



The Authority (Ofgem), the SEC Panel, SEC Parties
and other interested parties

21 July 2017

Dear Colleague,

CONSULTATION ON:

- **PROPOSED CHANGES TO THE DCC LICENCE TO ENABLE BEIS TO SET PROJECT INCENTIVES FOR DCC; AND**
- **PROPOSALS TO EXTEND THE DATE BY WHICH OFGEM MAY MODIFY THE OPR USING ITS POWER OF DIRECTION.**

1. This consultation sets out proposals for, and seeks views on, enabling changes to the DCC Licence so that:

- BEIS¹ may establish one or more schemes that would set incentives for DCC to deliver specific projects;
- Under such schemes, any Baseline Margin² that Ofgem permits DCC to recover and which is associated with a specific project (e.g. the Release 2.0 Project and the SMETS1 Enrolment and Adoption Project) would be put at risk against incentives determined by BEIS (rather than under the Operational Performance Regime);
- BEIS would be required to consult on any particular scheme associated with a specific project prior to its introduction.

2. This consultation also sets out proposals to modify the date by which the Operational Performance Regime needs to be developed and populated by Ofgem using its power of direction, to 31 August 2020 in order to allow for a

¹ Formally, it is the Secretary of State rather than BEIS that would make the schemes, although other than in Appendix B, for ease of reading, the term “BEIS” has been used throughout this document. Similarly the term “Ofgem” is used where formally the relevant body is “The Authority”.

² Capitalised terms in this document have the meaning set out in the DCC Licence.

suitable period of stable operation prior to the expiration of its powers under Condition 38 of the DCC Licence.

I. Background: DCC's Baseline Margin and Baseline Margin Performance Adjustment

3. The revenue that DCC is permitted to recover each year is controlled under its licence. The Allowed Revenue formula in Condition 36.7 of the DCC Licence permits the DCC to include a Baseline Margin within the revenues it may recover. The values of the Baseline Margin for each Regulatory Year were initially determined at the time that the DCC Licence was granted.
4. Appendix 2 to Condition 36 of the DCC Licence enables adjustments to be proposed to the Baseline Margin values and for Ofgem to assess and determine those proposals. In particular, DCC is permitted to propose a Relevant Adjustment to the values of the Baseline Margin where a variation has taken place, or is likely to take place, in one or more of the following aspects of its Mandatory Business:
 - (a) the total volume of the activities comprising that business;
 - (b) the characteristics of the activities comprising that business;
 - (c) the mixture (whether by category or volume) of the activities comprising that business;
 - (d) the risks (whether financial or operational) to which DCC is exposed in the carrying on of that business; and
 - (e) the timescales or deadlines that DCC is required to meet (whether under the DCC Licence or otherwise) in the carrying on of that business.
5. The Allowed Revenue formula also includes a Baseline Margin Performance Adjustment term which, depending on how DCC performs against various incentives, reduces its Allowed Revenue by an amount up to the Baseline Margin in any Regulatory Year. The combined effect of the Baseline Margin and the Baseline Margin Performance Adjustment terms is therefore that DCC may be permitted to recover a net amount between zero and its entire Baseline Margin within any particular year depending upon its performance.
6. The incentive scheme which now determines the Baseline Margin Performance Adjustment is the Operational Performance Regime (OPR) which Ofgem is currently finalising, and which replaces the Implementation Performance Regime (IPR). The IPR was used by BEIS to incentivise DCC to mobilise its operations

and deliver the first suite of DCC functionality and consisted of 10 Implementation Milestones (IMs)³.

7. On 18 and 24 January 2017, the BEIS gave separate directions under Condition 13.14 of the DCC Licence requiring DCC to update its plans to include the delivery of a SMETS1 Enrolment and Adoption service, and Release 2.0, respectively.
8. The SMETS1 Enrolment and Adoption project relates to implementing changes that enable the provision by DCC of a data and communications service for SMETS1 Meters. DCC consulted stakeholders on a plan to deliver such a service on 26 May 2017, and it due to submit a resulting plan to BEIS shortly for approval. Enrolment of SMETS1 Meters with DCC would significantly improve interoperability (i.e. the ability for a customer to maintain smart services following a change of supplier) for these smart metering systems.
9. The Release 2.0 project encompasses the provision by DCC of Dual Band Communications Hubs (DBCHs), although a number of other changes to the Technical Specifications and Great Britain Companion Specification are also included within its scope. DBCHs are expected to be needed in order to establish working Home Area Networks (HANs) in approximately 26.5% of premises in which smart meters are installed. The timely availability of DBCHs is therefore important for the completion of the smart meter roll-out and the realisation of the associated benefits.
10. DCC may propose one or more Relevant Adjustments to the Baseline Margin values in the DCC Licence which would, if allowed by Ofgem, provide it with additional margin in relation to the costs associated with each of these projects. Based on the existing arrangements within the DCC Licence, where Ofgem determines a proposed adjustment to the Baseline Margin values, the revenues at risk under the OPR would also include this additional margin.
11. BEIS continues to be closely involved with the SMETS1 Enrolment and Adoption and Release 2.0 projects under transitional governance arrangements, including the review and approval of plans whose milestones would be appropriate for use in placing associated margin at risk. Consequently, we propose that BEIS, rather than Ofgem, is best placed to set the incentive arrangements under the DCC Licence in relation to these two projects.

³ The final IM regime was approved on 19 October 2016 - https://www.smartdcc.co.uk/media/407672/2016_10_19_dcc_im_proposal_-_sofs_direction_-_final.pdf

II. BEIS-led incentive scheme for SMETS1 and Release 2.0 projects

12. Following discussions between BEIS and Ofgem, BEIS proposes to modify the DCC Licence so that:
 - Any additional Baseline Margin associated with these projects as determined by Ofgem would not be put at risk under the OPR;
 - It would instead be put at risk against incentive regimes determined by BEIS; and
 - These arrangements could potentially be extended to other future projects if it was appropriate for BEIS to determine the incentives rather than Ofgem, although at the present time BEIS is not aware of any such other projects.
13. At this stage, BEIS is not consulting on the specific details of the incentives that would apply to the two projects, but instead only on the changes to the DCC Licence that would allow these incentives to be determined by BEIS rather than by Ofgem.
14. We intend to consult on the actual project incentives in due course. On the Release 2.0 project, examples of milestones that could be used to set incentives are:
 - a) the date on which DCC is able to make available a testing service that enables testing of the interoperability of devices with the updated DCC systems (i.e. an updated version of the GFI service currently provided in accordance with Section X9 of the SEC);
 - b) the date on which Instrumented Test DBCHs, or an equivalent service, are made available in User Interface Testing for Release 2.0;
 - c) the date on which the new services go live; and
 - d) the subsequent stable operation of the DCC systems.
15. On the SMETS1 Enrolment and Adoption project, examples of milestones that could be used to set incentives are:
 - a) the date on which DCC is able to make testing services available that enable the undertaking of end-to-end tests by energy suppliers and other relevant parties;
 - b) the date on which DCC is able to make a SMETS1 Service operational in relation to at least one cohort of eligible SMETS1 Meters; and
 - c) the date on which DCC is able to make a SMETS1 Service operational in relation to the last cohort of eligible SMETS1 Meters.
16. It is proposed that the new incentive arrangements would operate as follows:
 - a) Ofgem would continue to determine any proposed adjustments to DCC's Baseline Margin values following requests for additional margin from DCC.

- b) Where DCC applies for additional margin, it would have to separately identify amounts applied for in relation to its Internal Costs associated with the development phases of each of the Release 2.0 and SMETS1 Enrolment and Adoption projects.
- c) Ofgem would continue to determine the OPR, but the OPR would not put at risk Baseline Margin associated with projects that fall within the scope of the new arrangements.
- d) Instead, BEIS would set the regime against which the Baseline Margin for these projects is put at risk. This would entail introducing a new Baseline Margin Project Performance Adjustment term into the calculation of the value of Baseline Margin Performance Adjustment.
- e) The Baseline Margin associated with any particular project would be put at risk against defined Project Activities, although it may not end up being put at risk in the same Regulatory Year as the one in which Ofgem allows the additional Baseline Margin. This is because the Project Activities that we may wish to incentivise DCC to deliver may not be due to complete in the same Regulatory Year as all the adjustments to the Baseline Margin associated with that project are made.
- f) The parameters of a scheme provide flexibility to, if set in a particular way and depending upon how DCC performs, allow DCC to retain more than 100% of its Baseline Margin. This would make possible, for example, the incentivisation of DCC to deliver earlier than planned on a milestone that is significant for industry. BEIS would consult on any proposals to set the parameters of a scheme in such a way, as part of its consultation on the introduction of any particular scheme.
- g) BEIS would be required to consult DCC and SEC Parties on proposed schemes (for example, on the proposed Project Activities and associated Project Activity Weighting Factors) before they were introduced or any amendments to existing schemes were made.

17. More details of how the proposed arrangements would work are included in Annex A.

III. Extending the date by which Ofgem must develop and implement the OPR using its power of direction

18. Condition 38.9 of the DCC Licence requires Ofgem to develop and populate Schedule 4 to the DCC Licence (the Operational Performance Regime) by 31

October 2018 in a direction to be given to DCC, and following consultation with DCC, the SEC Panel and SEC Parties.

19. At the time this licence condition was originally developed, it was expected that DCC would by 31 October 2018 have been operating under a stable operating regime for some time, and that this would be taken into account by Ofgem when implementing the regime using its power of direction.
20. Given the timings of the delivery of DCC's initial suite of functionality (compared to that proposed at Licence Award in September 2013), and in order to allow the OPR to be set based on a period of stable DCC operation, it is proposed to modify the date by which Schedule 4 to the DCC Licence needs to be developed and populated to 31 August 2020. This would have the effect of allowing Ofgem to give directions to develop and populate the provisions of the OPR until this date and after having undertaken the relevant consultations.

We would welcome views on the following questions:

- i. **Do you agree that BEIS, rather than Ofgem, should set the incentive regime that places DCC's Baseline Margin associated with the Release 2.0 and SMETS1 Enrolment and Adoption projects at risk (and any potential BEIS driven future projects)?**
- ii. **Do you agree with our proposed framework for introducing the new incentives? Please provide details of your views.**
- iii. **Do you agree with our proposal to extend the date by which the Ofgem must develop and implement the OPR using its powers of direction? Please provide details of your views.**
- iv. **Do you have any comments on the proposed legal drafting in Annex B?**

Responding to this consultation

Comments on these proposals, should be submitted by 17:00 on **18 August 2017** to: smartmetering@beis.gov.uk

or addressed to:

Smart Metering Implementation Programme – Regulation,
Department for Business, Energy & Industrial Strategy,
Orchard 5, 1 Victoria Street
London, SW1H 0ET

Information provided in response to this consultation, including personal information, may be subject to publication or release to other parties or to disclosure in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004).

BEIS may publish the individual responses to this consultation on its website and you should therefore let us know if you are not content for the response or any part of it to be published. If you indicate that you do not want your response published we will not publish it automatically but it could still be subject to information requests as detailed above. If you do not want your individual response to be published on the website, or to otherwise be treated as confidential please say so clearly in writing when you send your response to the consultation. For the purposes of considering access to information requests it would also be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded by us as a confidentiality request.

Yours faithfully,

A handwritten signature in blue ink, appearing to read 'D Stone', with a stylized flourish at the end.

Duncan Stone

Head of Delivery

Smart Metering Implementation Programme

Annexes:

Annex A: Detailed description of the proposed changes

Annex B: Proposed DCC Licence Changes (appended as separate document)

ANNEX A: DETAILED DESCRIPTION OF THE PROPOSED CHANGES

Changes are proposed to Conditions 35, 36 and 38 of the DCC Licence.

Condition 35

The principal change to Condition 35 is to introduce the concept of a “Project”, for example the Release 2.0 project. Essentially a Project is one or more related activities that DCC is undertaking to support a change in the nature of the services it provides, and which takes place during a specified period of time. A Project, including the associated period of time, would be defined in a direction given by the Secretary of State.

Any Baseline Margin arising from a Relevant Adjustment that is associated with DCC’s Internal Costs relating to a Project would not be put at risk by the Authority under the Operational Performance Regime, but instead under a Baseline Margin Project Performance Adjustment Scheme determined by the Secretary of State.

Other proposed changes to Condition 35 are to add descriptions of the additional acronyms that are proposed to the list in Condition 35.8.

Condition 36

In addition to a number of consequential changes proposed to Condition 36, it is proposed to add a new term “BMPPA_t” to the calculation of the BMP Adjustment term in Condition 36.12. This new term is essentially the contribution to the Baseline Margin Performance Adjustment term from the incentive schemes determined by the Secretary of State.

A new Condition 36.17 explains that the new BMPPA_t term is determined in accordance with Part D of Condition 38.

Changes to Appendix 2 of Condition 36 require DCC to separately identify any element of a proposed Relevant Adjustment that relates to a Project. The purpose of this is to separately identify the amount of Baseline Margin that is to be put at risk under the Secretary of State-determined incentive arrangements rather than under the Operational Performance Regime determined by the Authority.

A change to Part E of Appendix 2 is proposed that clarifies that the details of any scheme should be disregarded when making any proposal or determination of a Relevant Adjustment.

Condition 38

In addition to a number of consequential changes, the proposed changes to Condition 38 include:

- i) A change to Condition 38.10 to exclude any Project Baseline Margin from the Operational Performance Regime (“OPR”), i.e. the Baseline Margin associated with a Project is excluded from the OPR because it will instead be put at risk under incentive arrangements set by the Secretary of State.
- ii) The introduction of a new Part D that sets out how the $BMPPA_t$ term is calculated. In essence the value of the $BMPPA_t$ term, which feeds into the calculation of the Baseline Margin Performance Adjustment, is, in any Regulatory Year, the sum of the individual performance adjustments from each Project in that Regulatory Year. The individual performance adjustments from each Project or “Project Performance Adjustments” are defined in Appendix 1 of Condition 38.
- iii) Appendix 1 of Condition 38 provides for the Secretary of State to make a Baseline Margin Performance Adjustment Scheme (a “Scheme”) by giving notice to DCC in writing.
- iv) Each Scheme must include one or more Project Activities, which are essentially the activities relating to a Project for which DCC will be incentivised.
- v) Each Project Activity has an associated Weighting Factor. The Weighting Factor determines the proportion of the Project Baseline Margin that is put at risk depending on DCC’s performance in delivering that Project Activity. The Weighting Factors for any individual Project will normally amount to 1, reflecting the fact that the whole of the Project Baseline Margin is to be put at risk across all of the Project Activities. The sum of the Weighting Factors cannot exceed 1, reflecting the fact that no more than the total Project Baseline Margin can be put at risk under a Scheme.
- vi) Each Project Activity also has a Project Activity Milestone, which is a performance target that relates to that Project Activity and an associated Project Activity Performance Factor. The Project Activity Performance Factor is ultimately the measure of how well DCC has performed in carrying out the Project Activity. A value of 1 would, for example, mean that DCC had wholly failed to meet its performance targets for that Project Activity, and hence all of the Project Baseline Margin associated with that Project Activity (i.e. the Project Baseline Margin multiplied by the Weighting Factor) would be recovered back from DCC. Conversely a factor of zero would mean that DCC had wholly succeeded in meeting the performance target, and hence could retain all of the associated Project Baseline Margin.
- vii) Provision is also made for a Project Activity Performance Factor to be less than 1 (i.e. negative). A negative Project Activity Performance Factor would allow

DCC not only to retain the Project Baseline Margin associated with that Project Activity but also to recover additional monies. For example, if the factor was, say, -0.2, DCC would be permitted to retain the associated margin plus an additional 20%. This would provide flexibility to, for example, incentivise early delivery of a milestone that is significant for industry.

- viii) Appendix 1 goes on to explain that a Project Activity Milestone may be defined in relation to one or a number of different factors and that a Project Activity Performance Factor may vary by reference to such factors. A Scheme may also include provisions for interpreting and giving effect to the Scheme, for example setting out how it will be identified whether DCC has reached a Project Activity Milestone and how the associated Performance Activity Factor is to be calculated. It may also provide for an audit or assessment of DCC's performance by any person.
- ix) Before making or amending any Scheme, the Secretary of State must first consult with the Authority, DCC and SEC Parties and take into account the consultation responses.
- x) The Project Performance Adjustment for any Project in any Regulatory Year is the sum of the contributions in that year from DCC's performance in relation to each of the Project Activities (each contribution being the Project Activity Amount). This contribution from any particular Project Activity is zero in any year prior to: (i) the year in which DCC first completes the Project Activity; or (ii) the year in which, had the activity been completed, the Project Activity Performance Factor would be 1 – i.e. DCC has wholly failed to deliver against that particular Project Activity for the purposes of the incentive arrangements.
- xi) In the year DCC first completes the Project Activity (or the year in which, had the activity been completed, the Project Activity Performance Factor would be 1, indicating that the DCC will lose all of the associated Baseline Margin) the Project Activity Amount is the product of the Weighting Factor, the Project Activity Performance Factor (which is now known) and the sum of the values of Project Baseline Margin (adjusted, where appropriate by RPI) over all previous years. In subsequent years the Project Activity Amount is the product of the Weighting Factor, the Project Activity Performance Factor and the Project Baseline Margin for that year.

ANNEX B: PROPOSED DCC LICENCE CHANGES

A marked-up version of the proposed changes to the DCC Licence is published separately alongside this consultation document.