Data Communications Company

Smart DCC
Ibex House
2nd Floor
42-47 Minories
London
EC3N 1DY

FAO Jacqui Russell
Head of Metering & Market Operations
Ofgem

By email to: smartmetering@ofgem.gov.uk

27 November 2020

Dear Jacqui,

Response to Ofgem Consultation on increasing DCC's revenue at risk against the Operational Performance Regime (OPR)

We welcome the opportunity to respond to your consultation to increase the revenue at risk against DCC's operational performance regime (OPR) incentives to be equal to the sum of our Baseline Margin (BM) and the External Contract Gain Share (ECGS).

We note the context in which this proposal was made - apparent requests from our customers to increase the incentive on DCC to perform well against the OPR, or rather, given that our regime is margin at risk only, to increase our penalty for poor performance. Ofgem states that respondents to its May 2020 consultation on the revised OPR regime wanted an increase in our margin at risk.

We are unable to assess the validity of these suggestions, or whether these are based on a full understanding of DCC's finances, as Ofgem has not published the consultation responses, nor provided further information on whether those who made this suggestion were in the minority.

Ofgem's stated policy is to publish all non-confidential responses on its website and in its library. We responded to the May 2020 consultation, it was not confidential and appears not to have been published. Please could Ofgem confirm where the consultation responses can be found on its website, and if they have not been published, confirm the reasons for not following its own policy.

Our top priority continues to be high performance delivery of our core services and maximising the value for money in doing so. We are fully aware of our customers' concerns around our costs, which have grown significantly over time as government has asked us to perform more activities. Given our margin is a function of our internal costs, as we spend more to deliver government's programmes, our margin will increase in absolute terms.

Our margin is far from excessive, and only earned on internal costs. As an example, our baseline margin in the last four years has been in the 1% to 2% range - which is significantly lower than the average margin made by the large energy suppliers since 2010. It is also significantly below the rate of return Ofgem allows the infrastructure companies it regulates. Furthermore, these internal costs are subject to efficiency assessment under the Price Control and any additional margin which DCC claims over and above that which is stated in the licence is subject to a baseline margin application. Hence Ofgem has ample opportunity to disallow either internal costs or associated margin where it does not believe that they are justified.

As we earn no margin on our External costs – essentially delivering them at cost – the ECGS application process is our only route to earn a return on the activities we undertake to create savings for customers and the industry. This includes taking on significant financing risks when we have renegotiated complex deals to achieve lower interest rates, the savings from which we pass on. The concept of Gainshare is common throughout regulated sectors and the percentage we apply for is conservative when compared with others, as Ofgem presumably recognises given that it has never challenged our proposed share.

If ECGS is put at risk against our performance on a revised OPR regime, Ofgem will be disincentivising us from seeking savings for our customers and the wider industry. It may be that the result of this incentive is that customers lose out more than they would ever gain through some proportion of our gainshare being clawed back under OPR and returned to them.

In terms of the process Ofgem is following with this consultation, under its s.5A duties of the Utilities Act 2000, Ofgem is required to conduct Impact Assessments for issues it considers important. This duty covers smart metering. Ofgem's proposal to increase DCC's revenue at risk meets two of its stated criteria for importance including:

- Exercising a significant new power for the first time

- Significant impacts on persons engaged in smart meter communication services, including having significant costs for industry participants and/or those involved in connected commercial activities

Ofgem's ambition for its consultation is to significantly increase our margin at risk – it has stated its aim is to increase it by around £3m, an increase of between a third and a half of our baseline margin. It is doing this by introducing a new term $R(OPR)_t$ (without consultation) in the direction it issued on 28 October 2020. Neither as part of its process on changing the OPR regime or its consultation on including our revenue at risk has it produced an Impact Assessment or set out its reasons why it has chosen not to. Before it makes its decision, Ofgem must conduct an Impact Assessment.

We are concerned that Ofgem's proposal sets a precedent that goes against the incentive framework under which we currently operate. DCC margin is, as per our current Licence, put at risk via either our performance regimes or disallowed costs, i.e. spend that Ofgem considers inefficient or uneconomic. ECGS is not margin; it serves a different Licence purpose, that of an **upward adjustment only** to our revenue that reflects a reduction in our external costs, and Ofgem assesses and disallows parts of. By putting the ECGS at risk against our OPR, this proposal will introduce a significant change to the balance of risk and reward that we currently have as well as result in a disincentive to realise efficiencies in the future. We note Ofgem has suggested that it is considering whether it would allow us to apply for ECGS on more activities and contracts than are currently the case. If it does not do this and merely increases how much we stand to lose, Ofgem will not be acting reasonably or fairly.

Before it makes its decision, Ofgem should set out clearly the full features of its proposals and include them in an Impact Assessment on which it consults. Making a decision without providing the full features of its proposals for comment would be a significant procedural defect and in conflict with Ofgem's stated policy that it will consult when it has "concrete proposals to put forward rather than vague ideas."

We regret that such a significant proposal was not consulted on in advance of your decision on the revised OPR framework, nor was it subject to a formal Impact Assessment. These omissions have led to a number of outstanding questions and concerns about the future balance of risk and reward DCC will face. Ofgem should now take the time to go through an effective and fair consultation and decision-making process to avoid forcing unintended consequences on DCC.

I would be happy to discuss the contents of this letter with you.

Kind regards

Siobhan Stanger
Chief Regulatory Officer
By email