

The background of the slide features a close-up, artistic photograph of interlocking metal gears. The lighting is dramatic, with bright highlights and deep shadows, creating a sense of motion and mechanical complexity. The colors are primarily metallic greys and blues, with some warmer tones from the lighting.

DCC financeability and cost recovery

SMG Sub-Group 3
5th October 2010

Agenda

- **Introductions**
- **Terms of References**
- **DCC Financeability and Cost Recovery**
 - Presentation
 - Consideration of discussion document
- **Issues Log**
- **AoB**
- **Date of next meeting**

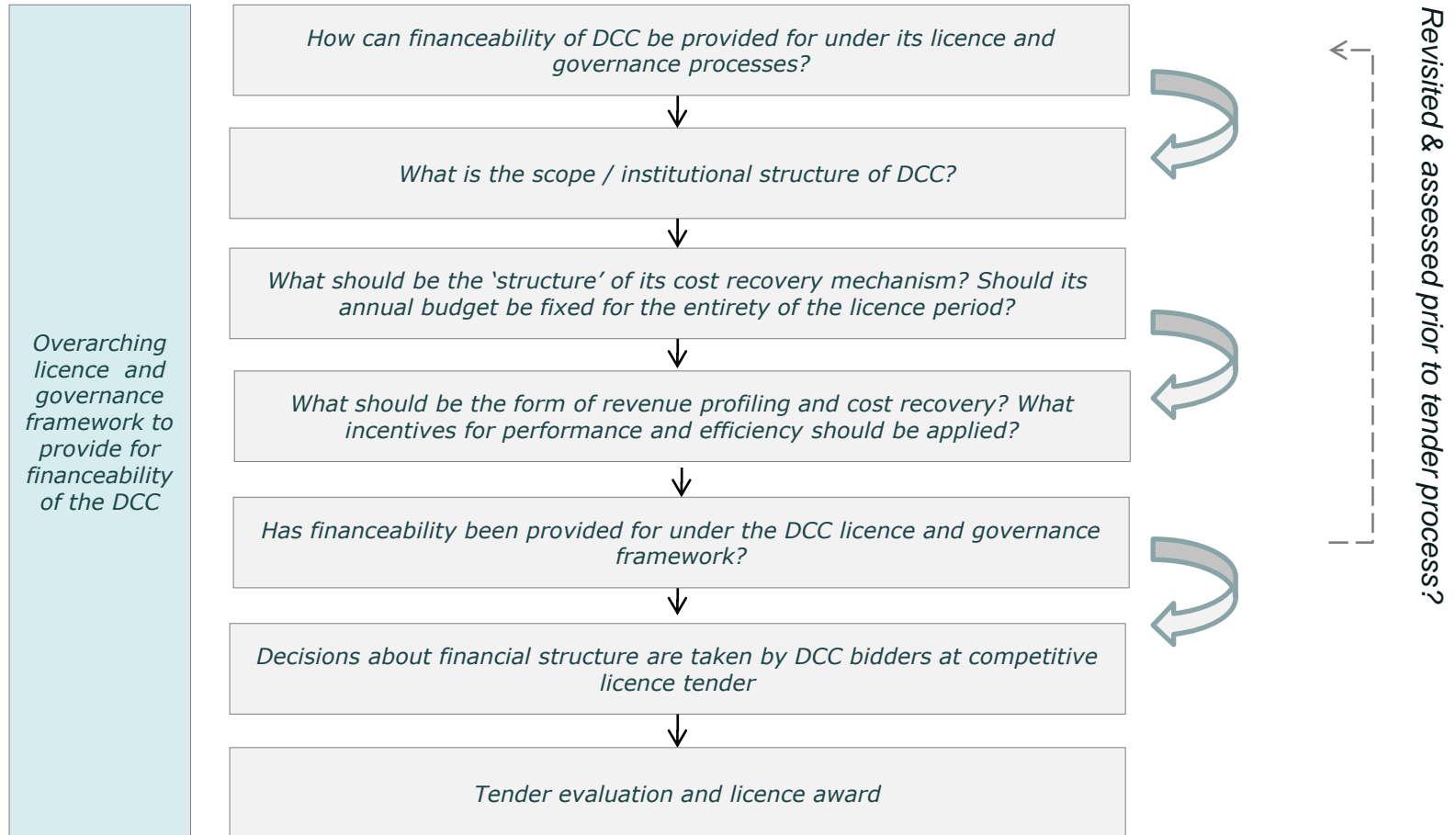
Issues to address

- How can financeability of the DCC be provided for in its licensing and governance framework, including the funding options that allow the DCC to meet its start-up costs and support initial activities?
- Given current proposals for DCC scope, structure and function, how should the DCC recover its costs and the costs of its service providers through its regulatory framework and charging methodology?
- What charging methodology principles and structure of service user charges should be adopted to provide appropriate pricing signals to the users of the DCC's services?

DCC financeability - principles

- Realisation of DCC will require the entity to be bankable and attractive to bidders at the competitive licence tender process.
- Financeability of the DCC therefore needs to be *provided for* under the terms and conditions of its licence and governance processes.
- DCC's financial viability will depend on the exclusivity granted by its licence, its ability to recover its costs and the manageability of the risks which are allocated to it.
 - DCC will need to have a contractual right to recover from its service users its own internal costs and the cost of the contracts of its service providers.
 - DCC's licence and regulatory regime will also need to provide a credible commitment to service providers to fund any capital invested and provide for a level of ongoing profitability (*ex ante*) that reflects the risks of service provision.

DCC Financeability Framework



Proposals for DCC business model

- Our proposed approach is to grant a licence, through a competitive process, to the DCC as a vendor governance, procurement and contract management entity.
- A key role for this new entity would be to run competitive tenders to procure a number of service providers, which would together deliver the full scope of the data and communications services required.
- The proposed business model will allow the governance, regulation and incentivisation of the DCC and its service providers to be objective-driven and designed to facilitate the realisation of the benefits of the smart metering programme.

Issues to address

- DCC will have a pivotal role at the heart of the smart metering system and will require sound governance, regulation and funding arrangements.
- A number of important decisions need to be made with respect:
 - DCC cost recovery mechanism;
 - Charging arrangements / principles for cost allocation to industry users;
 - Any initial funding mechanisms of the DCC entity structured to promote evolution of services?

Cost recovery - principles

- DCC will need to recover its internal costs and the costs of its service providers through a cost setting mechanism.
 - DCC licence award process will expose DCC internal costs to competitive pressures.
 - But the variation of the DCC's internal cost base will depend on the activities undertaken by the entity over the course of its licence.
 - This may require DCC's internal operating plan and budget to be set at the beginning of the licence period but reviewed once its activities reach "steady-state".
- The DCC's cost setting / recovery model will also need to provide appropriate commercial incentives for the delivery of key outputs, service performance and cost savings over the course of its licence period.

DCC Cost recovery - options

Cost setting and recovery could be based on a combination of models

Options for service provider contract cost setting and recovery	Options for DCC cost setting and recovery
Commodity (upfront) pricing	Costs fixed for entirety of licence period
Utility (demand-driven) pricing	Fixed for a set period and then reviewed at an agreed window in the licence period ¹

DCC cost recovery models will need to be reflected in the underlying pricing and tendering of DCC service provider contracts and the business plan of the DCC

1: This could be a performance or cost review agreed for a set point in the DCC licence period or alternatively a trigger or reopener window built into DCC's licence to allow for the variation in its costs.

User charging arrangements - principles

DCC standard service charges need to reflect the relevant cost drivers amongst other objectives

The appropriate principals for DCC's charging /cost allocation methodology may include:

- **Cost reflectivity**
 - **Facilitation of competition**
 - **Predictability**
 - **Transparency**
- 

DCC Structure of Charges

- **Activation charge**
- **Standing charge**
- **Volume charge**
- **General charges**

But which users of the DCC services should contribute to these charges?

Structure of charges – illustrative options

Allocation of fixed costs

Options	Description
Supplier allocation of fixed costs	Suppliers pay the full costs of activation and the standing charge
Supplier / network company apportionment of fixed costs	Divide charges for WAN on some agreed basis, for example, linked to volumes required

Added capability and non-core services

- ‘User-pays’ principal for additional capability requirements applying to DCC’s core electricity and gas smart metering services.
- No cross-subsidy between core users of DCC services and non-core users (i.e. users of value-added services) as access to these providers should be on a non-discriminatory basis.

Upfront DCC funding requirement?

- DCC will need to be established before services can be delivered. As rollout will build up gradually, cash flows could be negative for a period after service commencement, implying a need for additional finance.
- Start-funding may be required to support activities such as the procurement of the underlying service provider subcontracts, IT system procurement and integration, pilot trials and testing.
- The choice and level of funding required will depend in large part on the willingness of DCC's contracted service providers to finance particular activities as well as the DCC's cost of borrowing and the profile of its projected cash flows.

Examples of upfront DCC funding options

Options	Description
User funding	This could be structured as a loan repayable out of future operating cash flows and might be provided pro rata to the number of meter points for which each supplier is responsible.
Commercial funding	For example, funding from commercial banks or the DCC Parent company repayable out of future operating cash flows. The loan will also need to be secured or provided a guarantee for lenders to be prepared to lend to the DCC under this funding model.

An alternative, is a hybrid of options, for example, a combination of energy supplier financing and bank financing. This could allow different sources of funding to be adopted for different DCC start-up activities and costs.

The background of the slide features a composite image. On the left, there are rows of solar panels under a bright, hazy sky. On the right, a hand is shown holding a white document or envelope. The overall color palette is light and airy, with blues, greens, and whites.

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