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Date: 6 April 2016

Dear Colleagues

## **Statutory consultation: final proposals for DCC penalty interest rate**

### **Summary**

This letter:

- Summarises responses to our statutory consultation published on 17 December 2015<sup>1</sup> with respect to our proposed licence drafting changes to amend the definition of regulated revenue and to introduce a penalty interest rate for over-recovery of revenue in DCC's licence ('the licence')<sup>2</sup>.
- Clarifies the intended effect and timing of implementation of our penalty interest rate proposals following requests for clarification from consultation respondents.
- Seeks views on our revised proposed licence modifications<sup>3</sup> to bring into effect our proposals, following drafting comments from consultation respondents.

It does not address responses to our proposed licence drafting changes on DCC's role in developing a Central Registration Service (CRS). We are considering responses to those consultation questions regarding the CRS, and intend to publish a separate document addressing these.

### **Background**

In July 2015, we reviewed the arrangements in the licence that require DCC to take all reasonable steps to secure that its regulated revenue does not exceed a prudent estimate of its allowed revenue. We consulted on:

- clarifying within the licence that any interest accrued on over-recovered service charges is returned to service users in subsequent regulatory years;
- introducing a penalty interest rate above the Bank of England base rate for overcharging to create sharper incentives for DCC to accurately estimate its allowed revenue; and
- the appropriate form of a penalty interest rate regime.<sup>4</sup>

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<sup>1</sup> Proposals for DCC's role in developing a Central Registration Service (CRS) and penalty interest proposals, Ofgem, 17 December 2015: <https://www.ofgem.gov.uk/publications-and-updates/final-proposals-dcc-s-role-developing-centralised-registration-service-and-penalty-interest-proposals>.

<sup>2</sup> The Smart Meter Communication Licences granted pursuant to Sections 7AB(2) and (4) of the Electricity Act 1989 and Sections 6(1A) and (1C) of the Gas Act 1986. This consultation is being conducted in respect of both of those licences. Together, those licences are referred to as 'the licence' throughout this document.

<sup>3</sup> Annexed to this letter

We presented a range of options for the form of the penalty interest rate regime, and set out that we saw the greatest benefit in a 'Report and Direct' form. In this form of penalty interest rate regime, if:

- DCC over-recovered service charges beyond a certain threshold (expressed as a percentage of its allowed revenue), it would be required to report to the Authority<sup>5</sup> explaining its justification for the over-recovery;
- the Authority deemed DCC's over-recovery to be unjustified, it would then have the ability to direct a penalty interest rate (expressed as a certain number of percentage points above the Bank of England base rate) after consultation with stakeholders.

We sought views on an appropriate threshold for over-recovery of revenue which could trigger a penalty interest rate direction. We suggested that a threshold of between 110 and 115 per cent of allowed revenue would be appropriate. We also sought views on the appropriate rate of penalty interest, suggesting 3 percentage points above the Bank of England base rate as a preferred option.

After considering responses to the July consultation, our preferred policy position remained to make clarifications to the licence (in particular, the definition of regulated revenue in licence condition 35) regarding interest accrued on service charges. Our preferred policy position on the penalty interest was to introduce the 'Report and Direct' penalty interest rate regime with a threshold for over-recovery of service charges of 110 per cent of allowed revenue, and a penalty interest of 3 per cent above the Bank of England base rate. On 17 December 2015, we consulted on changes to the licence to give effect to our proposals.<sup>6</sup>

## **Responses to our December consultation**

We received seven responses to our December statutory consultation which specifically addressed our proposed penalty interest licence drafting. These responses showed general support for our proposals and the draft licence changes.

We have summarised the issues which were raised by respondents and set out our responses to those views in this document. For avoidance of doubt, we will take into consideration stakeholder responses to both our December statutory consultation and responses to this statutory consultation in making our final decision. We would welcome stakeholder responses to our current statutory consultation, even if these are brief responses to make explicit that there are no further comments on the proposals.

### *Visibility of penalty interest rate*

One respondent called for transparency of the value of any penalty interest rate, and in particular visibility for DCC service users of the penalty interest rate at least fifteen months prior to the penalty coming into effect to avoid pricing shocks.

To minimise regulatory burden, we envisage consulting on and making any future penalty interest rate directions alongside our price control consultations and determinations. Therefore, we envisage making any future penalty interest rate directions in the last quarter of any regulatory year to apply to the revenue reported by DCC for the previous regulatory year. This would enable DCC to factor in the correction factor (including any

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<sup>4</sup> DCC's role in developing a Central Registration Service (CRS) and penalty interest proposals, Ofgem, 28 July 2015: <https://www.ofgem.gov.uk/publications-and-updates/dccs-role-developing-central-registration-service-and-penalty-interest-rate-proposals> .

<sup>5</sup> The Office of the Gas and Electricity Markets Authority (Ofgem) supports the Gas and Electricity Markets Authority ('the Authority') in its day to day work. In this document, 'us/we', 'Ofgem' and 'Authority' are often used interchangeably.

<sup>6</sup> Proposals for DCC's role in developing a Central Registration Service (CRS) and penalty interest proposals, Ofgem, 17 December 2015.

penalty interest rate) to its service charges in time for the forthcoming regulatory year (subject to consent to a shorter than three month notice period from the Authority).

This cycle is a feature of the current ex-post price control regime. Any penalty would be a small proportion of any unjustified over-recovery amount and it aims to incentivise less over-recovery by DCC.

#### *Appropriate threshold for over-recovery*

One respondent argued that 106 per cent threshold for over-recovery would provide a more appropriate, stronger incentive for DCC to forecast its costs accurately and would align more closely with incentives network companies face.

We responded to this point in our December document. Our current views remain unchanged that a 110 per cent threshold for over-recovery is appropriate for DCC. DCC is in the early stages of implementation and it faces cost uncertainty at the time of setting service charges. This uncertainty is mainly because of the distinct features of the smart metering programme and its design evolution. This level of uncertainty is one of the reasons for our proposed threshold and our proposal to introduce a report and direct model of penalty interest rate regime.

We also note that the majority of respondents felt a threshold of regulated revenue reaching between 110% and 115% of allowed revenue was an appropriate materiality threshold for triggering a potential penalty interest rate. Of these respondents, most expressed a preference for 110%. Furthermore, we propose that the Authority retains the ability to revise the threshold by direction in future after consultation with stakeholders.

We recognise that DCC will continue to face considerable uncertainty after its services are operational. Our intention is to have a proportionate approach to incentivising DCC to forecast its costs accurately. We wish to avoid creating unnecessary reporting burdens. So, the nature of the justification we would expect from DCC in the event of an over-recovery which breached the threshold should continue to be proportionate to the circumstances DCC faced in setting its charges.

#### *Timing of implementation*

One respondent suggested that the penalty interest rate regime should apply to reporting for regulatory year 2016/17 at the earliest because the regime had not been proposed when DCC was required to set its service charges for 2015/16 (in December 2014).

DCC has a licence obligation to take all reasonable steps to ensure its regulated revenue does not exceed a prudent estimate of its allowed revenue. We also note that our November 2014 price control consultation signaled the introduction of a penalty interest rate regime if we remained concerned by DCC's approach to the prudent estimate.<sup>7</sup>

We recognise that the changes to the licence would come into effect a matter of days before DCC is due to submit its 2015/16 price control reporting<sup>8</sup>. To remain proportionate we would like to use 2015/16 as an opportunity to test the reporting practice. We invite DCC to submit voluntary reporting in line with the proposed licence modifications as part of their 2015/16 price control submission which would not be subject to a penalty interest rate.<sup>9</sup> Our intention therefore is for the penalty interest rate regime to formally apply to DCC for regulatory year 2016/17.

#### *Licence drafting*

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<sup>8</sup> After the consultation period and at least 56 days following the publication of our decision notice, subject to any appeals raised, for the modification to take effect.

<sup>9</sup> Not the DCC Price control Regulatory instructions and guidance (RIGs) are capable of accommodating this in their current form.

Two respondents commented that our proposed licence drafting did not align with the description of our policy proposals in the statutory consultation document. In particular, these respondents commented that our proposals as described in the consultation document permitted more over-recovery by DCC up to the threshold of 110 per cent of allowed revenue while the proposed licence drafting allowed for a penalty interest rate to be applied to any portion of over-recovery that DCC did not justify to the Authority. These respondents sought clarity on the intended effect of our proposals.

One respondent also commented that the formula for the correction factor in the proposed licence drafting (licence condition 36.17) did not reflect our proposal that a portion of DCC's over-recovery may be justified to the satisfaction of the Authority, and would be exempt from a penalty interest rate above the Bank of England base rate. This respondent suggested amending the correction factor formula in the proposed licence drafting to reflect this effect.

We address these responses in the section below.

## **Our final proposals**

Following responses to the December consultation on proposed modification to the licence, we are now taking the opportunity to:

- clarify the intended effects of our proposals on the penalty interest rate; and
- propose revised modifications to the licence to give effect to our penalty interest rate proposals.

### *Clarification of intended effects*

The intended effect of our proposals on the penalty interest rate is that from regulatory year 2016/17:

- if DCC has not over-recovered service charges by 110 per cent of allowed revenue or more in any regulatory year, the Bank of England base rate would apply to the entire over-recovered amount of revenue (the difference between its regulated revenue received through service charges and allowed revenue);
- if DCC, over-recovers service charges by 110 per cent of allowed revenue or more, in any regulatory year, it should provide an explanation to the Authority by 31 July of the subsequent regulatory year justifying that event;
  - the Authority may, after consultation with stakeholders, direct a penalty interest rate of 3 per cent above the Bank of England base rate to apply to any proportion of the over-recovery (the difference between regulated revenue received through service charges and allowed revenue) that DCC has not justified to the Authority's satisfaction;
  - the Bank of England base rate would apply to any portion of the over-recovery (the difference between DCC's regulated revenue and allowed revenue) that DCC has justified to the Authority's satisfaction.

### *Revision of proposed licence modifications*

Our revised licence drafting proposals are set out in the notice of proposed licence modifications annexed to this letter. The revisions can be found in the formula for the correction factor (licence conditions 36.15 and 36.16) and to the description of how the penalty interest rate will be determined (licence condition 36.17).

These revisions seek to bring into effect our proposals. In particular, the drafting reflects the effect of our proposal that a proportion of the over-recovery may not be justified by DCC and could attract the penalty interest rate, if the threshold has been breached, while a proportion may be well-justified and would only attract the Bank of England base rate. The licence drafting we proposed in December set out this potential effect in words (in licence condition 36.17) but was not reflected in the correction factor formula. We recognise that

DCC is required to report its correction factor as part of its price control reporting, and that the formula should reflect all possible scenarios in which the penalty interest rate may be directed.

*This consultation*

We are seeking views on the revised proposed licence drafting, and whether stakeholders agree that it reflects our policy intent. This letter, along with the notice of proposed licence modifications annexed, constitute our statutory consultation on proposed changes to the licence.

**Next steps**

This consultation closes on 5 May 2016. Responses should be sent to Laura Nell, Head of Smarter Metering, Office of Gas and Electricity Markets, 9 Millbank, London, SW1P 3GE or by email to [smartermarkets@ofgem.gov.uk](mailto:smartermarkets@ofgem.gov.uk). Responses will be published on our website unless marked as confidential. We will consider responses in making our final decision which we aim to publish in June 2016.

If you have any queries about this letter, please contact [smartermarkets@ofgem.gov.uk](mailto:smartermarkets@ofgem.gov.uk)

Yours faithfully,

Rob Salter-Church  
Partner, Consumers and Competition.

