ELEXON

26 March 2021

By e-mail to: smartmetering@ofgem.gov.uk

Jacqui Russell
Ofgem
Canary Wharf
10 S Colonnade,
London
E14 4PU

Dear Jacqui,

Call for evidence: Review of the regulatory arrangements for the Data Communications Company

Thank you for the opportunity to provide/share our views and evidence with regards to reviewing the current regulatory framework for the Data Communications Company (DCC). We consider the DCC services to be a cornerstone of an efficient and well-functioning retail energy market and welcome Ofgem's early efforts to ensure it is fit for purpose through to 2050.

As you are aware, Elexon is the Code Manager for the Balancing and Settlement Code (BSC). We are responsible for managing and delivering the end-to-end services set out in the BSC and accompanying systems that support the BSC. This includes responsibility for the delivery of balancing and imbalance settlement and the provision of assurance services to the BSC Panel and BSC Parties. We manage not just the assessment, but also the development, implementation and operation of changes to central systems and processes.

In addition, through our subsidiary, EMR Settlement Ltd, we act as settlement agent to the Low Carbon Contracts Company (LCCC) and the Electricity Settlements Company (ESC), calculating, collecting and distributing payments to Contract for Difference (CfD) generators and Capacity Market (CM) providers. EMR services are provided to the LCCC/ESC through a contract and on a non-for-profit basis.

For a number of years Elexon has been calling for the simplification and consolidation of the energy codes and Code Bodies, in addition we would highlight that Ofgem and BEIS are in the midst of a review of all of the energy industry codes. BEIS is also undertaking a review of energy market System Operation. Therefore we believe that it is fundamentally important to ensure that the consideration of the arrangements for the DCC are made in tandem with these reviews.

Elexon has undertaken a lot of engagement in relation to the future of the energy codes and also the arrangements for managing the codes and changes to them. From this we have constructed a number of thought pieces, Elexon Policy Views, to aid in the debate and allow a number of options to be considered. In our most recent Policy View (which can be found here: https://www.elexon.com/2021/02/15/policy-proposes-changes-to-operator-roles-and-code-arrangements/), we propose that it would be beneficial to consider the creation of a Market Operator, to work alongside a System Operator(s) and bring all of the Code arrangements together under the Market Operator. This proposal would see the DCC/SEC arrangements encompassed within the Market Operator. Developing such a proposal would have an initial indirect benefit of reducing the corporate/back office overheads of having multiple companies managing the energy industry arrangements and a direct benefit of reducing the interfaces for industry participants.

As well as calling for simplification and consolidation of the industry Codes, Elexon has also proposed that there should be a fundamental review of how the industry arrangements are funded and managed. This is because there are a number of different funding models and governance arrangements across the sector, ranging from not-for-profit, to commercial, to Price Controlled (in the case of DCC). Each of these models drives different behaviours and places different costs on the industry and the consumer. In total, including the costs of the DCC, the arrangements account for over £500m per annum (the bulk of which relates to the DCC), which is ultimately paid for by end consumers. For this reason we believe that it is incumbent on Ofgem to look at the most optimum and efficient way to deliver the services, which arguably when considering the double digit margins in the existing DCC arrangements is not the current regime. We would note that the returns allowed for the DCC are greatly in excess of what is allowed for other Priced Controlled entities and of significantly greater scale than margins allowed under the Retail Price Cap.

We have set out our points in respect of the RFI below for you to consider. If you would like to discuss any areas of our views, please contact Amanda Rooney, Head of Strategy and External Affairs on 020 7380 4121, or by email at amanda.rooney@elexon.co.uk.

Yours sincerely,

Angela Love
Director of Future Markets and Engagement

DCC Review of regulatory Arrangements

This licence provides the impetus to design, build and operate critical national infrastructure. As such, it is imperative that the licensee/service provider provides a stable, sustainable service.

Since the creation of the Smart DCC licence in 2012 significant fundamental changes have occurred both in the energy industry and more broadly, across technology and telecommunications. During the same period energy consumers' expectations have also changed. For that reason Elexon believes that it is necessary to consider the underlying assumptions and incentives in the current licence which may need to be reconsidered or reconstructed. The arguments for the monopolisation of individual services change significantly between set up and operation and we examine each of these below. The GB Smart Meter Implementation Programme was one of the first household smart metering programmes in the world, however in the years since the GB smart roll out commenced many countries have designed and implemented smart metering systems. There are therefore many case studies and comparisons that can be drawn from international examples to consider market architecture options and the associated costs.

The Terms of Reference for the regulatory review should, we believe, start with the premise that it is efficient, and in keeping with the Competition Act, to re-tender the DCC Licence. In particular given the scale of the costs and services involved, we believe that it would be prudent to test the market to ensure that customers are both getting value for money and that new technologies and innovation can be explored. We further believe that the incumbent should have the right to bid for the licence (an inherent right to continue to hold the Smart Meter Communication Licence). However, the licence may have a different form to reflect the fact that the arrangements are no longer in 'set up' mode, but reflecting operational licensable activities, which by 2025 should be mature.

We consider that the tasks which make up the current conditions of the Smart DCC licence are no longer an efficient grouping of tasks and responsibilities and nor should they all be delivered under monopoly arrangements. In addition the Codes Reform work and Electricity System Operator reforms being considered by Ofgem and BEIS mean that the tasks under the DCC licence could have a newly formed natural home that would provide additional operational efficiencies.

We are concerned that the current make-up of the 'bundle' of services detailed within the DCC licence may not be best suited to be delivered by a single provider, or indeed for them to be provided under a monopoly arrangement. We believe with the Review of the Industry Codes and System Operator services, that it would be beneficial to consider if there are existing arrangements where some of these services should sit. In particular we would highlight that since the DCC was established there have been new governance arrangements put in place under the Retail Energy Code, which may give another option for the some of the DCC services to be undertaken.

We have provided links and detail, which we hope aids your information discovery exercise and provides evidence to inform your review.

Current DCC Services detailed in Licence condition

The DCC licence contains a number of services outlined across the licence conditions. The development of the Core service suffered delays and cost overruns as detailed in the NAO Report[1]. The construction of the services and assets that make up the Core service

[1] https://www.nao.org.uk/wp-content/uploads/2018/11/Rolling-out-smart-meters-Summary.pdf

are detailed below, as well as the Additional and Elective Services. We believe it would be worth reviewing each component of the service individually to ascertain whether the service could be better delivered by another provider such as a Code Manager or System Operator before considering using a private company. In addition, as outlined in our cover letter we also believe that it would be beneficial to consider whether there would be merit in creating a Market Operator, who could encompass the work of the DCC and envelope the SEC governance arrangements.

Core Service

We would highlight that since the DCC licence was set up a large number of countries have begun, and some have finished, their smart meter rollouts. We would note that no other nation which has rolled out smart metering has used a private company, such as Capita, to hold the smart metering data and be responsible for the security of the network. In some countries the Distribution Network company or Single Supplier own the metering infrastructure and network, whereas others have used an existing nationalised, or quasi-nationalised entity, such as EireGrid, in Southern Ireland. There are a number of reasons for these different approaches, such as the indemnities and liabilities associated with the risks of failure or cyber-attack of the network. Most assets which make up critical national infrastructure have alternative ownership and governance structures.

We understand that Ofgem was keen to hear the benefits of a not-for-profit (NFP) entity. As you are aware, Elexon is a non-profit entity and provides services to industry under the Balancing and Settlement Code to which over 480 industry participants are signatories (known as BSC Parties). Similarly Elexon provides services to the Low Carbon Contracts Company (LCCC) and the Electricity Settlements Company on a NFP basis relating to the calculation, collection and distribution of payments to Contracts for Difference (CfD) generators and Capacity Market (CM) providers. Before discussing NFP, we first describe below our ownership, funding sources and governance structure, as we believe these three are relevant to the NFP question.

Elexon is owned by National Grid ESO, funded directly by the Electricity generators and suppliers and other market participants based on their market share, with an independent Chair and Board. The members of the Board do not represent their employer or a particular constituency and can be removed by a vote of industry (subject to deminimis thresholds etc) at an annual meeting. Whilst previously this was at the annual meeting following their commencement of the role (or following a re-appointment), the Board has recently decided that all Directors should be subject to a vote every year – thus giving BSC Parties an annual opportunity to determine the Board composition. The BSC establishes the BSC Panel, which is made up of industry members appointed for their expertise (and who are not representatives of their employer), plus other non-industry experts such as academics, who make recommendations to the Regulator about proposed changes to the BSC rules based on their own experience.

Elexon purely exists for the benefit of the energy industry and we believe that the not-for-profit model under which we operate delivers reliable, cost effective and efficient services to BSC Parties and the LCCC. This is demonstrated by Elexon topping the Ofgem survey of Code Body customer satisfaction on each of the last three occasions. Our governance structure gives us independence from all. We are charged to uphold competition in the Supply and Network markets. This independence allows us to support and enable market change and innovation without prejudice. We believe this structure enables us to generate and preserve value over the longer term by:

- engaging with stakeholders in developing our strategic objectives and ensuring that our stakeholders continue to support those objectives through a customer centric approach to all aspects of our governance and changes;
- investing in technology to continue to provide best in class services and be responsive to the market and BSC Parties' needs;
- enabling new innovative products and services, which challenge the current market structure, such as the introduction of Virtual Lead Parties into the balancing mechanism to provide greater market access for challenger business

models and electricity flexibility;

- enabling a better understanding of the skills needed to perform in a rapidly changing energy market through the right balance between flexibility and the robust, predictable service delivery for which Elexon is recognised; and
- maintaining our focus on knowledge sharing and transfer through impartial services to all market participants.

We consider that it would be appropriate and prudent to give in-depth consideration of the different governance and funding models across the energy landscape, firstly looking at what behaviours Ofgem would like to see in relation to the DCC services and secondly which funding and governance models will drive those behaviours.

We recommend that independence should be the priority. This requires independence in decision making from industry and from other stakeholders, which in turn requires the absence of single company control via shareholding or director appointments. Access to capital should be the next consideration. If capital has to be provided by a shareholder or investor, then that immediately provides conflict between that funder's interests and the desire for independence. Hence we advocate for funding from industry via charges on users (as per the BSC) with the ability to enter into commercial loans if required. The next consideration is risk versus reward. Having established independence as key and resolved that funding is via users, it is then not necessary to attract external capital with the associated need to reward that capital with a financial return. Instead services can then be offered on a NFP basis.

Where services are provided on a NFP basis, it is important that levels of transparency are high in order to promote confidence amongst the paying users and industry generally. At Elexon we publish our Business Plan every year and encourage all BSC Parties to comment on our strategy and detailed budget. Throughout the year we provide monthly forecasts of our expenditure and where we achieve underspend this is returned to our paying customers rather than retained as upside to Elexon. It is also important that where appropriate, services are subcontracted to providers under contracts that are regularly market tested or retendered. At Elexon, for our 2021/22 budget, over 60% of our costs are from such service providers, the remaining c40% being costs attributable to our people and accommodation, which is used by our staff and (pre-COVID) for a significant industry meeting programme.

For the reasons described above, we consider the independent NFP model a potential candidate for the provision of central, monopoly services, however as explained earlier we believe that an assessment should be carried out of all the current models to determine which is best at delivering the behaviours that are to be encouraged.

Finally, we would highlight that we do not believe the current DCC arrangements are driving the right behaviour. But this is to be expected, as they are being delivered under a commercial contract where the incumbent is focused on making returns for its shareholder and expanding services, which do not seem to be requested by the user of the DCC service[2].

Leading the contract and commercial management of Service Providers for individual components of the DCC system and Managing Service Providers' performance; Assessing commercial changes to Service Provider contracts and DCC services;

Services tendered by DECC (now BEIS) for some of these services, such as Telefonica and Arqiva data services, have differing periods to the DCC licence and the inevitable re-tender for these services will require an ever evolving contract and relationship. The contract and commercial management of contracts originally constructed and negotiated by another Party (in this case DECC) can lead to Principal/Agent problems with conflicts of interest and failure of alignment of the contractors' goals. Conflicts of interest in this

[2] https://www.ofgem.gov.uk/system/files/docs/2020/10/dcc_price_control_consultation_-_regulatory_year_2019-20.pdf 3.61- 3.67

relationship can also lead to less efficient operation of the contract. We believe that these potential issues should be considered as part of this review, both in respect of how the contracts are let and what terms and conditions are used to incentivise the right outcomes.

We further believe that the performance management of these contracts, whether by the calculation of Service Credits, or by other means, is a necessary function of the contract. This task should remain with the management of the contract, but again, should remain flexible as these contracts are re-tendered and the counter-parties are liable to change.

It is this area which will require different incentives and oversight from the set-up phase of the contract evolution (Design, Build, and Test), given that the arrangements are now in day-to-day operation and operating at scale. The management of Service Providers was originally expected to be a small part of the licensable activities, but recent Price Control submissions show ever growing resources dedicated to Service Provider management. We believe that the assumption of contracting for these services should be reviewed in line with changes in technology and changes in other information technology services such as with BT/ OpenReach.

Commercial and financial reporting into DCC governance processes;

The DCC price control regime has so far sought to ensure value for money through the Design, Build and Test phases of the system. At this point we believe that the review should consider other models of governance and financing for DCC services. The current ex-post regime could be changed to an ex-ante regime, in line with the principles of RIIO2, Another option could be put the DCC work into the Market Operator that we proposed and secure funding from Parties in a similar way to the existing charging methodology. As above, the natural end and re-tendering for Service Providers involved in the DCC services could allow for contract changes to accommodate deeper transparency.

Reporting provisions could be considered for external assurance to ensure independent verification and greater trust between parties.

Procuring additional and replacement auditing capability to deliver the DCC service.

We consider that the assurance of Service Providers is a necessary and desirable activity to give comfort that services are being performed in line with contract requirements. Depending on the future model developed, in so much as whether it is procured from a commercial entity or not, we believe that assurance could investigate Service Providers.

Under a Market Operator model, it could be the case that the Service Providers who are audited and the audit is instructed by the Market Operator.

Hardware: Communications Hubs - Smart DCC handles the ordering and delivery of Communications Hubs to Energy Suppliers and their agents who install them.

The model for the provision of this condition was the National Grid rollout of modern metering services in the 1970s, and the privatisation of the metering assets to Transco in the 1980s. Such conditions are no longer common place in the UK energy market. Issues related to current household smart metering system have been noted and alternative plans presented[3].

We would question whether competition is best served by the existing DCC model. Beyond this concern, we believe that economic efficiencies of this model should also be reviewed.

[3] https://www.stark.co.uk/resources/news/oxera-consultings-assessment-of-the-smart-meter-roll-out/

Elective Services - management of the Elective Services process, which allows Smart DCC customers to request tailored messages and alerts, to and from the smart meters of their customers.

The DCC Licence is the only Ofgem Licence to include this provision and is closest to the BT licence issued by Ofcom. At the time that this provision was included it was expected to encourage innovation and provide flexibility to innovate the core service beyond its initial design. As yet the provision has not been used and indeed making changes to the DCC core service via the Smart Energy Code have proven to be far more expensive than anticipated and also suffers severe delays, often lasting years.

Furthermore, it is not demonstrated how conflicts of interest, such as how an equal service would be provided if one DCC User were to make more use of these services. Nor is there any clear transparency around the costs associated with winning and developing this business and how these would be subsidized through the price control. Our understanding is that energy consumers are currently subsidizing the development of this service and we are unclear of the benefit it brings, if any, relative to the costs incurred by consumers. We believe that this structure should be considered irrespective of the ownership/ governance of the DCC activities.

Non-Core Additional Services

We would note the lack of consideration and consultation in respect of non-core additional services. When compared to the requirements on Elexon under the BSC, which has clear conditions in respect of any additional services. We would highlight the four conditions that are required to be met by Elexon, if the BSC services are to be extended:

- BSC Parties should benefit from any diversification,
- the arrangements should not place disproportionate risk on BSC Parties,
- standards of service under the BSC should be maintained, and
- Elexon's BSC role should not give it any undue competitive advantage in a contestable activity.

Testing Services: they enable parties to test with all smart metering devices.

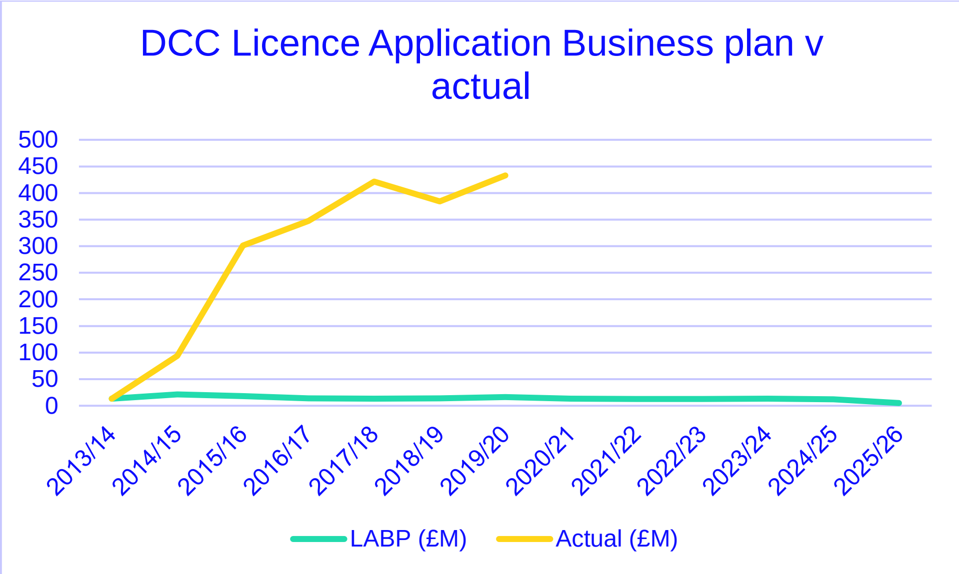
We note that the DCC currently offers exclusive services to test new hardware and software for smart metering at its own secure premises using an exclusive test environment. We would question why this service is best served by monopoly provisions. Whilst this provision may have been necessary for the original development of SMETS2 smart meters, we are unclear why meter testing would fall under Ofgem's vires. It also remains unclear why this service is bundled into the DCC licence, why it is a licensable activity and whether the DCC is the logical place for such activity to be centred, if it is needed at all. We would note that in the network side of the market, typically standards are created and it is for market participants to make sure that standards are met. We would highlight that there has been a recent review of standards and perhaps smart metering could be considered as part of the wider industry standards.

Other Services

We consider that the regulation and delivery of the Central Registration Service (CRS) (switching) and DCC's activities in support of this programme should be within the scope of this review. This is because we believe that the fundamental structure of the energy market has shifted since the bundling of these services within the Smart DCC licence, and will shift further in the coming years, not least to enable Net Zero. Additionally, the CRS has moved from the development phase to being operational. The CRS also has a central role in Market wide Half Hourly Settlement (MHHS) and discussions and consultations are ongoing about the nature and requirements of the service. It is therefore paramount to consider the optimal placement of this service to ensure that it does not constrain the design of MHHS and to consider if additional efficiencies can be made. We would note that the registers which pre-dated the CRS were not licenced and perhaps it is therefore prudent to discuss what merits, if any, there are from moving to a licenced arrangement.

Other Issues

Costs



We note costs associated with the development of the DCC Central System has been consistently and sustainably above those originally forecast. A move from an ex-post to ex-ante regime would help Suppliers plan costs better and increase stability. In addition, we consider that the break-up of the services would allow for stakeholders to have more granular information about the costs and make it easier for them to be challenged.

Margin

There remains an issue that the margin for the provision of DCC services is substantially higher than those which are allowed for holders of Supply licences under the Retail Price Cap and those allowed under the RIIO2 Network Price Control arrangements. We are unclear why this would be the case, in particular in relation to the Retail Energy Market, where the burden of consumer debt falls on Suppliers. As such, we believe that it is imperative that the DCC arrangements are looked at, with a view to changing the arrangements from 2025, to ensure that they are cost effective and that the optimum funding and governance model are in place.