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

Northern Powergrid's response

Key Points

- **We broadly welcome the review of the electricity distribution licence but it should close not widen existing regulatory distortions.**
- Having been heavily involved in the development of the proposals we are generally very supportive of the intent behind the changes and of the way in which they are to be delivered.
- With the exception of standard licence condition ("SLC") 38B *'Treatment of payment claims for last-resort supply where Valid Claim is received on or after 31 March 2019'* ('SLC38B'), we believe the proposed drafting is generally fit for purpose, although we make some suggestions for improvement to all of the SLCs to improve clarity of the drafting.
- SLC38B uses a period of **60 days** to determine two separate key milestones but we believe the reference needs to **revert back** to **three months** as previously drafted. This is required to:
  - **Prevent a four year lag** between a DNO incurring cost and recovering revenue (where the materiality threshold is not breached); and
  - Ensure a DNO has **sufficient time** to provide the **requisite 40 day notice period** when publishing revised use of system charges (where the materiality threshold is breached).
- The proposed licence drafting seeks to determine the proportion of use of system debt which can be recovered relative to the age of the debt at the time a supplier becomes insolvent. The drafting would benefit from being **explicit** on the treatment of **invoices which have not been issued at the time of default** (i.e. "unbilled debt").
- Ofgem's stated wish to avoid protecting one group of network companies (DNOs) and not others (independent distribution network operators (IDNOs)) from bad debt is based on an over-simplification of the differences between the regulatory regimes they operate under.
- Allowing IDNOs and DNOs operating out of area to recover bad debt will result in a **windfall gain** for these parties and **widen a pre-existing regulatory distortion**.
- **Simple changes** to the proposed licence drafting are necessary to prevent a DNO operating out of area from being allowed to recover out of area use of system bad debt from in-area customers. Whatever the arrangements, they should ensure **consistency** with IDNOs.
- As the consultation document has the potential to **mislead readers** in some areas and is inaccurate in others, we have identified areas where **additional clarity** would be beneficial.
- We acknowledge that Ofgem is considering whether the system operator is best-placed to deal with SoLR costs in the future and we recognise this could be a better long-term solution. However, the advantages and disadvantages of this approach need to be thoroughly assessed to **avoid regressive changes** – both for consumers and to ensure that relevant parties are neutral to costs.

Contents

1. Introduction

1. We welcome the opportunity to respond to Ofgem's *'informal consultation on modification to the Electricity Distribution Licence to recover the costs associated with appointing a Supplier of Last Resort'* (hereafter referred to as 'the consultation').

2. We are generally very supportive of the intent behind the proposed changes and the way in which they are to be delivered in terms of amendments and additions to both the standard licence conditions ('SLCs') and charge restriction conditions ('CRCs') of the electricity distribution licence.

3. We have identified a number of areas where further consideration is needed. These focus on:

    a. a number of concerns with the licence drafting which we think should be addressed;

    b. the treatment of bad debt for independent distribution network operators (IDNOs) and distribution network operators (DNOs) operating out of area;

    c. some inaccuracies in the consultation, which we are concerned have the potential to mislead respondents; and

    d. general comments on the intent behind the changes and the way in which the proposed licence changes deliver that intent.

The following sub-sections cover each of these points in turn, followed by detailed comments on each of the proposed licence conditions.

Licence drafting concerns

4. We have identified a number of minor concerns with the licence drafting, which we have detailed briefly in the sections on each condition which follow. Appendix A includes a marked-up version of the proposed licence drafting to highlight where changes are required. Most notably there is a need to:

    a. extend the period of time between DNOs receiving a claim and making payments from 60 days to a minimum of three months (SLC 38B '*Treatment of payment claims for last-resort supply where Valid Claim is received on or after 31 March 2019*', hereafter 'SLC38B');

    b. clarify the application of the materiality threshold in SLC38B to ensure that this does not include a Valid Claim to be both paid and recovered in the period, such that the materiality threshold is assessed only in relation to Valid Claims to be recovered with a two year lag;

    c. remove an inconsistency with SLC 9 '*Claims for Last Resort Supply Payment*' ('SLC9') of the electricity supply licence and SLC38B with regards to frequency of payments made by a DNO to a Claimant; and

    d. clarify the recoverable proportion of bad debts which arise as a result of invoices which have not yet been issued at the time of supplier insolvency (BA5 '*Valid Bad Debt Claims*', hereafter 'BA5', and CRC 2B '*Calculation of Allowed Pass-Through Items*', hereafter 'CRC2B').

IDNO and DNO out of area use of system bad debt

5. The Distribution Connection and Use of System Agreement (the "DCUSA") defines IDNOs and DNOs operating outside of their Distribution Services Area collectively as licensed distribution network operators (LDNOs). We will use this term throughout this response.

6. We do not support allowing LDNOs to recover use of system bad debt. LDNOs will have priced the risk of use of system bad debts into the business decisions they made when making new developments (either explicitly or through assumptions on the cost of capital). Allowing LDNOs to recover use of system bad debts again will result in a windfall gain for LDNO shareholders at the expense of consumers.

7. We believe LDNOs should put forward their case as part of this consultation as to why they should be allowed to recover use of system bad debt. LDNOs may have a rational argument in this respect but we have not yet seen one.

8. Whatever Ofgem's eventual position on whether LDNOs should be able to recover their bad debts, we think there is an inconsistency within the proposed mechanisms that needs to be resolved. This is because a DNO operating out of area can currently recover out of area use of system bad debt via its distribution licence and the price control close-out mechanism, whereas IDNOs currently do not have a mechanism to recover use of system bad debt.

9. Simple changes to the proposed licence drafting are therefore necessary to prevent a DNO from being allowed to recover out of area use of system bad debt from customers connected within its Distribution Services Area. These changes are necessary regardless of Ofgem's final position on allowing LDNOs to recover use of system bad debt:

    a. If Ofgem decides that no new mechanism should be introduced allowing LDNOs to recover use of system bad debt, allowing a DNO to continue to recover out of area use of system bad debt from customers connected within its Distribution Services Area would create a clear distortion in competition between IDNOs and DNOs operating out of area.

    b. If Ofgem decides that LDNOs are to be allowed to recover use of system bad debt, allowing a DNO to recover out of area use of system bad debt from customers connected within its Distribution Service Area would result in an inconsistent treatment between DNOs operating out of area and IDNOs in the form of a cross-subsidy, with customers connected within a DNO's Distribution Services Area funding out of area use of system bad debts in respect of which those customers have no interest. An arbitrary distinction like this is questionable.

10. On the basis that Ofgem appears to hold the view that LDNOs should be allowed to recover use of system bad debt, the changes we propose to the licence drafting amend to whom the conditions apply only (i.e. to avoid the cross-subsidy risk noted in point b above).

Inaccuracies in the consultation

11. The consultation itself is somewhat misleading in places. Consequently, we have identified some areas where additional clarification would be beneficial in respect of:

a. the circumstances in which DNOs and IDNOs will be treated on an equivalent basis as a result of the proposed licence drafting;

b. some of the shortcomings of SLC38 '*Treatment of payment claims for last-resort supply*' ('SLC38'); and

c. the impact of the materiality threshold proposed as part of SLC38B.

12. We provide further detail on these points in section nine.

General comments

13. We agree with Ofgem's assessment that costs associated with the appointment of a supplier of last resort (SoLR) should be recovered via use of system charges and not 'other charges', as defined in paragraph 19.2.1 of the DCUSA and which essentially includes an approved last resort supply payment ("LRSP") claim i.e. a Valid Claim.

14. This will ensure consistency in the methodology used to recover Valid Claims and mitigate the need for DNOs to request derogations from the Authority. It will also ensure that customers connected to LDNO networks contribute to the recovery of Valid Claims.

15. In relation to changes to the electricity system operator ("ESO") licence conditions, we acknowledge that Ofgem is considering whether or not the ESO is best-placed to deal with SoLR costs in the future. We presume this would be limited to Valid Claims only. We recognise this approach could be a better long-term solution but the advantages and disadvantages need to be thoroughly assessed to avoid regressive changes which do not better protect customers. It should also ensure that: (i) all network companies are ultimately left in a financially neutral position, once any process which requires costs associated with supplier default to be included in use of system charges, has concluded; and (ii) the SoLR is able to recover reasonably incurred costs within a reasonable timeframe.

16. In relation to potential changes to the gas distribution licence we agree that consistency between gas and electricity licences can be desirable and we would support a review of the gas distribution licence based on the proposals on which Ofgem is consulting. We recognise that, in relation to Valid Claims, gas distribution network operators already recover the costs using pass-through arrangements, albeit utilising a miscellaneous pass-through term which no longer exists in the electricity distribution licence.

17. In the following sections we comment specifically and in more detail on each proposed licence condition in turn and on the consultation itself. We also refer to the relevant paragraph of Appendix A, where appropriate, which sets out our proposed changes to the licence conditions, other than minor changes which do not alter intent or correct for errors in which case no reference shall be made to the change beyond it being highlighted in Appendix A.

2. Standard licence condition 1 '*Definitions for the standard conditions*' ('SLC1')

18. We support the amendments made to SLC1 to include additional definitions which apply to more than one condition as a result of the proposed changes.

19. We agree that, where definitions have not been moved to SLC1, this is the appropriate treatment.

3. Standard licence condition 38 '*Treatment of payment claims for last-resort supply*' ('SLC38')

20. We support the amendments made to SLC38 to cease the application of this condition to claims received before 31 March 2019.

21. However, Ofgem has amended paragraph one (albeit this is not highlighted as having been changed) to say 'which must be read in conjunction with condition 38A'. We understand and agree with the intent of this amendment, being to effectively de-activate SLC38. However, we do not believe this sufficiently prescribes how a DNO should treat a Valid Claim received before 31 March 2019. It does not adequately direct a DNO to follow the process set out in SLC38A 'Treatment of unresolved payment claims for last-resort supply where Valid Claim is received before 31 March 2019' ('SLC38A') instead of the process set out in SLC38.

22. We have amended paragraph one of SLC38 in Appendix A to provide greater clarity as to when SLC38 should be followed.

4. Standard licence condition 38A '*Treatment of unresolved payment claims for last-resort supply where Valid Claim is received before 31 March 2019*' ('SLC38A')

23. We support the introduction of this new SLC which applies when:

    a. A Valid Claim was received before 31 March 2019 but where the DNO has not commenced recovering costs for the Claimant. We consider 'commenced recovering' to mean that the licensee has published use of system charges to recover a Valid Claim, but would welcome Ofgem's view to ensure consistent application of the licence conditions. A Valid Claim would then be recovered in accordance with SLC38B.

    b. A Valid Claim was received before 31 March 2019 and where the DNO has commenced recovering the costs for the Claimant, but where the DNO has not commenced recovering/returning any shortfall/excess revenue after the Relevant Regulatory Year (as defined in SLC38). The shortfall/excess would be recovered/returned in accordance with SLC38B.

    c. A Valid Claim was received before 31 March 2019 and where the DNO has commenced recovering/returning any shortfall/excess revenue after the Relevant Regulatory Year, or was unable to recover/return and shortfall/excess due to rounding thresholds on use of

system tariffs, both of which will inevitably have left a residual imbalance at the conclusion of the existing SLC38 process. The residual imbalance would be dealt with in accordance with SLC38B.

24. We have identified a minor but necessary change in paragraph two to remove a reference to 'the Original SLC38'.

25. Paragraph three provides clarity as to the treatment of any shortfall or excess (including any residual imbalance following an attempt to correct for any such amount in accordance with paragraphs four and five of SLC38). However, in referring to the defined term "Specified Amount" without a definition specific to SLC38A the definition in SLC1 would apply.

26. The definition of "Specified Amount" differs between SLC1 and SLC38 in relation to interest, with the SLC1 definition being appropriate for SLC38B but the SLC38 definition appropriate for SLC38A. To remedy this inconsistency an 'Interpretation' section should be added to SLC38A, with a new paragraph four, to include a definition of Specified Amount consistent with SLC38.

5. Standard licence condition 38B '*Treatment of unresolved payment claims for last-resort supply where Valid Claim is received on or after 31 March 2019*' ('SLC38B')

27. We support the introduction of this new SLC which applies to any Valid Claim received on or after 31 March 2019 and in the circumstances set out in SLC38A.

28. However, we have identified a number of concerns relating to:

a. the 60 day period in paragraph three, which defines the period of time between a DNO receiving a Valid Claim and being required to make payment instalments to the Claimant where the materiality threshold is not breached. We believe there are unintended consequences of the change which Ofgem has made to the draft licence conditions we proposed (which amended this timeframe from three months to 60 days);

b. the 60 day period in paragraph 11, which defines the Relevant Regulatory Year, being the regulatory year in which the DNO will increase use of system charges should a Valid Claim breach the materiality threshold. 60 days does not give sufficient time for DNOs to receive the necessary DCUSA derogations and publish use of system charges, whilst still providing 40 days' notice of the change;

c. the application of the materiality threshold, where, as drafted, the condition requires the DNO to include all payments made in respect of any and all previous Valid Claims (including those where the materiality threshold was previously breached) when determining whether a subsequent Valid Claim breaches the materiality threshold. We do not believe this to be aligned to the intent;

d. the frequency of payments to the Claimant in light of interactions with equivalent clauses in the supply licence; and

e. a number of minor issues.

More detail is given on each of these areas in turn below.

60 day notice period for making payments

29. A minimum period of three months from (and including) the date a Valid Claim is received is essential to ensure that a DNO can include that claim in its published use of system charges for the year in which revenue will be recovered. Three months is only viable providing that, as a minimum:

    a. Ofgem has already published its minded to position on the value of a Valid Claim;

    b. network companies have been advised how much will be recovered between gas and electricity network operators; and

    c. each DNO can calculate with reasonable certainty how much it will be required to pay in that regulatory year and so how much it will be required to recover in the regulatory year for which it is about to publish charges.

    Otherwise we believe a period of four months is appropriate.

30. For example (assuming the modifications to the electricity distribution licence were already implemented and using 60 days to illustrate), if a Valid Claim were received on 1 January 2019 a DNO would commence payment instalments in mid-February 2019. Consequently, the costs would be incurred in regulatory year 2018/19 and, due to the two-year lag, the associated revenue would be recoverable in 2020/21.

31. The DNO will already have published use of system charges for 2020/21 in December 2018 therefore this will manifest as under-recovery and be recovered via the correction mechanism. As the correction mechanism is itself lagged for a further two years, the DNO will not recover the revenue until four years after the cost has been incurred.

32. The materiality thresholds proposed in SLC38B are set at a level considered appropriate to protect DNOs from cash flow risk for two years only. Consequently, if Ofgem were to continue with the 60 day period, we would be seeking a decrease to the materiality thresholds proposed.

33. In relation to the need to provide for a period of a minimum of three months in paragraph three, it is worth recognising the supporting DCUSA modification proposals, which we have raised[1] in anticipation of these licence changes in agreement with Ofgem and the other DNOs. These proposals are primarily to ensure that LDNOs do not unduly benefit from LDNO discounts being applied to SoLR and use of system bad debt cost recovery.

34. In order for this to work, DNOs require 15 months' notice of the values to be included in the new pass-through terms for a given regulatory year (in order to have final values when providing 15 months' notice of a change to use of system charges). In practice this requires the cost being passed

[1] DCP 332 'Appropriate treatment and allocation of Last Resort Supply Payment claim costs'
DCP 333 'Appropriate treatment and allocation of eligible use of system bad debt costs'
DCP 334 'Update to Schedule 15 ('Cost Information Table') to maintain alignment with the distribution licence'

through in the regulatory year for which use of system charges will apply to be known by December of the regulatory year in which the cost is incurred, even though any Valid Claims to be recovered will not be fully paid to the Claimant at this point.

60 day notice period for changing use of system charges

35. If a Valid Claim breaches the materiality threshold, a period of at least three months is required from (and including) the date a Valid Claim is received to the start of the regulatory year in which a DNO must increase charges. This is to ensure that a DNO has sufficient time to publish revised use of system charges and provide the 40 days' notice required under the DCUSA in doing so.

36. A period of 60 days would only provide 20 days for a DNO to:

    a. assess the impact of the Valid Claim to determine whether payments, when considered alongside any other Valid Claims which it has already received, will result in a breach of the materiality threshold in any regulatory year;

    b. decide whether it wishes to invoke its right to request a derogation to increase previously published use of system charges if the materiality threshold is breached;

    c. provide notice to the Authority of its intention to increase use of system charges at short notice;

    d. receive a derogation from the Authority allowing it to change already published use of system charges;

    e. satisfy internal assurance and approval requirements; and

    f. publish and communicate the revised use of system charges.

37. We intend to progress a DCUSA change to alleviate the need for a DNO to request a derogation to change already published use of system charges in this specific circumstance (i.e. to remove the need for part d above). However, at this stage we cannot assume this change will be implemented. Requesting and receiving a derogation alone is likely to take more than 20 days.

38. We note further similar replacements in other licence conditions but we believe that only SLC38B is fundamentally impacted. Consequently, we do not propose to change any additional amendments to 'three months', other than one instance in CRC2B which has resulted in a contradictory requirement – we will cover this in section 8.

39. If the amendment to paragraph 11 is not made, Relevant Regulatory Year is defined in both SLC38A and SLC38B using a 'condition specific' definition. As that definition is the same in both SLC38A and SLC38B, it should be moved to SLC1. However, we believe it is essential that the change is made in SLC38B to revert to three months as opposed to 60 days.

Application of the materiality threshold

40. The intent of the materiality threshold is to protect DNOs from excessive cash flow risk in the period between paying and recovering a Valid Claim, with the default position being that a DNO would recover the costs two years later where the threshold is not breached.

41. We believe that the intent of the changes was that any Valid Claim which breached the materiality threshold should be paid and recovered from customers in the same year but that any subsequent claim should be assessed against the materiality threshold **as if the Valid Claim which breached the threshold had not occurred**. This is because the DNO is already protected from cash flow risk in respect of the Valid Claim which breached the materiality threshold (by virtue of the timing of cost and revenue being closely aligned) and so, if there was 'headroom' below the cap in any given regulatory year before the Valid Claim which breached the materiality threshold was received, that 'headroom' should remain available for future claims.

42. However, as drafted, the assessment of whether a given claim breaches the materiality threshold in any given regulatory year would include any payments to be made by the DNO in that period in relation to all Valid Claims, including those where the materiality threshold had been breached.

43. Paragraph five of SLC38B should be amended to ensure that any payments to a Claimant relating to a Valid Claim, which has both breached the materiality threshold and is being recovered in accordance with paragraph nine of SLC38B, are not included when calculating whether a new Valid Claim would breach the materiality threshold.

44. For example (assuming the modifications to the electricity distribution licence were already implemented and the changes to paragraphs three and 11 as discussed above were made), if a DNO received a claim in December 2018 of £1.5m which breaches the DNO's materiality threshold of £1.0m, the DNO would recover the Valid Claim and pay the Claimant in 2019/20. If the DNO then received a Valid Claim for £0.4m in April 2019, which would be paid in instalments from July 2019 to June 2020 (i.e. £0.3m in 2019/20 and £0.1m in 2020/21), the aggregate value of payments made in respect of Valid Claims in 2019/20 would be £1.8m and so would breach the materiality threshold. However, the second claim only exposes the DNO to cash flow risk in respect of £0.3m in 2019/20. The DNO is already protected from cash flow risk in respect of the first claim because cost and revenue are both in 2019/20. Consequently, the materiality threshold is only breached for the second claim because the drafting does not exclude the £1.5m Valid Claim which breached the materiality threshold.

45. The determination of a breach of the materiality threshold, therefore, needs to exclude any Valid Claims which breached the materiality threshold and are being recovered and paid in the same regulatory year. Otherwise, every subsequent Valid Claim which requires any payment in that regulatory year will automatically breach the materiality threshold.

Frequency of payments to a Claimant

46. Paragraphs three and nine of SLC38B specify that payments made to a Claimant will be made in monthly instalments. However, SLC9 (of the electricity supply licence) provides for a Claimant to request payment in monthly or quarterly instalments. Ofgem recently closed its statutory

consultation on proposed modifications to the SoLR supply licence conditions[2] and, unless this can be changed to provide for monthly instalments only, SLC38B should be consistent with the electricity supply licence. For the avoidance of doubt our preference is for payments to always be in monthly instalments in the interests of simplicity and predictability. We have not made this amendment in Appendix A but have indicated where the conflict exists.

Other changes

47. Paragraph one (b) contains a typographical error.

48. Paragraph three references a 'schedule defined by the Authority, and in any event by no later than 15 months from the date on which the Valid Claim was received', which we understand is to provide flexibility over payment terms. However, we do not believe flexibility beyond the payment instalments specified in SLC38B is necessary. This is on the basis that any instalments would still need to ensure the Claimant was compensated in full within 15 months of making a Valid Claim and where we would question why it was necessary e.g. why an LRSP claim small enough to be considered appropriate to have been paid in fewer instalments should be approved by the Authority in the first place. A Valid Claim which would reasonably be paid in additional instalments is restricted by the need to be fully paid within 15 months. Either this period also needs to be flexible or there is no benefit in the Authority defining the schedule. We can see the potential benefit of flexibility for a particularly large Valid Claim to be spread across more than one regulatory year. However, such a Valid Claim should perhaps be dealt with as an Energy Supply Company Administration Order, which applies to an undefined 'large gas or electricity supply company' and, therefore, the insolvent supplier would ideally not be subject to the SoLR process.

49. Paragraph four inappropriately uses the defined term Relevant Regulatory Year, which applies only where a breach of the materiality threshold has occurred.

50. Paragraph four references paragraph five of SLC38B but this should reference paragraph nine where the Excess Specified Amount is dealt with i.e. it determines the pass-through cost in CRC2B and what the DNO must do thereafter.

51. Paragraph seven references paragraphs in SLC38A but this should reference the equivalent paragraphs (five and six respectively) in SLC38B instead.

52. Paragraph nine (a) refers to CRC2B paragraph 35. However, it should be noted that, where CRC2B applies to SSEH only, the relevant paragraph is 38. We have not made this amendment in Appendix A but have indicated where the conflict exists.

53. Paragraph nine (b) will not achieve the desired outcome without supporting DCUSA changes which we intend to raise. In the absence of a DCUSA change which will alleviate the need for a DNO to request a derogation in accordance with paragraph six of SLC38B, it is likely that a number of

[2] https://www.ofgem.gov.uk/publications-and-updates/statutory-consultation-proposed-modifications-solr-supply-licence-conditions

contradictions will arise in trying to follow the approved use of system charging methodology in order to change previously published use of system charges. For the avoidance of doubt, paragraph nine (b) does not need to be changed when supported by a change to the DCUSA, therefore we have not made this amendment in Appendix A but have indicated where the conflict exists.

54. Paragraph 10 essentially repeats most of paragraph eight and could, therefore, be deleted. Paragraph eight should be retained as it determines the treatment of any Valid Claim received after a breach of the materiality threshold applies in accordance with paragraph nine of SLC38B, but where the Specified Amount of a subsequent Valid Claim would not breach the materiality threshold. An amendment is required to paragraph eight following deletion of paragraph 10 to provide clarity as to how the Valid Claim should be recovered.

55. Paragraph 11 (which will become paragraph 10 as a result of paragraph 54 of this response) and, specifically, the definition of Excess Specified Amount references paragraph nine of SLC38A but this should reference paragraph nine of the same condition i.e. SLC38B.

56. This definition would also benefit from being more explicit that the intention is for an entire Valid Claim which results in breach of the materiality threshold being recovered, and not just the amount above the materiality threshold.

6. Standard licence condition 38C '*Treatment of Valid Bad Debt Claims*' ('SLC38C')

57. As stated in section 1 we do not support allowing LDNOs to recover use of system bad debt. However, we believe that SLC38C will deliver the desired intent to enable a DNO to recover a Valid Bad Debt Claim received from a Bad Debt Claimant.

58. Ofgem's stated wish to avoid protecting one group of network companies (DNOs) and not others (LDNOs) from bad debt is based on an over-simplification of the differences between the regulatory regimes under which different licensees operate. Existing regulatory distortions render this inappropriate:

    a. In respect of DNOs operating within area, Ofgem has yet to discharge its duties in respect of bad debt costs to the extent that DNOs need some allowance for those costs. Ofgem has put in place a policy to allow recovery, but it has not yet executed that policy in respect of these specific bad debt costs under the current arrangements unless the price control settlement close out recognises those costs.

    b. In respect of LDNOs, Ofgem has already discharged its duties, by choosing to regulate them in a light-touch manner, and allowing them to choose profitable parts of a DNOs distribution network to which the LDNO is to connect. When making that choice an LDNO prices in costs, including bad debt, in making adoption payments for new connections, whether that be explicit or in cost of capital assumptions.

59. Further to our position set out in section 1, we are concerned that the competition provided by LDNOs can result in benefits flowing to property developers, rather than to customers. Giving LDNOs relief from use of system bad debt would widen this pre-existing issue.

60. If we were to accept that LDNOs should be allowed to recover use of system bad debt, we believe that the intent of standard licence condition BA5 '*Valid Bad Debt Claims*' ('BA5') should be applied to DNOs operating out of area as well as to IDNOs.

61. Subject to changing BA5 to apply to all LDNOs, the only perceived impact on SLC38C would be to remove the definition of Non-Distribution Services Provider. This definition would need to be changed and moved into SLC1.

62. Paragraph three references paragraph 10 of BA5 however this should reference paragraph 11 of BA5 instead.

7. Standard licence condition BA5 '*Valid Bad Debt Claims*' ('BA5')

63. Where Ofgem appears to hold the view that LDNOs should be allowed to recover use of system bad debt, we believe that BA5 generally delivers the desired intent.

64. However, as stated in section 1 and section 6, on the basis that Ofgem's policy position is that LDNOs should be able to recover use of system bad debt, we do not support a position where a Valid Bad Debt Claim can be made by a Bad Debt Claimant that applies only to IDNOs and not to DNOs operating out of area.

65. On this basis the suggested amendments focus on:

    a. the consistency of application of BA5 to IDNOs and DNOs operating out of area;

    b. the treatment of bad debts arising from invoices which are not yet due for payment at the time of failure; and

    c. a number of other minor changes which we think are needed.

Application of condition BA5

66. Failure to treat all LDNOs consistently (i.e. IDNOs and DNOs operating out of area) will result in a cross-subsidy of use of system bad debt incurred in relation to customers in the Distribution Services Area of other DNOs by customers within the Distribution Services Area of the DNO that is operating out of area.

67. BA5 as drafted proposes that IDNOs recover use of system bad debt proportionately from DNOs in whose Distribution Services Area the debt has been incurred. This principle should also apply to DNOs operating out of area.

68. IDNOs currently have no retrospective mechanism to recover use of system bad debt, whereas a DNO operating out of area can retrospectively recover these costs under its distribution licence. We believe the following changes are needed to ensure that a DNO operating out of area is not allowed to recover use of system bad debt incurred whilst acting in this capacity under its DNO licence (point a below), and to facilitate it recovering use of system bad debt using a Valid Bad Debt Claim consistent with IDNOs (points b and c below):

a. CRC 2B 'Calculation of Allowed Pass-Through Items' ('CRC2B') paragraph 40 (paragraph 43 for SSEH) should be amended to be:

38A.4. Where the licensee has incurred bad debts with respect to Use of System Charges owed to the licensee by one of more Defaulting Electricity Suppliers within a given Regulatory Year, and where the Use of System Charges owed relate to the licensee acting in its capacity as a Distribution Services Provider only, within 60 days of the end of that Regulatory Year the licensee shall submit to the Authority a statement in a form that has been prescribed by the Authority setting out the amount of the bad debt arising as a result of the Defaulting Electricity Supplier(s)' insolvency during that Regulatory Year, together with any prior year adjustments following receipt of the Final Reconciliation Settlement Run for the final day of supply by the Former Electricity Supplier.

b. For BA5 to apply to DNOs operating out of area, a new section in the licence will be required e.g. Section C named 'Additional standard conditions for Electricity Distributors who are not Distribution Services Providers or in respect of Exit Points outside of their Distribution Services Area'. The condition (e.g. standard licence condition 53 'Valid Bad Debt Claims') will need to be located in a chapter within the new section and paragraph references will need to be updated accordingly. References to BA5 in standard licence condition 38C 'Treatment of Valid Bad Debt Claims' ('SLC38C') will also need to be amended.

c. The definition of Non-Distribution Services Provider in SL38C and BA5 should be removed. That definition should be added to SLC1 but amended to be:

Non-Distribution Services Provider means any Electricity Distributor in whose Electricity Distribution Licence the requirements of Section B of the standard conditions of that licence do not have effect (whether in whole or in part) or in respect of Exit Points outside its Distribution Services Area.

69. We have not amended Appendix A to reflect the comments in paragraph 68 of this response. This is a policy position that Ofgem needs to be satisfied is fair in the context of the different regulatory treatment between DNOs and LDNOs. Any amendments made to Appendix A are to better achieve and/or clarify the delivery of the proposals in respect of both who can make a Valid Bad Debt Claim and how the DNO then recovers it.

Treatment of bad debt arising from invoices not yet due

70. Regardless of to whom the condition applies, a change is needed to BA5 to deal with the treatment of debt not due for payment at the time an electricity supplier becomes insolvent.

71. The proposed licence drafting seeks to remove the need to reference the 2005 best practice guidelines for gas and electricity network operator credit cover[3]. This guidance document was largely superseded by Schedule 1 'Cover' of the DCUSA and the proposed licence drafting attempts to embed the rules which determine the proportion of use of system bad debt a licensee can recover, which is relative to the age of the debt at the time of insolvency.

72. Appendix 1 of BA5 fails to adequately recognise any debt not yet due for payment at the insolvency date (i.e. any unbilled use of system bad debt). Licensees are required to provide this information when claiming to recover use of system bad debt (currently via the price control closeout process), and which should be 100% pass-through.

Other changes

73. Paragraph four includes parts (c) to (d) which should be (a) to (b) respectively.

74. Paragraph nine (a) would benefit from being more specific that the bad debt is that incurred by the licensee.

75. Paragraph nine (b) should be more prescriptive in defining the year in which the Bad Debt Claim will be paid.

76. Paragraph nine (c) would benefit from greater clarity as to the default payment instalments.

77. Paragraph 14, specifically the definition of Relevant Distributor, would benefit from clarity that a Bad Debt Claimant will only make a Valid Bad Debt Claim to a DNO in whose Distribution Services Area the Bad Debt Claimant operates, as well as being where the Bad Debt Claimant had customers supplied by the insolvent supplier.

78. Paragraph 14, specifically the definition of Valid Bad Debt Claim, references BA5 but could simply refer to 'paragraph 5 of this condition' instead.

8. Charge Restriction Condition 2B '*Allowed Pass-Through Items*' ('CRC2B')

79. For the avoidance of doubt we refer to CRC2B but recognise that there are multiple conditions which apply to different DNOs. We reference these throughout where appropriate.

80. We support the amendments made to CRC2B to introduce two new pass-through terms to allow DNOs to recover costs associated with the appointment of a SoLR (primarily Valid Claims) and use of system bad debt (including any Valid Bad Debt Claims as may be required).

81. Paragraph 35 (paragraph 38 for the SSEH only equivalent), specifically in relation to part (a) of the meaning of the SLRAt-2 term, should reference the appropriate paragraph in SLC38B as well as the condition itself, being paragraph four of SLC38B.

[3] https://www.ofgem.gov.uk/sites/default/files/docs/2005/02/9791-5805_0.pdf

82. Paragraph 35 (paragraph 38 for the SSEH only equivalent), specifically in relation to part (b) of the meaning of the SLRAt-2 term, should reference the appropriate paragraph in SLC38A as well as the condition itself, being paragraph three of SLC38A.

83. Paragraph 35 (paragraph 38 for the SSEH only equivalent), specifically in relation to part (d) of the meaning of the SLRAt-2 term, should apply to SLC38A as well as SLC38B where a DNO incurs reasonably incurred costs.

84. In paragraph 39 (paragraph 42 for the SSEH only equivalent), specifically in relation to part (b) of the meaning of the RBDt-3 term, the reference to the EBDA term should be replaced with the LBDA term as the EBDA term relates to DNO use of system bad debt only.

85. Paragraph 39 (paragraph 42 for the SSEH only equivalent), specifically in relation to the IBDAt term, incorrectly references SLC38C. It refers to the correct condition by name but when it was SLC38B in an earlier version of the drafting in support of this consultation.

86. Paragraph 39 (paragraph 42 for the SSEH only equivalent), specifically in relation to the IBDAt term, should reference the appropriate paragraph in SLC38C as well as the condition itself, being paragraph four of SLC38C.

87. Paragraphs 40 and 45 (paragraphs 43 and 48 for the SSEH only equivalent) are contradictory. Paragraph 40/43 specifies that a DNO has 60 days from the end of a regulatory year to advise the Authority of the amount of bad debt it is seeking to recover, whereas paragraph 45/48 specifies that, if the Authority has not received such a 'claim' by 30 June for the previous regulatory year, then the DNO will recover nothing in relation to that period. The two should be consistent.

88. Paragraph 41 (paragraph 44 for the SSEH only equivalent) would benefit from the word 'of' being inserted between 'time' and 'the'.

89. Appendix 7 (Appendix 8 for the SSEH only equivalent) should be amended consistently with the change proposed to Appendix 1 of BA5 to specifically refer to the treatment of unbilled use of system debt at the time an electricity supplier becomes insolvent.

90. Paragraph 38 (SSEH only) includes parts (c) to (h) which should be (a) to (d) respectively.

91. Paragraph 42 (SSEH only) includes parts (c) to (d) which should be (a) to (b) respectively.

92. Paragraph 35 (WPD only) includes parts (i) to (l) which should be (a) to (d) respectively.

93. Paragraph 39 (WPD only) includes parts (e) to (f) which should be (a) to (b) respectively.

9. Clarifications on the consultation

94. In the overview Ofgem states that the proposed modifications seek to ensure that IDNOs are "treated on an equivalent basis" to DNOs. This is not true of either bad debts or Valid Claims.

    a. We agree that the proposals seek to ensure IDNOs can retrospectively recover use of system bad debt in a similar manner to DNOs. But IDNOs have the option to price in bad debts when adopting new developments which DNOs do not, and so the treatment of DNOs and IDNOs remains fundamentally inconsistent.

b. DNOs and IDNOs will not be treated the same in relation to Valid Claims. A SoLR will levy a Valid Claim on DNOs (and gas equivalents) only. Whilst we agree this is appropriate (providing IDNOs do not unduly benefit, which the aforementioned DCUSA changes (see paragraph 33 of this response) are seeking to address), it nonetheless does not result in equivalent treatment of DNOs and IDNOs.

95. In relation to a Valid Claim, Ofgem states that, due to the requirement to provide 15 months' notice, unless granted a derogation by the Authority, this can

> *"produce a time-delay between when the DNOs have to make good on their obligation to pay the appointed SoLR its approved LRSP claim and when the DNOs can then recover their costs through the new revised UoS charges"*

This is not true based on the status quo. In accordance with SLC38, and due to the shortcomings of this condition, DNOs cannot recover the costs without derogation from the Authority. Further, SLC38 specifies that DNOs must increase use of system charges in the Relevant Regulatory Year, being the year in which the DNO will pay the Valid Claim.

96. In relation to SLC38B, and we believe specifically in relation to the process which follows a breach of the materiality threshold, Ofgem states that

> *"one of the consequences of these proposed changes would be that there could be multiple changes in charges within a charging year".*

This is not true. The materiality threshold seeks to minimise cash flow risk to DNOs, where payments made to a Claimant would otherwise not be recouped for two years. In doing so it provides a means for a DNO to change use of system charges without providing the requisite DCUSA 15 months' notice via Authority derogation (or potentially without derogation depending on associated DCUSA changes being raised and approved).

97. It does not seek to alter the requirement to change use of system charges from 1 April only (in accordance with standard condition 14 'Charges for use of system and connection'). Therefore 'within a charging year' only one set of charges will apply; they may supersede previously published 'final' use of system charges but they will never supersede charges which have come into force.

98. We agree with Ofgem's assessment that costs associated with the appointment of a SoLR should be recovered via use of system charges and not 'other charges', as defined in paragraph 19.2.1 of the DCUSA, and which includes Valid Claims. We intend on raising a DCUSA change to remedy this inconsistency which was previously identified in the joint DNO letter[4] requesting the necessary derogations to recover Co-operative Energy Limited's Valid Claim.

[4] http://www.northernpowergrid.com/asset/0/document/4097.pdf