SEEBOARD

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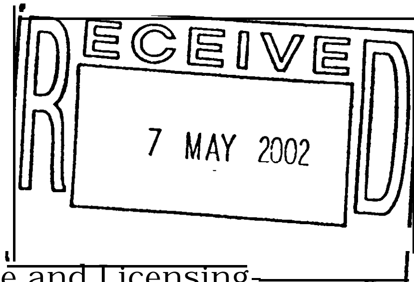

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Ms. Fran Gillon,
Head of SupplierFail.ure and Licensing
Ofgem,
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Dear Fran

Arrangements for gas and electricity supply and gas shipping credit cover: Consultation Document

Thank you for the opportunity to comment on the above consultation. The views expressed in this response from SEEBOARD include comments from both our Distribution business (SEEBOARD Power Networks) and Supply business (SEEBOARD Energy).

We are disappointed that the options in the document do not allow distributors to take a more commercial approach with suppliers in terms of allowing them to reward those suppliers with a good credit rating and payment record with a reduced requirement for credit cover. Such an approach is not discriminatory as it treats suppliers of equal credit worthiness in the same way. It would encourage suppliers to establish and maintain a good payment record to keep their costs down for the benefit of their customers and the development of their business and would also reduce exposure to bad debt for such suppliers/customers resulting from other supplier failure.

Such an approach does not represent an unfair barrier to entry for new suppliers. In the commercial environment the provision of some form of credit cover for a new business is regarded as a normal part of set-up costs. A precedent for this already exists in the electricity industry as new customers of suppliers who cannot provide evidence of a good payment record can be asked to provide a security deposit. This is returned to the customers when a good payment record has been established.

The above approach would reduce the scope of regulation and allow the operation of the normal commercial market where possible in a regulated environment. Regulation would, of course, still be necessary but would be reduced to covering only exceptional circumstances. These would include

the unforeseen financial collapse not only of the supplier but also of the parent company (Enron) and areas where a distributor is prevented from taking prompt normal commercial action (customer disconnections) to cease providing services where bills are not paid and, as a result, the debt is allowed to grow beyond the level of normal credit cover provided. In such exceptional circumstances our view is that, provided a distributor had acted reasonably, full recovery of the bad debt would be allowed.

We hope Ofgem will reconsider the use of such an approach.

The remainder of this letter summarises the key aspects of our views on the options that are presented in the Ofgem document. The attachment provides more detail on these points.

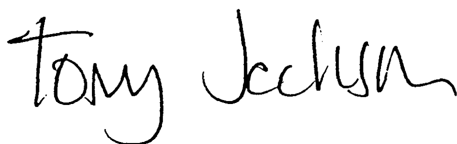
Key Points on Options in the Consultation

- We support Ofgem's view that the current credit cover arrangements in electricity distribution are not appropriate on their own to provide distribution businesses with adequate protection from bad debt.
- We feel that the option to pass through bad debt via the price control is the option most compatible with a distribution business's low risk status, providing that full pass through is guaranteed where the distributor has acted reasonably.
- Pass through is the least costly option to the industry, as it avoids the over provision which would characterise the LoC/Cash option by ensuring that distributors, and therefore customers, only pay for supplier failure as and when it occurs.
- For the price control option to work effectively we consider that distributors should be given adequate enforcement mechanisms under the DUoSA. The tests that Ofgem would apply to ensure they had acted reasonably to minimise any losses should be clearly set out.
- We would expect there to be a clear and simple, independent appeals/dispute procedure available to us, should we disagree with Ofgem's calculation of the level of pass through that we are allowed to recover.
- If Ofgem takes away the right of disconnection, and does not replace it with an equally effective measure, then distribution businesses will be prevented from effectively minimising their exposure to risk.
- If Ofgem believe that the alternative solution of mutualisation/credit pools could be quickly and effectively implemented, we would welcome further exploration of this option.

- Any change to billing cycles, and therefore billing systems, would incur considerable cost.

Please contact us if you have any queries about our response.

Yours sincerely,



Dr. A. F. Jackson,
Director of Strategy and Regulation

Arrangements for gas and electricity supply and gas shipping credit cover: Consultation Document

Detailed Points on Options in the Consultation from SEEBOARD plc

Ofgem's view that the current arrangements for providing credit cover as protection from bad debt for electricity distribution are no longer appropriate

We support Ofgem's view that the current credit cover arrangements in electricity distribution are not appropriate on their own to provide distribution businesses with adequate protection from all bad debt.

The current regulatory framework exposes distributors to significant risk from non-payment of DUoS charges. This conflicts with the policy of regulating distributors as low risk businesses, with the current price control making no allowance for recovery of bad debt.

The demise of Independent Energy (IE) and more recently of Enron Direct (EDL) has exposed SEEBOARD Power Networks, along with all other distribution businesses, to significant bad debt, which in the case of IE was not fully recovered. The bad debt that distribution businesses incurred as a result of the failures of IE and EDL not only contradicts distribution businesses low risk status, but also highlights the inadequate enforcement and escalation mechanisms within the current Distribution Use of System Agreement (DUoSA) that allow distributors to minimise their risk.

The failures of IE and EDL also highlighted the inherent risks associated with relying on Approved Credit Ratings (ACR) and Parent Company Guarantees (PCG). We, along with all other distributors, have long considered that relying on ACRs is not an acceptable form of credit protection. As recognised by Ofgem within the consultation, ACRs do not provide a guarantee that a supplier will not fail, and do not provide any money to cover any bad debt should they do so. We therefore support Ofgem's view that ACRs and PCGs are not acceptable forms of credit cover on their own against all bad debt.

For these reasons, we welcome Ofgem's view that distribution businesses should be protected from supplier failure by either price control recovery or through Letters of Credit (LoC)/cash.

All bad debt resulting from supplier or shipper failure should be addressed within the price control framework

We feel that the option to pass through bad debt via the price control is the only option in the consultation most compatible with a distribution business' low risk status, providing that full pass through is only guaranteed where the distributor has acted reasonably.

The consultation states that the option to recover any bad debt, resulting from supplier failure, through the price control would be accompanied by incentives both on network operators to minimise their exposure to bad debt and on suppliers to pay promptly.

At the industry workshop Ofgem indicated distributors would receive 100% pass through of bad debt relating to properly unbilled amounts and amounts not yet due for payment, but recovery of any further debt would be scaled back where the distributor is judged to have taken insufficient action to recover the overdue amounts. We would expect to receive full pass through of all bad debt where we have used the following reasonable endeavours to minimise our exposure, irrespective of whether the debt is overdue for payment:

- We would expect to have to demonstrate to Ofgem that billing to suppliers had been carried out on a timely and accurate basis, based upon the data received from the supplier's agents. However, we would expect allowances to be made where it could be demonstrated that delays in billing had resulted from failures by supplier (and their agents) to provide billing data on a timely and accurate basis. Reasonable steps would include contacting suppliers (by telephone and/or in writing) on a timely basis following a debt becoming overdue. It would also include the reasonable escalation of action against suppliers including threatening to (and actually) stopping the registrations of new customers, threatening to (and actually) terminating the DUoSA and retention of the right to disconnect some or all of the supplier's customers.

  We believe it would not be in the interests of suppliers and end customers to specify an inflexible timetable for distributors to carry out some or all of the actions set out above. Our recommendation would be for Ofgem to look at the actions taken by each distributor following a failure to satisfy themselves that they had behaved reasonably.

- We would expect to have to demonstrate to Ofgem that we had actively chased suppliers for overdue amounts and taken reasonable steps within the framework of the sanctions to us to recover such outstanding debts.
- Where overdue amounts were being disputed by suppliers we would expect to have to demonstrate that we acted promptly in trying to resolve the relevant disputes.

Although the pass through option would have to be accompanied by clear unambiguous rules for determining the appropriate level of recoverable debt, the rules and the specifics of each case will certainly be subject to a degree of interpretation by Ofgem. We would, therefore, expect there to be a clear and simple, independent appeals/dispute procedure available to us, should we disagree with Ofgem's calculation of the level of pass through which we are allowed to recover.

To ensure that both distributors and customers are adequately protected from supplier failure, distributors need clear enforcement measures to prevent suppliers from paying late under the DUoSA. As detailed above, apart from the threat of termination, the DUoSA currently only allows distributors to apply interest on late

payments. We have not found the right to apply interest to be an effective deterrent against late payment, with suppliers often preferring to pay late payment interest rather than pay on time. Late payment of invoices is potentially an indication of a supplier's financial difficulties, and we therefore feel that we should have the ability to prevent a supplier from registering new customers immediately that payment is late. We would therefore welcome Ofgem's clarification of the circumstances in which distributors can prevent a supplier from registering new customers, as this would be an important tool to chase late payment, and therefore, to minimise the build up of debt. We consider that there would be value in developing a common approach to the follow up of overdue payments, whether this be through clarifying the provisions of the DUoSA, or through an industry set of rules.

Ofgem has said that a distributor's right to de-energise a customer in the event of its supplier's failure is not in the interests of the customer and has therefore proposed that this ability be removed. The current right to de-energise a customer for its supplier's failure is a distributor's ultimate sanction against a defaulting supplier. If Ofgem takes away the right of disconnection, and does not replace it with an equally effective measure, then distribution businesses will be prevented from effectively minimising their exposure to risk. We do not believe that preventing registrations alone will act as a sufficient deterrent to a supplier in financial difficulty to ensure all debts are paid as they fall due. We therefore seek clarification from Ofgem of what replacement mechanism distributors will be given, which will increase their ability to aggressively pursue overdue debt. We feel that to effectively limit customers' exposure to increased risk and to cap industry losses it is vital that Ofgem uses its powers to revoke a supplier's licence and to appoint a SOLR as soon as possible in the event of supplier failure. This may be difficult if a large supplier fails, as it is likely to take longer to find a SOLR for such a large customer base, Any delay in appointing a SOLR will clearly lead to an increase in risk to the distributor and therefore the customer.

We feel that one potential problem with the pass through option is the time lag between a supplier's failure, and the time when the cost of any bad debt can be recovered. The two failures so far have been of relatively small suppliers, and although these have had implications in terms of working capital and cash flow, recovery through price control has not caused too much disturbance. Should a large supplier, for example, an ex-PES supply business fail, then any delay in the pass through of bad debt could effect the distributor's ability to maintain an investment grade rating in accordance with its licence obligation and could ultimately jeopardise a distribution business's chance of survival. It would therefore be vital that Ofgem finalises the level of pass through, including funding costs, in a timely manner.

There are potentially further problems associated with the failure of an ex PES supply business. For example, if this were to occur, SEEBOARD Power Networks could face debt in excess of f30 million, which if passed through the price control would be approximately an 1 1% increase in DUoS charges, if the debt were recovered over a 12-month period. Customers in SEEBOARD Power Network's distribution services area would, therefore, see just over a 2% increase in their total electricity bill for the 12 month period. It can however be argued that all customers are enjoying the

benefits of competition, and that the price increase resulting from the pass through is a feature of that competition.

Failure of an ex-PES supply business is likely to result in a disproportionately high percentage of bad debt falling on the distributor responsible for the ex-PES area. Ofgem will need to consider how recovery of such debt can be spread across the whole industry rather than being borne largely by suppliers/customers operating in one particular area.

The option to allow distribution businesses' pass-through of bad debt through the price control is clearly the least costly option presented in the consultation to the industry, especially if there are few or no future supplier failures. This method ensures that the industry, and therefore, customers, only pay for supplier failure if and when failure occurs. This option, unlike the LoC/cash option, discussed in detail below, does not impose any barriers to entry to new suppliers.

Letters of Credit/Cash as appropriate forms of credit cove-r

We agree that LoCs or cash could be considered appropriate ways of providing credit cover, providing that the level of indebtedness has been calculated accurately, and there are robust mechanisms for enforcement of credit cover requests. However, we feel that there are a number of significant problems associated with ensuring that Letters of Credit/Cash will guarantee distribution businesses 100% recovery of any bad debt.

The first problem is ensuring that a LoC or cash deposit is actually provided and maintained. Because of the inadequate enforcement measures available under the DUoSA, we have experienced great difficulty in trying to ensure that suppliers, who do not hold an ACR, provide alternative cover. As Ofgem recognises, there is some uncertainty as to whether distributors are entitled to prevent a supplier from registering new customers, where insufficient credit cover is in place. Without adequate enforcement mechanisms under the DUoSA, we have been obligated to provide services to suppliers who have no or insufficient credit cover in place.

It is therefore vital that, should the LoC/cash option be chosen as the way forward, the DUoSA provides distributors with robust enforcement measures to ensure that adequate cover is in place at all times. In line with the current provisions of the Balancing and Settlement Code (BSC), we would expect there to be clear rules for drawing down on credit cover together with rules for suppliers to top up their credit provision where it is insufficient. The BSC allows automatic suspension of registrations immediately that a trading party reaches a certain level of their indebtedness, i.e. before the credit provision is insufficient. We would therefore expect this approach to be mirrored in the DUoSA.

The use of LoCs/Cash as credit cover under the DUoSA will clearly lead to increased administrative burden on both the distribution business and the supplier, at the time of first putting cover in place, and when the level of the cover is reviewed. A significant amount of time is currently spent negotiating the terms/wording of LoCs

with suppliers. We would therefore consider that there should an industry standard LoC, as exists for LoCs provided under the BSC.

The DUoSA currently -requires suppliers to provide credit cover for 60 days. Given our recent experiences with IE and EDL, we consider 60 days to be far from adequate as a level of protection. At the time that a supplier fails, there will always be unbilled energy and there is also likely to be billed energy not yet due for payment. Furthermore, it is highly likely that a supplier in financial difficulty will fail to pay debts as they fall due in the weeks (and months) leading up to their failure. In light of this, we consider that suppliers should be obliged to provide at least 120 days worth of credit cover in order to ensure that the residual risk is minimised. This would amount to approximately f60 million being tied up in either LoCs or in cash deposits, in SEEBOARD Power Network's distribution services area alone. Given the extent of the industry debt caused by the failures of IE and EDL, the option for all suppliers to provide LoCs/cash at this level would seem to be an overly costly solution, tying up a significant amount of resources for the industry. It should also be noted that it is possible to envisage circumstances where even 120 days cover may be insufficient.

Should the LoC/cash option be chosen as the way forward, there will clearly be a significant increase in cost to the industry, not only because those suppliers who previously relied upon ACRs would have to provide cover, but because we feel that all suppliers would have to provide cover for 120 days instead of the current requirement for 60 days. This option would mean that all suppliers would bear the cost of putting cover in place, i.e. the commission charged for the LoC (or the interest differential on cash deposits), and more importantly the opportunity cost of providing credit cover each year, even if there are no supplier failures.

Should there be many more supplier failures in the future, it's possible that suppliers may find it more expensive or more difficult to obtain LoCs

In addition, we feel that the LoC/Cash option, without the back up of pass through recovery, is likely to lead to distributors facing residual risk. Ofgem recognises that the current price control makes no allowance for bad debt. Distributors therefore should not face risk where they have acted in accordance with the requirements of the DuoSA.

Other options

Mutualisation/Credit Pools

Whilst we can see merit in this alternative solution, including the avoidance of the problem of over-provision within the industry, reflection of a supplier's credit worthiness; we feel that the likelihood of this arrangement being set-up and implemented within a sensible timeframe would seem remote. If, however, Ofgem believe such a solution could be quickly implemented, we would welcome further exploration of this option.

Commercial Insurance

We believe that there is considerable doubt as to whether sufficient insurance capacity exists in the very limited Credit Insurance market, to insure all supplier debts at cost effective premiums with low levels of excess. The insolvency market is geared to protecting small to medium exposures (say up to several hundred thousand). Some suppliers may represent multi million pound exposures, which are too large for the market – especially if cover is sought for ex-PES suppliers.

Insolvency insurances are based on the notion that further trading and the advance of credit can be stopped immediately a debtor is in breach of payment terms. Cover is usually lost if trading continues in such circumstances. The only way for distributors to comply with such conditions would be to disconnect customers of the DUoS debtors in breach of credit terms.

Insurance cannot be obtained for suppliers with poor credit ratings or for new suppliers with no rating. Furthermore, cover may be refused solely on the basis that a particular Insurer already has a large exposure on other accounts for the same debtor.

As the insurance market learns (from actual claims) that it is being required to carry the risk of supplier insolvency without being able to take any preventative action once a risk is known to be developing, it will be increasingly less likely to grant cover. In the long run, premium cost will reflect losses paid. The current cost to SEEBOARD Power Networks is 0.09% of turnover, but this rate reflected a policy with no previous losses in a world where Suppliers had been thought to be solid risks and the policy excluded losses relating to the majority of suppliers who did not hold an ACR.

Billing Cycles

The consultation and the recent industry workshop touched upon the idea of changing billing cycles to reduce the amount of credit cover a supplier would need to provide. As Ofgem recognises within the consultation, any change to billing cycles, and therefore billing systems would incur considerable cost. The costs will clearly depend on how cycles are proposed to be changed, and whether there would be a change in the way distributors receive settlement data. The simplest change would be for distributors to move away from billing on actual data, and to instead bill on estimates. The costs to change SEEBOARD Power Network's billing system in this way would be well in excess of £100,000. Although this approach would mean that suppliers would be paying one month earlier than they currently are, when bearing in mind that the current 60 day credit cover requirement is insufficient, suppliers would still have to provide cover for at least 60 days.