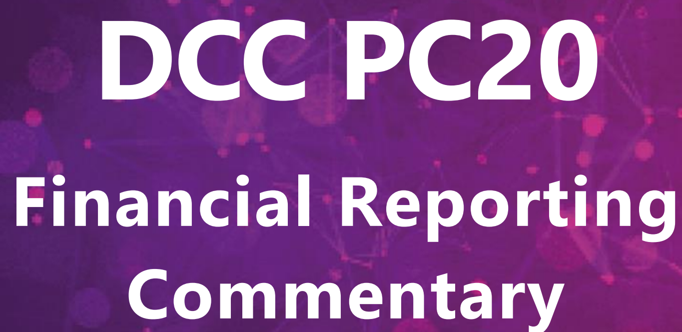

DCC PC20

Financial Reporting Commentary

Version: Redacted
Date: 01.10.2020
Author: DCC
Classification: DCC Public

Table of Contents

1 Introduction and purpose 2

2 Developing the 'RIGs forecast' 2

3 RIGs worksheet 3: the correction factor 4

4 RIGs worksheet 8: Regulated Revenue v statutory revenue 6

5 RIGs worksheet 9: cashflow 7

6 Specified information: supporting questions 13

7 Penalty Interest 22

1 Introduction and purpose

The purpose of this document is to set out supporting financial information to the DCC Price Control 2020 submission. In summary it sets out:

- the assumptions applied in populating the RIGs template
- responses to questions in the RIGs template (worksheets 3, 8 and 9)
- specified information: supporting questions 9.7, 9.8, 9.14, 9.16 and 9.17; and
- commentary and justification, if required, for the penalty interest regime.

2 Developing the 'RIGs forecast'

The 'RIGs forecast' is the forecast costs included in the RIGs price control templates. These are determined as part of the business planning process undertaken in early 2020, which focusses on forecasts for the next four years.

We allocate all forecasts to one of two categories they are 'committed' or 'discretionary'. The forecasts included in the price control forecast are only those deemed 'committed' as these meet the certainty threshold required for price control i.e. more likely to be incurred than not. For this reason, the RIGs forecast will always be lower than the forecasts included in the quarterly charging statements and budgets. Factors used to determine which category to assign costs are:

- Committed – all costs subject to signed agreement, for changes it will be only those that have an associated CAN (Change Authorisation Note)
- Discretionary – expected but not yet contracted e.g. CRs raised but not yet contractually, contingency, etc

The following sections set out some key assumptions made when setting the RIGs forecast.

2.1 Internal costs

2.1.1 Payroll, non-payroll and recruitment

These three GL codes[1] fall under what we call 'resource' costs. Whilst we have included forecasts for these categories for all future years, detailed justification has been provided for RY2020/21 and RY2021/22 only. This is due to the uncertainty we face as we exit the rollout phase of smart metering. However, we expect to continue to require much of the resource until the end of the licence.

2.1.2 Internal Services

Internal services are largely contractual in nature. Therefore, wherever possible, we have estimated cost forecasts based on the known contracted values and end date. There are some contracted services which we know will be required beyond the contract end date. For those, we have produced estimates based on a cost trend of the existing services.

[1] Ofgem, July 2019, Regulatory Instructions and Guidance (RIGs), Appendix 4

2.1.3 IT services

IT services are forecasted in a similar manner to external and internal services in that we base estimates on existing contracted values and end dates, or extensions where we know services will be required beyond the contract end date. There is a variable element to this, which is based on headcount.

2.1.4 Accommodation

Accommodation forecast costs are based on annual contract values and contract terms. DCC assumes a continuation of existing accommodation costs until the end of the Licence in 2025. Although all accommodation costs have cancellation clauses that allow DCC to exit the contracts based on the individual contract's notice period (usually a year), and for the Manchester office (Brabazon House) the lease can be renegotiated with the landlord in September 2021, we have forecast through to the end of the Licence in recognition that DCC is obligated to provide the services set out in our Licence. As such, we consider this to meet the condition of sufficiently more likely than not to occur. Note that all accommodation costs are recognised in the Corporate Management cost centre.

2.1.5 All other costs

External services and Service Management costs are based on contracts with specific start, end dates, and values. Therefore, we have forecasted to contract end date, distributing the cost evenly if there are no milestone payments or when it crosses over multiple regulatory years. There are some small values against the 'office sundry' category such as subscriptions. There is no forecast under the 'transition' GL code.

2.1.6 Additional baseline and new scope

For this year's submission we have moved all 'new scope' items to 'additional baseline', this was due to a change in the template by Ofgem. In this year's submission, there are no items in 'new scope'. For ease of variance analysis, we have also moved the baseline to additional baseline (see tab 12c in the main RIGs reporting template).

2.2 External costs

2.2.1 Set-up costs

Where set-up costs extend beyond the length of the DCC Licence they have not been included in the RIGs. This means that a CAN value or total contract value may be higher than the total included in the RIGs for the related change request (CR)/contract.

User integration testing charges and Communication Hub asset and maintenance charges are shown as invoiced in the respective lines in baseline. Variations comprising of CRs, indexation impact and volume changes will be explained as part of the variance explanation.

Financing arrangements for the CSPs have been reflected as they are invoiced. For both CSPs they have multiple CRs and projects that have been financed in one tranche of financing, and therefore one invoice is received for this tranche. In the RIGs, this is reflected as one line – e.g. Financing Tranche 1. Explanations in the narrative will be provided based on material CRs and projects within these categories. To provide more detail on the components of the financing tranches for both Arqiva and Telefonica supplementary schedules have been provided in the RIGs supplementary schedules document.

2.2.2 Fixed operational charges or enduring costs

Where these costs extend beyond the length of the DCC Licence they have not been included in the RIGs. This means that a CAN value or total contract value may be higher than the total included in the RIGs for the related change request (CR)/contract.

All fixed operational charges billed as a single value for fixed operational charge each month from the supplier are shown in the 'fixed operational charges' or 'enduring costs' line in baseline external costs. Variances to LABP and prior year regulatory reporting, which will comprise new CRs and indexation, will be explained as part of the variance explanation. Indexation is not shown separately in the RIGs, it is explained in Section 6.4 of this document.

3 RIGs worksheet 3: the correction factor

Q1: Please provide associated commentary regarding the Correction Factor. This should include commentary regarding significant components of the Correction Factor (such as prudent budget, credits from service provider performance, unclaimed service provider incentive payments, related interest received).

The cumulative correction factor as at the end of RY2019/20 is £31.555m. This correction factor is the total of variances between Regulated Revenue and Allowed Revenue for each regulatory year, adjusted for indexation, as shown in the table below. Variations for all prior years have been explained in prior year submissions; therefore, we have focussed the explanation on the variance for RY2019/20.

	RY13/14	RY14/15	RY15/16	RY16/17	RY17/18	RY18/19	RY19/20
Regulated Revenue	19.500	44.800	115.643	241.209	257.924	403.647	518.434
Allowed Revenue	13.396	32.184	99.173	195.880	220.771	371.227	474.906
Correction factor unindexed	6.104	6.482	3.790	28.809	(8.337)	(4.981)	10.876
Annual correction factor		(6.134)	(6.515)	(3.801)	(28.911)	8.392	5.016
Cumulative correction factor indexed		(6.134)	(12.680)	(16.521)	(45.490)	(37.401)	(32.652)

Table 1 – Annual correction factor (£m)

The table below sets out the key components of the variance for RY2019/20, which contributes to the correction factor.

	RY19/20
Additional revenue from increased meter numbers against estimate	2.742
Interest received on cash balance	0.969
Correction factor returned to customers	(6.452)
Lower Pass-through costs than estimated	0.006
Unused prudent estimate	10.885
BMPA	1.322
Switching margin variance to CS20	0.234
Explicit and comms hub charges recognised in PC19 but billed in PC20	1.003
Timing adjustments	0.167
Total	**10.876**

Table 2 – Correction factor components RY2019/20 (£m)

Regulated Revenue in the year is composed of fixed charges invoiced to customers in accordance with the Charging Statement for RY2019/20, explicit charges invoiced to customers for specific additional

products or services e.g. user gateway connections, remote test labs, CIO assessments and test hubs and interest accrued on cash balances in the year.

The main components driving a variance between Regulated Revenue and Allowed Revenue shown in the table above include:

- Lower pass-through costs than estimated, primarily due to SECCo Ltd incurring less costs than it had budgeted
- Unused prudent estimate after allocating additional External and Internal costs
- Additional revenue from additional meter numbers
- Return of previous year's correction factor
- Balance of explicit charges and Communications Hub charges to be billed out to customers as at the end of March 2020.

3.1 The correction factor and its impact on RY2019/20 charges

We use the correction factor to:

- return (or recover) any difference between Allowed Revenue and Regulated Revenue with respect to the prior Regulatory Years (which may include the prudent estimate); and
- to reflect any incurred costs disallowed by Ofgem

Four categories of correction factors apply, they are:

- Main correction factor
- Single Band Communications Hubs correction factor
- Dual Band Communications Hubs correction factor
- Alt HAN correction factor

These are separated as they apply to different charges payable by different customer types.

Under the standard correction factor process, any over/under-spend is returned/recovered from customers two years later. This is because all expenditure is subject to price control, therefore all allowed expenditure for a given year is confirmed almost a year after the end of that period and so is reflected in the following year's charges[1].

[1] For example, under the standard process all allowed expenditure in RY2017/18 (ending March 2018) was confirmed in February 2019, therefore it would have been reflected in RY19/20 charges therefore paid/recovered in full by March 2020.

4 RIGs worksheet 8: Regulated Revenue v statutory revenue

Q1: Where Regulated Revenue differs from revenue as presented in the statutory accounts, please provide an explanation of the divergence between these.

The revenue reported in the statutory accounts for the year ended 31 March 2020 was £433.046m, and finance income was £14.519m[1]. The Regulated Revenue for the same period was £518.434m.

	RY19/20
Regulated Revenue	**518.434**
Annual correction factor (see Section 3)	(10.876)
Explicit and Comms Hub charges recognised in balance sheet	(18.017)
Net impact of milestone and finance charge accruals offset against invoicing for External costs	(37.600)
Accruals for items to be included in Price Control in a future year	(2.617)
Assets capitalised on the balance sheet	(2.000)
Timing for recognition of baseline margin/ECGS/disallowed costs in Annual report vs Price Control	0.242
Revenue reported in the statutory accounts	**447.565**

Table 3 – Variance between Regulated Revenue and statutory accounts revenue (£m)

The main contributors to the variance include:

- **Annual correction factor** – see Section 3 of this document
- **Explicit and Comms Hub charges recognised in balance sheet** - in the statutory accounts, these charges are accounted for on an agency basis and therefore are not reflected as a cost or revenue in the income statement, but on the balance sheet. They are recognised in Regulated Revenue in Price Control.
- **Net impact of milestone and finance charge accruals offset against invoicing for External costs** – the accounting treatment applied for recognition of milestone values when achieved and accrued finance charges on the liability position with suppliers (i.e. amounts owing to suppliers for milestones they have achieved, being repaid on a monthly basis over a set period of time). In Regulated Revenue only amounts invoiced in the year are included.
- **Accruals for items to be included in Price Control in a future year -** recognition of provisions in the statutory accounts for costs that will not be confirmed until a future year, e.g. the final payment of a long-term incentive scheme spanning two years.
- **Assets capitalised on the balance sheet** – these assets are in relation to the Manchester office (Brabazon House) and do not appear as costs, and therefore revenue in the statutory income statement. The value of these assets is included as recoverable costs in Regulated Revenue.
- **Timing for recognition of baseline margin/ECGS/disallowed costs in Annual report vs Price Control** - recognition of External Contract Gainshare and Baseline Margin application values in the statutory accounts relating to the accounting period up to March 2020 (i.e. on an accruals basis). In Price Control these are recognised in the relevant regulatory year where they can be charged, in line with Ofgem's direction. There is a timing mismatch with adjustments being directed to a future year's charging statement but being accrued in the statutory accounts in the period they relate to.

[1] We report this income separately in order to comply with IRFS15. This income relates to the finance charges we incur from the DSP and CSPs

5 RIGs worksheet 9: cashflow

5.1 Cashflow

Q1: Please provide a supporting commentary of the Smart Meter Communication licensee's monthly cash flow balances

5.1.1 Factors impacting cashflow

The monthly cashflow balances are driven by the following factors with respect to cash payments and receipts:

- Invoices to SEC Parties are charged on or around the third working day of each month following the charging period. Payments are received within five working days following the receipt of the invoice.
- Internal Costs, Baseline Margin and corporate overhead are invoiced by CBSL (Capita Business Services Limited) to DCC on a monthly basis in arrears. Cash settlement is usually made in the month following receipt of the invoice.
- VAT is charged on invoices at 20%, and payments to HMRC are due quarterly in February, May, August and November.
- Pass-Through Costs to SECCo Ltd and AltHANCo Ltd for the year are based on their respective budgets and are normally charged in 12 equal monthly instalments. Invoices are received monthly in arrears and payment terms are 30 days. For SECCo Ltd, subsequent to the year-end a balancing credit or debit is calculated and issued.
- DCC pays invoices for Internal, External and Pass-Through Costs within 30 days after invoice, depending on the payment terms.
- Payments for accrued costs will be made in the following month, dependent on timing of receipt of invoices and relevant payment terms.

5.1.2 Cash balances in RY2019/20

At the end of March 2020, our closing cash balance was £54.975m. Of this amount £14.975m was credit cover held for customers, and £40.000m was available to cover liabilities due at the end of the year, including VAT payments, amounts relating to March 2020 invoices due to CBSL and to other Service Providers, and short-term accruals.

The table below shows the breakdown of month end cash balances in RY2019/20 between the trading account and the credit cover deposit account.

£m	Apr-19	May-19	Jun-19	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19	Jan-20	Feb-20	Mar-20
Trading Account	44.886	54.197	45.572	41.369	43.309	48.388	42.846	51.482	44.058	48.229	54.304	40.000
Credit Cover	7.536	7.536	7.692	7.696	8.283	8.799	9.062	9.400	9.419	15.877	16.144	14.975
Cash Balance	**52.423**	**61.760**	**53.264**	**49.065**	**51.591**	**57.187**	**51.908**	**60.883**	**53.477**	**64.107**	**70.488**	**54.975**

Table 4 – Breakdown of month end cash balances in RY2019/20

Figure 1: Cashflow and month end balances in RY2019/20 below illustrates our month end cash balances, cash inflows and cash outflows over RY2019/20.

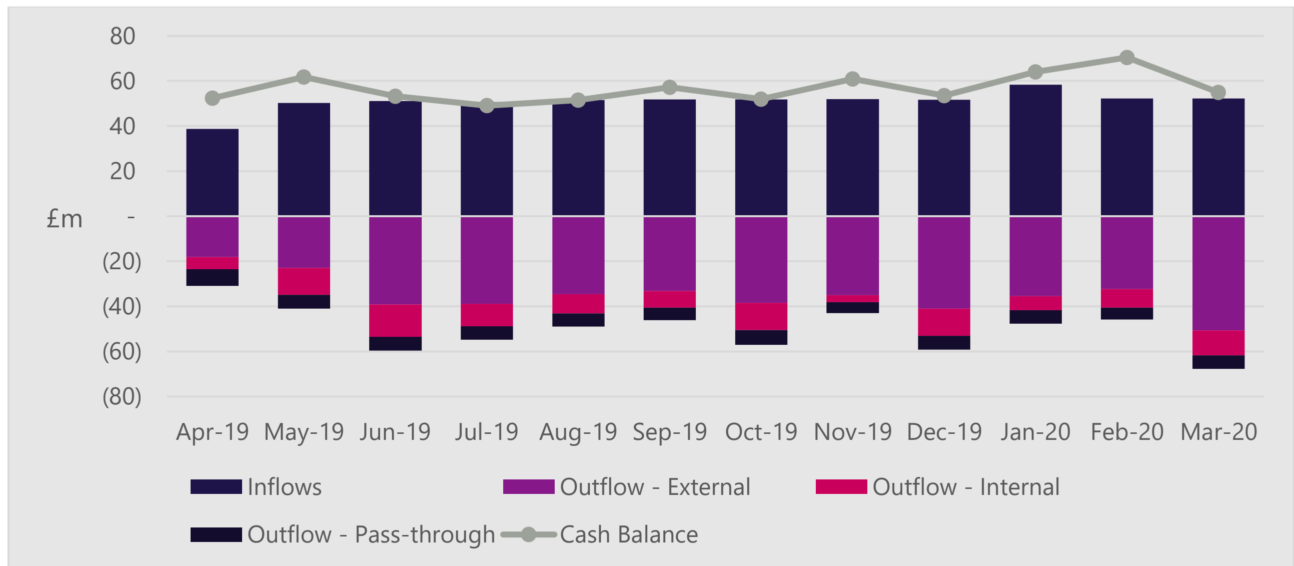

Figure 1: **Cashflow and month end balances in RY2019/20**

April 2019 had a reduced cash inflow because of amendments to the RY2018/19 charging statement to issue the correction factor back to customers early. April 2019 is also the cash inflow relating to the RY2018/19 March 2019 Fixed charge to customers, the RY2018/19 fixed charge was lower than the RY2019/20 fixed charge. The Fixed Charge cash inflow for the remainder of RY2019/20 was then consistent, the variations to the inflows are due to customer credit cover adjustments.

Cash Outflows – Internal costs and margin

Cash outflows for Internal Costs have ranged from £3.123m to £14.417 throughout RY2019/20, and on average are £8.681m per month (excluding VAT). Figure 5-1 includes the impact of VAT payments within Internal costs.

Cash Outflows – External costs

Payments to FSPs (including SMETS1) have ranged between a low of £18.193m in April 2019 to a high of £50.510m in March 2020. For the three SMETS2 FSPs, new milestones continue to be contracted, with repayments under new financing arrangements commencing in RY2019/20. SMETS1 payments have continued throughout RY2019/20. Payments to Switching suppliers have also commenced in RY2019/20, driving a higher average cash outflow of £35.0m compared to the prior year (£30.1m).

The largest cash outflow was in March 2020 of £64.862m. [REDACTED]

Cash Outflows – Pass-Through Costs

Average Pass-Through Costs outflows were £3.097m per month, including VAT in RY2019/20.

5.1.3 Forecast cash balances in RY2020/21

At the end of RY2020/21, the estimated closing cash balance is £63.0m. Cash inflow increases from May 2020 onwards to an average of £66.3m per month including VAT, which comprises monthly fixed charges of £61.8m and estimated billing for Communications Hubs and Explicit Charges.

£m	Apr-20	May-20	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20	Jan-21	Feb-21	Mar-21
Trading Account	27.602	30.979	11.839	17.949	26.002	30.563	21.526	18.450	25.047	29.006	40.211	48.046
Credit Cover Deposit	14.982	14.982	14.982	14.982	14.982	14.982	14.982	14.982	14.982	14.982	14.982	14.982
Cash Balance	**42.584**	**45.960**	**26.821**	**32.931**	**40.984**	**45.545**	**36.508**	**33.431**	**40.029**	**43.988**	**55.193**	**63.028**

Table 5 – Breakdown of month end cash balances in RY2020/21

Figure 2 shows our forecast month end cash balances, cash inflows and cash outflows over RY2020/21.

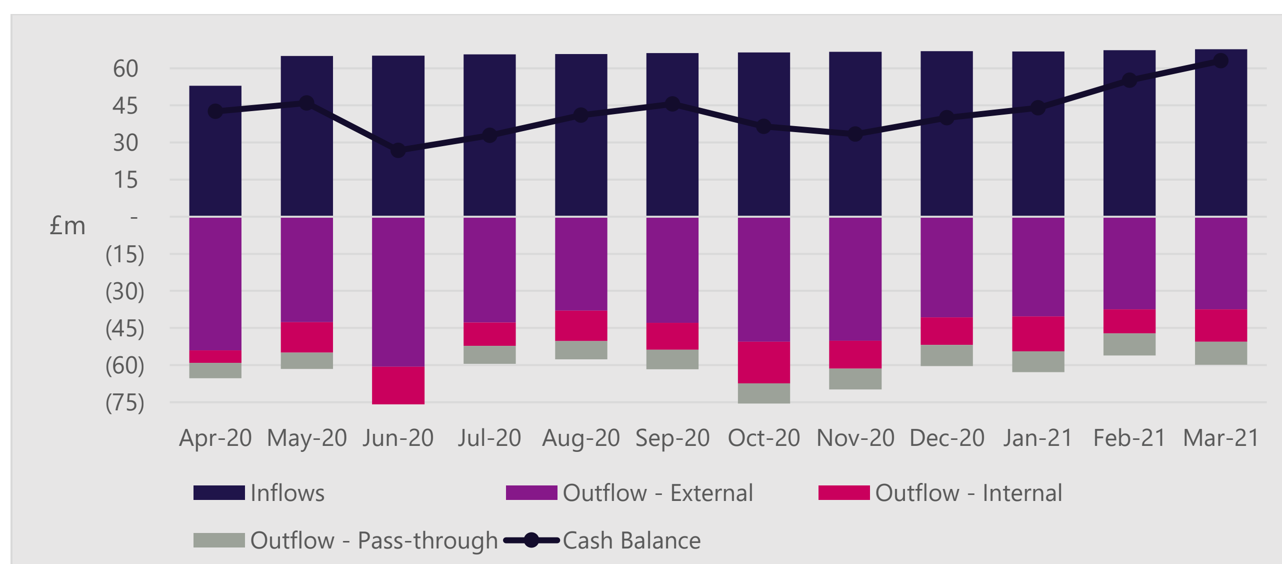

Figure 1. Cashflow and month end balances in RY2020/21

The cash balance peaks in April 2021 at £63.0m, largely due to the cash inflow being straight line and the first half of the year incurring larger outflows than the second half of the year.

Cash Outflows – External costs

External Costs are the main contributor to material cash outflows. The level of monthly payments is forecast to average £43.782m. The largest monthly outflow is forecast to be £57.136m and the lowest to be £36.889m. We are also forecasting an increased level of charges for Communications Hubs in line with increased volume assumptions.

Cash Outflows – Internal costs and margin

Internal costs (including margin) cash outflow is forecast to be, on average, £11.152m per month. The highest outflow is forecast in June 2020 (£16.825m) largely due to DCC paying Capita for the DCC RY19/20 and two-year retention bonus pay outs. The cost recharges covered in these payments will include outcomes of the RY2018/19 price control determinations (i.e. additional baseline margin amounts and external contract gain share values, billed in April 2020).

Cash Outflows – Pass-Through Costs

Overall Pass-through costs outflows are forecast to be higher than RY2019/20, with the average outflow forecast at £3.402m in RY2020/21.

5.2 Liquidity Requirements

Q2: Please explain the operating liquidity requirements of the licensee's business. What are the factors impacting on peak business cashflow requirements?

It is very important that DCC provides predictable forecasts to its customers so that they can manage costs and cashflows ahead of time. Most of the receipts from customers are based on a fixed charge per meter and are set in advance; therefore, cash inflows are relatively consistent on a month by month basis. DCC's ability to remain liquid is dependent on the accuracy of its cost forecasting, which forms the basis of the advance charges to customers. DCC maintains a policy of charging enough to be able to meet its cost obligations without increasing charges in the year, in line with our Licence obligations. Where feasible we have returned funds to customers within the year as part of the final charging statement, amending monthly charges for the last 2 or 3 months of the year. This has been done in both RY2017/18 and RY2018/19.

Several of DCC's costs have payment profiles that can be reasonably forecast across the course of the year. They are either made up of regular, fixed payment amounts, or they are known in advance, for example Baseline Margin amounts stipulated in the Licence. These cost elements include the following:

- Pass-Through Costs to SECCo Ltd are agreed in advance at the beginning of the year. The charge is normally spread across the year in 12 equal monthly instalments. At the end of the year, a balancing debit or credit amount is charged to DCC and is settled in the following Regulatory Year
- The Baseline Margin in any given year is defined in the Licence and is therefore known in advance for the entirety of the Licence term
- Rent, rates and service charges are outlined in our lease agreements which are fixed for a set period, subject to inflation

- Resource costs for permanent DCC staff can reasonably be estimated month on month. Costs for contractors and new resources are more difficult to forecast with certainty
- An element of costs with Service Providers that are made up of fixed charge amounts; these costs are defined in their contracts. These can also include financing payments made either to FSPs or directly to banks.

The factors affecting DCC's peak cashflow requirements are therefore driven by expenditure with less predictable or fluctuating payment profiles and values. These include:

- SMETS2 External Costs: Expenditure to our FSPs is based on contractual payments and represents DCC's largest cash outflow. There are three main SMETS2 Programmes where costs could change compared to the forecast; DIT extension, Release 3.2 and the yearly June and November release which includes SEC Modifications. The potential change is much lower than in previous years as the total size of these programmes are considerably smaller than previous SMETS2 Releases.
- SMETS1: Payment profiles for SMETS1 fluctuate, this is due to the programme not currently being live. Due to the complexity of the programme, if go-live dates change, then set-up costs for the programme may change/increase. We expect operational costs to offset additional build costs if the programme commences later. Mitigation for an increase in costs might be compensated for by a drawdown of the prudent estimate and/or financing costs. Currently, most of the SMETS1 set-up costs are charged on a time and materials basis.
- CRS/Switching: the Design, Build and Test phase is well under way. Cost forecasts for this programme are more certain, we do not expect to CRS to be volatile enough to materially impact our cash flows.
- Network Evolution: The largest programme that is in its infancy is Network Evolution, with some key decisions still to be made. The costs for this programme are expected to be material and for RY2020/21 we have included a high-level placeholder cost forecast. We are actively managing any risk associated with achieving spend within the assigned placeholder.
- Resource costs: the timing of recruitment and volume of FTE can be impacted in particular by any change in the go-live and updated plan for SMETS1 and the increase in the volume of activity. In the past sometimes short-term FTE have been required for longer and more FTE have been required to support the additional activity.
- IT costs and non-resource costs: Until SMETS1 is live the risk that the programme can be extended remains. Potential cost increases are from additional use of the SMETS1 delivery partner and other professional services.

5.3 Prudent Budgeting Arrangements

Q2: Please explain how prudent budgeting arrangements have been applied in managing the licensee's cash balances. Please provide supporting assumptions.

5.3.1 Management of cash balances

DCC does not aim to (and has not, to date) asked for additional funds from customers mid-way through a regulatory year. In fact, in RY2017/18 and RY2018/19 DCC took proactive steps to return cost savings (earned in RY2016/17& RY2017/18 through cost savings) to its customers earlier than it would have done through the correction factor mechanism.

DCC's key step to prudent budgeting is the maintenance of a detailed cashflow forecast, updated and reviewed monthly, with comparison to actuals, to determine the timing of significant cash inflows and outflows. DCC engages in a continuous, ongoing process of risk assessment and review with respect to cash outflows. This ensures that cash balances do not fall to levels that are too low at any point in time.

This minimum balance has increased from the prior year as our regular monthly charges have increased with the payments of External costs, although the absolute level of cash as at 31 March 2020 is broadly in line with the balance at the beginning of April 2019.

Internal and External cost forecasts are prepared, challenged and maintained by the Finance Business Partners. They are reviewed on a monthly basis by the Head of Commercial Finance and the Chief Financial Officer.

The Board has the ultimate responsibility for assessing risk and making strategic cashflow decisions. The overall process is in place to ensure that costs are challenged robustly to ensure that DCC only spends money where necessary and that it can justify as being economic and efficient in the overall delivery of DCC services.

The management of the cashflow forecasting process is further supported by the following activities:

- Bottom-up annual budget process that involves the challenge of all existing assumptions
- Quarterly reforecasting and review process with the business, including all DCC internal budget owners and external providers

How do we apply prudent budgeting arrangements?

The cash forecasting process is broadly based around three factors:

- Consideration of any commitments for the year ahead
- Consideration of the revenue to be collected through the period
- Opening and closing cash balances at the end of that period

Understanding our commitments to forthcoming expenditure is therefore the key driver in understanding our required cash inflows, and thus, developing a prudent budget.

External Costs

External costs make up the largest future cash commitments for DCC and therefore uncertainties in timing and volume with respect to these items have the most material impact on our cashflow forecasting. The following, specific assumptions are made with respect to cash outflows for External costs when preparing the monthly cash forecast data:

- The timing, value and profile of cash outflows are assumed to be in line with the current contracts with FSPs.
- The timing, value and profile of cash outflows with respect to agreed contract changes are assumed to be in line with details outlined in the change authorisation notes, or in line with details provided directly from the FSPs via the commercial team.
- Where contract changes have not been approved, the value of the cash outflow is assumed to be in line with the latest Impact Assessment value received from the FSPs.
- For contract changes where an Impact Assessment is not yet available, a judgement is made to establish a ‘rough order of magnitude’ for the value of the contract change using information provided from the FSP. Where the FSP provides a range for the ‘rough order of magnitude’, we use the midpoint as the best estimate.
- Where the FSP cannot provide an early indication as to the magnitude of the change value, we use historic information for similar changes proposed, or values proposed for the same change by other Service Providers as a basis. One or more changes with a similar nature and magnitude are chosen as a benchmark.

- The Commercial Finance team works closely with the programme, design & assurance and operational teams to understand the pipeline of activities they have identified as future spend. The relevant size and payment profile of these changes are analysed against existing changes and added to our forecast of future activities.

Internal Costs

The following specific assumptions are made with respect to cashflows for Internal costs when preparing the monthly forecast data:

- The basis of cash flow forecasts for Internal costs is the budget set at the start of the year for each business area. The uncertainties around the delivery timetable and the changing timeline of the plan have a direct impact on Internal costs as teams review and amend their recruitment plans.
- Monthly financial performance review meetings are undertaken with budget owners. Any material costs that the budget owner is aware of but for which a business case is still outstanding will be included in the cashflow forecast using the budget owners' most up-to-date cost and timing assumptions.
- Rent, rates and service charge cost information are based on amounts included in our lease agreements and is known to be charged on a monthly basis. Other accommodation costs associated with the maintenance of the building are estimated and included using historic data as a basis for any assumptions.
- For other internal or external services procured, we use values included in signed agreements, engagement letters or contracts. The assumption is that values will be the same amount where the engagement will be renewed on an ongoing basis. This would include recurrent costs such as audit fees.
- For IT contracts, fixed cost amounts are included in the cashflow forecast based on original signed contracts. Time and materials costs are based on up-to-date models or current forecasts from the Service Provider, which are assessed by the project managers we have in place for each material project.
- During Quarter 3 of each year, we undertake a detailed business planning review for each cost centre and activity to assess the validity of roles and activities in DCC. This is an exercise to test the validity of all interim roles and activities that are undertaken by each cost centre. The cost centre managers are asked to take a strategic view on future direction of their departments and how it is working to deliver on DCC's main objectives. This is an exercise to challenge the assumptions and agree on a credible and realistic budget position for each area in DCC.

6 Specified information: supporting questions

This section responds to 6 of 16 of the supporting questions detailed in Section 9.2 to 9.17 of the RIGs guidance document. They are:

1. Definition of baseline (9.7)
2. New Scope project[1] definitions (9.8)
3. Prudent estimate of Allowed Revenue (9.9)
4. Real Price Effects (9.14)
5. Income Statement (9.16)
6. Approach to materiality (9.17).

[1] 'Project' in this context is not limited to 'Project' as defined in the Licence as work linked to a Baseline Margin Project Performance Adjustment Scheme.

6.1 Definition of baseline (9.7)

Please provide a full definition of the requirements that the Licensee considers to be included in its reported and forecast Baseline Internal and External Costs. Please confirm that this definition of requirements has been used to report incurred and forecast Baseline costs in the current year regulatory reporting template.

The definition of the requirements that are included in baseline internal and external costs are unchanged from the previous reporting year.

New items added to additional baseline are:

- Internal costs: one new project has been added to 'additional baseline' which is network evolution. This project is explained in Part 4 of the PC20 submission.
- External costs: new projects have been added for contracted changes and finance tranches approved in the year. These have been explained in Part 3 of the PC20 submission.

We can confirm that this definition of requirements has been used to report incurred and forecast Baseline costs in the RY2019/20 regulatory reporting template.

6.2 New scope project definitions (9.8)

Please provide definitions and justification for any additional New Scope projects that were added to the reporting template in the current regulatory reporting year. Please explain how the project scope relates to the scope of Baseline activities and existing New Scope projects. Please provide explanations for the New Scope projects' forecast costs.

No New Scope projects were added to the RY2019/20 regulatory reporting template.

6.3 Prudent estimate of Allowed Revenue (9.9)

Please detail the uncertainties, activities, assumptions and any relevant modelling that has informed the prudent estimate of Allowed Revenue for the current reporting year and updated forecasts of Allowed Revenue prudent estimates for future regulatory reporting years. Please describe the steps that the Licensee has taken to manage its prudent estimates of Allowed Revenue efficiently

DCC must achieve a balance between raising charges in-year and collecting more cash from customers than required. Reasons why it may need to raise charges in-year may be due to assumptions being incorrect at the time of setting charges or new spend being required at short notice. However, it recognises that this can cause disruption and uncertainty for customers.

DCC includes a prudent estimate in accordance with Licence Condition 36.5 to ensure that the Service Charges they apply for in the relevant regulatory year will not need to be amended in the course of that year except in response to a reasonably unlikely contingency. This requires DCC to consider the risk associated with its costs at the time the Charging Statement is set.

Allowed Revenue for any year is first set in the Charging Statement for a particular regulatory year. This prudent estimate of Allowed Revenue is built up from our budgeting and forecasting of cashflow, resulting in two models; an Internal cost model and an External cost model. These models are maintained independently and consolidated to provide the total estimated Allowed Revenue, which forms the budget for that Regulatory Year.

Our prior year submission provided information in relation to the prudent estimate of Allowed Revenue for the forecast year of RY2019/20. Therefore, our response in this year's submission focuses on the forecast prudent estimate of Allowed Revenue for RY2020/21.

We set the prudent estimate for RY2020/21 equivalent to three weeks' expenditure i.e. the value is set at 5.8% (3/52) of the forecast Internal and External costs for forecast for that year, capped at £20m p.a. The Internal and External costs, and the assumptions and uncertainties around this are key in ensuring that DCC does not charge customers too early. The prudent estimate of Allowed Revenue set in our RY2020/21 Charging Statement is based on the following areas:

- Activities
- Uncertainties; and
- Assumptions.

These are explained in further detail below.

6.3.1 Activities

The costs included in the estimate all relate to activities required for the provision of Mandatory Business, including new projects that we have been tasked to manage and support. In RY2020/21, it was forecast that these activities would centre on ongoing assurance of solution design, testing, assurance of service delivery, supporting the ramp-up of installations during the year, the Design Build and Test phase of Switching, SMETS1 Enrolment and Adoption and initial scoping on Network Evolution. Further detail on these are set out in the main submission.

6.3.2 Uncertainties

There were significant uncertainties identified in relation to RY2020/21 at the time of setting the Charging Statement. These included:

- Changes in assumptions underpinning Communications Hub Device Revenue forecasts, including overall volume and SBCH/DBCH order split.
- The volume of SMETS1 meter migrations.

The uncertainties required DCC to perform analysis of the cost position over the coming regulatory years (with their subsequent impact on cash requirements) based on different assumptions. As an ongoing initiative for cost transparency, we share and explain our assessment of the risks and opportunities to the forecast with customers in the quarterly finance and programme briefing events. As discussed above, the prudent estimate is included to reduce the risk of raising charges in year.

6.3.3 Assumptions

Future Releases

- It is planned that there will be two releases per year going forward, planned for June and November. In addition, it is assumed there will be three annual maintenance releases in each year (April, May and January).

Resource

- For each existing resource, it is assumed that their cost will remain constant, allowing for any salary increases and bonus accruals.

- For new resource, assumptions about the volume and cost are set during the budget process. The number of FTE has been justified and assessed and the cost has been benchmarked by HR.
- Travel and expenses are assumed to be 20% lower than the previous year
- Recruitment fees for new resource are assumed at 15%, which is in line with the assumption in the LABP and [REDACTED].
- Car allowance benefit is assumed at [REDACTED] (capped at [REDACTED]), which is in line with Capita benefits that employees obtain.
- Pension contribution is assumed at an average of [REDACTED] per FTE, the maximum available being [REDACTED].
- For contractors, a utilisation rate of 92% is assumed.

External and Internal services

- Provisions of annual services that are renewed each year are assumed to be at the same cost incurred for the prior year, assuming there is no increase in the scope or volume of work. For example, the cost of statutory audits in each year is assumed to be £0.092m per annum.
- Provision of a service for which a longer-term contract is in place with fixed prices is estimated at the price stipulated in the contract and the estimated dates in the contract at which payments will be made, for example, the contracts for SMKI and Parse and Correlate
- Provision of a service for which a contract is in place with time and materials as the basis is estimated by using an estimate of the number of days to provide the service and the day rates stipulated in the contract, with an additional percentage to allow for expenses. The percentage for expenses can vary depending on the contract. The number of days estimated is informed from previous activity that has been carried out of a similar nature or estimate information received from the Service Provider
- In some cases, the Service Provider will share forecast models detailing their assumptions of the cost of providing the service over an extended period of time
- Where a service has not yet been procured an approximation is made of the cost by the relevant budget owner requiring the service or project manager managing the service. This estimate may be informed from quotes already received, early estimates from potential suppliers or knowledge and previous experience of a reasonable cost for the service.

Accommodation

Below are the assumptions for the London office (Ibex House);

- Rent is assumed to be [REDACTED] per square foot, as per the lease agreement.
- Service charge is assumed to be [REDACTED] per square foot, as per the lease agreement.
- Rates are assumed to be [REDACTED] per square foot, as per the lease agreement.
- A rent-free period of [REDACTED] months is assumed as per the lease agreement, with the saving being spread over the lease term.
- It is assumed that the capex cost is charged by [REDACTED] in line with depreciation of the assets.

Below are the assumptions for the Manchester office (Brabazon House);

- Rent is assumed to be [REDACTED] per square foot, as per the lease agreement. This is rent passed to DCC under the negotiated assignment from [REDACTED].
- Service charge is assumed to be [REDACTED] per square foot, as per the lease agreement.
- Rates are assumed to be [REDACTED] per square foot, as per the lease agreement.
- A rent-free period of [REDACTED] months is assumed as per the lease agreement, with the saving being spread over the lease term.

- It is assumed that fitout cost will be depreciated over the period of the lease.

External Costs

- The timing, value and profile of cash outflows are assumed to be in line with baseline contracts with FSPs.
- The timing, value and profile of cash outflows with respect to agreed contract changes are assumed to be in line with details outlined in the Change Authorisation Notes, or in line with details provided directly from the FSPs via the Commercial team.
- Where contract changes have not been approved, the value of the cash outflow is assumed to be in line with the latest Impact Assessment value or if applicable, latest estimates provided by the Commercial team.
- For contract changes where an Impact Assessment is not yet available, a judgement is made to establish a 'rough order of magnitude' for the value of the contract change using information provided from the FSP. Where the FSP provides a range for the 'rough order of magnitude', we use the midpoint as the best estimate.
- Where the FSP cannot provide an early indication as to the magnitude of the change value, we use historic information for similar changes proposed, or values proposed for the same change by other Service Providers as a basis. One or more changes with a similar nature and magnitude are chosen as a benchmark.
- All cost estimates provided by the FSP are challenged robustly by the Supply Chain management team, so we ensure that we obtain value for money and reduce costs wherever possible.

In the Price Control submission, the estimate of Allowed Revenue that is provided for RY2020/21 is based on the model for the Charging Statement, so the same assumptions have been applied. However, for costs where there is significant uncertainty these are removed from the forecasts. These include:

- Services that have not yet been procured and there is no contract in place.
- Services that have not yet been procured and there is no prior year cost to support an economic and efficient forecast.
- Contract change values for External Service Providers where a change request has not yet been approved.

DCC manages its prudent estimate of Allowed Revenue efficiently through the following mechanisms:

- Maintaining a detailed forecast, updated and reviewed monthly, with comparison to actuals and budget
- Engaging in a continuous, ongoing process of risk assessment and review with respect to costs incurred against the budget, and expectation of future costs to arise. This allows us to track expenditure in relation to the budget and determine the likelihood of over or under-spend. This exercise is carried out in parallel with the review of our cashflow forecast, which ensures we have an appropriate level of funds to allow for potential over-spend against the budget.
- A summary of incurred and forecast costs is prepared monthly by the Financial Planning and Analysis Manager. These are reviewed by the Chief Financial Officer, and form part of the monthly report that is reviewed by the Board. The Board have the ultimate responsibility for assessing risk of future costs and making strategic cash flow decisions.

The management of the prudent estimate of Allowed Revenue is further supported by the following activities:

- Any changes to the budget set for the year that arise due to additional costs or change in activities do not require formal approval if they are less that £0.1m and managed within the original budget value. For an activity or expenditure that is outside of a functional business plan and that exceeds £0.1m, a business case will need to be written and approved at the monthly financial performance review meetings.
- Costs are challenged by Finance Business Partners and by functional leads to ensure value for money for every pound spent. There are cost savings targets set at a functional and Corporate level.
- Monthly financial performance review meetings are undertaken by Finance Business Partners with budget owners. Costs incurred in the month and year to date are compared to the budgeted costs, and explanations are obtained for variances. Budget owners have targets to maintain within their overall budget and they are challenged on how they will meet these to minimise the risk of over-spend.
- Furthermore, budget owners will also indicate if there are any material costs that they are aware of, but for which a business case is still outstanding. This information is then used in the updated forecast.
- Following monthly financial reviews, a consolidated position of the updated forecast is produced, which provides a view of how the total updated forecast compares to the original budget. This is reviewed by the Head of Commercial Finance and the Chief Financial Officer.
- The Finance Business Partner works closely with the Commercial team to understand the pipeline of change requests which have been raised, and prepares revised forecasts accordingly, which include the potential of the impact of all changes to provide the worst-case view. This is compared to the budget set for External costs. This assessment will inform the strategy adopted in negotiation with Service Providers, approving a change request and agreeing the timing of cash outflow.
- The Finance Business Partners engage with Programme Directors and Project Managers for IT services to form the best view of expected costs in the year for contracts which are not fixed price.
- During the autumn of each year we undertake a detailed bottom-up business planning review for each cost centre and activity to assess the validity of roles and activities in DCC. This is an exercise to test the validity of all roles and activities that are undertaken by each cost centre. The cost centre managers are asked to take a strategic view on future direction of their departments and how it is working to deliver on DCC’s main objectives. This is an exercise to challenge the assumptions and agree on a viable budget position for each area in DCC.

6.4 Real price effects (9.14)

Please report on the assumptions used to inflate costs over time so as to report the Regulatory Year in nominal terms. This report should include descriptions of how cost centres are inflated over time relative to economy-wide inflation as measured by the retail prices index (RPI). So, for example, if the Licensee’s labour costs are indexed to CPI, please report the extent to which those labour costs have risen relative to the previous reporting year and the difference between this increase and RPI.

To reflect the costs in the RIGs tables in 2019/20 prices there are two main cost areas that have been inflated compared to the prior year:

- External Costs
- Internal Costs – resource costs

Although some other Internal Costs have been impacted by inflation (primarily some of the contracts with external service providers) the value of this impact is immaterial.

6.4.1 External Costs

The following FSP contract areas are eligible for indexation:

- Rate card as per Schedule 7.1, Appendix 4.
- Testing services charges as per Schedule 7.1 paragraph 5.3.
- Fixed operational charges as per Schedule 7.1 paragraph 10.
- Transactions charges as per Schedule 7.1 paragraph 9.
- Catalogue services as per Schedule 7.1 paragraph 15.3.

The FSP contracts define how indexation should be calculated[1] and to which cost types it is applicable. Indexation can be applied on the anniversary of the signature date of each contract.

Indexation is calculated as:

$$amount\ or\ sum \times \left(\frac{index_o}{index_d}\right)$$

Where:

- $Index_o$ is the value of CPI published or determined with respect to the period immediately preceding 1 April in each contract year i.e. the year that precedes the year in which the amount or sum falls due
- $Index_d$ is the value of CPI on the commencement date of the contract.

In RY2019/20, the indexation value calculated was the same for each FSP:

$$\left(\frac{107.0}{99.1}\right) = 1.0797$$

- $Index_o$ at March 2019 = 107.0
- $Index_d$ at signature date in September 2013 = 99.1
- Calculated indexation rate = 7.97%

The way this indexation percentage is applied to each FSP contract is agreed with the FSP as part of the change request.

The impact of indexation on baseline contract values and any changes that had been authorised prior to that date is shown in the RIGs supplementary schedules.

6.4.2 Internal Costs - resource costs

Our labour costs are adjusted using RPI as the basis. Increase in labour costs occurs once a year in April and is approved by the Remuneration Committee. These increases reflect inflationary increases and adjustments for any changes in roles and responsibilities.

In March 2019, the Remuneration Committee approved funds for relevant salary increases, reflecting both real price increases and upward adjustments for changes in roles and responsibilities.

The value of the pot was determined as 3.14% of the sum of the total basic salaries of permanent staff on the payroll as at January 2019. Only permanent staff on the payroll as at this date were eligible for salary increases.

[1] Schedule 7.1, Part A, Paragraph 2

3.14% was determined using the same methodology that is applied in adjusting the Baseline Margin value in Licence Condition 36, calculated as the % change between the six-month average of the RPI index from July to December 2018 (284.0[1]) and July to December 2017 (275.3). This provided a pot of £0.517m to be used to increase base annual salaries and for role changes and promotions.

Overall, £0.456m of the pot was utilised to increase annual salaries, which represents 2.73% of the total annual salaries as at March 2019.

Comparison to RPI and other labour metrics

The % change in RPI over a different time period (the period April 18 to March 19) was 1.93%. In comparison, the real price increase made to DCC employees was 2.73%.

We have further compared the 2.73% to the most relevant ONS earnings metrics between April 2018 and March 2019 published in the provisional Annual Survey of Hours and Earnings (ASHE) data released in October 2019, shown in the table below. DCC's increase was below this benchmark.

	Increase %	Comparison to DCC rate
Median gross weekly earnings full time employees	2.9%	+0.17%

Table 6 – ASHE earnings metrics

[1] At the time of the calculation the RPI for December 2018 had not been released, therefore November 18 was used as an estimate. The final average RPI from July to December 2018 was 284.1.

6.5 Income Statement (9.16)

Q1: Please explain any variance between Allowed Revenue and amended regulatory revenue as shown in Sheet 8.

The Regulated Revenue for RY2019/20 was £518.434m. The Allowed Revenue (costs) for the same period was £474.906m.

	RY19/20 (£m)
Regulated Revenue (RR)	**518.434**
RY2019/20 correction factor, discussed in Section 3 of this document	(10.876)
Cumulative correction factor brought forward	(32.652)
Allowed Revenue (AR)	**474.906**

Table 7 – Variance between Regulated Revenue and Allowed Revenue (costs)

This variance is explained in Section 3 of this document.

6.6 Approach to materiality (9.17)

Please explain how and why DCC has selected materiality thresholds to apply to its cost justifications. Please include an explanation of what proportion of DCC's cost base falls below DCC's materiality thresholds (i.e. how much cost does DCC consider to be "immaterial").
DCC obligations with respect to materiality

Internal Costs: any variance above £0.150m is considered material. This is the same as last year. External Costs: any variance above £1.000m is considered material. This is the same as last year.

6.6.1 How much of our cost is 'immaterial'?

External Costs

3.210% of the External Costs incurred in RY2019/20 are considered immaterial. This is set out below.

	[REDACTED]				SMETS1	Switching	Total (£m)
Impact assessments	0.404	0.939	0.168	0.188	0.146	-	**1.846**
Catalogue services	0.526	0.674	0.131	0.150	-	-	**1.481**
Projects	5.710	0.322	0.686	0.408	-	-	**7.126**
CRs	0.410	0.125	0.189	0.103	-	-	**0.827**
Total	**7.050**	**2.060**	**1.174**	**0.850**	**0.146**	**-**	**11.281**
						Total external costs 2020 (incl CRS)	**351.410**
						% immaterial	**3.210%**

Table 8 – Immaterial External Cost variance

Internal Costs

0.893% of the Internal Costs variance is considered immaterial. This is set out in the table below.

	C. Mgt	Commercial	D&A	Finance	Industry	Ops	Prog	Security	SMETS1	Network Evo	Total
PR	-	-	-	-	(0.001)	-	-	-	0.123	-	**0.122**
NP	-	0.063	-	-	-	(0.021)	(0.087)	(0.006)	(0.128)	0.005	**(0.174)**
RC	0.092	(0.002)	-	-	-	(0.125)	(0.071)	0.011	(0.077)	0.009	**(0.163)**
AC	-	-	0.135	-	-	-	-	-	0.065	-	**0.200**
ES	-	0.078	-	-	-	-	-	-	-	0.036	**0.114**
IS	0.129	-	(0.022)	0.015	-	0.013	0.039	-	0.137	0.065	**0.376**
SM	-	-	-	-	-	-	-	-	-	-	**-**
TR	-	-	-	-	-	-	-	-	-	-	**-**
IT	0.026	0.020	-	0.071	-	-	-	0.111	0.007	-	**0.235**
OS	0.122	-	-	0.052	-	-	-	0.000	0.001	-	**0.175**
Total	**0.369**	**0.159**	**0.113**	**0.138**	**(0.001)**	**(0.134)**	**(0.119)**	**0.116**	**0.127**	**0.116**	**0.885**
Total internal Costs (excl service charge)											**99.102**
% immaterial											**0.893%**

Table 9 – Immaterial Internal Cost variance (£m)

7 Penalty Interest

In accordance with the formula included in Ofgem's final decision on the DCC penalty interest rate, we have calculated the proportion of Regulated Revenue to Allowed Revenue as:

Regulated Revenue (RR)	£518.434m
Allowed Revenue (AR)	£474.906m
Proportion	109.2%
Threshold	110.0%

Table 10 – Penalty interest

As the proportion is within the threshold no further explanation is required.