

## Operational Performance Regime Review: Working Paper

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### Overview

There is concern amongst DCC customers, BEIS and Ofgem that the current Operational Performance Regime (OPR) does not incentivise DCC effectively. As SMETS2 meters are rolled out and SMETS1 meters are enrolled, the number of meters which are dependent on DCC are increasing. Therefore, it is vital that DCC is incentivised appropriately to ensure it is operating effectively and delivering better outcomes for customers.

This working paper explores ideas on how to amend the current OPR, which, at present, solely focuses on a narrow range of DCC's technical outputs to assess the system performance aspect of DCC's functions. We explore six new outcome based areas to incentivise under system performance and consider performance by meter generation (SMETS1, SMETS2) and region. We also consider incentivising DCC on two new areas which have caused concern among DCC's stakeholders: customer engagement, and contract management and procurement. We explore the different qualitative assessment criteria and processes which could potentially be used to assess DCC on these new areas.

This working paper will be followed by a formal consultation in the spring. Stakeholder engagement and feedback will be key to ensure the amended OPR is robust, functions as intended, and DCC is effectively incentivised to deliver good outcomes for customers.

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## Associated documents

2018/19 Price Control Decision: <https://www.ofgem.gov.uk/publications-and-updates/dcc-price-control-decision-regulatory-year-201819>

2018/19 Price Control Consultation:  
[https://www.ofgem.gov.uk/system/files/docs/2019/10/dcc\\_price\\_control\\_consultation\\_-\\_regulatory\\_year\\_2018-19.pdf](https://www.ofgem.gov.uk/system/files/docs/2019/10/dcc_price_control_consultation_-_regulatory_year_2018-19.pdf)

Decision on DCC's Operational Performance Regime:  
[https://www.ofgem.gov.uk/system/files/docs/2017/09/1\\_decision\\_on\\_dcc.pdf](https://www.ofgem.gov.uk/system/files/docs/2017/09/1_decision_on_dcc.pdf)

Consultation on the implementation of the Operational Performance Regime:  
[https://www.ofgem.gov.uk/system/files/docs/2017/06/consultation\\_on\\_the\\_implementation\\_of\\_the\\_operational\\_performance\\_regime.pdf](https://www.ofgem.gov.uk/system/files/docs/2017/06/consultation_on_the_implementation_of_the_operational_performance_regime.pdf)

DCC Operational Performance Regime: Principles and Objectives:  
[https://www.ofgem.gov.uk/system/files/docs/2016/03/dcc\\_operational\\_performance\\_regime\\_principles\\_and\\_processes.pdf](https://www.ofgem.gov.uk/system/files/docs/2016/03/dcc_operational_performance_regime_principles_and_processes.pdf)

## 1. Introduction

- 1.1. We are concerned that the current Operational Performance Regime (OPR) metrics may not be providing the best incentives to DCC nor be indicative of customer experiences. The aim of this working paper is to explore potential options for amending the OPR metrics and optimising the incentives placed on DCC to deliver a good quality service and value for money for customers.
- 1.2. Through our stakeholder engagement, we have identified a range of issues and mapped them to three broad categories: system performance; customer engagement; and contract management and procurement. We are exploring how the OPR could be updated to incentivise better performance in all three of these areas.
- 1.3. We welcome stakeholder views on the ideas presented in this working paper to feed into our policy design process in advance of our formal consultation on the OPR in Spring 2020.

## Background

- 1.4. The Licence stipulates that DCC's Baseline Margin be put at risk each Regulatory Year under the relevant performance incentive regimes. These comprise the OPR and the Baseline Margin Project Performance Schemes. DCC's performance against the metrics established under these incentive regimes determines the margin DCC retains each Regulatory Year. DCC's margin is 100% at risk against these incentive regimes, with the majority at risk against the OPR.
- 1.5. Under the Smart Meter Communication Licence, the OPR can provide incentives under four broad categories: Service User Measure (SUM); Service Delivery Measure (SDM); Delivery and Innovation (DIM); and Value for Money (VMM).<sup>1</sup> The OPR currently only has measures under SUM and SDM.

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<sup>1</sup> Schedule 4 of the Smart Meter Communication License

- 1.6. Both the performance measures and the target performance levels for DCC are defined in the Smart Energy Code (SEC). DCC reports its performance against its targets to both the SEC Panel and Ofgem. A simple calculation following the end of the Regulatory Year<sup>2</sup> determines the margin DCC retains, although we are able to adjust these values where compelling evidence has been provided.
- 1.7. Following DCC's submission of its performance under the current OPR for the RY18/19 price control we became concerned that the OPR metrics may not be providing the best incentives to DCC, and may not be reflecting customer experiences.
- 1.8. We asked stakeholders in our DCC Price Control RY18/19 consultation for their views on how the OPR can be modified and improved. All respondents, including DCC, agreed with our concerns and supported a review of the current OPR framework.

## Aim of OPR Review

- 1.9. The aim of the OPR review is to optimise the incentives placed on DCC. Based on feedback from DCC's customers, we are exploring potential incentives in three areas:
  - 1.9.1. **system performance** to support business-as-usual (BAU) operations, where we anticipate identifying a set of quantitative metrics, selected from updated SEC performance measures, as an evolution of the current OPR. These metrics are likely to sit under the SUM and SDM categories.
  - 1.9.2. **customer engagement** in decision-making. We are exploring whether placing a relatively small proportion of DCC's margin at risk against the quality of its customer engagement activity would be appropriate and effective to drive better performance. Performance would be measured against qualitative metrics and would be most likely to sit under the VMM category.
  - 1.9.3. **contract management and procurement.** We are exploring whether placing a relatively small proportion of DCC's margin at risk against the quality of its contract management activity would be appropriate and effective to drive improvements in DCC's performance. Performance would be measured against qualitative metrics and would be most likely to sit under the VMM category.

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<sup>2</sup> The Regulatory Year starts on 1 April and runs to 31 March

## 2. Options for amending the Operational Performance Regime

- 2.1. This section presents our thinking on the three areas where we are considering incentivising DCC under the amended OPR metrics, and how these areas can potentially be split and weighted against the margin at risk.

### System Performance

- 2.2. System performance concerns the reliability of DCC systems, which is critical for the efficient and successful delivery of the smart meter rollout and business-as-usual operations.
- 2.3. The OPR is currently entirely focussed on system performance. It consists of five groups of metrics: DCC Service Desk, Communication Hubs, DCC WAN Coverage, Core Service Requests, and System Availability. Most of these metrics measure technical outputs, which do not appear to be strongly correlated with customer experience and outcomes. We therefore wish to replace them with more outcome based measures to assess DCC's performance.
- 2.4. DCC's customers are well placed to determine what constitutes good performance, according to their business needs. The SEC Operations Sub-Group (SEC Ops Group) have been reviewing the SEC performance measures to identify new metrics, which better measure system performance and better reflect outcomes for customers. We have been engaging with this work and intend any amended OPR metrics to be derived from the updated SEC performance measures.

### Areas to Incentivise

- 2.5. In response to our consultation question on how to improve the OPR, stakeholders highlighted a number of areas in DCC's performance where they believed DCC should be further incentivised.
- 2.6. Separately, the SEC Ops Group has identified areas that have a high impact on customers. These areas are consistent with those highlighted by stakeholders through our consultation.

2.7. As a result, the areas we are considering incentivising under system performance are listed below:

- **install and commission** – a component of this is covered in the current OPR through the WAN Coverage metric. However, it would be broadened to incentivise all DCC services required in the install and commission of a smart meter.
- **change of supplier** – this is not covered in the current OPR and would be concerned with the services required of DCC in a change of supplier scenario.
- **prepayment** – this is not covered in the current OPR and would be concerned with DCC's role in delivering top-ups to prepayment meters.
- **service reliability/availability** – this is an evolution of the current system availability measure, and should more successfully measure the reliability/availability of the service provided by DCC.
- **communication hubs** – these metrics are not in the scope of the SEC Ops Group review and will be unchanged from the current measures unless changed in the SEC.
- **meter management** – this is not covered in the current OPR and would be concerned with in-life meter management, predominately firmware upgrades.

2.8. As OPR system performance metrics are a subset of the SEC Ops performance measures, any amendments to the OPR metrics are dependent on the outputs of the SEC Ops Group's review of its performance measures and on their subsequent implementation. We currently expect the updated performance metrics to be confirmed by the SEC Panel in April.

2.9. We will also need to consider the relative weightings across the selected set of metrics. Our starting point is to assume an equal weighting, which is the approach taken under the current OPR arrangements, but we wish to further explore the relative importance for customers of different areas of system performance.

### **Performance Across Meter Generations**

2.10. Currently, all SMETS1 meters are planned to be enrolled into the DCC system by the end of 2021. Once they are enrolled, the effective operation of these meters will be incentivised under the OPR.

- 2.11. We wish to ensure DCC meets the SEC performance requirements for both SMETS1 and SMETS2 meters. To achieve this, we are considering whether it is appropriate for performance in relation to SMETS1 and SMETS2 meters to be assessed separately within each of the measures. This includes considering whether to split the margin attributed to SMETS1 vs SMETS2 meters by the proportion of meters that are of each meter type.
- 2.12. Splitting margin by meter generation would affect the penalty<sup>3</sup> on DCC for poor performance. Dividing the margin between SMETS1 and SMETS2 meters would ensure that a significant fault with either SMETS1 or SMETS2 meters would be more likely to result in a penalty for DCC, as it would effectively lower the bar required for a penalty for each meter type. Conversely, it would also reduce and limit the amount that could be lost for poor performance in just one generation of meter.

### **Performance Across Regions**

- 2.13. We have received several requests for regional metrics in responses to our RY18/19 price control consultation and in our other engagement. We are therefore also exploring whether margin should be split between the three DCC communication service regions<sup>4</sup> across relevant metrics.
- 2.14. We are considering splitting the margin equally between the three regions, regardless of how many meters are currently operating in each region. This would mean that the same number of failures in one region results in larger penalty than a region with more meters. Additionally, if the regions were weighted by the number of meters in each region, it could potentially create perverse incentives on DCC to slow the rollout in a more problematic region.
- 2.15. As with the meter generation split, while DCC would be more likely to be subject to a penalty for poor performance in any one region, in the event of extremely poor performance in a single region having a regional split would reduce and limit the amount of margin that could potentially be lost to 33.3% of the total.

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<sup>3</sup> 'Penalty' within this paper means a negative financial incentive or loss of margin

<sup>4</sup> North, South and Central regions

- 2.16. We are also considering an alternative penalty mechanism which would allow for poor performance in a single region to result in a penalty of 50% of the total margin, and would incentivise marginal improvements to performance below the minimum performance level. For a full description of this mechanism please see the Annex.

## **Customer Engagement**

### **Rationale for a Customer Engagement Incentive**

- 2.17. We want to see DCC's decisions strongly informed by an understanding of its customers' needs, replicating the pressures a company would experience in a competitive market to drive better value for money. As customers have repeatedly raised concerns with the DCC's engagement, we have made it clear that we expect DCC to provide evidence of customer engagement in its annual price control submission.
- 2.18. DCC has recently made some improvements to its engagement with customers, for example with its consultation on an engagement strategy and the improvements it has made to its quarterly finance forums. However, we are not confident that these improvements will be implemented quickly enough and to the standard required by customers. Therefore, we are exploring introducing a financial incentive on customer engagement, including engagement around contract management and procurement, as we believe it could help drive improvements to address the concerns of customers.
- 2.19. In exploring a customer engagement incentive, we have drawn on Ofgem's wider experience in engagement incentives, from the RIIO-1 Stakeholder Engagement Incentive and the Discretionary Recovery Mechanism from the Switching programme financial incentives, as well as wider research.

### **Assessment Criteria**

- 2.20. To assess DCC's engagement we are considering defining a set of criteria against which DCC's engagement over the year would be assessed. DCC would have to explain how it undertook customer engagement from end-to-end; including strategy, implementation and the outcomes of its engagements. Table 2.1 provides an indicative list of criteria that could be used in the assessment of DCC's customer engagement.



**Table 2.1 Customer Engagement Assessment Criteria**

	<b>Aspects of customer engagement</b>	<b>Assessment Questions</b>
1	Timing of relevant engagement	Has DCC engaged proactively with customers, enabling them to feed in views at appropriate points in decision-making cycles, and provided feedback to customers on how their views and interests have been taken into account?
2	Information provided by DCC	Has DCC provided its customers with easy access to information that enables them to compare costs and benefits of different options, and understand the drivers of those costs and benefits?
3	Transparency of engagement process	Has DCC ensured customers are clear about when and how they can contribute views?
4	Transparency of communication	Has DCC communicated transparently with its customers on costs and performance, and actions being taken to manage both?
5	Proportionality of engagement relative to impact	Has DCC sought greater input, and provided greater transparency, where decisions have greater potential impact on customers?
6	Relevance of engagement to individuals engaged	Has DCC engaged the right stakeholders (including people within organisations)? Has engagement been tailored to these stakeholders demonstrating a clear understanding of how they want to be engaged?

**Assessment Process**

2.21. We have identified several options for assessing DCC’s customer engagement:

- DCC self-assessment
- Ofgem assessment
- SEC Panel assessment
- Expert panel assessment
- Auditor assessment

2.22. Our current view is that it may be most suitable to use a combination of the above options, where Ofgem would receive submissions from both DCC and the SEC Panel in order to conduct our assessment. We are also considering using an expert panel assessment as an alternative option.

2.23. The combined assessment process could involve the following steps:

2.23.1. We would publish guidance which would set out our expectations in terms of content for the submission from DCC. This would likely include:

- A published, comprehensive, fit for purpose and up-to-date customer engagement strategy
- Examples of holistic approaches embedded within its business processes
- Examples of engagement on specific projects, such as those related to contract management, procurement and re-procurement activity or potential new areas of activity

2.23.2. We would expect DCC to explain the outcomes of its engagement while demonstrating the feedback loop it has with its customers. It is important that outcomes are demonstrated by DCC so that we can assess the effectiveness of its engagement processes. We would also expect DCC to showcase its key successes whilst providing context of how these sit within its wider customer engagement.

2.23.3. DCC would then submit its self-assessment along with any supporting evidence to Ofgem, following our guidelines.

2.23.4. The SEC Panel would also submit evidence and provide an assessment of DCC's performance, ensuring we receive input which is independent from DCC.

2.23.5. After reviewing the two submissions from DCC and the SEC Panel, we would consult on our provisional assessment based on the evidence provided to us. We would also take any further evidence into account when finalising our assessment during the consultation process and making our decision.

2.24. An expert panel assessment process would likely look similar:

2.24.1. We could recruit 3-4 engagement experts to sit on the panel, which would be chaired by Ofgem, or an independent chair.

2.24.2. The expert panel would again assess submissions provided by DCC and the SEC Panel. Once the panel has come to a decision, they could provide a report or recommendation along with a score to Ofgem, who would then make the final decision after a consultation process.

2.24.3. It is likely that initial set-up and ongoing organisation of a panel would be resource intensive, and may require additional funding for the external panel members. We would need to consider whether the additional resource implications justified any benefits of this approach.

*Scoring*

2.25. DCC’s performance regarding customer engagement would be assessed against the set of questions outlined in Table 2.1. We currently consider that these assessment criteria should not have explicit weightings, and could instead be considered as a whole when assigning a score, with scores assigned on a qualitative basis using a scale of 0-4.

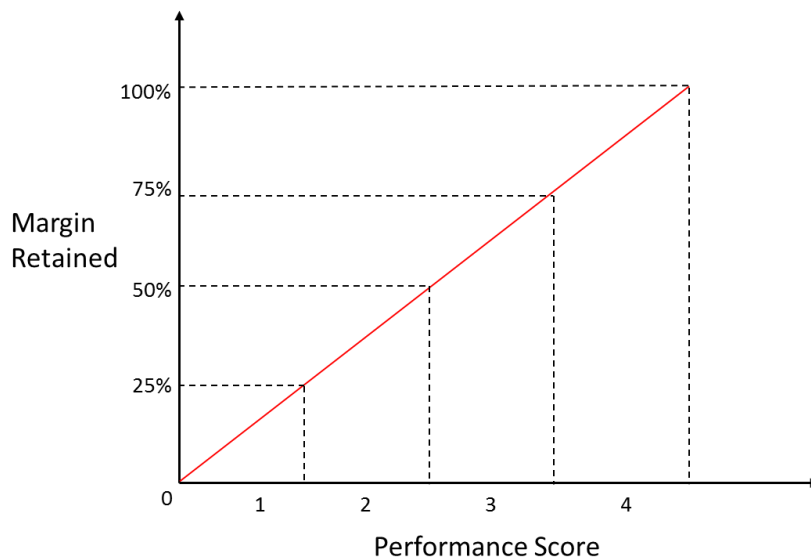
2.26. The below Table 2.2 gives a guideline of how each score could be assigned. We would publish guidance for both DCC and relevant stakeholders to understand in more detail what each of these scores would look like in practice.

**Table 2.2 – Score Descriptions**

<b>Score</b>	<b>0</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
<b>Description</b>	Unacceptable	Poor	Fair	Good	Excellent

2.27. Each score could have a range of margin associated with it, allowing for varying amounts of margin to be retained within a score bracket. An example of what this may look like is shown in Figure 2.1.

**Figure 2.1 – Scoring mechanism**



## **Contract Management and Procurement**

### **Rationale For A Contract Management Incentive (also covering procurement and change management)**

- 2.28. DCC was appointed using an outsourced service model, to manage contracted smart metering service providers. External Costs compose the largest proportion of DCC’s costs – in RY18/19 they were 74% of DCC’s total costs. As such, it is critical that these contracts are entered into, managed and closed out effectively and efficiently. Proactive, best in class contract management and procurement have the potential to deliver real benefits to DCC customers, both through strong commercial acumen driving value for money and by facilitating fast and cost-effective change to central industry systems.
- 2.29. To date, not all of DCC’s service providers have performed to the level expected by DCC (see DCC’s [Annual Service Reports](#)). In addition, several of the original Service Provider contracts will require re-procurement and/or extension in the coming years. The number of DCC service providers and the complexity of the contractual landscape has also increased as SMETS1 meters have started to be enrolled into DCC. As such, DCC will need to retain and increase focus in this area in the coming years.

- 2.30. Since the SEC went live, over 100 Modification Proposals have been raised by SEC parties. While not all of these impact DCC's outsourced systems and processes, a significant number do. We anticipate that this rate of change will continue as a requirement to support the UK's "Net Zero" decarbonisation delivery agenda drives change throughout the energy market. DCC is in a position where relatively small efficiencies in assessing, refining and delivering change can have a disproportionately positive impact across industry.
- 2.31. As such, we are exploring whether, in addition to Ofgem's annual assessment of whether DCC has incurred external spend efficiently and effectively (and the disallowance of any spend which does not meet these criteria), DCC is provided with a further incentive (in the form of retained margin) to drive improvements in contract management and procurement.

### **Areas for Assessment**

- 2.32. DCC's contractual landscape is constantly evolving; however, at the highest level, there are a number of core work areas that will always require focus by DCC. We consider these to be:
- Management of existing DCC External Service Provider Contracts and other service provider contracts;
  - Delivery of DCC-initiated change (including procurement or contract change) of new or varied Relevant Service Capabilities (ie those related to their Mandatory Business);
  - Delivery of SEC Mod initiated change (including procurement or contract change) of new or varied Relevant Service Capability (ie those related to their Mandatory Business); and
  - DCC preparation for re-procurement of Relevant Service Capability at contract end/break point.

### **Assessment Framework**

- 2.33. Skilled contract management is a requirement for many businesses, other central delivery bodies within the energy sector and also for Government. As such a number of assessment frameworks already exist to assess these capabilities and the level of proficiency within an organisation.

2.34. The National Audit Office (NAO) has published its insights and views on emerging best practice for commercial and contract management (which are available [here](#)) and also a [guide](#) to good practice in commercial and contract management for Government. In summary, the NAO best practice covers the following areas:

- **commercial strategy:** Is there an overarching commercial strategy, with a clear rationale for the approach being taken?
- **commercial capability and governance:** Does the organisation have the capability needed to manage the contract and is it developing capability for the future?
- **market management and sourcing:** Has sourcing supported the commercial strategy and followed recognised good practice to optimise value for money?
- **contract approach:** Does the balance of risk and reward encourage service improvement, minimise perverse incentives and promote good relationships?
- **contract management:** Is the service being managed well, with costs and benefits being realised as expected?
- **contract lifecycle:** Will the service continue to demonstrate value for money through its lifecycle?
- **transition and termination:** Is the organisation ready for the end of the contract?

2.35. Within each of these sections, the NAO provides a number of judgement questions, indicators of good practice and three levels of attainment descriptions. This NAO Contractual Relationships Audit Framework is available [here](#).

2.36. We regard DCC's position in relation to contract management analogous to Government, other central energy industry bodies, and other private sector businesses with significant outsourcing. As such, this NAO framework is potentially an appropriate mechanism to assess DCC's performance in contract management.

2.37. Table 2.3 below provides a mapping between the NAO Framework and the areas of DCC's work that we consider should be assessed. We consider the mapping to be robust with a few specific gaps that relate to DCC's role within the energy industry – in particular the requirement for active engagement in the SEC Modifications process – and customer engagement. The former would be dealt with by the potential additions highlighted in column 3 of Table 2.3; while customer engagement on contract management and procurement would be incorporated as part of the customer engagement incentive, as set out above in the customer engagement section.

**Table 2.3 DCC Assessment Areas to NAO Framework Mapping**

	<b>DCC Areas of work for assessment</b>	<b>Relevant NAO Assessment questions / justification questions</b>	<b>Potential gaps, and questions that could be added to close these</b>
1	Management of existing DCC External Service Provider Contracts and other service provider contracts	NAO AF 2 <sup>5</sup> (Capability & Governance): Does DCC have the capability needed to manage the contract and is it developing capability for the future? NAO AF 4 <sup>5</sup> (Contract Approach): Does the balance of risk and reward encourage service improvement, minimise perverse incentives and promote good relationships? NAO AF 5 <sup>6</sup> (Contract Management): Is the service being managed well with costs and benefits being realised as expected? NAO AF 6 <sup>7</sup> (Contract Lifecycle): Will the service continue to demonstrate value for money through its lifecycle?	None
2	Delivery of DCC-initiated change (including procurement or contract change) of new or varied Relevant Service Capabilities (i.e. those related to their Mandatory Business)	NAO AF 1 <sup>5</sup> (Commercial Strategy): Is there an overarching commercial strategy, with a clear rationale for the approach being taken? NAO AF 3 <sup>5</sup> (Market Management & Sourcing): Has market management driven long-term value for money?	None
3	Delivery of SEC Mod initiated change (including procurement or contract change) of new or varied Relevant Service Capabilities (i.e. those related to their Mandatory Business)	NAO AF 5.2: Are the suppliers delivering in accordance with the contracts and are they actively managed by DCC to meet or exceed requirements (including on IAs)? NAO AF 6.3: Is change controlled and well managed and does the contract remain current?	Do IAs contain a clear breakdown of costs and a statement of technical requirements that link back to proposed SEC Modification Proposal outcomes/business requirements? Are approved SEC Mods tested and implemented effectively, efficiently <sup>8</sup> and to time?
4	DCC preparation for re-procurement of Relevant Service Capabilities at contract end	NAO AF 7 <sup>5</sup> (Transition & Termination): Is DCC ready for the end of its contracts?	None

<sup>5</sup> Including all of the associated justification questions

<sup>6</sup> Except justification question 5.2

<sup>7</sup> Except justification question 6.3

<sup>8</sup> Considering wider industry costs and benefits rather than just those of DCC.

2.38. If we were to adopt this framework to support the OPR, we would need to further consider the relative weightings of the assessment questions and areas of work. Our initial thinking is that contract management could be weighted more heavily than procurement. We would also need to expand the three attainment levels described by the NAO to cover the additional questions set out in Table 2.3.

### **Assessment process**

2.39. As with the customer engagement incentive, for contract management we considered the five assessment processes listed previously. We narrowed these to three processes: the combined assessment, an expert panel assessment and an auditor assessment.

2.40. Our initial view is that an auditor may be the most suitable. An auditor would be able to provide the required expertise, time, and resources in order to thoroughly assess DCC's contract management processes, and would likely be more efficient than a panel assessment process. An auditor would be able to thoroughly scrutinise DCC's processes whilst fully respecting any required commercial confidentiality arrangements. An auditor may also have the advantage of being able to provide dedicated feedback to DCC, for continuous improvement.

2.41. We have outlined the auditor assessment process below:

2.41.1. An independent auditor would assess DCC against the relevant set of criteria, and provide a report to Ofgem, including recommended scores.

2.41.2. We would review the auditor's submission and consult on our proposed assessment of DCC's performance before making our decision.

2.41.3. We have considered who might appoint an auditor, where options include DCC, Ofgem, or the SEC Panel.

2.42. An expert panel or internal assessment process would likely look similar to the processes described in the customer engagement section.



### *Scoring*

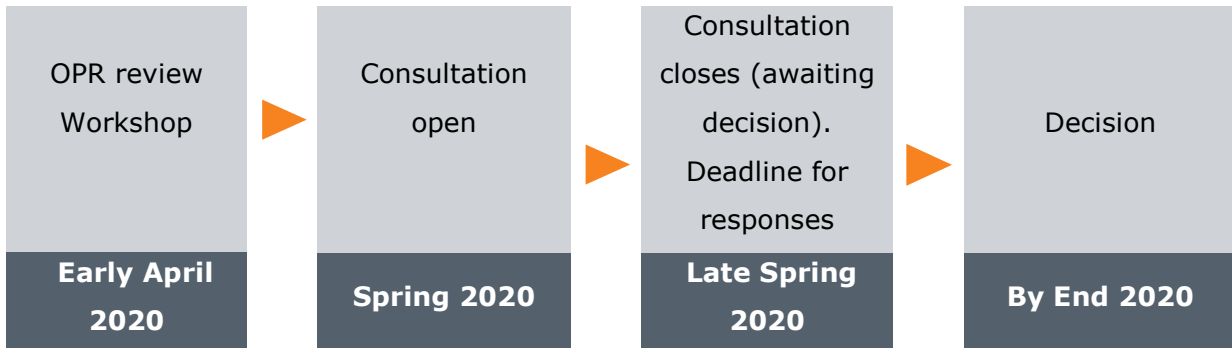
- 2.43. The NAO Framework describes three attainment levels for categorising performance. We are exploring whether to use these attainment levels when scoring DCC's performance in contract management, or whether to adapt these to match the five levels discussed in the customer engagement scoring methodology.

### **Weighting across performance categories**

- 2.44. The relative weighting of the three categories will determine the amount of margin at risk against each category. Our initial view is that system performance should have the largest weighting as it is fundamental to assessing the outcomes of DCC's performance. Contract management and customer engagement should be sufficiently weighted to provide a strong incentive to DCC. Therefore, we are considering allocating approximately a 60-80% weighting to system performance and a 10-20% weighting both to contract management and customer engagement.

### 3. Next Steps

Figure 3.1 Next steps



3.1. We welcome your views. We plan to hold a workshop to discuss with stakeholders the ideas raised in this working paper. We then plan to issue a formal consultation on our proposals in the spring to further refine our position based on consultation responses. We expect the amended OPR to take effect for RY21/22 (ie from 1 April 2021).

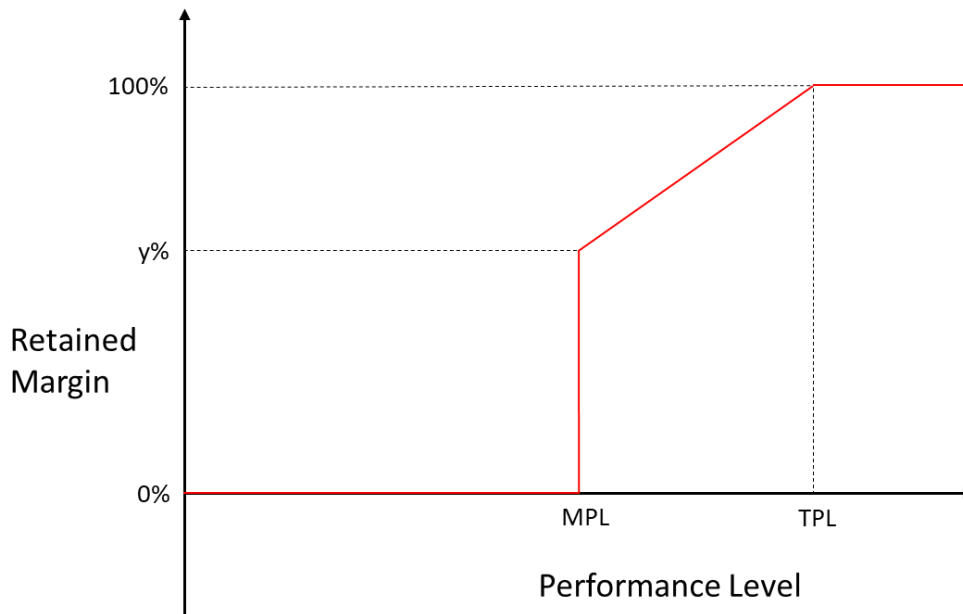
#### How to respond

- 3.2. We welcome stakeholders’ views on the ideas discussed in this working paper to feed into our policy design process in advance of the consultation in the spring.
- 3.3. Please send any views in relation to the ideas discussed in this working paper to [smartmetering@ofgem.gov.uk](mailto:smartmetering@ofgem.gov.uk)

## 4. Annex – Penalty Mechanism Under a Regional Split

- 4.1. The current penalty mechanism utilises the Minimum Performance Level (MPL) and Target Performance Level (TPL) set for the SEC Performance Measures. If DCC performs at the TPL for a given metric, it retains all of the margin associated with that metric. If DCC performs at the MPL, it retains 70% of the margin associated with that metric. Performance between TPL and MPL results in margin retention calculated by a linear line drawn between the two points. Performance below MPL results in the retention of zero margin associated with that metric.
- 4.2. Given the MPL set by the SEC operations group, one option for the new OPR is to review the margin retained at MPL performance, thus adjusting the penalty and incentive faced by DCC. Figure 4.1 is a graph describing this current penalty mechanism, where  $y$  is the margin retained at MPL.

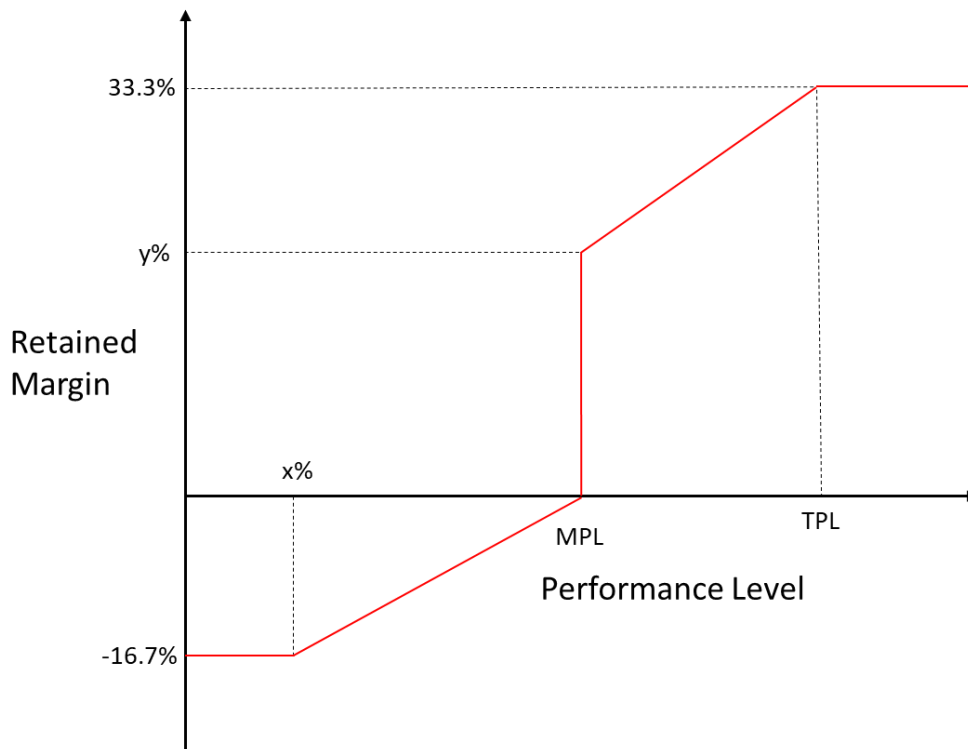
**Figure 4.1 Current penalty mechanism**



- 4.3. We are also exploring an alternative penalty mechanism, which would aim to address the 33.3% limit placed on margin lost for poor performance in a single region that arises from including regional splits. This alternative penalty mechanism would measure performance for each region within a metric, then the retained margin from each region would be summed.

- 4.4. TPL performance would result in the retention of 33.3% of the margin associated with the measure (ie 100% of the margin associated with the region). MPL would result in less than 33.3% retention, but greater than 0%. However, performance below MPL would be calculated on a linear line between 0 margin at MPL and -16.7%<sup>9</sup> of margin at performance level x%. Performance level x% would be between zero and MPL, and could take the value of zero (ie  $0 \leq x < \text{MPL}$ ).
- 4.5. We would then sum the retained margin across regions for each metric and place a non-negative condition on this sum, such that DCC cannot lose more margin than it had. [ie Retained Margin =  $\max(\text{RN} + \text{RC} + \text{RS}, 0)$ , where RN = retained margin in North region, RC = retained margin in Central region, and RS = retained margin in South].
- 4.6. Figure 4.2 is a graph describing this alternative penalty mechanism, where y is the margin retained at MPL, and x is the performance at which -16.7% margin is retained.

**Figure 4.2 Alternative penalty mechanism**



<sup>9</sup> Achieving -16.7% margin in one region yields a total lost margin of 50%, if 33% is retained in the two other regions

- 4.7. This alternative penalty mechanism has the advantage of providing a marginal incentive on DCC to perform better (below TPL) no matter how poorly it performs in any one region (unlike the current penalty mechanism which does not provide a marginal incentive below MPL).
- 4.8. The alternative penalty mechanism caps at 50% the amount of margin that DCC can lose due to poor performance in any one region, while using the current penalty mechanism would cap lost margin in a single region at 33.3%. It is possible that DCC could lose all of its margin for below MPL performance across two regions, but this would likely require below TPL performance in the remaining region also.
- 4.9. Some scenarios are as follows, DCC retains:

30% in South + 30% in Central + -10% in North = 50% of margin retained

-15% in South + -15% in Central + 25% in North = 0% margin retained (due to the non-negative restriction on the total)