



Department for  
Business, Energy  
& Industrial Strategy

Department for Business,  
Energy & Industrial Strategy  
1 Victoria Street,  
London SW1H 0ET

[www.gov.uk/beis](http://www.gov.uk/beis)

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

9 October 2017

Dear Colleague,

**CONCLUSIONS 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. On 21 July 2017, BEIS consulted on proposals to change the DCC Licence<sup>1</sup> so that:
  - BEIS may establish one or more schemes that would set incentives for DCC to deliver specific projects;
  - under such schemes, any additional Baseline Margin<sup>2</sup> that Ofgem permits DCC to recover, and which is associated with a specific project (e.g. the SMETS1 Enrolment and Adoption project), would not be put at risk under the Operational Performance Regime (OPR);
  - it would instead be put at risk against incentives determined by BEIS;
  - BEIS would be required to consult on any particular scheme prior to its introduction.
2. The consultation also set out proposals to modify the date by which the OPR needs to be developed and populated by Ofgem, using its power of direction, to 31 August 2020, in order to allow for a suitable period of stable operation prior to the expiration of this power under Condition 38 of the DCC Licence.

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<sup>1</sup> The smart meter communication licence granted to Smart DCC Ltd (DCC) by the Secretary of State pursuant to sections 7AB(2) and (4) of the Gas Act 1986 and sections 6(1A) and (1C) of the Electricity Act 1989.

<sup>2</sup> Capitalised terms in this document have the meaning set out in the DCC Licence.

3. Six responses to the consultation were received. This letter summarises the points made by respondents to the four consultation questions and sets out BEIS's conclusions in light of these.

**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)?**

4. Three respondents agreed with the proposal that BEIS should set the incentives. Three did not agree, although of these the main point raised by one related to who decided whether the incentives had been met, rather than who set them in the first place. In addition, much of the content of the responses related more to the design of any future projects (which BEIS would consult on separately). The principal relevant points raised in response to this question by one or more respondents were that:

- an objective, independent party should determine whether or not the incentives have been met;
- the Baseline Margin adjustment mechanism was not designed for ex-ante incentives, and it may not work harmoniously with other regulatory arrangements. But if the Baseline Margin is used to deliver project incentives, BEIS rather than Ofgem should also set the margin on the associated project costs;
- the DCC Licence should be changed to allow margins associated with the internal costs of specific projects to be set at the time that the Condition 13 plan for the project is finalised;
- any new incentive scheme should incorporate lessons from the Implementation Performance Regime (IPR) and DCC's service provision record to date;
- the arrangements should not set a precedent that BEIS should determine the incentives for future projects beyond Release 2.0 and SMETS1 Enrolment and Adoption. BEIS should work closely with Ofgem and ensure alignment with the OPR;
- delivery and ongoing operation should not be covered by separate incentive regimes, as a project can only be considered to have been successfully delivered if subsequent operation delivers the requisite level of service, and this removes overall accountability from Ofgem;

- the joint DECC/Ofgem letter to industry in 2014 stated that Ofgem would be responsible for setting DCC incentives once DCC Services were operational, and the proposals were inconsistent with this. Instead, for consistency, Ofgem should set the incentives;
  - no further incentivisation should be needed for DCC to meet its obligations, and it is already generously rewarded; and
  - at this stage, it is not necessary to decide whether future projects should also be incentivised by BEIS; this can be considered on a case-by-case basis.
5. BEIS considers that whether or not incentives have been met should be determined objectively and, where a degree of judgement needs to be exercised, this should be undertaken by a suitably competent independent body. We will consult on how it is proposed that performance in relation to each of the incentives that apply to any particular project would be measured as part of the specific project incentive schemes.
  6. Regarding the use of part of the existing Baseline Margin regime for project incentives, we continue to believe that this is appropriate given the time-limited nature of the development of BEIS-driven projects. BEIS does not, at this point in time, have any plans to use the provisions to make schemes beyond the development of the Release 2.0 and SMETS Enrolment and Adoption projects. The focus of the incentives arrangements will be on how existing margin is best placed at risk to drive the right behaviour by DCC. BEIS does not agree that it is necessary for the Baseline Margin associated with a particular project to be set by BEIS, nor that there is a need to change the timing of when Baseline Margin adjustments may be applied for. We believe that DCC is in a good position to form a reasonable view of the internal costs it is likely to incur in relation to any particular project. It can also form a reasonable view on the rate of any additional margin that may be allowed by Ofgem.
  7. BEIS acknowledges that the design of the specific incentives needs to incorporate lessons learned from the operation of the IPR incentives. We recognise that it will be important to ensure that appropriate quality criteria are incorporated into relevant incentives in order for DCC to be considered to have successfully delivered.

**Do you agree with our proposed framework for introducing the new incentives? Please provide details of your views. A more detailed description of the proposed changes is included in Annex A.**

8. Three of the respondents agreed with, or broadly supported, the proposed framework. Another respondent expressed the view that industry should have an early opportunity to input into the specific incentives, and two disagreed with the proposal. The principal relevant points raised in response to this question about the proposed framework (as opposed to specific scheme designs which will be consulted on separately) were that:
- the proposals appear to be introducing further complexity in the way that DCC's costs are monitored, and DCC may use the schemes to maximise financial reward over and above providing services to users;
  - the proposals seem to introduce an effective hierarchy of change, and more clarity is needed over the interaction between the OPR, project incentives and DCC's delivery of code modifications; and
  - incentives allowing recovery of more than 100% of margin seem contrary to the fact that DCC is already being paid for these projects as part of DCC's core delivery, noting that such incentives might lead to the risk that DCC will incur inappropriate cost increases in order to meet these incentives.
9. We do not believe that the proposals will introduce further complexity in the way that DCC's costs are monitored, since it is proposed that Ofgem will continue to monitor all DCC's costs as it does now. It is acknowledged that, depending on the design of the scheme, DCC may be incentivised to spend more money to meet certain milestones. However, this is a consideration for the design of any incentive mechanism and not something that arises as a direct consequence of the possibility of recovery of more than 100% of margin.
10. In general, it is the purpose of the OPR to provide incentives for DCC to deliver operational services. BEIS accepts that the interactions between any project incentives set by BEIS and the incentives under the OPR should be considered when developing any project-based incentives, but in principle we remain of the view that it is appropriate to place a proportion of DCC's margin at risk based on its performance in delivering projects. Absent such incentives, DCC would arguably have an incentive to focus solely on OPR incentives to the detriment of delivering on projects. We note Ofgem's recent decision on the operation of the OPR and that this regime will begin in 2018 without an interim year. But we also acknowledge Ofgem's arguments that, whilst there is no monetary incentive on DCC's performance between Release 1.3 and April 2018, there is a reputational incentive on DCC to demonstrate to industry that they can deliver services.

Ofgem also notes that there are performance reporting requirements under the SEC and that it is in DCC's interests to establish a reliable service, so that it has the experience to maximize its performance under the OPR when this comes into effect.

**Do you agree with our proposal to extend the date by which Ofgem must develop and implement the OPR using its power of direction? Please provide details of your views. A more detailed description of the proposed changes is included in Annex A.**

The majority of respondents agreed with this proposal, although two did not. The principal points made were that:

- Ofgem should be permitted to modify the OPR over the entirety of the DCC Licence's duration;
  - the consultation did not make clear what any interim incentive regime would be, and the lack of certainty over the OPR might have an impact on effective installation and operation of smart meters as part of the rollout; and
  - moving the date may mean that DCC is not operationally incentivised for a further two years.
11. BEIS notes that the effect of the proposed extension is only to extend the date by which Ofgem may modify the OPR using its power of direction under the DCC Licence. It does not affect Ofgem's more general powers to propose licence changes under the Gas and Electricity Acts in order to further modify the OPR, if it is considered subsequently appropriate to do so.
12. We do not believe that the extension of the date will have any impact on the initial operation of the OPR, and again note that Ofgem has recently published its decision on the initial operation of the OPR.

**Do you have any comments on the proposed legal drafting in Annex B?**

13. The principal drafting points raised in response to this question (beyond policy points that are already captured above) were:
- in light of the drafting in Part E of Appendix 2 of Condition 36, which states that the details of any scheme should be disregarded when determining any Relevant Adjustment of the Baseline Margin, how the Relevant Adjustment would be assessed and what degree of transparency there would be over the process;

- that the concept of a “Project” might lead to misconceptions that they were not core deliverables, and the overlap between the definition of “Projects” and “Mandatory Business Services” makes it difficult to understand who sets the value to be put at risk and how. The respondent making this comment also raised questions over the relationship between some of the proposed drafting in Conditions 36 and 38; and
  - a minor drafting correction was also suggested, for which we are grateful.
14. The provisions of Part E of Appendix 2 of Condition 36 are intended to clarify that Ofgem should apply its “standard” processes when considering the magnitude of any Relevant Adjustment that relates to activities including those which fall within a project that is the subject of incentives set by BEIS, i.e. that Ofgem should simply determine the Relevant Adjustment in the same way that it would do in the absence of any project incentive.
15. It should be noted that the scope of DCC’s existing Authorised Business does not currently include the provision of services relating to dual band communications hubs, or services in relation to SMETS1 meters. Consequently, we do not believe that there is any overlap between the Mandatory Business and the scope of the ‘Projects’.

### **Next Steps**

16. BEIS concludes that it is appropriate to modify the DCC Licence, both to make provisions for BEIS to set DCC project incentives and to extend the date by which Ofgem may modify the OPR. We will therefore proceed to lay the proposed changes before Parliament in line with the requirements of Section 89 of the Energy Act 2008.
17. Separately, BEIS is developing proposed incentives for each of the Release 2.0 and SMETS1 Enrolment and Adoption projects and will consult industry on these later this year.

Yours faithfully,

**Duncan Stone**  
Head of Delivery  
Smart Metering Implementation Programme

**Annexes:**

Annex A: Proposed DCC Licence changes revised in light of responses to the consultation (appended as separate document)