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DCC, SEC Panel, DCC customers
and Other Interested Parties

Email: smartmetering@ofgem.gov.uk

Date: 28 October 2020

Dear Stakeholders,

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

This consultation proposes to increase the revenue at risk against DCC's operational performance incentives such that it is equal to the sum of DCC's Baseline Margin (BM) and External Contract Gain Share (ECGS) in each year from Regulatory Year 2021/22 onwards.

This proposal comes in response to requests from stakeholders we received through our May 2020 OPR Review consultation to increase the incentive on DCC to perform well against the OPR. It would increase the revenue at risk against the OPR from a minimum of ~£7m to at least ~£10m per year, achieving the aim of stronger incentives.

Context

The Data Communications Company (DCC) is responsible for managing the smart metering infrastructure. It is a monopoly, subject to an ex-post price control.

DCC's performance is incentivised through the OPR, which reduces DCC's revenue if it performs below expected standards. The revenue at risk against the OPR is currently equal to DCC's Baseline Margin[1] (~£7m to ~£10m per year of revenue it recovers in excess of costs).

[1] This does not include Project BM, BM that is associated with work for which there is a Baseline Margin Project Performance Adjustment Scheme (BMPPAS), any such BM is placed at risk against the relevant BMPPAS.

We consulted in May 2020 on proposals to revise the metrics underpinning DCC's Operational Performance Regime (OPR). The revised OPR comprises three components: a System Performance Incentive, a Customer Engagement Incentive and a Contract Management Incentive (the decision to the May consultation has been published alongside this consultation).[2] We intend the revised OPR to take effect for RY21/22.

The External Contract Gain Share (ECGS) is an incentive mechanism that awards additional revenue to DCC for reducing the cost of a service provider contract that existed at licence award, with the aim of driving more efficient contract management. DCC has the opportunity to submit applications for ECGS on an annual basis, and has been awarded additional ECGS in every Regulatory Year since RY15/16, with the revenue then recovered over future years. To date all ECGS applications have been based on DCC's refinancing of payment milestones, rather than increases in efficiencies through proactive contract management.

Proposal

We are considering three options:

1. Increase the revenue at risk against the OPR in regulatory year t to be equal to the sum of the BM_t and $ECGS_t$ and retain the original weighting between the three components of the OPR ie 70% system performance, 15% costumer engagement, and 15% contract management;
2. Increase the revenue at risk against the contract management incentive to be equal to $ECGS_t$, whilst the revenue at risk against system performance and customer engagement is equal to BM_t (weighted 80%, 20% respectively);[3]
3. Maintain the revenue at risk against the OPR equal to the BM, ie the status quo.

It is important to note that with implementation of Option 1 or 2, DCC will still not be able to make a loss through poor performance against these incentives alone; BM and ECGS are revenue in excess of DCC's costs.

Option 1 will increase the revenue at risk against all elements of the OPR, thereby strengthening the incentive for DCC to perform well in all areas. As it will increase the revenue at risk against the system performance metrics, it will help counteract the fragmentation of the incentive caused by breaking performance down by meter generation

[2] DCC Operational Performance Regime Review: October 2020 Decision: http://www.ofgem.gov.uk/publications-and-updates/dcc-operational-performance-regime-review-october-2020-decision
[3] With option 2 the weighting would approximately be 56% system performance, 14% customer engagement, and 30% contract management, but would vary from year to year.

and region by bolstering the fragmented incentive, thereby ensuring the fragmented incentive remains material.

Option 2 will principally increase the revenue at risk against the contract management incentive, but will also provide a small increase to the system performance and customer engagement incentives. The rationale for this approach is that it is consistent with the purpose of the ECGS, ie to encourage good contract management. However, it may weight the contract management incentive disproportionately high when compared to the other incentives.

Option 3 maintains the status quo. This option ensures consistency in terms of DCC’s revenue at risk against the OPR, but could result in less effective incentives due to the smaller amount of revenue at risk (especially when considering the fragementation caused by the meter generation and region breakdowns).

Our minded-to position is option 1 as it resolves the fragmentation issue; it more broadly increases the revenue at risk against all areas of DCC’s performance; and it retains the weighting between the incentives in line with our previous consultation.

To note, Licence Condition 38.10 states that we must put at risk revenue at least equal to 100% of DCC’s Baseline Margin (excluding Project Baseline Margin). However, the Licence does not provide an upper bound to the revenue to be put at risk. Therefore, this proposal does not require a change to DCC’s Licence (the Smart Meter Communication Licence), instead this change would be implemented through the OPR direction and OPR Guidance.

Impact on the ECGS Incentive

This proposal does not merge the ECGS incentive with the OPR, the ECGS application will continue to be assessed separately from, and will not be prejudiced by, DCC’s operational performance.

Nevertheless, increasing the revenue at risk against the OPR by the value of the ECGS may reduce the revenue that DCC expects to retain from any cost saving activity. Therefore, theoretically, the incentive on DCC to find cost savings will be slightly weakened. However, we do not believe it will reduce the incentive sufficiently for DCC to stop seeking cost savings on its external contracts, as it still remains in DCC’s best interests to make these savings.

Expanding the ECGS Incentive

At present, the Licence limits the application for an ECGS adjustment to savings on activities that were included in the "original External Service Provider Contracts". This limitation may be reducing the effectiveness of the ECGS mechanism as DCC now has many contracts with other service providers, and is performing activities not initially included in those original External Service Provide Contracts.

For this reason, we are considering whether we should expand the ECGS mechanism to include activities and contracts that were not included in the original External Service Provider Contracts. This expansion would require a separate statutory consultation to make changes to the Licence. However, we invite stakeholders to informally share their views on this at this stage, if they wish.

Consultation Question

What are your views on our minded-to position to increase the revenue at risk against the OPR to be equal to the sum of the BM and ECGS?

Next Steps

If you wish to give a response to this consultation, please send it to smartmetering@ofgem.gov.uk by 27 November 2020.

We plan to publish the decision on this consultation in January 2021, with the intention that the revised OPR (and therefore this proposal) takes effect for Regulatory Year 2021/22.

Yours faithfully,

Jacqui Russell
Head of Metering & Market Operations
Duly authorised on behalf of the Gas and Electricity Markets Authority
28 October 2020