

30 May 2012

Dear

Ofgem's response to DECC's consultation on the draft Data Communications Company (DCC) licence¹

We welcome the opportunity to respond to your consultation on the draft DCC Licence. We see this instrument as a key tool in the new regulatory framework that will govern the activity of the Data and Communications Company (DCC). As the DCC will be a monopoly provider of smart metering communications services the DCC's licence should safeguard against abuses of its privileged position. Additionally, the licence should regulate the DCC's operation in the interests of consumers. Non-discriminatory access to DCC's services will be an important enabler of competition in energy markets in the future so it is vital that the DCC licence facilitates this outcome.

Ofgem regulates the gas and electricity markets in Great Britain. We have an important role in ensuring the interests of consumers are protected, both during the transition to smart metering and in the enduring framework. We will also play a key role in monitoring and, where appropriate, enforcing compliance with the new DCC licence conditions and associated regulatory framework. As such, we have provided advice to DECC on the development of the DCC licence. We welcome continuing constructive engagement with DECC as the licence is refined over the coming months.

Overall, the draft licence requirements are clear and well developed. We encourage DECC to keep the draft licence under review as related parts of the commercial and regulatory framework develop. We have identified a few policy themes that we think require further consideration. There are some other aspects of the licence that we think could be improved upon. We set out below our main observations in this regard.

Provision for DCC failure

We are concerned that special administration arrangements are unlikely to be in place for DCC from the outset and that without these arrangements consumers could be impacted in the event of DCC failure. The implications of DCC experiencing financial distress and struggling to carry on the mandatory business may impact consumers through a reduction in or loss of service and exposure to increased costs. The primary responsibility for the financial integrity of DCC will lie firmly with its management and shareholders. Ofgem's primary responsibility will be to manage effectively the risks of DCC's deteriorating financial health and performance impacting on energy consumers.

¹ Part of a wider consultation document titled: Consultation on the Draft DCC Licence and Licence Application Regulations

We do not think that the licence alone is the appropriate vehicle to make provision for DCC failure (neither financial nor performance related). It is vital that the right tools are in place to enable business continuity in the event of DCC failure. Special administration, modelled on the regimes which exist in the energy field, provides a tailor-made solution to this problem. It provides for an administration process that specifically operates in the interests of consumers and not creditors to ensure that essential services to consumers remain uninterrupted and secure. In our view it is the fundamental piece of the regulatory framework for DCC that is missing. While we recognise the constraints upon introducing new measures into legislation, we are nonetheless disappointed that special administration was not planned for this year's Energy Bill. We strongly encourage DECC to take this forward at the earliest opportunity.

We recognise that the proposed "Management Order" condition (condition 41, *Management Orders for the Licensee*) has been designed as an interim solution for both performance-related and financial DCC failures. In the absence of special administration or provider of last resort arrangements for DCC, we understand that it would be sensible to make some provision in the licence to try and address circumstances where DCC is facing difficulties. In our view such provision must be time limited. Further, it may be possible to refine the condition to improve its practical application and we will continue to work with DECC on this. However, in our view, these arrangements cannot provide an enduring solution. They place significant onus on Ofgem having intimate knowledge of, and involvement in, the operation and governance of the DCC, to an extent that may not be practicable or desirable for a regulator.

DCC price control

We note that the price control proposals have changed significantly since DECC's September 2011 consultation on the regulatory and commercial framework for DCC. We understand that you have adopted a phased approach to the revenue restriction to allow for the evolution of DCC's role and changing priorities over time. However we have some concerns about the proposed strength of incentives on DCC in the early phase and consider that there needs to be stronger disciplines in place on DCC to manage its costs efficiently over time. The testing and trialling stage will be a challenging period for stakeholders operationally – building and testing systems to meet the readiness criteria in preparation for mass rollout. DCC's role will be critical in coordinating efforts of users and service providers. With the right incentives in place and the correct allocation of risk between parties, DCC will be able to influence a positive outcome in a cost efficient way. Without sight of the service provider contracts, and an understanding of DCC's obligations and liabilities relative to its service providers, it is difficult to judge whether these proposals can deliver the desired outcome.

We remain hopeful that the competitive application process will produce the best value DCC for consumers. We are committed to continued engagement with DECC on the design of DCC's revenue restriction to enable this. To us, best value means the optimal balance between capability and price. We consider that applicants should be required to commit to their fixed costs as part of their bid to get the best value outcome from this process and that this should be reflected in the revenue restriction. The alternative – an obligation to ensure that costs are efficient, with ex post assessment – affords less protection for consumers and requires intrusive regulatory scrutiny.

Communications hub

We note that the consultation document gives detailed consideration to parties' prospective responsibilities in relation to the communications hub. We consider that DECC's procurement of service provider contracts and its engagement with potential DCC applicants and industry will help determine the optimal solution to this issue. From a regulatory perspective we urge DECC to retain the supplier hub principle. This will preserve the relationship between customers and suppliers and ensure that the commercial arrangements designed will support that principle. However, we note that there are

uncertainties as to who should carry the liabilities were communication hubs to be purchased and subsequently found to not be fit for purpose. We look to these being resolved as the Programme progresses the procurement process.

DCC and SEC objectives

It is important that DCC's general objectives are designed to ensure that they provide suitable signals for the conduct of DCC and interact appropriately with other parts of the licence such as the SEC relevant objectives, procurement objectives and the future development objectives. In our view, elements of the DCC general objectives (Condition 5, *General Objectives of the Licensee*) and the SEC objectives (Condition 22, *The Smart Energy Code*) would benefit from further scrutiny and refinement. The majority of the DCC general objectives provide a useful set of guiding principles. However, we consider that the inclusion of part (c) related to the reduction in the price payable by those receiving Mandatory Business Services is not relevant and should be removed. In principle, we agree that those receiving the mandatory business service should be entitled to benefit from value added services – however we do not agree that the pursuit of value added services should be a general objective of DCC, especially in the early years of its tenure.

We agree with DECC that it is not appropriate for the SEC to include a specific consumer interest objective. We agree there is a risk that this could dilute the importance of protecting consumers, were this to be one objective to be balanced in the round against the other objectives. As an alternative approach, DECC has proposed that the licence should set out that the SEC achieves the objectives if it does so in the round "with due regard to consumers' interests".

We note that this approach is intended to highlight the importance of ensuring that the interests of consumers are taken into account. We are concerned, however, that this could be perceived to have the opposite effect to what is intended, by 'subordinating' consumer interests to sit beneath the objectives. We do not think this is appropriate, given that the SEC will sit within a framework governed ultimately by Ofgem's principal objective to protect consumers. We do not think it is necessary to highlight the importance of protecting consumers under SEC in the manner proposed and it is not clear to us that industry is best placed to form a view on what is in consumers' interests. Ofgem has overall regulatory oversight of SEC, and any decisions we make, including in relation to any matters relevant to SEC, must be consistent with our principal duty to protect consumers. We think that the approach that applies to all other industry codes affords an appropriate high level of consumer protection.

Licence mechanics

DECC has proposed that the licence will expire without intervention from the Authority. This is different from all other energy licences, which are granted in perpetuity and contain a set of revocation procedures governing the end of the term. DECC's proposed approach relies heavily on the appointment process for the successor DCC being carefully timed to coincide with the expiry of the incumbent DCC licence. Our key concern is that if the expiry date for the incumbent DCC's licence is immovable, the incoming DCC may seek to use this as leverage in finalising its price control package, in the knowledge that if they do not accept the licence there will be no DCC licence holder. This would clearly not provide a good outcome for consumers. We recognise that the Terms of the DCC licence have been drafted to allow an additional licence term under prescribed circumstances. This mitigates some of the risk described above, but lacks flexibility in the event of a failed tender process or where unforeseen commercial circumstances cause delays.

Our proposal is to grant the DCC licence in perpetuity and constrain the revenue stream to a fixed period of time. This would still provide for a fixed term DCC, but will also provide flexibility at the end of the licence term to suit the commercial circumstances of the handover. The tenure and revenue restriction of the incumbent could be varied to suit the

particular circumstances. This would enable a smooth transfer of obligations and if necessary a gradual ramping-up/down of obligations between DCCs which may be a more efficient way of enabling the handover. We recognise the importance of regulatory certainty in the bidding process and are keen to avoid a perception of risk amongst DCC applicants. However, in our experience, bidders have been receptive to the model of a perpetual licence with a time limited revenue stream, as the offshore transmission regime has demonstrated.

Role of the Authority

There is a clear distinction between the responsibilities of DECC and Ofgem in relation to DCC, where DECC is responsible for the design and implementation of the regulatory framework and Ofgem for monitoring and where appropriate enforcing compliance with the framework once in place. This distinction may not naturally lead to a clear point in time where DECC's role ends and Ofgem's begins. The requirements of the DCC appointment process and the continued role of the smart metering implementation programme until 2018 mean that the Secretary of State has an ongoing interest in some aspects of the DCC's activities after it is licensed. In light of this, we consider that further work is needed to establish a clear boundary between the role of the Authority and that of the Secretary of State. This is important in order to provide regulatory certainty to DCC applicants. We have identified certain activities where this issue is manifested such as in relation to procurement and the incorporation of energy registration services. In that case, the licence condition (Condition 15: *Incorporation of Energy Registration Services*) sets requirements for the Secretary of State that must be met before he can require the DCC to take on registration. This risks introducing uncertainty into what is likely to be a significant project for the industry.

We accept that a gatekeeper role for Ofgem is necessary in relation to value added services but such a role may not be sufficient to deal with non-energy propositions appropriately and rigorously. This is because Ofgem must primarily consider the impacts on gas and electricity customers where DCC is providing services to other industries. It may be necessary to establish working arrangements with other regulators to ensure that impacts in non-energy markets can be considered and accounted for in decisions concerning value added services. We are committed to working with DECC and other regulators to develop a set of arrangements that can achieve this. Further work will also be needed to ensure that there are appropriate controls around unsolicited information entering customers' homes as well as ensuring customers retain control over their own data in relation to value added services.

We recognise and appreciate your constructive engagement with us and other stakeholders thus far on the crafting of the licence. We look forward to further discussions in the coming months as the draft licence is refined. If you have any questions about this response in the meantime, please contact

Yours sincerely