Decision

Decision on proposals to modify arrangements for the Over-Recovery of Allowed Revenue, Housekeeping Changes to the Licence and the Baseline Margin Indexation Change

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Contact:	Arno Vanden Eynde and Robert Wilcox
Team:	DCC Oversight and Regulatory Review
Telephone:	020 7901 7000
Email:	DCCregulation@ofgem.gov.uk

In June 2023 we published our proposals to introduce changes to the existing Licence arrangements that the define DCC's over-recovery of Allowed Revenue, the Baseline Margin Indexation as well as minor housekeeping changes to the Licence. This document outlines our decisions on these proposals following consideration of the responses to our consultation.

Any enquiries related to the text of this publication should be sent to Ofgem at:

10 South Colonnade, Canary Wharf, London, E14 4PU.

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Introduction

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 consulted in June 2023 and ran a statutory consultation[1] with the view of amending the Smart Meter Communications Licence (the Licence) to achieve the following two key aims. First, to reduce the scale of cumulative over-recovery of revenue by DCC from its customers. Second, to facilitate the return of this existing over-recovered revenue back to DCC customers.

To achieve the first aim, we proposed a reduction in DCC's Allowed Revenue over-recovery threshold in the correction factor formula in LC36.19, currently set at 110%. This is the degree of tolerance above DCC's forecast Allowed Revenue before DCC must justify any over-recovered revenue, or else it will face a penalty interest rate on this revenue. This threshold exists to allow for the degree of uncertainty inherent in cost forecasting. Our proposal was to reduce the over-recovery threshold from 110% to 105% of DCC's forecast Allowed Revenue for any given Regulatory Year (RY).

To achieve the second aim, we proposed the introduction of a backstop date into the Licence by which DCC must return the entire value of all historic, cumulative, over-recovered revenue (known as the Cumulative Correction Factor) to customers.

Alongside these proposals, we also proposed switching from the Retail Price Index (RPI) to the Consumer Price Index plus Housing costs (CPI-H) as the inflation parameter used for the price index adjuster for RY2024/25 until the end of the Licence. The price index adjuster is used to determine DCC's Baseline Margin and Allowed Revenue values. We also proposed a range of minor housekeeping changes to the Licence, such as updating company addresses or correcting spelling errors.

[1] Consultation on proposals to modify arrangements for the Over-Recovery of Allowed Revenue, Housekeeping changes to the Licence and the Baseline Margin Indexation change | Ofgem

In total, we received five responses to our consultation. Having taken on board these responses, we have decided to proceed with our proposals as outlined in our decision, with only minor amendments to our proposed housekeeping changes to the Licence. In this document, we summarise respondents' thoughts on each of our proposals and outline our decisions in detail.

Context and Related Publications

The RY22/23 consultation on our proposals to modify the arrangements for the Over-Recovery of Allowed Revenue, Baseline Margin Indexation and Housekeeping changes to the Licence and the change: Consultation (ofgem.gov.uk)

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

Our decision-making process

Decision-making stages

Date	Stage description
30/06/2023	Stage 1: Consultation open
25/08/2023	Stage 2: Consultation closes (awaiting decision), Deadline for responses.
4/12/2023	Stage 3: Responses reviewed.
15/12/2023	Stage 4: Consultation decision and responses published.

General feedback

We believe that consultation is at the heart of good policy development. We are keen to receive your comments about this report. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall quality of this document?
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. Are its conclusions balanced?
5. Did it make reasoned recommendations?
6. Any further comments

Please send any general feedback comments to DCCregulation@ofgem.gov.uk

1. Decision – Over-Recovery of Allowed Revenue threshold

Section summary

All respondents to our consultation agreed with the principle of our proposal to reduce the over-recovery threshold, arguing that a reduction was overdue and agreeing with our consultation position that DCC should be better able to forecast its costs at this stage of the Smart Metering Implementation Programme (SMIP). DCC agreed that a lowering of the threshold was appropriate at this stage, though disagreed with our proposed reduction to 105%. Instead, DCC proposed a revised threshold of 108%.

Following consultation, we have decided to proceed with our proposal as outlined at consultation and reduce the over-recovery threshold to 105%.

Questions from the consultation

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

Background

1.1 To allow for a degree of uncertainty that is inherent to cost forecasting, DCC's Allowed Revenue is subject to a 110% threshold: no penalties are applied if DCC's Allowed Revenue exceeds 100% but stays below 110% of its forecast value from the prior Regulatory Year. If DCC's Allowed Revenue exceeds 110%, it must, by no later than 31 July of the Regulatory Year, explain and demonstrate to the Authority in writing why that event is justified. Where DCC is unable to provide such satisfactory response, we may decide to apply a Penalty interest rate on the revenue that has been over-collected. As outlined in the Licence, DCC is expected to take all reasonable steps to return over-collected revenue from prior Regulatory Years back to customers in the following Regulatory Year.

1.2 In our consultation we proposed a reduction of the threshold beyond which DCC must justify any over-collected revenue from 110% to 105%; we consider that DCC's costs are more certain at this stage of the Smart Metering Implementation

Programme (SMIP), and thus DCC should be able to forecast them to a greater degree of accuracy, as well as return cash back to customers on a more frequent basis.

Respondents' views

1.3 All respondents, including that of DCC, agreed that a reduction of the over-recovery threshold was appropriate at this stage of the SMIP, with DCC highlighting the improvements in reporting they have achieved through the Business Accuracy Programme (BAP). Aside from DCC, all responses supported our proposed reduction of the over-recovery threshold to 105%.

1.4 DCC instead suggested a reduction in the over-recovery threshold to 108%. It disagreed with our approach of using the £20m prudent estimate (included in historic charging statements) as a basis for calculating a revised over-recovery threshold of 105% (£20m represents between 4-5% of DCC's Allowed Revenue for all Regulatory Years between now and the end of the Licence). DCC stated that the £20m prudent estimate was outdated and had not been included in its forecasts since April 2022; instead, it now aims to hold three weeks (or 106%) of annual revenue as a reserve liquidity fund, with its revenue typically operating within a 2-percentage point range of this target (ie 104-108%). DCC stated that the over-recovery threshold should therefore not fall below the top end of this range.

1.5 DCC foresees three unintended implications if the over-recovery threshold were to fall below the target of 106%:

1. It could attract a Penalty interest rate despite operating in what it considers a healthy cash range (ie 106-108%).
2. It may have to delay programmes in order to stay beneath the over-recovery threshold, as DCC can only adjust its charges every 3 months and charges are the avenue through which DCC funds its programmes.
3. It could be disincentivised to seek efficiencies and more generally adopt a cautious business approach in order to avoid incurring costs that threaten to raise its Allowed Revenue above the over-recovery threshold.

1.6 DCC also proposed that the introduction of a faster mechanism to return revenue to customers, as well as clearer criteria for when the penalty interest rate applies and for penalty interest to only apply to in-year over-recovery.

1.7 No comments were raised in relation to our proposed Licence amendments that would adjust the over-recovery threshold to 105%.

Reasons for our decision

1.8 Having carefully considered all responses to our consultation, **we have decided to proceed with our consultation proposal of adjusting the over-recovery threshold from 110% to 105%**. While this proposal received unanimous support from stakeholders aside from DCC, we appreciate the arguments put forward by DCC to instead adjust the threshold to 108%. Below, we provide our thoughts on DCC's response and alternative proposals.

1.9 Before discussing the three potential unintended implications raised by DCC above (see paragraph 1.5), we highlight an important characteristic of the over-recovery threshold mechanism: breaching the over-recovery threshold does not automatically initiate the Penalty Interest Rate on any over-recovered revenue. The over-recovery threshold simply signals the level above DCC's forecast Allowed Revenue beyond which we expect DCC to provide a satisfactory reason of why it could not have reasonably forecasted such costs.

1.10 The over-recovery threshold recognises that that there is a degree of uncertainty that is inherent to the forecasting of costs a year in advance; it also accounts for the fact that DCC is an organisation that has grown in functions and responsibilities that were not always envisaged at the beginning of the SMIP. However, as all stakeholders agreed in their responses, at this stage of the SMIP, DCC's costs are far less volatile than in prior years, with its costs and functions more certain than before. Given this, we expect smaller deviations from any forecast Allowed Revenue values in future Price Controls and, as such, expect a greater level of detail and justification from DCC of any deviations that do arise in future.

1.11 As previously explained in our consultation, we consider our proposals to be particularly important now considering the forthcoming expiry of the Licence on 22 September 2025 as well as the recent development of policies elsewhere to ensure that suppliers cannot accrue and use customers' payments as working capital[2].

2 Action plan on retail financial resilience (ofgem.gov.uk), published 15th December 2021

1.12 In relation to the above three key unintended implications of a 105% threshold raised by DCC, we reiterate that the Penalty interest rate does not automatically apply, and provide the following specific counterpoints:

1. *DCC could face a penalty interest rate despite operating in what it considered a healthy cash range:* if DCC can provide a satisfactory reason as to why it could not have reasonably forecast that its cash requirements for a given Regulatory Year exceeded 105% of its Allowed Revenue, then it will not face a penalty interest rate for holding this cash.
2. *DCC could have to delay programmes in order to stay beneath the over-recovery threshold:* We disagree with this statement as any decision in respect of programme expenditure should not be dependent on whether or not it could risk to DCC recovering revenue over and above the threshold. We expect any programme spend, rather, to always take into account several factors including for example, the obligations to incur costs economically and efficiently, the delivery of mandatory business, as well as the level of engagement and customer feedback that is required throughout; if DCC is able to demonstrate that the over recovery of revenue was the result of necessary programme spend that could not have been reasonably forecasted then it will not attract any penalty interest rate.
3. *DCC could be disincentivised to seek efficiencies and more generally adopt a cautious business approach in order to avoid breaching the threshold:* as per the above, regardless of whether costs fall under or above the over-recovery threshold, we expect DCC to ensure that the costs it incurs are economic and efficient.

1.13 DCC further noted in its response that it is "*exploring the option of using a new committed funding facility to replace part of the cash held within DCC's healthy cash range"*. We welcome further discussions with DCC to better understand and assess the viability of such an option.

1.14 In response to DCC's request to streamline the governance process for returning revenue to customers faster, we refer to Licence Conditions 19.10-19.11. These enable DCC to not only amend the content of the Service Charges as well as request for an amendment of the Service Charges more than once in a single regulatory year. Whilst restrictions around the governance process seek to minimise the level of uncertainty around charges in the interest of customers, we have historically accommodated several requests from DCC to expedite this process, often at short notice, where appropriate.

1.15 In respect to having clearer criteria for applying a penalty interest rate, we expect DCC to be able to provide sufficient detail on what has led to the over-recovery and explain why it could not have reasonably avoided that cost increase and was unable to forecast that cost.

2. Decision – Backstop date amendment to Licence

Section summary

Responses to our proposal were overall positive. Respondents agreed with the proposal in principle, though some wanted further clarity and detail on how the backstop date would operate in practice. One response suggested that the proposal was not challenging enough and proposed a per-year backstop date to return all over-recovered revenue.

Questions from the consultation

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 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.

Background

2.1 In response to our RY21/22 Price Control consultation, DCC customers raised concerns around the year-on-year growth in DCC's cumulative Correction Factor. The Correction Factor is the portion of over-collected revenue from prior Regulatory Years that has not since been returned by DCC to its customers.

2.2 To facilitate the return of revenue to DCC customers, we proposed the introduction of a backstop date (the end of the Licence term, or any additional term thereafter) by which the entire value of the cumulative Correction Factor must be returned to customers. We also proposed that DCC shares a plan with us for approval (within 3 months of these changes taking effect), and reports progress against via the annual price control.

Respondents' views

2.3 Overall, respondents supported both our proposal to introduce a backstop date Licence obligation, as well as our proposal for DCC to report on their progress against this Licence obligation. However, greater detail was requested on how we expected the backstop date to work in practice. Particularly, how a definition of "as soon as reasonably practicable" would be reached.

2.4 One respondent considered the proposals did not go far enough to facilitate the return of over-collected money, and instead proposed that this money should be returned on an annual basis, with a 3-month backstop date instead of 6 months.

2.5 DCC outlined potential issues with how the backstop date would interact with the expiry date of the current Licence (ie the date at which the current DCC Licence will expire and a new Licence will be granted to the new licensee) . They foresaw that, if no over-collected revenue was held at this date, the new licensee may not have enough reserve liquidity to operate, as payments and contracts in place would still continue at this time. DCC proposed that only money above the over-recovery threshold (which they proposed be amended to 108%) should be subject to the proposed backstop date requirements.

2.6 With regards to the proposed Licence amendment text itself, DCC proposed changes to reflect their preferred position of a 108% over-recovery threshold.

2.7 DCC also claimed that the over-recovery threshold arrangements do not oblige DCC to hold revenue below the threshold that is set in the Licence; DCC therefore proposed that the wording of the Licence is amended so that it is required to only return any over-recovery of Allowed Revenue that sits above that threshold.

Reasons for our decision

2.8 Following consideration of all responses, we are **proceeding with our proposed Licence amendment to introduce a backstop date by which all over-recovered revenue must be returned to customers**, as well as for DCC to produce a plan to fulfil this Licence requirement and report their progress against it as part of the annual Price Control.

2.9 We acknowledge that further work is required on the practicalities of this Licence requirement in time for when it takes effect at the time that the current Licence expires, as well as on initial operational and logistical issues the new Licensee may face upon transfer of the Licence. We will incorporate work on these issues into future phases of the DCC Review.

2.10 We would like to correct DCC's interpretation that the over-recovery threshold does not oblige DCC to hold revenue below the set threshold. The over-recovery threshold merely sets the level at which we expect DCC to provide a satisfactory reason of why it could not have reasonably forecasted such costs; under the Licence, DCC is expected to take all reasonable steps to return over-collected revenue from prior Regulatory Years back to customers in the following Regulatory Year.

3. Decision – Penalty interest rate

Section summary

Three responses to our consultation agreed with our proposal to leave the Penalty interest rate unchanged. One response expressed support for a rise in the Penalty interest rate. One stakeholder did not provide a response to this question.

We have decided to proceed with our consultation position and leave the penalty interest rate unchanged.

Questions from the consultation

Question 3: We welcome views from stakeholders on our proposal not to change the Penalty interest rate.

Background

3.1 Under the Licence, a Penalty interest rate may be applied against the portion of revenue that DCC over-recovers for which it is unable to provide a satisfactory reason of why it could not have reasonably forecasted this. 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.[3]

3.2 Currently, a Penalty interest rate of 3% plus the Bank of England Base Rate may be applied on any proportion of over-recovery that DCC has not justified to the Authority's satisfaction.

3.3 We previously considered whether it would be appropriate to recalibrate the incentive by adjusting the current Penalty interest rate. Considering the recent interest rate rises, we decided 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.

Respondents' views

3.4 All but one response agreed that the current PIR was reasonable and supported no further changes.

[3] 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

3.5 One response suggested for an increase in the Penalty interest rate to further incentivise the proper use and return of customer funds by DCC, stating that, while the Bank of England Base Rate has risen in recent times, it remains changeable and can decrease in future, decreasing the interest paid by DCC on over-collected revenue.

Reasons for our decision

3.6 Following consideration of all stakeholder responses, we have decided to **proceed with our consultation position to not amend the Penalty interest rate.**

3.7 We consider the self-adjusting component of the Penalty interest rate, which is aligned to the Bank of England Base Rate, to be an adequate mechanism to track fluctuations in market interest rates and offset any interest that DCC may be earning on over-collected customer money prior to its return to customers.

4. Decision – Inflation index change to CPI-H

Section summary

Three responses to our consultation supported our proposal, agreeing that a move from RPI to CPI-H is aligned with other regulatory regimes within Ofgem such as RIIO-2 as well as broader government guidance on inflation adjustment. DCC suggested incorporating discussion around this change into the ongoing DCC Review for consideration for the next DCC Licensee. One stakeholder provided no response.

Questions from the consultation

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 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.

Background

4.1 One of the components of the calculation of DCC's Allowed Revenue is Baseline Margin. The Baseline Margin is defined in the Licence as *"in relation to each Regulatory Year an 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 included (subject to the operation of the Baseline Margin Performance Adjustment) in the Licensee's Allowed Revenue, and is determined in accordance with the provisions of Part C of Condition 36".*

4.2 Currently, the Licence stipulates the use of the Retail Prices Index (RPI) to adjust the Baseline Margin value for inflation when determining DCC's Allowed Revenue[4]. The use of the RPI is however discouraged by both the UK Statistics Authority (UKSA)[5] and Office for National Statistics (ONS)[6], which have highlighted its shortcomings as an inflation measure in recent years.

[4] LC 36.7 – Part C: Determination of the Allowed Revenue (AR) term
[5] [ARCHIVED CONTENT] National Statistician announces outcome of consultation on RPI - ONS (nationalarchives.gov.uk)
[6] Shortcomings of the Retail Prices Index as a measure of inflation - Office for National Statistics (ons.gov.uk)

4.3 We consulted on moving away from using the RPI as an inflation index for the determination of DCC's Baseline Margin; instead, we proposed using the Consumer Price Index plus Housing Costs (CPI-H) from RY24/25 onwards. We consider that this would both align our Baseline Margin adjustment calculation with economic best practice as outlined by the ONS, and also improve internal consistency, as CPI-H is already used elsewhere within Ofgem (such as for calculations within the RIIO-2 framework).[7,8,9,10]

Respondents' views

4.4 Overall, no respondents disagreed with our proposal. Three responses agreed, concurring that a shift to CPI-H better aligns with industry best practice and provides consistency across Ofgem's inflation calculations in other areas of the energy system.

4.5 While DCC did not argue for or against our proposal, it suggested that this should instead be incorporated into discussions around Licence renewal and the future DCC Licence holder as part of the ongoing DCC Review.

4.6 No responses offered any specific feedback on our proposed Licence amendments that would accompany this change.

Reasons for our decision

4.7 Following consideration of all responses, we have decided to **proceed with our proposal to change the DCC BM inflation index from RPI to CPI-H** from RY24/25 onwards.

4.8 Considering the shortcomings of RPI as an inflation measure documented by the UKSA and ONS, we consider it important to move towards a more credible economic measure as soon as practicable.

[7] For example, see para 6.97, page 62 of RIIO-2 Framework (ofgem.gov.uk) Decision
[8] See Consumer Prices Index including owner occupiers' housing costs (CPIH) - Office for National Statistics
[9] RIIO-2 Framework (ofgem.gov.uk)
[1010] Rationale is set in paragraphs 6.87 to 6.94 RIIO-2 Framework (ofgem.gov.uk)

5. Decision – Housekeeping changes to Licence

Section summary

All responses agreed with our proposed Licence housekeeping changes.

Questions from the consultation

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

Background

5.1 In our consultation we proposed a series of minor housekeeping changes to the Licence, which update the Licensee's company address; remove redundant paragraphs which were erroneously re-inserted in later revisions of the Licence; correct spelling errors; and update incorrect cross-references to other paragraphs within the Licence.

Respondents' views

5.2 All respondents supported our proposed changes to the Licence.

5.3 Our proposed update to the Licensee's address was incorrect. We erroneously proposed a new address of 17 Gresham Street. DCC provided the correct address, 65 Gresham Street, in their response.

5.4 DCC also proposed a series of other minor Licence amendments relating to updating Licence term definitions.

Reasons for our decision

5.5 Following consultation, **we are proceeding with our proposed Licence housekeeping changes as set out in our consultation.**

5.6 We will amend our update to the Licensee's address on the second cover page of the Licence to reflect the correction submitted by DCC in their response. The new address will read 65 Gresham Street, London, EC2V 7NQ.

5.7 With regards to the other housekeeping changes proposed by DCC in its response, as we did not include these in our consultation, we will incorporate these in our proposals the next time we consult on any future housekeeping changes to the Licence.

Appendices

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Appendix 1 – Changes to the Licence following this Decision

The Licence document published alongside this Decision on our website sets out the changes to the Licence as detailed in this document.