



Making a positive difference  
for energy consumers

Applicants for the Smart Meter  
Communication licence, future  
service users and other  
interested parties.

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Dear Colleagues,

### **The proposed Smart Meter Communication Licence - Guidance on particular aspects of Ofgem's regulatory approach**

As part of the government's policy to roll out smart meters across Great Britain by the end of 2019, it has created a new licensed activity to provide data and communications services in relation to smart meters. The new licensed activity will be carried out by the Data and Communications Company (DCC) which will be appointed by the Department for Energy and Climate Change (DECC) following a competitive process.

The purpose of this letter is to provide high level guidance on the regulatory approach that Ofgem<sup>1</sup> would expect to take with respect to several key licence requirements. Potential DCC licensees may wish to take this information into account in preparing their bid submissions. Ofgem will have a role in approving such arrangements once the Smart Meter Communication Licence (hereafter referred to as 'the licence') has been granted by the Secretary of State.

#### **Introduction**

The DCC will have an important role in providing secure communications between energy suppliers, network operators and authorised third parties on the one hand, and compliant smart metering equipment in domestic and certain non-domestic premises on the other. The competition to appoint a DCC licensee is now underway and DECC expects to grant the licence in summer 2013. Thereafter, Ofgem will be the regulator for the DCC and the Secretary of State for Energy and Climate Change will retain only certain time-limited powers with respect to the licence. DCC applicants have sought clarity on some aspects of the draft licence where Ofgem will have regulatory oversight. We have summarised below the relevant licence conditions, followed by guidance on each of the aspects raised by DCC applicants.

#### **Background on relevant licence conditions**

The most recent version of draft licence was published in November 2012<sup>2</sup>. DECC proposes to make a limited number of updates to the licence in light of feedback arising from other

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<sup>1</sup> Ofgem is the Office of the Gas and Electricity Markets Authority

<sup>2</sup> Government response to consultation: Annex 1 Draft DCC licence, 08 November 2012

<https://www.gov.uk/government/consultations/smart-meter-data-and-communications-company-dcc-licence-conditions-and-licence-application-regulations-data-and-communications-company-dcc-licence-conditions-and-licence-application-regulations>

smart metering policy consultations, points raised by DCC licence applicants and areas of ongoing clarification. The relevant proposed updates are explained in this letter where relevant to our guidance. Draft condition 26 (Financial stability and financial security) of the licence imposes separate financial stability and financial security requirements on the licensee. The purpose of this condition is to provide some assurances about the DCC's access to funding on reasonable terms and to require the licensee to provide financial security in a form approved by Ofgem. The two sets of financial arrangements must be submitted to Ofgem within three months of the licence commencement date (a date to be confirmed in summer 2013). A 'Relevant Sum' required as part of the financial security arrangement will initially be determined by the Secretary of State during or as a consequence of the licence application process. DECC proposes to update this condition so that the 'Relevant Sum' can be varied by Ofgem in particular circumstances.

Draft condition 25 (Undertakings from an Ultimate Controller) and draft condition 29 (Provision of Information by the Licensee) require the DCC to procure and maintain legally enforceable undertakings from any Ultimate Controller<sup>3</sup> in favour of the licensee, in a form specified by Ofgem. The purpose of these undertakings is to ensure that any Ultimate Controllers of the DCC refrain from actions that would cause the DCC to fail or breach its obligations, and also provide such information as the DCC requires to comply with obligations under draft condition 29.

DECC proposes to update draft condition 37 (Assessment of Mandatory Business costs (previously 'Monitoring and Assessment of Licensee's costs')) to enable Ofgem to review costs associated with the DCC's business services and take appropriate action where costs are considered to have been uneconomically or inefficiently incurred.

Applicants will need to take account of these requirements in formulating their final bids in the DCC competition.

## **Guidance on financial stability and security**

### *Part A - Requirements for financial stability*

The first licence requirement refers to arrangements for 'continuing financial stability' but does not specify what those arrangements should be, leaving it to the DCC to submit proposals to the Authority for approval. While we recognise that there may be alternative arrangements that would satisfy these requirements, in the interests of providing some guidance to applicants, we consider that a regime that combines the qualitative and quantitative assurance measures summarised below would be likely to be acceptable:

- Reference to financial governance aspects of the DCC's business plans and the 'internal control document' required under draft condition 7 of the licence;
- an undertaking to observe a range of financial ratios demonstrating financial health, including appropriate liquidity ratios and cash flow positions;
- the setting up of a non-executive committee (possibly involving the Sufficiently Independent Directors required under draft condition 9) to supervise the licensee's financial governance;
- routine/ad hoc updates to Ofgem, for example in relation to performance against the financial ratios referred to above;
- the granting of floating charge security<sup>4</sup> over the DCC's receivables and cash balances to fundamental service providers in respect of contractual liabilities; and
- A 'keep well agreement' with a parent company of the DCC referring to the provision of financial and/or operation resourcing support.

### *Part B - Requirements for financial security*

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<sup>3</sup> Ultimate Controller is defined in licence condition 1 of the draft DCC licence.

<sup>4</sup> The DCC would be subject to a general licence prohibition on the granting of security over its assets, but the Authority may consent to this exception.

The second licence requirement relates to arrangements for financial security. It includes a requirement for a 'Relevant Sum' of money to be set aside by the licensee, for the purposes of providing financial security, and accessible by the Authority to direct its release in two defined circumstances:

- a handover of the DCC licence to a new holder; and
- a management order<sup>5</sup> (intervention) by Ofgem.

Draft condition 26 of the licence provides some examples of acceptable financial security instruments<sup>6</sup>. These examples are indicative only and do not prevent the DCC from proposing alternative arrangements which Ofgem will consider on their own merits.

The licence requires funds to be applied as directed by Ofgem (as opposed to being dealt with by company management) and so the particulars of any facility would have to provide for this. The arrangement would also have to address the replenishment of funds by the licensee in appropriate cases.

Ofgem may wish to attach conditions to its approval of the form of the arrangement so that arrangements can be revised if necessary. In addition, DECC's proposed updates to draft condition 26 provide for the Relevant Sum to be increased by Ofgem in certain circumstances following an expansion of the DCC's activities or a significant change in the business environment.

### **Guidance on the form of undertakings from an Ultimate Controller**

Conditions 25 and 29 require the licensee to obtain and provide Ofgem with legally enforceable undertakings from its Ultimate Controller(s). The undertakings should be in a form specified by Ofgem. Applicants for the DCC licence have requested that guidance be provided on the required form of the undertakings. We expect to exercise the power in condition 25 by requiring an undertaking as per the form set out in the annex to this letter. This is based on the standard form used for network licences, which have similar ring fence requirements. We consider that, as adapted, this form is appropriate for the DCC. The licensee will need to determine which entity or entities are its Ultimate Controller(s) and have the actual undertakings in place from the grant of the licence. They will need to obtain undertakings from any new Ultimate Controller within seven days of it becoming an Ultimate Controller of the DCC.

### **Guidance on review of costs associated with the DCC's business services**

Draft condition 37 enables Ofgem to review the cost levels reported by the DCC with respect to its 'Mandatory Business Services'. DECC proposed to update this condition to provide for Ofgem to take appropriate action where those costs are considered to have been uneconomically or inefficiently incurred ('Unacceptable Costs'). The options open to Ofgem under the updated draft licence condition are:

- to exclude an amount of Unacceptable Costs from the DCC's future allowed revenues; or
- to accept an undertaking from the DCC with respect to the costs.

Applicants for the DCC licence have sought clarity on our approach to reviewing costs associated with Mandatory Business Services which we have provided below.

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<sup>5</sup> Draft condition 42 (Management Orders for the licensee) of the DCC licence enables the Authority to make management orders to secure the proper running of the business where necessary and appropriate to rectify actual or likely material failings (financial or operational).

<sup>6</sup> Examples include a parent company guarantee, an unconditional and irrevocable letter of credit and an escrow account containing the Relevant Sum.

We expect to undertake an annual ex post review of Mandatory Business Service costs to determine whether they were economically and efficiently incurred. This review will include DCC's own internal and the contract costs incurred. In doing so, we would initially expect to compare actual costs levels with those previously forecast by the DCC, taking into account the quality (in terms of supporting material) of those forecasts. The DCC will also be required to explain and justify any significant deviations from its forecast costs as part of its price control reporting. For the first regulatory year, we will refer to information provided by DCC in its application for the licence.

The DCC will inherit a set of competitively procured contracts from government with certain elements that will be fixed, including prices charged to the DCC by the external service providers. We expect the competitive procurement process to deliver value for money in the pricing of those contracts. We would not expect the DCC to be penalised in relation to actual cost levels that are outside its reasonable control and influence. Draft condition 37 provides for such factors to be formally taken into consideration. However, the DCC should expect to demonstrate that it has incurred contract costs and its own internal costs as efficiently and economically as possible, doing everything it reasonably can to ensure value for money. Over time, the DCC will need to have in place a robust strategy to ensure that the contract costs remain efficient and this will apply especially to any future contract procurement activity undertaken by the DCC.

### **Next steps**

DCC applicants should consider the preliminary guidance set out in this letter alongside other tender documentation in formulating their final proposals for the DCC competition. For the avoidance of doubt any future decisions to be taken by Ofgem, in relation to the matters referred to in this letter, will be taken on the basis of the regulatory framework and after taking account of relevant material factors and the prevailing circumstances at the time. This letter should not therefore be treated as creating any legitimate expectation regarding such future Ofgem decisions.

Should you have any questions in relation to this letter, please contact Laura Nell ([laura.nell@ofgem.gov.uk](mailto:laura.nell@ofgem.gov.uk) 020 7901 7147). Participants in the DCC licence competition should instead direct questions to DECC via the Bravo tendering portal. DECC will pass them to Ofgem for consideration.

Yours faithfully,

Maxine Frerk

**Partner, Retail Markets and Research**

## **Annex: Form of the Ultimate Controller Undertakings**

Schedule to Direction expected to be issued by the Gas and Electricity Markets Authority [dated]

**THIS DEED** made on       day of       between:

(1)       [ULTIMATE CONTROLLER] (a company registered in [ ] with number [ ] and whose registered office is at [ ]) (the “**Covenantor**”);

and

(2)       [Company] (a company registered in England with number xxx and whose registered office is at [ ]) (the “**Licensee**”);

### **WHEREAS:**

**(A)**       The Licensee is bound by certain obligations under the Gas Act 1986 and the Electricity Act 1989 (the “Acts”) and the Smart Meter Communication Licence granted under section 7AB(2) and (4) Gas Act 1986 and section 6(1A) and 6(1C) of the Electricity Act 1989 (the “Licence”).

**(B)**       Condition 25 (Undertakings from an Ultimate Controller) and Condition 29 (Provision of Information by the Licensee) of the Licence require the Licensee to procure from any person who is an Ultimate Controller (as defined in the Licence) of the Licensee enforceable undertakings in respect of:

- i.       the provision of information by the Licensee to the Gas and Electricity Markets Authority (the “Authority”), and
- ii.      the conduct of that person in relation to compliance by the Licensee with its statutory and Licence obligations.

**(C)**       The Covenantor is an Ultimate Controller of the Licensee.

**NOW THIS DEED WITNESSES** as follows:

**UNDERTAKINGS**

The Covenantor hereby undertakes in favour of the Licensee:

1. To give the Licensee, and to procure that any person (including, without limitation, a corporate body) that is a subsidiary of, or controlled by, the Covenantor (other than the Licensee and any of its subsidiaries) will give to the Licensee, in such manner and at such times as the Licensee may require, all such information as may be necessary to enable the Licensee to furnish to the Authority such information and reports as the Authority may reasonably require or as may be necessary for the purpose of performing the functions transferred to it by or under any Legislation (as defined in the Licence):
  
2. To refrain from any action, and to procure that any person (including, without limitation, a corporate body) that is a subsidiary of, or is controlled by, the Covenantor (other than the Licensee and any of its subsidiaries) will refrain from any action, which would be likely to cause the Licensee to breach any of its obligations under Parts A and B of Condition 29 of the Licence.

**GENERAL**

3. The undertaking given under this deed shall remain in full force and effect until such time as the Licensee ceases to hold the Licence or the Covenantor ceases to be an Ultimate Controller of the Licensee.
  
4. For the purposes of this deed;
  - i. Any reference to an Act of Parliament shall include any statutory modification or re-enactment thereof after the date on which this deed is executed,
  - ii. Any reference to the Licence shall include any modifications to the Licence after the date on which this deed is executed, and
  - iii. words and expressions defined for the purpose of any provision of such an Act or of the Licence held by the Licensee shall have the same meaning when used in this deed.
  
5. The Covenantor and the Licensee hereby exclude the operation of the Contracts (Rights of Third Parties) Act 1999.

6. This deed is governed by and shall be construed in accordance with English law.

**IN WITNESS** of which, this deed has been executed and delivered on the date first appearing on page 1.

**EXECUTED AS A DEED BY**

The Common Seal of

[Name of Ultimate Controller]

was hereunto affixed in the presence of

\_\_\_\_\_ Authorised signatory

[or]

[Name of Ultimate Controller]

Acting by two directors or a director and the company secretary

\_\_\_\_\_ Director

\_\_\_\_\_ Director/Company Secretary

And

**EXECUTED AS A DEED BY**

The Common Seal of

[Name of Licensee]

was hereunto affixed in the presence of

\_\_\_\_\_ Authorised signatory

[or]

[Name of Licensee]

Acting by two directors or a director and the company secretary

\_\_\_\_\_ Director

\_\_\_\_\_ Director/Company Secretary