
Guidance for managing the effects of surplus residual charges

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This document contains guidance for Distribution Network Operators that are at risk of setting charges with an excessive surplus residual for 2026/27. It describes the process that such DNOs should follow to ensure that they are able to publish final tariffs for 2026/27 by 31 January 2025.

It also summarises the responses to our July 2024 Call for Input on this subject.

Guidance – Managing the effects of surplus residual charges

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Executive Summary

To produce charging statements in advance, Distribution Network Operators (DNOs) must use approved cost models to generate tariffs that recover the relevant expected allowed revenues. In recent years, some DNOs have found the models have produced tariffs that are not in line with good charging practice. In other cases, the models have failed to produce tariffs using the desired inputs, and intervention has been required. We refer to these issues as being caused by an 'excessive surplus residual'.

This guidance has been informed by responses to our July 2024 Call for Input on this subject. We summarise the responses and prescribe the approach that DNOs should follow to address this issue when requesting a derogation.

If the Extra High Voltage Distribution Charging Methodology (EDCM) produces fixed credits, then the DNOs should follow the prescribed process using one of two intervention options subject to the principal cause of the issue.

If the Common Distribution Charging Methodology (CDCM) is unable to produce a full set of charges, then the DNOs should follow the prescribed process to ensure that the residual is set at a point where the model is able to produce a full set of charges.

Any DNO at risk of facing these issues for 2026/27 should:

1. Seek a derogation from the 15-month notice period
2. Once it has confirmed that it is facing the issue, seek a derogation from compliance with the relevant charging methodology, using the appropriate intervention option as prescribed in this guidance.
3. Subject to Ofgem assessment and decision, publish final 2026/27 charges by 31 January 2025.

1. Introduction

Background

- 1.1 This document is our Guidance to the Distribution Network Operators (DNOs)¹ to manage specific issues within the existing Distribution Use of System (DUoS) Charging Methodologies and our response to the 'Managing the effects of surplus residual charges' Call for Input, which we published in July 2024.
- 1.2 DUoS charges are levied by DNOs to recover their revenues.² DUoS charges are calculated according to the Charging Methodologies as approved by the Authority³. This document refers to the Extra-High Voltage (EHV)⁴ Distribution Charging Methodologies (EDCM), and the Common Distribution Charging Methodology (CDCM), each set out in the Distribution Connection and Use of System Agreement (DCUSA).⁵
- 1.3 DNOs publish annual Charging Statements, which provide 15-months' advance notice of annual charges in accordance with clause 19.1A of the DCUSA.⁶
- 1.4 The Charging Methodologies include forward-looking charges, which signal to users how their behaviour can affect future network costs. The revenue recovered from forward-looking charging elements is typically less than the forecast of DNO allowed revenue that is due to be recovered (for example, owing to fixed costs that do not change regardless of network use).
- 1.5 The Charging Methodologies therefore also apply residual charges, which are used to bring the revenue recovered from DUoS charges into alignment with the DNOs' allowed revenue.

¹ DNOs are holders of electricity distribution licences granted or treated as granted under section 6(1)(c) of the Electricity Act 1989.

² Allowed revenues are determined by the RIIO process. View further [information on Network price controls 2021-2028 \(RIIO-2\)](#) on the Ofgem website.

³ The terms "we", "us", "our", "Ofgem" and "the Authority" are used interchangeably in this guidance document and refer to the Gas and Electricity Markets Authority.

⁴ Extra-High Voltage refers to users connected at (or above) 22kV, or to users connected into a substation where the primary infeed is at (or above) 22kV.

⁵ The most recent version of the [DCUSA document](#).

⁶ [Clause 19.1A of the DCUSA](#) - The Company may vary the Use of System Charges at any time by giving the requisite period of written notice to the User. The requisite period of notice is (subject to Clause 19.1B): 19.1A.1 where the Company is a DNO Party acting within that DNO Party's Distribution Services Area: in the case of the charges to apply from 1 April 2016 only, 3 months; or in the case of the charges to apply on or after 1 April 2017, 15 months.

- 1.6 In the 2023 charge-setting period, we were made aware of circumstances in which following the EDCM would result in a negative value 'surplus residual'.⁷
- 1.7 In some cases, this would result in a fixed daily credit being paid to certain sites. We do not consider that a fixed daily credit for Final Demand Sites is cost-reflective nor conducive to competition in the generation and supply of electricity.
- 1.8 We are similarly aware of limitations with how the CDCM seeks to manage a surplus residual. A process exists to reduce some of the forward-looking charges (discounting fixed charges and unit rates) to bring revenue recovery down to the target value. However, an especially large surplus residual may result in the CDCM exhausting the ability to apply discounting and failing to produce a complete set of charges for some network users. We do not consider that compliance with the Charging Methodology should result in the failure to produce a set of final tariffs.

Policy Development Process

- 1.9 From the point of the issues within the charging methodologies becoming known to us, we have sought to identify a robust and practical solution.
- 1.10 In response to a surplus residual arising in the EDCM of two DNOs in the 2023 charge-setting period, for 2025/26 charges, we granted a derogation to the affected DNOs to charge outside of the EDCM.⁸
- 1.11 We described these issues in greater detail in two explanatory notes published alongside our presentation to the March 2024 Charging Futures Forum.⁹ These notes invited interested stakeholders to share initial feedback on our identification of these issues. They also provide more context regarding how the existing CDCM discounting process works.
- 1.12 In July 2024, we published a Call for Input to the sector, which detailed our assessment of proposed approaches to manage the effects of surplus residual charges in both the EDCM and CDCM. The approaches were developed from workshops we held with DNO representatives to explore the issues in greater

⁷ Surplus residual is also understood as a 'negative residual'. This guidance document uses the term "surplus residual" for consistency with the DCUSA.

⁸ Read directions pursuant to SLC 13B Part E of the Electricity Distribution Licence relating to [National Grid Electricity Distribution](#), and to [Scottish and Southern Electricity Networks](#).

⁹ Read our [explanatory note on the priority issues related to the EDCM](#) on the NESO website. Read our [explanatory note on the priority issues related to the CDCM issue](#) on the NESO website.

detail. The Call for Input outlined and sought feedback on our prioritisation of this work, methods for addressing the issues, and our assessment of the proposed approaches. Responses to the Call for Input have been used to develop this guidance document.

- 1.13 To manage the effects of surplus residual charges within the Charging Methodologies in time for 2026/27 tariff setting, we consider that bespoke directions to affected DNOs to derogate from the Charging Methodologies is the most robust and practical approach.
- 1.14 We sought input from stakeholders to develop this approach through Question 3 of the Call for Input published in July 2024. Responses are assessed in the 'Responses to the July 2024 Call for Input' section of this guidance document. This guidance document details how to follow this process.
- 1.15 We ask that DNOs facing surplus residual values that lead to a fixed credit being produced in the EDCM or to a reference error for at least one tariff in the CDCM submit requests to derogate from the relevant Charging Methodology. These requests should include an impact assessment on 2026/27 tariffs, to demonstrate the impact of the proposed approach or approaches in their specific circumstances.
- 1.16 Details on the circumstances in which a DNO should submit a request to derogate from the charging methodology are outlined alongside the intervention options to apply, within the 'Specific guidance for addressing the EDCM issue' and the 'Specific guidance for addressing the CDCM issue' sections.
- 1.17 Ofgem will consider issuing directions in response to DNO requests for derogation from the Charging Methodologies.
- 1.18 If approved, DNOs should follow Ofgem directions to enable publication of 2026/27 tariffs.

Responses to the July 2024 Call for Input

- 1.19 We received 13 responses to the July 2024 Call for Input on Distribution Use of System Charging – Managing the effects of surplus residual charges. We have published all 13 responses alongside this Call for Input.
- 1.20 We were pleased to receive responses from five DNOs, one Independent Network Operator (IDNO), two network associations, three suppliers, one generator and one non-network trade association.

- 1.21 The consultation was open to written responses for six weeks and, in certain cases, was followed up with direct engagement. We have considered all responses when developing the content of this guidance document as detailed in the separate section on Call for Input responses. We express our thanks to all the respondents.

Context and related publications

- 1.22 You should read the sections in this document with the corresponding sections of the Call for Input. These provide in-depth explanations of the matters we were considering. We have omitted them here for brevity. If you need further detail, see the related publications section.

Related publications

- 1.23 Development of our policy to manage the effects of surplus residual charges within DUoS charging methodologies can be tracked chronologically through the publications listed.
- 1.24 Read directions to derogate under SLC 13B Part E of the Electricity Distribution Licence relating to the EDCM for:
- [National Grid Electricity Distribution](#)
 - [Scottish and Southern Electricity Networks](#)
- 1.25 Further information on the issues relating to both the EDCM and the CDCM:
- Discussed during the Distribution Charging update at the March 2024 Charging Futures Forum:
 - Read the [explanatory note on the issue relating to the EDCM](#) on the NESO website
 - Read the [explanatory note on the issue relating to the CDCM](#) on the NESO website
 - [Call for Input on managing the effects of surplus residual charges](#)

2. Process for addressing excessive surplus residual issues for the 2026/27 charge setting period

This section sets out the process by which DNOs should submit requests to derogate from the DCUSA 15-month notice period and relevant Charging Methodologies, in order to manage the effects of excessive surplus residual charges. We detail the intervention options to be applied, the requirements of the impact assessment and our review criteria.

Overview

- 2.1 In the July 2024 Call for Input, we outlined our intended process to resolve the identified issues using an adaptable approach, wherein DNOs submit requests to derogate from the Distribution Charging Methodologies in order to manage the effects of excessive surplus residual charges. We also proposed an approach to reviewing these derogation requests and how this would inform our final decisions. Following responses to the Call for Input, we have further developed a process for addressing excessive surplus residual issues that arise in the 2026/27 charge setting period, which we describe below.
- 2.2 Following the publication of this guidance document, we encourage DNOs to review their available indicative charging figures and to assess the likelihood of an excessive residual surplus occurring as a result of applying the Charging Methodologies to their licence areas. “Excessive” should be understood to mean that it results in the production of negative fixed charges for EHV users and/or the failure to produce a complete set of tariffs due to a reference error in the CDCM.
- 2.3 If a DNO anticipates a risk that excessive surplus residual charges will occur, we ask that the DNO requests a direction to derogate against the 15-month notice period. If approved, this would allow sufficient time for DNOs to apply the intervention options to manage the excessive surplus residual, submit a request to derogate against the relevant Charging Methodology and publish final charges following a decision from Ofgem. In the event that the DNO’s ordinary calculation of charges does not result in an excessive surplus residual being produced, we would expect the DNO to publish tariffs by 31 December 2024.

- 2.4 Ofgem will issue and publish a direction in response to the DNOs' requests to derogate against the 15-month notice period, ahead of any requests to derogate against the DCUSA charging methodologies.
- 2.5 When a DNO can calculate 2026/27 charges according to their ordinary processes and confirms the occurrence of an excessive negative residual in either or both Charging Methodologies, that DNO should apply the relevant intervention option detailed in this guidance document to the relevant Charging Methodology and conduct an impact assessment of the applied intervention option.
- 2.6 A DNO in this position should submit a derogation request against the CDCM and/or EDCM, including an impact assessment.
- 2.7 For further information on the requirements of this submission, read the 'Guidance on requests to derogate from the DCUSA Charging Methodology' in this document.
- 2.8 We will conduct a further assessment of the DNO's request to derogate from the Charging Methodology against our assessment criteria as described in the Call for Input.
- 2.9 Following our assessment, we will publish our decision regarding the request to derogate from the Charging Methodology. If approved, DNOs should enact our direction to derogate against the charging methodology and publish final tariffs. In the event that we cannot approve a request to derogate against the Charging Methodology, we will work with DNOs and wider industry to develop an alternative workable solution to manage the effects of excessive surplus residual charges.
- 2.10 We outline the process that we ask DNOs to follow, alongside indicative dates, below:
- **14 November 2024** – Our Guidance for managing the effects of excessive surplus residual charges (this document) is published.
 - **14 November 2024 to 20 December 2024** – DNOs to conduct ongoing assessment of the likelihood of an excessive surplus residual within their tariffs. If there is a risk of excessive surplus residual, the DNO submits a request to derogate against the 15-month notice period. Ofgem publishes directions in response to DNO requests.
 - **Up to 10 January 2025** – DNOs finalise their 2026/27 charging figures and confirm whether excessive surplus residual charges occur in their

tariffs. If so, the DNO submits a request to derogate against the affected Charging Methodology, alongside their impact assessment of the applied intervention option as set out in this guidance document.

- **10 January 2025 onwards** – Ofgem assesses the submitted derogation requests and publishes directions in response to DNOs requests.
- **Before 31 January 2025** – Affected DNOs with directions from Ofgem publish 2026/27 charging tariffs by 31 January 2025.

Guidance on requests to derogate from the DCUSA 15-month notice period

- 2.11 We ask that DNOs submit requests to derogate against the 15-month notice period at the point they identify a risk of an excessive surplus residual occurring in either or both DCUSA Charging Methodologies.
- 2.12 This is to allow time for DNOs to confirm the presence of an excessive residual surplus in their charging methodologies, apply the relevant intervention option and produce an impact assessment, followed by submitting a request to derogate against the DCUSA Charging Methodology to Ofgem.
- 2.13 In the event that DNOs do not experience an excessive surplus residual after a direction to derogate from the notice period, we would expect DNOs to publish charges by 31 December 2024, meeting the 15-month notice. This will be reflected in any directions to derogate from the notice period.

Guidance on requests to derogate from the DCUSA Charging Methodologies

- 2.14 We ask DNOs to submit derogation requests using the intervention option we have identified as being most appropriate for each Charging Methodology in this guidance.¹⁰ These are detailed in the following two sections.
- 2.15 This derogation request should include:
- what led to the residual surplus (principal cause)
 - tariffs affected (relative to the status quo)

¹⁰ The options are summarised in the Annexes with further detail in the Call for Input.

- how the intervention option is sufficient to correct for the issue in those circumstances
 - impact assessment – a quantitative assessment of the impact on tariffs. As a minimum, this should include the final tariff tables of implementing the intervention option: Annexes 1 (CDCM), 2 (EDCM) and 4 (both) of the Schedule of charges and other tables.
- 2.16 The above should inform the DNO's assessment of the intervention option against the DCUSA charging objectives¹¹ to provide justification for the approach in the circumstances. Such an assessment should also consider any potential unintended consequences of the intervention option.
- 2.17 DNOs can include a single derogation request to cover both the EDCM and the CDCM if they are both affected. For the avoidance of doubt, where an EDCM intervention option affects the CDCM, we would also expect the CDCM impacts to be included in the derogation request even if the surplus residual issue is limited to the EDCM.
- 2.18 If both the CDCM and EDCM are affected, then the DNOs should run the EDCM intervention before the CDCM intervention and iterate as appropriate given the interactions between the two. The impact assessment should show the final tariff impacts post-iteration.

Specific guidance for addressing the EDCM issue

- 2.19 We consider that intervention options 1 and 3 should be available, depending on the circumstances. Intervention options 2 and 4 should not be used.¹²
- 2.20 DNOs seeking derogations should submit their preferred intervention option with an impact assessment for the option including tariff impacts for Annexes 2 and 4 (and Annex 1 if the CDCM is also affected) of the Schedule of charges and other tables.
- 2.21 Unless the assessment reveals any significant concerns, we anticipate that the DNOs will select intervention option 1 or 3, depending on the principal cause of the residual surplus:

¹¹ The [DCUSA Charging Objectives are in clause 3.2 of DCUSA](#) and are set out in [Condition 22A of the Distribution Licences](#).

¹² EDCM intervention options are summarised in Annex 1.

- If the principal cause is a reduction in allowed revenue, then intervention option 1 should be used.
- If the principal cause is an increase in forward-looking charges, then intervention option 3 should be used.

Specific guidance for addressing the CDCM issue

- 2.22 We consider that intervention option 1A is applicable to any excessive degree of residual surplus, regardless of cause.¹³
- 2.23 We consider that a request to derogate against the CDCM should only be sought in circumstances when the existing residual surplus adjustment mechanism described in paragraphs 94 and 94A of Schedule 16 of the DCUSA is exhausted and a residual surplus still remains, resulting in the model used to calculate final tariffs presenting a reference error in the place of unit and fixed charges.
- 2.24 In addressing the defined issue within the CDCM, we expect that any request to derogate should only apply insofar as is necessary to prevent there being any residual surplus left unaccounted for by the existing means described in the DCUSA. For the avoidance of doubt, this means that an intervention should only be applied to the minimal extent, so that the residual surplus adjustment mechanism can take effect and produce a complete set of tariffs.
- 2.25 In applying this intervention option, we expect that the gross asset cost (£) for each network level of the Distribution Reinforcement Model¹⁴ is uniformly decreased by applying a scalar multiplier. In the DCUSA text, this relates to paragraphs 16-25 of Schedule 16. In the CDCM Model used by DNOs to calculate charges, this appears as "Inputs by network level: DRM asset costs".

Our Review

- 2.26 We will review the derogation requests and impact assessments against the assessment criteria. As described in the Call for Input, our assessment criteria will cover the DCUSA charging objectives, our principal objective and wider statutory duties, and the Strategy and Policy Statement charging principles.¹⁵

¹³ CDCM intervention options are summarised in Annex 2.

¹⁴ An input to the Charging Methodologies describing the cost of a hypothetical network reinforcement, and therefore the value of behaviour on marginal costs.

¹⁵ The government [Strategy and Policy Statement](#) states under paragraph 58 'In its role of approving the design of network tariffs, Ofgem will need to balance several competing principles alongside the key principle of cost-reflective network charges.'

- 2.27 We plan to issue directions during January 2025 and for DNOs to publish charges as soon as practicable after we have issued our direction.

Impact on LDNOs

- 2.28 Under the DCUSA, LDNOs¹⁶ are required to provide 14 months' notice of their charges. This is one month after the DNOs publish their own tariffs. In addition, LDNOs produce their own charging methodologies with customer tariffs that mirror the host DNOs' end user tariffs for CDCM customers.
- 2.29 Any derogations for DNOs under this process would therefore have implications for LDNOs operating in those DNO areas. We are considering possibilities for ensuring a proportionate approach to affected LDNOs in ensuring compliance with obligations related to their own charging notice period and methodologies. We will communicate further on this in any directions issued to affected DNOs.

¹⁶ An LDNO can be either an IDNO or a DNO operating outside of its own region.

3. Call for Input responses

This section summarises the responses to the Call for Input and how these have informed our Guidance. It starts with an overall summary before addressing each of the Call for Input questions in turn, under the headings used in the Call for Input.

Overall summary

- 3.1 Broadly there was support for our prioritisation of managing the effects of surplus residual charges in advance of 2026/27 charge setting period, and approach to both assessment of the proposals¹⁷ and intention to address the issue through directions to derogate. Responses were broadly supportive, although more mixed, regarding when intervention in the charging methodologies was justified.
- 3.2 Our assessment and conclusions of EDCM Proposals received unanimous support from the ten respondents to this question. Support for approaches to managing the surplus residual within the CDCM Proposals was generally split when considering the degree to which to scale intervention and the impact on non-final demand users compared to final demand users. However, there was broad support to our assessment of the Proposals.
- 3.3 Some respondents commented on this issue within the wider context of the ongoing DUoS Significant Code Review (SCR).¹⁸ This included commenting that delays to the implementation of the DUoS SCR contributed to this issue arising. There was also concern that the DUoS SCR should not delay an enduring solution to this issue being taken forward in the short-term, whether as part of that SCR or separately. We acknowledge these responses, and will factor them into our future work in this area.

¹⁷ Proposed Charging Methodology intervention options were referred to as 'Proposals' in the Call for Input, as they were not confirmed options at this point. To reflect the Call for Input accurately, they continue to be referred to as 'Proposals' throughout the 'Call for Input responses' section.

¹⁸ View our [publications on the DUoS Significant Code Review](#).

Prioritisation of work

Call for Input Question 1

Do you agree that managing the effects of surplus residual charges should be prioritised and requires consideration in advance of the 2026/27 charge setting period? Please provide your rationale.

Summary of Ofgem position

- 3.4 We continue to prioritise this issue, and this Guidance sets out the next steps for timely resolution for 2026/27 tariff setting. We are also keen to see an enduring solution, and will engage with industry to coordinate such an approach with the work we are doing on cost allocation as signalled in our recent 'Standing charges: domestic retail' options paper.¹⁹

Rationale and Call for Input responses

- 3.5 All but one respondent supported prioritising addressing the issue of excess surplus residuals.
- 3.6 Some DNO respondents highlighted that they shouldn't have to comply with a methodology that no longer works as originally intended. They also referred to the lack of progress on the DUoS SCR that may have helped mitigate these issues. Some considered that a code modification should be taken forward for future years to ensure an enduring solution. Other respondents highlighted the importance of transparency, and the impacts on both end consumers and suppliers.
- 3.7 We continue to prioritise this issue for the reasons explained in our Call for Input. While a modification could bring an enduring solution, based on the timelines, we did not consider that to be a feasible approach for this year.
- 3.8 The respondent that disagreed considered that there is nothing wrong per se with negative charges. Instead it called for a root and branch review of the Targeted Charging Review's (TCR) inner conflicts as the priority.²⁰
- 3.9 We do not support negative fixed per site charges which do not exist elsewhere in the GB in electricity network charging regime. As per our Call for Input, we consider that negative residuals could lead to distortive incentives for customers

¹⁹ Read the paper on [Standing charges: domestic retail options \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/publications/standing-charges-domestic-retail-options)

²⁰ View our [publications on the TCR SCR](#).

to hold or increase agreed capacity where it is not needed, which will not lead to efficient system use and could be harmful for competition if it prevents the efficient allocation of capacity to other users.

3.10 As noted in our *Standing charges: domestic retail options* paper. We are:

- Looking again at how electricity network costs are recovered provides an opportunity to consider options that may allow a larger reduction in standing charges in an enduring way. We will be undertaking a broad review of system costs, and will consider whether various cost recovery options, including those considered and ruled out in the TCR process, provide an improved means of recovering these costs.
- Considering and responding to non-domestic consumers on feedback on TCR-related arrangements.

Call for Input Question 2

Do you agree that interventions should be applied only when the Charging Methodology produces a fixed credit (in the EDCM) or results in failure (in the CDCM)? Please provide your rationale.

Summary of Ofgem position

3.11 For the EDCM, we continue to consider that intervention should only be applied in the case of negative fixed charges. While negative residuals may be counterintuitive, provided they don't lead to fixed credits, we do not believe the current application in the EDCM is distortive. We note the need for an enduring solution.

3.12 For the CDCM, we consider that intervention should only be applied in the case of a surplus residual causing a failure to produce a complete set of tariffs, instead producing reference errors for some users as discounting options are exhausted. We recognise that the current surplus residual allocation approach results in tariffs with a significantly different structure to what is produced before revenue matching; if the current approach is not believed to be suitable, then an enduring solution may be proposed. We recognise that a move away from this current approach may have complex interactions, and would require more detailed consideration and engagement than we have been able to conduct through this work.

Rationale and Call for Input responses

3.13 All but two of the 12 respondents commenting on the EDCM was supportive of the proposed intervention if negative fixed charges occur. One respondent

- disagreed specifically on the EDCM, considering that no intervention should be applied.
- 3.14 As for our response to Q1, we consider fixed credits could lead to distortive incentives with potentially negative consequences for efficiency and competition.
- 3.15 On the CDCM, all respondents agreed that intervention is required to allow for the production of a complete set of tariffs where the extent of the residual surplus causes an error state. Three respondents further stated that intervention was justified in case of any residual surplus, including when the existing methodology would ordinarily be able to accommodate this. These stakeholders indicated that they believed the current residual surplus allocation approach to be distortive and produces “unrealistic” tariffs when compared to what is initially produced by the cost model, particularly noting how Final Demand users would face lower fixed charges and time-banded unit rates than Non-Final Demand users.
- 3.16 We consider that a direction to derogate against the existing methodology, even in cases when it functions ordinarily, may not be proportionate given the additional risks this would create. In particular, it could undermine certainty and transparency as compared to the existing approach, and would affect Non-Final Demand users beyond what is required to produce a complete set of tariffs without strong supporting evidence. We invite further discussion on this point should an enduring code modification be raised.
- 3.17 Some of the responses covered both the CDCM and EDCM. Those supporting our Call for Input position cited the benefits of increased transparency and certainty. Others stated that the proposed intervention approach was appropriate for a short-term fix provided an enduring solution could be found as part of a wider review.
- 3.18 One respondent considered that the proposed intervention would create distortion between areas depending on whether or not they are affected by the issue and so require intervention.
- 3.19 While we note the benefits of an enduring solution, in the time available a code modification option is not possible. This guidance seeks to help ensure that consistent approaches are applied across affected DNOs.

Implementation

Call for Input Question 3

Do you agree with our view that addressing the issue via derogations rather than a code modification is appropriate for 2026/27 tariffs in order to preserve the 15-month notice period? Please provide your rationale.

Summary of Ofgem position

- 3.20 We continue to consider that derogations are the most pragmatic approach for maximising the notice period in the circumstances. While a code modification could bring an enduring solution, any modification at this stage would likely significantly impact the notice period, which suppliers and IDNOs in particular have indicated that they value.
- 3.21 Owing to timing constraints with finalising inputs to Charging Methodologies, we acknowledge that any DNOs requiring a derogation to address an excessive surplus residual will be unable to meet the 15-month notice period for setting charges. We have sought to maximise the notice period, while ensuring the process for assessing derogations from the Charging Methodology is robust.

Rationale and Call for Input responses

- 3.22 Eleven of the 13 respondents supported this position. A number of respondents agreed that it is the only pragmatic option at this stage, with some indicating that it is too late for a code modification if we want to preserve the notice period. Many respondents support a modification to address the issue on enduring basis. Other respondents noted the lack of progress of the DUoS SCR contributing to this issue. Suppliers and IDNOs indicated the value of the current 15-month notice period.
- 3.23 One respondent considered that addressing volatility in a more fundamental way is more important than preserving the notice period. Another respondent supports an urgent code modification to be started promptly.
- 3.24 We are keen to maximise the notice period for the impact of correcting these issues. We would still like to address the underlying causes of EHV volatility as part of our wider DUoS SCR; the EDCM interventions may help do that to some degree, albeit that is not the primary driver.
- 3.25 There is no scope for a code modification to be brought in at this stage that could address the issues and minimise delay to December 2024 tariff setting;

derogations are the only viable option. We would like to work with industry on any modification proposal that seeks to address this issue on an enduring basis.

Approach to assessment

Call for Input Question 4

Do you agree that we have considered the relevant factors in our approach to assessment of the proposed approaches to managing the surplus residual charges?

Summary of Ofgem position

- 3.26 We welcome the broad support for our assessment approach. We continue to consider that we should focus on the DCUSA charging objectives and our Principal Objective and statutory duties, while also considering the charging principles in the Strategy and Policy Statement (SPS) for Energy Policy.
- 3.27 When DNOs submit their derogation requests they should provide an assessment against the DCUSA charging objectives. In our assessment we will also consider our Principal Objective, statutory duties and SPS charging principles. We will also ensure that if proportionality and practicality are not adequately addressed in our wider assessment, we will consider them separately.
- 3.28 Alongside our decisions on derogation requests, we will publish the DNO derogation requests with impact assessments for the intervention applied. This will allow IDNOs to assess the impacts of the intervention on their own businesses.

Rationale and Call for Input responses

- 3.29 The majority of respondents provided at least some support for our proposed assessment approach. Some respondents felt that greater prominence should be given to certain factors, such as the TCR principle of practicality and proportionality, Ofgem's wider duties around net zero and the SPS principle of predictability. We are satisfied that we have considered these factors in our assessment, but will revisit them in our final assessment ahead of issuing any directions.
- 3.30 Two respondents highlighted the potential impact on IDNOs and their customers, noting that the Call for Input did not contain enough information for them to make that assessment. Our guidance asks DNOs to present the tariff

impacts of the proposed intervention in their derogation requests, which we will assess before making a decision. We will also publish the derogation requests, allowing IDNOs (and others) to assess the impacts.

- 3.31 Three respondents noted the value in understanding the drivers of the surplus residual issue and assessing Proposals to the extent that they address cost allocation. We consider that a broader review of drivers is beyond the scope of the current exercise, but we are keen to take such thinking forward in our cost allocation work and/or in any modification proposals that seek an enduring solution.

EDCM Proposal Assessment

Call for Input Question 5

Do you agree with our assessment that Proposals 1 and 2 perform best against the criteria and should be assessed on a case-by-case basis as potential options for future derogations? Please provide your rationale.

Summary of Ofgem position

- 3.32 We welcome the broad support for our assessment of the Proposals against the criteria. We consider that Proposals 1 and 3 should be available, depending on the circumstances. Proposal 2 and 4 should not be used.
- 3.33 DNOs seeking derogations should submit the impacts based on the appropriate Proposal. This should contain an impact assessment and rationale for applying that Proposal, with reference to the DCUSA charging objectives.
- 3.34 Unless the assessment reveals any significant concerns, we anticipate that the DNOs will select a Proposal, depending on the principal cause of the residual surplus in each case:
- If the principal cause is a reduction in allowed revenue, then Proposal 1 should be used.
 - If the principal cause is an increase in forward-looking charges, then Proposal 3 should be used.

Rationale and Call for Input responses

- 3.35 The majority of respondents considered that Proposals 1 and 2 performed best against the criteria. Between these two proposals, respondents had greater

- support for Proposal 1. This is because it only affects capacity charges, leaving unit rates unchanged, and it has a smaller impact on revenue recovered from CDCM, limiting the potential for cross-subsidy between user groups as a result of the intervention.
- 3.36 Those respondents expressing a view considered that the Proposal 2 variants that affected both Final Demand and Non-Final Demand would be more appropriate than the alternatives that only affected Final Demand.
- 3.37 Subsequent to the Call for Input closing, we received further feedback from the DNOs that Proposal 2 would be impractical to implement outside of the formal DCUSA change proposal (modification) process. They considered that, owing to its relative complexity, Proposal 2 would require the quality assurance offered by the DCUSA methodology change consultants before implementation. The other Proposals do not have the same degree of complexity.
- 3.38 A number of respondents noted that Proposals 1 and 2 may not work in all circumstances. In particular, where the issue is principally caused by high-forward looking charges rather than a reduction in allowed revenue. These respondents therefore considered that Proposal 3, which is known to work in these circumstances, should also be available for the DNOs to use. Respondents noted though that Proposal 3 cannot work as an enduring solution as it relies on fixing inputs based on historical data
- 3.39 There was no support for Proposal 4 because it would introduce a cross-subsidy between EHV and lower voltage users.
- 3.40 Other comments included support for having more than one Proposal for the DNOs to select from on a case-by-case basis. Another respondent noted that it believed all of the Proposals involve trade-offs as they seek to address the symptoms rather than the root cause of the issue.
- 3.41 We welcome the engagement on the EDCM Proposals. We continue to consider that Proposals 1 and 2 perform best against the criteria. However, we acknowledge that they do not work in all circumstances and Proposal 3 should be available if the principal cause of the negative residual is high forward-looking charges. Furthermore, we consider the relative complexity of Proposal 2 and quality assurance required means that it would be disproportionate to apply to one-off derogations. Proposal 1 adequately addresses the same principal cause of a drop in allowed revenue, while leaving unit rates unchanged.

- 3.42 We are therefore presenting two intervention options for DNOs to select from subject to the principal cause. The derogation submissions should provide justification for the selected Proposal in the circumstances, with reference to the principal cause.
- 3.43 We acknowledge the value in seeking to address the root cause of the issue, but also the need to be pragmatic in the circumstances. Therefore, we consider that Proposals 1 and 3 should be sufficient to address the issues for the coming year. We would expect any modification proposal for an enduring solution would consider and seek to address the root cause of the issue.

CDCM Proposal Assessment

Call for Input Question 6

Should interventions that scale forward-looking revenue recovery be applied until the point where the existing residual surplus scaling methodology is able to produce eligible final tariffs, or to the point where no surplus residual is created? Please provide your rationale.

Summary of Ofgem position

- 3.44 We believe that interventions to the CDCM should only apply insofar as is necessary to produce a complete set of tariffs, rather than to the point where no surplus residual is created. This is consistent with our position regarding Question 2. We also consider that this approach minimises risks associated with certainty and transparency in charge-setting, as greater divergence than necessary from the CDCM's revenue matching process may not align with the reasonable expectations of network users.
- 3.45 An option exists to intervene only when the methodology results in error *and* to the extent that the residual surplus is resolved entirely. This would create a strong distinction between the heavily-discounted tariffs produced under instances of a high but manageable surplus, compared to those produced under intervention against an unreconcilable surplus.
- 1.2 We note the apparent dissatisfaction with the existing surplus residual allocation approach in how it produces final tariffs with heavily reduced fixed and time-banded unit rate charges compared to what is initially produced by the Cost Model pre-revenue matching. We would expect any enduring solution to consider the complex interactions between surplus residual allocation and the

principle that compliance with the Charging Methodologies should result in charges which reflect costs incurred.

Rationale and Call for Input Responses

- 3.46 We heard mixed views from stakeholders regarding the extent to which an intervention should be applied. Six respondents suggested that the intervention should be scaled to the point where no surplus residual existed, whereas three respondents suggested that a derogation from the charging methodology should be minimal as compared to the process described in the DCUSA text. Four respondents indicated that there was not sufficient information available at the time of the Call for Input's publication to establish a preference.
- 3.47 Respondents that argued for a greater depth of intervention suggested that the current surplus residual allocation approach produces final tariffs that are irrational, undesirable, or an unintended consequence of the TCR. This is because it can result in Final Demand customers paying lower network charges than equivalent Non-Final Demand customers. As the residual surplus becomes larger, so does the effect on Final Demand tariffs: fixed charges and time-banded unit charges may be reduced to near-zero in some cases as the allocation methodology approaches its functional limit.
- 3.48 In carrying out our regulatory duties and functions, including in any direction we provide to licence holders such as to derogate from the Charging Methodologies, we must have regard to the principle that our activities are proportionate and targeted only at cases in which action is needed. As our position regarding Question 2 clarifies that intervention is more justified in cases of the methodology failing to produce a complete set of tariffs, we believe that a proportionate direction to derogate from the CDCM should be to restore the ability to produce tariffs. This is in contrast to prescriptively affecting the appearance of final tariffs (such that they more closely resemble what is initially produced by the cost model) without a full assessment of its effect.
- 3.49 We believe that consistency between our position regarding Question 2 and Question 6 allows for a clear and principled set of outcomes resulting from any directions to derogate from the CDCM as a result of this issue. If one took the position that tariff distortion against the status quo is only justified in cases of failure, but is more significant than necessary when implemented, then Final Demand tariffs would be heavily discounted against the cost model in a predictable way in cases of a large residual surplus, but appear significantly different in cases of unmanageable surplus. The justification of such an

- approach is less clear than an approach which seeks to only act in cases of failure and only to the minimum extent necessary to produce final tariffs.
- 3.50 Scaling interventions to the point where the residual surplus is eliminated entirely involves a more significant departure from the Charging Methodologies. This carries with it associated risks, resulting in a charge-setting process that may not align with the reasonable expectations of network users.
- 3.51 A risk associated with a more extensive intervention (i.e., to the point of no residual surplus) is the consequential impact on the relative winners and losers of the existing residual surplus allocation approach. Currently, Final Demand users in higher residual bands benefit to a greater extent than users in lower residual bands. Whereas, scaling to the point of no residual surplus would result in users of different sizes facing the same charges: the disbenefit associated with a derogation is much more significant for some users than others.
- 3.52 As discussed further in our position regarding Question 7, intervention to the point of no residual surplus has a proportionately larger effect on the charges faced by Non-Final Demand users, who are ordinarily not liable to contribute to the allocation of a residual shortfall or surplus. More minimal intervention results in tariffs that look most similar to the status quo arrangements.
- 3.53 We believe that a reduced scope of intervention also assists in the predictability of tariffs for some IDNOs and users of the network, when taken in conjunction with our position regarding Question 2. There is a recognisable upper limit to the amount that charges can be discounted before the methodology fails to function: unit rate charges for higher-banded users can be reasonably anticipated to be very low, and fixed charges for most final demand users can reasonably be anticipated to be zero.
- 3.54 A related risk is that scaling forward-looking revenue recovery to the point that the residual surplus is negated would have a significant year-on-year impact on final tariffs for users in regions where the residual surplus is ordinarily within a manageable range, without a complete understanding of the distributional or behavioural implications of such a change.
- 3.55 Furthermore, DNOs did not indicate whether the extent of intervention would affect their ability to fulfil their licence obligations as described under the first DCUSA Charging Objective, or whether the same would negatively affect general efficiency in implementing and administering the Charging Methodologies as described under the sixth DCUSA Charging Objective.

Call for Input Question 7

Should surplus residual scaling impact charges for Non-Final Demand users as well as Final Demand users? Can you identify any further distortionary impacts that this may have on market participation? Please provide your rationale.

Summary of Ofgem position

- 3.56 We believe that by only intervening to the extent that the charging methodology can produce a complete set of tariffs, the relative positions of Final and Non-Final Demand users (post-revenue matching in cases of surplus) are unaffected. The effect of a derogation from the CDCM on competition in the generation and supply of electricity, and demand response, is therefore minimal.
- 3.57 We recognise that any modification to the Distribution Reinforcement Model to address a residual surplus would affect all users, regardless of their Final Demand status. By seeking to minimise the extent of such modification, we believe that the effect on Non-Final Demand users is minimal and proportionate to the specific exceptional circumstances of a failure to produce tariffs.
- 3.58 We would expect any enduring solution should seek to ensure that the treatment of Final and Non-Final Demand in cases of residual surplus is justified against the relevant objectives.

Rationale and Call for Input Responses

- 3.59 Four respondents considered that both Final and Non-Final Demand should be affected by the intervention. They considered that the TCR failed to anticipate or mitigate against the effect of a residual surplus on tariffs for Final and Non-Final Demand users. One supplier noted that the change in relative incentives between demand response (Final Demand) and generation (Non-Final Demand) could be distortive to competition.
- 3.60 In contrast, six respondents considered that only Final Demand should be affected by intervention. They considered that this approach would be fairer, as it would maintain a parallel to how only Final Demand users are liable to contribute to a residual shortfall through additions to their charges. However, in cases where the methodology fails to produce a final set of tariffs and substantive changes to the Charging Methodology are delivered through a direction to derogate, there would inevitably be a large effect on Non-Final Demand user tariffs, either directly or indirectly by a change to the relative value of Final and Non-Final Demand tariffs.

- 3.61 We consider that both Final Demand and Non-Final Demand should be affected by a direction to derogate, but only to a minimal extent. We consider that this is consistent with our position regarding Questions 2 and 6, where we expect one-off intervention to be more justified when the methodology fails and only to the extent needed to allow for the creation of final tariffs. The relative positions of winners and losers of the current residual surplus allocation regime are therefore minimally affected by derogation from the Charging Methodology.
- 3.62 Minimal intervention limits impacts on different customers groups relative to the current charging regime. We consider such an approach is proportionate for derogations to enable production of charges for a single year. We did not receive sufficient evidence from the Call for Input to assess the extent to which demand response and generation are harmed by the existing approach; any enduring solution should explicitly consider this.

Call for Input Question 8

Do you agree with our assessment of the performance of each Proposal against the criteria? Please provide your rationale.

Summary of Ofgem position

- 3.63 We welcome the support for our assessment of the performance of each Proposal against the criteria. We consider that the mechanism of Proposal 1A is most compatible with our position of only intervening in cases of failure and only to the extent necessary to produce a complete set of tariffs.

Rationale and Call for Input Responses

- 3.64 Respondents broadly agreed with our initial assessment of the Proposals. We received feedback that some parts of the initial qualitative analysis performed could be considered subjective, and that our reasoning could have been made clearer. Respondents concluded that the depth of analysis was appropriate within the limited scope of the Call for Input, but that further consideration would be required for robust decision-making: this guidance develops our thinking further based on the useful feedback and views submitted. We consider that in the event of a request to derogate from the charging methodology, the quantitative impact assessment and engagement process should provide high-quality evidence to inform our decision on that request.
- 3.65 Five respondents considered Proposal 2B to be the most suitable, primarily due to its simplicity to implement and explain, as well as its universal application to

Final and Non-Final Demand user tariffs. While we recognise the inherent simplicity of this approach, it does not align to the existing residual surplus or shortfall approaches, which may contradict the expectations of network users in affected areas. In applying this approach only in cases where the methodology fails to produce tariffs, this approach may create inconsistency in tariffs as compared to cases of more moderate residual surplus.

- 3.66 Four respondents agreed with us that Proposal 1B was least suitable, due to the arbitrary 10% residual shortfall value adding standing charges to users without clear justification. Two of these suggested that the 10% value could be revised and set at a more appropriate level to reflect some network fixed costs, but that this would need to be considered more thoroughly and suggested that this was taken forward within the scope of the DUoS SCR.
- 3.67 We note that due to the complexity of the issue, stakeholder views across questions 2, 6, and 7 did not necessarily align with responses to question 8. We consider that the questions of when derogation is needed, who should be affected by derogation, how to implement change, and how far to change from the existing residual surplus allocation methodology are closely related. This guidance seeks to put forward a solution mindful of differing views by aligning outcomes on final tariffs as closely as possible to the existing DCUSA text and leaving enduring solution design open to fuller discussion.

Annex 1: Intervention options for addressing the EDCM issue

In the Call for Input, we summarised the EDCM proposed intervention options, as below. For more explanation of the proposals, please see the Call for Input.

- **Option 1:** Reapportion negative fixed charges for final demand consumers within a residual band to the capacity charge for the same group of consumers.
- **Option 2:** Reduce forward-looking components of charges by a set percentage such that the residual is equal to zero. Option 2 contains four variants for its implementation depending on which tariff components are reduced:
 - **2A** – all sites, all tariff components
 - **2B** – all sites, import tariffs and export fixed charge
 - **2C** – Final Demand sites, all tariff components
 - **2D** – Final Demand sites, import tariffs and export fixed charge
- **Option 3:** Carry over locational components and network use factors from previous years.
- **Option 4:** Reapportion 'excess' surplus residual to the CDCM.

Annex 2: Intervention options for addressing the CDCM issue

In the Call for Input, we summarised the CDCM proposed intervention options, as below. For more explanation of the options, please see the Call for Input.

- **Option 1:** Reducing the value of the Distribution Reinforcement Model (DRM), an input to the cost allocation methodology used for determining the incremental value of forward-looking signals
 - **1A** – Reduce value of DRM such that the forward-looking charges of the CDCM recover a particular value (e.g. to a point where the residual surplus is at a level that allows production of a complete set of tariffs)
 - **1B** – Reduce value of DRM such that the forward-looking charges of the CDCM recovers 90% of the CDCM's target revenue, with the remaining 10% to be recovered through the residual shortfall process
- **Option 2:** Reducing the value of all charges produced through the normal cost allocation process, such that forward-looking charges recover a particular value (e.g. the CDCM's target revenue)
 - **2A** – Application of a scaler to Final Demand site tariffs
 - **2B** – Application of a scaler to all tariffs