Decision on consultation on proposals to introduce a DCC Switching performance incentive regime

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This document sets out our response to our November 2022 consultation on the DCC Switching Incentive Regime (SIR) following analysis of the eight consultation responses we received.

We are making the following policy decisions:

1. We will establish the SIR in the Licence as per our consultation position.

2. We will revoke / replace the May 2019 Direction in order to give effect to the SIR, with a start date of 01 April 2023.

3. We will establish the SIR using the four categories of measure as consulted on: Service User Measure, Service Delivery Measure, Development and Improvement Measure and Value for Money Measure.

4. We will award DCC a margin of 7% on its economic and efficient internal costs on Switching from 01 April 2023 onwards, equating to 7.5% Rate of Return.

5. We will incentivise DCC's margin in the early post- go live period until 01 April 2023 through Option 1. Under this approach, the value of the earned margin in this period will be put at risk against DCC's performance against their Design, Build and Test (DBT) phase milestones.

We will also be making the Licence changes to the Smart Meter Communication Licence necessary for the establishment of the SIR.

Finally, we intend to consult shortly on the content of the Direction required to give effect to the SIR from 01 April 2023 onwards.

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

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

1. Introduction

1.1. This decision is in response to our consultation on the DCC Switching Incentive Regime ("**SIR**, hereafter), published on 21 November 2022.[1,2] The consultation was a combined policy and statutory consultation on both policy changes and Licence changes to the Smart Meter Communication Licence ("the Licence", hereafter).

1.2. The SIR is a financial incentive regime designed to incentivise The Data Communication Company (**DCC**) in its roles in the enduring Switching arrangements, to be provided through its Price Control.[3] DCC's three roles in Switching are as provider of the Central Switching Service (**CSS**), the Certificate Authority (**CA**) and the Switching Operator (**SO**) services.

Context and related publications

1.3. The new Switching arrangements went live on 18th July 2022 as part of the Switching Programme. Details of all previous publications relating to the Switching Programme can be found on the Switching Programme page on the Ofgem website.[4]

1.4. As a monopoly company providing services to the energy market, DCC is subject to a Price Control. Details of all previous publications relating to the DCC Price Control, including its role in the Design, Build and Test (**DBT**) phase of the Switching Programme, can be found on the Ofgem website in the Master Publications Library.[5]

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[1] The terms 'we', 'us', 'our' refer to the Gas and Electricity Markets Authority. Ofgem is the office of the Authority
[2] Ofgem consultation on the DCC Switching Incentive Regime: https://www.ofgem.gov.uk/publications/consultation-dcc-switching-incentive-regime
[3] For clarity, when referring to the enduring Switching arrangements, we mean the Switching arrangements going forward under steady state operations
[4] The Switching Programme page on the Ofgem website: https://www.ofgem.gov.uk/energy-policy-and-regulation/policy-and-regulatory-programmes/switching-programme
[5] Ofgem Master Publications Library: https://www.ofgem.gov.uk/master-publications-library

1.5. The Retail Energy Company (**RECCo**) published a consultation on DCC Service Provider Performance Charges in 2022.[6] The consultation sought views on how DCC's performance against its Service Level Agreements (**SLA**s) as defined in the Retail Energy Code (**REC**) could be incentivised, ie directly through the REC, or under the DCC Price Control under Licence. The consultation closed in May 2022, shortly after which RECCo published its response.[7]

1.6. Further to this RECCo have also been progressing REC Change Proposal R0025 (CP-R0025), which seeks to introduce an economic incentive regime for DCC in its performance against its SLAs.[8] Under RECCo's proposals, DCC would incur performance charges if it failed to meet its SLAs. At the time of writing CP-0025 is with us for decision, which we expect to make and publish in late January. As previously discussed in our consultation, we think this financial incentive scheme can act as the operational performance element of the SIR that we are introducing as part of this decision.

What did we consult on?

1.7. We consulted on four aspects of DCC's roles under the new Switching arrangements:

1. The establishment of a financial incentive regime for DCC (the SIR), provided for under its Price Control under Licence[9]

[6] RECCo consultation: https://www.retailenergycode.co.uk/recco-issues-a-consultation-on-dcc-service-provider-performance-charges/
[7] RECCo's response to the consultation: https://www.retailenergycode.co.uk/recco-response-to-consultation-on-dcc-service-provider-performance-charges/
[8] Details of Change Proposal R0025 can be found on the REC Portal: https://recportal.co.uk/group/guest/-/service-provider-performance-charges-erds-grds-dcc-
[9] Link to the Smart Meter Communication Licence. The Price Control provisions are set out in Chapter 9: https://epr.ofgem.gov.uk/Content/Documents/Smart%20DCC%20Limited%20-%20Smart%20Meter%20Communication%20Consolidated%20Licence%20Conditions%20-%20Current%20Version.pdf

2. How to incentivise DCC's margin earned in the "early post- go live period" between Central Switching Services (**CSS)** Go Live on 18 July 2022, and the start of Regulatory Year (**RY**) 23/24 on 01 April 2023

3. The percentage value of the margin that DCC should be allowed to earn in its Switching roles under its Price Control from RY 23/24 onwards

4. Licence changes we consider are required to transpose those policy proposals into the legal framework

1.8. We asked six questions in our consultation in total, five on policy changes and one on Licence changes as follows:

Question 1: Do you support the establishment of the Switching Incentive Regime (SIR) in the Licence as the mechanism for assuring the Switching element of DCC's Price Control?

Question 2: Do you agree in principle with the revocation and replacement of the May 2019 Direction, in the event that we establish the SIR?

Question 3: Do you agree with the definition of the four categories of measure identified that will constitute the SIR?

Question 4: Do you agree with our proposal that DCC should be able to earn a margin somewhere in the range of 6 – 9% of its economically and efficiently incurred internal costs under the enduring Switching arrangements (equating to a range of 6.4 – 9.9% in terms of return on costs)?

Question 5: Do you support either of the options we have identified for incentivising DCC's margin in the early post- go live period of Switching? Are there any other options you think should be considered?

Question 6: Do you agree that the proposed Licence drafting appropriately reflects the policy intent of our proposal to establish the Switching Incentive Regime?

1.9. The document is structured as follows:

Structure of the document

- Chapter 1 sets out key background information relevant to the consultation.
- Chapter 2 sets out our decisions in response to the policy consultation. We address each of the five policy questions in turn. We address the points made in the responses received, before setting out our policy decisions and our reasons for taking those decisions.
- Chapter 3 then sets out our decisions in response to the statutory consultation on Licence changes. We discuss all of the comments received in the responses, before setting out our decisions on Licence changes and our reasons for taking those decisions.

Our decision-making process

1.10. We have followed the below process in order to arrive at the decisions we are publishing in this document.

Date	Stage description
21/11/2022	Stage 1: Consultation open
19/12/2022	Stage 2: Consultation closes / Deadline for responses
26/01/2023	Stage 3: Consultation decision / policy statement

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 mailto:stakeholders@ofgem.gov.uk

2. Policy consultation – decisions in response

Section summary

This chapter sets out our decisions in response to the policy consultation. We address each of the five policy questions in turn. We address all of the points made in the responses received, before setting out our policy decisions and our reasons for taking those decisions.

2.1 For full details of our reasoning behind our policy proposals, please refer back to the consultation document.[10]

2.2 We received eight responses to the consultation in total, all of which are non-confidential and have been published alongside the consultation document on our website.

2.1 Establishment of the DCC Switching Incentive Regime (SIR)

2.3 We asked three questions related to the establishment of the SIR.

Question 1: Do you support the establishment of the Switching Incentive Regime (SIR) in the Licence as the mechanism for assuring the Switching element of DCC's Price Control?

2.4 All eight respondents agreed with our proposal to establish the SIR. Reasons provided included:

[10] Ofgem consultation on the DCC Switching Incentive Regime: https://www.ofgem.gov.uk/publications/consultation-dcc-switching-incentive-regime

- Incentivising DCC to deliver good levels of performance in its service delivery on Switching is essential given its status as a monopoly service provider, particularly given the criticality of the services it provides to the retail energy market. The framework will help to emulate the commercial incentives to drive good service delivery from DCC that would otherwise exist in a competitive market.
- A well designed framework that places 100% of DCC's margin for the services it provides at risk will incentivise good quality of service
- Incentivising DCC in this way will be beneficial to consumers
- The framework provides regulatory certainty and clarity for all parties

2.5 One respondent suggested an alternative incentivisation mechanism. Instead of DCC collecting its full margin as standard through the REC budgeting process, with negative adjustments only being applied in the event of underperformance, it was proposed that extra revenue should only be available to DCC for exceeding the required levels of service (ie its SLAs) in a way that is linked to whole system benefit, with penalties applying for non-delivery of the required service levels. The respondent felt that this mechanism would ensure that extra reward is only available to DCC for extra performance.

2.6 DCC itself, whilst supporting the establishment of the SIR, believe that further work is needed on the SLAs themselves for the operational performance element of the SIR to function as intended. DCC also believe that more detail is required to support the SLA performance reporting process, such as measurement methodologies and target levels. DCC also flagged the need to ensure that it is not held financially accountable under the framework for any factors outside of its control, such as poor performance of a third party.

Ofgem response:

2.7 We welcome the views received from respondents and have carefully considered these as part of our decision process.

2.8 Whilst noting the suggestion for an alternative mechanism, following careful consideration we have decided that our proposed mechanism through which the framework will operate, which allows DCC to collect its margin as standard with negative adjustments applying if an SLA is missed, is appropriate and fit for purpose. This is consistent with the mechanism through which DCC earns its margin on its Smart Metering business as part of the Operational Performance Regime (**OPR**). We consider that DCC meeting its SLAs as defined within the Service Definitions in the REC is sufficient for it to retain its margin, as it has provided its services with the required quality to enable to the switching services to function as intended. Underperformance against its SLAs will then result in a downward adjustment being made to this earned margin, with 100% of its margin at risk across the RY.

2.9 We do not consider that any further work is needed on the SLAs as they currently exist in the REC in order for the scheme to function as intended. DCC were integral to the development of the SLAs and their subsequent incorporation in the REC. Furthermore, DCC have then been required to comply with these SLAs in the REC since CSS Go Live on 18 July 2022. Given this, we consider it appropriate that the SLAs as currently drafted can be utilised within the SIR .

2.10 As the SLAs are defined within the REC, any changes to them will be subject to the REC change process. DCC is able at any point to raise a change to the REC through the usual process if it feels changes are required.

2.11 We have decided to go ahead and establish the SIR in the Licence as per our consultation position. This will involve the following:

- Establishing the SIR in the Licence through the addition of a new Schedule 6, the details of which will be populated in future through the issuing of a Direction. The exact details of the Licence amendments we consider are required and are therefore making are set out later in this document in our response to question 6.
- Providing that the maximum possible sum of all defined performance adjustment metrics in the SIR in use in a RY will equal 100% of DCC's Switching margin, such that DCC's potential liability under the scheme in any given RY is equal to 100% of its predetermined allowed Switching margin for that RY.

Question 2: Do you agree in principle with the revocation and replacement of the May 2019 Direction, in the event that we establish the SIR?

2.12 Seven respondents supported our proposed approach to establishing the SIR of revoking and replacing the May 2019 Direction.[11] One respondent did not answer the question.

2.13 The principal reasons offered in support were that, as the 2019 Direction relates principally to the DBT phase of Switching, and now that the CSS is operating as an enduring service, it makes sense for the Direction to be revoked and the enduring SIR established in a new Direction.

2.14 One respondent noted the benefit of the proposed approach in that it allows flexibility for the Authority to issue new or replacement Directions in future years following consultation in order to amend the SIR as necessary, including the margin value in the event that DCC's risk profile materially changes.

Ofgem response:

2.15 We again welcome respondents' views in response to the consultation.

2.16 Having considered the responses, we will revoke the May 2019 Direction and replace it with a new Direction to give force to, and provide the detail for, the SIR going forward. The Direction will be underpinned by provisions we are introducing into the Licence in the new Schedule 6 as discussed later in the document.

2.17 We intend to consult shortly on the content of the Direction and accompanying guidance. We will then provide our decision and final Direction in response to the consultation. We intend that the SIR will take effect from 01 April 2023.

Question 3: Do you agree with the definition of the four categories of measure identified that will constitute the SIR?

2.18 Seven respondents supported the definition of the four categories of measure in principle, though some provided comments suggesting improvements as discussed below. One respondent did not answer the question.

[11] Link to the May 2019 Direction: https://www.ofgem.gov.uk/sites/default/files/docs/2019/05/cws_dbt_direction_260419_0.pdf

2.19 Reasons provided in support were that the categories represent a good broad set of criteria for use in the scheme, and that there is merit in keeping them consistent with those used in the OPR.

2.20 One respondent raised the issue that we interchanged terminology in the consultation document between customer / service user engagement and stakeholder engagement, noting that stakeholder is a wider group than customer. The respondent suggested that we committed to using one specific term when referring to engagement to avoid confusion.

2.21 One respondent suggested that contract management should be called out as a specific measure given that, in their view, challenges have been seen in this area with DCC on Smart Metering.

2.22 Another respondent expressed concerns over our proposed 80/20 split between operational performance (SUM1) and customer engagement (VMM1) respectively, instead suggesting that SUM1 should be weighted at maximum 70% and VMM1 increased to 30% as a minimum. The respondent felt that incentivising DCC's customer engagement to a great degree will provide an increased probability of improving overall switching performance for consumers.

2.23 Another respondent noted that their greatest area of concern with DCC in its Switching roles is in service management, specifically the quality of communication to and from the Switching Service Desk and the quality of information provided on the Service Management Portal. The respondent felt that incentivising part of the margin against measures in this area would lead to increased performance.

2.24 One respondent asked that we provide clarity in the future guidance accompanying the Direction to confirm which measures are included in each category as they feel it is currently ambiguous, for example how Service User Measure (**SUM**) and Service Delivery Measure (**SDM**) differ from one another. The respondent also noted their view that the Delivery and Improvement Measure (**DIM**) should only be used where it will deliver value for money and tangible consumer benefits.

2.25 One respondent suggested some modifications to the nomenclature used to define the different categories in order to keep them distinct and avoid confusion with the existing OPR measures. The response suggested we insert the "SIR-"

prefix ahead of each of the terms used in the SIR, so SUM becomes SIRSUM, DIM becomes SIRDIM etc.

2.26 Finally, one respondent suggested that the proposed customer engagement survey should not be defined as a Value for Money Measure (**VMM**) but instead as something more consistent with the intent of the survey, such as a new Stakeholder Engagement Incentive measure (**SEI**).

Ofgem response:

2.27 We welcome the feedback received from respondents and note the points made.

2.28 We will ensure we commit to using customer engagement going forward when referring to DCC's engagement with their CSS customers, and avoid using stakeholder engagement which we agree is a wider term.

2.29 Regarding contract management, we appreciate the need to ensure good performance here, however this would necessitate reducing the scale of the other measures where we feel there is greater value in terms of incentivising good performance given all measures must equal 100% of DCCs margin. We also note that there is an element of contract management performance embedded within the SLAs, such that if DCCs contract management performance is poor it could potentially lead to an SLA being missed and performance charges applying anyway. Similarly, regarding the 80/20 point, whilst appreciating the advantages of increasing the weighting on customer engagement we do think that incentivising operational performance is more critical, and that 80% of the total SIR value is the right level for now. We consider that good operational performance will deliver greater overall benefits for consumers relative to good performance on customer engagement. In response to both points however, whilst we consider that our proposed design is appropriate for the incentive scheme to function now, we will keep it under constant review such that if circumstances change in future the measures can be adapted, subject to consultation.

2.30 Regarding service management, we propose to explicitly account for this in the customer engagement survey under the VMM measure as we want to directly incentivise good performance here. Details of this will follow shortly in our consultation on the Direction and accompanying guidance.

2.31 We also note the point around the need for further clarity on the definitions of the measures in the guidance, and confirm we will seek to provide this.

2.32 We agree with the point made around the need to amend the nomenclature, and agree that the suggested method of including the "SIR-" prefix provides greater clarity in differentiating the measures from those used in the SIR.

2.33 Finally, whilst noting the point made, we consider that the customer engagement survey can appropriately be defined as a VMM measure, as good customer engagement performance represents value for money to DCC's customers and ultimately wider consumers.

2.34 We have therefore decided to establish the SIR in the Licence using the four categories of measure as consulted on – Service User Measure (**SUM**), Service Delivery Measure (**SDM**), Development and Improvement Measure (**DIM**) and Value for Money Measure (**VMM**). We are however making the following related changes following consultation:

- We will include the SIR- prefix in the abbreviations all of the measures in paragraph 36.10A and in Schedule 6 – see later in the document where we set out the Licence changes for more details.
- We have also decided to reclassify the operational performance element of the framework from a Service User Measure (SUM1) to a Service Delivery Measure (now SIRSDM1 as described above), as we feel service delivery better describes that particular element of DCC's role. Details will follow in our consultation on the Direction and guidance. Note, this is purely a nomenclature reclassification and does not impact on the underlying scheme design in any way.

2.2 DCC margin on Switching Activity from RY 23/24 onwards

2.35 This section sets out our decision in response to question 4, which proposed the value of margin that DCC should be awarded for their services delivered under the enduring Switching arrangements.

Question 4: Do you agree with our proposal that DCC should be able to earn a margin somewhere in the range of 6 – 9% of its economically and efficiently incurred internal costs under the enduring Switching arrangements (equating to a range of 6.4 – 9.9% in terms of return on costs)?

2.36 We received eight responses to question 4.

2.37 Three respondents felt that the value should be set at the lower end of the range between 6-7%. Key reasons provided included:

- Agreement with the assessment in the consultation that DCC's risk profile under its enduring Switching business is significantly reduced relative to Smart Metering and earlier phases of Switching, where higher margins are earned. Key points noted were the reduced technical complexity of the business, less DCC investment required in physical infrastructure and a much lower financial exposure to DCC in general.
- DCC had control over both the DBT phase of the Programme and its contract procurement activities, which should act to reduce its risk going forward
- DCC also face reduced levels of regulatory risk given the strong governance environment that exists within the REC
- DCC faces a low risk of non-payment from its direct customers
- DCC do not carry the risk of operating at a loss, as it is able to recover its costs through the Price Control process. Only DCC's actual profit margin will be at risk through the SIR.
- There is a need to ensure costs being passed on to consumers are as affordable and justifiable as possible given the current market conditions and high energy prices

2.38 One respondent did not specify an actual figure, but noted that they feel it should be lower than what DCC earn on Smart Metering (ie 15%) as a result of the reduced risk profile.

2.39 Another respondent noted that the range of 6-9% was higher than the returns earned in lower risk utilities, and that we should ensure that the margin awarded is reflective of current market conditions and other regulatory returns.

2.40 One respondent felt that the figure should not be set “arbitrarily”, and should instead be set at a value approximating that which a supplier would pay to a Price Comparison Website-type service as this would be reflective of the value of the service to a supplier.

2.41 One respondent, whilst agreeing with the assessment of the risk profile to DCC as presented in the consultation, did caution against reducing the value of the margin too far relative to earlier phases of Switching as it may act to reduce incentives on DCC to provide a good service.

2.42 DCC however noted in its response that it feels there is compelling evidence to support a figure of 15%. The response referred to the independent review it had commissioned, which found the risk profile under its enduring Switching business to be higher than on the DBT phase (12%) and instead broadly comparable with Smart Metering (15%). DCC noted that the report also presented a range of external comparators which were found to have earned in the range of 12-15% over the past five years.

Ofgem response:

2.43 We note the comments received, and appreciate there exists a range of views in terms of what respondents feel is an appropriate margin.

2.44 We note the general support for our assessment of DCC’s risk profile and the margin range of 6-9% we proposed in the consultation. We also welcome the additional evidence we received from some respondents regarding DCC’s risk profile, which in their view supported a value towards the lower end of the range.

2.45 We also appreciate DCC providing us with its independent assessment, which had proposed a higher margin of 15%. We referred to this report in paragraph 5.17 of our consultation, and note that we did consider its findings when determining our consultation position and proposed margin range.

2.46 We recognised in the consultation that suitable external comparators to DCC's Switching business are difficult to identify, and we therefore felt it appropriate to apply greater consideration to the internal comparators of DCC's own roles in Smart Metering and earlier phases of Switching. We have not received any additional evidence of suitable comparators in the responses which would change our view on that. We note again however that DCC's own report found that the average earnings before tax (**EBT**) over the years 2017 to 2021 of its seven closest external comparator businesses, for which the risk profiles are unknown but are likely in our view to be greater than DCC's, was 9%. We also note that DCC's financial liability through the proposed inventive scheme is capped at the value of its margin and it is still permitted to recover its economic and efficient costs through the Price Control. It is likely that most if not all of the comparators operate at a higher level of financial risk, which would justify a higher margin award.

2.47 As we also noted in the consultation, we intend to apply the principle that margin awarded should be commensurate with the degree of risk associated in providing the services. Having carefully considered all responses received, we remain of the view that our assessment of the risk profile presented in the consultation is reasonable.

2.48 With this in mind, and noting all of the comments received, we intend to award DCC a margin of 7% on its internal costs. Using the calculation methodology adopted for DCC's previous Switching roles, which we will continue to apply, this equates to 7.5% in terms of return on costs.

2.49 We consider that this margin value strikes a fair and reasonable balance between providing value for money to consumers in a time of high energy costs, and suitably incentivising DCC to deliver a quality service. We also consider that the reduction in the value relative to Smart Metering and earlier phases of Switching is appropriate given the reduced risk profile of DCC's Switching business.

2.50 We confirm that 100% of this Switching margin in any given RY will be put at risk against the SIR.

2.51 These provisions, including the value of the margin, will be provided for in the Direction which we intend to consult on shortly.

2.3 Incentivisation of DCC's margin in RY 22/23

2.52 This section sets out our decision in response to question 5, which asked stakeholders whether they supported either of our proposals for incentivising DCC in the early post-go live period.

Question 5: Do you support either of the options we have identified for incentivising DCC's margin in the early post- go live period of Switching? Are there any other options you think should be considered?

2.53 We received seven responses to question 5, with one respondent not providing an answer.

2.54 To reiterate our consultation position for clarity, we proposed two options for incentivising DCC's margin in the early post- go live period of Switching, that being the period between CSS Go Live on 18 July 2022 and the new SIR coming into place, which as noted we expect to be 01 April 2023:

1) DBT phase Delivery Milestones – under this approach, 100% of DCC's allowed margin for the early post- go live period would be put at risk against the five DBT phase Delivery Milestones (DM1t to DM5t) as defined as part of its performance incentive regime for the DBT phase.[12] The DBT Delivery Milestones were used to determine the % of internal costs incurred during the DBT phase that DCC were permitted to earn margin against. Under this proposed approach, we would use that % figure to determine the % of margin earned during the early post- go live period that DCC would be permitted to retain.[13]

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[12] May 2019 Direction on margin and incentives for DCC's role in the DBT phase of the Switching Programme, which sets out details of the DM5 Specified Criteria: https://www.ofgem.gov.uk/sites/default/files/docs/2019/05/cws_dbt_direction_260419_0.pdf

[13] For example, if DCC were permitted to earn margin against 70% of its DBT costs as a result of performance against the five DM milestones, it would then be permitted to also retain 70% of its margin earned during the early post- go live period.

2) Future Switching Incentive Regime – under this approach, 100% of DCC's allowed margin for the early post- go live period would be carried forward to be put at risk against future incentivisation criteria. This could be implemented through the SIR we are introducing from RY 23/24 onwards, for example by putting the value of money earned by DCC during the early post- go live period at risk against the requirements of the SIR over a defined period of time, eg one or two years.

2.55 Two respondents supported option 1 as the favourable approach. Key reasons provided in support were as follows:

- Incentivising DCC against their performance during the DBT phase will provide a more temporal relevance to the effect of the underperformance than the alternative option proposed
- The alternative (option 2) will be commercially complex given that the DCC's Switching business is funded through the Smart Energy Code (**SEC**) until the end of RY 22/23, and through the REC thereafter

2.56 DCC felt that, given the choice between the two options presented, option 1 would be the most acceptable. It considers option 2 to be unreasonable for the following reasons:

- It is unreasonable that margin earned in the early stages of operations should be placed at risk
- Applying this option would result in necessary changes being made to the reporting methodology for a single RY, which may not be proportionate with the value of money at stake

2.57 In contrast, four respondents supported option 2. Key reasons provided in support were as follows:

- Applying the margin against DCC's delivery milestones in the past (ie under option 1) will not act as a relevant performance incentivisation measure, now or in the future.
- The proposed incentivisation measures in the future SIR better suit the service that DCC should have been providing in the early post- go live period when the margin has been earned.

- Carrying the margin earned in this period forward into the SIR in future will act to further incentivise DCC to provide a good service for customers during this period.
- The alternative (option 1) does not provide a relationship between the performance measures against which DCC's margin award is calculated and the actual DCC performance levels that service users will have experienced during the early post- go live period.

2.58 Finally, we did not receive any proposals from respondents for any alternative options that we should consider.

Ofgem response:

2.59 Noting the responses received, we appreciate there are differing views amongst stakeholders on which option for incentivising DCC in the early post- go live period is most favourable. We accept that both options have arguments both for and against, and there is not one clear and obvious best approach.

2.60 Whilst neither option represents a mechanism for directly incentivising DCC in its service delivery in this early post- go live period as the milestones it would be incentivised against are either in the past or future, we do think it is critical that 100% of its margin earned in this period is put at risk in some way.

2.61 It is however important we ensure that the costs and effort involved for all parties in implementing an approach is commensurate to the value of money at stake. Assuming we implement the new SIR with a start date of 01 April 2023, the value of money at stake for DCC in this early post- go live period will represent approximately 8.5 months of its margin earned against economic and efficient internal costs at the DBT phase margin of 12% (calculated as a 13.6% Rate of Return).

2.62 Given this, we consider that the most pertinent argument is the one made around the difficulty of option 2 in terms of reporting and accounting, given that DCC's Switching business is funded through the SEC until the end of RY 22/23 and the REC thereafter. Noting the points made, we think that carrying margin earned by DCC in this period, which has been paid by SEC parties, forward and put at risk against performance measures at a time when the margin is being funded by REC parties, is likely to prove problematic and carry accounting and administrative costs that are disproportionate with the value of margin at stake.

2.63 **We are therefore taking the decision to implement Option 1**. Under this approach, the value of margin that DCC earn in the early post- go live period will be put at risk against DCC's performance against their DBT phase milestones.

2.64 For the purposes of the calculation of the term CRSPAt (Central Registration Service Performance Adjustment) in this phase therefore, we consider that the May 2019 Direction will achieve the policy intent and provide for Option 1 until the end of RY 22/23 on 31 March 2023.[14] This will allow DCC to earn margin against the DBT phase incentive framework in the Direction as set out below.[15] We expect that Direction to then be replaced by the new Direction we anticipate publishing to provide for the details of the SIR, which will take effect from 01 April onwards.

The value of $CRSPA_t$ shall be calculated according to the following formula:
$CRSPA_t = CRSPAT_t + CRSPAD_t$

Where:

The performance adjustment term for the Transitional Phase of the Switching Programme (CRSPAT) is:

$CRSPAT_t = 13.6\% * (CRSICT_t - TM1_t - TM2_t - TM3_t + R_t)$

This is unchanged in this amendment from the March 2017 direction apart from amendments in terminology to further clarify and differentiate the two phases.

[14] May 2019 Direction on margin and incentives for DCC's role in the DBT phase of the Switching Programme, which sets out details of the DM5 Specified Criteria: https://www.ofgem.gov.uk/sites/default/files/docs/2019/05/cws_dbt_direction_260419_0.pdf

[15] Note, the CRSPAT element of the framework relating to the Transitional Phase of the Switching Programme has ceased to function following the end of the Transition phase.

And

The performance adjustment term for the Design, Build and Test ('DBT') Phase of the Switching Programme (CTSPAD) is:

$$CRSPAD_t = 13.6\% * (CRSICD_t - DM1_t - DM2_t - DM3_t - DM4_t - DM5_t + DRM_t) + DDR_t$$

2.65 Note, the CRSPATt element of the framework relating to the Transitional Phase of the Switching Programme has ceased to function following the end of the Transition phase.

2.66 The CRSPADt element of the framework determines the % of its internal costs incurred during the DBT phase that DCC are permitted to earn margin against. All internal costs borne by DCC in the early post- go live phase up to and including 31 March should therefore be classed as CRSICDt (Central Registration Service Internal Costs as applied to the DBT phase).

2.67 There are five delivery milestones in total (DM1t to DM5t), underperformance against any of which will result in a % decrease in internal costs against which margin can be earned.

2.68 There is also a mechanism contained within the framework known as the Discretionary Recovery Mechanism (**DRM**). The DRM, which is calculated after all five milestones have passed, allows DCC to recover a proportion of any margin sacrificed against the DBT milestones if it can demonstrate it has fulfilled certain criteria, up to a maximum of 30% of the total value of the DBT phase margin sacrificed. Details of the DRM are set out in our DRM guidance, published in May 2019.[16]

[16] Guidance for the Discretionary Recovery Mechanism for DCC under the Design, Build and Test Phase of the Switching Programme: https://www.ofgem.gov.uk/sites/default/files/docs/2019/05/drm_guidance_document_1.pdf

2.69 Finally, there is a further award defined within the DBT phase performance incentive framework unrelated to the Delivery Milestones through which DCC are able to earn extra reward on its Switching activity, known as the Data Discretionary Reward (**DDR**). The DDR allows for a one-off discretionary adjustment to be made to DCC of +/- £200k based on its performance in Retail Energy Location (**REL**) address matching and associated service provider contract management. Details of the DDR are set out in our DDR guidance, also published in May 2019.[17]

2.70 We will make our final decision on the % of internal costs against which DCC are permitted to earn margin for the DBT and early post- go live phases as part of our 22/23 price control determination, likely to be published in February 2024.

[17] Guidance for the Discretionary Data Reward (DDR) for DCC under the Design, Build and Test Phase of the Switching Programme: https://www.ofgem.gov.uk/sites/default/files/docs/2019/05/ddr_guidance_document_0.pdf

3. Statutory consultation on Licence changes – decisions in response

Section summary

This chapter addresses the comments we received in response to our statutory consultation. We address all of the points made in the responses received before setting out our decisions on Licence changes and our reasons for taking those decisions.

3.1 This chapter addresses the comments we received in response to our statutory consultation on the Licence changes we consider are required in order to transpose our policy proposals as consulted on into the legal framework.

3.2 For full details of our reasoning behind our Licence change proposals, please refer back to the consultation document. [18]

3.3 Again, we received eight responses to the consultation in total, all of which are non-confidential and have been published alongside the consultation document on our website.

3.4 We consider that the policy decisions that we have now taken as discussed in Chapter 2 do not vary from our consulted on position to the extent that any further consultation is required. We are therefore now implementing the Licence changes as set out in the consultation with some minor amendments, as discussed below.

3.5 We received some comments and suggestions for Licence changes that are not related to the functioning of the SIR, such as apparent errors in the drafting and the use of potentially out of date terminology. We recognise that we need to review various parts of the Licence from a housekeeping perspective, and are planning to conduct this exercise in the future. Whilst we appreciate these comments from respondents therefore, for now we are proceeding only with

[18] Ofgem consultation on the DCC Switching Incentive Regime: https://www.ofgem.gov.uk/publications/consultation-dcc-switching-incentive-regime

making the changes we consider are required for the effective implementation and functioning of the SIR. Any changes we consider are not necessarily required for this purpose will be logged and addressed later as part of that exercise on housekeeping changes.

3.6 Please refer to the accompanying document published alongside this consultation where we set out all of the final Licence changes in redlined form.

Question 6: Do you agree that the proposed Licence drafting appropriately reflects the policy intent of our proposal to establish the Switching Incentive Regime?

3.7 We received seven responses in total to question 6. One respondent did not respond to the question.

3.8 Six respondents agreed that the drafting reflected the policy intent, though one of these respondents did raise some points for consideration. One further respondent meanwhile felt that further work was required to ensure the changes reflected the policy intent.

3.9 The points raised by the two respondents who provided substantive comments in response are addressed below.

3.10 The additional changes we are making in response to this consultation are marked up in yellow highlight.

1) Condition 35.5 - The definition of 'Centralised Registration Service Margin' should reflect that this amount of revenue is determined in accordance with the provisions of Part D of Condition 36.

Ofgem response:

We agree with the point made. The definition as consulted on included reference to "Part C of Condition 36", which was an error. We are therefore changing the definition to instead make reference to Part D of Condition 36 (see our final Licence text below in response to point 2))

2) Condition 35.5 – We would query if it were appropriate to define the term 'Centralised Registration Service Margin' by reference to 'Centralised Registration Service Revenue', of which 'Centralised Registration Service Margin' is now proposed to be a component.

Ofgem response:

We agree with the point made, as the definition in the consultation risks being read as a circular reference. Rather than completely removing the term however, we consider that it is clearer to set out that the term represents a component of the overall revenue term over and above the Licensee's internal and external costs. We consider that this new amended definition is a clear and accurate description of the term. We are therefore making the following changes to the definition of Centralised Registration Service Margin:

> ***Centralised Registration Service Margin*** *means in relation to each Regulatory Year ~~an amount of~~ a component in the calculation of the term Centralised Registration Service Revenue, over and above the sum of the Licensee's Centralised Registration Service Internal Costs and Centralised Registration Service External Costs, that the Authority has agreed shall be included in the Licensee's Centralised Registration Service Revenue, and is determined in accordance with the provisions of Part ~~C~~ D of Condition 36.*

3) 36.10 - There is a typographical error in paragraph (a) of the meaning of CRSMt, where the semi-colon looks to be in an incorrect place.

Ofgem response:

We consider that the drafting functions as intended with or without the semi-colon in place, as per the precedent set elsewhere in the Licence, so do not regard this change as required.

4) Condition 36.10 – We consider it appropriate to include a 'latest date' by which DCC will receive the direction that determines the Centralised Registration Service Margin in paragraph (b) of the meaning of this term.

   We would also expect the latest date by which a Direction of the Authority will be issued to DCC for the purpose of Condition 36.10B to be established, so there is certainty as to when the CRSPA will be determined, similar to the window within which the Authority was required to give a Direction under Condition 38.9 relating to the term BMOPA.

Ofgem response:

We do not consider it appropriate to include a backstop date by which time the Direction to determine CRSM or CRSPA must have been issued, as this would risk impairing our ability to administer the SIR. We recognise that Condition 38.9 did include a backstop date of 31 August 2020 for the development and population of Schedule 4 relating to the BMOPA formula, however that was required at the time in order to provide regulatory certainty around when the framework for defining BMOPA would come into effect as the Licence condition was introduced some time ahead of the finalisation of the framework design and publication of the Direction. We consider in the case of the SIR that we have been clear that we expect it to commence on 01 April 2023 and that we will be consulting on the required Direction very shortly, so consider that we have provided sufficient regulatory certainty for all parties.

5) Condition 36.10 - There are three references in the Licence drafting to the "REC Panel" in 36.10B, 36.10B(a) and in the definition for CRSMt in 36.10. However in the REC there is no concept of a "REC Panel" and no new definition has been included in the drafting of the Licence. We seek clarity on which part of REC governance Ofgem is intending to refer to here.

   The requirements of the "panel" as referenced in Standard Condition 11B of the Electricity Supply Licence is in practice delivered by the Change Panel:

   11B.8 The REC must provide for:

(a) a panel body, as specified in the REC (the "panel") whose functions shall include the matters required by this condition and as set out in the REC; and…..

However, we also note that it is Ofgem and the government's intention to replace code panels as part of Energy Code Reform. We would therefore suggest that the Licence drafting include a future-proofed reference, for instance to "the Panel, or such other body as may be constituted under the REC pursuant to Condition 11B of the Electricity Supply Licence." (and/or Condition 11 of the Gas Supply Licence, as the case may be). This would provide a clear interpretation of the intent of this reference.

Ofgem response:

The intention of including the three references to the "REC Panel" in 36.10, 36.10B and 36.10B(a) in the proposed Licence text in the consultation was to specifically define it as a consultee in the development of the provisions of a Direction to determine the values of CRSMt and CRSPAt.

Following consideration of the responses, we agree that it would not be correct to make reference to the "REC Panel" in the Licence without also including a new definition of the term.

Furthermore, following a full review of the definitions in light of the comments received, we also on balance consider that it is not necessary to define "REC Parties" as specific consultees in the definitions.

Instead, we are rewording the definitions to make reference to "relevant stakeholders" as required consultees in place of "the REC Panel and REC Parties". We consider this to be the right approach for the following reasons:

- The consultation requirements are specified in relation to the issuing of a Direction. We would issue a full public consultation on the content of a Direction as standard, so consider that all stakeholders and interested parties would always have the opportunity to respond to the proposals. We do not therefore consider that REC Parties require being defined as specific consultees within the Licence definition.

- The new drafting requires us to consult with all relevant stakeholders and not just the specific consultees identified, which serves to increase the scope of the Licence requirement on the Authority.

- The new phrasing serves to futureproof the definition

We are therefore making changes to 36.10, 36.10B and 36.10B(a) as follows:

> *…. following consultation with the Licensee~~, the REC Panel and REC Parties~~ and relevant stakeholders as appropriate.*

We also recognise the comments we received in relation to the definitions of some of the Centralised Registration Service Revenue formula terms in 36.10 where reference is made to the SEC Panel and SEC Parties. The response noted that, with the introduction of the SIR and the finance flows through the REC as opposed to the SEC from 01 April 2023, it is not clear why there should be a SEC governance role in the Switching arrangements going forward and the definitions should therefore be reviewed. We welcome the comment and have noted it for inclusion in our future housekeeping review of the Licence, as referred to above.

6) Schedule 6 – Suggestion to modify the nomenclature used to define the different categories in the SIR in order to keep them distinct and avoid confusion with the existing OPR measures, by inserting the “SIR-“ prefix ahead of each of the terms.

Ofgem response:

As noted in chapter 2, we agree that this would be beneficial in providing greater clarity and preventing confusion. We will therefore include the SIR- prefix in the abbreviations all of the measures in paragraph 36.10A and in Schedule 6, so SUM is now SIRSUM, SDM is now SIRSDM, DIM is now SIRDIM and VMM is now SIRVMM.

4. Next steps

4.1 The Licence document published alongside this decision on our website sets out the changes we are making to the Licence in redline form. The document shows the changes against the up to date version of the Licence conditions at the time of publishing. New text is marked up with double underline and removed text in strikethrough. The additional changes we are making in response to this consultation are marked up in yellow highlight.

4.2 We have also published a Notice of Licence Modification alongside this decision document.

4.3 The Licence changes will take effect 56 days from publication of this decision on 23 March 2023.

4.4 As noted, we intend to consult shortly on the Direction required to populate the newly inserted Schedule 6 with the provisions required for the SIR. We expect to publish this consultation over the next 1-2 weeks.