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Mr. Duncan Stone
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By email to: smartmetering@beis.gov.uk

18th August 2017

Dear Duncan,

DCC's response to BEIS' consultation on proposed changes to the DCC Licence:

- **To enable BEIS to set project incentives for DCC and**
- **To extend the date by which Ofgem may modify the OPR using its power of Direction.**

DCC welcomes the opportunity to contribute to the development of the incentive framework for BEIS initiated projects, as well as the proposed modification to the Licence to enable Ofgem to modify OPR for a longer period.

DCC broadly agrees with both proposals. Nonetheless, we have comments and suggestions on the detail, in particular relating to the incentive framework. Our detailed response to BEIS' questions can be found in the annex to this letter.

In brief DCC's response to the two proposals is as follows:

BEIS' projects incentive framework

We consider that the proposed framework's overarching principles are clear, as is BEIS' intent to use the existing Baseline Margin (BM) adjustment framework as the vehicle to identify margin to deliver BEIS' projects. However, there are certain practical difficulties with use of the BM adjustment mechanism which need to be addressed.

We have a particular concern relating to the timing of the application for a BM adjustment and how this fits with the projects.

The licence permits DCC to submit any application for BM adjustment in July following the relevant expenditure or when forecast expenditure becomes 'significantly more likely than not to occur'[1]. However, BEIS wishes to apply this mechanism to identify the margin associated with each of SMETS1 and R2.0.

The timing of the direction on to the respective LC13 plans is likely to be such that DCC would be expected to start delivering both projects many months ahead of submitting the application and potentially as much as 18 months ahead of Ofgem making a final determination. As a result, the value of the margin associated with each project would not be known until it is well-advanced and conceivably after certain incentivised milestones have been passed. It is our view that the incentive properties would be weakened significantly if DCC was engaging in a project where the margin was not known beforehand, hence there is no measurable incentive[2]

To address this issue, we propose that the licence be modified to enable DCC to make a BM application for a BEIS-directed project as and when the LC13 plan has been agreed. This application will be based upon the associated resource plan at that time and we would not expect it to be unreasonably refused or reduced in value. Subsequent applications may be made to the usual July timescales to take account of increases in the cost base, as a result of, for example, modifications to scope or timelines which are outside of DCC's control.

In addition, the BM adjustment framework, as currently defined, requires the rate of margin to be justified. For the purposes of SMETS1 and release 2.0, it is DCC's view that the margin rate should be the same as for the SMETS2 programme, as both projects were part of the scope against which Capita bid for the DCC licence. To ensure the incentive properties of these schemes, DCC would wish to see this margin rate confirmed ahead of submitting the BM application.

Finally, it is important that the incentive framework can cope with realistic changes so that it fairly and accurately incentivises DCC to deliver the agreed milestones. Hence, an appropriate change control mechanism will need to be defined to account for events outside DCC's control which may impact the timely completion of a milestone.

Extension to the date by which Ofgem may modify the OPR

Due to the nature of DCC operations over the Licence period, we consider that Ofgem should be able to modify OPR over the entirety of the Licence. This will enable OPR to accurately reflect DCC's customers and energy consumers' needs and preferences. Hence, we anticipate, that OPR will potentially evolve yearly to account of these changes.

Ultimately, if Ofgem had no powers to update OPR, it would rapidly lose its incentive properties and we believe that both DCC customers and consumers would not got the best out of the DCC service.

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[1] See paragraph 4.18 - https://www.ofgem.gov.uk/system/files/docs/2017/06/2017.06_processes_and_procedures_guidance.pdf

[2] Forecasts of what the margin at risk would be would face a high level of uncertainty as Ofgem, who would have had limited involvement in the planning, development and execution of the project, will make an assessment whether the expenditure and associated rate of return are acceptable.

If you have any questions on our response, please do not hesitate to contact Julian Rudd (Julian.Rudd@smartdcc.co.uk) in the first instance, or myself.

Yours Sincerely

Helen Fleming
Director of Corporate Affairs

Annex – Detailed consultation responses:

Do you agree that BEIS, rather than Ofgem, should set the incentive regime that places DCC's BM associated with the Release 2.0 and SMETS1 Enrolment and Adoption projects at risk (and any potential BEIS driven future projects)?

DCC agrees that BEIS is best placed to develop the incentives for discrete projects driven by its policy objectives. BEIS as the project sponsor, who approves the project's delivery plan is best placed to identify what the appropriate incentive scheme should be and where it is milestone-based:

- what the incentivised milestones ought to be,
- what the margin associated each milestone should be[3],
- the conditions under which the milestone has been met.

We believe that BEIS is best placed to incentivise the delivery of projects such as SMETS1 and release 2.0. DCC and BEIS have worked very closely through the life of these projects to-date and hence BEIS has a detailed understanding of the projects and their delivery. In our view, BEIS is also well-placed to appreciate the challenges, risks, dependencies and necessary assumptions associated with the agreed Licence Condition (LC) 13 plans.

This should ensure that the milestones reflect the activities and milestones agreed for the delivery plan. However, this will require that the agreed delivery plan is realistic and achievable in order to ensure that DCC is effectively incentivised. If the plan and the scheme milestones are unrealistic, the incentives are likely to prove ineffective. An approach which could be used to prevent this scenario from materialising may be by a requirement in the framework for the final plan to be assessed and assured by an external organisation for its viability.

Furthermore, in a scenario where BEIS needed to add requirements or change the scope of the project, BEIS is well placed to accept changes to the delivery plan and implement the required changes to the incentive scheme. This framework should enable BEIS to make any necessary consequential changes to the specific incentive scheme.

That said, as BEIS will be undertaking the role of project sponsor, defining the incentive framework and ultimately deciding whether the incentivised milestones have been met, this could be said to make BEIS the 'judge and jury' of the project. We consider that it would be appropriate for BEIS to include the requirement of an independent auditor to assess DCC's performance in its delivery of the milestones.

Finally, this does bring into question the use of existing regulatory mechanisms, and specifically the BM adjustment mechanism, which is overseen by Ofgem. This mechanism was designed to provide an ex-post adjustment to the margin retained by DCC, in the event of various criteria being met. It was not intended to be used in an "ex-ante" form to define an amount of margin which will be allocated to an activity and it is not clear that it will work harmoniously with the other regulatory

[3] Please read in conjunction with our answer to the subsequent question.

arrangements, such as an ex-post assessment of the economic and efficient nature of the project costs.

Further comments on the appropriateness or otherwise of the BM adjustment mechanism are provided under our response to the second question covered in this response.

On a different point, BEIS hasn't indicated in the consultation which powers it envisages that it will use to make this amendment, however we assume that BEIS is likely to use Section 88 of the 2008 Energy Act. If this is the case, there is a question in our minds as to whether these powers are sufficiently broad to make the proposed changes to DCC's Licence.

Do you agree with our proposed framework for introducing the new incentives? Please provide details of your views.

DCC broadly agrees with the policy presented by BEIS in the consultation, however there are some areas were we consider that the framework could be strengthened by providing additional clarity and certainty. We believe that the inclusion of these changes will enable DCC to deliver projects such as SMETS1 and Release 2.0 effectively under a fair and realistic project incentive scheme.

Our comments on the different elements of the framework are described under three headings:

1. those we agree with as they are described,
2. those which we consider should be modified,
3. those which have not been included in the consultation, but we consider should be part of the incentives framework

1. DCC agrees with the following elements of the framework:

- **Upside incentives** – These would provide DCC with the opportunity to deliver above expectations, where there is a benefit for energy consumers. The reasons why this is important are:
  - In order to outperform DCC will be encouraged to innovate which will not only add value to the project, but to future projects.
  - It will reduce the risk of late delivery, as DCC strives to receive the upside incentive, even if ultimately the upside is not achieved. In addition, the reduction in the likelihood of potential delays should also reduce costs to DCC customers and hence energy consumers.
- **Individually designed incentive schemes** – The framework treats projects independently taking account of the individual characteristics of each. We consider that this approach is crucial to ensure that the deliverables required by BEIS for each specific project are achieved.
- **Ring-fencing of each projects margin –** The proposal separates the margin associated to distinct projects. This ensure that the project teams are incentivised to deliver as per the individual projects scheme, regardless of the performance of other DCC projects. We consider that this principle is important to ensure that each project is delivered by DCC as effectively as possible.
- **Transparency and opportunity for challenge** – It is crucial that the framework provides transparency and the opportunity for SEC parties to

input into each project's incentive scheme. DCC consider this to be a very important element, thus providing external challenge to DCC and BEIS to help ensure that the scheme is robust and clear to stakeholders.

2. DCC considers that the following elements should be modified:

- **Use of the BM adjustment mechanism -** DCC understands BEIS's preference to use existing regulatory mechanisms where possible to facilitate the proposed framework. However, we do not consider that the BM adjustment mechanism is particularly well-suited for this task.
  However, if BEIS decided to use this mechanism as is currently envisaged, we consider that the margin rate should be agreed between BEIS, as the project's 'customer' and DCC, as the delivering organisation. This should be agreed alongside the delivery plan and not as part of the BM application.
  In respect to SMETS1 and release 2.0, as these are delivering functionality envisaged at the time of the LABP, we consider that these projects should accrue the same margin rate as the core SMETS2 programme.
- **Alignment of timing of the BM application window, with the final LC 13 delivery plans** – Currently, a BM application can only be made in July and we are required to make that application when a significant level of certainty of expenditure is reached. We regard this as being problematic if it is to be used in conjunction with specific projects, running to their own timelines.
  Therefore, we propose that the mechanism should be modified to allow for an application to be submitted once the delivery plan is finalised and that the determination of that application should follow as quickly as possible afterwards and within clearly laid-out timescales.
  Nonetheless, even if this proposal was implemented, it should be noted that early milestones may have been passed before the application is determined, which would potentially weaken the incentive properties.
  A further challenge is that the process may become more complicated and cumbersome if it proves necessary for further BM applications to be made in respect of a project, as a result of, for example, changes in the scope. This could result in the need to revisit margin calculations in respect of milestones that have been past previously.

3. DCC considers that the following elements should be included:

- **Consideration of the impact of events outside of DCC's control -** The framework doesn't currently include any mechanism to account for events outside of DCC's control, which may unfairly hamper DCC's ability to meet a milestone thus unduly penalising DCC. This argument applies for milestones which have external dependencies over which DCC has limited or no control.
- **Alignment between the agreed delivery plan and the incentive scheme** The framework should include a principle of ensuring that the incentivised milestones fully align with the BEIS' approved LC 13 plan. This will ensure there is no room for discrepancy between the project's scheme and the approved delivery plan.
- **Mechanism to allow for the modification of the incentive scheme -** Further to the above, the framework doesn't include a mechanism to allow for the modification of the regime based on changes to the project which are

made after the milestones have been set. Example include changes in the scope, assumptions and timing changes due to dependencies. This is crucial to ensure that the incentive scheme remains anchored to a realistic delivery plan.

- **Principles to be followed when creating/modifying an incentive regime –** From DCC's perspective, it is important that the Secretary of State has due regard to the impact of the scheme on DCC's finances and the purpose of the incentive scheme. DCC is concerned that BEIS ensures that these considerations are also taken into account, should the scheme need to be varied, and that these should be reflected in any associated consultation processes.

The framework should consider, and where possible seek to, identify and address consequential changes outside of the Licence. A clear example of this is that Ofgem will need to update their guidance on Price Control processes and completion of the RIGs.

Ofgem will require time to make these updates ahead of the next BM application window. This will in turn give DCC a fair opportunity to plan and make a realistic assessment based on Ofgem's updated guidance for the application for any incentivised projects, such as SMETS1 and Release 2.0.

Finally, even though DCC has previously been incentivised via a milestone-based incentive arrangement, we believe that BEIS should consider alternative incentive arrangements for delivery of future projects (beyond SMETS1 and release 2.0). For example, an arrangement, similar to the existing 'gain share'[4] arrangement, could be used where DCC retains a set margin of the gains/savings/benefits it achieves through the delivery of the project.

The design of any incentive scheme should reflect the nature of the project to be executed.

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.

We agree with BEIS' proposal to extend the date by which Ofgem must develop and implement OPR. However, we do not think that the amendment provides Ofgem with the necessary flexibility to change, update and enhance OPR, over the full duration of the Licence, as will be necessary based on empirical evidence of DCC's stable operation and potentially evolving role and responsibilities post-2020.

As DCC is a first-of-its-kind organisation, the role and responsibilities of DCC will change over time, as will the needs and priorities of DCC's customers. Hence, we consider that it is of vital importance that Ofgem is able to modify OPR as it deems necessary, which may be as often as every year, to reflect the interests of current and future energy consumers.

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[4] See LC 39 Appendix 1 for reference.

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

Given our answers to the previous questions, DCC doesn't consider that it would be appropriate to comment on the specific drafting of the Licence amendments relating to these proposals, at this time.

This consultation is the first formal opportunity we have had to comment on BEIS full proposal and we have raised several points for BEIS' consideration. Likewise, other consultees will provided their own comments and suggestions. Hence, as BEIS considers the consultation responses and brings some of the suggestions in to the policy, the inclusion of any material elements will have a significant impact on the legal drafting and the policy's implementation. Therefore we believe that BEIS should issue a subsequent draft of the legal text for consultation.