. As part of its submission, DCC presents a comparison of the remuneration of permanent members of staff with the Hays 50th percentile at the cost centre level.

3.15. This year five cost centres report a remuneration above the 50th percentile, with four of these cost centres reporting deviation greater than 5% from the 50th percentile. In aggregate, DCC exceed the 50th percentile by 3% across all cost centres. DCC states that this was due to the nature of these "highly specialised" roles and the skills and experience to undertake these roles are scarce in the market.

Contractors

3.16. Similar to permanent staff, DCC stated that it benchmarks at various stages during the recruitment process:

- Before the role is launched;
- Before DCC chooses to interview a candidate; and
- Prior to agreeing a remuneration package with a candidate.

3.17. Approximately 80% of contractors and their associated expenditure fall within the Design, Assurance, Programme, Operations and Security cost centres. This mirrors the situation in RY17/18.

3.18. As part of its submission, DCC justified its benchmarking process by commissioning an independent IT recruitment consultancy to determine minimum and maximum market rates over the year for job descriptions and role profiles for which DCC hired contractors. 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.

3.19. Of the 206 individual contractor recruitments benchmarked, 34 fell under the market range, 122 fell within the market range and 50 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 provided some justification to explain why some contractors were recruited above the market range – mostly related to the increasing work around the SMETS1 and R2.0 programmes and requirement for specialised skills.

3.20. DCC provided individual justifications for some senior roles such as board directors, consultants, those involved in large scale transformation and those roles where no benchmarking outcomes were available.

3.21. In response to our Cost Visit questions DCC clarified that for contractors DCC takes the maximum market rate (where market ranges are available) as the benchmark, as in the past DCC has found that this enables DCC to hire the right expertise to work on complex programmes at short notice. DCC has assured that in the future, it will test this approach by applying a benchmark at the mid-point of the market range received from external assurance providers and align the process with benchmarking of permanent staff.

Our view

Permanent-contractor staff ratio

3.22. We welcome DCC's continuous improvement in the permanent-contractor staff ratio. We recognise that there are always likely to be some roles that are most efficiently filled by contractors rather than permanent staff.

Permanent staff

3.23. Similar to last year, we note that DCC excludes bonus payments from remuneration for permanent staff. In future years we would expect more justification around bonus payments, given that DCC has also launched a new Retention Bonus Scheme.

3.24. DCC has provided justifications by cost centre level and for those cost centres which exceed the 50th percentile. DCC has also provided some justification around individual roles by cost centre level. This is an improvement from last year and is acknowledged.

3.25. DCC is expected to justify payments above the 50th percentile in its submission. DCC's justification for instances where remuneration was above the 50th percentile was lack of specialist skills given the unique nature of DCC work and to meet programme deadlines such as SMETS1.

3.26. Overall, we consider that the permanent staff costs have been shown to be economic and efficient.

Contractors

3.27. This year, DCC has commissioned an external IT recruitment consultancy for benchmarking purposes and this is acknowledged.

3.28. DCC's methodology uses the maximum market rate as the benchmark for contractor daily rates. We do not believe this is a fair or robust approach to benchmarking contractor daily rates and securing economic and efficient outcomes.

3.29. We consider that DCC has not provided sufficient evidence to demonstrate 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 costs where they fall above reasonable market rates.

3.30. **In light of the above, we are therefore, minded to disallow £0.539m of contractor costs in RY18/19.**

3.31. As in previous years, we remain open to receiving additional evidence from DCC to justify its remuneration of contractors and would use such evidence to revisit the proposed disallowance.

3.32. As stated in our last year's consultation, we expect DCC to apply a consistently robust approach to recruiting contractors, making an appropriate use of benchmarking to determine rates of remuneration for each appointment. We expect DCC to provide evidence of the internal processes it follows and the decision making process especially when remuneration exceeds the maximum daily market rate. We acknowledge that contractors are sometimes recruited at short notice to deliver projects with tight timelines and we believe this all the more necessitates the existence of a robust internal recruitment process with the right checks and balances to ensure recruitment is economic and efficient.

External Services

Context

3.33. DCC uses external services to provide support such as short term technical expertise and assistance in fulfilling regulatory requirements. DCC has applied for the external services costs shown in Table 3.2. These show, in particular for RY18/19, a significant increase on last year's forecast.

Table 3.2 External service costs compared to last year's forecast

Ex. Ser. (£m)	RY18/19	RY19/20	RY20/21	RY21/22	RY22/23	RY23/24	RY24/25	RY25/26
RY17/18 baseline	1.342	0.727	0.729	0.641	0.640	0.640	0.641	0.390
RY17/18 new scope	3.241	1.968	1.887	1.841	0.095	0.095	0.095	0.092
RY17/18 total	**4.583**	**2.695**	**2.616**	**2.482**	**0.735**	**0.735**	**0.736**	**0.482**
Baseline variation	5.615	1.518	0.138	0.181	0.181	0.181	0.166	0.006
New scope variation	1.063	0.546	0.440	0.204	-0.005	-0.005	-0.005	-0.002
Total variation	**6.678**	**2.065**	**0.578**	**0.385**	**0.175**	**0.176**	**0.161**	**0.004**
RY18/19 baseline	6.958	2.245	0.867	0.822	0.821	0.821	0.807	0.397
RY18/19 new scope	4.304	2.515	2.328	2.045	0.090	0.090	0.090	0.090
RY18/19 total	**11.261**	**4.760**	**3.194**	**2.867**	**0.911**	**0.911**	**0.897**	**0.487**

3.34. Over time DCC's use of external services in its Baseline activities has increased. While the increase was initially fairly steady with it reaching £1.2m in RY16/17 and representing 4% of Baseline costs, in RY17/18 it increased to £6.5m and 15% of Baseline costs. This year it increased to £7.0m, 12% of Baseline costs. In RY18/19, Design and Assurance accounted for the highest expenditure on external services and it was largely driven by Device Integration Testing (DIT) and Emulators.

DCC's justification

3.35. DCC provided us with satisfactory evidence of the procurement process that it undertook when procuring these external services. In most cases, DCC provided us with an explanation of the need for the external services it procured, provided us with the range of options that it considered could meet that need, and set out why it chose the procurement of the external service over the alternative options.

3.36. DCC has justified the majority of its external services for RY18/19. The exception to this is the expenditure on a KPI Dashboard where DCC has not provided sufficient justification for why this short term investment was required when a tactical solution was in place and the dashboard was being implemented by DCC's internal team as part of the Technical Operations Centre (TOC).

Our view

3.37. Given DCC's increasing reliance on external services, we expect DCC to exercise rigour around the decision to use external services. Where such services are likely to be required on a regular basis, we expect DCC to consider recruiting the necessary skills to be able to take on these activities in house. Where DCC consider it not possible to do these tasks in house, there needs to be clear justification as to why external services were necessary. DCC should also plan for efficiencies to be achieved through long term solutions before investing in short term external services.

3.38. DCC's justification of most of its incurred external service costs for RY18/19 are acceptable. However, DCC's decision to procure an external service to develop a Key Performance Indicator (KPI) dashboard has placed additional costs on consumers for which we have not seen sufficient evidence of additional value, and so we do not consider that the costs associated are economic and efficient. This is especially in light of:

- A tactical solution already being in place.
- In the same year DCC's business information management tool (BIMI) implemented a change request (CR1014) to establish the Technical Operations Centre's (TOC) 'Monitoring and Alerting – Strategic' project at a cost of £0.248m. This was approved in DCC's RY17/18 Business plan for the approval of creating TOC.
- The full TOC Monitoring and Alerting Solution went live in March 2019 and the KPI Dashboard is now produced through the TIX and EDAM software tools that were produced as part of the TOC Programme.

3.39. In response to our clarification questions DCC provided additional evidence. However, we have not been able to reconcile the additional evidence with the original price control submission and Cost Visit discussions. Moreover, the additional evidence does not establish clear links between the external service procured, the costs associated with CR1014 and the KPI Dashboard being produced through the TIX and EDAM tools of the TOC Programme.

3.40. Where existing internal teams are delivering or have capability to deliver activities DCC should consider carefully if procuring an external service is efficient. Before procuring an external service we expect DCC to review existing business plans and explore if efficiencies can be achieved through integrating the project with existing or planned services.

3.41. We have not seen sufficient evidence to justify the development of the KPI dashboard through external services when in the same year CR1014 costs were incurred and TOC implemented a KPI dashboard through the TIX and EDAM tools. **We are therefore minded to disallow all costs associated with the external service to develop a KPI Dashboard, which amount to £0.455m.**

Baseline forecast costs

DCC's justification

3.42. DCC baseline forecast costs for RY21/22 onwards increased by an average of £32m each year. DCC however did not provide any justification for this increase in forecast costs.

3.43. In response to our clarification questions, DCC said that it attempted to justify forecast costs for only RY19/20 and RY20/21 as the criteria for inclusion (of whether activity and costs were significantly more likely to occur than not) had not been met from RY21/22 onwards.

Our view

3.44. **We are minded to disallow all variation in forecasts from RY21/22 onwards given the lack of evidence and certainty provided in justifying these costs. This amounts to £171.810m.**

3.45. We expect DCC to be committed to finding efficiencies and delivering value for money. We are concerned that, in its submission, DCC made no mention of finding future efficiencies. We expect that DCC should be able to identify and plan for efficiencies and be able to reduce its headcount. In particular, as current projects (such as SMETS1, DBCH and Switching implementation) draw to a close we would expect to see increased efficiencies.

3.46. We recognise DCC's efforts to communicate its approach to identifying savings to its customers through the quarterly finance updates. However, in its price control submission, DCC provided little evidence on how efficiency savings are planned and realised for the different cost centres. In future price control submissions, we expect DCC to publish and commit to efficiency targets in order to demonstrate to customers that cost efficiency is central to its business planning strategy.

SMETS1 programme

Context

3.47. Internal costs of the SMETS1 programme has increased significantly (47% for RY18/19 and 215% over the Licence term) from last year's forecast. The main cost driver of this change is the higher Payroll costs. The material variation in Payroll costs are driven by the restructure of the programme which required a significantly increased resources profile. Table 3.3 summaries the cost variations in SMETS1 internal costs compared to last year's forecast by GL code.

Table 3.3 Cost variations in SMETS1 internal costs compared to RY17/18 forecast (inflation adjusted)

	Variation for RY18/19		Total variation over the full Licence term	
	£m	%	£m	%
External services	1.02	113	1.07	9
Payroll	1.31	32	44.19	444
Recruitment	-0.07	-61	0.07	25
Non payroll	0.23	220	2.20	1,015
Total	**2.49**	**47**	**47.53**	**215**

DCC's justification

3.48. DCC has provided justification of incurred and forecasted payroll variances (up to RY20/21) and provided evidence on the uplift in the resourcing profile which followed the restructure of the SMETS1 programme.

3.49. DCC described the two main factors driving resources and an extended timeline:

- the need to address additional programme complexity and scope; and
- strengthening programme management structure and governance.

3.50. Another cost driver for cost variations in RY18/19 is the higher cost of external services. DCC has procured a Delivery Partner through a competitive procurement process. DCC believes that failure to adequately resource the SMETS1 programme would result in a significant risk to delivery. A Delivery Partner would provide appropriately skilled resources within committed timescales and at preferential rates.

Our view

3.51. DCC's justification of its incurred SMETS1 internal costs for RY18/19 are acceptable. DCC has provided the assurance that the SMETS1 programme is appropriately resourced to ensure its timely delivery.

3.52. DCC has justified the forecast of SMETS1 internal costs for RY19/20 and RY20/21. The forecasted resource for the SMETS1 programme will peak as the activities ramp-up in preparation of the actual migration and operational readiness, before gradually tailing off as the programme reaches completion at the end of RY20/21. However, DCC's forecasts of the Payroll and Non-payroll costs for SMETS1 programme up to RY25/26 do not reflect completion of the programme. DCC did not justify SMETS1 programme costs beyond RY20/21. Therefore, **we propose to disallow the forecasts of SMETS1 internal costs of £28.436m** for the period of RY21/22 to RY25/26.

Shared Service Charge

Context

3.53. DCC pays a Shared Service Charge to its parent company, Capita, to cover support services such as HR tools, property services, payroll, IT and senior management input. Inclusion of the Shared Service Charge was part of the competitive bid during the Licence tender. It is calculated as a percentage of Internal Costs, as set out in the LABP.

3.54. DCC is required by the RIGs to report information on the Shared Service Charge, including how it has been calculated and how the Shared Service Charge provides value for money. DCC must also ensure there is no cross-subsidisation across affiliates or related undertakings.[13]

3.55. In the RY16/17 price control decision,[14] we decided that in future years we would not require further justification for the Shared Service Charge associated with Baseline Activity[15] for price control purposes.

3.56. For New Scope Activities,[16] DCC must provide full justification to demonstrate that any Shared Service Charge relating to these activities is economic and efficient.

3.57. In its response to the RY17/18 consultation 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".

DCC's justification

3.58. This year DCC applied the Shared Service Charge at a rate of 9.5% on Baseline costs, which amounted to £5.52m in RY18/19 and £33.97m in forecast costs to the end of the Licence term.

3.59. DCC did not apply for a Shared Service Charge on its Switching Programme expenditure this year, so did not submit any justification for this charge.

[13] This is a requirement under Licence Condition 11 of the Smart Meter Communication Licence.
[14] https://www.ofgem.gov.uk/system/files/docs/2017/03/2017.02_data_communications_company_dcc_price_control_decision_201511.pdf
[15] Baseline Activity is activity associated with delivering the requirements provided to the Licensee during the Licensing Competition. This includes both activities that the Licensee was expected to fully cost in the LABP and activities that were known but not fully scoped at that time and so not fully costed.
[16] New Scope Activities are activities associated with delivering requirements additional to those that the Licensee was expected to deliver at the time of Licence Award. The Switching Programme is considered New Scope.

Our view

3.60. As in previous years, we propose 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.

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

3.62. Last year, we welcomed the commitment by DCC, supported by Capita, to carry out an in-depth review of Capita Shared Services. We understand that this review is ongoing.

3.63. **We propose to disallow the Shared Service Charge associated with the proposed unacceptable Internal Costs. This amounts to a disallowance of £0.094m in RY18/19 and £20.645m in forecast costs to the end of the Licence term**.

Switching costs

Context

3.64. The Switching programme has been established to improve consumer's experience of switching between energy suppliers. DCC plays a central role in delivering this programme.

3.65. The costs and performance of the Switching programme are dealt with separately from the rest of DCC's business.

3.66. For the Switching programme all costs must be justified as the Business Plan was not competitively tendered, and therefore cannot be considered inherently economic and efficient.

DCC's justification

3.67. DCC submitted costs for the Switching programme until the end of the Licence. These were £5.172m of incurred costs in RY18/19 and £23.098m of forecast costs.

3.68. DCC only provided justification for forecast costs in RY19/20 and RY20/21, and these are within the business case consulted on by DCC.

Our view

3.69. Due to the lack of justification, **our minded-to position is to disallow all forecast costs from RY21/22 to the end of the Licence period, £15.026m. We will therefore also disallow the corresponding margin (which is calculated as a percentage of costs), an additional £2.044m.**

4. Performance Incentives

Section summary

This section covers DCC's submission of its performance under the Operational Performance Regime (OPR), any relevant Baseline Margin Project Performance Adjustment Schemes, and the Switching incentive regime.

DCC submitted a reduction in its margin of £0.038m under the OPR, £0.093m due to its project performance, and no reduction due to its switching performance.

We propose to increase the reduction due to DCC's performance under the OPR by £1.267m to £1.305m. We propose no changes to the reduction due to DCC's project performance or switching performance.

We believe there is scope to optimise the OPR metrics to provide better incentives on DCC to provide a good service to its customers. We are therefore initiating a review of the OPR and request stakeholders' input.

Question 5: What are your views on our proposed position on DCC's operational performance?

Question 6: What are your views regarding DCC's failure to ensure all CSPs met their contractual milestones and our proposed performance adjustments in response to this?

Question 7: What are your views on how the Operational Performance Regime could be modified to better incentivise DCC to provide a good service to its customers and deliver upon its objectives?

Question 8: What are your views on our proposed position on DCC's project performance?

Question 9: What are your views on our proposed position on DCC's switching performance?

Background

4.1. All of DCC's Baseline Margin (BM) (including adjustments) is at risk against one of DCC's performance regimes.

4.2. Initially DCC's BM was subject to the Implementation Performance Regime (IPR). The IPR required that DCC met a series of Implementation Milestones (IMs). If DCC failed to meet an IM by the specified date it would lose a proportion of the BM associated with that IM. The proportion was determined by the length of the delay.

4.3. The last year of the IPR was RY16/17. Overall DCC's margin was reduced by £5.194m[17] through the IPR.

4.4. DCC's performance in RY17/18 was not assessed through a performance regime as the IPR had concluded and the OPR had yet to begin. All of the Baseline Margin recovered in RY17/18 is being put at risk across RY18/19, RY19/20 and RY20/21.

4.5. This year is the first year in which DCC's performance is being assessed by the Operational Performance Regime (OPR), and by a Baseline Margin Project Performance Adjustment Scheme (BMPPAS). All of DCC's BM is at risk under these performance regimes.

4.6. Separately to the BM, DCC receives margin on the Switching Programme. This Switching margin is at risk under a separate performance regime. The first milestones of this performance regime have been assessed in this year.

[17] In current year prices

Operational Performance

Context

4.7. The OPR was initially consulted on in March 2016 and the final decision and direction was published in September 2017.

4.8. The OPR consists of five equally weighted performance measures: two Service User Measures (SUM) and three Service Delivery Measures (SDM). Table 4.1 lists the five measures and their subdivisions.[18]

Table 4.1 Operational Performance Measures

Measure	Area of reporting	Metric	Weighting
SUM1	DCC service desk	Percentage of incidents resolved within Target Resolution Time	20%
SUM2a	Communication Hubs	Percentage of Communications Hubs delivered on time	10%
SUM2b		Percentage of Communications Hubs accepted by customers	5%
SUM2c		Percentage of Communications Hubs not faulty at installation	5%
SDM1a	DCC WAN coverage	All CSP contractual milestone dates met	20%
SDM1b		Percentage of first time SMWAN connectivity at install	
SDM2	Core service requests	Percentage of service responses delivered within Target Response Time	20%
SDM3	Service/System Availability	Percentage availability of Data Service, User Gateway, Service Management System and Self Service Interface	20%

[18] For more detail on the OPR please refer to the decision document and consultation documents: https://www.ofgem.gov.uk/publications-and-updates/decision-dcc-s-operational-performance-regime

4.9. These OPR performance measures are composed of a combination of the performance measures reported to the SEC and described in DCC's Performance Measurement Methodology.

DCC's submission

4.10. The total BM at risk under the OPR this year is £6.336m. DCC reported its performance resulting in the loss of £0.038m of its BM (and therefore the BMOPA term in taking the value of -£0.038m). Table 4.2 shows the performance DCC reported and the corresponding margin lost.

Table 4.2 DCC's submitted OPR values

OPR measures	BM at risk (£m)	BM reduction (£m)	% margin lost
SUM1	1.267	0.000	0.0%
SUM2a	0.634	0.038	6.0%
SUM2b	0.317	0.000	0.0%
SUM2c	0.317	0.000	0.0%
SDM1	1.267	0.000	0.0%
SDM2	1.267	0.000	0.0%
SDM3	1.267	0.000	0.0%
Total	**6.336**	**0.038**	**0.6%**

4.11. In DCC's submission they requested adjustments to two of five performance measures, SUM2 (a and b) and SDM1, to reduce the amount of BM it would lose. These are the only measures where DCC would lose margin under the default position of the OPR. The requests are discussed below.

SDM1

4.12. As part of SDM1, DCC must ensure that the CSPs meet all contractual coverage commitments in the Regulatory Year. If DCC does not achieve this, it will lose all of the BM associated with SDM1. (This is irrespective of how DCC perform in the other component of SDM1: Percentage of first time SMWAN connectivity at install.)

4.13. This year DCC missed one of two milestones. The milestone that was missed was in the north region and covered 112k delivery points. DCC worked with the CSP to make sure that the milestone was met as soon as possible within the Regulatory Year.

4.14. DCC requested that it retain all BM associated with this measure because the impact on customers was small and it resolved the problem within the Regulatory Year, therefore DCC believe that a reduction of £1.27m is not proportionate to the detriment caused.

SUM2a

4.15. SUM2a measures the percentage of Communication Hubs delivered on time. If the percentage is below the target performance level DCC loses BM on a sliding scale to the minimum performance level, below which DCC loses all BM associated with the performance measure.

4.16. DCC ran a customer preferencing exercise where it reduced the number of Communication Hubs it delivered to its customers in line with its customers' preferences.

4.17. DCC believe that this meant that the Communication Hubs that were delivered late had a disproportionate impact on the SUM2a measure as it is calculated as a percentage of the total number of Communication Hubs delivered.[19] Therefore, DCC requested that this loss of BM be reduced.

SUM2b

4.18. SUM2b measures the percentage of Communication Hubs accepted by DCC service users. As with SUM2a, if the percentage is below the target performance level DCC loses BM on a sliding scale to the minimum performance level, below which DCC loses all BM associated with the performance measure.

4.19. DCC had two deliveries rejected by a customer. The issues around both of these rejected deliveries have been resolved, and all of the Communication Hubs in question have been delivered to, and accepted by, customers.

[19] Assuming the number of Communications Hubs delivered late is constant, and the number of Communications Hubs delivered is reduced, the percentage that are delivered late increases and DCC is penalised more greatly (the BM reduction increases).

4.20. DCC believe that these deliveries should not be counted as part of the SUM2b measure.

Our view

4.21. We note that DCC has performed well in the OPR performance measures, but we propose to adjust the amount of BM lost by DCC through the BMOPA term from the value DCC submitted.

Table 4.3 Our proposed OPR values for the adjusted measures

OPR measures	BM at risk (£m)	Submission BM reduction (£m)	Consultation BM reduction (£m)	% margin lost submission	% margin lost consultation
SUM2a	0.634	0.038	0.038	6.0%	6.0%
SUM2b	0.317	0.000	0.000	0.0%	0.0%
SDM1	1.267	0.000	1.267	0.0%	100.0%
Total	**6.336**	**1.305**	**1.305**	**0.6%**	**20.6%**

SDM1

4.22. We acknowledge DCC's arguments that the missed milestone had minimal impact and DCC worked to resolve the issue quickly.

4.23. However, we believe that it is important that DCC ensures that the CSPs meet their contractual commitments. While DCC argued that the reduction to BM by £1.27m is not proportionate to the detriment caused, it failed to provide any evidence of engagement with the SEC panel or affected stakeholders to verify this point.

4.24. Therefore, we are seeking additional evidence from DCC and stakeholder's views on the impact of the missed milestone.

4.25. Our minded-to position based on the evidence we have received is to follow the OPR and reduce the retained BM by the full value of BM associated with the SDM1 milestone £1.267m.

4.26. However, should we receive additional evidence that demonstrates the missed milestone had minimal impact we propose a decreased reduction of £0.317m (25% of the full reduction) calculated on the basis of: one of two milestones having been missed; the limited impact of the missed milestone; and DCC's actions in resolving the issue quickly.

4.27. We wish to receive responses from stakeholders on this issue to enable us to make an informed decision. In future submissions when suggesting adjustments to the BM DCC would lose on account of performance measures, we expect DCC to provide robust evidence. This may include SEC panel views or engagement with affected stakeholders.

SUM2a

4.28. We recognise the benefit DCC provided customers through the customer preferencing exercise.

4.29. However, it is not clear that had there been a greater number of Communications Hubs delivered DCC would have delivered all of these on time. Therefore, we propose to maintain the default position of the OPR and reduce DCC's retained BM by £0.038m.[20]

SUM2b

4.30. As the issues around the two rejected deliveries have been resolved at a minimal cost to all parties involved, we propose to agree with DCC's position that the rejected deliveries do not contribute to the SUM2b measure. Therefore, we propose not to make a reduction to the BM associated with the SUM2b measure.

Conclusion

4.31. We propose to increase the reduction of the BM through the BMOPA term by £1.267m to £1.305m.

[20] This is consistent with DCC's submitted values, but is a rejection of DCC's argument that it should have this reduction reduced due to the effect of its customer preferencing exercise.

OPR Review

4.32. We are concerned that the current OPR metrics may not be providing the best incentives to DCC, and may not be reflecting customer experiences.

4.33. We are therefore initiating a review of the OPR. As part of this work, we will engage with the SEC Panel Operations sub-group who are reviewing the set of metrics that DCC provides in the Performance Measurement Report (PMR). A subset of these SEC defined measures feed into the OPR and thus any changes to the metrics could impact the OPR.

4.34. We would like to receive your views on how the OPR could be modified to better incentivise DCC to provide a good service to its customers and deliver upon its objectives.

Project Performance

Context

4.35. The Secretary of State may create a BMPPAS which defines a Project and describes the incentive regime which determines the proportion of the BM associated with that Project that DCC retains. BM adjustments which are awarded to DCC for work associated with such a Project are held at risk by the BMPPAS incentive regime.

4.36. Any reductions made due to a BMPPAS incentive regime are made through the BMPPA term given in the Licence.

4.37. This is the first year in which a BMPPAS incentive regime has come into effect. The BMPPAS regards the R2.0 project.

DCC's submission

4.38. DCC submitted results for six of the eight milestones described in the R2.0 BMPPAS incentive regime. The total reduction to the BM this year is £0.093m, 74% of the total possible £0.124m. Table 4.4 gives the proportion of margin lost for each milestone, and the overall percentage.

Table 4.4 DCC's submitted R2.0 performance values

R2.0 measure	BM at risk (£m)	BM reduction (£m)	% margin lost
1A	0.016	0.008	48.3%
1B	0.016	0.008	48.3%
2A	0.021	0.021	100.0%
2B	0.021	0.005	25.0%
3A	0.026	0.026	100.0%
3B	0.026	0.026	99.2%
Total	**0.124**[21]	**0.093**	**74.4%**

4.39. Due to the nature of the project performance mechanism in the Licence, any reductions made due to a missed milestone in this year will also lead to reductions in future years where BM is associated with the missed milestone. DCC will have its BM reduced by a minimum of an additional £0.386m across future years because of these missed milestones.

Our view

4.40. We have identified no issues with DCC's reporting of its performance in the R2.0 project, but note that DCC has performed poorly in meeting the milestones set out in the BMPPAS.

Switching Performance

Context

4.41. We published our decision on the margin and incentives for DCC's role in the Transitional Phase of the Switching programme in March 2017.[22] An updated incentive regime which included the Design, Build and Test Phase of the programme was then consulted on, with the decision given in May 2019.[23]

[21] Numbers may not sum to total due to rounding.
[22] Decision on margin and incentives for DCC's role within the Transitional Phase of the Switching Programme
[23] Decision on margin and incentives for DCC's role within the Design, Build and Test Phase of the Switching Programme

4.42. The margin and incentives for the Switching programme are entirely separate of the BM and the BM adjustment process. The details of the incentive regime can be seen in the May 2019 decision.

4.43. This is the first year in which milestones of the Switching programme have been met. Our proposed position on whether DCC met these milestones and the length of any delay is published in this section, however the final values that these represent in terms of margin retained will be finalised when the Transitional Phase concludes in RY19/20. The final Transition Milestone (3b, Service Management Contract Award) will be assessed as part of the RY19/20 price control.

DCC's submission

4.44. DCC submitted evidence that it met Transition Milestones 1 (CRS Detailed Design), 2 (CSS Tender Packs Issued) and 3a (CSS Contract Award). These were approved by Ofgem on 23 February 2018, 9 August 2018 and 12 February 2019.

4.45. DCC submitted on the basis of this evidence that it should retain all margin associated with Transition Milestones 1, 2 and 3a.

Our view

4.46. We propose to accept DCC's submission that it should retain all margin associated with Transition Milestones 1, 2 and 3a.

5. Baseline Margin and External Contract Gain Share

Section summary

This section summarises DCC's application for adjustments to its Baseline Margin and External Contract Gain Share.

DCC submitted an application for an adjustment to its Baseline Margin of £11.046m for RY18/19 to RY20/21. We find that DCC has not provided sufficient evidence to support part of its application, and propose to reduce it by £2.970m. Considering both this, and the disallowances from our assessment of Internal Costs, we propose to amend DCC's Baseline Margin application and allow £8.076m.

DCC submitted an application for an adjustment to its External Contract Gain Share (ECGS) of £8.210m across RY18/19 to RY25/26. This was as a result of refinancing agreements for set-up payments. We propose to accept DCC's ECGS Adjustment application of £8.013m and reject £0.197m ECGS Adjustment relating to SMETS1 programme.

Question 10: What are your views on our assessment of DCC's application to adjust its Baseline Margin?

Question 11: What are your views on cost uncertainty in relation to Baseline Margin applications and the process for dealing with this issue?

Question 12: What are your views on our assessment of DCC's application to adjust its ECGS?

Baseline Margin

Background

5.1. 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.

5.2. The Baseline Margin adjustment mechanism was included in the Licence in recognition of the uncertainty of the nature and risks of DCC's Mandatory Business over the Licence term. The adjustment mechanism is intended to ensure that DCC is compensated for material changes in certain aspects of its Mandatory Business – including the volume, characteristics, risks and timescales of these activities. Greater detail of the conditions and requirements for a Baseline Margin Relevant Adjustment can be found in the RIGs, and the processes and procedures document.

5.3. DCC's Baseline Margin (including adjustments) is subject to DCC's performance regime under which its Baseline Margin may be reduced for poor performance. The Operational Performance Regime (OPR) began this Regulatory Year (RY18/19), and 100% of the Baseline Margin recovered this year is held to account either by the OPR, or by a Baseline Margin Project Performance Adjustment Scheme directed by the Secretary of State.

DCC's application

5.4. Alongside its RY18/19 price control submission, DCC has applied for a £11.046m adjustment to its Baseline Margin for work performed in RY18/19, RY19/20 and RY20/21.

5.5. DCC has identified five new drivers of change to aspects of its Mandatory Business. In addition, DCC has applied for adjustments where there is increased cost certainty associated with drivers accepted in RY16/17 and RY17/18, including for activity related to SMETS1 and R2.0.

5.6. DCC has identified the following new drivers:

- Facilitating Additional Relevant Services
- Investing in Business Process Volume Management
- New Scope – Future DCC Activities
- Increase in Demand for Customer and Stakeholder Engagement
- Operational Resilience

5.7. Facilitating Additional Relevant Services relates to DCC's new office at Brabazon House which will provide space for testing, and will house the Technical Operations Centre and Security Operations Centre, as well as many other staff. DCC is applying for an adjustment of £1.673m due to work associated with this driver.

5.8. Investing in Business Process Volume Management relates to work which DCC believes has been driven by external requirements which have increased in scale and variety beyond the original requirements of the LABP. This work is primarily new processes and systems that have been put in place to cope with these increases. DCC is applying for an adjustment of £0.720m due to work associated with this driver.

5.9. New Scope – Future DCC Activities relates to upcoming work for which DCC has begun to plan the resourcing. DCC is applying for an adjustment of £0.410m due to work associated with this driver.

5.10. Increase in Demand for Customer and Stakeholder Engagement relates to the increased degree to which DCC believes it must engage with its customers and stakeholders compared to what was envisaged at LABP. DCC is applying for an adjustment of £0.383m due to work associated with this driver.

5.11. Operational Resilience relates to the cost of managing change required by the multiple programmes DCC is required to deliver without impacting business-as-usual operations. DCC is applying for an adjustment of £0.232m due to work associated with this driver.

5.12. To calculate the proposed adjustment, DCC first quantified the change in volume of activities associated with each driver in terms of the number of FTE resources that have worked on them, as well as the additional external services used in lieu of DCC recruiting more in-house resources. DCC then calculated the Baseline Margin such that it was 15% of the sum of the Baseline Margin and associated costs for each role (this is consistent with previous years and the original Baseline Margin given in the Licence – please see the RY16/17 price control consultation document for more information).[24]

[24] The rate of margin is discussed in more detail in paragraphs 4.20 and 4.21 of the RY16/17 price control consultation.

Our view

5.13. We consider that the conditions for DCC to make a Relevant Adjustment to the Baseline Margin have been met. However, DCC has not provided sufficient evidence to support the full amount for which it has applied.

5.14. When determining any Relevant Adjustments to DCC's Baseline Margin the Licence requires us to have regard to DCC's expected rate of return on its activities over time. As part of last year's price control we considered a 15% margin to be acceptable given DCC's ex-post regulatory framework; that the activities are similar in nature to those included with the LABP; DCC's limited fixed and intangible assets; and that this is the same margin as that agreed at bid, and as such was established through a competitive tender.

5.15. **For RY18/19 we regard 15% to be an acceptable margin** given that DCC's position and characteristics relevant to earning margin have not substantially changed since last year.

New Drivers

5.16. We have identified four of the five new drivers where we propose to make a reduction to the Baseline Margin Relevant Adjustment associated with them for which DCC has applied. The reasons for these reductions differ for each driver.

5.17. We accept the Facilitating Additional Relevant Services driver, but propose to amend the calculation of the cost, and therefore the Baseline Margin, associated with it. DCC is housing many of the staff that used to be based in Preston Brook at this new office. This accounts for existing expense and cannot be considered for Baseline Margin under this driver. We are therefore reducing the BM being awarded by an amount proportionate to the cost of the Preston Brook office as DCC will no longer be paying rent at Preston Brook. DCC will also need to take this into account in any future Baseline Margin applications based on this driver. This is a proposed reduction of £0.132m.

5.18. We reject the Investing in Business Process Volume Management driver as the activities that DCC have listed are primarily related to the increase in SMETS2 volumes. The volumes of SMETS2 meters are in fact below what was expected at LABP due to the SMETS2 rollout progressing more slowly than was originally anticipated. Therefore, it does not meet the conditions for a Relevant Adjustment given in the Licence. This is a proposed reduction of £0.720m.

5.19. We reject the New Scope – Future Activities driver as there is not sufficient certainty of the costs of any of the activities listed. However, we are not making a decision or commenting on whether any of the activities listed by DCC meet the criteria for a Relevant Adjustment. DCC may choose to apply for Baseline Margin on these activities in future. This is a proposed reduction of £0.410m.

5.20. We reject the Increase in Demand for Customer and Stakeholder Engagement driver as DCC has not provided sufficient evidence to support the premise that demand for customer and stakeholder engagement has increased. It is our view that demand for customer and stakeholder engagement has remained fairly constant, and that DCC has begun to meet this demand where previously there was an engagement deficit. This is a proposed reduction of £0.383m.

5.21. We accept the Operational Resilience driver. This position is consistent with our previous decisions to allow Relevant Adjustments to work performed in relation to the multi-release and multi-programme delivery.

Cost Uncertainty

5.22. Where the certainty of costs associated with a previously accepted driver[25] have increased and there has been an increase in these costs, DCC has applied for the margin associated with that increase in costs. We have accepted this in previous years, and we are proposing to again accept the adjustments on this basis this year.

[25] This is a driver for which DCC has previously been awarded Baseline Margin.

5.23. This year for the first time we noted material decreases in costs associated with some drivers which have previously been awarded Baseline Margin. DCC has not provided explanations for these cost decreases.

5.24. We believe that DCC should not recover Baseline Margin on costs that have not been incurred due to work not having been done, or because DCC has overestimated the cost associated with the work.

5.25. There can be opposing incentives which need to be taken into consideration when formulating our approach:

- If DCC were allowed to recover Baseline Margin associated with costs it has not incurred, for work that has not been done, it could incentivise DCC to delay work such that it could reapply for effectively the same work in future years.
- If DCC were allowed to recover Baseline Margin associated with work that has been done but has cost less than originally predicted, it could incentivise DCC to overestimate the costs associated with any and all pieces of work.
- However, if DCC were not allowed to recover Baseline Margin associated with the full cost of work where it later found efficiencies, reducing the Baseline Margin by the amount of any and all cost reductions, it could disincentivise DCC from finding efficiencies.

5.26. Our position on this issue both this year and in the future must balance these different incentive risks.

5.27. As DCC has not provided any explanation as to why there are decreased costs for some drivers which had previously been awarded Baseline Margin, we propose to reduce the Baseline Margin adjustment by an amount proportionate to these decreases in costs. This is a proposed reduction of £0.858m.

5.28. We remain open to receiving additional evidence from DCC on the reasons for the decreased costs and would use such evidence to revisit the proposed reduction.

Other Reductions and Proposed BM Adjustment

5.29. There were a number of roles to which DCC has attached no grounds on which the application was being made. We reject all of the Baseline Margin associated with these roles. This is a proposed reduction of £0.426m.

5.30. The total reduction we are proposing excluding any effects of the cost disallowance is £2.930m.

5.31. In addition to these disallowances, DCC cannot receive a Baseline Margin adjustment on costs that are not economic and efficient. We calculate the effect of the proposed disallowances in the cost assessment on the Baseline Margin application to be £0.040m.

5.32. Due to the ex-post nature of the price control, the Baseline Margin adjustment is recovered by DCC after the year in which the work on which it is based was performed. The years to which we are proposing the adjustment is made to are RY20/21, RY21/22 and RY22/23.

5.33. Taking all of these disallowances into account, **we propose reducing the adjustment by £2.970m, therefore amending DCC's application to an adjustment of £8.076m between RY20/21 and RY22/23**, as shown in Table 5.1.

Table 5.1 Proposed Baseline Margin compared to Baseline Margin as of the RY17/18 price control decision

Baseline Margin (£m)	RY20/21	RY21/22	RY22/23	Total
Baseline Margin as of RY17/18 decision	6.863	4.636	2.113	13.611
Adjusted by RY18/19 application (Difference from RY17/18)	9.747 (2.884)	8.305 (3.669)	6.605 (4.493)	24.657 (11.046)
Adjusted by RY18/19 consultation proposal (Difference from RY17/18)	8.573 (1.711)	7.154 (2.519)	5.960 (3.847)	21.688 (8.076)

Figure 5.1: Comparison between DCC's application and our proposed adjustment

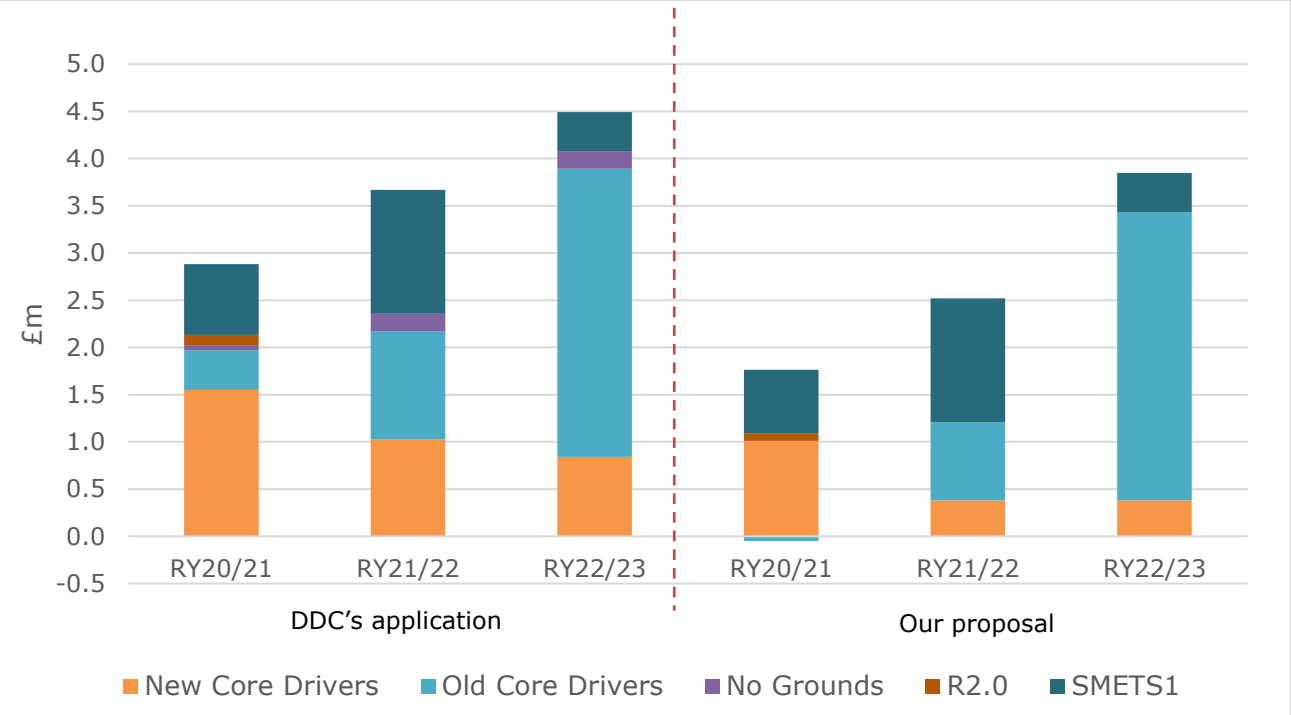


Figure 5.1 Data table

Driver	Application			Proposal		
	RY20/21	RY21/22	RY22/23	RY20/21	RY21/22	RY22/23
New Core Drivers	1.006	0.335	0.332	1.006	0.269	0.266
Old Core Drivers	0.425	0.240	0.055	0.000	0.000	0.000
No Grounds	0.000	0.200	0.210	0.000	0.000	0.000
R2.0	0.113	0.142	0.128	0.000	0.000	0.000
SMETS1	0.005	0.112	0.115	0.005	0.112	0.115

Table 5.2 Proposed Baseline Margin adjustment compared with DCC's application[26]

Driver	Application			Proposal		
	RY20/21	RY21/22	RY22/23	RY20/21	RY21/22	RY22/23
Facilitating Additional Relevant Services	1.006	0.335	0.332	1.006	0.269	0.266
Investing in Business Process Volume Engagement	0.425	0.240	0.055	0.000	0.000	0.000
New Scope	0.000	0.200	0.210	0.000	0.000	0.000
Increase Demand for Customer and Stakeholder Engagement	0.113	0.142	0.128	0.000	0.000	0.000
Operational Resilience	0.005	0.112	0.115	0.005	0.112	0.115
Service Standard Expectations	0.160	0.463	0.492	0.158	0.463	0.492
Change to DCC's Supply chain structure	0.030	0.166	0.282	-0.008	0.157	0.282
Increase in Security Requirements	0.058	0.227	0.114	0.057	0.227	0.114
People Transformation	0.037	0.067	0.142	0.037	0.067	0.142
Moving from Project to Multiple Programme Delivery	0.018	0.075	0.747	-0.036	-0.050	0.747
Operational Change	0.014	0.048	0.476	-0.181	-0.029	0.476
Supporting a Changing Business	0.008	0.012	0.181	-0.021	-0.033	0.181
Increase in Customers	0.026	0.029	0.143	-0.014	0.012	0.143
Technology Driven Change	0.018	0.018	0.150	-0.010	-0.001	0.150
SMETS2Ops	0.039	0.037	0.324	0.008	0.013	0.324
SMETS2	0.014	0.000	0.000	-0.040	0.000	0.000
No Grounds	0.053	0.187	0.187	0.000	0.000	0.000
R2.0	0.108	0.000	0.000	0.080	0.000	0.000
SMETS1	0.752	1.312	0.415	0.671	1.312	0.415
Total	**2.884**	**3.669**	**4.493**	**1.711**	**2.519**	**3.847**

[26] Negative values in Table 5.2 are the result of the cost uncertainty reduction to the application described in paragraph 5.27.

External Contract Gain Share

Background

5.34. 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 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.

DCC's application

5.35. DCC has applied for a Relevant Adjustment to the ECGS term for RY18/19 to RY25/26 that reflects a reduction in External Costs as a result of refinancing agreements for set-up milestones. DCC's role in securing the refinancing savings included: setting up a specialist team within DCC to implement refinancing; launching an external procurement to assist DCC in exploring alternative finance arrangements; and securing a financier for the new arrangements.

5.36. DCC provided a justification of its proposed distribution of the savings, which included benchmarking against comparable gain share arrangements in other regulated industries.

5.37. DCC applied for the Relevant Adjustment on the basis of £30.642m of savings. DCC has proposed a Relevant Adjustment of £8.210m (26.8%) covering RY18/19 to RY25/26, with the adjustment terms taking effect on 01 April 2020.

Customer's benefits

5.38. ECGS is a mechanism which incentivises DCC to identify and secure reductions in the costs of the FSP contracts. The reduction of such costs brings benefits to DCC's customers in the form of savings from lower contractual interest rates on financed milestones.

5.39. Between RY15/16 (DCC's first ECGS Adjustment application) and RY18/19 (including this year's application), DCC has secured cost reductions of £99.5m in the FSP contracts based on DCC's ECGS applications[27], and brought benefits of £53.1m (53% of total cost reductions) to DCC's customers through lower charges.

Our view

5.40. We consider the Relevant Adjustment to the ECGS term is based on the cost reductions made to the original External Service Provider Contract[28]. SMETS1 programme contracts awarded to existing DSP and CSPs should be considered as new contracts. Therefore, the interest rates agreed while signing SMETS1 contracts should not be treated as cost reduction factors.

5.41. For this reason, we propose to reject ECGS Adjustment application of £0.197m which is based on the "cost reduction" of £0.787m in SMETS1 related costs to DSP.

5.42. Apart from the SMETS1 programme related ECGS Adjustment application, we consider that DCC's application is duly made and that DCC has provided sufficient evidence that it was instrumental in the arrangement. DCC's application justified that the overall saving from the refinancing would not have been achieved without DCC's involvement.

5.43. We also consider that DCC's proposed distribution of the savings between its customers, the FSPs and DCC is consistent with previous years and appropriate based on the evidence provided by DCC, and regulatory precedent in the industry.

5.44. **We therefore propose Relevant Adjustment to the ECGS term by a total of £8.013m between RY18/19 and RY25/26.**

[27] This figure could be smaller if the SMETS1 programme related ECGS adjustment for DSP is not included. Please see 1.41.
[28] Licence Condition 39 A4.

Appendices

Index

Appendix 1 – Responding to this consultation

A1.1. We'd like to hear your views on any of the issues in this document. We would particularly like to hear from SEC users. We would especially welcome responses to the questions at the beginning of each section. These are replicated below.

A1.2. Please make sure we have your response by 20 December 2019. Send them to:

Ayena Gupta
Metering and Market Operations
Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU
020 7901 7000
smartmetering@ofgem.gov.uk

A1.3. Unless you mark your response as confidential, we'll publish it in our library and on our website (www.ofgem.gov.uk). If you ask us to keep your response confidential we'll respect this request unless a legal duty means we can't, for example under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

A1.4. If you'd like your response to be confidential, mark it clearly to that effect and include your reasons. Please restrict any confidential material to an appendix. Once we've considered the responses to this consultation, we plan to publish our final decision in February 2020.

QUESTIONS

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

Question 2: What are your views on our proposals on DCC's approach to benchmarking of staff remuneration?

Question 3: What are your views on our proposal to disallow all costs associated with the external service to develop a KPI Dashboard?

Question 4: What are your views on our proposal to disallow all costs associated with the external service to develop a KPI Dashboard?

Question 5: What are your views on our proposed position on DCC's operational performance?

Question 6: What are your views regarding DCC's failure to ensure all CSPs met their contractual milestones and our proposed performance adjustments in response to this?

Question 7: What are your views on how the Operational Performance Regime could be modified to better incentivise DCC to provide a good service to its customers and deliver upon its objectives?

Question 8: What are your views on our proposed position on DCC's project performance?

Question 9: What are your views on our proposed position on DCC's switching performance?

Question 10: What are your views on our assessment of DCC's application to adjust its Baseline Margin?

Question 11: What are your views on cost uncertainty in relation to Baseline Margin applications and the process for dealing with this issue?

Question 12: What are your views on our assessment of DCC's application to adjust its ECGS?

Appendix 2 – External Costs assessment

A2.1. In Appendix 2, we provide further context on the External Costs that materially contributed to the variation in RY18/19 (as identified in Section 2). We have included the DCC's summary of its use of the governance provisions and value for money mechanism as defined in Schedules 7 and 8 of the FSP contracts.

Key material variances

R2.0

A2.2. In RY17/18, the progress in R2.0 has followed through from initial design work for the DBCH that was funded under PR023, to development of the DBCH under CR184 and upgrade of the system for GBCS 2, through to support for DBCH under CR194. During RY18/19, the project moved to the collaborative System Integration Testing (SIT) phase and Device Integration Testing (DIT) phase. Thereafter testing with Service Users commenced in the UIT phase. This was initially covered by CR253 for SIT and DIT phases and CR274 for the UIT phase. CR253 and CR274 are covered in this PC submission. Change Requests (CRs) associated with R2.0 are listed in Table A2.1 below.

Table A2.1 Change Requests associated with R2.0

Material CRs	Description	Service Providers Affected
CR253	CR253 came from the continuation of the R2.0 programme previously described in the RY2017/18 price control submission. It relates to (SIT) and (DIT) for R2.0.	CSP (N) CSP (S&C)
CR274	CR274 was raised due to the continuation of the R2.0 programme previously described in the RY2017/18 price control submission. It relates to UIT for R2.0.	CSP (N) CSP (S&C) DSP
CR1005	CR1005 is required to ensure sufficient coverage of SIT and DIT requirements following the addition of further functional changes for R2.0 and delays in the availability of real devices for testing.	DSP
CR301	CR301 covers Transition to Operation (TTO) activities that are required to ensure the DCC eco-system is ready to go live with R2.0. The purpose of the TTO phase is to ensure that Service Management processes are prepared, and that Operations teams are ready to support the changes introduced by the wider release	DSP
CR1034	CR1034 was raised due to the continuation of the R2.0 programme previously described in the RY2017/18 price control submission. It relates to the continuation of SIT and DIT for R2.0 in October and November 2018.	CSP (N) CSP (S&C) DSP
CR1046	CR1046 covers the inclusion of additional scope for DIT for R2.0. This additional testing is required to ensure that the DIT phase covers all test requirements sufficiently.	CSP (N) DSP

A2.3. In Table A2.1, these CRs contributed around £60m in cost variation for External Costs over the Licence term, of which the largest are CR253, CR274 and CR1034.

Release 1.2

A2.4. While Release 1.2 and 1.3 are live, there have been CRs released for post-production work related to hardware life-cycles, for example, Communication Hubs. CR144 and CR135 are related to such post-production, and described in Table A2.2 below. The costs of CR144 and CR135 are around £3m over the Licence term.

Table A2.2 Change Requests associated with R1.2

Material CRs	Description	Service Providers Affected
CR144	CR144 was raised for FSP's to assess the impact of implementing a capability for the DCC to track reconditioned communications hubs through the existing Remedy Returns Record module design, principally in order to comply with the DCC Charging Methodology obligations defined by SEC Sections K7.5(o) and K7.5(p).	CSP (N)
CR135	CR135 was raised as a result of updates to SD4.4.3 and SD4.7.1 Interface Specifications, which govern the interface between the CSP(N) and the DSP systems, since the previous ARQCAN021/CR032a was agreed. For this CR the following versions of the specs had to be adopted to align with the Release 1.2 baseline which had been approved by Arqiva/CGI and by the DCC Design Assurance Board: • SD4.4.3 v3.7 CSP Management Interface • SD4.7.1 v2.5 DSMS Interface.	CSP (N)

Operate at Scale Programme

A2.5. The installation of SMETS2 meters has ramped up considerably since the first SMETS2 meter was installed in November 2016. The Operating at Scale project is to support these ongoing installations and mitigate risk around high-volume meter roll out from 1 October 2018. There were eight main work streams to this project:

- Disaster Recovery (DR N+1, meaning Disaster Recovery time plus standard response time. Many response times are codified within the SEC)
- Application N+1 (The process of implementation and acceptance to the first standard response time)
- Resilience (Improvements in overall recovery times and backup systems)
- Enabling Change (Improvements to the process by which change is implemented in the system)
- Northbound Application Traffic Management (The ability to protect the system against floods of messages from meters, through a situation such as a 'denial of service' attack)
- Arqiva Retry Enhancements
- Suppression of Communication Alerts (Detecting and deleting repeating messages)
- Local Pre-payment top ups.

A2.6. Table A2.3 summaries the CRs associated with this project, and they contributed £6.2m of the cost variation in External Costs over the Licence term.

Table A2.3 Change Requests associated with Operate at Scale Programme

Material CRs	Description	Service Providers Affected
CR1003	As part of DCC's assessment of readiness to Operate at Scale, the DCC commissioned a review (the Ready to Scale review) of the DSP Services. Working with the DSP, a number of recommendations have been agreed to implement changes and improvements to the DSP Services. CR1003 covers changes related to the network infrastructure resilience and failover. Whilst the current network infrastructure is designed as a highly available service, the changes proposed will further increase the availability of the service by reducing the likelihood of failure and the time taken to recover from a fault.	DSP
CR1004	The scope of supply under this change is a subset of items identified in the Ready to Scale (R2S) discovery program (later known as Operate at Scale). The following applications have been identified as requiring additional N+1 resilience.	DSP
CR1007	CR1007 introduces additional physical servers into DSP's recovery data centre to enable N+1 server resilience in a Disaster Recovery scenario. The exact scope and impacted servers are detailed within the embedded IA	DSP
PR069	PR069 covers a request to DSP to provide a team to undertake Agile development of the SSI, SSMI and Remedy platforms. This should include the provision of a capability to develop User Interface strategy and design based on a "design thinking" approach that includes customer engagement and research. The aim of the Agile delivery approach is to release new functionality and User Interface changes every week, with a three-week development cycle	DSP

Message Buffering

A2.7. Message Buffering is DCC led change, which was based on feedback from DCC's customers and incorporates the addition of a Message Buffering facility to the CSP(N) Arqiva solution. The reason for the change was to alleviate reliance on the short-term retry strategy when parallel Service Requests (SRs) are sent to the SMWAN GW Interface via the DSP. If not implemented, Service Users would be unable to run their business processes.

A2.8. CR313 accounted for £1.7m cost variation in External Costs over the Licence term.

Testing Services

A2.9. User Integration testing services have continued throughout RY18/19, in the prior year it was only assumed until December 2018 as it was unknown at the time how long the charges will continue for.

A2.10. CR279 relates to the continued provision of Testing Services to support User Entry Process Testing (UEPT) and End to End Testing by Service Users and Production Support Testing. Cost variation in CR279 contributed 17% of cost variation in External costs from last year's forecasts.

A2.11. The UIT service described in this CAN097 and associated embedded FIA is based on providing testing services to DCC from a core service composed of different functions. The services provided under this CAN compromise of:

- Testing Services which provides industry facing testing services across the UIT-A and UIT-B environments
- Production Support Testing provides testing support for production Systems Integration Activities on the SIT-A environment
- System Integration (SI) Release Management Team

SMETS1 Programme

A2.12. As the SMETS1 programme evolved it became apparent that the complexity was greater than envisaged:

- A more complex architecture choice opted in April 18 for solution IP5b;
- Industry feedback did not reflect actual meter behaviour – Meter behaviour was different to assumptions made based on industry feedback; and
- Customers needed more implementation time – Customer feedback on the management of meter migration resulting in a broader scope and the requirement for an extended period for development of the approach for transition and migration.

A2.13. A restructure of the Programme was subsequently carried out in the last quarter of 2018. DCC consulted on a revised LC13 plan:

- IOC (Initial Operating Capability) in end May 2019 comprising the Aclara, Honeywell Elster and Itron meters currently operated by CGI IE;
- MOC (Middle Operating Capability) at end August 2019, comprising the Honeywell Elster meters currently operated by MDS and the Secure Meters group; and
- FOC (Final Operating Capability) at end October 2019 comprising Landis + Gyr (L+G) meters currently operated by either BG SMSO, DXC or CGI IE and, if directed by Government following a consultation in due course, the EDMI meter group.

A2.14. There were 6 new contracts signed with SMETS1 service providers in RY18/19. DCC set out its procurement strategy and a SMETS1 Sourcing Strategy for all S1SPs and DCOs. Its preferred option of negotiation contains the following criteria:

- Separate the negotiation of the life cycle to maximise value of parallel option running;
- Run a contract negotiation for a time-and-materials contract (with some additional delivery incentives) so that the SMSO can start delivery of its Option 5b solution;
- Subsequently, run the contract negotiation with each SMSO for commitment to enduring agreement
- Each individual contract was also negotiated through both technical delivery elements as well as commercial contract components

A2.15. DCC believes that its preferred option provided the best value for money. It enabled DCC to carry out a strategy whereby progressing IEPFR IP4 in parallel meant that each SMSO felt under competitive pressure to offer a good deal for delivery of the changes to its services required to support SMETS1 and delivery of the competitive enduring agreements.

Appendix 3 – Internal Costs Assessment

A3.1. DCC's internal Baseline costs are reported by cost centre. DCC reports separately on New Scope costs.[29] Table A3.1 gives an overview of the types of costs associated with each cost centre.

Table A3.1 Overview of costs associated with each cost centre

Cost centre	Functions include:
Corporate Management	• Costs for the managing director, the senior management team, and the DCC board • Communications • Regulation, and risk and compliance • Strategy and development • Internal controls and business improvement
Industry	• Leads engagement with DCC's customers • The team is due to be disbanded in the future
Finance	• Commercial finance activities including the production of the company-wide budget and business plan, and the development and application of the charging methodology in order to set charges • Operational finance activities including cost control, cash flow management, managing billing and credit cover • Regulatory finance activities, including the price control and other regulatory and statutory reporting • Developing staff and structure of the organisation

[29] New scope refers to activity associated with delivering requirements additional to those that the Licensee was expected to deliver at the time of Licence Award. The Centralised Registration Service is considered new scope.

Commercial	• Leads the contractual and commercial management of service providers • Oversees DCC's procurement strategy • Evaluates services procured from Capita and additional contracts which require management, such as SMKI, Parse and Correlate • Legal Team (who were transferred from Corporate Management last year) • Supplier Relationship Management – new function established this year to manage relationship between DCC and Service Providers to drive improved performance.
Design and Assurance - CTO	• Leads the development and maintenance of DCC technical architecture and service design • Works closely with the FSPs • Responsible for technically assuring DCC services and overseeing the delivery and implementation of the test strategy and test approach • Enables innovation, designing product architecture
Operations	• Ensuring that DCC services meet the needs of all service users • Designing and providing the day-to-day operational interface for service users including a first line service desk • Responsible for operational reporting and the provision of any transitional services ahead of go-live, early life support and enduring operations • Manages the operational relationship with DCC's service providers • Technical Operations Centre which ensures that the service availability is managed though the monitoring and management of events • Testing of live customer and user systems, devices and processes to validate working as designed post-test environments.

Programme	• Coordinating delivery across the whole DCC ecosystem during the implementation phase • Ensuring that the services, systems, resources and assets are all in place in accordance with the programme plan • Allow DCC to appropriately design and build activities to be completed to facilitate integration and user integration testing • Ensures fit for purpose governance to enable multiple concurrent programmes of work in a consistent and well controlled manner.
Security	• Assuring the security of all DCC systems • Establishing an information security policy, including security assurance standards, processes, procedures and implementation timescales • Maintains information security standards and certification throughout the Licence

A3.2. Figure A3.1 shows the variance in Internal Costs by cost centre compared to the RY17/18 forecast. This shows that the increase in costs compared to last year are concentrated in the Corporate Management, Programme and Operations cost centres.

Figure A3.1 Cost variance by cost centre – compared to RY17/18 in current year prices

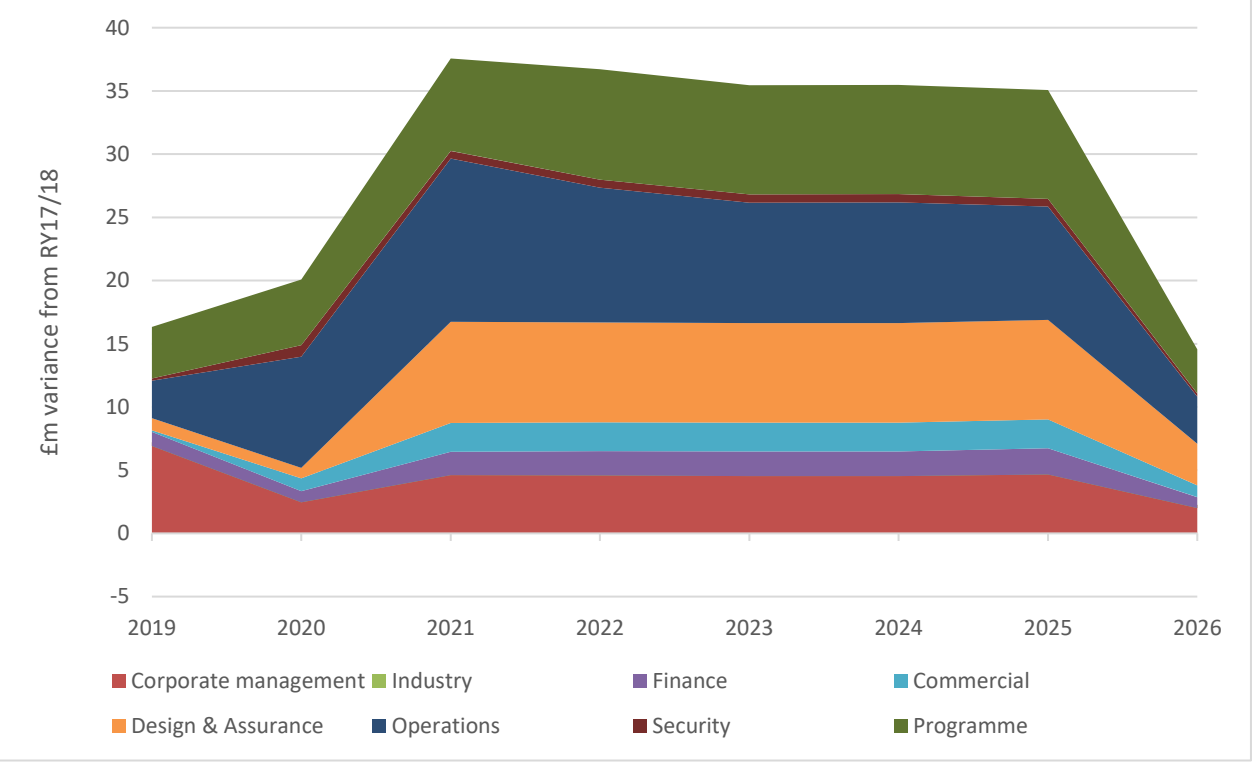


Figure A3.1 data table

£m	RY18/19	RY19/20	RY20/21	RY21/22	RY22/23	RY23/24	RY24/25	RY25/26
Corporate management	7.2	2.9	5.2	5.2	5.1	5.1	5.2	2.2
Industry	-0.3	-0.4	-0.6	-0.6	-0.6	-0.6	-0.6	-0.2
Finance	1.1	0.9	1.8	1.9	1.9	1.9	2.1	0.9
Commercial	0.1	1.0	2.3	2.3	2.3	2.3	2.3	0.9
Design and Assurance	1.0	0.8	8.0	7.9	7.9	7.9	7.9	3.3
Operations	3.0	8.8	12.9	10.7	9.5	9.5	8.9	3.7
Security	0.2	0.9	0.6	0.7	0.7	0.7	0.6	0.3
Programme	4.1	5.2	7.3	8.7	8.6	8.6	8.6	3.5

A3.3. Figure A3.2 shows the variance in Internal Costs by cost centre compared to the LABP. This shows that the costs incurred in RY18/19 compared to the LABP are concentrated in corporate management and closely followed by design & assurance and programme.

Figure A3.2 Cost variance by cost centre – compared to LABP in current year prices

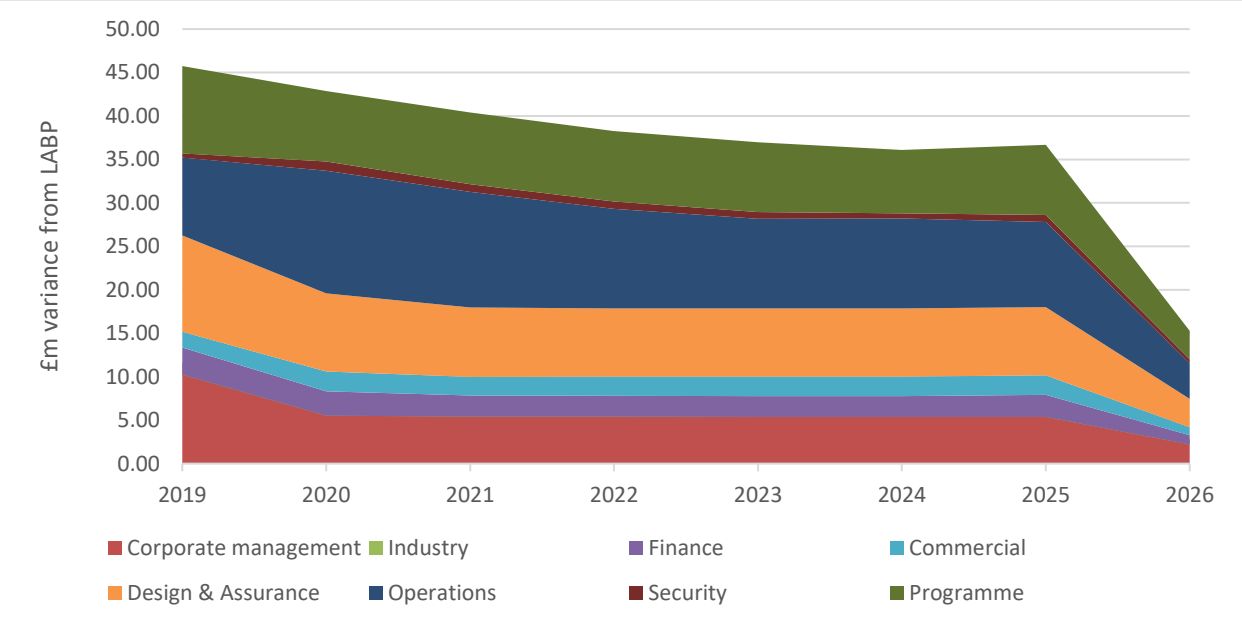


Figure A3.2 data table

£m	RY18/19	RY19/20	RY20/21	RY21/22	RY22/23	RY23/24	RY24/25	RY25/26
Corporate management	11.6	7.0	6.9	6.8	6.8	6.8	6.8	11.6
Industry	-1.4	-1.5	-1.5	-1.4	-1.4	-1.4	-1.4	-1.4
Finance	3.1	2.8	2.4	2.4	2.4	2.4	2.5	3.1
Commercial	1.8	2.3	2.1	2.2	2.2	2.2	2.2	1.8
Design and Assurance	11.1	9.0	8.0	7.9	7.9	7.9	7.9	11.1
Operations	9.0	14.1	13.3	11.4	10.3	10.3	9.8	9.0
Security	0.5	1.1	0.9	0.9	0.8	0.6	0.8	0.5
Programme	10.0	8.1	8.3	8.1	8.0	7.3	8.0	10.0

A3.4. Payroll costs are a major driver of Internal Costs across the different cost centres. Table A3.2 summarises DCC's headcount from RY18/19 to RY19/20 as measured in full time equivalents (FTEs) by cost centre. In RY19/20 forecast, there is a 31% increase in FTE compared to RY18/19.

Table A3.2 FTEs by cost centre

Cost centre	RY18/19	RY18/19 forecast for RY19/20
Corporate Management	37.7	53.6
Industry	1.1	0.0
Finance	34.9	38.2
Commercial	16.0	26.1
Design and Assurance	99.8	97.9
Operations s	78.5	127.1
Security	13.0	17.4
Programme	52.2	59.1
New scope	56.9	92.0
Centralisation registration service	31.0	39.7
Total	**421.2**	**551.1**

Appendix 4 – Proposed Allowed Revenue

Table A4.1. Proposed Allowed Revenue for each year to the end of the Licence term

Regulatory Year	RY18/19	RY19/20	RY20/21	RY21/22	RY22/23	RY23/24	RY24/25	RY25/26
LABP (18/19 prices)	163.873	202.403	234.379	238.794	235.497	242.149	250.019	105.746
Previous year (18/19 prices)	301.195	371.256	400.651	358.072	333.075	332.542	323.964	121.937
Submitted AR RY18/19	**373.583**	**410.839**	**537.832**	**516.377**	**478.873**	**475.371**	**472.849**	**205.501**
Cost Disallowances								
Baseline forecast internal costs	0.000	0.000	0.000	-40.111	-38.732	-38.760	-38.306	-15.902
CRS forecast internal costs	0.000	0.000	0.000	-3.449	-3.389	-3.389	-3.389	-1.412
SMETS1 forecast internal costs	0.000	0.000	0.000	-6.438	-6.438	-6.438	-6.438	-2.683
Benchmarking	-0.539	0.000	0.000	0.000	0.000	0.000	0.000	0.000
External Services	-0.455	0.000	0.000	0.000	0.000	0.000	0.000	0.000
Shared Service Charge	-0.094	0.000	0.000	-4.794	-4.657	-4.660	-4.616	-1.918
Total cost disallowances	**-1.088**	**0.000**	**0.000**	**-54.792**	**-53.216**	**-53.246**	**-52.749**	**-21.915**
Performance Adjustment Reductions								
OPR	-1.267	0.000	0.000	0.000	0.000	0.000	0.000	0.000
CRS performance	0.000	0.000	0.000	-0.469	-0.461	-0.461	-0.461	-0.192
Consultation AR excluding BM and ECGS adjustments	**371.227**	**410.839**	**537.832**	**461.116**	**425.196**	**421.664**	**419.639**	**183.395**
Baseline Margin and ECGS adjustments								
BM adjustment (18/19 prices)	0.000	0.000	1.711	2.519	3.847	0.000	0.000	0.000
ECGS adjustment	0.000	0.000	2.602	1.189	1.151	1.248	1.418	0.406
Consultation AR with BM and ECGS adjustments	**371.227**	**410.839**	**542.144**	**464.823**	**430.195**	**422.911**	**421.056**	**183.800**

Table A4.2. Total Proposed Allowed Revenue across the whole Licence term

Regulatory Year	Total across Licence term (£m, RY18/19 prices)
LABP (18/19 prices)	2055.335
Previous year (18/19 prices)	3131.065
Submitted AR RY18/19	**4056.194**
Cost Disallowances	
Baseline forecast internal costs	-171.810
CRS forecast internal costs	-15.026
SMETS1 forecast internal costs	-28.436
Benchmarking	-0.539
External Services	-0.455
Shared Service Charge	-20.739
Total cost disallowances	**-237.006**
Performance Adjustment Reductions	
OPR	-1.267
CRS performance	-2.044
Consultation AR excluding BM and ECGS adjustments	**3815.877**
Baseline Margin and ECGS adjustments	
BM adjustment (18/19 prices)	8.076
ECGS adjustment	8.013
Consultation AR with BM and ECGS adjustments	**3831.966**

Appendix 5 – Privacy notice on consultations

Personal data

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally), not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer

The Gas and Electricity Markets Authority is the controller (for ease of reference, "Ofgem"). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. ie a consultation.

3. With whom we will be sharing your personal data

We are not intending to share your personal data with other organisations. We are intending to publish non-confidential consultation responses, including any personal data that may be contained within them.

4. For how long we will keep your personal data, or criteria used to determine the retention period

Your personal data will be held for six months after the consultation closes.

5. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data
- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at https://ico.org.uk/, or telephone 030 3123 1113.

6. Your personal data will not be sent overseas

7. Your personal data will not be used for any automated decision making

8. Your personal data will be stored in a secure government IT system

9. More information

For more information on how Ofgem processes your data, click on the link to our "Ofgem privacy promise".