

## Consultation on proposals to modify arrangements for the Over-Recovery of Allowed Revenue, Housekeeping changes to the Licence and the Baseline Margin Indexation change

Subject	Details
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We<sup>1</sup> are consulting on proposals to introduce changes to the existing Licence arrangements that define the over-recovery of Allowed Revenue. In addition to these proposals, we are also taking the opportunity to propose minor housekeeping changes to the Licence. We want to hear from anyone interested in this consultation.

This document outlines the scope, purpose, and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses. We want to be transparent in our consultations. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at [Ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations).

If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

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<sup>1</sup> The terms 'we', 'us', 'our' refer to the Gas and Electricity Markets Authority. Ofgem is the office of the Authority

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## Executive summary

DCC is the central communications body licenced to provide the communications, data transfer and management required to support smart metering. It has a pivotal role in ensuring the successful rollout and ongoing operation of smart metering in the GB energy market. As a monopoly service provider, it is vital that appropriate controls are in place over its costs and that it is subject to an appropriate incentive regime that focuses on providing a good quality service to its customers, which include energy suppliers and network companies.

We are proposing Licence amendments to reduce the scale of revenue over-recovery by DCC of its customers and facilitate a return of historic over-collected revenue back to customers. As part of its annual Price Control, DCC must provide forecasts of its revenue for future years and keep its spending within these forecasts over time. To allow for a degree of future cost uncertainty, DCC's Allowed Revenue is subject to a 110% threshold: no penalties are applied if it exceeds its 100% but stays below 110% of its forecast value. This portion of over-collected revenue, referred to as the Correction Factor is incorporated into DCC's Allowed Revenue for the following Regulatory Year. As outlined in the Licence, DCC is expected to take all reasonable steps to return the Correction Factor back to customers in the following year.

From RY24/25 onwards, we are proposing a reduction of the 110% threshold that DCC's Allowed Revenue is subject to, as well as the introduction of a backstop date by which the entire value of the cumulative Correction Factor must be returned to customers, in order to facilitate an earlier return of this revenue back to DCC customers. We invite stakeholders to provide their views on our proposals.

We are also proposing a change to the price index adjuster mechanism in the Licence. In particular, we are considering switching to Consumer Prices Index including owner occupiers' housing costs (CPIH) from the Retail Prices Index (RPI) as the inflation parameter used in the price index adjuster from 2024/25 until the end of the Licence. The price index adjuster is used to determine the Baseline Margin value (and therefore, the Allowed Revenue) in each Regulatory Year. The reason for this proposed change is that RPI is no longer seen as a credible measure for inflation whereas CPIH is considered to be the most comprehensive one.

We want to hear from anyone interested in this consultation.

## **Approach and next steps**

This is a consultation on both policy and licence changes. We are seeking stakeholder views both on the underlying policies we are minded implementing, and on the proposed licence modifications we feel appropriately facilitate those policies in the Smart Meter Communication Licence ("the Licence").

The consultation closes on 25 August 2023. We appreciate the time which organisations and individuals will need to put into reading and responding to this consultation and will carefully consider all evidence which we receive.

## Introduction

### What are we consulting on?

We are consulting on a range of Licence amendments to reduce the scale of revenue over-recovery by DCC of its customers and facilitate a return of historic over-collected revenue back to customers. More specifically, we are proposing:

1. A reduction from 110% to 105% to the over-recovery threshold of DCC's Allowed Revenue, at which DCC must justify any over-collected revenue in its Price Control submission.
2. A Licence amendment to introduce a backstop measure by which all outstanding over-recovered revenue must be returned by DCC to its customers.

We are also proposing a change to the price index adjuster mechanism in the Licence. In particular, we are considering switching to Consumer Prices Index including owner occupiers' housing costs (CPIH) from the Retail Prices Index (RPI) as the inflation parameter used in the price index adjuster from 2024/25 until the end of the Licence.

In addition to these proposals, we are also taking the opportunity to propose minor housekeeping changes to the Licence. We want to hear from anyone interested in this consultation.

### Consultation questions

Question 1: We welcome views from stakeholders on our proposal to reduce the threshold on DCC's Allowed Revenue, at which DCC must justify any over-collected revenue in its Price Control submission, from 110% to 105%?

Question 2: We welcome views from stakeholders on our proposed Licence amendment to introduce a backstop date by which all outstanding over-recovered revenue must be returned by DCC to its customers?

Question 3: We welcome views from stakeholders on our proposal not to change the Penalty Interest Rate?

Question 4: We welcome views from stakeholders on our proposal to move away from RPI to CPIH for DCC Price Control from RY24/25 onwards?

Question 5: We welcome views from stakeholders on the proposed Licence modification to the tolerance threshold for the over-recovery.

Question 6: We welcome views from stakeholders on the proposed Licence drafting to introduce a new obligation on DCC to realise the phased return to customers of over-recovered revenue.

Question 7: We welcome views from stakeholders on the proposed Licence modification to move away from RPI to CPIH for DCC Price Control from RY24/25 onwards.

Question 8: We welcome views from stakeholders on the proposed housekeeping changes to the Licence.

## **Consultation assessment process**

This is a consultation on both policy and Licence changes. We are seeking stakeholder views both on the underlying policies we are minded implementing, and on the proposed Licence modifications we feel appropriately facilitate those policies in the Smart Meter Communication Licence.

The consultation combines both the policy and statutory Licence modification consultation aspects in the interests of efficiency. The proposed areas of change to the over-recovery of the Allowed Revenue were signposted via the DCC Price Control Decision: Regulatory Year 2021/22. We have also discussed and engaged with DCC on these potential changes prior to the consultation. The proposed housekeeping changes to the Licence are minor in nature; they comprise a range of grammatical and formatting typos as well as an incorrect reference to a paragraph and a redundant term.

We will carefully consider all responses we receive on both the policy and Licence modifications. We will then decide on the policy aspects and, in turn, assess and decide on whether the proposed Licence modifications as consulted on remain appropriate in terms of reflecting those policy decisions.

## Related publications

The 2021/22 Price Control Consultation Document is at: [DCC Price Control Decision: Regulatory Year 2021/22](#)

The DCC Regulatory Instructions and Guidance 2022 is at: [Data Communications Company \(DCC\): Regulatory Instructions and Guidance 2022](#)

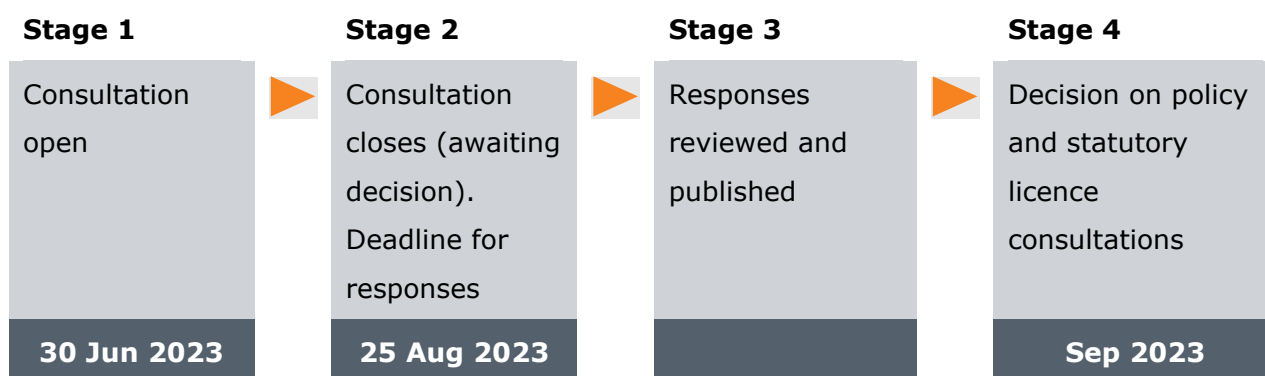
The DCC Price Control Guidance: Processes and Procedures 2022 is at: [DCC Price Control Guidance: Processes and Procedures 2022](#)

The DCC Licence can be found here: [Licences and licence conditions](#)

## Consultation stages

The figure below sets out the timeline that we expect to follow. This timeline allows the Licence changes to be in force by 01 April 2024, such that the proposed changes are in place for the start of the 24/25 Regulatory Year.

**Figure 1: Consultation stages**



## How to respond

We want to hear from anyone interested in this consultation. Please send your response to the person or team named on this document's front page.

We have asked for your feedback in each of the questions throughout. Please respond to each one as fully as you can.



We will publish non-confidential responses on our website at [www.ofgem.gov.uk/consultations](http://www.ofgem.gov.uk/consultations).

## Your response, data, and confidentiality

You can ask us to keep your response, or parts of your response, confidential. We will respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.

If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you *do* wish to be kept confidential and those that you *do not* wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we will get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

If the information you give in your response contains personal data under the General Data Protection Regulation (Regulation (EU) 2016/679) as retained in domestic law following the UK's withdrawal from the European Union ("**UK GDPR**"), the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations in Appendix 2.

If you wish to respond confidentially, we will keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We will not link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

## General feedback

We believe that consultation is at the heart of good policy development. We welcome any comments about how we have run this consultation. We would also like to get your answers to these questions:

1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?

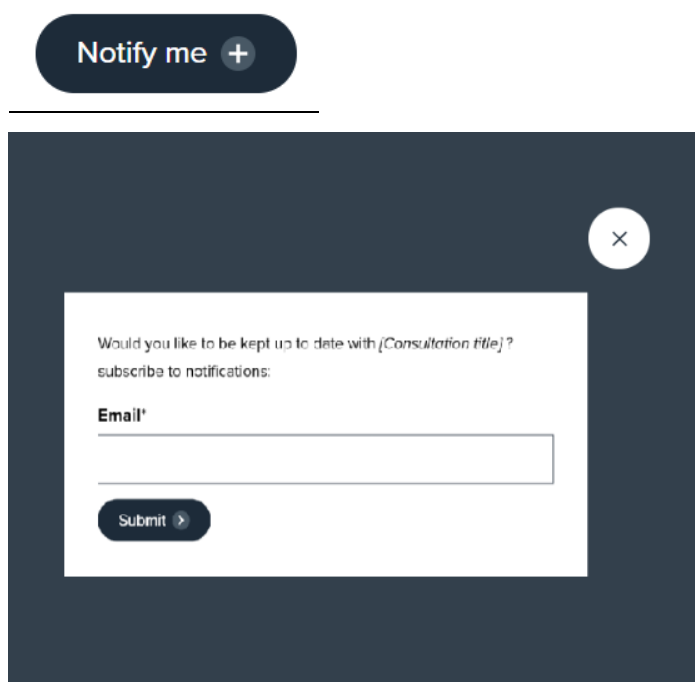
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

Please send any general feedback comments to [stakeholders@ofgem.gov.uk](mailto:stakeholders@ofgem.gov.uk)

## How to track the progress of the consultation

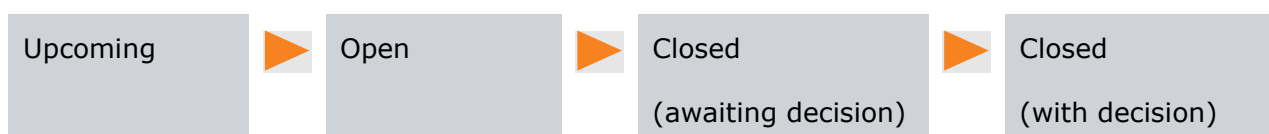
You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website.

[Ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations).



The image shows a 'Notify me' button with a plus sign. Below it is a dark blue modal box with a white 'X' in the top right corner. Inside the modal is a white form with the text: 'Would you like to be kept up to date with [Consultation title]? subscribe to notifications:'. Below this is an 'Email\*' label and a text input field. At the bottom of the form is a 'Submit' button with a right-pointing arrow.

Once subscribed to the notifications for a particular consultation, you will receive an email to notify you when it has changed status. Our consultation stages are:



## Consultation – Over-Recovery of Allowed Revenue

### Chapter summary

We are proposing a range of Licence amendments in order to reduce the scale of revenue over-recovery by DCC of its customers and facilitate a return of historic over-collected revenue back to customers. As part of its annual Price Control, DCC must provide forecasts of its revenue for future years and keep its spending within these forecasts over time. To allow for a degree of future cost uncertainty, DCC's Allowed Revenue is subject to a 110% threshold: no penalties are applied if it exceeds 100% but stays below 110% of its forecast value. This portion of over-collected revenue, referred to as the Correction Factor, is incorporated into DCC's Allowed Revenue for the following Regulatory Year. As outlined in the Licence,<sup>2</sup> DCC is expected to take all reasonable steps to return the Correction Factor back to customers in the following year.

We are proposing an adjustment to the threshold DCC's Allowed Revenue is subject to, to better reflect the degree of cost certainty expected at this stage of the Smart Metering Implementation Programme. We are also proposing the introduction of a backstop date by which the entire value of the cumulative Correction Factor must be returned to customers, in order to facilitate an earlier return of this revenue back to DCC customers. We invite stakeholders to provide their views on our proposals.

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<sup>2</sup> Part G: Calculation of the Correction Factor, LC36.18-LC36.20

### **Consultation questions**

**Question 1: We welcome views from stakeholders on our proposal to reduce the threshold on DCC's Allowed Revenue, at which DCC must justify any over-collected revenue in its Price Control submission, from 110% to 105%?**

**Question 2: We welcome views from stakeholders on our proposed Licence amendment to introduce a backstop date by which all outstanding over-recovered revenue must be returned by DCC to its customers?**

**Question 3: We welcome views from stakeholders on our proposal not to change the Penalty Interest Rate?**

## **Background**

- 1.1. The Licence requires DCC to take all reasonable steps to ensure that its Regulated Revenue does not exceed a prudent estimate of the Allowed Revenue for each Regulatory Year.<sup>3</sup>
- 1.2. The prudent estimate is DCC's best estimate of its Allowed Revenue. It was designed to ensure that (disregarding any within year adjustments that may be permitted in circumstances by the charging methodology of the DCC) service charges for a given regulatory year do not need to be amended in the course of that year except in response to reasonably unlikely contingency.
- 1.3. The concept of a prudent estimate is unique to DCC; it was introduced to account for the uncertainties involved in the initial scope and costs of the Smart Metering Implementation Programme (SMIP). Other companies we regulate have a general obligation to take reasonable steps to ensure that their Regulated Revenue does not exceed their Allowed Revenue. For reference, DCC has historically included in the

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<sup>3</sup> See LC36.4 – Part B: Duty of the Licensee with respect to Regulated Revenue

annual Charging Statement a prudent estimate that is equivalent to three weeks' expenditure of the Internal and External costs, capped at £20m per annum.

- 1.4. Following stakeholders' concerns in 2014 around the level of charges and DCC's application of the prudent estimate, a Penalty Interest Rate regime was introduced in RY16/17 to incentivise DCC to improve the accuracy of its charges to customers and deter it from over-recovering.<sup>4</sup>
- 1.5. After consulting with stakeholders, we decided to opt for a Penalty Interest Rate regime under a 'report and direct' incentive model. Under this model, DCC is required to report to the Authority to explain any over-recovery which exceeds a certain percentage of Allowed Revenue. Under the current arrangements we will consult and direct a Penalty Interest Rate if DCC does not sufficiently justify the over-recovery.
- 1.6. The choice for a 'report and direct' incentive model was mainly based on striking the right balance between deterring DCC from over-recovering versus providing DCC with the appropriate level of protection against future cost uncertainty. The model accommodates the possibility that a portion of the over-recovery in a Regulatory Year may be justified.
- 1.7. Under the existing terms of the Licence, the threshold for over-recovery of service charges is set at 110% of Allowed Revenue, and a Penalty Interest Rate of 3% plus the Bank of England Base Rate on any proportion of over-recovery that DCC has not justified to the Authority's satisfaction is to be applied.
- 1.8. The current threshold and Penalty Interest Rate were set on the basis of historic and forecast cost data and took account of the uncertainty in scope and design in the early stages of the SMIP. At the time of introducing the Penalty Interest Rate regime in RY16/17,<sup>5</sup> we mentioned that we would keep these thresholds under review and consider future potential Licence changes to ensure they continued to incentivise DCC to accurately forecast its costs.

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<sup>4</sup> Ofgem (2016), Decision to modify licence to introduce a DCC Penalty Interest Rate.  
[www.ofgem.gov.uk/publications/decision-modify-licence-introduce-dcc-penalty-interest-rate](http://www.ofgem.gov.uk/publications/decision-modify-licence-introduce-dcc-penalty-interest-rate)

<sup>5</sup> [Statutory consultation: final proposals for DCC penalty interest rate \(ofgem.gov.uk\)](http://www.ofgem.gov.uk/publications/statutory-consultation-final-proposals-for-dcc-penalty-interest-rate)

## Context

- 1.9. In RY21/22, DCC's Regulated Revenue exceeded its Allowed Revenue by 113%, exceeding the 110% threshold. As part of our RY21/22 Price Control decision,<sup>6</sup> we decided to apply a Penalty Interest Rate against the portion of revenue<sup>7</sup> that DCC had over-recovered for which it was unable to provide a satisfactory reason of why it could not have reasonably forecasted this.
- 1.10. In response to our RY21/22 Price Control consultation,<sup>8</sup> DCC customers raised specific concerns around DCC's ability to better predict its forecast costs as well as DCC's decision to allow the cumulative Correction Factor to grow year-on-year.<sup>9</sup><sup>10</sup> During the Price Control reporting period for RY21/22, DCC had indicated that it has allowed the cumulative Correction Factor to grow to allow DCC to manage potential spending peaks during the year, especially as several programmes have had uncertain spending profiles in their early stages of development. Similar concerns around DCC's forecasting accuracy were also raised by DCC customers in response to our DCC Review Phase 1 consultation, published last year, within the context of potentially transitioning to an *ex-ante* Price Control to, in part, address forecasting issues.<sup>11</sup>
- 1.11. In response to customers' concerns, we signalled as part of our RY21/22 DCC Price Control decision that we were minded to review this in more detail in the future, including the frequency of returning cash to customers as well as the appropriate level of over-recovery. This is particularly important now considering the forthcoming expiry of the initial DCC Licence Term in October 2025; the recent development of policies<sup>12</sup> elsewhere to ensure that energy suppliers do not accrue and use customers' payments as working capital; and the existing upper limit<sup>13</sup> of the aggregate liability between DCC and the parent company.

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[6 DCC Price Control Decision Regulatory Year 2021/22 | Ofgem](#)

<sup>7</sup> The total amount that we determined not to be justified by DCC in RY21/22 was £28.583m.

<sup>8</sup> [DCC Price Control consultation: Regulatory Year 2021/22 | Ofgem](#)

<sup>9</sup> The cumulative Correction Factor comprises the total over-recovery of funds compared to costs incurred in the previous Regulatory Years, adjusted for indexation.

<sup>10</sup> The Correction Factor (part G, LC36.18-36.19) requires over-recovery to be repaid inclusive of the Bank of England Base Rate.

<sup>11</sup> See Chapter 6 of the [DCC review: Phase 1 Consultation | Ofgem](#)

<sup>12</sup> Action plan on retail financial resilience (ofgem.gov.uk), published 15th December 2021

<sup>13</sup> The maximum aggregate liability (bond amount) is currently set at £10m

## Policy Proposals

- 1.12. As per our views elsewhere, and in previous years, we expect DCC to improve its cost forecasting accuracy. We recognise that DCC may continue to face a degree of uncertainty over the course of the next few years. When this is the case, we expect DCC to provide sufficient detail on what circumstances have led to unanticipated costs, and why it could not have reasonably avoided such cost increases.
- 1.13. We remain of the view that a 'report and direct' incentive model continues to be a proportionate approach to incentivise DCC to forecast its costs accurately. This approach avoids creating unnecessary reporting burdens as it accommodates the possibility for a portion of the over-recovery in a Regulatory Year to be justified.
- 1.14. We also continue to recognise that there are benefits to the use of a prudent estimate as a tool for managing uncertainty during the implementation and operation of the smart metering programme, and for changes in DCC's activities or scope. It allows DCC to accommodate changes to its responsibilities without creating instability for service users.
- 1.15. Considering the ongoing concerns regarding the need for improved forecast costs as well as the return of cash to customers on a more frequent basis, we have reviewed whether or not the current over-recovery threshold of 110% is still appropriate. The threshold was originally set in a context of cost and scope uncertainty that was particularly distinct to the early stages of the SMIP implementation. Now, in the operational phases of the programme, we expect DCC to better predict and manage cost uncertainty. On that basis, **we are proposing to recalibrate the incentive by adjusting the existing over-recovery threshold from 110% to 105%.** We consider that a 105% threshold for over-recovery is appropriate for DCC whilst taking into consideration the historic use of the prudent estimate (capped at £20m per annum) in proportion to the most recently approved forecasts of DCC's costs for the remaining Regulatory Years until the end of the Licence term (see table below).<sup>14</sup> We welcome, however, additional evidence and information from stakeholders as to whether they consider the proposed adjustment to be appropriate.

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<sup>14</sup> [DCC Price Control Decision Regulatory Year 2021/22 | Ofgem](#)

Table 1: Proportion of £20m Prudent Estimate to DCC's forecast Allowed Revenue for future Regulatory Years.

Regulatory Year	AR Forecast (£m)	% of £20m Prudent Estimate to AR
21/22	£499.66 (actual)	4.0%
22/23	£470.60	4.2%
23/24	£513.28	3.9%
24/25	£556.48	3.6%
25/26	£372.07	5.4%
<b>Average of above</b>	<b>£482.42</b>	<b>4.1%</b>

- 1.16. In addition to this, **we propose to introduce a new licence obligation on DCC to ensure that any over-recovery of Allowed Revenue, including the cumulative Correction Factor, is returned to customers as soon as reasonably practicable and before the end of the Licence term, or any additional term thereafter.** We also propose that to that effect, DCC produces a plan which it will share with us for approval, and report progress against via the annual price control.
- 1.17. We have also assessed whether, as a part of this policy change, it would be appropriate to recalibrate the incentive by adjusting the current Penalty Interest Rate. Considering the recent interest rate rises, we are proposing not to make any changes in this area; we continue to consider 3% plus the BoE Base Rate to be an appropriate Penalty Interest Rate under a report and direct model.



## Consultation – Baseline Margin price indexation change

### Chapter summary

We are proposing a change to the price index adjuster mechanism in the Licence. In particular, we are considering switching to CPIH from RPI as the inflation parameter used in the price index adjuster from 2024/25 until the end of the Licence. The price index adjuster is used to determine the Baseline Margin value (and therefore, the Allowed Revenue) in each Regulatory Year.

We invite stakeholders to provide their views on our proposals.

### Consultation questions

**Question 4: We welcome views from stakeholders on our proposal to move away from RPI to CPIH for DCC Price Control from RY24/25 onwards?**

## Background

- 2.1 Part C of Condition 36 of the Licence sets out the general formula for the calculation of the Allowed Revenue (AR) term,<sup>15</sup> which is the total amount of revenue determined on an accruals basis in relation to each Regulatory Year (RY).
- 2.2 One of the terms of the AR general formula is the Baseline Margin (BM). The BM is defined as the amount of additional revenue, over and above the sum of the Licensee's Internal Costs and External Costs, that the Secretary of State has agreed shall be

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<sup>15</sup> LC 36.7 – Part C: Determination of the Allowed Revenue (AR) term

included (subject to the operation of the Baseline Margin Performance Adjustment) in the Licensee's AR in relation to each RY.

- 2.3 LC 36.8 sets out the calculation of the BM value for each RY ( $BM_t$ ) as follows:  $BM_t$  is the amount of the Licensee's BM that is specified for the RY 't' in Appendix 1 of LC 36 (or such other amount as may have been determined for that RY pursuant to the adjustment mechanism for the BM term), as multiplied by the price index adjuster (PIBM) for that year, which in the RY2013/14 shall have the value of 1 and in each subsequent RY is derived from the following formula:

$$PIBM_t = \left[ 1 + \frac{RPI_t}{100} \right] \times PIBM_{t-1}$$

- 2.4 Where  $RPI_t$  means the percentage change (whether it is positive or negative) between (i) the arithmetic average of the Retail Prices Index (RPI) numbers published or determined with respect to each of the six months from July to December (inclusive) in Regulatory Year t-2, and (ii) the arithmetic average of the Retail Prices Index numbers published or determined with respect to the same months in RY t-1.

- 2.5 For the purposes of LC 36, "Retail Prices Index" is defined in LC 36.21 as follows:

- a. the general index of retail prices that is published by the Office for National Statistics each month in respect of all items; or
- b. if that index in respect of any month that is relevant for the purposes of this condition has not been published on or before the last day of February, such price index as the Authority, after consultation with the Licensee, may determine to be appropriate; or
- c. if there is a material change in the basis of that index, such other index as the Authority, after consultation with the Licensee, may determine to be appropriate.

## Policy Proposal

- 2.6 As explained above, the Licence stipulates the use of the RPI to adjust the Baseline Margin (BM) value for inflation when determining the value of the AR term in each RY (unless, after consultation with the Licensee, a different index has been decided appropriate by the Authority, which has not happened to date).

- 2.7 Our view, however, is that the RPI, as published by the ONS, is no longer the most appropriate inflation index, as it is upwardly biased and has lost its credibility as an accurate measure of inflation.<sup>16</sup>
- 2.8 We are therefore seeking stakeholders' views on whether we should move away from RPI to CPIH,<sup>17</sup> as it is considered the most comprehensive inflation index, for the determination of the BM (and, by extension, the AR) from RY24/25 onwards.

### **Rationale for change**

- 2.9 As noted above, our view is that the price index originally specified by the Licence to be used as a price adjuster, the Retail Price Index (RPI), is no longer fit for purpose because it is no longer seen as a credible measure of inflation. We base our view on the following:
- a) In 2013 the UK Statistics Authority (UKSA) cancelled the designation of the RPI as a National Statistic,<sup>18</sup> on the grounds that the methods used to produce the RPI were not consistent with international best practice.<sup>19</sup>
  - b) In 2018 the ONS published a paper on 'Shortcomings of the Retail Prices Index as a measure of inflation'.<sup>20</sup> The paper stated that "*Our position on the RPI is clear: we do not think it is a good measure of inflation and discourage its use. There are other, better measures available and any use of RPI over these far superior alternatives [note: the alternative measures considered in the paper were CPI and CPIH] should be closely scrutinised.*"<sup>21</sup>

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<sup>16</sup> For example, see para 6.97, page 62 of [RIIO-2 Framework \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/rpi-x-licensing/rpi-x-framework/rpi-x-framework-decision) Decision

<sup>17</sup> See [Consumer Prices Index including owner occupiers' housing costs \(CPIH\) - Office for National Statistics](https://www.ons.gov.uk/economy/inflationandcosts/bulletins/consumerpricesindexincludingowneroccupiershousingcostscpih)

<sup>18</sup> [Retail Prices Index – UK Statistics Authority](https://www.ons.gov.uk/economy/inflationandcosts/bulletins/retailpricesindex)

<sup>19</sup> [\[ARCHIVED CONTENT\] National Statistician announces outcome of consultation on RPI - ONS \(nationalarchives.gov.uk\)](https://www.nationalarchives.gov.uk/ukstatistician/articles/national-statistician-announces-outcome-of-consultation-on-rpi/)

<sup>20</sup> [Shortcomings of the Retail Prices Index as a measure of inflation - Office for National Statistics \(ons.gov.uk\)](https://www.ons.gov.uk/economy/inflationandcosts/bulletins/shortcomings-of-the-retail-prices-index-as-a-measure-of-inflation)

<sup>21</sup> Paragraph 3, Foreword by the National Statistician, [Shortcomings of the Retail Prices Index as a measure of inflation - Office for National Statistics \(ons.gov.uk\)](https://www.ons.gov.uk/economy/inflationandcosts/bulletins/shortcomings-of-the-retail-prices-index-as-a-measure-of-inflation)

- c) In 2019 Ofgem published its Decision to move away from RPI to CPIH for inflation measurement in calculating the Regulatory Asset Value (RAV) and allowed returns under RIIO-2,<sup>22</sup> after public consultation, on the basis that:<sup>23</sup>
- i. RPI was no longer seen as a credible measure of inflation (noting that the ONS had adopted CPIH as their headline measure of consumer price inflation) as it had an upward bias.<sup>24</sup>
  - ii. Many other regulators have moved to either CPI or CPIH, including Ofwat, Ofcom, the ORR and WICS.<sup>25</sup> HM Treasury currently sets the inflation target for the Bank of England in terms of the CPI.
  - iii. With the exception of network operators, there was an overwhelming stakeholder support for a move away from RPI.
- d) Given the above, moving away from RPI would help align the price adjustment methodology under the DCC Price Control with economic best practice, as stated by UK economic institutions such as the ONS and the UKSA, and followed by many other UK regulators including Ofgem in RIIO-2.

2.10 In relation to the question of which price index should be used instead of RPI, we are proposing to use the CPIH on the basis that:

- a) It is the ONS's lead and most comprehensive measure of consumer price inflation,<sup>26</sup> and therefore, is seen as a better option than CPI;
- b) it would align the DCC Price control with the latest Price Control frameworks within Ofgem such as RIIO-2, and Ofwat's Price Reviews (PR).

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<sup>22</sup> [RIIO-2 Framework \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/riio-2-framework)

<sup>23</sup> Rationale is set in paragraphs 6.87 to 6.94 [RIIO-2 Framework \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/riio-2-framework)

<sup>24</sup> in January 2015, a review by Paul Johnson explained that: "the use of the Carli formula (within RPI) is statistically flawed and can result in an upward bias in recorded inflation". See page 79 [cepa report on baseline allowed returns for riio-2.pdf \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/cepa-report-on-baseline-allowed-returns-for-riio-2.pdf)

<sup>25</sup> Water Industry Commission for Scotland

<sup>26</sup> [Consumer price inflation, UK - Office for National Statistics](https://www.ons.gov.uk/economy/inflationandcosts/articles/consumerpriceinflationintheuk/march2023) (March 2023)

## Expected effect of this change

2.11 Historical data shows that CPIH tend to be about 1 percentage point lower than RPI. If we look at the percentual change in prices calculated for each RY as instructed by the Licence,<sup>27</sup> between RY 2013/14 and RY 2022/23 CPIH was 0.9 percentage points lower than RPI in average. This means that the total BM for that period was about 3% higher compared to a counterfactual if CPIH would have been applied instead. If we include values for RY2023/24 and forecasts for RY24/25 and RY2025/26, this difference increases to 1.24 percentual points on average. This means that the practical effect of changing the index to CPIH would be a reduction in the BM calculated for each RY from RY24/25 onwards (worth noting that 100% of this BM will be then put at risk under the different performance schemes in each RY). We have estimated this reduction in BM to be about 9.5% (£1.6m) for the period RY24/25 to 25/26. The table below shows the estimated effect of this change on BM for each regulatory year in the period RY24/25 to 25/26.

Table 2 Estimated BM after applying the BM Price Index Adjuster (PIBM) using RPI and CPIH

Regulatory Year	Baseline Margin £m (13/14 prices)	Estimated Baseline Margin £m (real prices <sup>28</sup> ) applying RPI	Estimated Baseline Margin £m (real prices <sup>29</sup> ) applying CPIH	Baseline Margin difference applying RPI vs CPIH
24/25	5.8	8.6	7.7	0.8
25/26	3.9	5.7	5.2	0.5
<b>Total</b>	<b>9.7</b>	<b>14.3</b>	<b>13.0</b>	<b>1.4</b>

<sup>27</sup> LC 36.8 – Determination of the Allowed Revenue (AR) Formula

<sup>28</sup> Estimated real prices for each RY based on latest OBR forecast for RPI

<sup>29</sup> Estimated real prices for each RY based on latest OBR forecasts for CPI (CPI is used as proxy for CPIH forecast)

## Consultation - Licence changes (Over-Recovery of Allowed Revenue and Housekeeping Changes)

### Chapter summary

This chapter reflects our consultation on the following proposed modifications to the Licence:

1. Adjusted tolerance threshold for the over-recovery of Allowed Revenue.
2. New obligations on DCC to return the over-recovery of Allowed Revenue to customers before the end of the Licence term, or any additional term thereafter.
3. Amendments to the Licence, associated with the proposed policy change around the price indexation of Baseline Margin
4. Housekeeping changes

### Consultation questions

**Question 5: We welcome views from stakeholders on the proposed Licence modification to the tolerance threshold for the over-recovery.**

**Question 6: We welcome views from stakeholders on the proposed Licence drafting to introduce a new obligation on DCC to realise the phased return to customers of over-recovered revenue.**

**Question 7: We welcome views from stakeholders on the proposed Licence modification to move away from RPI to CPIH for DCC Price Control from RY24/25 onwards.**

**Question 8: We welcome views from stakeholders on the proposed housekeeping changes to the Licence.**

- 3.1 In order to establish and implement the proposed policy changes, we consider that modifications to the Licence are required.

- 3.2 The key amendments to the Licence, associated with the proposed policy changes around the **over-recovery of Allowed Revenue**, include:

**Condition 36. Determination of the Licensee's Allowed Revenue (Part G, Calculation of the Correction Factor (K))**

- A change to LC36.20(a) which determines that the Licensee must, by no later than 31 July of the Regulatory Year  $t$ , explain and demonstrate to the Authority in writing why, in respect of Regulatory Year  $t-1$ ,  $RR_{t-1}$  exceeds the threshold of 105 per cent of  $AR_{t-1}$ .

**Condition 27. Indebtedness and transfers of funds (Part B: Restricted Transactions Category 1)**

- New LC27.3A which proposes to place an obligation on DCC to ensure that it returns the over-recovery of Allowed Revenue to any person to whom such amount is payable as soon as reasonably practicable, and by no later than the end of the Licence Term, or any Additional Term.
- New LC27.3B which proposes that DCC prepares and submits to the Authority (within 3 months of these changes taking effect) for approval a plan for returning to customers the amount of over-recovery that has been accrued. We propose that this plan includes a timetable that supports the return of over-recovery in a phased manner. We also propose that DCC reports to us any progress against this plan as part of the annual Price Control process.
- New LC27.3C that clarifies that any residual amount of over-recovery, once the Licensee has complied with Condition 27.3A, will be paid to the successor Licensee, in accordance with Condition 43.16.

- 3.3 The key amendments to the Licence, associated with the proposed policy change around the **price indexation of Baseline Margin**, include:

**Condition 36. Determination of the Licensee's Allowed Revenue (Part C: Determination of the Allowed Revenue (AR) term)**

- A change to LC 36.8 which defines the AR Principal Formula terms. In particular, switch all reference to RPI by CPIH in the definition of the  $BM_t$  term.

**Condition 36. Determination of the Licensee's Allowed Revenue (Part H: Interpretation)**

- A change to LC 36.21 which defines RPI for the purposes of the LC. In particular, change reference to "Retail Prices Index" by "Consumer Price Index (including owner occupiers' housing costs)"
- A change to Appendix 1: values for the BM term. In particular, change reference to RPI by "relevant price index"

**Schedule 1; Appendix 1: Baseline Margin Project Performance Adjustment Scheme (Part C: Calculation of PPA)**

- A change to A17 which defines the PPA term formula. In particular, change references to RPI by CPIH in the definition of the PBM term.

3.4 In addition to the proposals around the over-recovery of Allowed Revenue and price indexing, we are also taking this opportunity to propose the following minor **housekeeping changes** to the **Licence**.

**Licensee Address – Second cover page**

- The Licensee's address on the second cover page is incorrect. The address should read 17 Gresham Street, as opposed to the current text of 17 Rochester Row.

**Licence Condition 8.4(e)**

This paragraph was removed by a BEIS modification in early 2020,<sup>30</sup> but was then accidentally reinstated by Ofgem when we made our next set of Licence amendments later in April 2021. It should therefore be removed again and 8.4(e) revert to "Not Used", as the reinstatement was an error.

**Licence Condition 15.4(d)**

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<sup>30</sup> See page 17 of the of the 16 January 2020 BEIS SEC and Licence consultation response [here](#)



- This paragraph was modified in our decision notice dated 2 July 2021; however, the text was incorrectly inserted into the Licence.<sup>31</sup> This change is therefore required to correct the text and bring it back in line with the definition as set out in the July 2021 decision letter, specifically by inserting the text “that meet the” as follows:

*(d) maintaining Interfaces for the secure, efficient and economical exchange of information with the Centralised Registration Service that meet the communication standards as described in the Retail Energy Code, which can be changed from time to time subject to the change procedures set out within the Retail Energy Code....*

### **Licence Condition 35.5**

- Our decision published on 30 Nov 2018 included the introduction of the new term "Centralised Registration Service External Contract Gain Share".<sup>32</sup> However, this term was incorrectly inserted into the Licence, and the definition instead appears as a duplication of the definition of the term "Centralised Registration Service External Cost". This change is therefore required to correct the definition and bring it back in line with the definition as set out in the Nov 2018 decision letter, as follows:

*Centralised Registration Service External Contract Gain Share:*

*means the component of the Allowed Revenue for the Centralised Registration Service (Condition 15) that is determined in accordance with the provisions of Condition 39 (Determination of External Contract Gain Share) so as to secure the effect set out in Part A of that condition and in accordance to the provision set out in the Retail Energy Code.*

### **Licence Condition 36.19**

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<sup>31</sup> Link [here](#) to our July 2021 decision to modify the Smart Meter Communication Licence

<sup>32</sup> Link [here](#) to our November 2018 decision to modify the Smart Meter Communication Licence

- The term “ $INT_t$ ” in the formula for the K term is erroneously referring to paragraph 36.17 as opposed to paragraph 36.20 where it is determined. We are proposing to update Licence Condition 36.19 as follows:

*$INT_t$*

*means the interest rate adjustment in Regulatory Year  $t$  made in respect of the relevant amount of over-recovery of Regulated Revenue as determined in accordance with paragraph 36.1720.*

## Appendices

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## **Appendix 1 – Draft Licence changes**

The Licence document published alongside this consultation on our website sets out the draft changes to the Licences proposed in this consultation. The document shows the proposed changes against the up-to-date version of the consolidated Licence conditions available on our website at the time of publishing.

## Appendix 2 – Privacy notice on consultations

### Personal data

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (**GDPR**).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

#### 1. The identity of the controller and contact details of our Data Protection Officer

The Gas and Electricity Markets Authority is the controller, (for ease of reference, "Ofgem"). The Data Protection Officer can be contacted at [dpo@ofgem.gov.uk](mailto:dpo@ofgem.gov.uk)

#### 2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

#### 3. Our legal basis for processing your personal data

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. i.e. a consultation.

#### 4. With whom we will be sharing your personal data

We are not intending to share your personal data with other organisations. We are intending to publish non-confidential consultation responses, including any personal data that may be contained within them.

#### 5. For how long we will keep your personal data, or criteria used to determine the retention period.

Your personal data will be held for six months after the consultation closes.

#### 6. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data

- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data
- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3<sup>rd</sup> parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at <https://ico.org.uk/>, or telephone 0303 123 1113.

**7. Your personal data will not be sent overseas**

**8. Your personal data will not be used for any automated decision making.**

**9. Your personal data will be stored in a secure government IT system.**

**10. More information**

For more information on how Ofgem processes your data, click on the link to our "[Ofgem privacy promise](#)".