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11 July 2018

Dear Lesley

Response to Ofgem's proposed modifications to SoLR supply licence conditions

Thank you for the opportunity to comment on Ofgem's proposed modifications to the supply licence to refine the conditions relating to the appointment of a supplier of last resort (SoLR). We welcome the opportunity to work further with Ofgem and industry to understand areas of ambiguity and contradiction within legal drafting surrounding the SoLR process.

Following the recent insolvency of Future Energy (Supply) Limited and Future Energy Utilities Limited ('Future Energy'), and potential risk for more frequent occurrences of supplier failure, we recognise the importance of assessing and implementing an enduring solution to the issues raised as soon as is practicable.

I wrote to you on 13 June 2018, shortly before your consultation was issued (a copy of the letter is included with this response). In that letter I set out our position on the recovery of costs associated with the SoLR process and requested that at the earliest opportunity Ofgem mobilised a stakeholder group to review these arrangements. Whilst we welcome the opportunity to respond to your consultation, it remains our view that a stakeholder group should be mobilised at the earliest opportunity.

Intent of the Proposed Changes

We consider that the scope of Ofgem's proposed licence changes is too narrow and needs to be widened to include the distribution licence. The processes by which costs associated with a Last Resort Supply Payment (as defined in the supply licence, hereafter 'LRSP') claim made by a SoLR are inherently flawed. This has been demonstrated by:

- The need for Ofgem to issue derogations to distribution licensees to deal with material contradictions both within the various conditions of the distribution licence; and between the

distribution licence conditions and the distribution connection and use of system agreement, most notably the requirement to give 15 months' notice of a change to use of system charges; and

- The recovery of Co-operative Energy Limited's LRSP claim being only from customers connected direct to one of the 14 distribution licensees in whose licence Section B has effect ('Distribution Network Operators', hereafter 'DNOs') and not from customers connected to distribution licensees in whose licence Section B does not have effect ('Independent Distribution Network Operators', hereafter 'IDNOs').

We believe it is not appropriate for Ofgem to consider amending the licence arrangements by which a SoLR is appointed without also amending the process by which the SoLR's associated costs can be recovered from customers to ensure simplicity, equitability, and minimal disruption to parties.

In the consultation, Ofgem makes reference to work being considered by industry through 'relevant network charging groups'. Despite our requests for such a group to be mobilised, to our knowledge no group exists which is comprehensively reviewing changes to the distribution and supply licences needed to ensure fair and efficient recovery of LRSP claims and distributor bad debt costs supported by robust processes which ensure all parties are financially neutral to the impact.

Risk of Unintended Consequences

We consider there may be at least three unintended consequences of the proposed changes.

- Firstly, the extension to the period over which a SoLR can make a claim does not resolve the underlying issue whilst creating a long period of uncertainty for other industry parties.

  Allowing a SoLR to make a LRSP claim up to five years after its Last Resort Supply Direction (as defined in the supply licence) ceases will increase the likelihood that any costs recovered from the administrator can be taken into account when compared to the status quo. But unless a SoLR is required to wait for the completion of the administration process before making a LRSP claim, this does not guarantee that the SoLR will not recover its costs twice (both through a LRSP claim and the administration process). Existing licencing arrangements are not fit for purpose should such a situation arise, with a likely need for a 'negative' LRSP claim in order to return the money to customers; hence the extension does not resolve the underlying issue.

  With the distribution licence as it stands, the extension to the period over which a LRSP claim can be made extends the period over which DNOs may be required to change use of system charges at short notice, and thus undermines the certainty which the 15-month notice period required for a change to use of system charges seeks to achieve.

- Secondly, the changes proposed seek to require a SoLR to make any LRSP claim from all DNOs, rather than only from those who had customers of the failed supplier connected to their networks at the time of failure.

  We consider this to be an appropriate change to make in the longer-term, ensuring that all customers contribute to the 'safety net' from which they benefit, regardless of their location. However, allowing claims to be made from all DNOs whilst the contradictions and weaknesses of the distribution licence remain simply exacerbates these problems, most notably the need to undermine the 15-month notice period required for a change to use of system charges.

- Thirdly, the changes proposed are likely to increase the magnitude of any LRSP claim made by a SoLR with a corresponding increase to the magnitude of the change in use of system charges

needed, thus increasing the impact on industry parties of the application of flawed processes for the recovery of such costs from customers.

Whilst we are in agreement that it is appropriate that the SoLR should be able to recover costs associated with the credit of former customers of the failed supplier, this is likely to increase LRSP claim values. Allowing claim values to increase whilst the contradictions and weaknesses of the distribution licence remain simply exacerbates these problems.

Proposed Legal Drafting

We broadly agree that the proposed licence amendments will deliver the intent of the changes proposed, but consider that a revision is required to the definition of 'Relevant Distributor' to enact the intended change to require a LRSP claim to be recovered from all DNOs. The existing definition is as follows:

> ***Relevant Distributor*** *in relation to any premises, means, except in standard condition 15 (Assistance for areas with high distribution costs scheme: payments to System Operator), the Licensed Distributor to whose Distribution System those premises are connected and in whose licence Section C has effect.*

The distribution licence no longer includes a Section C, and we believe the references to Section C in this definition should in fact refer to Section B.

We look forward to contributing to further changes to licencing arrangements to ensure that, should suppliers fail in the future, industry processes are sufficiently robust to ensure costs can be recovered simply, equitably and with minimal disruption to parties.

Yours sincerely,

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CC: Philippa Pickford, Lesley Nugent, Chris Brown, Dave Nanda

13 June 2018

Dear Jonathan

Supplier of last resort and associated cost recovery methodologies

I am writing to set out our position on the recovery of costs associated with the supplier of last resort (SoLR) process including use of system (UoS) bad debts, and to request that at the earliest opportunity Ofgem mobilises a stakeholder group to review these arrangements. We welcome Ofgem's recent announcement[1] to review its approach to licensing energy suppliers and that the scope of the review includes supplier failure and the safety net arrangements, and consider that the scope needs to also cover the fair and efficient recovery of costs associated with the appointment of a SoLR. This review should have a view to: developing and implementing a more robust process which will better serve the interests of Ofgem, distributors, energy suppliers and ultimately consumers; and seek to raise the necessary licence changes in the near future which are broader in scope than supplier licensing arrangements.

Following Co-operative Energy Limited's (CEL's) last resort supply payment (LRSP) claim, the distribution network operators (DNOs) jointly requested the necessary derogations to enable the recovery of the respective claims in a letter[2] dated 1 February 2018, to which Ofgem responded with a decision[3] dated 6 February 2018. Both highlighted issues relating to this maiden LRSP claim and the need to work collaboratively to review the arrangements.

My colleagues met with Ofgem, Chris Brown and David McCrone, on 8 March 2018 to discuss this matter, and welcomed Ofgem's view on the principles underpinning an enduring solution, which align to our own views, namely: simplicity; equitability; and minimising disruption to

[1] https://www.ofgem.gov.uk/system/files/docs/2018/06/180611_supply_licensing_review_open_letter_for_publication.pdf
[2] http://www.northernpowergrid.com/asset/0/document/4097.pdf
[3] https://www.ofgem.gov.uk/system/files/docs/2018/02/coop_solr_derogation_letter_0.pdf

parties. It was also noted that Ofgem intended to finalise its own position and then mobilise a stakeholder group to assess the changes needed. Whilst we welcome Ofgem's review of supplier licensing arrangements, we are disappointed that such a group has not yet been initiated.

We recognise that the industry, and network charging in particular, is in a period of unprecedented change with the ongoing Ofgem-led initiatives such as the Targeted Charging Review (TCR) and the Charging Futures work (including the Access project), as well as industry-led initiatives such as the Energy Network Association (ENA) Open Networks project and ongoing Distribution Connection and Use of System Agreement (DCUSA) open governance change proposals. However, like Ofgem, we consider this matter still to be a 'hot topic' and recognise the increasing need to implement robust arrangements to remedy the identified flaws and protect against an increasing risk of further suppliers ceasing trading.

The need to review the arrangements was highlighted further by the failure of Future Energy (Supply) Limited and Future Energy Utilities Limited ('Future Energy') in January 2018, and the risk that more may follow in the near future. Indeed we contacted Ofgem on 5 June 2018 to advise that we had rejected a request from a small electricity supplier to defer a UoS payment for 19 days. This is the second such request; we agreed to defer a smaller payment by 2 days last month. We are continuing to closely monitor all suppliers in this regard.

We await a potential LRSP claim from Green Star Energy, the SoLR appointed to Future Energy's customers, and fully expect that any such claim will need to be resolved in a similar manner to CEL's due to the absence of an enduring solution. Unfortunately we expect that this will result in a further need to undermine the requirement to give 15 months' notice of a change to UoS charges, with DNOs having published charges effective from 1 April 2019 in December 2017 and due to publish charges effective from 1 April 2020 in December 2018. In addition, it remains possible that in respect of CEL's claim, there may be the need for DNOs to vary 2019/ 20 UoS charges in line with standard licence condition 38 (SLC38) to remedy any shortfall or excess revenue relative to the claim. This is covered by the current derogation that Ofgem have granted but this derogation does not cover changes required for any future LRSP claims.

Given all of the above, we consider it vital that the industry finds a simple, transparent and predictable enduring arrangement to: align the requirements of the licence and DCUSA; preserve notice periods; ensure equitable cost recovery; provide a mechanism to ensure all parties are neutral to reasonably incurred costs; and thus better protect the interests of existing and future consumers.

Appendix A sets out our initial thoughts on an enduring solution, building on those discussed in the joint DNO letter, which we welcome the opportunity to discuss further with Ofgem and wider stakeholders.

Yours sincerely,

Patrick Erwin

Patrick Erwin

Policy and Markets Director

Appendix A - Initial thoughts on the changes need to the current cost recovery arrangements

There are two fundament issues with the current arrangements:

1. How (including when and from whom) DNOs recover and treat LRSP claims; and
2. The recovery of associated distributor bad debt.

How and when are costs recovered?

SLC38 does not specify any methodology to amend UoS charges in relation to a LRSP claim, and requires DNOs to breach the DCUSA requirements to provide 15 months' notice of a change to UoS charges.

Fundamentally, the treatment of LRSP claims is inconsistent between the DCUSA and SLC38.

- Clause 19.1D of the DCUSA - allows a DNO to vary 'Other Charges' without giving the same notice as is required for UoS charges;
- Moreover, clause 19.2.1 of the DCUSA defines Other Charges to include the charges necessary to deal with a LRSP claim;
- However, SLC38 requires that DNOs shall respond to a claim by varying its UoS charges; and
- Unless the term 'Use of System Charges' has a different meaning in the DCUSA and the electricity distribution licence there is a contradiction that we think has probably gone unnoticed before now.

A modification is therefore needed to align the DCUSA to SLC38, which as a minimum would require the removal of references to LRSP and SLC38 from clause 19.2.1.

In applying a reasonable interpretation of the course of action necessary, namely following SLC38, DNOs required a derogation to charge other than in accordance with their methodologies as approved under standard licence condition 13 (SLC13) in order to recover CEL's costs.

In response to the original joint DNO proposal to recover CEL's claim, and following stakeholder feedback, Ofgem proposed a methodology which facilitated utilising the existing published DNO charging methodologies (i.e. the common distribution charging methodology (CDCM) and extra-high voltage distribution charging methodologies (EDCM)).

Ofgem advised DNOs that it considered it necessary to provide additional notice of changes to UoS charges, whilst stating that DNOs should continue to make payment to CEL in the Relevant Regulatory Year (as defined in SLC38, being 2018/19 in this instance), and that it intended to change licence conditions to treat the costs as under-recovery of allowed revenue.

In practice this aligned to the DNO-proposed enduring solution, which would:

- Preserve the 15 months' notice;
- Retain use of approved charging methodologies;
- Based on current UoS charging methodologies, ensure all customers contribute to the cost-recovery (via increased unit charges); and

- Be consistent with other pass-through cost allowances (e.g. transmission connection point charges) which are recovered with a two year lag plus time value of money adjustment.

However, the practical challenges (in particular implementation) were significant, including the following.

- This would have necessitated a breach of licence and a policy commitment allowing DNOs to recover the costs in future;
- Despite Ofgem's assurances that it had the necessary statutory enforcement powers to not apply the conditions of SLC38 and amend/insert conditions into existing licences in line with its enforcement guidelines[4], any such licence change would be subject to statutory consultation and as such open to third party appeal, and therefore be unachievable in a short timeframe; and
- Although unknown to DNOs at the time, this would have been consistent with the proposed approach by Gas Distribution Networks (GDNs) to recover their claims, whereby the RIIO-GD1 licence retained a 'miscellaneous pass-through costs' term which allows a GDN to recover relevant expenditure with a two year lag plus time value of money adjustment. Although included in the DPRC5 licence, this term did not survive RIIO-ED1 and was therefore not an option for DNOs.

Ultimately this course of action was sensibly not followed.

In practice, to implement the enduring solution it is anticipated that charge restriction condition 2B 'Calculation of Allowed Pass-Through Items' (CRC2B) would be amended to introduce a new term, which could potentially be specific to 'reasonably incurred' SoLR costs and distributor bad debt or to re-introduce a miscellaneous pass-through term consistent with the GDN approach. It is anticipated that in either case, the Authority would direct the value to be recovered. This approach would benefit from greater simplicity, transparency and predictability, and key to this being the preservation of the 15 months' notice period of a change to UoS charges.

As it currently operates, SLC38 only makes provision for a single correction attempt, therefore consumers, the SoLR or the network company carries the risk relative to the quantum of the differential between total revenue recovered and the claim value, at the end of the year following the Relevant Regulatory Year. The DNO is obliged to pay the SoLR the lesser of the claim value or the consequential increase in revenue recovered, and will therefore never be 'short changed', but in the event the DNO has recovered excess revenue at the end of the year following the Relevant Regulatory Year, there is presently no mechanism to allow it to return any excess.

Indeed, under the approach to recovering CEL's claim, rounding thresholds (fixed charges are rounded to two decimal places) may not facilitate DNOs amending UoS charges in the year following the Relevant Regulatory Year (i.e. 2019/20), and therefore the DNO carries risk of a revenue shortfall or excess determined at the end of the Relevant Regulatory Year, in

[4] https://www.ofgem.gov.uk/system/files/docs/2017/10/enforcement_guidelines_october_2017.pdf

particular as this must be forecast to ensure the minimum of 40 days' notice of changes to UoS charges is provided if a correction is necessary.

We propose that any licence change facilitates retrospective corrections to ensure that any shortfall or excess revenue recovery in relation to CEL's claim (and any subsequent claim recovered in a similar manner) is remedied, with the DNO recovering additional revenue in the event of a shortfall in order to remunerate the SoLR, and the DNO returning excess revenue to customers in the event of it recovering more than the claim value from the SoLR.

In addition to CRC2B, it would also be necessary to change SLC38, primarily (but not exclusively) in relation to the DNO cost recovery, applying a modified version whereby the DNO:

- Would be required to pay the SoLR the claim amount in the Relevant Regulatory Year (as defined in the SLC38 presently) in instalments as specified in the claim, or potentially settled in full within a specified number of days from receipt of a claim;
- Would not seek to recover anything in the Relevant Regulatory Year, and where following this obligation as it stands in SLC38 would require the DNO to pay nothing (where the requirement is to pay the lesser of the claim amount or the revenue derived from increased UoS charges in the Relevant Regulatory Year);
- Would (for any period) set its UoS charges to recover its allowed distribution network revenue as calculated in accordance with CRC2A 'Restriction of Allowed Distribution Network Revenue' (CRC2A); and
- Any shortfall or excess revenue recovery would be corrected by the standard over/under-recovery correction mechanism which operates in perpetuity, subject to any lag which may operate (currently two years).

Who pays?

With regards to the recovery of CEL's claim, Ofgem raised concerns in respect of the difficulties associated with the ability of some independent distribution network operators (IDNOs) to pass through the proposed increase in UoS charges. As a result Ofgem requested IDNOs to be excluded, such that domestic customers connected to an IDNO network will not contribute to the recovery of CEL's claim, unlike domestic customers connected directly to the DNO network.

Under the proposed approach all customers, who arguably benefit from the protection provided by the SoLR process, including those connected to IDNO networks and non-domestic customers, would contribute to cost recovery.

However, based on the current charging methodologies the majority of the costs would be recovered via volatile volumetric charges, which would manifest as a stronger price signal to be avoided by users who are able to via e.g. behind the meter generation.

- This would be at odds with the principles of the Ofgem-led TCR;

- However, subject to potential code modifications, the methodologies could be amended to allow the specific costs to be allocated directly to specific customer groups and/or to a specific charging elements (e.g. the fixed charge); and
- Ofgem's 'safety net' guidelines[5] states that business customer's credit balances are not protected under the safety net, so it may be appropriate that business customers do not contribute to the recovery of any LRSP claim.

Our preference would therefore be to progress a DCUSA code modification in parallel with a licence change which provided (as a minimum) the flexibility to allocate associated costs to specific customer groups and specific charging elements (this should be linked to the outcome of the TCR). This would improve cost-reflectivity, whilst better facilitating cost recovery, and providing costs were not recovered on a volumetric basis would improve simplicity and predictability.

IDNO discounts should not be applied to the resulting increase in charges, thereby ensuring that IDNOs are not able to increase their margin unduly.

Other considerations

Further, and from a regulatory finance perspective, the treatment of the consequential revenue (be it positive or negative) is seemingly not clear under the current regime. SLC38 (paragraph 7) requires that, for the purpose of setting UoS charges to recover allowed distribution network revenue, any SoLR revenue should be disregarded (i.e. regulated distribution network revenue should exclude it) to prevent it flowing into over/under-recovery and consequently the correction mechanism.

In addition to removing inconsistencies between the DCUSA and licence, a minimum licence change should be to amend the definition of regulated distribution network revenue in paragraph 25 of CRC2A to specifically state that revenue derived (be it positive or negative) in accordance with SLC38 should be excluded.

The current SoLR arrangements do not adequately or efficiently facilitate a correctional adjustment in the event that the SoLR recovers some costs from the liquidation of the failed supplier; having included those costs in its LRSP claim.

Presently, a retrospective adjustment to the claim would be required to ensure that the SoLR returned any such revenue to DNOs in order to return this to consumers. In such instances, and primarily due to timing, the DNO would likely be required to request derogations from Ofgem to facilitate this and the probability that the exact benefit would be returned to consumers via UoS charges is slim.

This process increases the likelihood additional changes to UoS charges will be required, and potentially beyond the scope of the two year period covered by SLC38 (i.e. after the year following the Relevant Regulatory Year).

The proposed approach set out in this letter would better facilitate the return of revenue in the eventuality that parties are beneficiaries of the liquidation process, whereby the Authority could direct a negative adjustment to DNO allowed revenue which would be

[5] https://www.ofgem.gov.uk/consumers/household-gas-and-electricity-guide/extra-help-energy-services/ofgem-safety-net-if-your-energy-supplier-goes-out-business

returned to consumers via approved UoS charging methodologies and corrected in perpetuity via the correction mechanism. This approach would also facilitate the return of distributor bad debt.

Distributor bad debt

DNOs currently recover bad debt via a 'logging-up' mechanism throughout a price control period, which subject to credit cover guidelines is recovered via an adjustment to allowed revenue in the subsequent prince control period. This is in line with the 2005 best practice guidelines[6] ('the Guidelines'). At the time of failure, GB Energy Supply Limited owed Northern Powergrid £0.5m.

If Ofgem committed to changing the licence conditions to implement the new arrangements, to provide consumers additional notice period, whilst also removing risk from the SoLR, it is the ideal opportunity to introduce a mechanism to allow DNOs to recover their own costs on an annual (albeit lagged) basis as opposed to the next price control.

The Guidelines were not written specifically with IDNOs in mind, whose presence was not significant at the time, and at present there is no mechanism for IDNOs to recover their bad debt. IDNOs are pursuing changes to the DCUSA to allow them to recover a proportion of bad debt relating to upstream assets (i.e. the host DNO's) via DCUSA change proposal 314 'Appropriate treatment of Bad Debt following appointment of Supplier of Last Resort' ('DCP 314'), which seeks to provide a means by which the IDNO can recover costs from the DNO relating to insolvent suppliers, whereby the IDNO collects revenue relating to the use of the DNO assets as well as its own assets, and therefore the IDNO bears some bad debt in respect of DNO assets having subsequently made a payment to the DNO.

The IDNO's own bad debt cannot presently be recovered, and as part of DCP 314 the working group is considering the need to progress licence changes, which we are encouraging the need to consider alongside the wider SoLR arrangements.

We propose that in addition to recovering the SoLR costs, DNOs recover IDNO bad debt as well, such the DNO would indemnify both the SoLR and IDNO, and then seek to recover all costs via an increase to allowed distribution network revenue. Under this approach, the DNO, IDNO and SoLR would be neutral to their respective reasonably incurred costs.

Consideration should again be given to ensure that IDNO discounts are only applied where appropriate to avoid IDNOs receiving undue benefit from DNOs seeking to recover industry costs.

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