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Acronyms and Defined Terms SEC Glossary	

Ofgem Consultation - DCC Price Control Regulatory Year 22/23

1. Purpose

This paper provides an overview and summary of the Ofgem consultation on DCC Price Control for Regulatory Year (RY) 2022/2023.

The annex to this paper provides a summary of the Ofgem Price Control consultation for RY22/23 and initial views of SECAS for Panel consideration.

The Panel is requested to note the contents and discuss areas for inclusion in a response. A copy of the consultation can be found [here](#).

2. Next Steps

SECAS will work through the detail and seek input from relevant Sub Committees. SECAS will provide a draft response for Panel for approval at SECP_123 19 December 2023.

3. Recommendations

The Panel is requested to:

- **NOTE** the contents of the Annex and provide views of issues for inclusion in a Panel response.

Tim Newton

SECAS Team

17 November 2023

Attachments: Consultation Summary and Considerations – Annex 1

Annex 1 – DCC Price Control Consultation Summary Key Findings and Questions

Headline DCC Total Cost RY22/23.

DCC total reported costs for RY22/23 have increased by 24% to 611m, compared to last year's forecast costs for RY22/23. Ofgem notes that as with previous years DCC's inability to accurately forecast costs associated with procurement of new contracts as factors in the increase, along with an 81% increase in Internal Costs, in comparison to forecasts costs accepted under the previous Price Control review. This is quite concerning, given the potential move to Ex Ante in the near term and expectation that DCC costs and services are such there is confidence in the predictability.

Over the Licence Term (RY13/14 – RY25/26) DCC total costs are forecast to be 5.48billion, a 13% increase compared to the forecast last year for the same period.

External Costs Summary

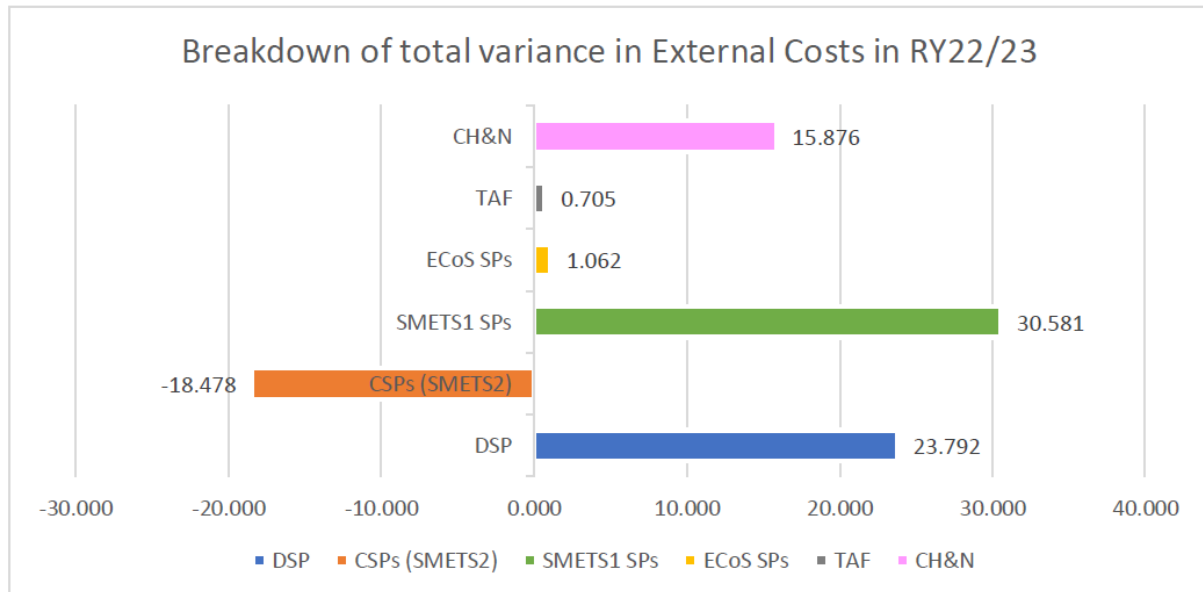
External Costs account for 70% of DCC Total costs in RY22/23. These costs are incurred by DCC Fundamental Service Providers (FSP) e.g., Data Service Provider and Communication Service Providers, plus SMETS1 Service Providers, 4G Communications Hub and Networks (4GCH&N), Test Automation Framework, Switching and Enduring Change of Supplier providers.

Over the course of RY22/23, DCC incurred c.£445.3m in External Costs, including Switching External costs. Table 1 below provides a breakdown of costs per programme.

Programme	Costs Incurred RY22/23 (£M)
SMEST2 Core	302.7
SMETS1	103.1
Switching	16.0
ECOS	6.9
4GCH&N	15.9
TAF	0.7
Total	445.3

Table 1.

When compared to last year's forecast, External costs are 14% higher in Y22/23 and 7% higher over the Licence Term. DSP and SMETS1 costs account for 71% of the increase in External costs. The consultation includes a helpful graphic copied below setting out the variances.



Ofgem Assessment External Costs

Ofgem have determined that DCC submission is acceptable to provide justification for most of its External Costs. However, DCC failed to provide in its initial submission any justification for the new contracts associated with the 4G CH&N programme and Test Automation Framework despite reporting £16.837m in new incurred costs. DCC also reinstated previously disallowed costs with contract extensions of two SMETS1 service providers without accompanying explanation. Ofgem also notes a number of reporting errors and a need to ask over a hundred clarification questions of DCC.

Ofgem propose to

- disallow £4.159m in incurred and £12.406m in forecast External Costs associated with associated with SMETS1 supply chain.
- disallow £2.675m in connection with poor performance of the SEMST1 service providers.
- disallow costs associated with 4G Comms Hubs & Networks procurements and, contingent on additional evidence, propose to disallow *up to* the full amount of costs incurred by DCC in RY22/23 in respect of one of its newly procured contracts.
- Ofgem propose to disallow £44.054m in forecast FSP External Costs on the grounds of insufficient evidence and uncertainty.

Ofgem ask 5 questions relating to External Costs

Question 1: What are your views on our proposal to disallow £4.159m in incurred External Costs and £12.406m in forecast External Costs associated with DCC's procurement of an interim solution for the SMETS1 supply chain?

Question 2: What are your views on our proposed cost disallowance of up to £2.675m in relation to SMETS1 service stabilisation in RY22/23?

Question 3: What are you views on our proposal for a disallowance up to the amount of External Costs incurred on a directly awarded contract in the 4G CHs & Networks programme?

Question 4: What are your views on our proposal to disallow £44.054m in forecast FSP External Costs?

Question 5: Do you have any other views on External Costs?

Initial SECAS views on issues arising from External Costs

- Disappointing recurring themes from last year e.g., procurement process not applied / followed. Concern that lessons do not seem to be learned / applied. DCC core role and purpose is contract management and procurement, it is concerning that competitive procurement is being called into question again.
- Very concerned that many clarifications were asked, and that recurring issues on quality of submission surface again. Panel called this out in response last year. This raises questions as to the rigour DCC applies to the process or seriousness its senior team places on the submission.
- Does Panel feel Ofgem are giving this area (accounting for 70% of overall costs) the right attention, given DCC monopoly position and core purpose to procure and manage contracts.

Internal Costs Summary

DCC Internal Costs are costs incurred excluding External costs, comprising Payroll Costs, Non-Payroll Costs, Recruitment, Accommodation, External Services, Internal Services, Service Management, Transition, IT services, and Office Sundry. DCC must demonstrate these costs are incurred economically and efficiently in the provision of the Services.

Internal costs are reported as £139.916m for RY22/23. An increase of £62m compared to forecast in RY21/22.

Ofgem Assessment Internal Costs

DCC has provided sufficient justification for most of these costs. Ofgem state there is an over reliance on external consultants for planning, scoping of projects and DCC has not provided evidence that alternative options have been considered. This may in part be explained by inclusion this year of Capita consultancy that was excluded in last year's submission. Ofgem remains concerned that DCC's management of existing contracts is not dealing with issues of poor performance and control of DCC Service Providers. Ofgem notes concerns that DCC is not focussing on Mandatory Business and has made disallowances for "innovation activities."

However, Ofgem propose to

- disallow £9.605m of non-resource costs incurred in RY22/23 due to a range of factors including inefficiencies in the planning and resourcing of activities, additional spend on the Business Accuracy Programme, Shared Service Charges, contractor benchmarking, as well as continued activity relating to innovation, which is not part of DCC's Authorised Business.
- disallow £1.914m of resource costs due to a lack of justification for the extra resource, particularly in the Security, Design and Assurance and Corporate Management cost centres, and the Network Evolution programme.
- disallow £44.625m of DCC's forecast costs over RY23/24 and RY24/25 which comprises of both resource and non-resource costs, due to insufficient justification for the additional resource and increasing costs.

- disallow £89.613m of baseline forecast costs for RY25/26 (end of the Licence term) due to a lack of justification provided by DCC.

Ofgem ask 8 questions related to Internal costs.

Question 6: What are your views on our proposals on disallow a 50% proportion of the RY22/23 resource costs associated to Corporate Management, Design and Assurance, Security cost centres and the Network Evolution programme?

Question 7: What are your views on our proposals on DCC's approach to benchmarking of staff remuneration for both contractor and permanent staff?

Question 8: What are your views on our proposal to disallow the continued costs that are linked to the activities that we disallowed in RY21/22 – these include additional costs associated with the Executive training programme, innovation, and growth as well as a continuation of the RY21/22 non-competitive procurements?

Question 9: What are your views on our proposal to disallow a proportion of the costs linked to the activities that we consider not have been resourced in the most economic and efficient way?

Question 10: What are your views on our proposal to disallow costs directly associated with the Business Accuracy Programme?

Question 11: What are your views on our proposal to disallow costs associated with the RY22/23 non-competitive procurements for which we have not received satisfactory justification or evidence?

Question 12: What are your views on our proposals on the Shared Service Charge?

Question 13: What are your views on our proposal to disallow forecast resource cost variances in RY23/24 and RY24/25; and disallow all baseline forecast costs for RY24/25 onwards?

Initial SECAS views re Internal Cost issues.

- Agree where insufficient evidence is provided or rationale that it is appropriate to disallow costs or deem them unacceptable. Agree DCC should prioritise core mandatory services, Panel raised these issues in the response last year.
- Focus should be on ensuring competition and proper use of procurement techniques to deliver value for consumers.
- Disappointing a number of issues are re occurring from last year e.g., Business Accuracy Programme.
- Disappointed that Ofgem notes that DCC is again incurring disallowed costs for innovation activity outside its Authorised Business.

Performance Incentives

Two performance incentives are reviewed in this year's Price Control review: the Operational Performance Regime (OPR) and Baseline Margin Project Performance Adjustment Scheme (BMPPAS). This is the first year the BMPPAS is reviewed.

DCC Baseline Margin (BM) margin at risk under the terms of the OPR for RY22/23 is £7.612m. 70% of margin at risk is associated with systems performance and 15% each is associated with customer engagement and contract management.

BMPPAS are set by the Secretary of State. The BMPPAS defines a Project and an incentive regime, which determines the BM DCC retains based on its performance in the defined Project. BM adjustments that are awarded to DCC for work associated with such a Project are held at risk by the BMPPAS incentive regime.

Ofgem Assessment Performance Incentives

Ofgem proposes the following actions following its review of DCC submission in accordance with OPR and BMPPAS for SMETS1.

- DCC should retain the full margin associated with system performance for RY22/23.
 - Ofgem note that no alternative means to measure DCC performance of SRV8.11 has yet been agreed. Ofgem will consult further on this issue ahead of the RY23/24. In respect of system performance calculation for RY22/23 Ofgem proposes to “zero weight the SRV8.11 metric for RY22/23”.
- the contract management incentive, is reduced by £0.489m.
 - Ofgem note a number of findings of the audit are like those of last year and that DCC has failed in some areas to act on the findings of last year. As a result, Ofgem have reduced the scores provided by the Auditor in respect of managing supplier performance and ensuring competition.
- the customer engagement incentive, is reduced by £0.381m.
 - Ofgem believe DCC has made sufficient efforts to engage and seek views from stakeholders, but there needs to be greater consistency with its quality of customer engagement. As a result, Ofgem proposes a reduction in the Baseline Margin.

In relation to the SMETS1 BMPPAS, Ofgem propose a reduction of DCC's BM of £6.995m. Ofgem accept that the reporting provided by DCC is acceptable, but DCC has performed poorly in meeting targets set out in the BMPPAS. Further Ofgem has rejected DCC request for a distribution of the BM reduction over a three-year period.

Ofgem asks 4 questions related to Performance Incentives

Question 14: What are your views on our proposed position on DCC's System Performance?

Question 15: What are your views on our proposed position on DCC's Contract Management?

Question 16: What are your views on our proposed position on DCC's Customer Engagement?

Question 17: What are your views on our proposed position on the assessment of the SMETS1 Baseline Margin Project Performance Scheme (BMPPAS)?

Initial SECAS Views on the issues relating to Performance Incentives.

- SECAS will work with OPSG members to garner views on the Ofgem assessment this year. Note the intent to consult further on System Performance and in particular the reference to SRV8.11.
- Observations on Contract Management per Auditor are welcomed. This has been a long-standing issue. The findings of the Auditor have already been scrutinised by Panel and commented upon this year. SECAS will repeat messaging where appropriate.
- Note the variability in messaging and communications that has occurred over RY22/23. SECAS will work with and seek endorsement of responses to this area from OPSG.
- Agree with the proposals for SMEST2 BMPPAS, assume Parties would seek to recover costs sooner where possible.

Baseline Margin Adjustment and External Contract Gain Share (ECGS)

The DCC Licence has a mechanism for DCC to apply to adjust the DCC Baseline Margin, recognising uncertainty over the nature of DCC Mandatory Business over the term of the Licence. The adjustment mechanism aims to ensure DCC is compensated for material changes in certain aspects of its Mandatory Business.

DCC has applied for a £24.02m Relevant Adjustment to its Baseline Margin for work performed (or forecasted) in RY22/23, RY23/24 and RY24/25. This is a significant increase compared to previous years' applications. For example, last year DCC applied for 13.27m.

The External Contract Gain Share (ECGS) acts as an incentive to DCC to seek and achieve costs savings, in the Fundamental Service Provider contracts.

DCC has applied for £5.208m over RY22/23 to RY25/26 relating to refinancing arrangements across Communication Service Providers (CSP).

Ofgem Assessment Baseline Adjustment and ECGS

Ofgem propose that,

- DCC application of £24.02m be adjusted to £10.424m (a reduction of £13.597m) from the application. This reduction is mainly due to cost disallowances for RY23/24 and RY24/25. If the forecast costs are justified in future Price Control submission, DCC will be able to keep the Baseline Margin associated.
- it accepts the DCC ECGS adjustment application for refinancing arrangements but rejects £0.051m relating to financing Tranche 2 Communication Hubs

Ofgem asks 2 questions relating to Baseline Margin Adjustment and External Contract Gain Share.

Question 18: What are your views on our assessment of DCC's application to adjust its Baseline Margin?

Question 19: What are your views on our assessment of DCC's application to adjust its ECGS?

Initial SECAS views on the Ofgem position.

- Agree with the position proposed for the Baseline Margin Adjustment. If the DCC has not provided appropriate justification and evidence this is the correct course of action.

- Agree with the proposal on External Contract Gain Share. It is not appropriate where costs have risen per unit price, (temporary or otherwise) for this mechanism to apply i.e., there has been no cost reduction.

Switching Programme

Whilst DCC Switching Programme costs are overseen by the Retail Energy Code (REC) manager, details of these are included here for completeness. As in previous years, we do not anticipate a Panel response to this section. DCC incurred total costs of £21.392m in RY22/23 relating to provision of services under the Switching Programme.

Ofgem Assessment Switching Programme.

Ofgem determines the costs incurred in RY22/23 are economic and efficient. However, Ofgem proposes to disallow DCC forecast costs to the end of the Licence which totals £44.514m (Internal costs of £13.432m and External Costs of £31.082m due to cost uncertainty and insufficient justification).

Ofgem also determines that the requirements of programme delivery milestone have been met and DCC is therefore entitled to earn the 30% of its margin at stake against that milestone. This means that DCC has earned 70% of its margin in total under the incentive framework, having met four of the five milestones available.

Ofgem asks 2 questions relating to the Switching Programme

Question 20: What are your views on our proposed position on DCC's costs associated with Switching?

Question 21: What are your views on our assessment of Delivery Milestone 5 of the Switching Programme?

Initial SECAS views on the issues raised.

- We note the proposal from Ofgem but as the Switching Programme is outside SEC governance, it is not appropriate to comment.

Proposals to amend DCC Baseline Margin Adjustment and Shared Service Charges

DCC Baseline Margin Adjustment

Ofgem propose that in future a reasonable margin for DCC to earn the Baseline Margin (BM) adjustment mechanism should be a range of 7-9%. (Since the start of the Licence Term it has been left at 15%). Ofgem believe now is an appropriate time to review the value of the BM adjustment.

Shared Service Charges

The inclusion of Shared Service Charges (SSC) was agreed through the Licence Tender process. It is calculated as a percentage of eligible internal costs set out in the LABP and enables Capita to recover 9.5% of the eligible services it provides to DCC. Between RY13/14 and RY21/22 DCC has procured Services from Capita with a value of c.77.5m. Ofgem believe it is no longer appropriate for Capita to recover charges at a rate that was deemed competitive 10 years ago. From April 2024, Ofgem propose that the SSC is adjusted to 4.5%, which Ofgem consider is more reflective of charges associated with the services provided under SSC.

Ofgem also propose that from April 2024 any services procured by DCC from Capita, whether through the SSC arrangement or through a separate service contract, should not be eligible to earn any additional BM through the adjustment process. Capita will still be able to bid for DCC contracts on a competitive basis. No amendment to the DCC Licence is required for these proposals to take effect.

Ofgem asks 3 questions relating to Baseline Margin Adjustment and Shared Service Charge Proposals.

Question 22: Do you agree with our proposal to apply a margin somewhere in the range of 7-9% when calculating BM adjustments from 01 April 2024 onwards? Do you have a specific figure that you think should be applied?

Question 23: Do you agree with our proposal to adjust the Shared Services Charge (SSC) from 9.5% to 4.5% from 01 April 2024 onwards?

Question 24: Do you agree with our proposal that any services provided to DCC by Capita, whether through a services contract or through the SSC arrangements, should not be eligible to earn any additional BM through the adjustment process from 01 April 2024 onwards?

Initial SECAS views for consideration.

- The arrangements have been in place since the original Licence award. A formal review is overdue. Do Panel members have specific views on the value of the % proposed – 7-9%.
- It is prudent that these are revised and adjusted to better reflect the services provided.
- It is appropriate that Ofgem have reviewed them, and that as with any other Service Provider any additional Baseline Margin, if appropriate, should only apply through an open and transparent process.