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Sent by email to RIIO-ED1@ofgem.gov.uk

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Dear Grant

Consultation on modification to the Electricity Distribution Licence to recover the costs associated with appointing a Supplier of Last Resort

Thank you for giving us the opportunity to provide our views on the proposed modification to the Electricity Distribution Licence to recover the costs associated with appointing a Supplier of Last Resort (SoLR).

Electricity North West Limited (ENWL) is the Distribution Network Operator for the North West of England serving 2.4 million customers in urban Manchester, through Lancashire and into rural Cumbria to the Scottish Border.

We welcome Ofgem's involvement in this area as it is our view that the current arrangements are not satisfactory because of those issues which you have also identified in the recovery of Last Resort Supply Payments and Use of System Bad Debt.

Historical experience of supplier failure and the Supplier of Last Resort process has been limited, with only a few failures of smaller supply companies. It is our view that, irrespective of the low materiality of previous failures, 2018 has shown an increase in the number of failures and therefore robust and scalable processes need to be in place in this area because of the possibility of larger or multiple failures in the future.

Our view is that much of the proposed modification is a considerable improvement on current arrangements but we do have a significant concern with regard to the cash flow impact of the changes to Last Resort Supply Payment arrangements, and some aspects of the bad debt arrangements.

Last Resort Supply Payment

We recognise that the proposed modification provides arrangements for SoLR cost recovery that are easier to administer than those in the existing licence, and addresses the concerns around dealing with residual unresolved payments claims.

However, we do have a significant concern regarding the change introduced by the proposed modifications that would require Distribution Network Operators to pay Last Resort Supply Payments in advance of the recovery of these amounts from customers by way of an increase to DUoS charges. In effect this aspect of the change would result in DNOs funding a SoLR balance which is not a role they currently undertake. This is one of a number of additional cashflow risks DNOs are being asked to manage.

For ENWL the total amount of funding required could be £4m in 12/13 prices (two years of the £2.0m specified in Appendix 1 of 38B). Under paragraph 38B.3 of the proposed modification DNOs would be required to begin paying claims to SoLRs 60 days after receipt of the claim.

DNOs would not be able to recover these amounts until two years later according to the definition of the proposed pass-through term, SLRA.

While recognising the need to protect the interests of customers, it is our view that it is in the interests of all industry stakeholders for the arrangements for SoLR payments to be as efficient as possible. We believe that the potential liabilities that could arise in DNOs from Last Resort Supply Payments are a financial risk that would result in DNOs operating a more expensive capital structure at the margin. In practical terms, DNOs would either need to hold larger cash reserves or make other financing arrangements. This would either make investment in DNO businesses less attractive or increase the costs associated with the financing of DNOs. Ultimately all industry costs are paid by end customers.

This issue could be addressed in one of two ways. DNO payments to SoLRs could be made in the year that the DNO received the amounts through increased DUoS charges. Bidders for the role for Supplier of Last Resort could be required to bid on this understanding, this would have the benefit of ensuring that the availability and cost of financing was considered by parties bidding for the role of SoLR and so may result in more economically efficient outcomes.

Alternatively, DNOs could be allowed to reflect a forecast aggregate LRSP balance amount when forecasting allowed revenue for the purposes of setting future DUoS prices. This would enable DNOs to hold a balance that could be used to settle SoLR payment claims as they came in, or that could be returned to customers if it was unused or found to be in excess of requirements. This could be achieved by including a pass-through term equal to the forecast average SoLR payments balance plus the aggregate amount of claims paid to date less the aggregate amount received through increased DUoS charges to date less the total amount previously recovered through this term to date.

If neither of these proposed alternative solutions are acceptable it is critical that DNOs are able to revisit their current year and next year tariffs out with providing 15 months notice if and once the materiality threshold referred to in our licence (ENWL £6.21m in 12/13 prices) is breeched.

Recovery of Bad Debt

We welcome the clarity provided by the proposed modification with regard to the recovery of bad debt. As regulated utilities, DNOs do not have the same discretion with regard to those businesses they provide credit to, in comparison with other commercial businesses operating in less regulated markets. It is therefore appropriate that there is a mechanism that enables DNOs to recover bad debt that has been incurred in the course of providing regulated services, in cases where the DNO has acted in accordance with best practice guidelines for credit cover. We are supportive of the proposed changes with regard to the recovery of DNO bad debt.

Furthermore, we recognise that Independent Distribution Network Operators (IDNOs) will incur bad debt and should be entitled to access a similar mechanism to recover that bad debt. It is our view that any material difference in the arrangements for the recovery of bad debt between DNOs and IDNOs would be a distortion of competition in the distribution of electricity. On this basis, we do not agree with the element of the proposed modification that would enable IDNOs to recover bad debt immediately (38C.2) but would require DNOs to wait three years (CRC 2B, Part I, 2B.37). We suggest that this should be changed so the same three year lag applies to IDNO valid bad debt claims.

We note that the terms 'interest' and 'relevant interest' are used in the drafting of BA5 and Part I of CRC 2B without any definition of these terms. It is our view that these terms should be clearly defined to remove any ambiguity.

We believe there may be unintended consequences resulting from the arrangements for DNOs operating out of area to recover bad debt. If DNOs recover bad debt incurred outside their area by increasing charges for customers in their area then that would be in effect a transfer of the cost from one area to another.

Adjustments to DNO allowed revenue to recover bad debt incurred by distributors operating in its area will result in increase to all-the-way (ATW) DUoS tariffs. An increase to ATW tariffs would result in a proportionate increase to the margin of IDNOs (the ATW tariff less the tariff paid by the IDNO) unless there is an equal increase to the IDNO tariff. Consequently we believe that the proposed modification will give rise to the need to amend DCUSA to ensure the IDNO businesses are not overly compensated for bad debt. We are happy to work with other industry parties to develop necessary changes[1].

Additionally any supplier bad debt costs should not be reported under the distribution element of the bill in Ofgem and other's cost reporting but should be added back onto the supplier portion of costs[2].

TRU Term

The pass-through items created by the proposed modification, SLR_t and EBD_t, should be included in the formulae for the TRU term defined in CRC 2A.11 and 2A.12. Changing the TRU term calculation in this way would ensure that the new terms are treated in a similar manner to existing pass-through items and changes between forecast and actual RPI rates are properly recognised.

Drafting issues

We have identified the following additional areas where we believe there are errors in the drafting:

Reference	Issue
38B.7	This paragraph refers to "paragraphs 38A.5 and 38A.6" but no such paragraphs exist. We suggest the correct wording is "paragraphs 38B.5 and 38B.6".
38B.11	In the definition of Excess Specified Amount, reference to "38A.9", paragraph does not exist. We suggest "38B.9".
2B.38(a)	Term $LBDA_t$ is not defined; we suggest this should be $IBDA_t$.
2B.39	The definition of $IBDA_t$ refers to "standard condition 38B. (Treatment of Valid Bad Debt Claims)". We suggest this should be 38C.

I hope these comments are helpful. Please do not hesitate to contact me or Chris Barker (chris.barker@enwl.co.uk) if you would like to follow up on any particular aspect of our response.

Yours sincerely

Paul Auckland
Head of Economic Regulation

[1] DCP314 Appropriate treatment of Bad Debt following appointment of Supplier of Last Resort is already looking at billing arrangements, other changes may be needed to look at charging methodologies.
[2] For example in this published information https://www.ofgem.gov.uk/data-portal/breakdown-electricity-bill