Making a positive difference
for energy consumers

DCC, SEC Panel, DCC customers
and Other Interested Parties

Email: smartmetering@ofgem.gov.uk

Date: 11 January 2021

Dear Stakeholders,

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

Summary

In October 2020, we consulted on increasing 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 would increase DCC's incentive to perform well against the Operational Performance Regime (OPR) and deliver a high quality service.

We also discussed expanding the ECGS mechanism to include activities and contracts that were not included in the original External Service Provider Contracts, as we believe the current limitation on eligible savings may be reducing the effectiveness of the ECGS mechanism.

Following strong support from stakeholders, we have decided to increase DCC's revenue at risk by the full value of ECGS in each regulatory year across all three incentive areas of the OPR. However, given that Regulatory Year 2021/22 will be part of a transition phase for the System Performance incentive, and that we consider it reasonable to provide DCC with time to make improvements to its performance ahead of facing increased incentives, we consider it appropriate to delay increasing the revenue at risk to Regulatory Year 2022/23.

We have also decided to conduct a further consultation to review the ECGS incentive framework to explore how to expand the scope, as the majority of stakeholders also supported this proposal. In addition, DCC raised some concerns around the process for implementing the changes to the revenue at risk against the OPR. Therefore, we will consult on the process for such amendments in 2021, alongside our proposals for expanding the scope of the ECGS framework.

1. Context

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

1.2. 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).

1.3. Following consultation in May 2020[2], we published our decision in October[3] to revise 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. We are currently consulting on the OPR Guidance and Transition Phase for the revised OPR[4].

1.4. The External Contract Gain Share ('ECGS')[5] 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.

[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.
[2] Consultation on DCC Operational Performance Regime Review May 2020: https://www.ofgem.gov.uk/system/files/docs/2020/05/opr_review_consultation.pdf
[3] DCC Operational Performance Regime Review: October 2020 Decision: http://www.ofgem.gov.uk/publications-and-updates/dcc-operational-performance-regime-review-october-2020-decision
[4] OPR Guidance Consultation: www.ofgem.gov.uk/publications-and-updates/opr-guidance-consultation-january-2021
[5] See Licence Condition 39 'Determination of External Contract Gain Share' of the Smart Meter Communication Licence: https://epr.ofgem.gov.uk/Content/Documents/Smart%20DCC%20Limited%20-%20Smart%20Meter%20Communication%20Consolidated%20Licence%20Conditions%20-%20Current%20Version.pdf

1.5. In response to our May 2020 OPR Review consultation, we received requests from stakeholders to increase the incentive on DCC to perform well against the OPR. In October 2020 we consulted on whether we should increase the revenue at risk against the OPR such that it is equal to the sum of DCC's Baseline Margin (BM) and ECGS in each year from Regulatory Year 2021/22 onwards.[6] This would result in an increase from a minimum of ~£7m to at least ~£10m per year, achieving the aim of stronger incentives to encourage higher levels of performance as expected by DCC customers.

1.6. In that consultation we considered three options:

1.6.1. 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;

1.6.2. 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);[7]

1.6.3. maintain the revenue at risk against the OPR equal to the BM, ie the status quo.

1.7. Our minded-to position was 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.

1.8. As part of this consultation we also noted that we were considering expanding the ECGS mechanism to include activities and contracts that were not included in the original External Service Provider Contracts, as we believe the current limitation on eligible savings may be reducing the effectiveness of the ECGS mechanism.

1.9. In our consultation, we noted the impact that this policy may weaken the ECGS incentive on DCC to seek cost savings. However, we considered it would remain DCC's best strategy to continue to seek savings and make ECGS applications to maximise revenue, even when that revenue was put at risk. We therefore concluded that weakening the ECGS incentive was outweighed by the positive impact on DCC's performance we expect from putting this revenue at risk against the OPR.

[6] October 2020 Consultation in Increasing the Revenue at Risk against the OPR: https://www.ofgem.gov.uk/publications-and-updates/consultation-increasing-dcc-s-revenue-risk-against-operational-performance-regime

[7] 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.

1.10. We also noted that though this policy change would increase DCC's revenue at risk, DCC would still remain protected from making a financial loss as result of the OPR, which is in line with the overall OPR framework.

1.11. We invited stakeholder views on this issue to understand DCC and stakeholder desire for us to conduct a review of the ECGS mechanism.

2. Decision on increasing the revenue at risk against the OPR

2.1. We have decided to increase the revenue at risk by the full value of ECGS in each regulatory year against all incentive areas of the OPR from Regulatory Year 2022/23 onwards.

Stakeholder response

2.2. The majority of stakeholders agreed with our proposal to increase the revenue at risk against the OPR. Almost all of these respondents also supported our minded-to position of increasing the revenue at risk by the value of the ECGS in each year, and retaining the original weighting between the three components of the OPR.

2.3. Two respondents believed that the revenue at risk should be increased beyond the value of the ECGS, such that DCC could make a loss if its performance were sufficiently poor.

2.4. One respondent believed that a weighting of 80% for the System Performance incentive, and 10% each for the Customer Engagement and Contract Management incentives better reflected the impact of poor system performance.

2.5. One respondent favoured option 2 in the consultation, which would set the revenue at risk against contract management equal to the ECGS, placing a stronger incentive on contract management.

2.6. DCC opposed the proposal primarily on the grounds that it would disincentivise DCC from seeking savings for their customers and wider industry, and that the ECGS is gain share and is therefore an upwards adjustment only.

2.7. DCC also noted that its margin is 1-2% of its total revenue, which it does not believe is excessive and is below the rate of return of the network companies Ofgem regulates.

Our view

2.8. We acknowledge the desire of stakeholders for stronger incentives on DCC. This is why we have decided to increase the revenue at risk against the OPR by the value of the ECGS in each year.

2.9. Some stakeholders suggested that we go further to increase the revenue at risk beyond the value of ECGS, allowing for DCC to make a loss for poor performance in the OPR. The current OPR framework[8] ensures that DCC cannot make a loss, to alter this would be a significant change to DCC's risk and rewards. We do not consider it appropriate at this stage to make such a change.

2.10. We believe that retaining the original weighting of 70% for the System Performance incentive and 15% for the Customer Engagement and Contract Management incenitves is optimal, as it ensures that the two qualitative incentives are sufficiently weighted to be effective. It also reflects the impact of poor system performance by placing most of the revenue at risk against the System Performance incentive. Given that the majority of respondents also agreed with our position, we have decided to implement this option.

2.11. We decided we should implement the proposal in Regulatory Year 2022/23 rather than Regulatory Year 2021/22 as was proposed in the consultation. As we have set out in our consultation on the OPR Guidance[9], Regulatory Year 2020/21 will be part of a transition phase for the System Performance incentive. We therefore do not believe it would be appropriate to increase DCC's revenue at risk in RY2020/21, as this will be the first year DCC will be reporting under the new system performance measures, and we consider it reasonable to provide DCC with an opportunity to improve its performance before facing this increased incentive.

2.12. In response to DCC's concerns around weakening the ECGS incentive, we set out our view in the consultation that though this proposal could weaken the strength of

[8] See Licence Condition 38 'Determination of the BMP adjsutment' of the Smart Meter Communciation Licence: https://epr.ofgem.gov.uk/Content/Documents/Smart%20DCC%20Limited%20-%20Smart%20Meter%20Communication%20Consolidated%20Licence%20Conditions%20-%20Current%20Version.pdf
[9] OPR Guidance Consultation: www.ofgem.gov.uk/publications-and-updates/opr-guidance-consultation-january-2021

the incentive on DCC to seek savings in its contracts, it would not provide a disincentive for DCC to seek these savings, and seeking them will remain DCC's best strategy for maximising its revenue.

2.13. We also note that stakeholders have signalled that they are prepared to take the risk posed by the weakened incentive on finding cost savings in exchange for stronger incentives on DCC's operational performance.

2.14. In the consultation we also discussed that the increase to the revenue at risk will not prejudice ECGS applications or impact its function. The ECGS will remain an upwards adjustment to DCC's revenue to incentivise seeking cost savings, and this proposal could never result in DCC making a net loss across the Baseline Margin, ECGS and OPR performance adjustment.

2.15. In regards to the points made in DCC's response, DCC's margin is not compared or calculated as a proportion of its total revenue as it would create significant perverse incentives for DCC as a key component of its role is managing its External Costs. DCC's Baseline Margin is instead calculated as a proportion of Internal Costs that satisfy the conditions of the Baseline Margin adjustment mechanism in its Licence. At present DCC's Baseline Margin is approximately 10% of its Internal Costs.

2.16. In addition to this, the network companies Ofgem regulates are required to make substantial capital investment in the infrastructure they manage, the cost of which plays a key role in determining their rate of return. DCC is asset light and is not required to make any such capital investments.

2.17. Finally, we note that the desired outcome of this proposal is to provide a sufficiently strong incentive for DCC to perform well against the OPR, and not to reduce DCC's margin. If DCC meets all of its target performance levels it will retain all of its Baseline Margin and ECGS.

3. Decision on reviewing the ECGS incentive

3.1. We have decided to review the ECGS incentive framework to explore how to expand the scope. We will publish a consultation with our proposals in 2021.

Stakeholder response

3.2. The majority of stakeholders agreed with our intention to expand the ECGS. Respondents highlighted that Ofgem should ensure there is no scope for 'gaming' of the incentive mechanism. One respondent stated that consideration needs to be given to the sort of contracts and activities that ought to be in scope of the ECGS incentive, and how assurance will be provided that all relevant areas have been captured.

3.3. DCC also strongly supported expanding the scope of the ECGS, arguing that it would only be appropriate for Ofgem to increase the revenue at risk against the OPR if Ofgem also expanded the ECGS to maintain the balance of risk and rewards for DCC.

Our view

3.4. As we stated in the consultation, the ECGS mechanism is limited to only incentivising savings on areas that were included in the "original External Service Provider Contracts". This may reduce the effectiveness of the ECGS as DCC now has many contracts with other service providers, and is performing activities not initially included in those original External Service Provide Contracts.

3.5. We therefore think it is appropriate to review the scope of this mechanism, ahead of putting ECGS at risk against the OPR. During the review, we will consider DCC activities that are appropriate to include under the ECGS mechanism, as well as how to mitigate the risk of gaming. We will seek further stakeholder views on this as part of the consultation.

4. Decision on process for implementing increased revenue at risk

4.1. Alongside consulting on expanding the scope of the ECGS, we have decided to consult on the process for amending the revenue at risk against the OPR, as well as providing further transparency on the impacts of the policy, for implementation in Regulatory Year 2022/23.

Stakeholder response

4.2. In DCC's response to our consultation, DCC stated that Ofgem were implementing the increase in revenue through the introduction of the term R(OPR) into the OPR Direction, which had not been consulted on.

4.3. DCC also argued that Ofgem had not conducted an impact assessment as part of the consultation process, as stated in section 5A of the Utilities Act 2000[10].

Our view

4.4. We noted in the consultation that given Licence Condition 38.10 states that we must put revenue at risk at least equal to 100% of DCC's Baseline Margin (excluding Project Baseline Margin), this set a framework that allowed for increases in the revenue at risk beyond the value of the Baseline Margin.

4.5. Under the previous OPR, the revenue at risk was defined in the OPR Direction[11] by the term BM(OPR) – the value of the Baseline Margin. We amended the notation of this term in the OPR Direction published in October 2020[12] to R(OPR), the value of which would be determined by the outcome of our consultation on increasing the revenue at risk.

4.6. Nevertheless, we accept that we should take on further stakeholder views as to whether the value of R(OPR) is best set in the OPR Direction – requiring public consultation – or in the OPR Guidance, which only requires consultation with the DCC. We will therefore use the consultation in 2021 to consult stakeholders on the process of amending the revenue at risk against the OPR.

4.7. In regards to section 5A of the Utilities Act 2000, we set out the impacts of this policy change as part of the October consultation, which we have outlined again as part of this decision letter. This included our assessment of the impacts on DCC's performance through stronger incentives; impacts on the ECGS incentive; and that DCC would remain protected from making a financial loss as a result of these proposals.

[10] See the Utilities Act 2000 here: https://www.legislation.gov.uk/ukpga/2000/27/contents
[11] OPR Direction published in September 2017:
https://www.ofgem.gov.uk/system/files/docs/2017/09/direction.pdf
[12] OPR Direction published in October 2020:
https://www.ofgem.gov.uk/system/files/docs/2020/10/opr_review_direction_0.pdf

4.8. In addition, our October consultation on revenue at risk followed our May 2020 consultation[13] on the OPR review, and our November 2016 consultation[14] that introduced the OPR, both of which set out in detail why the intervention was necessary, policy objectives, proposals and the impacts. To ensure further transparency, we will include a further assessment of the impacts of increasing the revenue at risk against the OPR as part of the further consultation in 2021.

Yours faithfully,

Jacqui Russell
Head of Metering & Market Operations
Duly authorised on behalf of the Gas and Electricity Markets Authority
11 January 2021

[13] DCC Operational Performance Regime Review: May 2020 Consultation: https://www.ofgem.gov.uk/publications-and-updates/dcc-operational-performance-regime-review-may-2020-consultation
[14] DCC Operational Performance Regime: Final Proposals: https://www.ofgem.gov.uk/publications-and-updates/dcc-operational-performance-regime-final-proposals