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Dear Grant

Response to Ofgem's statutory consultation on modifications to the Electricity Distribution Licence to recover the costs associated with appointing a Supplier of Last Resort.

Having contributed fully to the consultation process, we are supportive of the intent behind the proposed changes to the electricity distribution licence ('the licence') and generally of the way in which they are to be delivered.

We are pleased to note that the majority of the changes we have proposed to the licence modifications since the informal consultation have been adopted. However, we believe a small number of further changes are necessary to:

- Retain the distinction between a Valid Claim, which breaches the Materiality Threshold, and one which does not, with regards to when payment is made to a supplier of last resort (SoLR);
- Cater for all scenarios in relation to the timing of payment where an independent distribution network operator (IDNO) makes an adjusted Valid Bad Debt Claim and is required to pay a distribution network operator (DNO);
- Remove ambiguities in the definition of the Relevant Regulatory Year;
- True-up differences between actual and forecast inflation indices appropriately; and
- Ensure consistent treatment of the recovery of use of system bad debt in 2021/22 for all Distribution Services Providers.

We expand on each of these points below in the respective licence condition to which it relates, as well as proposing some additional areas which would benefit from greater clarity.

We have also attached with this response a mark-up of the relevant sections of the proposed licence drafting, which addresses the concerns that we have raised. Where we have not commented on a licence condition we are satisfied with the intent and drafting proposed by Ofgem.

Standard licence condition 38 '*Treatment of payment claims for last-resort supply where Valid Claim is received before 1 April 2019*' ('SLC38')

Definition of Relevant Regulatory Year is ambiguous

The definition of Relevant Regulatory Year in paragraph 12 is ambiguous due to the relevance of the period of 60 days before the beginning of *"a Regulatory Year"*; which could be considered to be 'any' regulatory year.

We propose that the definition is amended to relate to the 60 days before the beginning of '*the next*' regulatory year. Hence, if a Valid Claim is received more than 60 days before the beginning of the next regulatory year, the Relevant Regulatory Year should continue to be "*that Regulatory Year*", otherwise it should be '*the year after*' the next regulatory year.

Standard licence condition 38B '*Treatment of payment claims for last-resort supply where Valid Claim is received on or after 1 April 2019*' ('SLC38B')

Definition of Relevant Regulatory Year

The definition of Relevant Regulatory Year in paragraph 11 should be addressed in accordance with the proposed amendment to SLC38, albeit it should relate to 'three months' rather than '60 days'.

The words "*for this condition only*" at the start of the definition of Relevant Regulatory Year in paragraph 11 should also be removed, as this is already stipulated in the first sentence of paragraph 11.

Distinction between Valid Claims with regards to a breach of the Materiality Threshold

Paragraph three sets out the obligations on a DNO to pay a Claimant. This paragraph has been amended since the informal consultation to remove the distinction between a Valid Claim which breaches the Materiality Threshold and one which does not do so. A distinction is necessary for the intent of the Materiality Threshold to be realised.

In accordance with paragraph nine, a DNO should pay a Valid Claim to a Claimant in the Relevant Regulatory Year, when that Valid Claim results in a breach of the Materiality Threshold. There will be circumstances in which a Valid Claim is not subject to paragraph nine, in which case a DNO will commence paying a Claimant three months from the date on which the DNO received the Valid Claim.

The Relevant Regulatory Year for the purposes of SLC38B depends on whether a Valid Claim was received more than three months before the beginning of 'the next' regulatory year or not. For example, for a Valid Claim received on 1 January 2020, which breaches the Materiality Threshold, the Relevant Regulatory Year would be 2021/22. The DNO would not, therefore, commence paying the Claimant until April 2021 at the earliest. However, if a Valid

Claim received on 1 January 2020 did not breach the Materiality Threshold or the DNO decided to treat it as if it had not, the DNO would commence paying the Claimant from April 2020.

Consequently, it is essential that amendments are made to paragraphs three and nine, as follows:

- Paragraph three should begin with '*Subject to paragraph 9 of this condition*', and
- Paragraph nine part (c) of the drafting proposed in the informal consultation should be reinstated, which requires the DNO to '*during the Relevant Regulatory Year, make payments to the Claimant by monthly or quarterly instalments that equate to the total Specified Amount*'.

Points of clarification

As indicated in our response to the informal consultation, 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*". We believe the intent of this drafting is to provide flexibility over payment terms. However, we do not believe that additional flexibility, beyond the payment instalments specified in SLC38B, is necessary, at least in such a limited capacity.

Any instalments would still need to be calculated in such a way so as to ensure that the Claimant was compensated in full within 15 months of making a Valid Claim. The DNO would therefore be restricted by the requirement to fully pay that Valid Claim within 15 months. Consequently, either the 'end' date by which the DNO should have made payment in full also needs to be flexible or there is no apparent benefit in the Authority defining a schedule.

We can see the potential benefit of flexibility for a particularly large Valid Claim to be paid over more than one regulatory year. However, such a Valid Claim should be dealt with under an Energy Supply Company Administration Order, which applies to an undefined 'large gas or electricity supply company' and, therefore, the insolvent supplier would not be subject to the SoLR process. The Authority or the Department for Business, Energy and Industrial Strategy (BEIS) can make such an application in accordance with the Memorandum of Understanding between the Authority, BEIS and Her Majesty's Treasury[1].

A particularly large Valid Claim would presumably breach the Materiality Threshold. So any flexibility to pay in instalments which extends beyond the Relevant Regulatory Year also should be referenced in paragraph nine part (c), as we have commented above.

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

The timing of a payment from an IDNO

Part (c) of both paragraphs 11 and 13 set out the requirement for an IDNO to return to a DNO bad debt claimed from that DNO as a result of Settlement inaccuracies or where that IDNO has subsequently recovered some of the bad debt from the administrator of a Defaulting Electricity Supplier.

[1] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/590016/201612_05_-_SAR_MOU__2_.pdf

The intent is to align the timing of such a repayment to a date on which the IDNO is due to receive a payment itself from the DNO in relation to the original Valid Bad Debt Claim. The purpose of this arrangement is to potentially net off the value of the repayment to be made by an IDNO against payment to be received by that IDNO from the DNO, and to avoid a potential scenario where an IDNO is required to pay the DNO before that DNO has paid the original Valid Bad Debt Claim to that IDNO.

The date on which an IDNO is required to pay a DNO is relative to the date on which that IDNO provides notice to that DNO of that IDNO's adjusted Valid Bad Debt Claim, where:

- if the date on which the next payment due from a DNO to an IDNO is more than or equal to 30 days from the date on which that IDNO provides notice to that DNO, the payment date is aligned to that next payment date; or
- if the date on which the next payment due from a DNO to an IDNO is less than 30 days from the date on which that IDNO provides notice to that DNO, the payment date is aligned to the next date that DNO is due to pay that IDNO which is more than 30 days from the date on which that IDNO provides notice to the DNO; or
- if no further payments will be made from a DNO to an IDNO, the payment from that IDNO to that DNO is required within 30 days of that IDNO providing notice to that DNO.

Part (c) of both paragraphs 11 and 13 do not, but should, cater for a scenario where a payment from a DNO to an IDNO is less than 30 days from the date on which that IDNO provides notice to that DNO.

Charge restriction condition 2A '*Restriction of Allowed Distribution Network Revenue*' ('CRC2A')

Costs which should be subject to the retail price indices (RPI) true-up

The modifications to CRC2A are necessary to ensure that the new pass-through costs, which are subject to the forecast inflation indices (i.e. the RPIF term), are included in the RPI true-up mechanism (i.e. the TRU term). This is achieved by including the costs within the REV term, which represents the aggregate value of all costs which are subject to the forecast inflation indices.

The REV term is set out in paragraph 11. However, the drafting of the formula in the Scottish Hydro Electric Power Distribution plc (SSEH) only section does not include the Allowed Pass-Through Items revenue adjustment (i.e. the PT term), which it needs to.

Costs which should not be subject to the RPI true-up

The PT term includes costs which are not subject to the forecast inflation indices (e.g. the HB and UNC terms which apply to SSEH only). The REV term, therefore, excludes these costs, which are separate terms and directly constitute the PT term. However, the Excess Specified Amount i.e. the ESA term, which is not subject to the forecast inflation indices, is included within the SoLR pass-through cost adjustment (i.e. the SLR term which is a constituent part of the PT term).

The ESA term represents the aggregate value of all Valid Claims which have breached the Materiality Threshold in accordance with SLC38B, excluding any claims that the DNO is treating as if the Valid Claim had not breached the Materiality Threshold. These costs are not subject to a two year lag in order to facilitate a DNO recovering the costs without providing 15 months' notice of a change in use of system charges. Consequently, the ESA term is not subject to a time value of money adjustment.

The ESA term should, therefore, be excluded from the REV term. As the REV term is on a two year lagged basis, the ESA term should also be subject to the same treatment even though it is not directly within the SLR term.

Charge restriction condition 2B '*Calculation of Allowed Pass-Through Items*' ('CRC2B')

Recovery of bad debt costs in 2021/22

Paragraph 37 (which does not apply to the sections relating to SSEH or Western Power Distribution (WPD)'s licensees) implies that the principle formula should be used to calculate EBD for both 2021/22 and 2022/23. Part (a) of paragraph 38 applies explicitly to 2021/22. Hence, paragraph 37 should only apply to 2022/23 and paragraph 38 should apply to 2021/22. This is consistent with the equivalent paragraph for both SSEH (paragraph 40) and WPD's licensees (paragraph 37). Paragraph 37 should, therefore, say '*For the purposes of the Principal Formula, subject to paragraph 2B.38, EBDt is derived in accordance with the following formula:*' and paragraph 38 should say '*For Regulatory Years 2015/16, 2016/17, 2017/18, 2018/19, 2019/20, 2020/21 and 2021/22*'.

Treatment of other costs returned from a SoLR

Part (c) of Paragraph 35 (which is paragraph 38 in the SSEH section) relates to costs returned by a SoLR to a DNO where the SoLR has recouped some of the relevant costs from the administrator of the Former Electricity Supplier.

On 24 January 2019, Ofgem published its final decision[2] to allow Octopus Energy Limited ('Octopus') to recover £13.2m from the gas distribution network operators (GDNs) and DNOs. Of the £13.2m claimed, £10.9m relates to credit balances, of which 9% were estimated. Ofgem's final decision was "*conditional upon Octopus adjusting the final amount claimed to reflect the final, agreed credit balance for all relevant customer accounts*".

On finalising the credit balances, Octopus will claim any additional costs (or return any surplus costs) from the GDNs and DNOs in proportion to the original Valid Claim.

In the scenario where Octopus returns surplus costs, it is not clear how a DNO will return those costs to customers via use of system charges. Such costs could be included in part (d) of paragraph 35, which is somewhat of a 'catch all' item but is intended to represent, for example, financing costs incurred by a DNO if it needed to raise capital in order to pay Valid Claims. We propose to introduce a new defined term named 'Returned Costs' to which part (c) of paragraph 35 (and paragraph 38 for SSEH) would relate. Returned Costs should relate to all retrospective costs received by a DNO from a SoLR.

[2] https://www.ofgem.gov.uk/publications-and-updates/last-resort-supplier-payment-claim-octopus-energy-final-decision

Points of clarification

A general point of clarity in relation to the recovery of DNO bad debt would be to specify that any debt claimed must be net of value added tax (VAT), which DNOs recover from Her Majesty's Revenue and Customs in any event.

Other comments on the consultation

Regulatory distortions between IDNOs and DNOs

We recognise Ofgem's view that the modifications to the licence do not favour IDNOs or DNOs operating out of area (which are collectively defined as licensed distribution network operators (LDNOs) in the distribution connection and use of system agreement ('the DCUSA')).

We welcome Ofgem's plan to further investigate the regulatory distortions between DNOs and LDNOs which may lead to changes in how it regulates LDNOs in the future.

Biannual price cap revisions

We recognise concerns expressed in response to the informal consultation in relation to setting price caps, specifically in relation to a DNO recovering a Valid Claim which has breached the Materiality Threshold in accordance with SLC38B.

There are two factors which interact closely with this:

- Since the informal consultation, the definition of Relevant Regulatory Year has changed to increase the 60 day period to three months before the beginning of the next regulatory year. This will allow DNOs to provide greater notice of a change to use of system charges beyond the 40 days required by the DCUSA.
- We have submitted a DCUSA change proposal[3] which seeks to introduce a conditional exemption from the need to provide 15 months' notice of a change to use of system charges where a Valid Claim has breached the Materiality Threshold in accordance with SLC38B. This change will remove the need for DNOs to request directions from the Authority to change charges when a Valid Claim breaches the Materiality Threshold.

Both of these will bring forward the date on which a DNO can publish revised use of system charges to give greater notice ahead of the start of the Relevant Regulatory Year, when those revised charges will come into force. We are confident that, should the Materiality Threshold be breached, we will publish revised charges with sufficient notice before the start of the Relevant Regulatory Year to enable those revised charges to be included in the calculation of the price cap.

Necessary changes to the Regulatory Instructions and Guidance (RIGs)

The licence modifications require an update to the revenue reporting pack (Annex C) and the cost and volumes reporting pack (Annex B) of the RIGs.

[3] DCP 340 '*Notice period required to recover approved last resort supply payment claims which breach the materiality threshold*'

Annex C guidance for revenue reporting pack should clarify the method by which the Materiality Threshold in SLC38B is indexed to nominal prices in order to determine whether or not it has been breached.

When a DNO is assessing whether or not a Valid Claim has breached the Materiality Threshold, actual inflation for the regulatory year(s) in which the breach has occurred will not be known, nor will actual inflation for the regulatory year in which the Valid Claim was received. A DNO will therefore be required to forecast inflation, and therefore although the ESA term should not be subject to the RPI true-up, as commented above, we believe the forecast inflation term (i.e. the RPIF term) should be used to determine whether a Valid Claim has breached the Materiality Threshold or not.

A Valid Claim which would not have breached the Materiality Threshold based on actual inflation should not be retrospectively corrected.

The cost and volumes reporting pack needs to include the new pass-through costs which will be required as an input into the revenue reporting pack consistent with the other pass-through costs.

Please do not hesitate to contact me should you have any queries on any of the points raised in this response.

Yours sincerely,

Lee Wells

Commercial Manager – Regulated Revenue